Internal Revenue
cumulative
bulletin
1980-2
july-december

Department of the Treasury
Internal Revenue Service

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Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he is "protecting the revenue." The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

These principles of tax administration were previously published in the Internal Revenue Bulletin as Revenue Procedure 64-22, 1964-1 (Part I) C.B. 689. They are restated here to emphasize their importance to all employees of the Internal Revenue Service.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue Rulings represent the conclusions of the Service on the application of the law to the entire state of facts involved. In those that are based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and confidential information are deleted to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

Cumulative Bulletin 1980-2 is a consolidation of all items of a permanent nature published in the weekly Bulletins 1980-27 through 1980-52 for the period of July 1 through December 31, 1980. It includes a cumulative list of announcements relating to decisions of the Tax Court published in the Internal Revenue Bulletins.

The Internal Revenue Cumulative Bulletin is prepared in three parts as follows:

Part I.—1954 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1954. Arrangement is sequential according to Code and regulations sections. The Code section is shown at the top of each page.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Included in this Part is a list of persons disbarred or suspended from practice before the Internal Revenue Service.

The Bulletin Index-Digest System, a research and reference service supplementing the Bulletin, may be obtained from the Superintendent of Documents on a subscription basis. It consists of four Services: Service No. 1, Income Tax, Service No. 2, Estate and Gift Taxes; Service No. 3, Employment Taxes; Service No. 4, Excise Taxes. Each Service consists of a basic volume and a cumulative supplement that provide (1) finding lists of items published in the Bulletin, (2) digests of revenue rulings, revenue procedures, and other published items, and (3) topical indexes of Public Laws, Treasury Decisions, and Tax Conventions.

The synopses preceding Revenue Rulings, Revenue Procedures, and Court Decisions are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

The contents of this publication are not copyrighted and may be reprinted freely; a citation of the Cumulative Bulletin as the source would be appropriate.

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified,* below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified,* above.)

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1954 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified and superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A, B, C, etc.—Names of individuals.
Acq.—Acquiescence.
A.R.R.—Committee on Appeals and Review recommendation.
A.T.—Alcohol and tobacco tax ruling.
B.T.A.—Board of Tax Appeals.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
C.T.—Carriers Taxing Act of 1937.
Ct.D.—Court Decision.
Del. Order—Delegation Order.
D.C.—Treasury Department circular.
DISC—Domestic International Sales Corporations.
E.O.—Executive Order.
ERISA—Employee Retirement Income Security Act.
E.T.—Estate and gift tax ruling.
Em. T.—Employment tax ruling.
F.A.A.A.—Federal Alcohol Administration Act.
FICA—Federal Insurance Contributions Act.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
G.C.M.—Chief Counsel's memorandum (formerly General Counsel's memorandum).
I.R.B.—Internal Revenue Bulletin.
IR-Mim. — Published IR-Mimeograph.
I.T.—Income tax ruling.
M, N, X, Y, Z, etc.—Names of corporations, places or businesses, according to context.
M.T.—Miscellaneous tax ruling.
Mim.—Published mimeograph.
Nonacq.—Nonacquiescence.
O.D.—Office Decision.
P.T.E.—Prohibited Transactions Exemption.
Pub.L.—Public Law.
PS—Pension, profit-sharing, stock bonus or annuity plan ruling.
R.E.I.T.—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
R.S.—Revised Statute.
S.M.—Solicitor's Memorandum.
Sol. Op.—Solicitor's Opinion.
S.P.R.—Statement of Procedural Rules.
S.R.—Solicitor's Recommendation.
S.S.T.—Social Security Tax.
S.T.—Sales tax ruling
Stat.—Statutes at Large.
T.C.—Tax Court.
T.D.—Treasury Decision.
T.I.R.—Technical Information Release.
U.S.C.—United States Code.
x and *y* represent numbers and sums of money.

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Cumulative List of Announcements Relating to Decisions of the Tax Court Published in the Internal Revenue Bulletin from January 1, 1980 thru December 31, 1980

It is the policy of the Internal Revenue Service to announce in the Internal Revenue Bulletin at the earliest practicable date the determination of the Commissioner to acquiesce or not acquiesce in a decision of the Tax Court which disallows a deficiency in tax determined by the Commissioner to be due.

Notice that the Commissioner has acquiesced or nonacquiesced in a decision of the Tax Court relates only to the issue or issues decided adversely to the Government.

Actions of acquiescences in adverse decisions shall be relied on by Revenue officers and others concerned as conclusions of the Service only to the application of the law to the facts in the particular case. Caution should be exercised in extending the application of the decision to a similar case unless the facts and circumstances are substantially the same, and consideration should be given to the effect of new legislation, regulations, and rulings as well as subsequent court decisions and actions thereon.

Acquiescence in a decision means acceptance by the Service of the conclusion reached, and does not necessarily mean acceptance and approval of any or all of the reasons assigned by the court for its conclusions.

No announcements are made in the Bulletin with respect to memorandum opinions of the Tax Court.

The announcements published in the weekly Internal Revenue Bulletins are consolidated semiannually and annually. The semiannual consolidation appears in the first Bulletin for July and in the Cumulative Bulletin for the first half of the year and the annual consolidation appears in the first Bulletin for the following January and in the Cumulative Bulletin for the last half of the year.

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Bolnick, Ted, et ux [15]	3503-62	44	245
Buse, Delmer H., et ux [16]	5619-76	71	1129
Buse, Norman M., et ux [16]	5618-76		
Craig, Raymond A., et ux [26]	11403-78	73	1034
Danenberg, Julian S., et ux [27]	2103-76	73	370
Dobin, Darryl R., et ux [37]	12701-78	73	1121
Dumaine Farms [28]	13428-78X	73	650
Edmonds, Dean S., Est. of, Bank of New York, executor [38]	10164-75	72	970
Focht, Donald D.[22]	7807-73	68	223
Gentile, Alfred A., et ux [39]	509-74	65	1
Globe Products Corp.[2]	9070-75	72	609
Goodwin, David C.[3]	2087-77	73	215
Green, Gene P., et ux [23]	1785-73	66	538
Hensler, Inc., R. R.[29]	6677-75	73	168
Horne, J. E., Est. of, Andrew Berry, executor, & Amelia S. Horne [4]	3904-74	64	1020
Hyde, Gordon I.[5]	9044-72	64	300
Hyde, Janet C.[5]	9045-72		
Industrial Aid for the Blind [30]	11387-77X	73	96
Johnson, Frankie Lee (formerly Frankie Lee Yancey) [6]	3047-77	72	37
Johnson, Mary Helen [24]	10423-76	72	340
Koch, Carl E., et ux [17]	8953-74	67	71
Larry Lange Ford, Inc. [40]	4830-77	73	676

Taxpayer	Docket No.	Report Volume	Report Page
Middle Atlantic Distributors, Inc.[7]	1982-78	72	1136
Moseley, Ned W., et ux [8]	925-76	72	183
Professional Standards Review Organization of Queens County, Inc.[41]	9952-77X	74	240
Red Carpet Car Wash, Inc. [40]	4829-77	73	676
Sawyer, Jr., Charles, Est. of, John Sawyer, executor [31]	1004-72	73	1
Seaboard Coast Line Railroad Co.[9]	3771-71	72	855
United Telecommunications, Inc.[19]	7866-72	65 67	278 760
University of Massachusetts Medical School Group Practice [42]	2710-79X	74	—
Wendle Ford Sales, Inc.[20]	7614-76	72	447
Westbrook, Yvonne (now Yvonne Westbrook Maciel) [43]	618-79	74	—
Whiteco Industries, Inc.[21]	3918-73	65	664
Whiteco Industries, Inc., & Subs.[21]	3919-73 7188-74		
Yancey, Richard R.[6]	2453-77	72	37

The Commissioner does NOT ACQUIESCE in the following decisions:

Taxpayer	Docket No.	Report Volume	Report Page
Arrigoni, James M., et ux [32]	693-78	73	792
B.H.W. Anesthesia Foundation, Inc.[33]	1316-78X	72	681
Bankers Union Life Insurance Co.[10]	5807-71 442-73	62	661
Callahan Scholarship Fund, Nellies, Trust u/w/o Nellie Callahan, Deceased, Trustees Larry Jackson, Kenneth Bassett, Clifford Scholter, Shirley A. Webster & Iowa-Des Moines National Bank [34]	9512-77X	73	626
Chronicle Publishing Co.[11]	8550-74	67	964
Dumaine Farms [35]	13428-78X	73	650
Hills, Liston F., et ux [44]	4723-77	72	958
Hoover Co.[12]	2697-77 9646-77	72	206
Hutchinson Baseball Enterprises, Inc.[36]	13326-78X	73	144
Hyde, Gordon I.[13]	9044-72	64	300
Hyde, Janet C.[13]	9045-72		
Lee, Elizabeth M., Est. of, Rhoady R. Lee, Sr., executor & Rhoady R. Lee, Sr., individually [14]	8782-75	69	860
Marsh, Charles E., II, et ux [45]	6126-77	73	317
Voss, Edward G., et ux [44]	4724-77	72	958
Warren Jones Co.[18]	424-71	60	663

[1] Acquiescence in the issues relating to (1) whether payments made pursuant to a lease agreement in connection with a sale-leaseback with option to repurchase are deductible as rental expenses, and (2) whether a part of the understatement of tax is due to negligence or intentional disregard of rules and regulations.

[2] Acquiescence relating to whether an accrual basis taxpayer was entitled to a deduction for deficiency interest when it contested its liability for the underlying deficiency and interest in the following year.

[3] Acquiescence relating to whether petitioner received kickbacks which represented unreported income to him or whether he was merely acting as a conduit for the monies.

[4] Acquiescence in result relating to whether life insurance proceeds paid to a shareholder are taxable as a dividend where the corporation is the owner of the policy and pays all premiums. Acquiescence "in result" means acceptance of the decision of the decision of the Court but disagreement with some or all the reasons assigned for the decision.

[5] Acquiescence in the issues relating to (1) whether the acquisition of property on December 1, 1967 through a quitclaim deed resulted in the realization of income, and (2) whether petitioner must recognize gain on the sale of certain stock in 1968.

[6] Acquiescence in the issues relating to (1) which of the petitioners, who are divorced, is entitled to a dependency exemption for their minor child, and (2) whether petitioner is entitled to a child care expense deduction.

[7] Acquiescence in result relating to whether payments made by the petitioner pursuant to the settlement of a suit are nondeductible "fines or similar penalties" within the meaning of section 162(f) of the Code. Acquiescence "in result" means acceptance of the decision of the Court but disagreement with some or all the reasons assigned for the decision.

[8] Acquiescence relating to whether the premiums applicable to a "special reserve" provision of a twenty payment life insurance policy or all premiums paid under the policy as a whole should be an offset against the "special reserve" distribution in computing taxable income.

[9] Acquiescence relates to the fair market value approach in valuing reusable or relay rail and is limited to the deduction claimed for retirements and replacements for years ended prior to May 8, 1967, pursuant to Rev. Rul. 67-145, 1967-1 C.B. 54, and Rev. Proc. 68-46, 1968-2 C.B. 961.

[10] Nonacquiescence in the issues relating to (1) whether policy loan interest, not prepaid in cash, is includable in gross investment income under section 804(b)(1) of the Code, and (2) whether mortgage escrow funds, given to petitioner a mortgagee to pay taxes and insurance on realty, is incudable in "assets" under section 805(b)(4) of the Code.

[11] Nonacquiescence relating to whether certain cable television franchises have determinable useful lives for the purpose of depreciating their costs of acquisition under section 167(a) of the Code.

[12] Nonacquiescence relating to whether petitioner's purported sale of a "future sell contract" for foreign currency shortly before the time set for performance but subsequent to the devaluation of the currency resulted in short-term or long-term capital gain.

[13] Nonacquiescence in the issue relating to whether a statutory redemption fee is deductible as interest.

[14] Nonacquiescence in the issues relating to (1) whether decedent's community property interest in a block of stock amounting to 80% of a corporation's common and 100% of its preferred stock should be included in the gross estate at one-half of the value of the entire block or whether it should be valued a as minority interest comprised of 40% of the common and 50% of the preferred stock, and (2) whether the court properly determined the fair market value of 50% of the preferred stock to be $1,973,494.80.

[15] Nonacquiescence published in 1967-1 C.B. 3 is withdrawn and acquiescence is substituted therefor in the issue relating to the taxation of gain upon the redemption, at full face value but prior to maturity, of debentures which had been issued to petitioners in 1953 at an original issue discount. Acquiescence also in the issue relating to the offset of a tax deficiency for the year 1954 to the extent of an alleged overpayment of taxpayer's 1954 income tax for which a refund was claimed in the tax return filed for the year. See Rev. Rul. 80-143, 1980-1 C.B. 19.

[16] Acquiescence in the issues relating to (1) whether the taxpayers held a contract to cut for the required holding period thereby entitling them to elect section 631(a) treatment, and (2) what was the fair market value of the timber for section 631(a) purposes.

[17] Acquiescence in the issues relating to (1) whether payments made pursuant to "option agreements" were in substance interests payments, and (2) whether the option agreements provided for a series of options, each expiring at the end of a three-month period.

[18] Nonacquiescence in the issue relating to whether a real estate contract received by petitioner upon a sale of property not in the ordinary course of business, which contract provides for deferred payments to be made by the purchaser in an amount that is certain, constitutes "property (other than money)" under section 1001, so that, to the extent of its fair market value, it represents an amount realized by petitioners in the year of the sale.

[19] Acquiescence in result relating to whether construction-related depreciation of assets that are not "section 38 property" should be included in the basis of self-constructed "section 38 property" for purposes of determining the qualified investment in that property under section 46 of the Code. Acquiescence "in result" means acceptance of the decision of the Court but disagreement with some or all the reasons assigned for the decision.

[20] Acquiescence relating to whether petitioner, an automobile dealer who has properly elected the LIFO method of inventory valuation, must add to its cost of "base-year" units an additional charge for catalytic converters and electronic (solid state) ignition systems which were not present on base-year models.

[21] Acquiescence relating to whether petitioner's highway advertising signs are "inherently permanent" property which does not qualify for the investment credit under section 48 of the Code. See Rev. Rul. 80-151, 1980-1 C.B. 7.

[22] Acquiescence in the issues relating to (1) whether taxpayer recognized gain when he transferred liabilities, consisting primarily of trade accounts payable, to a corporation in a section 351 transaction which exceeded the adjusted basis of the assets transferred, and (2) whether petitioner failed to include receipts as rental income. See Rev. Rul. 80-199, page 122, this Bulletin.

[23] Acquiescence in the issues relating to (1) whether records of a partnership were adequate to reflect partnership income, (2) whether alleged gambling losses claimed by a partnership were deductible under section 165(d), and (3) whether the petitioners are liable for additions to the tax under section 6653(b).

[24] Acquiescence in the issues relating to (1) whether illegal income obtained by petitioner's husband in a false Federal income tax refund scheme constitutes community property, and (2) whether petitioner is entitled to deduct under section 212 a portion of the legal fees paid to defend her husband as a result of his participation in a false refund scheme.

[25] Acquiescence in the issue relating to whether petitioners were entitled to an interest expense deduction for the interest portion of the payments made by petitioners for their section 6672 and Minnesota sales tax liabilities.

[26] Acquiescence in result relating to when petitioner abandoned his residence in Switzerland. Acquiescence "in result" means acceptance of the decision of the Court but disagreement with some or all the reasons assigned for the decision.

[27] Acquiescence in the issues relating to (1) whether the court properly determined the amount realized from the transfer of petitioner's stock, (2) whether petitioner was insolvent both before and after the discharge of the indebtedness, and (3) whether any part of the underpayment of petitioner's taxes was due to fraud.

[28] Acquiescence in the issues relating to (1) whether petitioner was operated exclusively in furtherance of exempt purposes, and (2) whether petitioner served private rather than public interests.

[29] Acquiescence in result relating to whether certain expenditures made by petitioner in recovering, repairing and replacing flood damage equipment used in excavating business are deductible under section 162 in the year paid or incurred. Acquiescence "in result" means acceptance of the decision of the Court but disagreement with some or all the reasons assigned for the decision.

[30] Acquiescence relating to whether petitioner is entitled to continued tax-exempt status when it sells products made by the blind individuals at a profit and remits a portion of its profit to their tax-exempt organizations and to blind individuals.

[31] Acquiescence in the issue relating to whether under Ohio law the surviving spouse's share of the residuary estate should be reduced by a proportionate amount of the estate tax in computing the marital deduction.

[32] Nonacquiescence in the issue relating to whether petitioners were entitled to a sales tax deduction for payments they made for one of their corporations' unpaid Minnesota sales taxes.

[33] Nonacquiescence relating to whether petitioner, a non-profit incorporation of the Department of Anesthesiology of a section 501(c)(3) teaching hospital, which collects sums for the services of its members and disburses them to its members and the hospital, is an organization described under section 501(c)(3).

[34] Nonacquiescence relating to whether petitioner met the requirements of section 509(a)(3)(B) thereby qualifying for non-private foundation status as a supporting organization.

[35] Nonacquiescence in the issue relating to whether petitioner was organized exclusively for exempt purposes.

[36] Nonacquiescence relating to whether petitioner, whose purpose is the promotion of amateur athletics and whose principal activity is the owning and operation of an amateur baseball team that competes in a semi-professional league, is organized exclusively for charitable purposes.

[37] Acquiescence relating to whether the petitioners' occupancy of a new principal residence before the March 12, 1975 cut-off date disqualifies the purchase from the section 44 credit.

[38] Acquiescence relating to whether decedent retained at his death the power to alter or amend an intervivos trust so that the value of the trust would be includible in his estate under section 2036(a)(2) or 2038(a)(1).

[39] Acquiescence relating to whether petitioner's gambling activity constituted the carrying on of a trade or business.

[40] Acquiescence in the issue relating to whether taxpayer was the owner of a partnership interest for the purpose of deducting a share of the loss incurred by the partnership. Acquiescence in result in the issue relating to whether a controlled group of corporations are bound to equally allocate the $25,000 surtax exception as a result of the failure of the group to file an election provided under 1.1561-3A(2) of the regulations. Acquiescence "in result" means acceptance of the decision of the Court but disagreement with some or all the reasons assigned for the decision.

[41] Acquiescence relating to whether an organization that reviews the appropriateness and quality of service provided under Medicare and Medicaid is operated exclusively for charitable purposes.

[42] Acquiescence relating to whether an organization created by a state statute to serve as a component of the University of Massachusetts Medical School and its teaching hospital is organized and operated exclusively for charitable, educational, and scientific purposes.

[43] Acquiescence relating to whether installment payments made to petitioner by her former husband are taxable to her as alimony.

[44] Nonacquiescence relating to whether petitioners may exclude from gross income reimbursements paid to them for moving expenses pursuant to section 911.

[45] Nonacquiescence relating to whether petitioners recognized income from the interest-free use of money advanced to them.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1954

Subpart A.—Income Taxes
Chapter 1.—Normal Taxes and Surtaxes
Subchapter A.—Determination of Tax Liability
Part IV.—Credits Against Tax
Subpart A.—Credits Allowable

Section 37.—Credit for the Elderly

Credit for the elderly; community property laws. Rev. Ruls. 63-167, 63-138, and 63-169, relating to the effect of community property laws on the computation of retirement income credit for a social security beneficiary, a civil service retiree, and an Armed Forces retiree, are obsoleted with respect to the tax credit for the elderly in the case of a joint return filed for a taxable year beginning after December 31, 1977.

Rev. Rul. 80-325

The Tax Reform Act of 1976, section 503, 1976-3 C.B. (Vol. 1) 1, 35, amended section 37 of the Internal Revenue Code by replacing the retirement income credit with the credit for the elderly, effective for taxable years beginning after December 31, 1975.

Under section 37 of the Code, as amended, special rules for determining the tax credit for the elderly are available to certain individuals who retire under a federal, state, or local government retirement system.

The Revenue Act of 1978, section 701(a), 1978-3 C.B. (Vol. 1) 1, 131, added a new provision to the Code, section 37(e)(8), effective for taxable years beginning after December 31, 1977. Section 37(e)(8) provides that in the case of a joint return, section 37(e) will be applied without regard to community property laws.

Rev. Rul. 63-167, 1963-2 C.B. 17, Rev. Rul. 63-168, 1963-2 C.B. 9, and Rev. Rul. 63-169, 1963-2 C.B. 14, deal with the application of section 37 of the Code in certain situations.

Rev. Rul. 63-167 holds, in part, that for purposes of section 37 of the Code, the community or separate character of social security benefits is determined by the marital status and domicile of the primary beneficiary at the time the primary beneficiary becomes entitled to receive the payments.

Rev. Ruls. 63-168 and 63-169 concern civil service annuitants and retired military personnel living in certain community property states. These revenue rulings hold, in part, that for purposes of section 37 of the Code the community or separate character of the annuity or military retirement pay is determined by the marital status and domicile of the retired individual when the services to which the annuity or military retirement pay is attributable were performed.

In view of the amendment to section 37(e) of the Code for taxable years beginning after December 31, 1977, Rev. Ruls. 63-167, 63-168, and 63-169 are obsoleted with respect to the holdings under section 37 in the case of a joint return filed for a taxable year beginning after December 31, 1977.

Section 38.—Investment in Certain Depreciable Property

26 CFR 1.38-1: Investment in certain depreciable property.
(Also Sections 46, 48, 446; 1.46-3, 1.48-2, 1.446-1.)

Investment credit; public utilities; retired items reused. An electric utility's qualified investment in new section 38 property that is public utility property includes minor items that are treated as mass assets recovered for retired electric public utility property and are reused in the construction or reconstruction of electric utility property. A method for valuing the mass assets for detemining basis is explained. A change to the method of valuing such items is a change in accounting method. Rev. Rul. 70-114 modified and superseded.

Rev. Rul. 80-311

ISSUE

Under the facts described below, do certain minor items recovered from retired electric public utility property qualify as "new section 38 property" for investment credit purposes when again used in construction, reconstruction, or erection of electric utility property? Further, what are the proper tax bases for such mass asset type materials?

FACTS

The taxpayer, an electric utility, is engaged in the generation, transmission, distribution, and sale of electric energy. In the course of its operations, the taxpayer recovered reusable items from retirements of its electric utility property, generally from distribution and transmission lines. The reusable items recovered were stored at supply depots maintained by the taxpayer until again placed in service. Largely easily identifiable individual items such as transformers and meters were included in the materials and supplies account at original cost. The small items, numerous in quantity, including insulators, cross arms, brackets, etc., the identity of which could not be ascertained without undue refinement in accounting were included in the materials and supplies account at the average cost of similar items (new and used) already in the account. These items on retirement had been credited to the appropriate depreciation reserve account at the same average cost. This practice had been consistently followed for both regulatory and tax accounting.

In Rev. Rul. 70-114, 1970-1 C.B. 2, the same items of electric public utility property were involved. The taxpayer in that revenue ruling, however, could not determine either the original date of installation or the original cost for such mass assets. In the present case, the taxpayer's property records enable it to determine the original cost and installation date at the time these items are retired. However, the reusable small items are then transferred to a storage yard and are physically inter-

mixed with similar items already on hand. At this point, the taxpayer in this case is in the same position as the taxpayer in Rev. Rul. 70-114 in that it no longer knows the original cost of the reusable small items.

LAW AND ANALYSIS

Section 38 of the Internal Revenue Code allows a credit against federal income tax for qualified investment in section 38 property, and the determination of what property is qualified is made in accordance with rules provided in section 48.

Section 46(a)(2)(B) of the Code provides for a 10 percent investment credit for all taxpayers (including public utilities) for otherwise qualifying property.

Section 48(a)(1) of the Code provides that the term "section 38 property" means, among other things, tangible property subject to depreciation and having a useful life of 3 years or more.

Section 48(b) of the Code defines new section 38 property as section 38 property the construction, reconstruction, or erection of which is completed by the taxpayer, or acquired by the taxpayer, after December 31, 1961, provided the original use of such property commences with the taxpayer after such date (except as provided with respect to "suspension period property" defined in section 48(h) of the Code).

Section 1.46-3(c)(1) of the Income Tax Regulations provides that the basis of any new section 38 property shall be detemined in accordance with the general rules for determining the basis of property. The basis of such property would generally be its cost unreduced by any adjustment to basis, such as for depreciation, and also would include all items properly in the depreciable basis. Therefore, the basis for investment credit purposes is generally the same as the basis for depreciation.

Section 1.48-2(b)(3) of the regulations provides that the materials entering into construction of new property need not be new in use, nor that the materials be acquired after December 31, 1961. Therefore, it is of no consequence that the materials are recovered from the retired plant facilities.

Rev. Rul. 70-114 holds that such items of property are materials entering into construction of new property and need not be new in use nor be acquired after December 31, 1961, in order to qualify for the investment credit. This holding is followed in this revenue ruling. However, incidental replacements of a single pole, cross arm insulator, etc., do not constitute construction, reconstruction, or erection of public utility property and such replacements are not "section 38 property."

Section 1.446-1(a)(2) of the regulations provides that a method of accounting that reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with the accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income. For both regulatory and tax purposes, the taxpayer has consistently valued these reusable small items recovered from retirements of property at the average cost of similar items already in the materials and supplies account, and has used such cost as basis in computing depreciation.

HOLDING

The taxpayer's qualified investment in new section 38 property that is public utility property, with respect to its newly constructed or reconstructed electric utility property, includes the values determined to be the basis of the minor items that were reused in the construction or reconstruction of electric utility property. However, since these items in the present case are accounted for as mass assets, if the requirements of section 1.47-1(e)(2) of the regulations for the treatment of mass assets are met, the taxpayer may substitute data from an appropriate mortality dispersion table to compute or recompute the qualified investment with respect to its reused (and purchased) parts and components used in the construction or reconstruction of electric utility property.

Further, since the basis of property for investment credit purposes follows the general rules regarding basis, the taxpayer's bases for the minor items described above are also deemed to be "cost" for investment credit purposes unless it can be shown that the use of such bases in computing depreciation results in a distortion of income. A change to this method is a change in method of accounting within the meaning of section 446 of the Code.

Rev. Rul. 70-114, providing other rules to be followed in valuing reusable materials recovered from retirements, is modified and superseded since its provisions, as modified, are reflected herein.

This revenue ruling does not apply to taxpayers electing section 1.167(a)-11 of the regulations because that section requires that an asset transferred to a supplies account may not have a basis higher than its unadjusted basis.

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26 CFR 1.38-1: Investment in certain depreciable property.

Whether the sale of an undivided interest in its "section 38 property" by a utility company to a tax exempt cooperative disqualifies the utility company's retained interest as section 38 property. See Rev. Rul. 80-219, page 18.

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26 CFR 1.38-1: Investment in certain depreciable property.

Whether the liability created by a note given as the purchase price for a synthetic oil converter is included in the partnership's basis in the converter for purposes of the investment tax credits. See Rev. Rul. 80-235, page 229.

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26 CFR 1.38-1: Investment in certain depreciable property.

Whether a partnership is entitled to use as its basis for the investment tax credit

the amount paid to acquire engraved plates and the right to reproduce and distribute books made from the plates. See Rev. Rul. 80-327, page 23.

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26 CFR 1.38-1: Investment in certain depreciable property.

Whether concrete raceways and water diversion canals used in the raising of fish are property qualifying as "section 38 property" for purposes of the investment tax credit. See Rev. Rul. 80-341, page 24.

Section 43.—Earned Income

26 CFR 1.43-1: Earned income credit for taxable years beginning in 1975.

Earned income credit; life insurance salesperson. A self-employed full-time life insurance salesperson, within the meaning of section 3121(d)(3) of the Code, should report the gross commissions received as earned income under section 43(c)(2)(A)(i).

Rev. Rul. 80-194

ISSUE

How should the remuneration received by the life insurance salesperson described below be reported for purposes of the earned income credit provided by section 43 of the Internal Revenue Code?

FACTS•

A self-employed salesperson, who is a full-time life insurance salesperson, within the meaning of section 3121(d)(3) of the Federal Insurance Contributions Act (FICA), received remuneration of $6,500 in the form of commissions for the taxable year 1978 and incurred expenses of $3,000 in connection therewith. The salesperson qualifies for the earned income credit as an eligible individual.

LAW AND ANALYSIS

Section 43(a) of the Code allows an eligible individual a credit against the federal income tax for the taxable year equal to ten percent of the individual's earned income for the year as does not exceed $4,000, for taxable years beginning before January 1, 1979 ($5,000 for taxable years beginning after December 31, 1978), subject to the limitation provided by section 43(b). Under section 43(b) the amount of the credit allowable to an eligible individual is reduced (but not below zero) by an amount equal to ten percent of the individual's adjusted gross income (or, if greater, the earned income) as exceeds $4,000 for taxable years beginning before January 1, 1979. For taxable years beginning after December 31, 1978, the amount of the credit allowable is not to exceed the excess, if any, of (1) $500, over (2) 12.5 percent of so much of the adjusted gross income (or, if greater, the earned income) of the taxpayer for the taxable year as exceeds $6,000.

Under section 43(c)(2)(A) of the Code, the term "earned income" means (i) wages, salaries, tips, and other employee compensation, plus (ii) the amount of the taxpayer's net earnings from self-employment for the taxable year (within the meaning of section 1402(a)). Under section 1402(a), the term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual less the deductions allowed that are attributable to such trade or business. Section 1402(c) provides that the term "trade or business" when used with reference to self-employment income or net earnings from self-employment has the same meaning as when used in section 162 (relating to trade or business expenses) except that such term does not include the performance of service by an individual as an employee. Under section 1402(d), the term "employee" has the same meaning as when used in section 3121(d)(3) of the FICA which provides that the term "employee" includes an individual who performs services for remuneration for any person as a full-time life insurance salesperson.

The salesperson in this case had earned income for the year 1978, inasmuch as the salesperson performed services for, or on behalf of, other persons and received remuneration for such services. Thus, the salesperson is entitled to an earned income credit under section 43 of the Code. Since the salesperson is a full-time life insurance salesperson, the salesperson is a statutory employee under section 3121(d)(3) of the FICA. Therefore, under section 1402(c) of the Code, the salesperson is not carrying on a trade or business.

Accordingly, the commissions received by the salesperson are not earnings from self-employment under section 1402(a) of the Code but are commissions received as a statutory employee and includable in the wages category for purposes of the earned income credit.

HOLDING

The salesperson should report the gross commissions ($6,500) as earned income under section 43(c)(2)(A)(i) of the Code. The salesperson's earned income credit, as computed under section 43, is $150.

Section 44C.—Residential Energy Credit

26 CFR 1.44C-1: Residential energy credit.

T.D. 7717 [1]

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Residential energy credit

AGENCY: Internal Revenue Service, Treasury.

[1] This publication of the Treasury Decision contains the complete text of the amendments to the regulations. The instructions for modifying the notice of proposed rulemaking have been omitted.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to the residential energy credit. Changes to the applicable tax laws were made by the Energy Tax Act of 1978 [Pub. L. 95-618, 1978-3 C.B. (Vol. 2), 1]. These regulations provide the public with guidance needed for determining whether a residential energy credit is available with respect to certain expenditures.

DATE: The amendments are effective with respect to expenditures made after April 19, 1977, and before January 1, 1986.

FOR FURTHER INFORMATION CONTACT: Walter H. Woo of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:LR:T) (202-566-3297).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On May 23, 1979, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 44C and 1016 of the Internal Revenue Code of 1954 and to the Statement of Procedural Rules (26 CFR Part 601). The amendments were proposed to conform the regulations to section 101 of the Energy Tax Act of 1978 (92 Stat. 3175). A public hearing was held on September 12, 1979. After consideration of all comments regarding the proposed amendments, those amendments are adopted as revised by this Treasury decision. A new § 1.44C-6 is added to deal with the procedure and criteria for additions to the list of energy-conserving components or renewable energy sources which was previously the subject of § 1.44C-5. Section 1.44C-6 is reserved in this Treasury decision and will be dealt with in another regulation project. It should be noted that this Treasury decision does not reflect any of the amendments to section 44C made by the Crude Oil Windfall Profit Tax Act of 1980 [Pub. L. 96-223, 1980-3 C.B. 2].

The effectiveness of these regulations will be evaluated on the basis of comments and information received from the public, other Government agencies, and offices within the Treasury Department and Internal Revenue Service. Under the regulations, no additional reporting or filing requirements have been imposed on taxpayers.

IN GENERAL

The Energy Tax Act of 1978 provides a residential energy credit for insulation, certain other energy-conserving components, and certain renewable energy source property expenditures made in connection with the taxpayer's principal residence. In the case of insulation and other energy-conserving components, the credit is 15 percent of the first $2,000 of expenditures, for a maximum credit of $300. In the case of solar, wind, and geothermal energy property, the credit provided by the 1978 Act is 30 percent of the first $2,000 of expenditures and 20 percent of the next $8,000 of expenditures, for a maximum credit of $2,200 for expenditures made after April 19, 1977 and before January 1, 1980. It should be noted that the Crude Oil Windfall Profit Tax Act of 1980 has increased the credit for solar, wind, and geothermal property to 40 percent of $10,000 for a maximum of $4,000 for expenditures made after December 31, 1979 and before January 1, 1986. The taxpayer must reduce the maximum amount of allowable expenditures with respect to the dwelling unit to be used in computing the credit by the prior expenditures which were made by the taxpayer, and which were taken into account in computing the credit for prior taxable years.

The credit applies only to expenditures made on or after April 20, 1977, and before January 1, 1986. A credit with respect to expenditures made during 1977 (*i.e.*, on or after April 20) is to be claimed on the taxpayer's 1978 tax return. In the case of insulation and other energy-conserving component expenditures, the credit is available only with respect to a taxpayer's principal residence the construction (including reconstruction) of which was substantially completed before April 20, 1977. To the extent that the credit exceeds the taxpayer's tax liability, the taxpayer is allowed to carry over the unused credit to subsequent taxable years beginning before January 1, 1988.

DEFINITIONS OF QUALIFIED ITEMS

A number of comments requested that the definitions of various items qualifying for the credit be expanded, *e.g.*, that the definition of insulation be expanded to include awnings and shades; that the definition of a storm or thermal window be revised to include window films; and that the definition of solar energy property be made to include woodburning stoves or heat pumps. The regulations have not been expanded to include these items because we believe that Congress did not intend their inclusion. In the case of insulation, the regulations have been clarified to provide that an item must be installed between a conditioned area (*i.e.*, heated or cooled by conventional or renewable energy source means) and a nonconditioned area to qualify as insulation (except when installed on a water heater, water pipe, or heating/cooling duct).

It was suggested that the definition of a storm or thermal window should be in terms of R-values, rather than inches of insulating material. The

regulations have been amended to reflect this suggestion.

Several comments suggested that the rule excluding materials and components having a dual purpose from the definition of solar energy property be deleted. It was argued that this rule would disqualify most expenditures for passive solar construction or for modifications to an existing structure. Additional comments requested that the regulations be revised to allow a partial credit for materials and components that serve a dual purpose. The dual purpose rule was not deleted or modified to allow a partial credit in view of the support for the exclusion found in the House and Senate reports to the Act which clearly require the exclusion of property with a significant structural function.

However, the regulations have been revised to include a more comprehensive definition of a passive solar system. The final regulations provide that a qualifying passive solar system used for heating purposes must be composed of the following components: a solar collection area, an absorber, a storage mass, a heat distribution method, and heat regulation devices.

In response to inquiries, the definition of wind energy property has been revised to make it clear that devices that use wind merely to ventilate do not qualify as wind energy property.

The residential energy credit applies to property which transmits or uses energy derived from a geothermal deposit to heat or cool a dwelling or provide hot water for use within the dwelling. Several comments suggested that the definition of geothermal deposit be revised either by deleting the 60° Celsius temperature limitation or by lowering the temperature limitation. The temperature limitation has been lowered to 50° Celsius. It has been concluded that 50° Celsius is an appropriate measure for determining whether heat is derived from geothermal reservoirs (heated by the earth's magma) or is derived from heat associated with ground water that is affected by atmospheric temperatures.

DEFINITION OF CONSTRUCTION

One comment objected to defining reconstruction as construction for purposes of the April 20, 1977, cut-off date for new construction. This objection was rejected on the ground that a house that is reconstructed is basically a new house. Therefore, the cut-off date pertaining to new construction should also be applicable to reconstruction.

CERTIFICATION PROCEDURE

One comment suggested that the regulations be revised to allow request from any source for certification of items as qualifying for the credit. This suggestion was not adopted because the statute only authorizes the manufacturer to seek certification of an item.

It should be noted that the certification procedure is the subject of Rev. Proc. 80-36 [page , this Bulletin].

DRAFTING INFORMATION

The principal author of this regulation is Walter H. Woo of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, the following amendments to 26 CFR Part 1 are hereby adopted:

Paragraph 1. There are inserted immediately after § 1.44-5 the following new sections:

§ 1.44C-1 Residential energy credit.

(a) *General rule.* Section 44C provides a residential energy credit against the tax imposed by chapter 1 of the Internal Revenue Code. The credit is an amount equal to the individual's qualified energy conservation expenditures (set out in paragraph (b)) plus the individual's qualified renewable energy source expenditures (set out in paragraph (c)) for the taxable year. However, the credit is subject to the limitations described in paragraph (d) and the special rules contained in § 1.44C-3. The credit is nonrefundable (that is, the credit may not exceed an individual's tax liability for the taxable year). However, any unused credit may be carried over to succeeding years to the extent permitted under paragraph (e). Renters as well as owners of a dwelling unit may qualify for the credit. See § 1.44C-3(h) for the rules relating to the allocation of the credit in the case of joint occupants of a dwelling unit.

(b) *Qualified energy conservation expenditures.* In the case of any dwelling unit, the qualified energy conservation expenditures are 15 percent of the energy conservation expenditures made by the taxpayer with respect to the dwelling unit during the taxable year, but not in excess of $2,000 of such expenditures. See § 1.44C-2(a) for the definition of energy conservation expenditures.

(c) *Qualified renewable energy source expenditures.* In the case of any dwelling unit, the qualified renewable energy source expenditures are the renewable energy source expenditures made by the taxpayer with respect to the dwelling unit during the taxable year, but not in excess of—

(1) 30 percent of the expenditures up to $2,000, plus

(2) 20 percent of the expenditures over $2,000, but not more than $10,000.

See § 1.44C-2(b) for the definition of renewable energy source expenditures.

(d) *Limitations*—(1) *Minimum dollar amount.* No residential energy

credit shall be allowed with respect to any return (whether joint or separate) for any taxable year if the amount of the credit otherwise allowable (determined without regard to the tax liability limitation imposed by paragraph (d)(3) of this section) is less than $10.

(2) *Prior expenditures taken into account*—(i) *In general.* For purposes of determining the credit for expenditures made during a taxable year, the taxpayer must reduce the maximum amount of allowable expenditures with respect to the dwelling unit in computing qualified energy conservation expenditures (under paragraph (b)) or qualified renewable energy conservation expenditures (under paragraph (c)) by prior expenditures which were made by the taxpayer or by joint occupants (see § 1.44C-3(h)) with respect to the same dwelling unit, and which were taken into account in computing the credit for prior taxable years. The reduction of the maximum amount under paragraph (c) must first be made with respect to the first $2,000 of expenditures (to which a 30 percent rate applies) and then with respect to the next $8,000 of expenditures (to which a 20 percent rate applies). This reduction must be made if all or any part of the credit was allowed in or was carried over from a prior taxable year.

(ii) *Change of principal residence.* A taxpayer is eligible for the maximum credit for qualifying expenditures made with respect to a new principal residence notwithstanding the allowance of a credit for qualifying expenditures made with respect to the taxpayer's previous principal residence. Furthermore, except in certain cases involving joint occupancy (see §1.44C-3(h)), a taxpayer is eligible for the maximum credit notwithstanding the allowance of a credit to a prior owner of the taxpayer's new principal residence.

(iii) *Example.* The rules with respect to the reduction for prior expenditures are illustrated by the following example:

Example. In 1978, A has $1,000 of energy conservation expenditures and $5,000 of renewable energy source expenditures in connection with A's principal residence. A's residential energy credit for 1978 is $1,350, made up of $150 of qualified energy conservation expenditures (15 percent of $1,000) plus $1,200 of qualified renewable energy source expenditures (30 percent of the first $2,000 plus 20 percent of the next $3,000). In 1979 A has an additional $2,000 of energy conservation expenditures and $3,000 of renewable energy source expenditures in connection with the same principal residence. A's residential energy credit for 1979 is $750, made up of $150 of qualified energy conservation expenditures (15 percent of the new maximum $1,000, which was reduced from $2,000 by $1,000 of energy conservation expenditures taken into account in 1978) plus $600 of qualified renewable energy source expenditures (20 percent of $3,000, which reflects the reduction of the maximum allowable expenditures by the $5,000 of renewable energy source expenditures taken into account in 1978). The maximum residential energy credit allowable to A with respect to the same principal residence in subsequent years in which the credit is allowable is $400 (20 percent of the new maximum of $2,000 for renewable energy source expenditures and none for energy conservation expenditures).

(3) *Tax liability limitation.* The credit allowed by this section shall not exceed the amount of the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year, reduced by the sum of the credits allowable under—

(i) Section 32 (relating to tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds),

(ii) Section 33 (relating to the taxes of foreign countries and possessions of the United States),

(iii) Section 37 (relating to retirement income),

(iv) Section 38 (relating to investment in certain depreciable property),

(v) Section 40 (relating to expenses of work incentive programs),

(vi) Section 41 (relating to contributions to candidates for public office),

(vii) Section 42 (relating to the general tax credit),

(viii) Section 44 (relating to purchase of new personal residence),

(ix) Section 44A (relating to expenses for household and dependent care services), and

(x) Section 44B (relating to employment of certain new employees).

(e) *Carryover of unused credit.* If the credit allowable by this section exceeds the tax liability limitation imposed by section 44C(b)(5) and paragraph (d)(3) of this section, the excess credit shall be carried over to the succeeding taxable year and added to the credit allowable under this section for the succeeding taxable year. A carryover that is not used in the succeeding year because it exceeds the tax liability limitation shall be carried over to later taxable years until used, except that no excess credit may be carried over to any taxable year beginning after December 31, 1987.

§ 1.44C-2 Definitions.

For purposes of section 44C and the regulations thereunder—

(a) *Energy conservation expenditures*—(1) *In general.* The term "energy conservation expenditure" means an expenditure made on or after April 20, 1977, and before January 1, 1986, by a taxpayer for insulation or any other energy-conserving component, or for labor costs allocable to the original installation of such insulation or other component, if all of the following conditions are satisfied:

(i) The insulation (as defined in paragraph (c)) or other energy-conserving component (as defined in paragraph (d)) is installed in or on a dwelling unit that is used as the taxpayer's principal residence when the installation is completed. See § 1.44C-3(e) for the definition of principal residence.

(ii) The dwelling unit is located in the United States (as defined in section 7701(a)(9)).

(iii) The construction of the dwelling unit was substantially completed before April 20, 1977. See § 1.44C-3

(f) for the definition of the terms "construction" and "substantially completed". In the case of expenditures made with respect to the enlargement of a dwelling unit, the construction of the enlargement must have been substantially completed before April 20, 1977.

(2) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). In 1978, A spent $500 for the purchase and installation of new storm windows to replace old storm windows, $100 to reinstall old storm windows, and $150 to transfer to A's house insulation which had been installed in A's garage. Only the $500 spent for new storm windows qualifies as an energy conservation expenditure. The $100 spent to reinstall storm windows and the $150 spent to transfer insulation to A's house do not qualify since the only installation costs that qualify are those for the original installation of energy conservation property the original use of which commences with the taxpayer.

Example (2). In June 1977, B purchased for B's principal residence a new house that was substantially completed before April 20, 1977. Pursuant to B's request the builder installed storm windows on May 1, 1977, the cost of this option being included in the purchase price of the house. The portion of the purchase price of the residence allocable to the storm windows constitutes an energy conservation expenditure. However, no other part of the purchase price may be allocated to energy conservation property (insulation and other energy conserving components) installed before April 20, 1977. To qualify as an energy conservation expenditure, an expenditure must be made (*i.e.*, installation of the energy conservation property must be completed) on or after April 20, 1977.

(b) *Renewable energy source expenditures.* The term "renewable energy source expenditure" means an expenditure made on or after April 20, 1977, and before January 1, 1986, by a taxpayer for renewable energy source property (as defined in paragraph (e)), or for labor costs properly allocable to the on-site preparation, assembly, or original installation of such property, if both of the following conditions are satisfied:

(1) The renewable energy source property is installed in connection with a dwelling unit that is used as the taxpayer's principal residence when the installation is completed. See § 1.44C-3(e).

(2) The dwelling unit is located in the United States (as defined in section 7701(a)(9)).

Eligibility as a renewable energy source expenditure does not depend on the date of construction of the dwelling unit. Thus, such an expenditure may be made in connection with either a new or an existing dwelling unit. Renewable energy source expenditures need only be made in connection with a dwelling, rather than in or on a dwelling unit. For example, a solar collector that otherwise constitutes renewable energy source property is not ineligible merely because it is installed separately from the dwelling unit. The term "renewable energy source expenditure" does not include any expenditure allocable to a swimming pool even when used as an energy storage medium or to any other energy storage medium whose primary function is other than the storage of energy. It also does not include the cost of maintenance of an installed system or the cost of leasing renewable energy source property.

(c) *Insulation.* The term "insulation" means any item that satisfies all of the following conditions:

(1) The item is specifically and primarily designed to reduce, when installed in or on a dwelling or on a water heater, the heat loss or gain of such dwelling or water heater. To qualify as insulation the item must be installed between a conditioned area and a nonconditioned area (except when installed on a water heater, water pipe, or heating/cooling duct). Thus, for example, awnings do not qualify as insulation. For purposes of this section the term "conditioned area" means an area that has been heated or cooled by conventional or renewable energy source means. Insulation includes materials made of fiberglass, rock wool, cellulose, urea based foam, urethane, vermiculite, perlite, polystyrene, and extruded polystyrene foam.

(2) The original use of the item begins with the taxpayer.

(3) The item can reasonably be expected to remain in operation at least 3 years.

(4) The item meets the applicable performance and quality standards prescribed in § 1.44C-4 (if any) that are in effect at the time the taxpayer acquires the item.

The term "insulation" shall not include items whose primary purpose is not insulation (*e.g.*, whose function is primarily structural, decorative, or safety-related). For example, carpeting, drapes (including linings), shades, wood paneling, fireplace screens (including those made of glass), new or replacement walls (except for qualifying insulation therein) and exterior siding do not qualify although they may have been designed in part to have an insulating effect.

(d) *Other energy-conserving components.* The term "other energy-conserving component" means any item (other than insulation) that satisfies all of the following conditions:

(1) The original use of the item begins with the taxpayer.

(2) The item can reasonably be expected to remain in operation for at least 3 years.

(3) The item meets the applicable performance and quality standards prescribed in § 1.44C-4 (if any) that are in effect at the time of the taxpayer's acquisition of the item.

(4) The item is one of the following items:

(i) *A furnace replacement burner.* The term "furnace replacement burner" means a device (for oil and gas-fired furnaces or boilers) that is designed to achieve a reduction in the amount of fuel consumed as a result of increased combustion efficiency. The burner must replace an existing burner. It does not qualify if it is acquired as a component of, or for use in, a new furnace or boiler.

(ii) *A device for modifying flue openings.* The term "device for modifying flue openings" means an automatically operated damper that—

(A) Is designed for installation in the flue, between the barometric damper or draft hood and the chimney, of a furnace; and

(B) Conserves energy by substantially reducing the flow of conditioned air through the chimney when the furnace is not in operation. Conditioned air is air that has been heated or cooled by conventional or renewable energy source means.

(iii) *A furnace ignition system.* The term "furnace ignition system" means an electrical or mechanical device, designed for installation in a gas-fired furnace or boiler that automatically ignites the gas burner. In order to qualify, the device must replace a gas pilot light. Furthermore, it does not qualify if it is acquired as a component of, or for use in, a new furnace or boiler.

(iv) *A storm or thermal window or door.* The terms "storm or thermal window" and "storm or thermal door" include the following:

(A)(*1*) A window placed outside or inside an ordinary or prime window, creating an insulating air space.

(*2*) A window with enhanced resistance to heat flow through the glazed area by multi-glazing.

(*3*) A window that consists of glass or other glazing materials that have exception heat-absorbing or heat-reflecting properties. For purposes of this subdivision (iv), the term "glazing material" does not include films and coatings applied on the surface of a window.

(B)(*1*) A second door, installed outside or inside a prime exterior door, creating an insulating air space.

(*2*) A door with enhanced resistance to heat flow through the glazed area by multi-glazing.

(*3*) A prime exterior door that has an R-value (a measurement of the ability of insulation to resist the flow of heat) of at least 2 throughout.

For purposes of this subdivision, "multi-glazing" is an arrangement in which two or more sheets of glazing material are affixed in a window or door frame to create one or more insulating air spaces. Multi-glazing can be achieved by installing a preassembled, sealed insulating glass unit or by affixing one or more additional sheets of glazing onto an existing window (or sash) or door. For purposes of this subdivision, a storm or thermal window or door does not include any film applied on or over the surface of a window or door.

(v) *Automatic energy-saving setback thermostat.* The term "automatic energy-saving setback thermostat" means a device that is designed to reduce energy consumption by regulating the demand on the heating or cooling system in which it is installed, and uses—

(A) A temperature control device for interior spaces incorporating more than one temperature control level, and

(B) A clock or other automatic mechanism for switching from one control level to another.

(vi) *Caulking and weatherstripping.* The term "caulking" means pliable materials used to fill small gaps at fixed joints on buildings to reduce the passage of air and moisture. Caulking includes, but is not limited to, materials commonly known as "sealants", "putty", and "glazing compounds". The term "weatherstripping" means narrow strips of material placed over or in movable joints of windows and doors to reduce the passage of air and moisture.

(vii) *Energy usage display meter.* The term "energy usage display meter" means a device the sole purpose of which is to display the cost (in money) of energy usage in the dwelling. It may show cost information for electricity usage, gas usage, oil usage, or any combination thereof. The device may measure energy usage of the whole dwelling, or individual appliances or systems on an instantaneous or cumulative basis.

(viii) *Components specified by the Secretary.* The Secretary (or his delegate) may, in his discretion, after consultation with the Secretary of Energy and the Secretary of Housing and Urban Development (or their delegates), and any other appropriate Federal officers, specify by regulation other energy-conserving components for addition to the list of qualified items. See § 1.44C-6 for the procedures and criteria to be used in determining whether an item will be considered for addition to the list of qualified items by the Secretary. The term "other energy-conserving component" is limited to items in a category specifically listed in section 44C(c)(4)(A)(i) through (vii) or added by the Secretary.

(e) *Renewable energy source property*—(1) *In general.* The term "renewable energy source property" includes any solar energy property, wind energy property, geothermal energy property, or property referred to in subparagraph (2), which meets the following conditions:

(i) The original use of the property begins with the taxpayer.

(ii) The property can reasonably be expected to remain in operation for at least 5 years.

(iii) The property meets the applicable performance and quality standards prescribed in § 1.44C-4 (if any) that are in effect at the time of the taxpayer's acquisition of the property.

Renewable energy source property does not include heating and cooling systems which serve to supplement renewable energy source equipment in heating or cooling a dwelling unit, and which employ a form of energy (such as electricity, oil or gas) other than solar, wind, or geothermal energy (or other forms of renewable energy provided in subparagraph (2)). Thus, heat pumps or oil or gas furnaces, used in connection with renewable energy source property, are not eligible for the credit. In order to be eligible for

the credit for renewable energy source property, the property (as well as labor costs properly allocable to on-site preparation, assembly or installation of equipment) must be clearly identifiable. See § 1.44C-3(1) for recordkeeping rules.

(2) *Renewable energy source specified by the Secretary.* In addition to solar, wind, and geothermal energy property, renewable energy source property includes property that transmits or uses another renewable energy source that the Secretary (or his delegate) specifies by regulations, after consultation with the Secretary of Energy and the Secretary of Housing and Urban Development (or their delegates), and any other appropriate Federal officers, to be of a kind that is appropriate for the purpose of heating or cooling the dwelling or providing hot water for use within the dwelling. For purposes of this section, references to the transmission or use of energy includes its collection and storage. See § 1.44C-6 for the procedures and criteria to be used in determining when another energy source will be considered for addition to the list of qualified renewable energy sources.

(f) *Solar energy property*—(1) *In general.* The term "solar energy property" means equipment and materials of a solar energy system as defined in this paragraph (and parts solely related to the functioning of such equipment) which, when installed in connection with a dwelling, transmits or uses solar energy to heat or cool the dwelling or to provide hot water for use within the dwelling. For this purpose, solar energy is energy derived directly from sunlight (solar radiation). Property which uses, as an energy source, fuel or energy which is indirectly derived from sunlight (solar radiation), such as fossil fuel or wood or heated underground water is not considered solar energy property. Materials and components of "passive solar systems" as well as "active solar systems", or a combination of both types of systems may qualify as solar energy property.

(2) *Active solar system.* An active solar system is based on the use of mechanically forced energy transfer, such as the use of fans or pumps to circulate solar generated energy, or thermal energy transfer, such as systems utilizing thermal siphon principles. Generally, this is accomplished through the use of equipment such as collectors (to absorb sunlight and create hot liquids or air), storage tanks (to store hot liquids), rockbeds (to store hot air), thermostats (to activate pumps or fans which circulate the hot liquids or air), and heat exchangers (to utilize hot liquids or air to heat air or water).

(3) *Passive solar system.* A passive solar system is based on the use of conductive, convective, or radiant energy transfer. In order to qualify as a passive solar system, a solar system used for heating purposes must contain all of the following: a solar collection area, an absorber, a storage mass, a heat distribution method, and heat regulation devices. The term "solar collection area" means an expanse of transparent or translucent material, such as glass which is positioned in such a manner that the rays of the sun directly strike an absorber. The term "absorber" means a surface, such as a floor, that is exposed to the rays of the sun admitted through the solar collection area, which converts solar radiation into heat, and then transfers the heat to a storage mass. The term "storage mass" means material, such as masonry, that receives and holds heat from the absorber and later releases the heat to the interior of the dwelling. The storage mass must be of sufficient volume, depth, and thermal energy capacity to store and deliver adequate amounts of solar heat for the relative size of the dwelling. In addition, the storage mass must be located so that it is capable of distributing the stored heat directly to the habitable areas of the dwelling through a heat distribution method. The term "heat distribution method" means the release of radiant heating from the storage mass within the habitable areas of the dwelling, or convective heating from the storage mass through airflow paths provided by openings or by ducts in the storage mass, to habitable areas of the dwelling. The term "heat regulation devices" means shading or venting mechanisms (such as awnings or insulated drapes) to control the amount of solar heat admitted through the solar collection areas and nighttime insulation or its equivalent to control the amount of heat permitted to escape from the interior of the dwelling.

(4) *Components with dual function.* To the extent that a passive or active solar system utilizes portions of the structure of a residence, only the materials and components whose sole purpose is to transmit or use solar radiation (and labor costs associated with installing such materials and components) are included within the term "solar energy property". Accordingly, materials and components that serve a dual purpose *e.g.*, they have a significant structural function or are structural components of the dwelling (and labor costs associated with installing such materials and components) are not included within the term "solar energy property". For example, solar collectors and roof ponds that form part of a roof (including additional structural components to support the roof), windows (including clerestories and skylights), and greenhouses do not qualify as solar energy property. In the case of a trombe wall (a south facing wall composed of a mass wall and exterior glazing), the mass wall (and labor costs associated with installing the mass wall) will not qualify. However, the exterior (non-window) glazing will qualify. Any shading, venting and heat distribution mechanisms or storage systems that do not have a dual function will also qualify.

(g) *Wind energy property.* The term "wind energy property" includes equipment (and parts solely related to

the functioning of such equipment) which, when installed in connection with a dwelling, transmits or uses wind energy to produce energy in a useful form for personal residential purposes. Examples of equipment using wind energy to produce energy in a useful form are windmills, wind-driven generators, power conditioning and storage devices that use wind to generate electricity or mechanical forms of energy. Devices that use wind merely to ventilate do not qualify as wind energy property.

(h) *Geothermal energy property.* The term "geothermal energy property" includes equipment (and parts solely related to the functioning of such equipment) necessary to transmit or use energy from a geothermal deposit to heat or cool a dwelling or provide hot water for use within the dwelling. Equipment such as a pipe that serves both a geothermal function (by transmitting hot geothermal water within a dwelling) and a non-geothermal function (by transmitting hot water from a water heater within a dwelling) does not qualify as geothermal property. A geothermal deposit is a geothermal reservoir consisting of natural heat which is from an underground source and is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure), having a temperature exceeding 50 degrees Celsius as measured at the wellhead or, in the case of a natural hot spring (where no well is drilled), at the intake to the distribution system.

§ 1.44C-3 Special rules.

(a) *When expenditures are treated as made*—(1) *Timeliness of an expenditure for the energy credit.* In general, for the purpose of determining whether an expenditure qualifies as being timely for the residential energy credit under section 44C (*i.e.*, is made after April 19, 1977, and before January 1, 1986), the expenditure is treated as made when original installation of the item is completed. Thus, solely for that purpose, the time of payment or accrual is irrelevant.

(2) *Special rule for renewable energy source expenditures in the case of construction or reconstruction of a dwelling.* In the case of renewable energy source expenditures in connection with the construction or reconstruction of a dwelling that becomes the taxpayer's new principal residence, the expenditures are to be treated as made (for the purpose of determining the timeliness of an expenditure for the residential energy credit) when the taxpayer commences use of the dwelling as his or her principal residence following its construction or reconstruction. The term "reconstruction" means the replacement of most of a dwelling's major structural components such as floors, walls, and ceiling. When a taxpayer reoccupies a reconstructed dwelling that was the taxpayer's principal residence prior to reconstruction, a renewable energy source expenditure is considered made when the original installation of the renewable energy source property is completed.

(3) *Taxable year in which credit is allowable.* For the purpose of determining the taxable year in which the credit for an expenditure is allowable (once it has qualified as timely under subparagraph (1) or (2)), an expenditure is treated as made on the later of (i) the date on which it qualifies as timely, or (ii) the date on which it is paid or incurred by the taxpayer.

(b) *Expenditures in 1977.* No credit under section 44C shall be allowed for any taxable year beginning before 1978. However, the amount of any credit under section 44C for the taxpayer's first taxable year beginning after December 31, 1977, shall take into account qualified energy conservation expenditures and qualified renewable energy source expenditures made during the period beginning April 20, 1977, and ending on the last day of such first taxable year.

(c) *Expenditures financed with Federal, etc., grants.* Qualified expenditures financed with Federal, State or other grants shall be taken into account for purposes of computing the residential energy credit only if such amounts are taxable as gross income under section 61 (relating to the definition of gross income) and the regulations thereunder.

(d) *Expenditures qualifying both as energy conservation expenditures and renewable source expenditures.* In the case of an expenditure which meets both the definition of an energy conservation expenditure (as defined in § 1.44C-2(a)) and a renewable energy source expenditure (as defined in § 1.44C-2(b)), the taxpayer may claim either a credit under §1.44C-1(b) (relating to qualified energy conservation expenditures) or §1.44C-1(c) (relating to qualified renewable energy source expenditures) but may not claim both credits with respect to the same expenditure.

(e) *Principal residence.* For purposes of section 44C, the determination of whether a dwelling unit is the taxpayer's principal residence shall be made under principles similar to those applicable to section 1034 and the regulations thereunder (relating to sale or exchange of a principal residence) except that ownership of the dwelling unit is not required. In making this determination, the period for which a dwelling is treated as a taxpayer's principal residence includes the 30-day period ending on the first day on which the dwelling unit would (but for this sentence) be treated as being used as the taxpayer's principal residence under principles similar to those applicable to section 1034. Thus, installations that are completed within that 30-day period may be eligible for the credit although, in the absence of the 30-day rule, the date of habitation of the dwelling unit by the taxpayer would mark the beginning of the taxpayer's use of the unit as a principal residence.

(f) *Construction substantially completed.* Construction of a dwelling unit is substantially completed when construction has progressed to the point where the unit could be put to use as a personal residence, even though comparatively minor items remain to be finished or performed in order to conform to the plans or specifications of the completed building. For this purpose, construction includes reconstruction as defined in paragraph (a)(2). This rule may be illustrated by the following example:

Example. On January 1, 1979, A purchases a dwelling that is to become A's principal residence. The dwelling unit was originally constructed in 1950. A spends $50,000 to reconstruct the dwelling by replacing most of the dwelling's major structural components such as floors, walls and ceilings. Included in the cost is $3,000 attributable to energy-conserving components. Reconstruction is substantially completed on April 1, 1979, and A moves into the reconstructed residence on May 1, 1979. Since construction includes reconstruction, A's reconstructed residence is not considered substantially completed before April 20, 1977. Thus, amounts spent with respect to A's reconstructed residence for energy-conserving components do not qualify as energy conservation expenditures

(g) *Residential use of property.* To be eligible for the residential energy credit, expenditures must be made for personal residential purposes. If at last 80 percent of the use of a component or item of property is for personal residential purposes, the entire amount of the energy conservation expenditure or the renewable energy source expenditure is taken into account in computing the credit under this section. If less than 80 percent of the use of a component or item of property is for personal residential purposes, the amount of an expenditure taken into account is the amount that bears the same ratio to the amount of the expenditure as the amount of personal residential use of the component or item bears to its total use. For purposes of this paragraph, use of a component or an item of property with respect to a swimming pool is not a use for a personal residential purpose. The rules with respect to residential use of property are illustrated by the following examples:

Example (1). In 1978 A makes an expenditure of $3,000 for the installation of storm windows of which 50 percent is on the portion of A's dwelling used as the principal family residence and 50 percent is on the portion of the dwelling used as an office. A has made no other energy conservation expenditures for the residence. The allowable energy conservation expenditure is $1,500 (50 percent of $3,000), the portion attributable to residential use. Therefore, the residential energy credit is $225 (the qualified conservation expenditure of 15 percent of $1,500).

Example (2). During 1979, B makes $10,000 of renewable energy source expenditures on solar energy property for B's principal residence. Approximately 60 percent of the use of the solar energy property will be for heating B's swimming pool; the other 40 percent will be for heating the dwelling unit. B had not previously made renewable energy source expenditures with respect to the residence. Since use for a swimming pool is not considered a residential use, less than 80 percent of the use of B's solar energy property is considered used for personal residential purposes. Therefore, only $4,000 (40 percent of $10,000), the proportionate part of B's expenditures representing personal residential use, is treated as a renewable energy source expenditure. B is allowed a $1,000 residential energy credit (30 percent of $2,000 plus 20 percent of $2,000) for 1979.

(h) *Joint occupancy*—(1) *In general.* If two or more individuals jointly occupied and used a dwelling unit as their principal residence during any portion of a calendar year—

(i) The amount of the credit allowable under section 44C by reason of energy conservation expenditures or by reason of renewable energy source expenditures shall be determined by treating all of the joint occupants as one taxpayer whose taxable year is such calendar year; and

(ii) The credit under section 44C allowable to each joint occupant for the taxable year with which or in which such calendar year ends shall be an amount which bears the same ratio to the amount determined under paragraph (h)(1)(i) of this section as the amount of energy conservation expenditures or renewable energy source expenditures made by that occupant bears to the total amount of each type of such expenditures made by all joint occupants during such calendar year.

The provisions of this subparagraph may be illustrated by the following example:

Example. A, a calendar year taxpayer, and B, a June 1 fiscal year taxpayer, make energy conservation expenditures of $2,000 (A making expenditures of $500 and B making expenditures of $1,500) on their principal and jointly occupied residence in 1978. A and B have not previously made energy conservation expenditures with respect to this residence. Of the $300 credit (15 percent of $2,000), $75 will be allocated to A ($500/$2,000 × $300) and $225 to B ($1,500/$2,000 × $300). A will claim the allocable share of the credit on A's 1978 tax return and B will claim the allocable share of the credit on B's tax return for the fiscal year ending May 31, 1979.

(2) *Minimum credit.* The fact that one joint occupant may be unable to claim all or part of the credit under section 44C because of insufficient tax liability or because that occupant's allowable credit does not exceed the $10 minimum credit (as set forth in paragraph (d)(1) of § 1.44C-1) shall have no effect upon the computation of the amount of the allowable credits for the other joint occupants.

(3) *Prior expenditures.* Because joint occupants are treated as one taxpayer for purposes of determining the residential energy credit, the maximum amount of energy conservation expenditures or renewable energy source expenditures must be reduced by the total amount of such expenditures made in connection with the dwelling unit during prior calendar years in which any one of the residents of the unit during the current calendar year was a resident (whether made by the current resident or by an individual previously occupying the dwelling with the current resident). However, the preceding sentence shall not apply to prior expenditures no part of which was taken into account in computing the credits under section 44C for such years. Prior years' expenditures are not to be allocated

among joint occupants to take into account the specific expenditures of each of the occupants in prior years.

(4) The rules of this paragraph may be illustrated by the following examples:

Example (1). Assume A and B have together made prior years' energy conservation expenditures of $1,600 (A having made $1,200 of expenditures and B having made $400) on their principal and jointly occupied residence. In the current year, each makes energy conservation expenditures of $300 with respect to the same residence. The maximum qualified expenditure with respect to the residence is reduced by the $1,600 of prior expenditures made by A and B. Therefore, only $400 of the $600 current expenditures are eligible as energy conservation expenditures. The resulting residential energy credit is $60 (15 percent of $400) of which $30 apiece will be allocated to A and B ($300/$600 × $60). The fact that A had previously computed the credit in prior years with respect to $1,200 of the total $1,600 of expenditures is irrelevant to the apportionment of the credit in the current year.

Example (2). Spouses C and D make $10,000 of renewable energy source expenditures with respect to their principal residence, half of which is paid by each spouse. No prior renewable energy source expenditures have been taken into account with respect to that residence by either C or D. C and D file separate returns for the calendar year. Under the joint occupancy rule, the maximum allowable renewable energy source credit with respect to C and D's principal residence is $2,200 (30 percent of the first $2,000, and 20 percent of the next $8,000 of expenditures). Half of this amount, or $1,100, will be allowed to each spouse. If either spouse makes renewable energy source expenditures with respect to the same principal residence in future years, none of those expenditures would be qualified renewable energy source expenditures for which a credit can be claimed. That is, not more than $2,200 may be taken in the aggregate by C and D as a renewable energy source credit with respect to their principal residence.

Example (3). In 1978, E and F make energy conservation expenditures of $1,500 on their principal and jointly occupied residence. In 1979, E moves away and G becomes the other joint occupant of the residence. F and G make energy conservation expenditures of $1,000 in 1979. In 1980 F moves away and H moves in with G. G and H make energy conservation expenditures of $500. The maximum qualified expenditure made by F and G with respect to the residence is reduced by the $1,500 of prior expenditures made in 1978 by E and F. The maximum qualified expenditures made by G and H with respect to the residence is reduced only by the expenditures in prior years in connection with the residence during which either C or H was a joint occupant. Accordingly, the maximum qualified expenditures made by G and H with respect to the residence is reduced only by the $1,000 of prior expenditures made in 1979 by F and G.

(i) *Condominiums and cooperative housing corporations.* An individual who is a tenant stockholder in a cooperative housing corporation (as defined in section 216) or who is a member of the condominium management association with respect to a condominium which he or she owns shall be treated as having made a proportionate share of the energy conservation expenditures or renewable energy source expenditures of such corporation or association. The cooperative stockholder's allocable share of the expenditures is to be the same as his or her proportionate share of the cooperative's total outstanding stock (including any stock held by the corporation). However, in the case where only certain cooperative stockholders are assessed for the expenditures made by the cooperative housing corporation, only those cooperative stockholders that are assessed shall be treated as having made a share of the expenditures of such corporation. In such case, the cooperative stockholder's share of the expenditures is the amount that the stockholder is assessed. The allocable share of a condominum management association member's energy conservation or renewable energy source expenditures is the amount that the member is assessed (or would be assessed in the case where expenditures are from general funds) by the association as a result of such expenditures. The residential energy credit for a qualified expenditure is allowable for the year in which the association or corporation has completed original installation of the item (or has paid or incurred the expenditure, if later). For purposes of this paragraph, the term 'condominium management association" means an organization meeting the requirements of section 528(c)(1) of the Code (other than subparagraph (E) of that section), with respect to a condominium project substantially all the units of which are used as residences.

(j) *Joint ownership of renewable energy source property*—(1) *In general.* Renewable energy source property includes property which is jointly owned by the taxpayer and another person (or persons). For example, the fact that a windmill, solar collector, or geothermal well and distribution system is owned by two or more individuals does not by itself preclude qualification as renewable energy property.

(2) *Example.* The application of this subparagraph may be illustrated by the following example:

Example. A, B, and C each has a separate principal residence. They agree to finance jointly the construction of a solar collector, each providing one-third of the costs and taking one-third of the output of the collector. Each will separately pay for the costs of connecting the solar collector with his or her principal residence. Provided the solar collector and connection equipment otherwise qualify as renewable energy source property, A, B, and C will each be considered to have made renewable energy source expenditures equal to one-third of the cost of the collector plus his or her separate connection costs. Such expenditures will be subject to the limitations and other rules separately applicable to A, B, and C with respect to each principal residence, such as those with respect to the $10 minimum (§ 1.44C-1(d)(1)), prior expenditures (§ 1.44C-1(d)(2)), residential use (paragraph (g) of this section), and joint occupancy (paragraph (h) of this section).

(k) *Basis adjustments.* If a credit is allowed under section 44C for any expenditure with respect to any property, the increase in the basis of that property which would (but for this paragraph) result from such expenditure shall be reduced by the amount of the credit allowed.

(l) *Recordkeeping*—(1) *In general.* No residential energy credit is allowable unless the taxpayer maintains the records described in paragraph (l)(2) of this section. The records shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(2) *Records.* The taxpayer must maintain records that clearly identify the energy-conserving components and renewable energy source property with respect to which a residential energy credit is claimed, and substantiate their cost to the taxpayer, any labor costs properly allocable to them paid for by the taxpayer, and the method used for allocating such labor costs.

§ 1.44C-4 Performance and quality standards.

[Reserved.]

§ 1.44C-5 Certification procedures.

(a) *Certification that an item meets the definition of an energy-conserving component or renewable energy source property.* Upon the request of a manufacturer of an item pursuant to paragraph (b) of this section which is supported by proof that the item is entitled to be certified, the Assistant Commissioner (Technical) shall certify (or shall notify the manufacturer that the request is denied) that:

(1) The item meets the definition of insulation (see § 1.44C-2(c)(1)).

(2) The item meets the definition of an other energy-conserving component specified in section 44C(c)(4) (see § 1.44C-2(d)(4)).

(3) The item meets the definition of solar energy property (see § 1.44C-2(f)), wind energy property (see § 1.44C-2(g)), or geothermal energy property (see § 1.44C-2(h)).

(4) The item meets the definition of a category of energy-conserving component that has been added to the list of approved items pursuant to paragraph (d)(4)(viii) of § 1.44C-2.

(5) The item meets the definition of renewable energy source property that transmits or uses a renewable energy source that has been added to the list of approved renewable energy sources pursuant to paragraph (e)(2) of § 1.44C-2.

(b) *Procedure*—(1) *In general.* A manufacturer of an item desiring to apply under paragraph (a) shall submit the application to the Commissioner of Internal Revenue, Attention: Assistant Commissioner (Technical), T:C:E, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. Upon being advised by the National Office, orally or in writing, that an adverse decision is contemplated a manufacturer may request a conference. The conference must be held within 21 calendar days from the date of that advice. Procedures for requesting an extension of the 21-day period and notifying the manufacturer of the Service's decision on that request are the same as those applicable to conferences on ruling requests by taxpayers (see section 9.05 of Rev. Proc. 80-20 [page , this Bulletin]).

(2) *Contents of application.* The application shall include a description of the item (including appropriate design drawings and specifications) and an explanation of the purpose and function of the item. There shall accompany the application a declaration in the following form: "Under penalties of perjury, I declare that I have examined this application, including accompanying documents and, to the best of my knowledge and belief, the facts presented in support of the application are true, correct, and complete." The statement must be signed by the person or persons making the application.

(c) *Effect of certification under paragraph (a).* Certifications granted under paragraph (a)(1), (2), or (3) will be applied retroactively to April 20, 1977. However, certifications granted under paragraph (a)(4) or (5) will be applied retroactively only to the date the applicable energy-conserving component or renewable energy source was added by Treasury decision to the list of qualifying components or sources. Certification of an item under this section means that the applicable definitional requirement of § 1.44C-2 is considered satisfied in the case of any person claiming a residential energy credit with respect to such item. However, it does not relieve manufacturers of the need to establish that their items conform to performance and quality standards (if any) provided under § 1.44C-4 and that their items can reasonably be expected to remain in operation at least 3 years, in the case of insulation and other energy-conserving components, or at least 5 years, in the case of renewable energy source property.

§ 1.44C-6 Procedure and criteria for additions to the approved list of energy-conserving components or renewable energy sources.

[Reserved.]

Par. 2. Section 1.1016 is deleted.

Par. 3. Section 1.1016-5 is amended by adding a new paragraph (t) to read as follows:

§ 1.1016-5 Miscellaneous adjustments to basis.

* * * * *

(t) *Section 44C credit.* In the case of property with respect to which a credit has been allowed under section 44C (relating to residential energy credit), basis shall be adjusted as provided in paragraph (k) of § 1.44C-3.

(This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).)

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved July 30, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 26, 1980, 4:04 p.m., and published in the issue of the Federal Register for August 29, 1980, 45 F.R. 57712)

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26 CFR 1.44C-5: Certification procedures.

The procedures necessary for a manufacturer to make application for "certification" that an item will be treated as insulation, an energy-conserving component, or renewable energy source property for the purposes of section 44C of the Code. See Rev. Proc. 80-36, page 769.

Subpart B.—Rules for Computing Credit for Investment in Certain Depreciable Property

Section 46.—Amount of Credit

26 CFR 1.46-1: Determination of amount.

Whether the liability created by a note given as the purchase price for a synthetic oil converter is included in the partnership's basis in the converter for purposes of the investment tax credits. See Rev. Rul. 80-235, page 229.

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26 CFR 1.46-3: Qualified investment.

Tax treatment of retired recovered mass asset materials from an electric utility's distribution and transmission systems. See Rev. Rul. 80-311, page 5.

Section 47.—Certain Dispositions, Etc., of Section 38 Property

26 CFR 1.47-2: "Disposition" and "cessation."
(Also Sections 38, 761; 1.38-1, 1.761-2.)

Recapture of investment credit; sale of undivided interest in facility to tax exempt cooperative. The investment credit recapture implications of the sale by a public utility company of an undivided interest in its electric generating facility to a tax exempt cooperative are discussed.

Rev. Rul. 80-219

ISSUES

(1) When a utility company sells an undivided interest in its "section 38 property" to a tax exempt cooperative, creating a partnership for federal tax purposes, does ownership of the undivided interest by the cooperative disqualify the utility company's retained interest in the property as section 38 property, thereby causing the recapture provisions of section 47(a) of the Internal Revenue Code to apply? Also, does the contribution by the utility company of its retained interest to the partnership constitute a disposition of section 38 property for purposes of section 47(a)?

(2) Will the federal income tax treatment be different if the partners elect under section 761 of the Code to be excluded from the application of subchapter K, chapter 1, of the Code?

FACTS

Situation 1.

M is an investor-owned electric utility company. *M* owned the entire interest in and operates facilities for the generation, transmission, and distribution of electricity. All of the facilities were acquired by *M* for use in its business and qualified as section 38 property. In 1978 *M* sold an undivided interest in certain generating facilities to *T*, a cooperative exempt from federal income tax pursuant to the provisions of section 501(c)(12) of the Code. The facilities are owned by *M* and *T* as a tenancy in common under a joint operating agreement classified as a partnership and each is considered to have contributed its interest in the facilities to the partnership for federal income tax purposes. The *M* and *T* partnership is subject to the provisions of subchapter K, chapter 1, of the Code.

Situation 2.

The facts are the same as Situation 1 except that the partners elected pursuant to the provisions of section 1.761-2(b) of the Income Tax Regulations to be excluded from the application of subchapter K, chapter 1, of the Code. Thus, *M* and *T* were excluded from partnership status.

LAW AND ANALYSIS

Section 38 of the Code allows an investment credit with respect to qualified investment in certain depreciable property.

Section 47(a)(1) of the Code provides that if during the taxable year any property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the useful life that was taken into account in computing the credit under section 38, then the tax under chapter 1 of the Code for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years that would have resulted solely from substituting, in determining qualified investment, for such useful life the period beginning with the time such property was placed in service by the taxpayer and ending with the time such property ceased to be section 38 property.

Section 47(b) of the Code provides that property shall not be treated as ceasing to be section 38 property with respect to the taxpayer by reason of a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as section 38 property and the taxpayer retains a substantial interest in such trade or business.

Section 1.47-3(f) of the regulations provides that no disposition of section 38 property will occur by reason of a mere change in form of conducting a trade or business if the following conditions are met. The conditions are: (1) the property is retained as section 38 property in the same trade or business, (2) the transferor retains a substantial interest in such trade or business, (3) substantially all the assets necessary to operate such trade or business are transferred, and (4) the basis of the property to the transferee is determined by reference to the basis in the hands of the transferor.

Section 721 of the Code provides that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Section 723 of the Code provides that the basis of property contributed

to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized to the contributing partner at such time.

Rev. Rul. 78-268, 1978-2 C.B. 10, holds that when an electric generating facility is owned as a tenancy in common under an arrangement classified as a partnership, the disallowance of the investment credit in respect of the interest of the cooperative and the city (two of the four partners) does not render the investment in the facilities by investor-owned utilities (the other two partners) ineligible for the investment credit.

HOLDING

Situation 1.

The sale by *M* of an undivided interest in its generating facilities to *T* will be treated as a disposition of property within the meaning of section 47(a) of the Code. Thus, there is a recapture of the investment credit taken on such property. The interest retained by *M* is not disqualified as section 38 property; thus, there is no disposition of property under section 47(a) that would result in a recapture of investment credit with respect to the interest retained by *M*.

The contribution of *M*'s retained interest in the facilities to the partnership is not a disposition of property within the meaning of section 47(a) because the conditions specified in section 1.47-3(f) of the regulations have been met.

Situation 2.

The election by *M* and *T* to be excluded from the provisions of subchapter K, chapter 1, of the Code does not alter the tax treatment set forth in Situation 1 above.

Section 48.—Definitions; Special Rules

26 CFR 1.48-1: Definition of section 38 property.

(Also Sections 167, 263; 1.167(a)-1, 1.263 (a)-1.)

Railway road crossings; investment credit; retirement-replacement depreciation method. Costs for replacement of railway road crossings over railroad tracks are included in the term "section 38 property." The retirement-replacement method of accounting for depreciation of crossings and the charge to expense of replacement costs are not proper.

Rev. Rul. 80-187

ISSUES

(1) Whether, under the circumstances described below, the term "section 38 property" includes the material and installation costs for replacement of private and public railway road crossings over the taxpayer's railroad tracks.

(2) Whether, for federal income tax purposes, it is proper to use the retirement-replacement method of accounting for depreciation of crossings and charge such replacement costs to expense.

FACTS

The material and installation costs at issue are for replacement of railway road crossings (in Interstate Commerce Commission (ICC) capital accounts 2½ and 39) that are paid for by the taxpayer, and involve items such as wooden planking laid parallel to the track, hardware, and paving or fill material directly adjacent to the track. The area inside of and surrounding the track is built up so that automobiles and other vehicles, including railroad work equipment, can cross the track and so that trains can operate through the crossings.

For book purposes, the replacement costs of these road crossing assets are capitalized and ratably depreciated. Retirements are charged to the depreciation reserve.

For tax purposes, the taxpayer has treated the initial costs of these road crossing assets as capital costs subject to recovery upon retirement without replacement. However, when such capitalized assets are replaced (retired for books), the costs of replacement have been currently expensed. Thus, the taxpayer has been using the same retirement-replacement method of accounting for depreciation of its crossings in ICC capital accounts 2½ and 39 that it uses for depreciation of its railroad track in ICC capital accounts 8, 9, 10, 11, and 12, on which investment credit is allowable for costs of replacement track materials and their installation under section 48(a)(9) of the Internal Revenue Code.

The average life of the private road crossings is 10 years, and the average life of the public road crossings is 8 years. The present trend in the industry is to eliminate road crossings at grade with underpasses and overpasses.

LAW AND ANALYSIS

Section 48(a)(9) of the Code, which was enacted by the Revenue Act of 1971, Pub. L. 92-178, 1972-1 C.B. 443, provides that section 38 property includes material for track on which the retirement-replacement method of accounting for depreciation is used. Replacements include the costs of rail, ties, ballast, other track materials, and their related installation costs.

Section 167(a) of the Code provides the general rule that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held for the production of income.

Section 263(a) of the Code provides the general rule that no deduction shall be allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property, or for any amount expended in restoring prop-

erty or making good the exhaustion thereof for which an allowance is or has been made.

Section 1.48-1(a) of the Income Tax Regulations provides the general rule that "section 38 property" means property (1) on which depreciation is allowable to the taxpayer, (2) that has an estimated useful life of 3 years or more, and (3) that is tangible personal property or other tangible property (excluding buildings and structural components) used as an integral part of furnishing transportation.

The road crossings are permanent improvements under section 263(a) of the Code for which ratable depreciation deductions are allowable under section 167(a). Their use as integral parts of furnishing transportation by allowing trains to operate through and vehicles to cross over the tracks qualify them as section 38 property eligible for the investment tax credit under section 1.48-1(a) of the regulations.

Rev. Rul. 78-199, 1978-1 C.B. 66, provides that the entire track structure of a railroad, including the main line, branch lines, spurs, and sidings, constitutes one unit of property for purposes of computing depreciation under the retirement-replacement method since the economic value of one element of the structure lies only on its relationship to the use of another or other elements of the structure as a whole. This single unit of property concept supports the underlying theory of the retirement-replacement method that the charges to expense on account of all track items retired or replaced in any particular year are taken as a rough equivalent of what would be a proper depreciation allowance for all the working track assets of the taxpayer for that year. Section 48(a)(9) of the Code recognizes the peculiarity of the retirement-replacement method for track.

Although the crossings are within and around the track at specific locations, and provide the necessary means for vehicles to cross over the track and allow trains to operate through them, they are not track nor accounted for as part of the track structure, which is accounted for in ICC capital accounts 8, 9, 10, 11, and 12. Each crossing is a distinct unit of property having a determinable useful life while the entire track structure of a railroad, including the main line, branch line, spurs and sidings, is treated as a unit of property having an indeterminate life under the retirement-replacement method of accounting for depreciation. Accordingly, deduction of replacement costs of crossings is not proper because the crossings are distinct units of property and have determinable useful lives over which ratable deductions may be taken annually.

HOLDINGS

(1) The term "section 38 property" includes the material and installation costs for replacement of private and public railroad road crossings over the taxpayer's railroad tracks.

(2) For federal income tax purposes, it is not proper to use the retirement-replacement method of accounting for depreciation of crossings and charge their replacement costs to expense. Such costs must be capitalized and depreciated over the useful lives of the crossings.

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26 CFR 1.48-1: Definition of section 38 property.

Investment credit; storage facilities; aluminum scrap. A taxpayer built a structure principally to store different grades and forms of aluminum scrap that are not intermingled. This storage of aluminum is not bulk storage of fungible commodities, and the structure does not qualify as section 38 property.

Rev. Rul. 80-195

ISSUE

Whether the storage of aluminum scrap in the taxpayer's structure, in the manner described below, is "bulk storage of fungible commodities" for purposes of section 48 of the Internal Revenue Code.

FACTS

A taxpayer is in the business of producing nonferrous metals alloys, primarily alloys of aluminum. All of the melting and refining activities are housed within a single building. Prior to 1978, taxpayer had no shelter for the raw materials used in production. After receipt, the raw materials were sometimes held in the railroad cars and trucks until used or stockpiled outside the building on adjacent land. This manner of storage, however, had often resulted in deterioration of the raw materials through oxidation and also made it difficult to handle the raw materials during or after rain and when snow was on the ground. During 1978, the taxpayer built a corrugated metal structure adjacent to the building housing the melting and refining activities to provide a sheltered storage area. The structure is erected on a single slab of concrete, contains no interior walls or partitions, and is 150 feet long, 60 feet wide and 20 feet high at the peak in the roof. The structure has lights, but no windows, water, toilet facilities, heating or cooling system, or insulation. It is subject to depreciation and has a useful life in excess of 3 years.

The principal materials stored in the taxpayer's structure is aluminum scrap of various grades. These materials are received in the form of ingots, sows (big slabs), and scrap clips. Scrap aluminum cans, for example, may be received in the form of metal clips. To the extent that skimmings from the molten metal operations contain reusable aluminum, they are recovered and stored in the structure. The stored materials are weighed upon receipt and tagged. The information entered on the tag includes: the name of the vendor, the weight of the material and, in some cases, its grade. Materials having similar characteristics are stored

together and are not intermingled with other materials. However, there are no separate bins in the structure and no particular area of the floor has been designated for specific materials. A variety of ways of storing the materials are used. Large size units, for example, may simply be stacked one on top of the other in one area of the structure while smaller size units are frequently bundled or baled and stacked on pallets or skids and stored in a separate area of the structure. The taxpayer's employees store and remove the material from the structure using forklift trucks. No processing of material is done within the structure.

LAW AND ANALYSIS

Section 48(a) of the Code provides, to the extent here pertinent, that the term "section 38 property" means tangible personal property or other tangible property (not including a building and its structural components) but only if such property is used as an integral part of manufacturing, production, or other specified activities, or if it constitutes a facility used in connection with manufacturing, production, or other specified activities for the bulk storage of fungible commodities. Section 38 property includes only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life of 3 years or more.

Section 1.48-1(d)(5)(ii) of the Income Tax Regulations provides that in the case of property constructed after August 15, 1971, such property will be a storage facility only if the facility is used principally for the bulk storage of fungible commodities. Bulk storage means the storage of a commodity in a large mass prior to its consumption or utilization. Thus, if a facility is used to store oranges that have been sorted and boxed, it is not used for bulk storage.

Rev. Rul. 74-3, 1974-1 C.B. 10, provides that partitioned enclosures inside a building devoted to the storing of inventoried parts and assembly elements, such as radios and air conditioners that are individually identified, are not facilities used principally for the bulk storage of fungible commodities.

S. Rep. No. 92-437, 92nd Cong., 1st Sess. 29 (1971), 1972-1 C.B. 559, 575, relating to the Revenue Act of 1971, Pub. L. 92-178, 1972-1 C.B. 443, discusses the bulk storage of fungible commodities requirement, which was added to section 48(a)(1)(b) of the Code. This report states that "bulk storage has reference to the keeping of a commodity in a large mass prior to its consumption or utilization. The commodity stored must be fungible in nature; that is, of such a nature that one part may be used in place of another."

The taxpayer's structure is used principally to store different grades of aluminum that are received in various forms such as ingots, sows, and scrap clips with individual units differing significantly in size and weight, with some material stored in bundled groups and others stored unbundled. Each unit or bundled group is tagged and identified as to vendor, weight, and often its grade.

Stored materials that vary in composition, size, and weight are not fungible in nature. One part cannot be used in place of another part and the materials cannot be estimated and replaced by simple reference to weight, measure and number.

Therefore, the storage of the materials in this case cannot be considered to be the bulk storage of fungible commodities.

HOLDING

The storage of the aluminum scrap in the taxpayer's structure in the manner described is not bulk storage of fungible commodities for purposes of section 48 of the Code. Therefore, the structure used to house the materials does not qualify as "section 38 property" for investment credit purposes.

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26 CFR 1.48-1: Definition of section 38 property.

Investment credit; public utilities; acquisition v. construction. A public utility contracted with a manufacturer of turbine generating units and with a general contractor for an exansion of its generating plant. The manufacturer exercised direction and control over installation, testing, and start-up of the turbine generating unit purchased by the utility, while the utility exercised continuing control over the important details of construction under the general contract for construction of the plant addition. The turbine generating unit was acquired within the meaning of section 1.48-2(b)(6) of the regulations, but the addition was constructed within the meaning of section 1.48-2(b)(1). The Service will not follow the *Public Service Co. of New Mexico* decision.

Rev. Rul. 80-312

ISSUE

Whether an addition to an electrical power plant was "acquired" or "constructed" by the taxpayer for purposes of determining the amount of the investment tax credit.

FACTS

The taxpayer is a public utility corporation in the business of furnishing electrical energy. In 1974 the taxpayer entered into contracts with a general contractor, company *X*, and also with company *Y*, the manufacturer of turbine generating units for the construction of an addition to an electrical generating plant. This addition was built on the taxpayer's land and was to be operated in conjunction with the taxpayer's existing plant facilities.

The contract with *Y* called for *Y* to manufacture a turbine generating unit

and exercise technical direction and authoritative control over its installation including the furnishing of all test procedures and their application. The turbine generating unit addition to the plant was installed and made operational by *Y*.

The contract with *X* provided that *X* would furnish the required engineering design, drafting, accounting, purchasing and expediting of materials, supervision, labor, and other requirements necessary for the construction of the addition to the electrical power plant which included mechanical, electrical, concrete, and site work; a railroad spur; and an addition to the generating building. The contract also specified that *X* would furnish the necessary construction facilities and engineering to turn over to the taxpayer a complete addition to the operating plant (with the exception of the turbine generating unit).

The builder's risk policy for the other additions to the electrical generating plant was secured and premiums were paid by the taxpayer. The taxpayer participated in and had the right of final approval over competitive bids from the manufacturers of the other additions of plant components. The specifications for the addition to the power plant, such as the technical data and performance details, were prescribed by the taxpayer. During the construction of the addition, the taxpayer and *X* had many meetings concerning the construction costs, bids, and design details affecting the operation of the addition to the plant. A representative of the taxpayer was at the construction site daily and acted as a liaison between the taxpayer and *X*. This resulted in the taxpayer having continuing control over important details of the construction. The construction of the addition to the plant began in 1974 and was not completed until mid-1975.

LAW AND ANALYSIS

Section 38 of the Internal Revenue Code allows a credit against federal income tax for qualified investment in section 38 property and the determination of what property is qualified is made in accordance with the rules provided in section 48.

Section 46(a)(2)(B) of the Code provides for a 10 percent investment credit for all taxpayers (including public utilities) for otherwise qualifying property that was acquired after January 21, 1975. For property acquired prior to that date the credit is 4 percent. The Tax Reduction Act of 1975, Pub. L. 94-12, 1975-1 C.B. 545, provided that, when the qualifying property was constructed, the 10 percent credit applied only to the portion of the basis of the property that was attributable to construction occurring after January 21, 1975. A 4 percent investment credit for public utility property applied to the portion of the basis attributable to construction before such date.

Section 48(a) of the Code, in defining the term "section 38 property," includes tangible personal property, or other tangible property (not including a building and its structural components) if such other tangible property is used as an integral part of certain specified activities, including the furnishing of electrical energy.

Section 48(b) of the Code which governs the extent to which particular items may be treated as "new section 38 property," states that "new section 38 property" means section 38 property, the construction, reconstruction, or erection of which is completed by the taxpayer after December 31, 1961, or acquired after December 31, 1961, if the original use of such property commences with the taxpayer and commences after such date.

Section 1.48-2(b)(1) of the Income Tax Regulations provides that property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for the taxpayer in accordance with the taxpayer's specifications.

Section 1.48-2(b)(6) of the regulations provides that property is deemed to be acquired when reduced to physical possession or control.

In *Madison Newspapers, Inc. v. Commissioner,* 47 T.C. 630 (1967), *acq.,* 1975-2 C.B. 2, the issue of whether the taxpayer was entitled to the investment credit depended on whether the printing press units in question were acquired as new section 38 property after December 31, 1961. To the Tax Court of the United States the critical question in *Madison Newspapers* was of *what* did the taxpayer acquire possession and control. The installation of the printing press units was a complex operation that required extensive time. The installation was conducted under the technical directions of persons designated by the seller but paid for by the taxpayer separately from the costs of delivered units. The Court concluded that the taxpayer acquired installed printing presses and hence the taxpayer was entitled to the credit because it found the property was built and installed in accordance with the seller's rather than the taxpayer's specifications.

A number of factors must be considered in determining whether the construction of property built by another may be attributed to a taxpayer as having been done for the taxpayer in accordance with taxpayer's specifications or whether the property was acquired by the taxpayer. The degree of control a taxpayer has over a planned construction project is an indication of whether property is constructed or acquired by the taxpayer. A taxpayer's control is indicated by ownership of the major components, ownership of the land upon which the construction took place, the carrying of builder's risk insurance, and the daily presence of the taxpayer's technical representative. Other factors are the taxpayer's participation in the bidding process, the purchase of certain major units by the taxpayer, and the taxpayer's right of final approval on all major units.

When a facility is acquired, the control by the taxpayer is minimal, as in the instant case where the installation and conducting of the generating unit's operational tests were performed by manufacturer *Y*.

Thus, when a taxpayer exercises continuing control of components added to its electrical generating plant, the components are "constructed" by the taxpayer, but where the components added to the plant are installed and made operational by a manufacturer, the components are "acquired" by the taxpayer. The facts of this case establish that, except for the turbine generator unit, the taxpayer had sufficient control over the construction project to conclude that it was built according to the taxpayer's specifications.

HOLDINGS

The turbine generating unit was acquired by the taxpayer within the meaning of section 1.48-2(b)(6).

The addition to the electric generating plant with the exception of the turbine generating unit under the continuing control of the taxpayer was "constructed" by the taxpayer within the meaning of section 1.48-2(b)(1) of the regulations. Therefore, the full 10 percent investment credit applies to the turbine generating unit and that portion of the addition constructed after January 21, 1975; however, only the 4 percent investment credit applies to that portion of the addition constructed prior to such date.

The Internal Revenue Service will not follow *Public Service Co. of New Mexico v. United States,* 431 F. 2d 980 (10th Cir. 1970), which reached a different conclusion based on similar facts.

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26 CFR 1.48-1: Definition of section 38 property.
(Also Section 38; 1.38-1.)

Investment credit; engraved plates and right to reproduce and distribute books. Limited partners in a partnership that purchased engraved plates and the right to reproduce and distribute books made from the plates may claim investment credit based only on the distinct cost of the engraved plates.

Rev. Rul. 80-327 [1]

ISSUE

Is a partnership entitled to use as its basis for the investment tax credit the amount paid to acquire engraved plates and the right to reproduce and distribute books made from the plates, under the circumstances described below?

FACTS

In March 1979 *P*, a corporation, contracted with certain book publishers to acquire the engraved plates necessary to print the text of hardcover and softcover books for 32 different literary works and the rights to print, publish, distribute, and sell the books in the English language. *P* paid 1,080*x* dollars in cash for these assets.

In August 1979 *P* offered to sell to individuals 24 units of a limited partnership, *X*, in which *P* would be the general partner. The purchase price of each unit of the limited partnership was 45*x* dollars, payable with a cash downpayment of 30*x* dollars and a promissory note of 15*x* dollars. The investor was personally liable on the promissory note, which was payable to *P* on February 15, 1980, with interest at the rate of 10 percent per annum.

P represented that each partner would be entitled to (1) a share of the investment tax credit based upon the purchase price of 1,080*x* dollars and (2) a share of the partnership losses, subject to the amount each is at risk within the meaning of section 465 of the Internal Revenue Code.

[1] Also released as News Release IR 80-118, dated November 14, 1980.

X acquired the engraved plates and the publication rights from *P*. From each set of plates, a number of books were printed and distributed for sale prior to December 31, 1979. *A*, who purchased one of the partnership units, deducted on *A*'s 1979 income tax return a share of the partnership losses limited to *A*'s at risk amount of 30*x* dollars and claimed a share of the investment tax credit based on the investment in the book properties.

LAW AND ANALYSIS

Section 38 of the Internal Revenue Code allows a credit against federal income tax for qualified investment in "section 38 property" as defined in section 48. Section 48(a)(1) provides that only certain tangible property, which is depreciable and has a useful life of 3 years or more qualifies as section 38 property. Section 1.48-1(f) of the Income Tax Regulations provides that intangible property does not qualify as section 38 property.

The investment tax credit is allowed only for tangible property. Engraved plates are tangible property that is necessary to produce hardcover and softcover books. The legal right to print, publish, distribute and sell books is an item of property separate and distinct from the plates necessary for the mechanical production of those books. The particular plates in question do not, in themselves, carry the right to print the work. Similar plates could be produced once the legal right to print, produce, distribute and sell the work is acquired. The right to reproduce and distribute hardcover and softcover books in the English language is one of several reproduction rights that emanate from the copyright of a literary work. That right is an intangible. *See* Rev. Rul. 70-403, 1970-2 C.B. 3. The investment tax credit, therefore, is applicable only to the tangible assets, which are the engraved plates. Thus, the maximum basis for purposes of computing the

credit would be the distinct cost of the engraved plates.

During 1979, *A*'s amount at risk is limited to the cash invested of $30x$ dollars. *A* is not at risk with respect to the amount of the promissory note payable to *P*, because *P* has an interest in the activity other than that of a creditor. *See* Section 465(b)(3)(A) of the Code.

HOLDING

X may claim the investment tax credit based on the cost of the engraved plates only.

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26 CFR 1.48-1: Definition of section 38 property.
(Also Section 38; 1.38-1.)

Investment credit; fish raising. The commercial raising of fish for food is a production activity within the meaning of section 48(a)(1)(B)(i) of the Code. Concrete raceways and concrete-lined water diversion canals that are designed and constructed to remain permanently in place and that are used as an integral part of the activity of raising fish qualify as section 38 property.

Rev. Rul. 80-341

ISSUE

Is the commercial raising of fish for food a production activity within the meaning of section 48(a)(1)(B)(i) of the Internal Revenue Code?

FACTS

Taxpayer is in the business of raising rainbow trout for sale to fish processing plants and other customers. Fertile eggs are purchased from a commercial fish breeder, hatched, and raised to market size, normally 10 to 12 inches in length. Taxpayer's facility includes a fish hatchery, which contains workspace and houses the necessary tanks and equipment for hatching eggs and growing the fish to a length of approximately 2 inches; outdoor raceway to which the fish are transferred and held until they reach market size; and a concrete-lined water diversion canal system that carries fresh water from a main spring water transmission ditch to the hatchery and raceways and then discharges the used water into a nearby river. The hatchery, which requires a constant supply of fresh water, is a one-story 30-by 90-foot concrete block structure. The raceways are rectangular, concrete-lined excavations varying in length from 70 to 100 feet and are approximately 3.5 feet deep. To control the volume of water entering the raceways, concrete head and tail gates are constructed at the ends. A vertical drop is necessary between sets of raceways for the water to achieve the required oxygen content.

In 1978, taxpayer constructed 12 new raceways and water diversion canals that supply the raceways. The taxpayer's new concrete raceways and concrete-lined canals are tangible depreciable property with a determinable useful life in excess of 3 years. Such property is depreciable property within the meaning of section 167 of the Code. Thus, the question presented is whether the raceways and canals are "section 38 property" for purposes of the investment tax credit.

LAW AND ANALYSIS

Section 48(a)(1) of the Code provides that the term "section 38 property" means (a) tangible personal property, or (b) other tangible property (not including a building and its structural components) but only if such property is used as an integral part of manufacturing, production, extraction, or certain other specified activities. Section 38 property includes only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life of 3 years or more.

Section 1.48-1(d)(2) of the Income Tax Regulations provides that for the purpose of the credit allowed by section 38 of the Code the terms "manufacturing," "production," and "extraction" include the raising of livestock.

Section 1.48-1(l)(1) of the regulations provides, in part, that the term "livestock" includes cattle, hogs, sheep, goats, and mink and other furbearing animals.

Taxpayer's concrete raceways and water diversion canals are inherently permanent structures that are not tangible personal property. For such structures to qualify as section 38 property, they must, therefore, qualify as other tangible property used as an integral part of "production" or one of the other activities specified by section 48(a)(1)(B)(i) of the Code.

The commercial activity of raising fish in an area where they are artificially fed, protected, cared for, etc., as opposed to the activity of merely catching and harvesting fish, is generally considered to be a farming activity. See, for example, section 1.175-3 of the regulations, which provides that for purposes of section 175 of the Code, the term "farm" is used in its ordinary, accepted sense and includes fish farms. For purposes of the investment tax credit, the term "production" is defined by section 1.48-1(d)(2) to include certain farming activities such as "the cultivation of the soil" and "the raising of livestock." The activities specifically listed in the definition, while indicating the kinds of activities to be treated as production, are illustrative and not all-inclusive. Other activities may be considered production activities if the facts indicate that the business purpose, processing steps, and economics involved are similar to those involved in an activity listed in the definition. In the present case, because the purpose, processing steps, and economics involved in the raising of fish are very similar to those involved in the raising of livestock, taxpayer's business of raising rainbow trout for sale for food is considered to be a production activity within the meaning of section 1.48-1(d)(2).

Rev. Rul. 68-279, 1968-1 C.B. 18,

holds that a lobster pound constructed by a taxpayer engaged in the wholesale lobster business is not "section 38 property" for purposes of the investment credit. The activities conducted in the lobster pound, such as retention of lobsters until they are marketable, periodic feeding, and daily testing of water for temperature and oxygen content, are necessary functions of a lobster wholesaler and are not "manufacturing," "production," or "extraction" as defined in section 1.48-1(d)(2) of the regulations.

HOLDING

The commercial raising of fish for food is a production activity within the meaning of section 48(a)(1)(B)(i) of the Code. Therefore, the concrete raceways and the concrete-lined water diversion canals that are designed and constructed to remain permanently in place and that are used as an integral part of the activity of raising fish are other tangible property that qualifies as "section 38 property" for purposes of the investment tax credit.

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26 CFR 1.48-1: Definition of section 38 property.

Whether the liability created by a note given as the purchase price for a synthetic oil converter is included in the partnership's basis in the converter for purposes of the investment tax credits. See Rev. Rul. 80-235, page 229.

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26 CFR 1.48-2: New section 38 property.

Investment credit; computer using reconstructed circuit boards. New computers that contain reconstructed circuit boards that conform to design characteristics similar to new unused components and that had been used in, and salvaged from, old scrapped computers qualify as "new section 38 property" when leased to customers.

Rev. Rul. 80-313

ISSUE

Do new computers that use reconstructed circuit boards that had been used in, and salvaged from, old computers qualify as new section 38 property when leased to customers?

FACTS

During 1975, the taxpayer was in the business of manufacturing, selling, and leasing computers. A computer product line generally becomes obsolete because of improvements in computer design. At the time of construction, the taxpayer's computers were estimated to have a useful life of 3 or more years.

After a computer is determined to be obsolete, the taxpayer withdraws it from leasing and scraps the computer, salvaging any reusable or serviceable parts. For accounting purposes, the scrapping of the computer is treated as an extraordinary retirement. When gain is not recognized on retirement, the adjusted basis is used as the basis in the materials and supply account when the parts are retired; however, if a loss is recognized on the retirement, the estimated salvage value, or the fair market value if greater at the time of retirement, is capitalized as the cost of such parts in the materials and supply account.

A major component used in the manfacture of a computer is its printed circuit boards, the configuration of which is dictated by the design of the computer. The printed circuit boards are salvaged from scrapped computers by the taxpayer for further use in newly designed computers.

These circuit boards are made up of integrated printed circuits. After being salvaged, these boards are reconstructed by rewiring or adding new circuitry to them so that they are able to perform their newly designed function in the same way that a wholly new board would perform the same function. Therefore, the reconstructed circuit board is equivalent to a new circuit board.

The reconstructed circuit boards are then used in association with other new components in the construction of new computers.

LAW AND ANALYSIS

Section 38 of the Internal Revenue Code allows a credit against the federal income taxes for qualified investment in new section 38 property. The determination of what property qualifies and whether it is new or used section 38 property is made in accordance with rules provided in section 48.

Section 48(a)(1) of the Code defines section 38 property as including tangible personal property with respect to which depreciation is allowable and having a useful life of 3 or more years.

Section 48(b) of the Code and section 1.48-2(a) of the Income Tax Regulations define new section 38 property as property, the construction, reconstruction, or erection of which was completed by the taxpayer after December 31, 1961, or was acquired by the taxpayer after that date provided the original use commences with the taxpayer after that date.

Section 1.48-2(b)(3) of the regulations provides that it is not necessary that materials entering into construction, reconstruction, or erection be new in use.

Section 1.48-2(b)(7) of the regulations provides that property will not be treated as reconditioned or rebuilt merely because it contains used parts.

Rev. Rul. 68-111, 1968-1 C.B. 29, concerns a railroad company that purchased and placed in service a current model diesel-electric locomotive to replace a locomotive that it had used in its trade or business for more than 8 years. In the purchase transaction, the replaced locomotive was traded in and its value allowed as a part of the purchase price of the replacement locomotive. The replacement locomotive was constructed by the manufacturer with some used materials and parts from its inventory. The ruling holds that the locomotive is new section 38 property within the meaning of section

48(b) of the Code and section 1.48-2 (b) of the regulations.

The method for determining the basis of recovered parts and components accounted for as mass assets salvaged from retired computers and reused to construct new section 38 property to be taken into account for investment credit purposes is described in Rev. Rul. 80-311, page 5, this Bulletin. A change to the method described in Rev. Rul. 80-311 is a change in method of accounting within the meaning of section 446 of the Code.

In this case, the newly designed computers, containing the salvaged and reconditioned circuit boards, go through a complete assembly process. The reconstructed circuit boards are reworked, tested and modified to perform a specific function. These circuit boards conform to design characteristice similar to new unused components that are to be incorporated into the new computer.

As recognized in section 1.48-2(b)(7) of the regulations, the presence of used circuit boards does not require the computers to be treated as reconditioned or rebuilt property. The new computers have different performance characteristics, are newly manufactured with new and used parts after December 31, 1961, and the original use will occur with the taxpayer after that date.

HOLDING

The new computers that are manufactured using reconstructed printed circuit boards that have been used in, and salvaged from, old computers qualify as new section 38 property when leased to customers.

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26 CFR 1.48-2: New section 38 property.

Tax treatment of retired recovered mass asset materials from an electric utility's distribution and transmission systems. See Rev. Rul. 80-311, page 5.

Part VI.—Minimum Tax for Tax Preferences

Section 56.—Imposition of Tax

26 CFR 1.56-1: Imposition of tax.

Application of minimum tax to preference deductions that do not provide a tax benefit. See Rev. Rul. 80-226, below.

Section 57.—Items of Tax Preference

26 CFR 1.57-1: Items of tax preference defined.
(Also Section 56, 58; 1.56-1.)

Minimum tax; tax benefit; preference deductions. Section 58(h) of the Code limits the application of the minimum tax to preference deductions that provide a tax benefit to the taxpayer. Steps to be followed in computing the minimum tax when a taxpayer has preference deductions that do not yield a tax benefit are provided.

Rev. Rul. 80-226

ISSUE

Does section 58(h) of the Internal Revenue Code limit the application of the minimum tax to preference deductions that provide a tax benefit to the taxpayer?

FACTS

The taxpayer and the taxpayer's spouse filed a joint federal income tax return (Form 1040) for the year ended December 31, 1978, and elected to itemize deductions.

The taxpayers' combined gross income for 1978 was 260*x* dollars consisting of wages and capital gains. The taxpayers' deductions from gross income, in computing adjusted gross income, consisted of a section 1202 deduction for capital gains of 30*x* dollars and nonpreference deductions of 130*x* dollars, resulting in an adjusted gross income of 100*x* dollars from which to subtract their itemized deductions.

In itemizing their deductions the taxpayers claimed a medical expense deduction of 10*x* dollars and other itemized deductions of 155*x* dollars. The taxpayers also claimed personal exemptions totalling 5*x* dollars.

The taxpayers listed their adjusted itemized deductions on Form 4625 (Computation of Minimum Tax—Individuals), as 40*x* dollars (itemized deductions not in excess of adjusted gross income of 100*x* dollars or 100*x* dollars, less 60 percent of adjusted gross income or 60*x* dollars). The taxpayers also listed 30*x* dollars of capital gains preference.

LAW AND ANALYSIS

Section 56(a) of the Code provides that in addition to the other taxes imposed by Chapter 1 of the Code, there is imposed for each taxable year, with respect to the income of every person, a tax equal to 15 percent of the amount by which the sum of the items of tax preference exceeds the greater of (1) $10,000 or (2) the regular tax deduction for the taxable year as determined under section 56(c).

Section 57(a) of the Code provides, for taxable years beginning before January 1, 1979, that adjusted itemized deductions for the taxable year of taxpayers other than corporations are items of tax preference subject to the 15 percent minimum tax. For taxable years beginning after December 31, 1978, adjusted itemized deductions are subject to an alternative minimum tax under section 55.

Section 57(b) of the Code defined "adjusted itemized deductions" for the taxable years beginning in or after 1977, but before January 1, 1979, as the amount by which the sum of the

deductions for the taxable year other than (A) deductions allowable in arriving at adjusted gross income, (B) the deduction for personal exemptions, (C) the deduction for medical, dental, etc. expenses, (D) the deduction for casualty losses described in section 165(c)(3), and (E) the deduction allowable under section 691 (c), exceeds 60 percent (but does not exceed 100 percent) of the taxpayer's adjusted gross income for the taxable year.

Section 58(h) of the Code provides that items of tax preference are to be properly adjusted when the tax treatment giving rise to such items does not result in a reduction of the taxpayer's tax under subchapter A of Chapter 1 of the Code.

The intent of Congress in enacting section 58(h) of the Code was that tax preference items that are of no tax benefit to a taxpayer are not to be included in the computation of the minimum tax on tax preferences. See S. Rep. No. 94-938, 94th Cong., 2d Sess. 113 (1976), 1976-3 C.B. (Vol. 3) 151.

To the extent itemized deductions (other than medical expenses and casualty losses) exceed adjusted gross income they are not considered in the computations under section 57(b) for taxable years beginning before January 1, 1979. If itemized deductions do not otherwise provide a tax benefit, they are not subject to the minimum tax under section 58(h).

In determining the extent to which a taxpayer's tax preference items of deduction reduce the taxpayer's gross income and thereby provide a tax benefit, a taxpayer will be treated as using all nonpreference deductions first (other than those itemized deductions that exceed 100 percent of adjusted gross income computed without regard to preference deductions), followed by preference items of deduction to the extent necessary to reduce taxable income to zero. This approach will limit a taxpayer's items of tax preference to the excess of (1) taxable income computed without regard to preference items, over (2) taxable income computed with regard to preference items. This excess represents the actual tax benefit received by a taxpayer from preference items.

The amount of preference items yielding a tax benefit equals gross income minus the taxpayer's "preference exclusion." In the case of a taxpayer with an adjusted itemized deductions preference, the "preference exclusion" is computed by totalling (1) nonpreference deductions allowable in arriving at adjusted gross income, (2) medical deductions and casualty losses, (3) itemized deductions to the extent of 60 percent of adjusted gross income computed without regard to deductions which are preference items, and (4) the deductions for personal exemptions.

The preference exclusion in the present case, of $223x$ dollars, includes the $130x$ dollars of nonpreference deductions used in arriving at adjusted gross income, the medical expense deduction of $10x$ dollars, itemized deductions to the extent of 60 percent of adjusted gross income computed without regard to deductions which are preference items, $78x$ dollars, and personal exemptions of $5x$ dollars. These nonpreference items are subtracted from gross income to determine the amount of preference deductions from which the taxpayers have received a tax benefit. Thus, $223x$ dollars is subtracted from the taxpayers' gross income of $260x$ dollars yielding $37x$ dollars. The taxpayers have $70x$ dollars in preference items ($30x$ dollars of capital gains preference plus adjusted itemized deductions equal to 40 percent of adjusted gross income, $40x$ dollars). Therefore, the taxpayers received a tax benefit from preference items to the extent of $37x$ dollars. The remaining $33x$ dollars of preference items did not yield the taxpayers any tax benefit and are not taken into account in computing their minimum tax liability.

HOLDING

The taxpayers' minimum tax for 1978 is computed by subtracting $10,000 from the $37x$ dollars for which they received a tax benefit and then taking 15 percent of that amount.

Section 58.—Rules for Application of This Part

Application of minimum tax to preference deductions that do not provide a tax benefit. See Rev. Rul. 80-226, page 26.

Subchapter B.—Computation of Taxable Income
Part I.—Definition of Gross Income, Adjusted Gross Income, Taxable Income, etc.

Section 61.—Gross Income Defined

26 CFR 1.61-1: Gross income.
(Also Section 72; 1.72-1.)

Gross income; interest; wrap-around annuity contracts. Under an agreement between a life insurance company and a federally insured saving and loan association, depositors in the savings and loan association purchase group single premium retirement annuity contracts from the insurer, and the insurer invests the proceeds, less certain expenses, in separate accounts with the savings and loan association until the annuity starting dates. The policyholders, and not the insurer, are the owners of the accounts for federal income tax purposes prior to the annuity starting dates, and the interest earned on the accounts is includible in the policyholders' gross incomes.

Rev. Rul. 80-274 [1]

ISSUE

Is the life insurance company or the depositor the owner for federal income

[1] Also released as News Release IR-80-97, dated September 24, 1980.

tax purposes of the savings and loan accounts established in accordance with the annuity plans described below?

FACTS

L, a life insurance company taxable under section 802 of the Internal Revenue Code, has developed so-called group single premium retirement annuity contracts ("annuity plans") that have been approved in several states by their respective regulatory departments. The terms "annuity" and "policyholder" as used in this revenue ruling are for descriptive convenience only and are not intended to have any substantive legal significance.

L has entered into agreements with participating federally insured savings and loan associations. Under each agreement, the participating association is designated as the group contract-holder under an annuity plan. *L* sells annuity contracts under the plan to existing depositors of the participating association and others wishing to establish accounts with the association ("depositors").

Under a plan, a depositor transfers cash, an existing passbook savings and loan account, or certificate of deposit to *L* in exchange for an annuity contract. The amount paid by the depositor to *L* is reduced by *L* from 2 to 5 percent for sales expenses, administrative expenses, and any premium tax imposed on *L*. This reduced amount is segregated by *L* and deposited into a separate account of the savings and loan association of the depositor. The amounts deposited are invested in a certificate of deposit for a term designated by the depositor. When the certificate of deposit expires, *L* is required under the contract to reinvest the proceeds in a certificate of deposit for the same duration unless an investment of the same duration would extend beyond the annuity starting date. In that event, a certificate of deposit with a maturity not extending beyond the annuity starting date will be purchased. If no such certificate of deposit is available, the funds will be invested in a passbook savings account.

At the option of the depositor (referred to in the contract as the "policyholder") additional amounts may be transferred to *L* that become part of the consideration for the contract.

Pursuant to the agreement between *L* and the participating savings and loan association, *L* may not dispose of the deposit, or convert it into a different asset, other than in accordance with the reinvestment provisions described above. *L* may not use the deposit for any purpose other than to benefit the particular policyholder. This arrangement is intended to afford each policyholder's deposit the maximum federal insurance coverage of $100,000 per account under federal regulations.

L does, however, retain the right to withdraw the deposits from a failing savings and loan association or from an association that terminates the plan. In the event of withdrawal, *L* must deposit the withdrawn amounts in another federally-insured savings and loan association.

Interest earned on the investments is credited annually to each anuity account by *L* after payment to *L* of an annual management fee of one percent of the accumulated value of the account. *L* guarantees that the deposit will earn interest at 4 percent per year compounded annually from the date of deposit. The current yields for certificates of deposit offered by the association range from 7% to 11% depending upon the term of the certificate. The policyholders have no contractual relationship with the association. Their rights are derived solely from their annuity contracts, and *L* may satisfy its obligations to the policyholders under these contracts using funds derived from sources other than the accounts held pursuant to the plans.

A policyholder may withdraw all or a portion of the cash surrender value of the contract at any time prior to the annuity starting date upon written request to *L*. The cash surrender value of the contract is the amount deposited plus interest credited less a charge for withdrawal. The withdrawal charge is the early withdrawal penalty charged by the savings and loan association plus any premium tax resulting from the withdrawal. The association does not have the right to distribute any assets from the savings and loan account directly to any policyholder or to any beneficiary or assignee.

The annuity contract allows the policyholder to elect one of a variety of settlement options including a lump-sum payment, a life income option, installment options for a specified period, and installment payments for a period certain and for life thereafter.

If a policyholder dies prior to the annuity starting date, a lump-sum is payable to the beneficiary in an amount equal to the cash surrender value on the date of death. The beneficiary, however, may instead elect to receive either an annuity for a term certain or a lifetime annuity, subject to a guaranteed minimum number of monthly installments.

LAW AND ANALYSIS

Section 61(a) of the Internal Revenue Code provides that gross income means all income from whatever source derived, including interest.

To the extent that a policyholder under an annuity contract with a life insurance company possesses substantial incidents of ownership in an account established by the insurance company at the direction of the policyholder, the policyholder may be considered the owner of the account for federal income tax purposes. See Rev. Rul. 77-85, 1977-1 C.B. 12.

Under the annuity contract, the policyholder's position is substantially identical to what the policyholder's position would have been had the investment been directly maintained or established with the savings and loan

association. Prior to the annuity starting date, *L* is little more than a conduit between the policyholder and the savings and loan association.

HOLDING

Prior to the annuity starting date, the policyholder, and not *L*, is the owner of the savings and loan account for federal income tax purposes and the interest on the account is thus includible in the policyholder's gross income under section 61(a) of the Code.

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26 CFR 1.61-1: Gross income.
(Also Sections 167, 191.)

National Historic Preservation Act of 1966. Payments received by a taxpayer under section 101 of the National Historic Preservation Act of 1966 are includible in the taxpayer's gross income.

Rev. Rul. 80-330

ISSUE

Are payments received by taxpayers pursuant to the National Historic Preservation Act of 1966, section 101, 16 U.S.C. sections 470 to 470t (1976), as amended, includible in their gross incomes?

FACTS

Under 16 U.S.C. section 470a, the Secretary of the Interior is authorized to establish a program of matching grants-in-aid to states for projects having as their purpose the preservation for public benefit of properties that are significant in American history, architecture, archeology, and culture. The term "project" means programs of state and local governments and other public bodies and private organizations and individuals for the acquisition of title or interests in, and for the development of, any district, site, building, structure, or object that is significant in American history, architecture, archeology, and culture, or property used in connection therewith, and for its development in order to assure the preservation for public benefit of any such historical properties. The term "historic preservation" includes the protection, rehabilitation, restoration, and reconstruction of districts, sites, buildings, structures, and objects significant in American history, architecture, archeology, or culture.

Upon approval of an application submitted to the Department of the Interior, grant funds, not exceeding 50 percent of the total cost of the project, are awarded by the Department to the state. The state distributes the federal funds to the persons responsible for the various programs for which the federal funds are awarded. Properties for which funds are provided must be included in or eligible for inclusion in the National Register of historic places.

A, a professional person, purchased a house that is included in the National Register and received grant funds from the state to restore the house, which *A* intended to use only as an office.

LAW AND ANALYSIS

Section 61 of the Internal Revenue Code and the Income Tax Regulations thereunder provide that, except as otherwise provided by law, gross income means all income from whatever source derived.

The Internal Revenue Service has consistently held that payments made under legislatively provided social benefit programs for the promotion of general welfare are not includible in the recipients' gross incomes. See, for example, Rev. Rul. 76-395, 1976-2 C.B. 16, concerning home rehabilitation grants received under the Housing and Community Development Act of 1974, Pub. L. 93-383, 1974-2 C.B. 418, and Rev. Rul. 76-144, 1976-1 C.B. 17, concerning grants received under the Disaster Relief Act Amendments of 1974, Pub. L. 93-288, 1974-2 C.B. 414.

The payments in this case are distinguished from welfare program payments such as those involved in Rev. Rul. 76-395 and Rev. Rul. 76-144. The ultimate recipients of the payments in this case can be governmental units and other organizations exempt from federal income taxation and they can be taxpayers, including individuals, corporations, and unincorporated entities. Payments made to individuals can be made with respect to the individual's personal residence, and they can be made with respect to property used in the individual's trade or business or for the production of income. Thus, the payments are not based on an individual recipient's personal financial status, health, educational background, or employment status, nor are they intended to improve the living conditions of low-income homeowners. Rather, the purpose of the payments is to preserve historically significant structures. Thus, the payments are not made under a social benefit program for the promotion of general welfare.

HOLDING

The payments received by *A* are includible in *A*'s gross income under section 61 of the Code. Because the house is used in *A*'s trade or business, *A* is entitled to a deduction under section 191, concerning amortization of certain rehabilitation expenditures for certified historic structures, or section 167(o) concerning depreciation with respect to such structures.

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26 CFR 1.61-1: Gross income.
(Also Sections 162, 527; 1.162-1.)

Surplus campaign funds transferred to office account. Surplus campaign funds transferred to an officeholder's office account are includible in gross income for the year the funds are transferred. Amounts disbursed from the office account for ordinary and necessary expenses of serving as an officeholder are deductible under section 162(a) of the Code, provided

the expenses otherwise qualify under that section and are not reimbursable.

Rev. Rul. 80-331

ISSUE

What are the federal income tax consequences to an officeholder of transfers of excess campaign funds to an office account?

FACTS

The transfer of excess campaign funds to an office account is specifically permitted under the Federal Election Campaign Act (FECA), 2 U.S.C. section 439a (1976), which is implemented by regulations issued by the Federal Election Commission (FEC), 11 CFR 113.

Section 113.2 of the FEC regulations provides, in part, that excess campaign funds may be used to defray any ordinary and necessary expenses incurred in connection with the recipient's duties as a holder of federal office.

Section 113.1(e) of the FEC regulations provides that the term "excess campaign funds" means amounts received by a candidate as contributions that the candidate determines are in excess of any amount necessary to defray the candidate's campaign expenditures.

Section 113.1(b) of the FEC regulations provides, in part, that the term "office account" means an account established for the purposes of supporting the activities of a federal officeholder that contains excess campaign funds and funds donated for the purpose of supporting the activities of the officeholder. An office account does not include (1) an account used exclusively for funds appropriated by Congress, (2) an account of the officeholder that contains only the personal funds of the officeholder, or (3) an account containing only appropriated funds and personal funds of the officeholder.

LAW AND ANALYSIS

Section 61(a) of the Internal Revenue Code and the Income Tax Regulations thereunder provide that, except as otherwise provided by law, gross income means all income from whatever source derived.

Section 162(a) of the Code provides that a taxpayer may deduct all the ordinary and necessary expenses incurred during the taxable year in carrying on any trade or business.

Section 527(a) of the Code provides that a political organization is subject to income taxation only to the extent provided in section 527.

Section 527(e)(1) of the Code provides that the term "political organization" means a party, committee, association, fund, or other organization (whether or not incorporated) organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures, or both, for an exempt function.

Section 527(e)(2) of the Code provides that the term "exempt function" means the function of influencing or attempting to influence the selection, nominating, election, or appointment of any individual to any federal, state, or local public office or office in a political organization, or the election of presidential or vice-presidential electors, whether or not such individual or electors are selected, nominated, elected, or appointed.

Section 527(d) of the Code provides that an amount is not treated as diverted for the personal use of a candidate or any other person if any political organization contributes the amount to or for the use of another qualifying political organization or certain charitable organizations or deposits the amount in the general fund of the Treasury or in the general fund of any state or local government.

In discussing the provisions of section 527(d) of the Code, Rep. No. 93-1357, 93rd Cong., 2d Sess. 30 (1974), 1975-1 C.B. 517, 534, states: "As under present law, when amounts are diverted from a political organization by a candidate for his personal use, the amount diverted is taxable income to the candidate in the year in which the funds are diverted."

When excess campaign funds are transferred to an office account, they are diverted for the personal use of the officeholder because the transfer is not an expenditure for an exempt function as defined in section 527(e)(2) of the Code and because the transfer is not a contribution or deposit described in section 527(d).

HOLDINGS

(1) Excess campaign funds transferred to an officeholder's office account are includible in the gross income of the officeholder under section 61 of the Code for the year in which the funds are transferred.

(2) Amounts disbursed from the office account for ordinary and necessary expenses paid or incurred by the officeholder during the taxable year in carrying on the officeholder's trade or business as an officeholder are deductible under section 162(a) of the Code, provided the requirements of that section are otherwise satisfied and the expenses are not reimbursable.

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26 CFR 1.61-1: Gross income.

Partner's earnings as executor remitted to partnership. A partner in an accounting firm was appointed executor of an estate in a state whose laws prohibit a partnership from serving as executor. Permission to accept the appointment was granted by the partnership and the fees received were turned over to it. The earnings are partnership income and excluded from the partner's individual gross income. Rev. Rul. 54-167 distinguished.

Rev. Rul. 80-338

ISSUE

Are fees earned by a partner, under

the circumstances described below, income of the partnership or of the individual partner?

FACTS

A, an individual, is a partner in accounting firm *P*. *P* requires that its partners obtain permission from *P* before engaging in business activities not directly related to the business of *P*. *A* was named executor of an estate in state *M*. Under the laws of state *M*, letters of administration are not issued to partnerships; therefore, *P* could not be appointed or serve as an executor. *P* approved *A*'s taking the position as executor subject to the requirement that the services provided by *A* would not include those available from *P* and that all fees earned by *A* be turned over to *P*.

LAW AND ANALYSIS

Section 61(a) of the Internal Revenue Code provides that gross income includes compensation for services, including fees, commissions, and similar items and a partner's distributive share of partnership income.

As long as the source of the income earned by a partner has a business nexus with the partnership, the income is included in the partnership's taxable income and excluded from the taxable income of the partner who received it. See *Bufalino v. Commissioner*, T.C.M. 1976-110.

Rev. Rul. 54-167, 1954-1 C.B. 152, holds that if a partnership may not perform the services of an elected public official for which a partner, in the partner's individual capacity, received compensation, the partner is required to report the compensation on his or her individual return, even though such compensation is pooled with the earnings of the partnership as required by the partnership agreement.

Rev. Rul. 64-90, 1964-1 (Part I) C.B. 226, which amplifies Rev. Rul. 54-167, holds that if the services provided by a partner in the partner's individual capacity are similar to those provided by the partnership, then the compensation for those services is partnership income if paid to the partnership in accordance with the partnership agreement.

In this revenue ruling the services provided by *A* as an executor depend on the exercise of *A*'s expertise and are similar to the services provided by *A* for *P*. Therefore, the compensation for the services by *A* as an executor is partnership income if paid to the partnership in accordance with the partnership agreement.

This case is distinguishable from Rev. Rul. 54-167. Although under the laws of state *M*, a partnership cannot be named an executor, such a function is within the range of services undertaken by accountants. It is not unusual in an accounting or legal practice that specific responsibilities must be assumed by an individual partner rather than by the partnership.

HOLDING

The fees that *A* earns as an executor and turns over to *P* are partnership income and are excluded from *A*'s gross income. However, *A*'s distributive share of *P*'s income must be reported on *A*'s U.S. Individual Income Tax Return (Form 1040).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 54-167 is distinguished.

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26 CFR 1.61-1: Gross income.
(Also Sections 162, 3121, 3306, 3401; 1.162-2, 31.3121(a)-1, 31.3306(b)-1, 31.3401(a)-1.)

Reimbursed convention expenses and lost salary; labor union members. Amounts paid by an international labor union to reimburse delegates from local chapters for expenses of traveling away from home to attend the annual convention are not includible in gross income, and no deduction is allowable for the reimbursed expenses under section 162 of the Code, even though reimbursement is received in a later year. Amounts received by the delegates as reimbursement for lost salary are includible in gross income, but are not "wages" under sections 3121, 3306, and 3401. Rev. Rul. 78-209 modified and superseded.

Rev. Rul. 80-348

FACTS AND HOLDING

The Internal Revenue Service has reconsidered Rev. Rul. 78-209, 1978-1 C.B. 25, which holds that reimbursements received by elected representatives of union locals from their international union for expenses of traveling away from home incurred in attending the union's annual convention and for lost salary in connection therewith are includible in the delegates' gross incomes under section 61 of the Internal Revenue Code, but are not "wages" subject to withholding under sections 3121(a), 3306(b), and 3401(a).

The question has also been raised as to the application of section 162(a)(2) of the Code, particularly in circumstances where the local union representative incurred the travel expenses in one taxable year and received reimbursement from the international union in the following taxable year.

Ordinarily, travel expenses incurred while away from home in carrying on any trade or business are deductible under section 162(a)(2). However, taxpayers are not allowed deductions under section 162(a) for expenditures for which they have a right or expectation of reimbursement. *Burnett v. Commissioner*, 356 F.2d 755 (5th Cir. 1966); *Canelo v. Commissioner*, 53 T.C. 217, 225 (1969), *aff'd*, 447 F.2d 484 (9th Cir. 1971); Rev. Rul. 79-263, 1979-2 C.B. 82.

Travel expenditures incurred at the close of one taxable period, even though they would otherwise be allowable under section 162(a)(2) of the

Code, may not be deducted because of the expectation of reimbursement. Also, the reimbursement that is received in the following taxable period would not be includible in income. See Rev. Rul. 79-263; see also Rev. Rul. 79-142, 1979-1 C.B. 58, concerning exclusion from taxpayer's gross income of certain reimbursements.

Accordingly, the reimbursements in question are not includible in gross income, and no deductions are allowable for the reimbursed expenses under section 162 of the Code even if reimbursement does not occur until a later year. Reimbursements for lost salary are, however, includible in gross income in the year received, but are not "wages" for employment tax purposes.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 78-209 is modified to the extent it holds that the reimbursement of expenses of traveling away from home incurred by a union representative is includible in the representative's gross income and, as modified, superseded.

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26 CFR 1.61-1: Gross income.

The federal income tax consequences to a corporation and its executives when the corporation "leases" suits for its executives. See Rev. Rul. 80-322, page 36.

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26 CFR 1.61-1: Gross income.

Whether a creditor-taxpayer may suspend the accrual of interest income on a loan that becomes uncollectible during the taxable year. See Rev. Rul. 80-361, page 164.

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26 CFR 1.61-1: Gross income.

Whether court awarded payments of interest, attorney's fees and back pay are includible in gross income. See Rev. Rul. 80-364, page 294.

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26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.
(Also Sections 83, 1012, 2511, 2512; 1.83-1, 1.1012-1, 25.2511-1, 25.2512-8.)

Transfer of stock by controlling shareholders to corporate employees. The transfer of a corporation's stock by the corporation's two shareholders to three employees for a valid business reason, to retain valuable employees, is compensation, is made for adequate and full consideration, and is not subject to the gift tax.

Rev. Rul. 80-196

ISSUE

What are the federal income and gift tax consequences of a transfer of stock under the situation described below?

FACTS

In 1979, *A* and *B*, individual founders of corporation *X*, each owned 50 percent of the 30,000 shares outstanding of the common stock of *X*. *X* employed 200 individuals. On December 31, 1979, *A* and *B* each transferred 100 shares of *X* to *N*, *O*, and *P* as a bonus in consideration of past services to *X*. *N*, *O*, and *P* were key employees of *X*, had provided exceptional duties to *X* for more than 5 years, and were considered valuable to the continued success of *X*. The stock transferred to them was fully transferable and not subject to any restrictions. Neither *A* nor *B* was related to *N*, *O*, or *P*, nor did any special personal relationship exist with *N*, *O*, or *P*.

LAW AND ANALYSIS—INCOME TAX

Section 61 of the Internal Revenue Code provides that gross income means all income from whatever source derived, including compensation for services.

Section 83(a) of the Code provides that when property is transferred to a person in connection with the performance of services, the person who performed the services must include in gross income the excess of (1) the fair market value of the property on the first date that the property is transferable or not subject to a substantial risk of forfeiture over (2) the amount, if any, paid for the property. The taxable year of inclusion is generally the first taxable year in which the rights of the person receiving the property are substantially vested (transferable or not subject to a substantial risk of forfeiture).

Section 83(h) of the Code and the Income Tax Regulations thereunder provide that if section 83(a) applies to a transfer of property, the person for whom the services were performed will be allowed a deduction equal to the amount included in gross income by the person who performed the services, but only to the extent such amount meets the requirements of section 162 or 212 and the regulations thereunder. Where property is substantially vested when transferred, the person for whom the services were performed is allowed a deduction in accordance with that person's method of accounting (in conformity with sections 446 and 461).

Section 1.83-6(d) of the regulations provides that if a shareholder of a corporation transfers property to an employee of such corporation or to an independent contractor (or the beneficiary thereof) in consideration of services performed for the corporation, the transaction shall be considered to be a contribution to the capital of the corporation, and immediately thereafter a transfer by the corporation of the property to the employee or independent contractor.

HOLDINGS—INCOME TAX

1. *N*, *O*, and *P* must include in gross income, for 1979, the fair market value, on the date of transfer, of the stock received. Section 83 of the Code and Rev. Rul. 69-140, 1969-1 C.B. 45.

2. *N*, *O*, and *P*'s basis in the stock received is the amount included in gross income for 1979. Section 1012 of the Code.

3. *X* will be entitled to a deduction,

for its taxable year 1979, of an amount equal to the amounts included in income by *N*, *O*, and *P*, provided such deduction meets the requirements of section 162 of the Code. Section 83(h) of the Code and section 1.83-6(d) of the regulations.

4. *A* and *B* will not recognize gain or loss as a result of the transfer.

LAW AND ANALYSIS—GIFT TAX

Section 2511 of the Code contains a broad statement as to what transfers constitute taxable gifts. Any voluntary transfer of property or an interest in property, whether direct or indirect, by one to another for less than adequate and full consideration in money or money's worth is subject to the gift tax.

Section 2511(a) of the Code provides that the gift tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 25.2511-1(g)(1) of the Gift Tax Regulations provides that donative intent on the part of a transferor is not an essential element in the application of the gift tax to a transfer. Whether the gift tax is applicable is based upon the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor. The tax, however, is not applicable to transfers for full and adequate consideration in money or money's worth or to ordinary business transactions. Under section 25.2512-8 of the regulations a transfer of property made in the ordinary course of business (a transaction that is bona fide, at arm's length, and free of donative intent) will be considered as made for adequate and full consideration. *Estate of Anderson v. Commissioner*, 8 T.C. 706 (1947); *Bryan v. Commissioner*, 16 T.C. 972 (1951); *Weller v. Commissioner*, 38 T.C. 790 (1962).

In *Weller* the court noted that donative intent is not a requisite for a gift for tax purposes. However, the absence of donative intent is relevant under the regulations in determining whether a transfer is made in the ordinary course of business.

Section 2512(b) of the Code provides that where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift and shall be included in computing the amount of gifts during the calendar quarter. However, under section 25.2512-8 of the regulations, a transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from donative intent) will be considered as made for an adequate and full consideration in money or money's worth.

HOLDINGS—GIFT TAX

The transfer of 100 shares by each of *A* and *B* to each of *N*, *O*, and *P* were in the ordinary course of business, since they were motivated by a valid business reason, that is, retaining valuable personnel in the employment of *X*. Thus, the transfers are considered as made for adequate and full consideration for gift tax purposes. Therefor, the transfers by *A* and *B* are not subject to the gift tax.

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26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.
(Also Sections 3101, 3111, 3401, 3402; 31.3101-1, 31.3111-1, 31-3401(c)-1, 31.3402(a)-1.)

Lifetime services assigned to trust. A corporation's employee assigned "lifetime services" to a trust, and the trust contracted to provide services to the corporation for a monthly fee equal to what otherwise would be the employee's gross monthly salary. The employee continued to perform the same tasks for the corporation, under the same conditions, and with the same amount of control as before the assignment. The assignment is ineffective as a means of avoiding the employee's income tax liability with respect to the payments for the services, and the payments are wages for purposes of the FICA and income tax withholding.

Rev. Rul. 80-321 [1]

ISSUE

What are the federal tax consequences to both an employer and an employee where the employee's "lifetime services" are assigned to a trust in the circumstances described below?

FACTS

In March, 1980, the taxpayer, a U.S. citizen, was approached by the promoter of a trust arrangement under which an assignment of the taxpayer's "lifetime services" would be made to the trust. Shortly thereafter, the taxpayer paid the promoter a fee and entered into the trust arrangement.

Prior to the assignment of the taxpayer's lifetime services to the trust, the taxpayer was employed in the United States by the *M* corporation, a domestic corporation. *M* treated the taxpayer's salary as wages subject to withholding of federal income tax and FICA taxes (imposed by the Federal Insurance Contributions Act, chapter 21, subtitle C, Internal Revenue Code). *M* corporation also made direct payments of the FICA tax on employers due because of the taxpayer's employment. After the assignment to the trust, the promoter, as trustee of the trust, and *M* corporation entered into a "services contract" requiring the trust to provide services to *M* corporation for a monthly fee equal to what would otherwise be the taxpayer's gross monthly salary. As a result,

[1] Also released as News Release IR-80-114, dated October 30, 1980.

instead of paying salary to the taxpayer, *M* corporation made monthly payments under the "services contract" without withholding federal income tax or FICA tax from the payments. *M* also discontinued its payments of the employer's FICA tax due because of the taxpayer's employment.

The trust, after the subtraction of the trustee's fees, paid the income to the taxpayer and to other persons or accumulated it.

The taxpayer continued to perform the same tasks for the *M* corporation, under the same conditions, with the same amount of control, as before the assignment of "lifetime services" was made.

LAW AND ANALYSIS

Section 61 of the Internal Revenue Code provides that the term "gross income" includes, among other things, compensation for services.

Under section 3401 of the Code, the term "wages" means, with certain exceptions not relevant to this case, all remuneration "for services performed by an employee for his employer," and the term "employer" means the person for whom an individual performed any service as the employee of such person. Section 3402(a) imposes a general requirement that every employer making payment of wages shall deduct and withhold federal income tax from the wages.

Section 3101 of the Code imposes FICA tax on an individual on wages received with respect to employment. Section 3102 provides for deducting such tax from the wages of the employee. Section 3111 imposes FICA tax on an employer on wages paid with respect to employment.

Section 3121(a) of the Code provides that for purposes of the FICA taxes the term "wages" means all remuneration for employment with certain exceptions not relevant in this case. Section 3121(b) provides that for purposes of the FICA taxes the term "employment" means any service of whatever nature performed by an employee for a person employing such employee.

Section 31.3121(d)-1 (relating to the Federal Insurance Contributions Act) and section 31.3401(c)-1 (relating to collection of income tax at source on wages) of the Employment Tax Regulations provide that, generally, the relationship of employer and employee exists when the person for whom the services are performed has the right to control and direct the individual who performs the services not only as to the result to be accomplished by the work, but also as to the detail and means by which the result is accomplished.

Rev. Rul. 75-257, 1975-2 C.B. 251, deals with a "family estate trust," to which a taxpayer assigned "lifetime services." The revenue ruling concludes that the attempt to assign "lifetime services" to a trust is ineffective as a means of avoiding the taxpayer's personal income tax liability on income the taxpayer has earned. Similar conclusions were reached in *Vnuk v. Commissioner,* Civil No. 79-1925 (8th Cir., July 11, 1980), *aff'g* T.C.M. 1979-164; *Wesenberg v. Commissioner,* 69 T.C. 1005 (1978); *Morgan v. Commissioner,* T.C.M. 1978-401; and *Horvat v. Commissioner,* T.C.M. 1977-104, *aff'd* 582 F.2d 1282 (7th Cir. 1978), *cert. denied* 440 U.S. 959 (1979). The conclusion of Rev. Rul. 75-257 is equally applicable to the facts of this case.

The payments made by *M* after the taxpayer attempted the assignment of "lifetime services" were wages. *M* did not lose its status as employer by virtue of the contract requiring direct payments to the trust. Accordingly, the wages paid with respect to the taxpayer's services in the form of the lifetime services fee are subject to income tax withholding requirements and FICA taxes to the same extent as the wages paid directly to the taxpayer before the taxpayer entered into the contract.

HOLDINGS

(1) The taxpayer's assignment of "lifetime services" is ineffective as a means of avoiding the taxpayer's income tax liability with respect to payments made by *M* in connection with the taxpayer's services.

(2) The payments by *M* under the lifetime services contract are wages for the purposes of federal income tax withholding requirements and FICA taxes. *M* has failed properly to withhold such taxes with respect to the taxpayer's employment. *M* has also failed properly to pay the employer's FICA tax.

The holdings of this revenue ruling are equally applicable when the lifetime services are assigned to a foreign trust.

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26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.
(Also Sections 501, 3121, 3401; 1.501(d)-1, 31.3121(b)(8)-1, 31.3401(a)(9)-1.)

Earnings of members remitted to religious organization. A member of a religious organization who has taken a vow of poverty and is instructed by the organization's superiors to obtain outside employment must include the remuneration remitted to the organization in gross income, and the remuneration is subject to FICA and income tax withholding. Another member of the organization who has also taken a vow of poverty and is instructed to perform services in the business office of the church that supervises the organization is not required to include the remuneration remitted to the organization in gross income, and the remuneration is not wages subject to FICA. An organization that is substantially dependent on wages earned by some of its members from outside employment does not qualify for exemption under section 501(d) of the Code. Rev. Rul. 77-290 amplified.

Rev. Rul. 80-332

ISSUE

Is Rev. Rul. 77-290, 1977-2 C.B. 26, applicable to members of an organization described in section 501(d) of the Internal Revenue Code?

LAW AND ANALYSIS

Rev. Rul. 77-290 holds that a member of a religious order, who has taken a vow of poverty and is instructed by the order's superiors to obtain employment with a law firm in the state is an agent of the law firm, not the religious order, and must include the remuneration remitted to the order in gross income. The remuneration is wages subject to the taxes imposed by the Federal Insurance Contributions Act and income tax withholding.

Rev. Rul. 77-290 also holds that another member of the same order who has also taken a vow of poverty and is instructed by the order's superiors to perform services in the business office of the church that supervises the order is an agent of the religious order and is not required to include the remuneration remitted to the order in gross income. In this situation the remuneration is not wages subject to the FICA and income tax withholding.

Section 501(d) of the Code provides for the exemption from federal income tax of religious or apostolic associations or corporations, if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members.

HOLDING

Although Rev. Rul. 77-290 deals with members of religious orders, the reasoning set forth in Rev. Rul. 77-290 equally applies to members of organizations described in section 501(d) of the Code and of other religious organizations who have taken a vow of poverty.

Furthermore, it should be noted that if an organization is substantially dependent on wages earned by some of its members from outside employment, rather than on an internally operated business, it does not qualify for exemption from federal income tax under section 501(d) of the Code. See Rev. Rul. 78-100, 1978-1 C.B. 162.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 77-290 is amplified.

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26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.

Whether fringe benefits are includible in gross income. See Rev. Proc. 80-53, page 848.

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26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.

When an employee is in receipt of income because of the grant to the employee of a stock appreciation right. See Rev. Rul. 80-300, page 165.

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26 CFR 1.61-7: Interest.

Whether interest on obligations of a political subdivision of a state will be exempt from tax. See Rev. Rul. 80-171, page 44.

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26 CFR 1.61-7: Interest.

Whether interest on obligations of a political subdivision will be exempt from tax. See Rev. Rul. 80-188, page 47.

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26 CFR 1.61-7: Interest.

Whether interest on obligations of a political subdivision will be exempt from tax. See Rev. Rul. 80-193, page 49.

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26 CFR 1.61-7: Interest.

Whether interest on obligations of a political subdivision will be exempt from tax. See Rev. Rul. 80-204, page 51.

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26 CFR 1.61-7: Interest.

Inclusion in gross income of interest on a reverse mortgage loan. See Rev. Rul. 80-248, page 164.

26 CFR 1.61-7: Interest.

Whether interest to be paid on obligations of a political subdivision of a state will be exempt from tax. See Rev. Rul. 80-257, page 52.

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26 CFR 1.61-7: Interest.

Whether interest on obligations of a political subdivision will be exempt from tax. See Rev. Rul. 80-328, page 53.

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26 CFR 1.61-7: Interest.

Whether interest to be paid on obligations of a city will be exempt from tax. See Rev. Rul. 80-356, page 47.

Section 62.—Adjusted Gross Income Defined

26 CFR 1.62-1: Adjusted gross income.

Whether interest and state and local taxes are deductible in addition to the amount of passenger vehicle expenses determined by use of the standard mileage rate. See Rev. Proc. 80-32, page 767.

Part II.—Items Specifically Included in Gross Income

Section 72.—Annuities; Certain Proceeds of Endowment and Life Insurance Contracts

26 CFR 1.72-1: Introduction.

Whether the life insurance company or the individual depositor is the owner for federal income tax purposes of funds placed in federal savings and loan associations in connection with the purchase of retirement "annuity" contracts. See Rev. Rul. 80-274, page 27.

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26 CFR 1.72-11: Amounts not received as annuity payments.

Taxability of the employer's appreciated stock distributed from a qualified profit-sharing plan upon an employee's separation from service. See Rev. Rul. 80-258, page 137.

Section 79.—Group-Term Life Insurance Purchased for Employees

26 CFR 1.79-1: Group-term life insurance —general rules.

Employees' group-term life insurance; coverage brackets. Life in-

surance covering fewer than ten full-time employees that would meet the qualifications of section 1.79-1(c) of the regulations only if all three of its coverage brackets were taken into account is not group-term life insurance for purposes of section 79 of the Code if no employee has ever been covered under the middle bracket.

Rev. Rul. 80-220

ISSUE

Does the life insurance described below qualify as group-term life insurance for purposes of section 79 of the Internal Revenue Code?

FACTS

In 1979 *X* corporation established a plan to provide life insurance for its four full-time employees. The amount of protection for the employees was computed on the basis of coverage brackets (established by the insurer) as follows:

Bracket	*Description*	*Amount of Coverage*
1	officer/shareholder	$50,000
2	junior professional	$25,000
3	bookkeeper/secretary	$10,000

Of the four full-time employees, three were eligible for coverage under bracket 1 and the remaining employee was covered under bracket 3. Although additional employees have been hired by *X* since inception of the plan, no employee has ever been covered under bracket 2.

LAW AND ANALYSIS

Section 79(a) of the Code provides that the yearly cost of group-term life insurance provided by an employer on the life of any employee will be includible in the gross income of the employee to the extent that such cost exceeds the sum of the cost of $50,000 of such insurance and the amount (if any) paid by the employee toward the purchase of such insurance.

Section 1.79-1(c) of the Income Tax Regulations provides that, as a general rule, life insurance provided to a group of employees cannot qualify as group-term life insurance unless, at some time during the calendar year, it is provided to at least ten full-time employees who are members of the group of employees. However, the general rule does not apply if, among other conditions, the amount of insurance provided is computed either as a uniform percentage of compensation or on the basis of coverage brackets established by the insurer. In general, the amount of insurance provided employees in a coverage bracket may not exceed 2½ times the coverage of the next lower bracket and the coverage of the lowest bracket must be at least 10 percent of the coverage of the highest bracket.

In the present case, the employees of *X* (a group including less than ten full-time employees) are entitled to amounts of insurance computed on the basis of three coverage brackets. However, since inception of the plan, no employee of *X* has ever been covered under bracket 2. Thus, for all practical purposes, there are only two brackets, 1 and 3, and the coverage of bracket 1 exceeds 2½ times the coverage of bracket 3. Therefore, the requirements of section 1.79-1(c) of the regulations have not been satisfied.

HOLDING

The life insurance provided to employees of *X* is not group-term life insurance for purposes of section 79 of the Code and the employees of *X* may not exclude from gross income any portion of the cost of such insurance.

Section 83.—Property Transferred in Connection with Performance of Services

26 CFR 1.83-1: Property transferred in connection with the performance of services.
(Also Sections 61, 162; 1.61-1, 1.162-7.)

Suits leased for corporate executives. A corporation leases custom-tailored suits for its executives for a two-year period and, at the end of the lease term, returns the suits to the lessor, who sells them for a nominal amount. The corporation is charged a rental fee and a consulting fee, which together equal the normal purchase price of the suits. The fair market value of the suits is includible in the executives' gross incomes, and the corporation may deduct the entire amount paid to lease the suits.

Rev. Rul. 80-322 [1]

ISSUE

What are the federal income tax consequences to a corporation and its executives when the corporation "leases" suits for its executives, under the circumstances described below?

FACTS

Corporation *X* offers to "lease" business suits for use by executives of its corporate customers. Forty percent of the cost to a customer will be billed as consulting fees for *X*'s advice on the appropriate number and style of suits and which executives should receive suits. *X* represents that the customer can deduct the consulting fee as a business expense in the year it is paid. A customer cannot "lease" suits from *X* without obtaining the consulting services.

The "leases" are for a two-year period, and at the end of the lease term the suits will be returned to *X*, who will sell them for a nominal amount. In April 1980 Corporation *Y* "leases" from *X* ten suits, five of which are to be custom tailored for *A*, an executive of *Y*. Upon the execution of the agreement, *Y* pays *X* 50*x* dollars (the full amount called for by the contract), of which 20*x* dollars is billed as a consulting fee for the advice given by *X* and 30*x* dollars is billed as the rental for the suits. Each

[1] Also released as News Release IR-80-114, dated October 30, 1980.

suit is appropriate for ordinary wear and could be purchased for approximately 5x dollars. Y and A are calendar-year taxpayers.

LAW AND ANALYSIS

Section 61 of the Internal Revenue Code defines gross income as income from whatever source derived, except as otherwise provided.

Section 83(a) of the Code provides that when property is transferred to a person in connection with the performance of services, the person who performed the services must include in gross income the excess of (1) the fair market value of the property at the time the rights of the person having the beneficial interest in the property are transferable or not subject to a substantial risk of forfeiture, over (2) any amount paid for the property. The taxable year of inclusion is generally the first taxable year in which the rights of the person receiving the property are transferable or not subject to a substantial risk for forfeiture.

Section 83(h) of the Code provides that, in the case of a transfer of property, a deduction is allowed under section 162 to the person for whom the services were performed. Section 1.83-6(a)(1) of the regulations provides that the amount of the deduction is equal to the amount includible as compensation in the gross income of the person who performed the services, but only to the extent the amount meets the requirements of section 162 and the regulations thereunder.

Section 162(a)(1) of the Code provides in general that 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 a reasonable allowance for salaries or other compensation for personal services actually rendered.

Y purportedly leased the suits from X. Whether an agreement is a lease or a sale depends upon the intent of the parties as evidenced by the provisions of the agreement, read in light of the facts and circumstances existing at the time the agreement was executed. *See* Rev. Rul. 55-540, 1955-2 C.B. 39. The fact that the suits were custom tailored for particular individuals and have little value at the end of the "lease term" establishes that Y has for federal income tax purposes purchased, rather than leased, the suits.

The advice provided by X as part of the arrangement consisted of services that are typically provided, at no additional cost, to customers by tailors and other sales representatives in the course of selling suits. The amount designated as consulting fees is properly treated as part of the purchase price of the suits, so that the cost of the ten suits is the total amount paid by Y to X.

An amount paid by an employer to an employee for reimbursement of the employee's cost of acquiring uniforms is includible in the employee's gross income under section 61 of the Code. *See* Rev. Rul. 72-110, 1972-1 C.B. 24. Similarly, an amount paid by an employer to an employee to defray the cost of a wardrobe is includible in the employee's gross income. *See* Rev. Rul. 68-20, 1968-1 C.B. 55.

Because Y has provided additional compensation to its executives by furnishing suits to them, they must include in gross income, under section 83(a) of the Code, the fair market value of the suits. The fair market value is equal to the purchase price. One-half the purchase price, or 25x dollars, is attributable to the suits provided to A. Pursuant to section 83(h), Y may deduct the total amount paid to X as a business expense under section 162(a)(1).

The cost of acquisition and maintenance of clothing is deductible by an employee as a business expense under section 162 of the Code only if the clothing is specifically required as a condition of employment and is not a type adaptable to general or continued usage. *See* Rev. Rul. 70-474, 1970-2 C.B. 34. Thus, because the business suits are appropriate for ordinary wear, the executive may not deduct the fair market value of the suits as a business expense.

HOLDINGS

1. Under section 83(a) of the Code, A must include in gross income for 1980 the fair market value of the suits provided to A in the amount of 25x dollars. A may not deduct this amount as a business expense under section 162.

2. Under section 162(a)(1) of the Code, Y may deduct in 1980 the total amount paid to X for the suits provided to Y's executives.

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26 CFR 1.83-1: Property transferred in connection with the performance of services.

Treatment of a transfer of corporate stock by controlling shareholders to employees of the corporation. See Rev. Rul. 80-196, page 32.

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26 CFR 1.83-7: Taxation of nonqualified stock options.

Federal income tax consequences of the acquisition of stock pursuant to the exercise of a nonqualified stock option where payment is made with shares of the same corporation's stock that were previously acquired pursuant to the exercise of a qualified stock option. See Rev. Rul. 80-244, page 234.

Section 85.—Unemployment Compensation

26 CFR 1.85-1: Unemployment compensation.
(Also Section 6050B; 1.6050B-1.)

T.D. 7705 [1]

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGIN-

[1] This publication of the Treasury Decision contains the complete text of the amendments to the regulations. The instructions for modifying the notice of proposed rulemaking have been omitted.

NING AFTER DECEMBER 31, 1953

Unemployment compensation

AGENCY: Internal Revenue Service, Treasury

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to the taxation of unemployment compensation. Changes to the applicable law were made by the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1] and the Technical Amendments Act of 1979 [Technical Corrections Act of 1979, Pub. L. 96-222, 1980-1 C.B. 499]. The regulations would provide the public with the guidance needed to comply with those Acts and would affect all taxpayers who receive unemployment compensation under a governmental unemployment compensation plan.

DATE: The regulations are effective for taxable years beginning after December 31, 1978.

FOR FURTHER INFORMATION CONTACT: John G. Schmalz of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:LR:T, 202-566-3432, not a toll-free call.

SUPPLEMENTARY INFORMATION

BACKGROUND

On December 19, 1979, the Federal Register published proposed amendments to the Income Tax Regulations [26 CFR Part 1] under section 85 of the Internal Revenue Code of 1954 [44 FR 75183]. The amendments were proposed to prescribe rules and regulations for the taxation of unemployment compensation received by certain taxpayers under certain governmental unemployment compensation plans. Although no public hearing was requested, one written comment was received which related to the proposed rules. Several other comments were received which questioned certain public policy decisions made by Congress when it enacted section 85. After consideration of the comments regarding the proposed amendments, those amendments are adopted as revised by this Treasury decision. The preamble to the notice of proposed rulemaking summarizes and explains the proposed amendments.

FRAUDULENTLY RECEIVED UNEMPLOYMENT COMPENSATION

One comment was received concerning the taxation of fraudulently received unemployment compensation. The commentator suggested that the regulations under section 85 of the Internal Revenue Code make it clear that no amount of unemployment compensation received as a result of a claimant's fraud will be exempt from taxation. Since this suggestion is consistent with the Service's position, a provision has been added to the proposed regulations stating that all amounts of fraudulently received unemployment compensation are taxable without regard to any limitation in section 85 of the Internal Revenue Code.

OTHER COMMENTS

Other comments were not adopted as they suggested changes that conflicted with express statutory provisions.

ADDITIONAL INFORMATION

These regulations are needed to guide the public and government employees responsible for the administration of section 85.

The preceding parts of the preamble evidence Service consideration of the public comments and respond to the issues raised by these comments. Evaluation of the effectiveness of the regulations after issuance will be based on comments received from offices within the Internal Revenue Service and the Treasury Department, other governmental agencies, State and local governments, and the public.

To a certain extent, section 6050B of the Internal Revenue Code of 1954 will require additional reporting and recordkeeping by payers of unemployment compensation, *i.e.*, certain payers will be required to report to the Service the amount of their payment along with other information and will also be required to provide the recipient with a Form 1099 UC.

DRAFTING INFORMATION

The principal author of this regulation was John G. Schmalz of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly the following amendments to 26 CFR Part 1 are hereby adopted:

Paragraph 1. Immediately after § 1.83-8, there is added the following new section:

§ 1.85-1 Unemployment compensation.

(a) *Introduction.* Section 85 prescribes rules relating to the inclusion in gross income of unemployment compensation (as defined in paragraph (b)(1) of this section) paid in taxable years beginning after December 31, 1978 pursuant to governmental programs. In general, these rules provide that unemployment compensation paid pursuant to governmental programs is includible in the gross income of a taxpayer if the taxpayer's modified adjusted gross income (as defined in paragraph (b)(2) of this section) exceeds a statutory base amount (as defined in paragraph (b)(3) of this section). If there is such

an excess, however, the amount included in gross income is limited under paragraph (c)(1) of this section to the lesser of one-half of such excess or the amount of the unemployment compensation. If such taxpayer's modified adjusted gross income does not exceed the applicable statutory base amount, none of the unemployment compensation is included in the taxpayer's gross income.

(b) *Definitions*—(1) *Unemployment compensation*—(i) *General rule.* Except as provided in paragraph (b)(1)(iii) of this section, the term "unemployment compensation" means any amount received under a law of the United States, or of a State, which is in the nature of unemployment compensation. Thus, section 85 applies only to unemployment compensation paid pursuant to governmental programs and does not apply to amounts paid pursuant to private nongovernmental unemployment compensation plans (which are includible in income without regard to section 85). Generally, unemployment compensation programs are those designed to protect taxpayers against the loss of income caused by involuntary layoff. Ordinarily, unemployment compensation is paid in cash and on a periodic basis. The amount of the payments is usually computed in accordance with a formula based on the taxpayer's length of prior employment and wages. Such payments, however, may be made in a lump sum or other than in cash or on some other basis.

(ii) *Disability and worker's compensation payments.* Amounts in the nature of unemployment compensation also include cash disability payments made pursuant to a governmental program as a substitute for cash unemployment payments to an unemployed taxpayer who is ineligible for such payments solely because of the disability. Usually these disability payments are paid in the same weekly amount and for the same period as the unemployment compensation benefits to which the unemployed taxpayer otherwise would have been entitled. Amounts received under workmen's compensation acts as compensation for personal injuries or sickness are not amounts in the nature of unemployment compensation. See section 104(a)(1) relating to the exclusion from gross income of such amounts.

(iii) *Employee contributions to a governmental plan.* If a governmental unemployment compensation program is funded in part by an employee's contribution which is not deductible by the employee, an amount paid to such employee under the program is not to be considered unemployment compensation until an amount equal to the total nondeductible contributions paid by the employee to such program has been paid to such employee.

(iv) *Examples of governmental unemployment compensation programs.* Governmental unemployment compensation programs include (but are not limited to) programs established under:

(A) A State law approved by the Secretary of Labor pursuant to section 3304 of the Internal Revenue Code of 1954.

(B) Chapter 85 of Title 5, United States Code, relating to unemployment compensation for Federal employees generally and for ex-servicemen.

(C) Trade Act of 1974, sections 231 and 232 (19 U.S.C. 2291 and 2292) [Pub. L. 93-618, 1975-1 C.B. 501].

(D) Disaster Relief Act of 1974, section 407 (42 U.S.C. 5177).

(E) The Airline Deregulation Act of 1978 (49 U.S.C. 1552(b)).

(F) The Railroad Unemployment Insurance Act, section 2 (45 U.S.C. 352).

(2) *Modified adjusted gross income.* The term "modified adjusted gross income" means the sum of the following amounts:

(i) Adjusted gross income (as defined in section 62);

(ii) All disability payments of the type that are eligible for exclusion from gross income under section 105(d); and

(iii) All amounts of unemployment compensation (as defined in paragraph (b)(1) of this section).

(3) *Base amount.* The term "base amount" means—

(i) $25,000 in the case of a joint return under section 6013.

(ii) Zero in the case of a taxpayer who—

(A) Is married (within the meaning of section 143) at the close of the taxable year,

(B) Does not file a joint return for such taxable year, and

(C) Does not live apart (as defined in paragraph (b)(4) of this section) from his or her spouse at all times during the taxable year.

(iii) $20,000 in the case of all other taxpayers.

(4) *Living apart.* A taxpayer does not "live apart" from his or her spouse at all times during a taxable year if for any period during the taxable year the taxpayer is a member of the same household as such taxpayer's spouse. A taxpayer is a member of a household for any period, including temporary absences due to special circumstances, during which the household is the taxpayer's place of abode. A temporary absence due to special circumstances includes a nonpermanent absence caused by illness, education, business, vacation, or military service.

(c) *Limitations*—(1) *General rule.* If for a taxable year, a taxpayer's modified adjusted gross income does not exceed the applicable statutory base amount, no amount of unemployment compensation is included in gross income for the taxable year. If there is such an excess, the taxpayer includes in gross income for the taxable year the lesser of the following:

(i) One-half of the excess of the taxpayer's modified adjusted gross income over such taxpayer's base amount, or

(ii) The amount of unemployment compensation.

(2) *Exception for fraudulently received unemployment compensation.* If a taxpayer fraudulently receives unemployment compensation under any governmental unemployment compensation program, then the entire amount of such fraudulently received unemployment compensation must be included in the taxpayer's gross income for the taxable year in which the benefits were received. Thus, the limitation in section 85 and in paragraph (c)(1) of this section, does not apply to such amounts.

(3) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). H and W are married taxpayers who for calendar year 1979 file a joint income tax return. During 1979 H receives $4,500 of disability income that is eligible for an exclusion under section 105(d). W works for part of 1979 and receives $20,000 as compensation and also receives $5,000 of unemployment compensation in 1979. Assume that H and W's adjusted gross income is $20,000. The modified adjusted gross income of H and W is $29,500 ($4,500 + $20,000 + $5,000). Since their modified adjusted gross income ($29,500) is greater than their base amount ($25,000), some of the unemployment compensation received by W must be included in their gross income on their 1979 joint income tax return. Under paragraph (c)(1) of this section, of the $5,000 which is unemployment compensation, the lesser of $2,250 (($29,500 − 25,000) ÷ 2) or $5,000 must be included in their gross income. Thus, $2,250 of the $5,000 received by W in 1979 is included in the gross income of H and W on their joint income tax return for 1979.

Example (2). Assume the same facts in example (1) except H receives $5,000 of disability income that is eligible for an exclusion under section 105(d) and W receives $28,000 as compensation, and $4,000 which is unemployment compensation. Assume that H and W's adjusted gross income is $28,000. The modified adjusted gross income of H and W is $37,000 ($4,000 + $28,000 + $5,000). Since their modified adjusted gross income ($37,000) is greater than their base amount ($25,000), all of the unemployment compensation received by W must be included in their gross income on their 1979 joint income tax return. Under paragraph (c)(1) of this section, of the $4,000 which is unemployment compensation, the lesser of $6,000 (($37,000 − $25,000) ÷ 2) or $4,000 must be included in their gross income. Thus, all of the $4,000 unemployment compensation received by W is included in the gross income of H and W on their joint income tax return for 1979.

(d) *Cross reference.* See section 6050B, relating to the requirement that every person who makes payments of unemployment compensation aggregating $10 or more to any individual during any calendar year file an information return with the Internal Revenue Service.

Par. 2. Immediately after § 1.6050-1, there is added the following new section:

§ 1.6050B-1 Information returns by person making unemployment compensation payments.

For taxable years beginning after December 31, 1978, every person who makes payments of unemployment compensation (as defined in section 85(c)) aggregating $10 or more to any individual during any calendar year shall file a Form 1099UC in accordance with the instructions to such form.

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved June 25, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 8, 1980, 8:45 a.m., and published in the issue of the Federal Register for July 9, 1980, 45 F.R. 46069)

Part III.—Items Specifically Excluded From Gross Income

Section 103.—Interest on Certain Governmental Obligations

26 CFR 1.103-7: Industrial development bonds.
(Also Section 7805; 301.7805-1.)

Industrial development bonds; security interest. The proceeds of bonds issued by a city will be loaned to developers of industrial buildings. Payments by the developers of principal and interest due on their loans will not be pledged as security for, and will not coincide with, debt service on the bonds. However, over the term of the bonds the payments by the developers will be approximately equal in present value to the debt service on the bonds. Because the "trade or business test" and the "security interest test" will be satisfied, the bonds will be industrial development bonds within the meaning of section 103(b)(2) of the Code. Rev. Rul. 75-403 revoked.

Rev. Rul. 80-251

ISSUE

Will bonds that a city proposes to issue be "industrial development bonds" within the meaning of section 103(b)(2) of the Internal Revenue Code?

FACTS

In order to provide loans to developers of industrial buildings, city *M* proposes to issue general obligation bonds that will be secured by *M*'s full faith and credit. Bond proceeds will be paid by the bond purchaser to the city director of finance, who will remit the proceeds to the board of finance (board) for deposit in the board's bank account. The board will disburse the proceeds for approved loans as directed by an administrative body of *M*. Repayment by developers of all loans made from bond proceeds will be made to the board. The board will transfer the funds to the director of finance for credit to the general fund of *M*.

In its annual budget, *M* includes in its general fund all debt service (principal and interest payments) on all outstanding general obligations. *M* is required by state legislation to levy ad valorem taxes at a rate and in an amount sufficient to produce revenue to pay debt service on such obligations.

Substantially all of the loans of bond proceeds will be used by the developers in connection with the purchase, construction, or reconstruction of industrial buildings that will be leased or sold to persons who are not "exempt persons" within the meaning of section 103(b)(3) of the Code for use in their trades or businesses.

The industrial buildings purchased, constructed, or reconstructed with bond proceeds will not be pledged as security for payment of debt service on the bonds. *M* will secure all loans to the developers financed with the bond proceeds with mortgages on the facilities financed by the loans. Payments by the developers of principal and interest due with respect to loans made from bond proceeds will not be pledged as security for payment of debt service on the bonds and such payments will not match or coincide with debt service amounts due with respect to the bonds. The interest paid by the developers on the loans made from bond proceeds may be less than, equal to, or greater than the interest paid by *M* on the bonds. However, it is anticipated that over the term of the bonds the principal and interest payments to be made by the developers and the total debt service on the bonds will be approximately equal in present value.

The bonds will not be "arbitrage bonds" within the meaning of section 103(c) of the Code.

LAW AND ANALYSIS

Section 103(a)(1) of the Code provides that gross income does not include interest on the obligations of a state or the political subdivision of a state.

Section 103(b)(1) of the Code provides that, except as otherwise provided in section 103(b), any industrial development bond shall be treated as an obligation that is not an obligation described in section 103(a)(1).

Section 103(b)(2) of the Code provides that the term "industrial development bond" means any obligation (A) that is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly in any trade or business carried on by any person who is not an exempt person (as defined in section 103(b)(3)), and (B) the payment of the principal or interest on which (under the terms of such obligation or any underlying arrangement) is, in whole or in major part (i) secured by any interest in property used or to be used in a trade or business or in payments in respect of such property, or (ii) to be derived from payments in respect to property, or borrowed money, used or to be used in a trade or business.

Section 1.103-7(b)(3) of the Income Tax Regulations provides that the trade or business test relates to the use of the proceeds of a bond issue. The test is met if all or a major portion (more than 25 percent) of the proceeds of a bond issue is used in a trade or business carried on by a nonexempt person. For example, if all or a major portion of the proceeds of a bond issue is to be loaned to one or more private business users, or is to be used to acquire, construct, or reconstruct facilities to be leased or sold to such private business users, and such proceeds or facilities are to be used in trades or businesses carried on by them, such proceeds are to be used in a trade or business carried on by persons who are not exempt persons, and the debt obligations comprising the bond issue satisfy the trade or business test.

Section 1.103-7(b)(4) of the regulations provides that the security interest test relates to the nature of the security for, and the source of, the payment of either the principal or interest on a bond issue. The nature of the security for, and the source of, the payment may be determined from the terms of the bond indenture or on the basis of an underlying arrangement. An underlying arrangement can be inferred from all the facts and circumstances.

Example (14) of section 1.103-7(c) of the regulations, which illustrates the existence of an underlying arrangement, reads as follows:

> J, a political subdivision of a State, will issue several series of bonds from time to time and will use the proceeds to rehabilitate urban areas. More than 25 percent of the proceeds of each issue will be used for the rehabilitation and construction of buildings which will be leased or sold to nonexempt persons for use in their trades or businesses. There is no limitation either on the number of issues or the aggregate amount of bonds which may be outstanding. No group of bondholders has any legal claim prior to any other bondholders or creditors with respect to specific revenues of J, and there is no arrangement whereby revenues from a particular project are paid into a trust or constructive trust, or sinking fund, or are otherwise segregated or restricted for the benefit of any group of bondholders. There is, however, an unconditional obligation by J to pay the principal and interest on each issue of bonds. Further, it is apparent that J requires the revenues from the lease or sale of buildings to nonexempt persons in order to pay in full the principal and interest on the bonds in question. The bonds are industrial development bonds because a major portion of the proceeds will be used in the trades or businesses of nonexempt persons and, pursuant to an underlying arrangement, payment of the principal and interest is, in major part, to be derived from payments in respect of property or borrowed money used in the trades or businesses of nonexempt persons.

An underlying arrangement will always be inferred if the payments to be made by the industrial user or users and the debt service on the bonds are approximately equal in present value. Other facts that tend to show an underlying arrangement are, first, that payments made by the industrial user or users are material to the security for the bonds, and second, that the identity of the industrial user or users can be determined with reasonable certainty at the time of issue.

In Rev. Rul. 75–403, 1975–2 C.B. 37, a state proposed to issue bonds in order to make loans to nursing homes to finance the costs necessary to meet federal and state safety standards. The bonds were to be secured by the full faith and credit of the state. The

nursing home loan repayments, the assets financed by such loans, and any other security on the nursing home loans were not to be pledged as security for the payment of principal or interest on the proposed bonds. Rev. Rul. 75–403 holds that the security interest test contained in section 103(c)(2) (redesignated section 103(b)(2)) of the Code will not be satisfied and the bonds will not be industrial development bonds.

In this case the bond proceeds will be loaned to developers for use in constructing or reconstructing industrial buildings that will be leased or sold to nonexempt persons. Because the building financed by the bond proceeds will be used in the trades or businesses of the nonexempt persons, the bond proceeds will be considered used in the trades or businesses of nonexempt persons and the "trade or business test" described in section 1.103-7(b)(3) of the regulations will be satisfied.

Although payments of principal of and interest on the loans by developers will not coincide with debt service on the bonds, an underlying arrangement can be inferred because the payments to be made by the developers and the debt service on the bonds are approximately equal in present value. Consequently, the payment of principal of and interest on *M*'s bonds will be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business within the meaning of section 103(b)(2)(B)(ii) of the Code. See example (14) of section 1.103-7(c) of the regulations. Therefore, the "security interest test" described in section 1.103-7(b)(4) will be satisfied.

The Service has reconsidered Rev. Rul. 75–403 and because Rev. Rul. 75–403 did not focus on whether an underlying arrangement would cause the security interest test to be satisfied, the Service will no longer follow that revenue ruling.

HOLDING

The bonds to be issued by *M* will be "industrial development bonds" within the meaning of section 103(b)(2) of the Code.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 75–403 is revoked.

PROSPECTIVE APPLICATION

Pursuant to the authority contained in section 7805(b) of the Code, this revenue ruling will not apply to obligations sold prior to September 15, 1980, the date this revenue ruling is published in the Internal Revenue Bulletin.

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26 CFR 1.103-7: Industrial development bonds.

Industrial development bonds; airline terminals and related facilities. A political subdivision of a state issued bonds to finance the construction of terminals and related airport facilities for several commercial airlines. The bond indenture provided that principal and interest on the bonds would be payable solely from the revenues derived from a toll bridge operated by the subdivision. However, the present value of the long-term payments to be made by the airlines is approximately equal to the present value of the debt service on the bonds. The bonds are industrial development bonds within the meaning of section 103(b)(2) of the Code.

Rev. Rul. 80-339

ISSUE

Will the bonds issued by a political subdivision of a state to finance the construction of terminals and related airport facilities for commercial airline carriers be "industrial development bonds" within the meaning of section 103(b)(2) of the Internal Revenue Code?

FACTS

The political subdivision issued revenue bonds and used the bond proceeds to construct terminals and related facilities for several commercial airline carriers. The political subdivision also operates a toll bridge that is used by the general public. The bonds are not "arbitrage bonds" as such term is defined in section 103(c) of the Code.

The bond indenture for the bond issue provided that principal and interest on the bonds would be payable solely from a pledge of revenues derived by the political subdivision from the toll bridge. The bond indenture further provided that unpledged revenues derived by the political subdivision from the terminals and related airport facilities might be used for any purpose of the political subdivision, subject to a priority to pay operating expenses and maintenance costs relating to the airport facilities. Revenues from the terminals and related facilities were derived from long-term lease payments.

The total revenues derived from the terminals, related airport facilities, and the toll bridge in 1979 were 100*x* dollars, of which 60*x* dollars were derived from the toll bridge. The long-term lease payments to be made by the airline carriers and the debt service on the revenue bonds are approximately equal in present value.

LAW AND ANALYSIS

Section 103(a)(1) of the Code provides that gross income does not include interest on obligations of a state.

Section 103(b)(1) of the Code provides that, with certain exceptions, the interest on "industrial development bonds" is not excludable from gross income.

Section 1.103-7(b) of the Income Tax Regulations defines industrial development bonds as obligations that meet the "trade or business test" and the "security interest test." The trade or business test is satisfied if a major

portion (more than 25 percent) of the bond proceeds is used in the trades or businesses of nonexempt persons. The security interest test is met if a major portion (more than 25 percent) of the payment of the principal or interest on the bonds is secured by any interest in property used in a trade or business or by payments in respect of such property, or is to be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business.

Section 1.103-7(b)(3) of the regulations provides that the trade or business test relates to the use of the proceeds of a bond issue. The test is met if all or a major portion (more than 25 percent) of the proceeds of a bond issue is used in a trade or business carried on by a nonexempt person. For example, if all or a major portion of the proceeds of a bond issue is to be loaned to one or more private business users, or is to be used to acquire, construct, or reconstruct facilities to be leased or sold to such private business users, and such proceeds or facilities are to be used in trades or businesses carried on by them, such proceeds are to be used in a trade or business carried on by persons who are not exempt persons, and the debt obligations comprising the bond issue satisfy the trade or business test.

Section 1.103-7(b)(4) of the regulations provides that the security interest test relates to the nature of the security for, and the source of, the payment of either the principal or interest on a bond issue. The nature of the security for, and the source of, the payment may be determined from the terms of the bond indenture or on the basis of an underlying arrangement. An underlying arrangement can be inferred from all the facts and circumstances.

Example (14) of section 1.103-7(c) of the regulations, which illustrates the existence of an underlying arrangement, reads as follows:

J, a political subdivision of a State, will issue several series of bonds from time to time and will use the proceeds to rehabilitate urban areas. More than 25 percent of the proceeds of each issue will be used for the rehabilitation and construction of buildings which will be leased or sold to nonexempt persons for use in their trades or businesses. There is no limitation either on the number of issues or the aggregate amount of bonds which may be outstanding. No group of bondholders has any legal claim prior to any other bondholders or creditors with respect to specific revenues of J, and there is no arrangement whereby revenues from a particular project are paid into a trust or constructive trust, or sinking fund, or are otherwise segregated or restricted for the benefit of any group of bondholders. There is, however, an unconditional obligation by J to pay the principal and interest on each issue of bonds. Further, it is apparent that J requires the revenues from the lease or sale of buildings to nonexempt persons in order to pay in full the principal and interest on the bonds in question. The bonds are industrial development bonds because a major portion of the proceeds will be used in the trades or businesses of nonexempt persons and, pursuant to an underlying arrangement, payment of the principal and interest is, in major part, to be derived from payments in respect of property or borrowed money used in the trades or businesses of nonexempt persons.

An underlying arrangement will always be inferred if the payments to be made by the industrial user or users and the debt service on the bonds are approximately equal in present value. Other facts that tend to show an underlying arrangement are, first, that payments made by the industrial user or users are material to the security for the bonds, and second, that the identity of the industrial user or users can be determined with reasonable certainty at the time of issue.

In this case the bond proceeds will be used in constructing facilities that will be leased to nonexempt persons. Because more than 25 percent of the bond proceeds will be used in the trades or businesses of nonexempt persons, the bond proceeds will be considered used in the trades or businesses of nonexempt persons and the "trade or business test" described in section 1.103-7(b)(3) of the regulations will be satisfied.

For purposes of satisfying the "security interest test," the substance and not the form of the transaction is to control. See section 1.103-7(b)(4) of the regulations. In this case, in order to fail the "security interest test," the political subdivision arranged the terms of the bond indenture to provide that the bonds will be payable only from pledged revenues. Notwithstanding the formal documents, an underlying arrangement can be inferred because the payments to be made by the airline carriers and the debt service on the bonds are approximately equal in present value. Consequently, payment of a major portion of debt service on the political subdivision's bonds will be derived from payments in respect of property used or to be used in a trade or business within the meaning of section 103(b)(2)(B)(ii) of the Code. See example (14) of section 1.103-7(c). Moreover, the use of toll bridge revenues (instead of the revenues derived from the terminals and related airport facilities) to pay debt service on the bonds does not significantly alter the economic consequences of the transaction. The use of toll bridge revenues to pay debt service on the bonds "frees up" the revenues from the terminals and related facilities or uses for which the toll bridge revenues would otherwise have been available. Since the political subdivision would not have issued the bonds in this case without requiring the commercial airline carriers to pay for the use of the bond-financed facilities, the revenues derived from the use of the bond-financed facilities are the true "source" of the debt service payments. Therefore, the "security interest test" described in section 1.103-7(b)(4) will be satisfied.

HOLDING

The bonds issued by the political subdivision to finance the terminals and related airport facilities are industrial development bonds within the meaning of section 103(b)(2) of the Code.

26 CFR 1.103-8: Interest on bonds to finance certain exempt facilities.
(Also Section 61; 1.61-7.)

Industrial development bonds; reserve fund. Bond proceeds are reduced by the amount of the issuance cost and the amount of a reasonable required debt reserve fund for purposes of determining if substantially all of the bond proceeds will be used for the purposes described in section 103(b)(4), (5), and (6) of the Code.

Rev. Rul. 80-171

ISSUE

Are bond proceeds reduced by the amount of a reserve fund for purposes of determining if substantially all of the bond proceeds will be used to provide exempt facilities described in section 103(b)(4) of the Internal Revenue Code?

FACTS

A political subdivision of a state proposes to issue $100x$ dollars of industrial development bonds to finance certain exempt facilities described in section 103(b)(4) of the Code for use by an industrial corporation. The cost of issuing the bonds will be $5x$ dollars and the political subdivision will use bond proceeds to establish a reserve fund of $15x$ dollars. This reserve fund will qualify as a reasonably required debt reserve fund. Of the remaining bond proceeds, $75x$ dollars will be used to construct the exempt facility and $5x$ dollars will be loaned to the corporation for working capital. Over the term of the bonds, the corporation will make periodic payments to the political subdivision that will equal total principal and interest payments on the bonds. The bonds will not be arbitrage bonds within the meaning of section 103(c).

LAW AND ANALYSIS

Section 103(a)(1) of the Code provides that gross income does not include interest on the obligations of a state or a political subdivision thereof.

Section 103(b)(1) of the Code provides that, with certain exceptions, the interest on "industrial development bonds" is not excludable from gross income.

Section 103(b)(4) of the Code provides that section 103(b)(1) shall not apply to industrial development bonds if substantially all of the bond proceeds are to be used to provide certain exempt facilities.

The "substantially all" test in section 103(b)(4) of the Code will be satisfied if 90 percent or more of the proceeds of an issue of governmental obligations are used to provide an exempt facility. For purposes of this test, proceeds are reduced by amounts properly allocable on a pro rata basis between providing the exempt facility and other uses of the proceeds ("neutral costs"). Section 1.103-8(a)(1)(i) of the Income Tax Regulations.

The example in section 1.103-8(a)(6) of the regulations demonstrates that proceeds are reduced by the costs of issuing the state bonds for purposes of arriving at the amount of bond proceeds to which the substantially all test will be applied.

In this case, the portion of the bond proceeds ($75x$ dollars) that will be used to construct the exempt facility will be a qualifying use of such proceeds. The portion of the bond proceeds ($5x$ dollars) to be used to furnish working capital to the corporation will be a nonqualifying use of such proceeds. The proceeds used for the cost of issuing the bonds and the amount of proceeds to be placed in the reserve fund will be considered neutral costs because they will be attributable to both the qualifying and nonqualifying uses of bond proceeds. The example in section 1.103-8(a)(6) of the regulations illustrates that the cost of issuing bonds are deducted in arriving at bond proceeds. The amount to be placed in the reserve fund will qualify for similar treatment. See section 1.103-8(a)(1)(i).

HOLDING

Bond proceeds will be reduced by the amount of the issuance cost ($5x$ dollars) and by the amount of the reserve fund ($15x$ dollars). Because substantially all ($75x$ dollars/$80x$ dollars equals 93.75 percent) of the bond proceeds will be used to provide exempt facilities, the bonds will qualify for the exception provisions of section 103(b)(4) of the Code and the interest on the bonds will be excludable from the gross incomes of the bondholders under section 103(a)(1).

The result would be the same if the bonds were issued to finance industrial parks described in section 103(b)(5) of the Code or were issued as an exempt small issue under section 103(b)(6).

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26 CFR 1.103-8: Interest on bonds to finance certain exempt facilities.

Industrial development bonds; reusable beverage container facilities. Machinery, equipment, and other facilities used by a beverage manufacturer to package beverages in reusable containers because a state law prohibited sale of beverages in nonreturnable containers do not qualify as solid waste disposal facilities under section 103(b)(4)(E) of the Code. The interest on industrial development bonds issued by various cities in the state to finance the facilities will not be excludable from the gross incomes of the bondholders under section 103(a).

Rev. Rul. 80-197

ISSUE

Do machinery, equipment, and other facilities acquired by a beverage manufacturer to package beverages in reusable containers qualify as solid waste disposal facilities under section 103(b)(4)(E) of the Internal Reve-

nue Code so that the interest on industrial development bonds issued to finance their acquisition is excludable from the gross incomes of the bondholders under section 103(a)(1) of the Code?

FACTS

The taxpayer, a beverage manufacturer, acquired machinery, equipment, and other facilities necessary to package all its beverages in reusable containers because a new state law prohibited the sale of beverages in "nonreturnable" containers. The purpose of this law was to reduce litter. The law specifies that a nominal deposit be paid upon the purchase of each beverage and that the deposit be refunded upon return of the beverage container. However, the law does not specify what type of beverage container is to be used (that is, reusable vs. nonreusable).

Before the enactment of this nonreturnable container law, the taxpayer's facilities were primarily adapted for providing beverages in disposable nonreusable containers.

The taxpayer has determined that the cost of using reusable containers is less than the cost of providing new containers for each sale cycle.

To package all of its beverages in reusable containers, the taxpayer acquired certain machinery, equipment, and other facilities. The taxpayer is financing the cost of this project with industrial development bonds to be issued by various cities located in state *X*.

LAW AND ANALYSIS

Section 103(a)(1) of the Code provides that gross income does not include interest on the obligations of 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.

Section 103(b)(1) of the Code provides that, except as otherwise provided in section 103(b), any industrial development bond shall be treated as an obligation not described in section 103(a)(1).

Section 103(b)(4)(E) of the Code provides that section 103(b)(1) shall not apply to any obligation that is issued as part of an issue substantially all of the proceeds of which are to be used to provide sewage or solid waste disposal facilities.

Section 1.103-8(f)(2)(ii)(a) of the Income Tax Regulations defines the term "solid waste disposal facilities" as any property or portion thereof used for the collection, storage, treatment, utilization, processing, or final disposal of solid waste. Only expenditures for that portion of property that is a solid waste disposal facility qualify as expenditures for solid waste disposal facilities. Whether a collection or storage facility qualifies as a solid waste disposal facility depends upon all of the facts and circumstances.

Section 1.103-8(f)(2)(ii)(b) of the regulations provides that:

> The term "solid waste" shall have the same meaning as in section 203(4) of the Solid Waste Disposal Act (42 U.S.C. Sec. 3252(4)), except that for purposes of this paragraph, material will not qualify as solid waste unless, on the date of issue of the obligations issued to provide the facility to dispose of such waste material, it is property which is useless, unused, unwanted, or discarded solid material which has no market or other value at the place were it is located. . . . The term "solid waste" means garbage, refuse, and other discarded solid materials, including solid-waste materials resulting from industrial, commercial, and agricultural operations, and from community activities, but does not include solids or dissolved material in domestic sewage or other significant pollutants in water resources, such as silt, dissolved or suspended solids in industrial waste water effluents, dissolved materials in irrigation return flows or other common water pollutants.

Section 1.103-8(f)(2)(ii)(C) of the regulations provides that a facility which disposes of solid waste by reconstituting, converting, or otherwise recycling it into material that is not waste shall also qualify as a solid waste disposal facility if "solid waste" constitutes at least 65 percent, by weight or volume, of the total materials introduced into the recycling process.

In the instant case the machinery, equipment, and other facilities acquired by the taxpayer can not qualify as solid waste disposal facilities if the containers processed by such facilities are not considered solid waste. For any material to be solid waste, it must be useless, unwanted, or discarded solid material that has no market or other value at the place where it is located.

The amount of any deposit mandated by the state is only an inducement to the beverage consumers to return the containers and has no relation to the container's value. If the reusable container is not returned, but is discarded, it can potentially become "solid waste" as the term is defined in section 1.103-8(f)(2)(ii) of the regulations. However, once the reusable container is returned to the taxpayer and the deposit is refunded to the retailer, the reusable container is not useless, unwanted, or discarded solid material. Upon its return, the container has been reintroduced into the distribution process and may be reused, barring breakage or damage, numerous times. Every time the beverage container is reused, the taxpayer has eliminated the need to purchase a new container. Therefore, even though a market for used containers does not exist by virtue of the mandatory deposit, the reusable containers do have value to the taxpayer because reuse of these containers is less costly than the purchase of new containers.

HOLDING

The used containers are not "solid waste" within the meaning of section 1.103-8(f)(2)(ii)(b) of the regulations and the facilities acquired by the taxpayer to package beverages in such containers are not solid waste disposal facilities within the meaning of section 103(b)(4)(E) of the Code. The interest on the bonds will not be excludable from the gross incomes of the bondholders under section 103(a).

26 CFR 1.103-8: Interest on bonds to finance certain exempt facilities.

Industrial development bonds; exempt facility; resolution. The governing body of a political subdivision adopted a resolution, prior to the commencement of construction of an exempt facility, that evidenced its intent to issue industrial development bonds to provide financing for the facility. Before the bonds can be issued they must be approved by a state official, who has the complete power to approve or disapprove the issue. The adoption of the resolution satisfies the requirement of section 1.103-8(a)(5)(iii) of the regulations that "some other similar official action" must be taken prior to commencement of construction, and the bonds will qualify for the exception provisions of section 103(b)(4) of the Code. Rev. Rul. 78-260 distinguished and Rev. Rul. 79-320 clarified.

Rev. Rul. 80-227

ISSUE

Will the adoption of a resolution to issue bonds by the issuer before commencement of construction satisfy the requirements of section 1.103-8(a)(5)(iii) of the Income Tax Regulations when final approval of the bond issuance must subsequently be made by a specified state official under the circumstances described below?

FACTS AND LAW

Authority *M* is a political subdivision of state *O* that was formed under the Industrial Development Authority Act of *O*. On January 2, 1980, the governing body of *M* adopted a resolution evidencing the intent of *M* to issue industrial development bonds to finance the construction of a facility described in section 103(b)(4) of the Internal Revenue Code. The land on which the facility will be constructed is presently owned by *M*. The facility will be leased on a long-term basis to corporation *X*, a nonexempt person. On April 2, 1980, *X* obtained temporary financing and commenced construction of the facility on *M*'s land. It is estimated that *X* will complete the facility and place it in use by March 1981.

M proposes to issue the bonds on January 2, 1981, and will use bond proceeds to reimburse *X* for the costs of construction. The Industrial Development Authority Act of *O* provides that before *M* may issue the bonds a specified official of *O*, after a public hearing, must determine that the facility will serve a public purpose, and that the financing of the facility is within the purview of the policy and authority of the Industrial Development Authority Act. Although the official's determination is to be based on the recommendation of *M*, the official has the complete discretion to approve or disapprove the bond issue. Neither *M* nor *X* may appeal the official's decision.

Section 1.103-8(a)(5)(iii) of the regulations provides that if the original use of a facility commences (or acquisition of a facility occurs) on or after the date of issue of obligations issued to provide such facility, a bond resolution with respect to such obligations must have been adopted by, or some other similar official action toward the issuance of such obligations must have been taken by, the issuer prior to the commencement of construction or acquisition of such facility in order for the facility to qualify as an exempt facility under section 103(b)(4) of the Code.

HOLDING

The adoption of the resolution by the governing body of *M* satisfies the requirement set forth in section 1.103-8(a)(5)(iii) of the regulations that "some other similar official action" must be taken prior to commencement of construction of the facility being financed by the bond issue.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 79-320, 1979-2 C.B. 35, concludes that the adoption by a governing body of a political subdivision of a resolution evidencing a present intent to have the political subdivision issue obligations to finance a specific exempt facility will satisfy the requirement of section 1.103-8(a)(5)(iii) of the regulations provided such governing body is authorized to have such obligations issued. Rev. Rul. 79-320 also concludes that the governing body of a political subdivision that adopts a resolution to have the political subdivision issue obligations that is subject to voter approval has not evidenced a present intent to issue obligations that satisfies the requirement of section 1.103-8(a)(5)(iii) on the date the resolution is adopted because the governing body lacks the necessary authority to have the obligations issued without prior voter approval. To the extent that these conclusions may imply that the authority of a governing body to cause the political subdivision to issue bonds must not be subject to any conditions on the date a resolution is adopted in order for such resolution to satisfy the requirement of section 1.103-8(a)(5)(iii), Rev. Rul. 79-320 is clarified. If, however, the conditions on the authority of the governing body result in the governing body not having the ability to express the present intent of the political subdivision to issue the obligations, a resolution adopted by the governing body will not satisfy the requirement of section 1.103-8(a)(5)(iii).

The situation in this revenue ruling is distinguishable from the situation described in Rev. Rul. 78-260, 1978-2 C.B. 99, as clarified by Rev. Rul. 79-320, 1979-2 C.B. 35, which holds that the adoption by the governing body of a political subdivision of a resolution to issue bonds subject to the approval of the voters of the political subdivision does not satisfy

the requirements of section 1.103-8(a)(5)(iii) of the regualtions. The resolution described in Rev. Rul. 78-260 fails to qualify as "some other similar official action" of the issuer because only the voters could express the present intent of the issuer to issue bonds. Thus, in Rev. Rul. 78-260 the governing body of the issuer could not express the present intent of the issuer to issue the obligations without voter approval. In this revenue ruling, however, because the issuer acts only through its governing body the resolution of the governing body approving the issuance of the bonds does express the present intent of the issuer to issue the obligations in question so that the resolution qualifies as "some other similar official action" within the meaning of section 1.103-8(a)(5)(iii).

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26 CFR 1.103-10: Exemption for certain small issues of industrial development bonds.
(Also Sections 61, 263; 1.61-7, 1.263(a)-2.)

Industrial development bonds; exempt small issue; moving acquired buildings. Bond proceeds that are to be used to pay for moving buildings that a corporation is purchasing from an unrelated corporation to the purchaser's property qualify as amounts used for the acquisition of property of a character subject to the allowance for depreciation within the meaning of section 103(b)(6)(A) of the Code; Rev. Rul. 79-135 distinguished.

Rev. Rul. 80-356

ISSUE

Will bond proceeds to be expended for the cost of moving buildings qualify as amounts used for the acquisition of property of a character subject to the allowance for depreciation within the meaning of secton 103(b)(6)(A) of the Internal Revenue Code?

FACTS AND LAW

City *M* proposes to issue industrial development bonds in the amount of $1,000,000 and loan the proceeds to corporation *X* for use in acquiring and moving several buildings. *X* will purchase the buildings from an unrelated corporation for $600,000. The cost of moving the buildings to *X*'s property will be $400,000. The bonds will not be arbitrage bonds within the meaning of section 103(c)(2) of the Code.

Section 103(a)(1) of the Code provides that interest on obligations of a political subdivision of a state is excludable from gross income. Section 103(b)(1) provides that, with certain exceptions, industrial development bonds will not be treated as obligations described in section 103(a)(1). Section 103(b)(6)(A) provides that an exempt small issue of $1,000,000 or less will not be treated as an industrial development bond if substantially all (90 percent or more) of the bond proceeds are to be used for the acquisition of land or property of a character subject to the allowance for depreciation.

Section 263 of the Code provides that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvement or betterments made to increase the value of any property. Section 1.263(a)-2 of the Income Tax Regulations lists as an example of a capital expenditure the cost of acquiring buildings having a useful life substantially beyond the taxable year.

The application of section 263 of the Code is illustrated in Rev. Rul. 72-113, 1972-1 C.B. 99, which holds that the costs of transporting horses purchased for breeding purposes to a taxpayer's farm are capital expenditures within the meaning of section 263(a) of the Code and are includible in the basis of the horses acquired.

HOLDING

The cost of moving the buildings to *X*'s property will be a capital expenditure that must be added to the basis of the buildings since it is part of the cost of the acquisition of such buildings. Therefore, the bond proceeds used to move the buildings will qualify as amounts used to acquire property of a character subject to the allowance for depreciation. Because substantially all (90 percent or more) of the bond proceeds will be used to acquire depreciable property, the bonds will qualify for the exception provisions of section 103(b)(6)(A) of the Code and the interest on the bonds will be excludable from the gross incomes of the bondholders under the provisions of section 103(a)(1).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 79-135, 1979-1 C.B. 78, which holds, in part, that amounts incurred for moving existing equipment to a new location will not qualify as expenditures for property subject to the allowance for depreciation, is distinguishable because the facts of Rev. Rul. 79-135 do not involve moving costs attributable to the acquisition of property.

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26 CFR 1.103-13: Arbitrage bonds.
(Also Section 61; 1.61-7.)

Arbitrage bonds; advance refunding issue; acquired obligations; matured Treasury bonds. The yield on matured Treasury bonds purchased in an escrow restructuring transaction with part of the proceeds of an issue of advance refunding bonds may not be taken into account in computing the yield on the major portion investments of the issue for the purpose of determining compliance with the arbitrage yield restrictions of section 103(c)(2) of the Code.

Rev. Rul. 80-188

ISSUE

Will bonds that have been issued by an authority that is a political sub-

division of a state be arbitrage bonds within the meaning of section 103(c)(2) of the Internal Revenue Code under the circumstances described below?

FACTS

Authority *M* is a hospital district that is a political subdivision of the state of *O*. On January 2, 1976, *M* issued its advance refunding bonds to refund construction bonds that were issued by *M* in 1975. The refunding bonds have a yield of 8 percent.

A major portion of the proceeds of the advance refunding bonds were immediately invested in United States Treasury obligations—State and Local Government Series (SLGS) at a restricted yield of 8 percent. Amounts representing a minor portion of the proceeds of the advance refunding bonds were immediately invested in SLGS at an unrestricted yield of 9 percent.

On February 4, 1980, *M* redeemed the SLGS that it had purchased in 1976 and used the proceeds to purchase United States Treasury bonds. *M* invested a minor portion of the proceeds of the redemption in United States Treasury bonds at an unrestricted yield. *M* invested part of the major portion of the proceeds of the redemption in United States Treasury bonds at a yield of 13 percent. *M* invested the remainder of the major portion of the proceeds of the redemption in United States Treasury bonds with a maturity date of February 1, 1980. *M* purchased all of the Treasury bonds at fair market value from *A*, an unrelated third person.

M directed the trustee for the advance refunding bonds not to redeem the Treasury bonds that matured on February 1, 1980, until five years had elapsed from the purchase of such bonds. In computing the yield on its major portion investments, *M* took into account the yield on the matured Treasury bonds as of the date the bonds would be presented for payment. As computed by *M*, the yield on all the Treasury bonds allocated to the major portion of the advance refunding bonds is 8 percent.

M allocated all of the costs of the purchase of the Treasury bonds to the minor portion of the escrow for the advance refunding bonds. At the time of the issuance of the advance refunding bonds *M* executed a no-arbitrage certification in accordance with the provisions of section 1.103-13(a)(2)(ii) of the proposed Income Tax Regulations published in the Federal Register of May 3, 1973 (38 F.R. 10944).

LAW AND ANALYSIS

Section 103(a)(1) of the Code provides that gross income does not include interest on the obligations of a state or a political subdivision of a state.

Section 103(c)(1) of the Code provides that, with certain minor exceptions, the interest on any arbitrage bond will not be excludable from gross income.

Section 103(c)(2) of the Code provides that the term "arbitrage bond" means any obligation that is issued as part of an issue all or a major portion (more than 15 percent) of the proceeds of which are reasonably expected to be used directly or indirectly (A) to acquire securities or obligations that may be reasonably expected at the time of issuance of such issue, to produce a yield over the term of the issue that is materially higher than the yield on obligations of such issue, or (B) to replace funds that were used directly or indirectly to acquire securities or obligations described in section 103(c)(2)(A).

T.D. 7627 (44 F.R. 32657), 1979-2 C.B. 45, which adopted the final arbitrage bond regulations, provides that, for governmental obligations issued on or before the effective date of the final regulations (May 31, 1979), the proposed income tax regulations, as amended, under section 103(c) of the Code shall apply.

Section 1.103-13(a)(2)(i) of the proposed regulations published in the Federal Register of May 3, 1973 (38 F.R. 10944), provides, in part, that under section 103(c)(2) of the Code the determination whether an obligation is an arbitrage bond depends upon the issuer's reasonable expectations, as of the date of issue, regarding the amount and use of the proceeds of the issue. The reasonable expectations regarding the amount and use of the proceeds of a governmental obligation may be established by the certification described in section 1.103-13(a)(2)(ii).

Example (1) of section 1.103-13(a)(2)(v) of the final regulations illustrates the effect of a no-arbitrage certification. In this example, city *A* issues bonds to construct a water treatment facility and in the certification *A* includes a statement that 85 percent of the receipts from the sale of the bonds will be used for construction costs within three years of the date of issue of the bonds. Subsequently, construction of the water treatment facility was determined by the Environmental Protection Agency to have certain adverse effects. As a result, 85 percent of the receipts from the sale of the bonds will not be expended for project costs within three years of the date of issue of the bonds. The example concludes that the certification is conclusive as to the issuer's reasonable expectations that 85 percent of the receipts will be expended for construction costs within three years of the date of issue of the bonds.

Section 1.103-13(b)(4)(i) of the proposed regulations published in the Federal Register of May 3, 1973 (38 F.R. 10944), provides that the term "acquired obligations" means securities and obligations allocated to the proceeds of an issue of governmental obligations during the period of time such issue is outstanding.

Section 1.103-13(b)(4)(iii) of the proposed regulations published in the Federal Register of May 3, 1973 (38 F.R. 10944), provides that the term "obligation" means any evidence of indebtedness that is not described in sec-

tion 103(a)(1) of the Code. An amendment to section 1.103-13(b)(4)(iii), published in the Federal Register of October 29, 1976 (41 F.R. 47680), provides that cash is not an acquired obligation. For example, cash held or received by a trustee is not taken into account as a zero-yield obligation for the period that it is held before being invested in an acquired obligation or for the period that it is held after repayment of an obligation and before being reinvested in an acquired obligation.

Section 1.103-13(b)(5) of the proposed regulations published in the Federal Register of December 3, 1975 (40 F.R. 56448), provides, in part, that in the case of a refunding issue the yield produced by acquired obligations allocated to the proceeds (other than transferred proceeds) of the refunding issue is materially higher than the yield produced by such issue if the yield of such acquired obligations exceeds the yield of such issue.

The only reason *M* directed the trustee not to redeem the matured Treasury bonds at their face amount on the date they were purchased was to reduce the yield on the major portion of the bond proceeds. Therefore, for purposes of section 1.103-13(b)(4)(iii) of the proposed and final regulations the matured Treasury bonds purchased by *M* are considered paid and are the equivalent of cash. Accordingly, the yield on the matured Treasury bonds purchased by *M* may not be taken into account in computing the yield on the major portion investments for its advance refunding bonds. As a result, the yield on the major portion investments for *M*'s advance refunding bonds is 13 percent.

The "reasonable expectations" test contained in section 103(c) of the Code and the certification procedure contained in section 1.103-13(a)(2) of the proposed and the final regulations both provide a high degree of certainty by generally assuring that the bonds will not be arbitrage bonds in the event of occurrences that are beyond the control of the issuer. Compare example (1) of section 1.103-13(a)(2)(v) of the final regulations which concerns the reasonable expectations of an issuer with respect to a matter it did not reasonably expect to occur and was beyond its control. However, neither the reasonable expectations test nor the certification procedure provides protection in this particular case where the issuer has taken deliberate and intentional actions to produce arbitrage.

HOLDING

M has failed to comply with the arbitrage yield restrictions of section 1.103-13(b)(5) of the proposed regulations. The no-arbitrage certification made by *M* will not prevent the advance refunding bonds from being arbitrage bonds. Thus, the advance refunding bonds issued by *M* are arbitrage bonds within the meaning of section 103(c)(2) of the Code and the interest on the bonds is not excludable from the gross income of the bondholders under section 103(a)(1).

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26 CFR 1.103-13: Arbitrage bonds.
(Also Section 61; 1.61-7.)

Arbitrage bonds; grant anticipation notes. A description is given of grant anticipation notes issued to provide interim financing for the construction of additions to a sewer system that are arbitrage bonds within the meaning of section 103(c)(2) of the Code.

Rev. Rul. 80-193

ISSUE

Will a sewer authority fail to comply with the arbitrage yield restrictions of section 103(c) of the Internal Revenue Code with respect to an issue of grant anticipation notes in the circumstances described below?

FACTS

On January 2, 1981, sewer authority *M*, a political subdivision of the state of *O*, will issue $4,500,000 in grant anticipation notes, the proceeds of which will be used to provide interim financing for the construction of additions to *M*'s sewer system. The total cost of the project will be $6,000,000. Construction will begin shortly after the notes are issued and is scheduled for completion by March 31, 1982.

On December 31, 1980, *M* expects to have $1,500,000 and a "reasonably required cash balance" of $400,000 on hand to begin the project. *M* anticipates that it will spend $400,000 a month and that grant installments of $1,500,000 will be forthcoming from the Environmental Protection Agency on June 30, 1981, December 31, 1981, and on June 30, 1982, and plans to retire $1,500,000 of notes within 6 months of the receipt of each installment. Thereafter, *M* expects to receive revenues in the nature of connection fees from hookups to the sewer system.

During the construction period, the note proceeds not being used to pay for construction expenses will be invested in federal obligations at a yield that is materially higher than the yield on the notes under section 1.103-13(b)(5)(iv) of the Income Tax Regulations.

LAW AND ANALYSIS

Section 103(a)(1) of the Code provides that gross income does not include interest on the obligations of a state or a political subdivision of a state.

Section 103(c)(1) of the Code provides that, with certain minor exceptions, the interest on any arbitrage bond will not be excludable from gross income.

Section 103(c)(2) of the Code provides that the term "arbitrage bond" means any obligation that is issued as part of an issue all or a major portion (more than 15 percent) of the proceeds of which are reasonably expected to be used directly or indirectly (A) to acquire securities or obligations that

may be reasonably expected at the time of issuance of such issue, to produce a yield over the term of the issue that is materially higher than the yield on obligations of such issue, or (B) to replace funds that were used directly or indirectly to acquire securities or obligations described in section 103(c)(2)(A).

Section 103(c)(4) of the Code provides that an obligation shall not be treated as an arbitrage bond solely by reason of the fact that the proceeds of the issue of which such obligation is a part may be invested for a temporary period in securities or other obligations until such proceeds are needed for the purpose for which such issue was issued.

Section 1.103-14(b)(1) of the regulations provides that original proceeds and investment proceeds of an issue of governmental obligations that are invested in acquired obligations during a 3-year period (or a longer period if determined to be necessary under paragraph (b)(5) of this section) beginning on the date of issue are invested for a temporary period if the expenditure test of paragraph (b)(2), the time test of paragraph (b)(3), and the due diligence test of paragraph (b)(4) are satisfied. However, section 1.103-14(b)(1) further provides that section 1.103-14(c) applies in the case of an issue of obligations issued in anticipation of taxes or other revenues.

Section 1.103-14(c)(1) of the regulations provides that in the case of an issue of obligations issued in anticipation of taxes or other revenues, proceeds that are invested are an investment for a temporary period if such obligations—

(i) Will not be outstanding after (A) a period ending 13 months after the date on which such obligations are issued, (B) a period ending 60 days (but not more than 24 months after such obligations are issued) after the last date for payment without interest or penalty of the anticipated tax (or last installment thereof) imposed by an annual tax levy or the first year's tax (or last installment thereof) of the anticipated tax imposed by a levy for more than 1 year, or (C) in the case of obligations issued in anticipation of governmental grants or advances and not in anticipation of taxes or revenues from other sources, a period ending 6 months after the date on which the issuer expects to receive such grants or advances (but not more than 30 months after such obligations are issued), and

(ii) Will not be issued in an amount greater than the maximum anticipated cumulative cash flow deficit to be financed by such anticipated tax or other revenue sources for the period for which such taxes or other revenues are anticipated and during which such obligations are outstanding.

Section 1.103-14(c)(2) of the regulations defines the cumulative cash flow deficit at any time during a period as an amount equal to:

(i) The amount that the issuing state or local government unit will expend from the beginning of such period to such computation date to pay expenditures that would ordinarily be paid out of or financed by the anticipated tax or other revenues, plus

(ii) The amount reasonably required by the issuer as a cash balance on hand at all times (the amount of the anticipated expenditures for a period of 1 month from such time being deemed to be reasonably required for this purpose), minus

(iii) The sum of the amounts (other than the proceeds of the issue in question), whether in the form of cash, marketable securities, or otherwise that will be available for the payment of such expenditures from the beginning of such period to such time.

Section 1.103-14(c)(3) of the regulations provides that amounts in accounts will be considered to be available for the payment of such expenditures to the extent that such accounts may, without legislative or judicial action, be invaded to pay such expenditures without a legislative, judicial, or contractual requirement that such accounts be reimbursed.

The following table illustrates the projected month-to-month financial

Month	Cumulative Surplus (or Deficit) At End of Month *	Expenditures	Receipts
Dec. 1980	$1,500,000	$ —0—	—0—
Jan. 1981	1,100,000	400,000	—0—
Feb. 1981	700,000	400,000	—0—
March 1981	300,000	400,000	—0—
April 1981	(100,000)	400,000	—0—
May 1981	(500,000)	400,000	—0—
June 1981	600,000	400,000	$1,500,000
July 1981	200,000	400,000	—0—
Aug. 1981	(200,000)	400,000	—0—
Sept. 1981	(600,000)	400,000	—0—
Oct. 1981	(1,000,000)	400,000	—0—
Nov. 1981	(1,400,000)	400,000	—0—
Dec. 1981	(300,000)	400,000	$1,500,000
Jan. 1982	(700,000)	400,000	—0—
Feb. 1982	(1,100,000)	400,000	—0—
March 1982	(1,500,000)	400,000	—0—
April 1982	(1,500,000)	—0—	—0—
May 1982	(1,500,000)	—0—	—0—
June 1982	—0—	—0—	$1,500,000

* Does not include amount of reasonably required cash balance of $400,000.

status of *M* for the period beginning one month before the notes are issued and ending when the last installment is received:

In this case the maximum anticipated cumulative cash flow deficit is the $1,500,000 deficit to be reached in March of 1982. This amount is determined by subtracting $4,900,000, the sum of the amounts that will be available to *M* until that date for the payment of expenditures, from $6,400,000, *M*'s total expenditures until that date plus one month's reasonably required cash balance. Although *M* will retire a portion of the note within 6 months of the receipt of each installment, this does not mean that these installments are unavailable to *M*. Evidence of this can be found by the fact that under prior versions of the regulations in existence before current section 1.103-14(c)(2)(iii) was promulgated as part of the proposed regulations of May 8, 1978 (43 FR 19675), the parenthetical in subparagraph (2)(ii) read "other than the proceeds of the anticipated tax or other revenues." This change in language indicates a specific intent that the grants be available. Thus, section 1.103-14(c)(1)(i)(C) does not require that *M* retire the notes until the earlier of 6 months after the last installment is received or 30 months after the notes were issued.

Because *M*'s issuance of notes will be in excess of the maximum anticipated cumulative cash flow deficit, *M*'s investment of the note proceeds in the federal obligations will not qualify as an investment for a temporary period under section 1.103-14(c)(1) of the regulations.

Section 1.103-13(b)(5)(i) of the regulations provides that the yield produced by acquired obligations is materially higher than the yield produced by a yield on an issue of governmental obligations if the yield produced by the acquired obligations exceeds the yield produced by the issue of governmental obligations by more than one-eighth of one percentage point.

Section 1.103-13(b)(5)(iv) of the regulations defines the term "materially higher" in those situations in which it is reasonably expected that the original proceeds of an issue will exceed the amount necessary for the governmental purpose or purposes of the issue by more than 5 percent of such amount. Any portion of the issue issued solely for the purpose of investing such portion at a materially higher yield as less than a major portion is not issued for a governmental purpose. The yield produced by acquired obligations acquired with the proceeds of such issue is materially higher than the yield produced by an issue of governmental obligations if the yield produced by the acquired obligations is higher than $Y + [(\$5{,}000 \times Y) \div P]$ where "Y" stands for the yield on the issue and "P" stands for the amount of the original proceeds of the issue.

M's issuance of the notes in the amount of $4,500,000 will exceed by more than 5 percent the amount necessary to satisfy the governmental purpose of the issue. Therefore, *M* will be subject to the yield restrictions of section 1.103-13(b)(5)(iv) of the regulations in determining the permissible yield for the note proceeds.

HOLDING

The issuance of *M*'s notes will fail to comply with the arbitrage yield restrictions of section 1.103-13(b)(5)(iv) of the regulations, and the notes will be arbitrage bonds within the meaning of section 103(c)(2) of the Code. Therefore, the interest on the notes will not be excludable from gross income under section 103(a)(1).

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26 CFR 1.103-13: Arbitrage bonds.
(Also Section 61; 1.61-7.)

Arbitrage bonds; temporary investment of proceeds. A political subdivision of a city issued bonds to finance construction of a water distribution facility more than two years before construction of the facility was to begin and invested a major portion of the proceeds in higher-yielding certificates of deposit to generate cash income from the large spread between interest rates on taxable and tax-exempt obligations. Because the political subdivision did not act with due diligence, the bond proceeds do not qualify for investment at a materially higher yield for a temporary period. Therefore, the bonds are arbitrage bonds, and the interest received by the bondholders is not excludable from their gross incomes.

Rev. Rul. 80-204

ISSUE

Are the bonds issued by an authority that is a political subdivision of a city subject to the arbitrage yield restrictions of section 103(c) of the Internal Revenue Code with respect to the investment of the bond proceeds under the circumstances described below?

FACTS

On January 1, 1979, Authority *M* was created as a political subdivision of City *O* in order to consolidate under one administration the various utilities within *O*. The first major project that *M* will undertake is construction of a water distribution facility. Because *M* has no revenues with which to pay for the construction, M planned to issue bonds for this purpose. Such bonds would not be "industrial development bonds" within the meaning of section 103(b)(2) of the Code.

On September 1, 1979, *M* incurred a binding obligation to corporation X involving the expenditure of $500,000 for planning and engineering services in connection with the water distribution facility. Because of the nature of the services, *X* will be unable to complete the planning process before October 1, 1981. It is estimated that construction of the facility will begin in

February 1982, and will be completed before August 31, 1982.

In accordance with ordinary financial practice, *M* would not issue bonds to pay for construction of the facility until the planning process was substantially completed. However, *M* issued $10,000,000 of 6 percent general obligation bonds on January 2, 1980. From the available bond proceeds of $9,400,000 (face amount minus costs of issuance and a portion of the $500,000 fee for planning and engineering), $8,400,000 was invested in a one-year certificate of deposit at a 12.5 percent interest rate, $500,000 was invested in a six-month certificate at 13 percent, and $500,000 was invested in a nine-month certificate at 12.5 percent.

The stated purpose of the abnormally early issuance is to take advantage of the large interest spread between taxable and tax-exempt obligations in order to generate cash income. The income will be used primarily to pay for the initial administrative costs of establishing *M*.

LAW AND ANALYSIS

Section 103(a)(1) of the Code provides that gross income does not include interest on obligations of a state or a political subdivision of a state.

Section 103(c)(1) of the Code provides that, with certain minor exceptions, the interest on any arbitrage bond will not be excludable from gross income.

Section 103(c)(2) of the Code provides that the term "arbitrage bond" means any obligation that is issued as part of an issue all or a major portion (more than 15 percent) of the proceeds of which are reasonably expected to be used directly or indirectly (A) to acquire securities or obligations that may be reasonably expected at the time of issuance of such issue, to produce a yield over the term of the issue that is materially higher than the yield on obligations of such issue, or (B) to replace funds that were used directly or indirectly to acquire securities or obligations described in section 103(c)(2)(A).

Section 103(c)(4)(A) of the Code provides that an obligation shall not be treated as an arbitrage bond solely by reason of the fact that the proceeds of the issue of which such obligation is a part may be invested for a temporary period in securities or other obligations until such proceeds are needed for the purpose for which such issue was issued.

Section 1.103-14(b) of the Income Tax Regulations provides in general that original proceeds and investment proceeds of an issue of governmental obligations that are invested in acquired obligations during a 3-year period beginning on the date of issue are invested for a temporary period if the expenditure test of paragraph (b)(2), the time test of paragraph (b)(3), and the due diligence test of paragraph (b)(4) are satisfied. The time test requires that the issuer must incur a substantial binding obligation to commence the project within 6 months after the date of issue. The due diligence test provides that after the substantial binding obligation is incurred, work on the facility must proceed with due diligence to completion. The expenditure test provides that at least 85 percent of spendable proceeds (as defined in paragraph (b)(2)(iii)) must be spent within the temporary period.

When bonds are issued to finance a public project, the due diligence test is ordinarily satisfied whenever the issuer endeavors to spend the bond proceeds on the project with reasonable dispatch. In determining whether due diligence has been exercised, any legal, financial, engineering, or other obstacle to engaging in work on the project will ordinarily be taken into account.

In this case, however, actual construction of the water facility will not begin until more than two years after the date of issue. Moreover, *M*'s purpose in proceeding with the bond issue prematurely was to secure an opportunity to invest the bond proceeds in higher yielding taxable obligations. Thus, *M* has deliberately acted to prolong the period between issuance of the bonds and expenditure of the proceeds, and has done so for the purpose of earning arbitrage. A deliberate act of this nature is inconsistent with the requirement of due diligence.

In these circumstances, *M* does not saitsfy the due diligence test of section 1.103-14(b)(4) of the regulations. However, this case is distinguishable from one where the date of issuance is determined solely with regard to bona fide financial or other nonarbitrage reasons (for example, where financing for one project is combined with financing for several others solely for economies of scale and other bond marketing advantages).

HOLDING

The bond proceeds do not qualify for investment at a materially higher yield during a temporary period described in section 1.103-14(b) of the regulations. Further, the bonds are arbitrage bonds, and the interest received by the bondholders is not excludable from their gross incomes under section 103(a)(1) of the Code.

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26 CFR 1.103-13: Arbitrage bonds. (Also Section 61; 1.61-7.)

Arbitrage bonds; proceeds invested by city pension fund. A city is required by state law to levy sufficient property taxes annually to provide the required funding for its firefighters' pension fund. The city proposes to issue general obligation bonds and distribute the proceeds to the pension fund for investment in obligations producing yields materially higher than the yield on the city's bonds. As a result, the city expects to substantially reduce the amount of taxes

that it will have to levy in future years to maintain the pension fund reserves. The bonds will be arbitrage bonds within the meaning of section 103(c)(2) of the Code.

Rev. Rul. 80-257

ISSUE

Will bonds issued by city *X* be arbitrage bonds as a result of the investment of bond proceeds by the trustees of the city *X* firefighters' pension fund?

FACTS

X is a political subdivision of state *Y*. *X* proposes to issue general obligation bonds maturing serially over 25 years, and to distribute the bond proceeds to the pension fund.

The statute enacted by the state *Y* legislature establishing city pension funds provides that the fund is a body politic and corporate, and is separate and apart from *X* and state *Y*. Under the statute, the trustees of the pension fund include certain officers of the fire department of *X*, representatives of the active firefighters, and a representative of the retired firefighters. The statute provides that the trustees are considered to be officials of the body politic and corporate.

The state statute provides for payment of pensions from the fund to retired firefighters and certain surviving relatives in amounts determined on the basis of each firefighter's age, salary, and years of creditable service with the fire department, rather than on the basis of earnings on, or appreciation of, assets in the pension fund. No separate accounts are established with the pension fund for individual firefighters.

Under the state statute, liabilities of the pension fund are the obligations of *X*. Moreover, *X* is required to levy a tax annually on all taxable property located within its bounds in an amount sufficient (1) to cover current service costs (sometimes referred to as "normal costs") and (2) to provide for amortization of unfunded accrued liabilities in the fund over a 20-year period. Since the statute was enacted, *X* has made annual contributions from taxes in an amount necessary to meet these funding requirements. However, *X* anticipates that contribution of the bond proceeds to the fund will satisfy the entire unfunded accrued liability of the pension fund. This contribution will equal approximately 10 times the annual contribution required under the statute to amortize unfunded accrued liabilities.

Tax revenues generated under the state statute will be used to pay debt service on the bonds.

The state statute requires investment of pension funds in certain enumerated categories of investment, including bonds of the United States. *X* reasonably expects that the trustees will use the bond proceeds to acquire obligations not described in section 103(a)(1) of the Internal Revenue Code producing yields materially higher than the yield on *X*'s bonds during the term of the bonds. *X* further expects that such investment of the bond proceeds will substantially reduce the amount of taxes *X* will have to levy in future years to maintain the pension fund reserves.

LAW AND ANALYSIS

Section 103(a)(1) of the Code provides that gross income does not include interest on obligations of a state or a political subdivision of a state.

Section 103(c)(1) of the Code provides that, with certain exceptions, an arbitrage bond is not treated as an obligation described in section 103(a)(1).

Section 103(c)(2) of the Code provides that the term "arbitrage bond" means any obligation that is issued as part of an issue all or a major portion of the proceeds of which are reasonably expected to be used directly or indirectly (A) to acquire securities or obligations that may be reasonably expected at the time of issuance of such issue to produce a yield over the term of such issue that is materially higher than the yield on obligations of such issue, or (B) to replace funds that were used directly or indirectly to acquire securities or obligations described in (A).

Because the amount of benefits paid by the pension fund is determined according to the age, salary, and years of service of the firefighters, the trustees' success or failure in investing the pension funds will not affect the amount of pensions paid. However, the success or failure of the trustees' investments, including investment of bond proceeds, will directly affect the amount of taxes that *X* must levy in future years, since *X* will remain obligated under the state statute to levy taxes annually as needed to cover normal costs and to amortize any unfunded accrued liabilities of the fund. Thus, the determination whether *X* will raise or lower taxes in future years will be dependent upon the yield and obligations acquired by the trustees with bonds proceeds. Consequently, *X* anticipates a substantial direct benefit from investment of bond proceeds by the trustees.

Therefore, it is concluded that all of the bond proceeds are reasonably expected to be used to acquire securities that are reasonably expected to produce yields materially higher than the yield on *X*'s bonds within the meaning of section 103(c)(2).

HOLDING

The bonds will be arbitrage bonds within the meaning of section 103(c)(2) of the Code. Therefore, interest on the bonds will not be excludable from gross incomes of the bondholders under section 103(a)(1).

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26 CFR 1.103-13: Arbitrage bonds.
(Also Section 61; 1.61-7.)

Arbitrage bonds; contemporaneous issuance of notes and bonds. Factual situations illustrate cir-

cumstances under which a political subdivision's short-term notes that are issued contemporaneously with long-term bonds will be arbitrage bonds.

Rev. Rul. 80-328 [1]

ISSUE

Will notes of political subdivisions of states be arbitrage bonds within the meaning of section 103(c)(2) of the Internal Revenue Code in the situations described below?

FACTS

Situation 1

On November 14, 1980, authority *M*, a political subdivision of state *O*, proposes to issue 185*x* dollars of 5-year notes. Of the note proceeds, 176*x* dollars will be used to acquire newly created mortgages on single-family residences; 6*x* dollars will be deposited into a "reasonably required" reserve fund; and 3*x* dollars will be used to pay for the issuance costs of the notes. The notes will be issued at a yield of 7 percent. Note proceeds of 176*x* dollars are to be invested in United States Treasury Obligations at an unrestricted yield of 8.25 percent for a temporary period until used to acquire the mortgages. The mortgages to be acquired with the 176*x* dollars of note proceeds will have a yield of 8.5 percent while subject to the lien of the notes and 10.5 percent thereafter.

Also, on November 14, 1980, *M* will issue 204*x* dollars of 30-year bonds. Of the bond proceeds, 176*x* dollars will be deposited in a note retirement fund; 24*x* dollars will be deposited into a reasonably required reserve fund; and 4*x* dollars will be used to pay issuance costs of the bonds. The bonds were issued at a yield of 9 percent and will be invested at a yield of 9 percent in United States Treasury Obligations — State and Local Government Series (SLGS) until the note retirement date. On the note retirement date the mortgages that are not more than 90 days delinquent in payment of the principal and interest will be transferred from the lien of the notes to the lien of the bonds. At that time an amount of bond proceeds from the note retirement fund equal to the outstanding principal amount of the transferred mortgages will be used for retirement of an equivalent portion of the notes. Any amount remaining in the note retirement fund after the mortgages are transferred will be used to redeem a portion of the bonds. The trustee under the note indenture will either sell or foreclose on mortgages not transferred to the lien of the bonds.

Based on the national experience with mortgages and the issuer's prior experience with similar mortgage purchase programs, the issuer reasonably expects that more than 99 percent of the mortgages will be transferred to the lien of the bonds on note retirement date.

Situation 2

On November 14, 1980, authority *N*, a political subdivision of state *P*, proposes to issue 76*x* dollars of 3-year notes yielding 7 percent. The proceeds of the notes will be used to make construction mortgage loans to developers of various multi-family housing projects. The projects to be financed out of note proceeds will be eligible for housing assistance payments under section 8 of the United States Housing Act of 1937, as amended, 42 U.S.C. section 1437f. *N* anticipates that construction of the projects will be completed within 3 years of the date of issue of the notes. Note proceeds will be invested for a temporary period pending disbursement in Treasury Obligations at an unrestricted yield of 8.50 percent.

In addition, *N* proposes to issue on December 1, 1980, 80*x* dollars of 30-year bonds yielding 9 percent. The note proceeds will not be expended until bonds are issued. Of the bond proceeds, 76*x* dollars will be deposited into the Bond Proceeds Account and 4*x* dollars will be deposited into the Debt Service Reserve Fund. All of the bond proceeds will be held as security for the bondholders until construction on the projects is completed, at which time proceeds in the Bond Proceeds Account will be used to pay the principal on *N*'s notes. While the notes are outstanding, bond proceeds held in the Bond Proceeds Account will be invested in SLGS yielding 9 percent.

If a project is not completed within 3 years of the date of issuance of the notes, amounts in the Bond Proceeds Account will be used to redeem bonds on that date.

All mortgage loans will be insured under the cash payment mortgage insurance program administered by the Federal Housing Administration (FHA), whether the construction mortgage loans are provided by the notes or the bonds. This insurance program will provide for payments of approximately 99 percent of the principal amount of an outstanding mortgage loan in the event of default by a mortgagor.

LAW AND ANALYSIS

Section 103(a)(1) of the Code provides that gross income does not include interest on the obligations of a state, a territory, or a possession of the United States, or any political subdivision of the foregoing, or of the District of Columbia.

Section 103(c)(1) of the Code provides that, with certain minor exceptions, the interest on any arbitrage bond will not be excludable from gross income.

Section 103(c)(2) of the Code provides that the term "arbitrage bond" means any obligation that is issued as part of an issue all or a major portion (more than 15 percent) of the proceeds of which are reasonably expected to be used directly or indirectly (A) to acquire securities or obligations

[1] Also released as News Release IR-80-117, dated November 7, 1980.

that may be reasonably expected at the time of issuance of such issue, to produce a yield over the term of the issue that is materially higher than the yield on obligations of such issue, or (B) to replace funds that were used directly or indirectly to acquire securities or obligations described in section 103(c)(2)(A).

Section 1.103-13(a)(2)(i) of the Income Tax Regulations provides, in part, that the determination whether an obligation is an arbitrage bond depends on the issuer's reasonable expectations, as of the date of issue, regarding the amount and the use of proceeds of the issue.

Section 1.103-13(b)(5)(iv) of the regulations defines the term "materially higher" in those situations in which it is reasonably expected that the original proceeds of an issue will exceed the amount necessary for the governmental purpose or purposes of the issue by more than 5 percent of such amount. Any portion of the issue issued solely for the purpose of investing such portion at a materially higher yield as less than a major portion is not issued for a governmental purpose. The yield produced by acquired obligations acquired with the proceeds of such issue (including any acquired obligations held during the temporary periods described in section 1.103-14(b), any amounts invested in the reserve or replacement fund as defined in section 1.103-14(d), and any investments of less than a major portion of such proceeds as described in section 1.103-13(b)(1)) is materially higher than the yield produced by an issue of governmental obligations if the yield produced by the acquired obligations is higher than Y+[($5,000 × Y) ÷ P] where "Y" stands for the yield on the issue and "P" stands for the amount of the original proceeds of the issue. Nothing in this subdivision implies that a deliberate over-issuance of less than 5 percent will not be treated as an artifice or device under section 1.103-13(j).

Section 1.103-13(j) of the regulations provides that if an artifice or device is employed in connection with the issuance of a governmental obligation, such obligation will be considered an arbitrage bond within the meaning of section 103(c)(2) of the Code. For purposes of this section, the term "artifice or device" means a transaction or a series of transactions that attempts to circumvent the provisions of section 103(c) of the Code or sections 1.101-13, -14, or -15 of the regulations—(1) enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to gain a material financial advantage and (2) increasing the burden on the market for tax-exempt obligations.

Section 1.103-13(j) of the regulations further provides that examples of increased burdens on the market for tax-exempt obligations include selling obligations that would not otherwise be sold, selling more obligations than would otherwise be necessary, and issuing obligations sooner or allowing them to remain outstanding longer than would otherwise be necessary.

As a general rule, the term "arbitrage bond" includes any obligation which is issued as part of an issue all or a major portion of the proceeds of which are reasonably expected to be used directly or indirectly to replace funds that were used directly or indirectly to acquire securities that may be reasonably expected to produce a yield that is materially higher than the yield on the obligations of such issue. When an issuer issues long-term bonds and short-term notes contemporaneously to provide for the same project, and the proceeds of the notes are used to finance the construction costs of the project while the bond proceeds are invested, the notes replace the bonds within the meaning of section 103(c)(2)(B) of the Code. Thus, the bond proceeds are replaced proceeds and have the same status and are subject to the same yield restrictions as the note proceeds. See Example (1) of section 1.103-14(e)(7) of the regulations. In *Situation 1* and *Situation 2,* the bond proceeds will be invested in securities of a materially higher yield than the yield on the notes.

In addition, as a general rule, short-term notes are issued in connection with a project to provide interim financing until market conditions are conducive to the issuance of long-term bonds to provide permanent financing for that project. If an issuer reasonably expects to issue long-term bonds as permanent financing for the project at the commencement of the project, then interim financing in the form of short-term notes is not necessary for the purpose of providing the project. In *Situation 1, M* will issue short-term notes and long-term bonds. *M*'s notes will not be issued to acquire the mortgage loans because permanent financing will already have been placed. In *Situation 2, N* will issue long-term bonds on a date certain on or before the commencement of its project of providing low-cost, multi-family housing. *N* will also issue short-term notes two weeks earlier than the date on which it reasonably expects to issue its bonds. Although *N*'s notes will be issued before its bonds, the notes will not provide interim financing for *N*'s project, because *N* reasonably expects to issue its long-term financing on a date certain on or before the commencement of its project. Thus, *N*'s notes will not be issued to provide the project.

Consequently, in *Situation 1,* the issuance by *M* of $176x$ dollars of notes contemporaneously with the issuance of $204x$ dollars of bonds will exceed the amount necessary for the governmental purpose of acquiring newly created mortgages on single-family residences by more than 5 percent. Similarly, in *Situation 2,* the issuance by *N* of $76x$ dollars of notes that are issued contemporaneously with the issuance of the $80x$ dollars of bonds will exceed the amount necessary for the governmental purpose of providing low-cost family housing by more than

5 percent. Thus, *M*'s notes and *N*'s notes are an over-issuance within the meaning of section 1.103-13(b)(5)(iv) of the regulations. Because *M* and *N* have made an over-issuance the yield restrictions of section 1.103-13(b)(5)(iv) apply to the investment of note proceeds. In *Situation 1* and *Situation 2* the applicable yield restrictions will be exceeded.

In *Situation 1* and *Situation 2*, the issuance of the 7 percent notes contemporaneously with the issuance of the 9 percent bonds will permit *M* and *N* to exploit the difference between the tax-exempt and taxable interest rates to gain a material financial advantage within the meaning of section 1.103-13(j)(1) of the regulations. By using the proceeds of the 7 percent notes to provide the projects (instead of the proceeds of the 9 percent bonds) and investing the bond proceeds in taxable securities yielding 9 percent, during the term of the notes the overall cost of borrowing to *M* and *N* will be 2 percentage points lower than it would have been if the notes had not been issued and the bond proceeds had been used to provide the projects. This reduced cost of borrowing is a material financial advantage that *M* and *N* will be able to gain as a result of having issued notes at the tax-exempt rate of 7 percent to carry the investment of the bond proceeds in taxable securities yielding 9 percent. In other words, the economic effect of the contemporaneous issuance of the notes and bonds is the same as if *M* and *N* had used the proceeds of the 9 percent bonds to provide the projects, invested the proceeds of the tax-exempt notes yielding 7 percent in taxable securities yielding 9 percent during the term of the notes, and used the arbitrage profits on this investment to lower the overall cost of borrowing during the term of the notes by 2 percentage points. See also Rev. Rul. 80-13, 1980-1 C.B. 27, in which the issuance of unnecessary bonds and the investment of the bond proceeds at a materially higher yield is an artifice or device. Furthermore, by issuing both notes and bonds contemporaneously in an aggregate principal amount of approximately twice the actual cost of their respective projects to gain this financial advantage, *M* and *N* will have sold more obligations, and allowed them to remain outstanding longer, than otherwise would be necessary. Thus, both *M* and *N* will have entered into a series of transactions that will have the effect of increasing the burden on the market for tax-exempt obligations within the meaning of section 1.103-13(j)(2). Consequently, in both situations *M* and *N* will issue their notes in connection with an artifice or device within the meaning of section 1.103-13(j).

HOLDING

In *Situation 1* and *Situation 2* the notes will be arbitrage bonds within the meaning of section 103(c)(2) of the Code. Therefore, interest on *M*'s notes and *N*'s notes will not be excludable from the gross income of the noteholders under section 103(a)(1).

Section 111.—Recovery of Bad Debts, Prior Taxes, and Delinquency Amounts

26 CFR 1.111-1: Recovery of certain items previously deducted or credited.

Whether an expression of doubt issued subsequent to the issuance of a charge off order by a supervisory federal authority constitutes a recovery of a bank's previously deducted bad debt. See Rev. Rul. 80-180, page 66.

Section 116.—Partial Exclusion of Dividends and Interest Received by Individuals

26 CFR 1.116-1: Partial exclusion of dividends.

Whether the holding of Rev. Rul. 70-597, 1970-2 C.B. 146 that dividends paid by a regulated investment company out of net short-term capital gains qualify for the $100 dividends received individual exclusion under section 116 of the Code subject to the limitations under section 854, is correct; and whether unexercised option gains realized by a regulated investment company are excluded from gross income for purposes of section 854(b). See Rev. Rul. 80-345, page 204.

Section 121.—One-Time Exclusion of Gain from Sale of Principal Residence by Individual Who Has Attained Age 55

26 CFR 1.121-1: Gain from sale or exchange of residence of individual who has attained age 55.

Sale of residence; exclusion of gain; ownership and use tests. A taxpayer who otherwise meets the requirements of section 121 of the Code may make the election to exclude gain on the sale of a personal residence if the ownership and use tests are met, even though the tests are not met simultaneously.

Rev. Rul. 80-172

ISSUE

May a taxpayer elect, under section 121 of the Internal Revenue Code, to exclude gain from the sale of the taxpayer's principal residence under the circumstances described below?

FACTS

In 1970, *A*, who was 60 years old, occupied a rental apartment as *A*'s principal residence. The building in which the apartment is located was subsequently converted to condominium ownership, and on July 15, 1974, *A* purchased the apartment, which remained *A*'s principal residence. In 1977, *A* became seriously ill and on April 15, 1977, was moved to a convalescent home. On February 15, 1980, while still at the convalescent home, *A* sold the apartment.

LAW

Section 121(a) of the Code provides that at the election of the taxpayer, gross income does not include gain from the sale or exchange of property if (1) the taxpayer has at-

tained the age of 55 before the date of the sale or exchange and (2) during the 5-year period ending on the date of the sale or exchange, the property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 3 years or more. Under section 121(b), the amount of gain excluded from gross income may not exceed $100,000.

Section 1.121-1(b) of the Income Tax Regulations provides that in the case of a sale or exchange of a residence before July 26, 1981, a taxpayer who has attained age 65 on the date of such sale or exchange may elect to have section 121 of the Code applied if during the 8-year period ending on the date of the sale or exchange, the property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 5 years or more.

In this case, because the sale occurred before July 26, 1981, and because *A* had attained age 65 on the date of the sale, the 8- and 5-year periods set forth in section 1.121-1(b) of the regulations may be elected. *A* sold the apartment on February 15, 1980; therefore, the 8-year period began on February 16, 1972, and ended on February 15, 1980. *A* purchased the apartment in 1974 and, therefore, owned the apartment for more than 5 years during the 8-year period. *A* resided in the apartment from 1970 until April 15, 1977, and, therefore, resided in the apartment for more than 5 years during the 8-year period beginning February 16, 1972. Thus, *A* has met both the ownership and use tests required by section 121 of the Code.

HOLDING

A may elect, under section 121 of the Code, to exclude gain from the sale of *A*'s principal residence.

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26 CFR 1.121-1: Gain from sale or exchange of residence of individual who has attained age 55.

Determination of the amount of each installment payment that is reportable under the installment method of accounting where the taxpayer elects to exclude gain pursuant to section 121 of the Code. See Rev. Rul. 80-249, page 166.

Part VI.—Itemized Deductions for Individuals and Corporations

Section 162.—Trade or Business Expenses

26 CFR 1.162-1: Business expenses.

Business expenses; punitive damages. Amounts paid by a corporation as punitive damages that arose as a result of a civil lawsuit against the corporation for breach of contract and fraud in connection with the ordinary conduct of its business activities are deductible as ordinary and necessary business expenses.

Rev. Rul. 80-211

ISSUE

Are amounts paid as punitive damages that are incurred in the ordinary conduct of the taxpayer's business operations deductible as an ordinary and necessary business expense under section 162 of the Internal Revenue Code?

FACTS

X, a domestic corporation, deducted a payment identified as punitive damages as an ordinary and necessary business expense. *X*'s obligation to make such payment arose as a result of a civil lawsuit in which *X* was sued by *Y*, another domestic corporation, for breach of contract and fraud in connection with the ordinary conduct of its business activities. Judgment was rendered against *X* by the court.

LAW AND ANALYSIS

Section 162 of the Code provides that 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.

Section 162(c) of the Code provides that no deduction shall be allowed under section 162(a) for any illegal payment, bribe, kickback, or rebate when made under any of the circumstances or to or by any of the persons described in section 162(c).

Section 1.162-1(a) of the Income Tax Regulations provides that business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business.

In applying these provisions, the courts and the Service have recognized that payments made in settlement of lawsuits are deductible if the acts which gave rise to the litigation were performed in the ordinary conduct of the taxpayer's business. *See, for example,* Rev. Rul. 78-210, 1978-1 C.B. 39; Rev. Rul. 69-491, 1969-2 C.B. 22; *Kornhauser v. United States,* 276 U.S. 145, T.D. 4222, VII-2 C.B. 267 (1928); *Mulgrew Blacktop, Inc. v. United States,* 311 F. Supp. 570 (S.D. Iowa 1969); and *Cochrane v. Commissioner,* 23 B.T.A. 202 (1931), *acq.* X-2 C.B. 14 (1931).

The Senate Finance Committee in S. Rept. 91-522, 91st Cong., 1st Sess. (1969), 1969-3 C.B. 423, 597, stated that the additions to section 162 of the Code made in section 902 of the Tax Reform Act of 1969, 1969-3 C.B. 10, 147, denying deductions for the following expenditures were intended to be *all inclusive* (Emphasis added): fines or similar penalties paid to a government for violation of any law, a portion of treble damage payments under the antitrust laws, bribes to public officials, and other unlawful bribes or "kickbacks".

In the present situation *X* was sued by another corporation for fraudulent acts and contractual violations perpetuated in the ordinary conduct of its business activities. Therefore, payment of the judgment by *X*, including amounts identified as punitive damages, is an ordinary and necessary cost of doing business. Further, the action against *X* is not based upon any of the

prohibited activities described in section 162(c) of the Code.

HOLDING

Amounts paid as punitive damages incurred by the taxpayer in the ordinary conduct of its business operations are deductible as an ordinary and necessary business expense under section 162 of the Code.

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26 CFR 1.162-1: Business expenses. (Also Sections 274, 3401; 1.274-5, 31.3401 (a)-1.)

Per diem allowance; away from home. An employee who participated in a 12-month executive training program at various offices throughout the country pending reassignment in a new location was away from home and could exclude from gross income a per diem allowance paid by the employer. The per diem allowance was not wages subject to income tax withholding.

Rev. Rul. 80-212

ISSUE

Under the circumstances described below, is a taxpayer who participates in a training program of the taxpayer's employer considered "away from home" within the meaning of section 162(a)(2) of the Internal Revenue Code?

FACTS

X, a corporation, conducts a training program whereby potential and current executives are given extensive classroom and on-the-job training at various offices of *X* throughout the United States. The participants in the training program are relieved of their job responsibilities immediately after selection for the program, their positions are filled by others, and they are assigned to 12 months of training. The purpose of the program is to provide *X* with a continuing supply of administrators to cope with the management problems of a complex organization. After satisfactorily completing the 12 months of training, the participants are to be given a permanent appointment to fill an executive vacancy in one of *X*'s offices. It is a virtual certainty that this permanent appointment will be at a location different from where the participant worked when selected by *X* for the program.

A, an unmarried individual who uses the cash receipts and disbursements method of accounting and files returns on a calendar year basis, was assigned to the program described above effective September 1, 1978. *A* had been employed regularly by *X* in city *M* since January 1973, and had been renting an apartment in *M* for 35*x* dollars a month. After *A*'s assignment to the program, *A* did not perform any duties for *X* in the vicinity of *M*, *A*'s position in *M* was filled by another individual, and *A* had no reasonable expectation of returning to *M* to work. However, *A*'s various administrative records continued to be kept in *M* and *X* continued to designate *M* as *A*'s official assignment office.

On August 31, 1979, *A* satisfactorily completed the 12-month training program of *X*. During that time *A* traveled to numerous offices of *X* throughout the country for short temporary periods to observe the various functions in those offices. *A* lived in motels and ate all meals in restaurants. *A* continued to maintain the apartment in city *M*. During this 12-month period, *A* returned to *M* at various times totalling 30 days. *A* stayed in the apartment, visited friends, attended to personal business matters, and generally maintained community contacts. *A* continued to maintain a post office box and bank account in *M* as well as a driver's license and voter registration for the state in which *M* is located. *A* also purchased insurance and filed tax returns in the state in which *M* is located during the 12-month period. *A* received a permanent assignment on September 1, 1979, to a new place of business.

During the training period while *A* was away from city *M*, *X* paid *A* a per diem amount based on the cost of living in the area where *A* was physically located at the particular time. *A* was required to and did provide an adequate accounting to *X* for all expenditures, and such expenditures were reasonable in amount. The per diem amounts were not in excess of such expenditures. *A* did not report the per diem amounts received during the training period in gross income.

LAW AND ANALYSIS

Section 274 of the Code and the regulations thereunder provide rules for reporting and substantiation of certain expenses paid or incurred by taxpayers in connection with the performance of services as employees.

Section 1.274-5(e)(2) of the Income Tax Regulations provides that, for purposes of computing tax liability, an employee need not report on the employee's tax return "business expenses" for travel, transportation, entertainment, gifts and similar purposes, paid or incurred solely for the benefit of the employer for which the employee is required to, and does, make an adequate accounting to the employer and which are charged directly or indirectly to the employer or for which the employee is paid through advances, reimbursements, or otherwise, provided that the total amount of such advances, reimbursements, and charges is equal to such expenses. Therefore, provided these requirements are met, the employee need not report such reimbursements in gross income.

Section 1.274-5(e)(1) of the regulations provides generally that the term "business expenses" means ordinary and necessary expenses for travel, entertainment, or gifts which are deductible under section 162 of the Code, and the regulations thereunder. Thus, the term "business expenses" does not include personal, living or family expenses disallowed by section 262, and advances, reimbursements, or allow-

ances for such expenditures must be reported as income by the employee.

Section 162(a)(2) of the Code provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, including traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business.

In this case *A* made an adequate accounting to *X* for all the expenses incurred. The per diem amounts were not in excess of such expenses, and the expenses were not lavish or extravagant. Therefore, whether *A* must report the per diem amounts received from *X* in gross income depends on whether *A*'s travel expenses were paid or incurred while "away from home" within the meaning of section 162(a)(2) of the Code.

Rev. Rul. 73-529, 1973-2 C.B. 37, provides that generally a taxpayer's "home" for purposes of section 162(a)(2) of the Code is considered to be located at (1) the taxpayer's regular or principal (if more than one regular) place of business, or (2) if the taxpayer has no regular or principal place of business because of the nature of the trade or business, then at the taxpayer's regular place of abode in a real and substantial sense. If the taxpayer comes within neither category (1) nor category (2), the taxpayer is considered to be an itinerant who has a "home" wherever the taxpayer happens to work, and thus is not "away from home" for traveling expense deduction purposes. The revenue ruling further provides that there are three objective factors that may be used to determine, with respect to the taxable year in question, the bona fide nature of an assertion that the taxpayer's claimed abode is the taxpayer's "regular place of abode in a real and substantial sense." They are:

(1) Whether the taxpayer performs a portion of the taxpayer's business in the vicinity of the claimed abode and uses such abode (for purposes of lodging) while performing such business there;

(2) Whether the taxpayer's living expenses incurred at the claimed abode are duplicated because the taxpayer's business requires travel away therefrom; and

(3) Whether the taxpayer—

(a) has not abandoned the vicinity in which the historical place of lodging and claimed abode are both located,

(b) has a member or members of the taxpayer's family (marital or lineal only) currently residing at the claimed abode, or

(c) uses the claimed abode frequently for purposes of lodging.

The Service will recognize that a taxpayer has a "home" for traveling expense deduction purposes if the taxpayer claims an abode and, under bona fide circumstances, satisfies all three objective factors set forth above. If a taxpayer, under bona fide circumstances, satisfies only two of the three objective factors set forth above, then all the facts and circumstances of the case will be subjected to close scrutiny to determine whether the taxpayer has a "home" for traveling expense deduction purposes in the form of a regular place of abode in a real and substantial sense. If a taxpayer fails to satisfy at least two of the three objective factors set forth above, the taxpayer will be regarded as having a "home" wherever the taxpayer happens to work, and thus cannot be "away from home" for purposes of section 162(a)(2) of the Code.

After *A* was assigned to the program on September 1, 1978, *A* did not have a regular or principal place of business in city *M* because *A* was released from all job responsibility in *M* and had no reasonable expectation of returning there to work. The fact that *A*'s administrative records continued to be kept at *M* and that *A*'s assignments were issued from *M* does not change this conclusion. Nor did *A* have a regular or principal place of business in any other location because *A*'s training assignments were temporary pending permanent assignment on September 1, 1979. Therefore, whether *A* was away from home depends on a determination of where *A*'s regular place of abode was in a real and substantial sense while *A* was a participant in the training program.

Applying the three objective factors listed above to *A*'s situation during the time period September 1, 1978, to August 31, 1979, *A* did not satisfy factor (1) because *A* did not perform any business in the vicinity of city *M*. However, *A* did satisfy factor (2) because *A* did duplicate living expenses incurred in *M* in that *A* continued to rent the apartment. *A* also satisfied factor (3) because *A* had not abandoned the vicinity in which *A*'s historical place of lodging and claimed abode were located in that *A* maintained the apartment in *M* and also returned to *M* to generally maintain community contacts there. In addition, *A* did use the claimed abode frequently for purposes of lodging.

Based on all the facts and circumstances of this case, including the satisfaction of factors (2) and (3) and the additional contacts with city *M* that *A* maintained (such as maintaining a post office box and bank account in *M*, maintaining a driver's license and voter registration for the state in which *M* is located, and purchasing insurance and filing tax returns in the state in which *M* is located during the 12-month period), *A* is considered to have had a home in *M* in the form of a regular place of abode in a real and substantial sense during the period from September 1, 1978, to August 31, 1979.

HOLDING

Because *A*'s home in the form of a regular place of abode in a real and substantial sense remained in city *M* during the training period which lasted

through August 31, 1979, *A* was "away from home" during the 12-month training period. Therefore, during that time, *A* need not report any per diem allowance received from *X* in gross income. In addition, the per diem allowance is not considered "wages" subject to income tax withholding pursuant to section 31.3401(a)-1(b)(2) of the Employment Tax Regulations.

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26 CFR 1.162-1: Business expenses.

Whether disbursements from an officeholder's office account are deductible. See Rev. Rul. 80-331, page 29.

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26 CFR 1.162-1: Business expenses.

Whether court awarded payments for attorney's fees to a union on behalf of its members are deductible by the members as a business expense. See Rev. Rul. 80-364, page 294.

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26 CFR 1.162-2: Traveling expenses.

Commuting expenses; construction worker. The Service will not follow the **Frederick** decision, which held that daily commuting expenses incurred over a three-year period by a construction worker who reasonably expected to be laid off when winter came were ordinary and necessary business expenses.

Rev. Rul. 80-333

The Internal Revenue Service will not follow the decision of the United States Court of Appeals for the Eighth Circuit in *Frederick v. United States,* 603 F.2d 1292 (8th Cir. 1979), as a precedent in the disposition of similar cases.

In *Frederick,* the court held that the transportation expenses incurred over a three-year period by the taxpayer in traveling daily from the taxpayer's home to a missile site where the taxpayer was employed as a carpenter were deductible as ordinary and necessary business expenses. The court held that because the taxpayer expected to be laid off when winter came and only a very small crew was needed for indoor construction work, the taxpayer was reasonable in expecting to be employed on the project only for a temporary period of time.

The Eighth Circuit's approach conflicts in principle with a long line of judicial authority holding that such expenses are not deductible. See *Commissioner v. Flowers,* 326 U.S. 465 (1946), *Peurifoy v. Commissioner,* 254 F.2d 483 (4th Cir. 1957), *aff'd per curiam,* 358 U.S. 59 (1958), *Boone v. United States,* 482 F.2d 417 (5th Cir. 1973), and *Babeaux v. Commissioner,* 601 F.2d 730 (4th Cir. 1979). It is also contrary to the published position of the Internal Revenue Service on the matter. See Rev. Rul. 60-189, 1960-1 C.B. 60. Accordingly, similar cases that arise in all circuits other than the Eighth Circuit will be disposed of in conformity with established judicial doctrine and the prior published ruling, and the Service will continue to hold that such expenses are not deductible.

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26 CFR 1.162-2: Traveling expenses.

Whether reimbursed expenses by a union to delegates to its annual convention are deductible when reimbursement occurs in a later year. See Rev. Rul. 80-348, page 31.

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26 CFR 1.162-5: Expenses for education. (Also Section 262; 1.262-1.)

Educational expenses; veterans; flight training. An airplane pilot may not deduct any otherwise allowable flight training expenses to the extent the expenses are directly reimbursed by the Veterans' Administration pursuant to 38 U.S.C. section 1677; Rev. Rul. 62-213 distinguished and clarified.

Rev. Rul. 80-173

ISSUE

Are an airline pilot's expenditures on tuition and fees for an aviation program involving the flying of certain types of small aircraft, deductible as ordinary and necessary business expenses under section 162 of the Internal Revenue Code when such expenses are directly reimbursed by veterans' benefit payments paid pursuant to 38 U.S.C. section 1677 (1976), as amended by Act of Nov. 23, 1977, Pub. L. 95-202, section 102 (1), 91 Stat. 1433?

FACTS

The taxpayer, a captain-pilot with a major airline, enrolled in an aviation program in which licensed pilots receive training in certain types of small aircraft. The total cost of the course was 10*x* dollars.

The taxpayer is a veteran, and therefore was receiving reimbursement from the Veterans' Administration under 38 U.S.C. section 1677 (1976) to the extent of 90 percent of the training expenditure. Such reimbursement is exempted from taxation by 38 U.S.C. section 3101 (1976), as amended by Act of Oct. 18, 1978, Pub. L. 95-479, section 301, 1978-2 C.B. 377.

LAW AND ANALYSIS

Section 262 of the Code provides that except as otherwise expressly provided, no deduction shall be allowed for personal, living, or family expenses.

Section 162 of the Code provides for the deduction of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Whether expenditures for education are deductible under section 162 of the Code and section 1.162-5 of the Income Tax Regulations is highly factual and cannot be determined on the basis of the facts described above. However, as a general rule, if the training is necessary to maintain or improve skills required in the taxpayer's employment, the expense would be deductible. If the expenditure is necessary to meet the minimal educational requirements of the employment, or if the education qualifies the

taxpayer for a new trade or business, the expenditure is not deductible.

If under the facts of a particular case, it is determined that an expense is otherwise properly deductible under section 162 of the Code, a taxpayer is not allowed a deduction for an expense to the extent it is allocable to a payment for which the taxpayer has been reimbursed (or for which the taxpayer's right to reimbursement has become fixed or mature). See Rev. Rul. 78-388, 1978-2 C.B. 110. Rev. Rul. 78-388 holds that certain moving expenses and the loss attributable to abandoned leasehold improvements, to the extent they are reimbursable, are not deductible under either section 162 or 165 of the Code.

If an expense has been (or will be) reimbursed in whole or in part, any deduction otherwise allowable with respect to the expense is disallowed to the extent of the reimbursement. In such a case, the taxpayer suffers no economic detriment and incurs no expense in making the expenditure to the extent of the reimbursement.

HOLDING

Provided it is determined that a deduction is allowable to the taxpayer under section 162 of the Code and section 1.162-5 of the regulations, the taxpayer may not deduct the 9*x* dollars under section 162 of the Code, which is the amount of the reimbursement to the taxpayer by the Veterans' Administration under 38 U.S.C. section 1677. Whether 1*x* dollars is deductible will depend on all the facts and circumstances in each case.

This holding applies only to reimbursement payments made under 38 U.S.C. section 1677. For treatment of subsistence and educational allowance payments made under 38 U.S.C. section 1681 (1976), which are not reimbursement payments determined by reference to amounts actually expended for tuition and fees, but rather are in the nature of a living stipend determined without regard to amounts expended, see Rev. Rul. 62-213, 1962-2 C.B. 59.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 62-213 is distinguished and clarified.

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26 CFR 1.162-7: Compensation for personal services.

The federal income tax consequences to a corporation and its executives when the corporation "leases" suits for its executives. See Rev. Rul. 80-322, page 36.

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26 CFR 1.162-17: Reporting and substantiation of certain business expenses of employees.

Simplified, optional method for computing the allowable deduction for the cost of operating an automobile for business purposes. See Rev. Proc. 80-32, page 767.

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26 CFR 1.162-17: Reporting and substantiation of certain business expenses of employees.

Substantiation of certain subsistence and travel expenses. See Rev. Rul. 80-203, page 101.

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26 CFR 1.162-21: Fines and penalties.

Business expenses; settlement payment; Department of Energy consent order. A payment to the U.S. Treasury, under a consent order specifically precluding imposition of civil or criminal penalties, that is made in settlement of claims and disputes resulting from a Department of Energy examination of a taxpayer's books and records is not a fine or similar penalty for purposes of section 162(f) of the Code and is deductible as an ordinary and necessary business expense. Such a payment made pursuant to a consent order requiring the imposition of a penalty for willful violation of the petroleum pricing statutes, however, is not deductible.

Rev. Rul. 80-334

ISSUE

Is a payment made by a taxpayer to the United States Treasury in a settlement of claims and disputes resulting from the examination of the taxpayer's books and records by the Department of Energy a fine or similar penalty for purposes of section 162(f) of the Internal Revenue Code and therefore not deductible as a business expense under section 162(a)?

FACTS

The taxpayer, a domestic corporation dealing in petroleum products, is subject to the jurisdiction of the United States Department of Energy with respect to petroleum pricing. The taxpayer's books and records were examined by the Department of Energy to determine whether the taxpayer was in compliance with their regulations.

Section 205.199J(a) and (e) of the Department of Energy Regulations (10 CFR 202.199J), provides as follows:

(a) Notwithstanding any other provision of this subpart, the DOE [Department of Energy] may at any time resolve an outstanding compliance investigation or proceeding, or a proceeding involving the disallowances of costs pursuant to § 205.119E with a Consent Order. A Consent Order must be signed by the person to whom it is issued, or a duly authorized representative, and must indicate agreement to the terms contained therein. A Consent Order need not constitute an admission by any person that DOE regulations have been violated, nor need it constitute a finding by the DOE that such person has violated DOE regulations. A Consent Order shall, however, set forth the relevant facts which form the basis for the Order.

* * * * *

(e) Notwithstanding the issuance of a Consent Order, the DOE may seek civil or criminal penalties or compromise civil penalties pursuant to Subpart P concerning matters encompassed by the Consent Order, unless the Consent Order by its terms expressly precludes the DOE from so doing.

The taxpayer and the Department of Energy entered into a consent order to settle all claims and disputes resulting from the examination. The consent order specifically states that the Department of Energy has determined that the imposition of civil or criminal

penalties would be inappropriate because the violation was unintentional, and that such penalties would not be sought from the taxpayer with respect to the period covered by the consent order.

The consent order requires the taxpayer to refund to its purchasers 5,000x dollars, of which 3,200x dollars is to be made available to purchasers of gasoline; 900x dollars to purchasers of No. 2 oils, 600x dollars to purchasers of general refinery products, and 300x dollars to purchasers of aviation jet fuel.

The first of three refund procedures set forth in the consent order provides that a specified portion of the 3,200x dollars will be refunded to purchasers of gasoline from the taxpayer's proprietary stations through a price reduction that will remain in effect until the specified amount has been refunded.

The second refund procedure involves refunds to nonretail and large volume retail customers of the taxpayer during the period covered by the consent order. These customers will be given the opportunity to obtain individual refunds by entering into a participation agreement with taxpayer within a specified time period.

Under the terms of a participation agreement a customer will receive the refund attributable to it under the consent order in return for its waiver and release of any and all claims against the taxpayer with respect to any possible regulatory violations that may have been committed during the period covered by the consent order. The agreement also will require the customer to submit to its own nonretail customers, if any, an application for secondary participation in the refund. The secondary participation agreement also will require the secondary participant to submit to its own nonretail customers, if any, a similar application for participation in the refund. This is to insure that the refund under this provision be passed on to the end-users or ultimate consumers.

If a customer fails to execute a timely participation agreement, the amount of the refund attributable to such customer is to be transferred to a common fund. Also, amounts withheld by or returned to the taxpayer because of the inability of its customers to pass through refunds in accordance with the terms of the participation agreements and secondary participation agreements to the end-users or ultimate consumers are to be deposited in this common fund. Interest earned on such fund will also be added as part of the fund.

The amount of any judgements or settlements paid by the taxpayer after the effective date of the consent order on account of alleged violations of federal petroleum price and allocation statutes or regulations committed during the period covered by the consent order will be subtracted from the common fund.

Subsequent to the expiration of a specified time period after the effective date of the consent order, there will be subtracted from the common fund an amount to serve as a reserve sufficient to cover the taxpayer's maximum creditable exposure to liability in civil actions based upon alleged regulatory violations during the period covered by the consent order.

The third refund procedure (this procedure will be invoked after the second refund procedure has been complied with) will distribute any monies remaining in the common fund, created as a result of the second refund procedure, through a price reduction on gasoline to purchasers from the taxpayer's proprietary stations until such fund is exhausted.

Under the terms of the consent order monies remaining in the reserve described above after the termination of all civil actions will be remitted to the United States Treasury. Thus, the unclaimed portion of the reserve fund would be paid to the United States Treasury, rather than to the party to whom the inventory item was sold because such party failed to take any action. The consent order does not indicate that the payment to the United States Treasury would be considered to be a fine or penalty. It is a method of closing out such reserve fund by a single payment. The other alternative for the disposition of the reserve fund would be to refund such amount through a price reduction on gasoline to purchasers from the taxpayer's proprietory stations until such reserve fund is exhausted.

LAW AND ANALYSIS

Section 162(a) of the Code provides that 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.

Section 162(f) of the Code provides that no deduction shall be allowed under section 162(a) for any fine or similar penalty paid to a government for the violation of any law.

Section 1.162-21(b)(1) of the Income Tax Regulations provides that for purposes of section 1.162-21 a fine or similar penalty includes an amount—

(i) paid pursuant to conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding;

(ii) paid as a civil penalty imposed by federal, state, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Internal Revenue Code of 1954;

(iii) paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or

(iv) forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty.

Section 162(f) was added to the Code by section 902(a) of the Tax Reform Act of 1969, Pub. L. 91-172, 1969-3 C.B. 10, 147.

The legislative history of section 162(f) indicates that the purpose of adding section 162(f) to the Code was to codify the general court position

with respect to fines and penalties. S. Rep. No. 91-552, 91st Cong., 1st Sess. 1645, 2311-12 (1969), 1963-3 C.B. 423, 597, provides as follows:

> First, the committee amendments provide that no deduction is to be allowed for any fine or similar penalty paid to a government for the violation of any law. This provision is to apply in any case in which the taxpayer is required to pay a fine because he is convicted of a crime (felony or misdemeanor) in a full criminal proceeding in an appropriate court. This represents a codification of the general court position in this respect.

The general court position referred to above is that set forth by the Supreme Court of the United States in *Tank Truck Rentals v. Commissioner,* 356 U.S. 30 (1958), Ct. D. 1819, 1958-1 C.B. 502, the only Supreme Court case on this subject. The rule announced by the Supreme Court in *Tank Truck Rentals* denied a deduction for any fine or penalty if the allowance of the deduction would severely frustrate a sharply defined national policy. The purpose of this rule was to prevent favorable tax treatment from "blunting the sting" of a validly imposed penalty by allowing the taxpayer a deduction for federal income tax purposes.

S. Rep. No. 91-552 further indicates:

> The provision for the denial of the deduction for payments in these situations [including fines or similar penalties] which are deemed to violate public policy is intended to be *all inclusive*. Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions. [Emphasis added.]

The Senate Finance Committee, in explaining Section 310 of the Revenue Act of 1971, Pub. L. 92-178, 1972-1 C.B. 443, discussed section 162(f) of the Code. The Committee stated:

> In connection with the proposed regulations relating to the disallowance of deductions for fines and similar penalties (sec. 162(f)), questions have been raised as to whether the provision applies only to criminal "penalties" or also to civil penalties as well. In approving the provisions dealing with fines and similar penalties in 1969, it was the intention of the committee to disallow deductions for payments of sanctions which are imposed under civil statutes but which in general terms serve the same purpose as a fine exacted under a criminal statute. The provision was intended to apply, for example, to penalties provided for under the Internal Revenue Code in the form of assessable penalties (subchapter B of chapter 68) as well as to additions to tax under the internal revenue laws (subchapter A of chapter 68) in those cases where the government has the fraud burden of proof (i.e., proof by clear and convincing evidence). It was also intended that this rule should apply to similar type payments under the laws of a state or other jurisdiction. S. Rep. 92-437, 92nd Cong., 1st Sess. 73, 74 (1971), 1972-1 C.B. 559, 600.

Here, although the consent order provides for the balance remaining in the reserve fund to be paid over to the United States Treasury, the consent order initially requires the taxpayer to make refunds to the purchasers of its products on which the overcharge occurred because of the alleged pricing violation. A reserve fund was established by setting aside unrefunded monies (unrefunded because claims were not filed or monies were unable to be refunded because of the inability of its customers to pass through the refunds to the ultimate consumers) for the purpose of covering the taxpayer's liability in civil actions based upon alleged pricing violations. By requiring the taxpayer to make refunds to its customers and paying the remaining balance in the reserve fund to the United States Treasury, the consent order prohibited the taxpayer from retaining any part of the agreed amount of refund.

Therefore, the payment made to the United States Treasury by the taxpayer as a result of a consent order entered into by the taxpayer and the Department of Energy does not come within the provisions of section 162(f) of the Code. Also, the consent order specifically states that the Department of Energy has determined that the imposition of civil or criminal penalties would be inappropriate, and that such penalties would not be sought from the taxpayer with respect to the period covered by the consent order.

HOLDING

The payment made by the taxpayer in the instant case to the United States Treasury pursuant to a consent order in settlement of claims and disputes resulting from the examination of the taxpayer's books and records by the Department of Energy is not a fine or similar penalty for purposes of section 162(f) of the Code. Thus, such amount is deductible as an ordinary and necessary business expense under section 162(a).

However, where the consent order specifically states that the taxpayer is required to pay a penalty for willful or intentional violation of the petroleum pricing statutes such amount falls under the provision of section 162(f) of the Code and is not deductible as an ordinary and necessary business expense.

Section 163.—Interest

26 CFR 1.163-1: Interest deduction in general.

Deduction for interest on a reverse mortgage loan. See Rev. Rul. 80-248, page 164.

Section 164.—Taxes

26 CFR 1.164-1: Deduction for taxes.

Whether social security payments made to a foreign country under a totalization agreement are deductible. See Rev. Proc. 80-56, page 851.

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26 CFR 1.164-1: Deduction for taxes.

Whether, in computing its U.S. taxable income, a U.K. corporation with a permanent establishment in the U.S. is entitled to deduct the U.K. income tax paid attributable to operations of its U.S. permanent establishment. See Rev. Rul. 80-243, page 413.

Section 165.—Losses

26 CFR 1.165-1: Losses.

Upon the exercise of the option to sell *X* a fractional interest in an acquired lease, the taxpayer will recognize gain or loss. Whether such gain or loss is subject to the provisions of section 1221 or 1231 of the

Code requires a factual determination of the holding period, and whether, in the hands of the taxpayer, such leases were property used in the trade or business or as investment property. See Rev. Rul. 80-176, page 97.

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26 CFR 1.165-1: Losses

Whether a taxpayer is entitled to a loss on investments in an individual retirement account (IRA) under the circumstances described. See Rev. Rul. 80-268, page 141.

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26 CFR 1.165-1: Losses.

Whether an investment prospectus, cancelled checks, and confirmation statements are sufficient to substantiate a loss deduction claimed by the taxpayer under the circumstances described. See Rev. Rul. 80-324, page 340.

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26 CFR 1.165-11: Election in respect of losses attributable to a disaster.

Disaster losses; year of deduction. Disaster areas in which losses during 1980 qualify for special tax treatment under section 165(h) of the Code are listed.

Rev. Rul. 80-357

LAW AND ANALYSIS—HOLDING

Under section 165(h) of the Internal Revenue Code, a taxpayer who suffers a disaster loss may elect to take a deduction for that loss on the federal income tax return for the taxable year immediately preceding the taxable year in which the disaster occurred, provided the loss is one that occurred in an area determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief Act of 1974, Pub. L. 93-288, 1974-2 C.B. 414.

The election to deduct for the preceding year must be made on or before the later of (1) the original due date of the taxpayer's income tax return for the year in which the disaster occurred, or (2) the due date of the preceding year's return (taking into account extensions of time for filing granted to the taxpayer). Section 1.165-11 of the Income Tax Regulations sets forth the procedures for making an election with respect to such losses.

The provisions of section 165(h) of the Code will apply only to losses that are otherwise deductible under section 165(a). An individual taxpayer may deduct losses if they are incurred in a trade or business, if they are incurred in a transaction entered into for profit, or if they are casualty losses under section 165(c)(3).

The President has determined that areas in the states and possession listed below have been adversely affected by disasters of sufficient severity occurring during 1980 to warrant disaster assistance by the Federal Government under the Disaster Relief Act of 1974.

Disaster Areas in 1980	Type of Disaster	Date Disaster Declared or Occurred
Alabama		
Counties of Lee, Mobile	Severe storms, tornadoes, and flooding	April 12, 1980
Arizona		
Counties of Gila, Maricopa, Mohave, Yavapai; Fort Apache and San Carlos Apache Indian Reservations	Severe storms and flooding	February 13, 1980
Arkansas		
Counties of Crittenden, Faulkner, Johnson, Lonoke, Pulaski	Severe storms and tornadoes	April 7, 1980
California		
Contra Costa County Reclamation Districts 799, 800, 2024, 2025 (Holland Tract), 2026 (Webb Tract), 2036, 2059, 2065, and Bethel Island Municipal Improvement District		
Sacramento County		
Reclamation Districts 341, 563, 756, 1601, 2111, and Brannan—Andrus Levee Maintenance District		
San Joaquin County		
Reclamation Districts 2, 38, 524, 544, 548, 684, 2021, 2023, 2027, 2028, 2029, 2030, 2033, 2037, 2039, 2040, 2041, 2042, 2044, and 2072	Torrential rains, high tides, and strong winds	January 13, 1980
Counties of Los Angeles, Orange, Riverside, San Bernardino, San Diego, Santa Barbara, Santa Cruz, Ventura	Severe storms, mudslides, and flooding	January 8, 1980
Upper and Lower Jones Tract in San Joaquin Delta of San Joaquin County	Flooding	September 26, 1980
Counties of Los Angeles, Orange, San Bernardino, Riverside [1]	Major fires and high winds	November 15, 1980

Disaster Areas in 1980	Type of Disaster	Date Disaster Declared or Occurred
Florida		
Counties of Broward, Dade, Monroe, Palm Beach [2]	Arrival of large numbers of undocumented aliens	April 13, 1980
Hawaii		
County of Maui	Severe storms, high surf, and flooding	January 7-16, 1980
Idaho		
Counties of Benewah, Bonner, Boundary, Clearwater, Kootenai, Latah, Nez Perce, Shoshone	Volcanic eruption of Mount St. Helens	May 18, 1980
Louisiana		
Parishes of Assumption, Iberville, Jefferson, Lafourche, Orleans, St. Bernard, St. Charles, St. Bernard, St. Charles, St. Martin, St. Mary, St. Tammany, Terrebonne, Washington	Severe storms and flooding	March 26-31, 1980
Parishes of Acadia, Calcasieu, Jefferson Davis, Lafayette, Pointe Coupee, Vermilion	Severe storms and flooding	May 15, 1980
Maine		
Counties of Cumberland, Hancock, Knox, Lincoln, Sagadahoc, Waldo, Washington, York	Toxic paralytic shellfish poisoning	July 30, 1980
Michigan		
Counties of Kalamazoo, Van Buren	Severe storms and tornadoes	May 13, 1980
Counties of Allegan, Berrien, Calhoun, Cass, Jackson, Ottawa, St. Joseph, Van Buren, Washtenaw, Wayne	Severe thunderstorms and high winds	July 15-20, 1980
Mississippi		
Counties of Adams, Forrest, George, Harrison, Jackson, Marion, Pike, Walthall	Severe storms, flooding, mudslides, tornadoes and high winds	March 28, 1980
Missouri		
County of Pettis	Severe storms and tornadoes	May 12, 1980
Nebraska		
Counties of Hall, Hamilton, Merrick	Severe storms and tornadoes	June 3, 1980
New Jersey	Water shortage	October 19, 1980
New York		
Love Canal area of Niagara County [2]	Adverse impact of chemical wastes in the Love Canal waste landfill in the City of Niagara Falls	May 5, 1980
Northern Mariana Islands		
Island of Saipan [1]	Typhoon Dinah	November 23, 1980
Ohio		
Counties of Belmont, Columbiana, Guernsey, Jefferson, Monroe, Muskingum, Noble	Severe storms and flooding	August 11, 1980
Pennsylvania		
Counties of Allegheny, Armstrong, Indiana, Westmoreland	Severe storms and tornadoes	June 3, 1980
Counties of Armstrong, Butler, Clarion	Severe storms and flooding	August 14, 1980

Disaster Areas in 1980	Type of Disaster	Date Disaster Declared or Occurred
Texas		
Aransas, Brooks, Cameron, Duval, Hidalgo, Jim Hogg, Jim Wells, Kenedy, Kleberg, Nueces, San Patricio, Willacy; Robert Mueller Airport in Travis County for repair and restoration of fixed hanger facilities	Hurricane Allen	August 10, 1980
Precinct One of Nolan County	Tropical Storm Danielle, intermittent rains, and flooding	September 5, 1980
Washington	Volcanic eruption of	
Entire area of the State of Washington	Mount St. Helens	May 18, 1980
West Virginia		
Counties of Fayette, Hancock, Harrison, Jackson, Kanawha, Marion, Marshall, Monongalia, Nicholas, Ohio, Preston, Putnam, Raleigh, Taylor, Webster	Severe storms and flooding	August 4, 1980
Wisconsin	Severe storms and	
Counties of Chippewa, Dunn, Eau Claire, Pierce	flooding	July 15, 1980

[1] Not previously published in the Internal Revenue Bulletin.
[2] No determination has been made by the Internal Revenue Service that losses suffered by taxpayers in the listed area will, in fact, qualify as casualty losses deductible under section 165 of the Code.

Section 166.—Bad Debts

26 CFR 1.166-1: Bad debts.

Whether a creditor-taxpayer may suspend the accrual of interest income on a loan that becomes uncollectible during the taxable year. See Rev. Rul. 80-361, page 164.

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26 CFR 1.166-2: Evidence of worthlessness. (Also Section 111; 1.111-1.)

Bad debts; banks; charge off; instructions of supervisory federal authority. A bank charged off the entire outstanding balance of a loan in accordance with a specific order by the bank's supervisory federal authority and deducted the balance on that year's tax return as a bad debt. In a later year, the authority reconsidered its charge off action and took the position that only two-thirds of the balance should be classified as a loss. The bank's bad debt deduction was proper and the later action by the authority does not constitute a recovery.

Rev. Rul. 80-180

ISSUES

Does a subsequent expression of doubt as to the worthlessness of a bank's loan by a supervisory federal authority affect the conclusive presumption of worthlessness arising from a specific order by that federal authority to charge off the entire outstanding balance of the questionable loan?

Does such an expression of doubt constitute a recovery of a previously deducted bad debt?

FACTS

A commercial bank made an unsecured loan to *X*, a corporation, in 1972. In 1973, *X* filed a petition for voluntary bankruptcy and has since been operating under section 77 of the Bankruptcy Act. In 1974, in obedience to the specific order of its supervisory federal authority, the bank charged off the entire outstanding balance of the *X* debt. The bank, which employs the specific charge off method of accounting for bad debts, deducted the balance of the *X* debt on its 1974 federal income return.

In 1976, the supervisory federal authority advised the bank by letter that it had reconsidered its charge off action regarding the *X* loan and had taken the position that only two-thirds of the *X* debt will be classified as a loss and the balance will be viewed as doubtful.

LAW AND ANALYSIS

Section 1.166-2(d)(1) of the Income Tax Regulations provides that if a bank, which is subject to supervision by federal authorities, charges off a debt in whole or in part in obedience to the specific orders of such authority, then the debt shall, to the extent charged off and deducted for federal income tax purposes, be conclusively presumed to be worthless during the taxable year.

The purpose of this regulation is to insure that a taxpayer receives fair and consistent treatment when dealing with

the Service and another branch of the federal government. *United States v. Beckman,* 104 F. 2d 260 (3d Cir. 1939). Thus a debt charged off pursuant to the orders of a supervisory federal authority is conclusively presumed to be worthless during the taxable year pursuant to section 1.166-2 (d) of the regulations. An expression of doubt on a subsequent year cannot affect the conclusive presumption. Therefore, the bad debt deduction claimed by the bank in 1974 is proper.

Section 1.111-1(a)(2) of the regulations provides that recoveries result from the receipt of amounts in respect of the previously deducted section 111 items, such as from the collection or sale of a bad debt. For there to be a recovery of a bad debt there must be a receipt of amounts attributable to such debt or an event inconsistent with the prior deduction. In this context, an event is inconsistent with the prior deduction only if the taxpayer's actual dealings with, as opposed to book entries with respect to, the item are inconsistent with such deduction. The mere expression of doubt does not constitute a receipt or an inconsistent event.

HOLDINGS

Because the expression of doubt, which was issued in a year subsequent to the issuance of the original charge off order, did not affect the conclusive presumption of worthlessness, the bank's bad debt deduction in 1974 was proper.

The expression of doubt does not constitute a recovery for purposes of the tax benefit rule.

Section 167.—Depreciation

Whether payments received pursuant to the National Historic Preservation Act of 1966 are includible in the gross incomes of the recipients. See Rev. Rul. 80-330, page 29.

26 CFR 1.167(a)-1: Depreciation in general.

Treatment of material and installation costs paid for by a railroad taxpayer for replacement of private and public railway road crossings over the taxpayer's railroad track. Also, whether the retirement-replacement method of accounting for depreciation of the railway road crossings is permissible. See Rev. Rul. 80-187, page 19.

26 CFR 1.167(a)-8: Retirements.

How to determine the amount of a charitable contribution when the donated property is retired from multiple asset accounts for which the Class Life Asset Depreciation Range system under section 1.167(a)-11 of the Income Tax Regulations has not been elected. See Rev. Rul. 80-174, this page.

26 CFR 1.167(a)-11: Depreciation based on class life asset depreciation ranges for property placed in service after December 31, 1970.

Revision of effective dates for Rev. Proc. 79-26, 1979-1 C.B. 566, and Rev. Proc. 79-35, 1979-2 C.B. 498, both of which prescribed certain changes to Rev. Proc. 77-10, 1977-1 C.B. 548, regarding the Class Life Asset Depreciation Range system. See Rev. Proc. 80-33, page 768.

26 CFR 1.167(a)-11: Depreciation based on class lives and asset depreciation ranges for property placed in service after December 31, 1970.

New asset guideline classes 13.0, Offshore Drilling, and 15.0, Construction. Deletion of asset guideline classes 15.1, Contract Construction Other than Marine and 15.2, Marine Contract Construction. See Rev. Proc. 80-58, page 854.

Section 170.—Charitable, Etc., Contributions and Gifts

26 CFR 1.170A-1: Charitable, etc., contributions and gifts; allowance of deduction.
(Also Section 167; 1.167(a)-8.)

Charitable contributions; depreciable property; multiple asset account. The method is provided for determining the amount of a charitable contribution for property retired from a multiple asset account for which the CLADR system has not been elected.

Rev. Rul. 80-174

ISSUE

How is the amount of the charitable contribution determined when property is retired from a multiple asset account and donated to a charitable organization?

FACTS

The taxpayer has a multiple asset account of machinery that is used in a trade or business as defined in section 1231(b) of the Internal Revenue Code. The Class Life Asset Depreciation Range (CLADR) system provided for by section 1.167(a)-11 of the Income Tax Regulations was not elected for use with respect to eligible property. The depreciation rate is based on the average expected useful life of the items. The depreciation method being used is the straight line method and pursuant to section 1.167 (a)-1(c) salvage value has been determined to be zero.

The taxpayer donated two items of machinery, identical types of property, to a charitable organization in the taxable year 1977. The use of the contributed property by the charitable organization is unrelated to the purpose or function constituting the basis for its exemption under section 501. Item *A* cost $200 in taxable year 1971 when it was added to the account, had a fair market value (FMV) of $50 as of the date of the contribution, and had reached a condition at which the taxpayer customarily retires similar assets.

Item *B* cost $300 when it was added to the account in the taxable year 1975 and it had a FMV of $250 on the date of the contribution. An average useful life of 5 years was estimated for these items and others of their type in establishing the depreciation rate for the account. Normally, the taxpayer retires assets similar to items *A* and *B* when they are 4 to 6 years old.

LAW AND ANALYSIS

Section 170(e)(1) of the Code provides that the amount of any charitable contribution of property otherwise taken into account under that section shall be reduced by the sum

of (A) the amount of the gain that would not have been long-term capital gain if the property had been sold by the taxpayer at its FMV at the time of such contribution, and (B) in the case of a charitable contribution of tangible personal property, if the use by the donee is unrelated to the purpose or function constituting the basis for its exemption under section 501, 40 percent (28/46 percent in the case of a corporation) of the amount of gain which would have been long-term capital gain if the property contributed had been sold by the taxpayer at its FMV at the time of such contribution.

Under the facts of this ruling the taxpayer would not have realized any long-term capital gain if the property contributed had been sold at its FMV at the time of the contribution. Thus, the amount described in section 170(e)(1)(B) of the Code is zero. As a result the amount of the charitable contribution otherwise allowed shall be reduced only by the amount described in section 170((e)(1)(A).

Section 1.170A-4(a)(1) of the regulations provides that in the case of a contribution of ordinary income property, as defined in paragraph (b)(1) of that section, the amount of charitable contribution which would be taken into account under section 170(a) of the Code without regard to section 170(e) shall be reduced by the amount of gain which would have been recognized as gain which is not long-term capital gain if the property had been sold by the donor at its FMV at the time of its contribution to the charitable organization.

Section 1.170A-4(b)(4) of the regulations provides that for purposes of applying subparagraphs (1) and (2) of that paragraph, property that is used in the trade or business, as defined in section 1231(b) of the Code, shall be treated as a capital asset except that any gain in respect of such property that would have been recognized if the property had been sold by the donor at its FMV at the time of its contribution to the charitable organization shall be treated as ordinary income to the extent that such gain would have constituted ordinary income by reason of the application of section 1245(a).

Section 1245(a) of the Code provides, in pertinent part, that for depreciable personal property sold during a taxable year beginning after December 31, 1962, the amount by which the lower of (1) the recomputed basis or (2) the amount realized exceeds the adjusted basis of the property shall be treated as ordinary income. "Recomputed basis" in the instant case means the original cost of the items since they were acquired after December 31, 1961 and all of the adjustments reflected in the adjusted basis of such property are on account of deductions allowed for depreciation. *See* section 1.1245-2(a) of the regulations.

Section 1.167(a)-8(c)(1) of the regulations provides that for normal retirements from multiple asset accounts for which the depreciation rate is based on average expected useful life, "adjusted basis" is the salvage value estimated in determining the depreciation deduction in accordance with section 1.167(a)-1(c).

Section 1.167(a)-8(c)(3) of the regulations provides that for an abnormal retirement from a multiple asset account, the adjustment for depreciation applicable to the retired asset shall be made at the rate that would have been proper had the asset been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) and is based upon either the average expected useful life or the maximum expected useful life of the asset, depending upon the method of determining the rate of depreciation used in connection with the multiple asset account.

Section 1.167(a)-8(b) of the regulations provides that a retirement is considered normal if made within the range of years taken into consideration in fixing the depreciation rate and the asset is in a condition at which the taxpayer customarily retires similar assets. If the retirement comes earlier it may be considered abnormal.

Since item *A* is 6 years old and the taxpayer ordinarily retires similar items when they are 4 to 6 years old, its withdrawal from the account is a normal retirement under section 1.167(a)-8(b) of the regulations. By the same measure, the removal of item *B* after 2 years is an abnormal retirement.

Based on the fact that item *A* has zero salvage value, its adjusted basis is also zero pursuant to section 1.167(a)-8(c)(1) of the regulations. For item *B*, the adjusted basis is the original cost of $300 less 2 years' allowable depreciation determined at the rate that would have been applicable if the item had been depreciated separately using the same method that was used for the multiple asset account. Therefore, 2 years' depreciation using a useful life of 5 years and a straight line method is $120 and the adjusted basis is $180.

The amount that would be recognized as ordinary income under section 1245(a) of the Code, if item *A* had been sold at its FMV at the time of its contribution, is the amount by which the lower of its recomputed basis ($200) or its FMV ($50) exceeds its adjusted basis ($0). Therefore, the amount of ordinary income gain is $50.

Similarly, if item *B* had been sold at its FMV at the time of its contribution, the amount that would have been recognized as ordinary income under section 1245(a) of the Code would be $70, the amount by which its FMV ($250) exceeds its adjusted basis ($180).

HOLDING

The amount of the contribution before applying the percentage limi-

tations of section 170(b) of the Code would be, with respect to item *A*, $0 (the FMV of $50 reduced by the $50 ordinary income gain if sold). With respect to item *B*, it would be $180 (the FMV of $250 reduced by the $70 ordinary income gain if sold).

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26 CFR 1.170A-1: Charitable, etc., contributions and gifts; allowance of deduction.

Charitable contributions; fair market value; Bibles. A taxpayer purchased Bibles from a promoter who asserted that they could be purchased at a considerable discount from "retail" price and claimed that if the taxpayer held the Bibles over twelve months and then contributed them to a charitable organization, the taxpayer would be entitled to deduct the "retail" price as a charitable contribution. The charitable deduction is based on the fair market value of the Bibles at the time of contribution, and the best evidence of the fair market value at that time is the price at which similar lots of Bibles are being sold to others.

Rev. Rul. 80-233

ISSUE

What is the fair market value of Bibles that are contributed to charity under the circumstances described below?

FACTS

P is a promoter who sells Bibles to individuals. *P* advises potential customers that they can purchase Bibles at a considerable discount from "retail" price, hold the Bibles for 12 months, and then, by donating them to a qualified charitable organization, claim a charitable deduction for the "retail" price.

In 1979 *D* purchased from *P* 500 copies of a single edition of a modern translation of the Bible for a total of 100*x* dollars. Upon receipt of *D*'s payment of 100*x* dollars, *P* furnished *D* with a statement that the 500 copies of the Bible had a total retail value of 300*x* dollars.

As part of the purchase agreement, *P* agreed to periodically furnish *D* with lists of religious organizations that were interested in receiving a donation of Bibles and for which the use of the books would be related to the organizations' exempt purposes. Pursuant to *P*'s suggestion that only one organization be the recipient of the Bibles, *D* selected from the list, *X*, an organization described in section 170(c) of the Internal Revenue Code, to be the recipient. At *D*'s direction, *P* mailed the Bibles directly to *X* 13 months after *D* had purchased them from *P*. At the time *D* contributed the Bibles to *X*, wholesale dealers of Bibles were selling similar lots of Bibles to members of the general public for 100*x* dollars.

LAW AND ANALYSIS

Section 170 of the Code provides, subject to certain limitations, a deduction for contributions and gifts to or for the use of organizations described in section 170(c), payment of which is made within the taxable year.

Section 1.170A-1(c)(1) of the Income Tax Regulations provides that if a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution reduced as provided in section 170(e)(1) of the Code and section 1.170A-4(a) of the regulations.

Section 1.170A-1(c)(2) of the regulations provides, in part, that fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

To determine fair market value, reference is made to the most active and comparable marketplace at the time of the donor's contribution. The most probative evidence of fair market is the prices at which similar quantities of Bibles are sold in arm's-length transactions. *See* Rev. Rul. 80-69, 1980-1 C.B. 55. The 100*x* dollars, at which similar lots of Bibles were sold to *D* and are still being sold to others, is the best evidence of fair market value at the time the Bibles are contributed to *X*.

HOLDING

The fair market value of the Bibles contributed to *X* is 100*x* dollars.

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26 CFR 1.170A-1: Charitable, etc., contributions and gifts; allowance of deduction. (Also Section 501; 1.501(a)-1.)

Charitable contribution; influencing legislation. A deduction is not allowable under section 170 of the Code for amounts paid to an organization exempt from tax under section 501(c)(3) and described in section 170(c)(2) that are earmarked for use in, or in connection with, influencing specific legislation.

Rev. Rul. 80-275

ISSUE

Is a charitable contribution deduction under section 170 of the Internal Revenue Code allowable for amounts paid to an organization exempt from federal income tax under section 501(c)(3) and described in section 170(c)(2), but which are earmarked for use in influencing specific legislation?

FACTS

X, a non-profit corporation, is exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3). Section 501(c)(3) provides such exemption for entities organized and operated for educational and other charitable purposes. *X* is also an organization described in section 170(c)(2).

X became concerned with proposed legislation under consideration in the

Congress of the United States. In order to obtain funds to enable it to influence specific legislation, *X* mailed to its members and the general public literature that described the pending legislation and requested contributions to be used to lobby members of the Congress to help defeat the specific proposed legislation.

HOLDING

No deduction is allowed under section 170 of the Code for contributions to *X* earmarked for use in, or in connection with, attempting to influence the legislation. See Rev. Rul. 79-81, 1979-1 C.B. 107; Rev. Rul. 68-484, 1968-2 C.B. 105; Rev. Rul. 62-113, 1962-2 C.B. 10; and Rev. Rul. 56-329, 1956-2 C.B. 125.

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26 CFR 1.170A-1: Charitable, etc., contributions and gifts; allowance of deduction.

Charitable contributions; Bibles. A promoter offers investors a choice of two plans to purchase Bibles and donate them to charities. Under one plan, investors purchase the Bibles and donate them to charity 12 months later. The investors are told that they may deduct the "retail" price, which is three times as high as the purchase price. Under the other plan, investors purchase the Bibles at the "retail" price, put down the same amount as the purchase price in the first plan, and execute promissory notes for the balance. Principal and interest on the notes is payable in 12 years. The investors then donate the Bibles to charity. The deduction is limited to the cash paid in the second plan.

Rev. Rul. 80-329 [1]

ISSUE

What is the fair market value of Bibles that are contributed to a charitable organization, under the circumstances described below?

FACTS

P, a promotor, offers to sell Bibles to individuals. Depending on when an investor desires the purported tax advantages, the investor has a choice of two purchase plans. If the investor is willing to wait 12 months for a charitable deduction, *P* advises that the customer can purchase Bibles at a considerable discount from "retail" price and, by donating them to a qualified charitable organization more than 12 months after purchase, claim a charitable deduction based on the "retail" price. Under this plan, the purchase price is one-third of the "retail" price. *See* Rev. Rul. 80-233, page 69, this Bulletin, which holds that the charitable contribution is limited to the price at which similar lots of Bibles were sold and were still being sold to others at the time of the contribution.

If the investor wants a charitable deduction within a year of purchase, *P* advises that the customer can purchase Bibles at the "retail" price on a deferred payment basis and claim a charitable deduction based on the "retail" price, upon donating them to a qualified charitable organization. Under the latter plan, the investor pays for the Bibles with cash in the amount of the discounted price and with a note for the balance. The note provides for interest at the rate of 8 percent per annum, and it matures in twelve years. Principal and interest are not due until the twelfth year.

In 1980 *A* contracted with *P* to purchase 500 copies of a single edition of a modern translation of the Bible. *A* had the option to pay 100*x* dollars in cash under the first plan or to pay 100*x* dollars in cash and execute a promissory note for 200*x* dollars under the second plan. *A*, who wanted to make a charitable contribution in 1980, purchased the Bibles under the second plan. On August 1, 1980, *A* donated the Bibles to *X*, which was an organization described in section 170 (c) of the Internal Revenue Code and for which the use of the books would be related to *X*'s exempt purposes.

LAW AND ANALYSIS

Section 170 of the Code provides, subject to certain limitations, a deduction for contributions and gifts to or for the use of organizations described in section 170(c), payment of which is made within the taxable year.

Section 1.170A-1(c)(1) of the Income Tax Regulations provides generally that if a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution reduced as provided in section 170(e)(1) of the Code.

Section 170(e)(1)(A) of the Code provides that if a taxpayer contributes property that would have resulted in gain which would not have been long-term capital gain if the property had been sold at its fair market value on the date of contribution, the amount of the contribution must be reduced by the amount of such gain. Section 1222(3) defines "long-term capital gain" as gain from the sale or exchange of a capital asset held for more than 1 year.

Section 1.170A-1(c)(2) of the regulations provides that fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

The definition of fair market value depends upon a knowledgeable willing buyer and a knowledgeable willing seller. The most probative evidence of fair market value is the prices at which similar quantities of Bibles are actually sold in arm's-length transactions. *See* Rev. Rul. 80-233. *P* was selling similar lots of Bibles for either 100*x* dollars or

[1] Also released as News Release IR 80-118, dated November 14, 1980.

300x dollars. Neither the quantity nor the quality of the Bibles varied with the price; rather, the difference between the two prices was solely at the discretion of the buyer. P was a willing seller for 100x dollars. The fair market value of the Bibles is 100x dollars, the amount at which similar lots of Bibles could be purchased from P by members of the general public.

If P were not offering Bibles for 100x dollars, the fair market value of the Bibles contributed would be determined by all the relevant facts and circumstances including the sales price of comparable Bibles by others; the sales price by P of 300x dollars would not conclusively determine the value of the Bibles.

HOLDING

The fair market value of the Bibles contributed to X is 100x dollars.

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26 CFR 1.170A-1: Charitable, etc., contributions and gifts; allowance of deduction.

Standard mileage for computing the allowable deduction for the cost of operating an automobile for transportation in connection with rendering gratuitous services to a charitable organization. See Rev. Proc. 80-32, page 767.

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26 CFR 1.170A-1: Charitable, etc., contributions and gifts; allowance of deduction.

Whether and to what extent payments to an organization that operates an exchange program for children of the United States and a foreign country qualify as charitable contributions. See Rev. Rul. 80-286, page 179.

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26 CFR 1.170A-9: Definition of section 170 (b)(1)(A) organization.

Private foundation controlled by community trust; contribution limitation. A trust is operated, supervised, and controlled by the distribution committee of a community trust. Each individual donor to the trust has the right to designate charitable recipients of the income and corpus of the trust attributable to the donor's contribution. The trust is described in section 170(b)(1)(D)(iii) of the Code and the 50 percent charitable deduction limitation of section 170(b)(1) is applicable for transfers to the trust.

Rev. Rul. 80-305

ISSUE

Does the trust described below qualify for status as an organization described in section 170(b)(1)(D)(iii) of the Internal Revenue Code?

FACTS

The trust is exempt from federal income tax under section 501(c)(3) of the Code. Its governing instrument states that it was created to receive donations, to pool them in a common fund, and to distribute all of its income to organizations that are publicly supported organizations under section 509(a)(1). The trustee is required to keep an accounting of the portion of the income that is attributable to the contribution of each of the donors. Each donor has the right to designate annually the recipient of such portion, subject to the requirement that the recipient be a publicly supported organization under section 509(a)(1), and to direct (by deed or by will) the payment, to an organization described in section 509(a)(1), of the corpus in the common fund attributable to his or her contribution. All of the income of the trust is required to be (and is) distributed to one or more organizations described in section 509(a)(1) not later than the 15th day of the third month after the close of the taxable year in which the income is realized by the trust. All of the corpus attributable to any donor's contribution to the trust is required to be (and is) distributed to one or more organizations described in section 509(a)(1) not later than one year after the death of the donor or the donor's surviving spouse if the surviving spouse has the right to designate the recipients of the corpus.

The trust is subject to the control of the distribution committee of a community trust that is a publicly supported organization described in sections 170(b)(1)(A)(vi) and 509(a)(1) of the Code. If a donor does not exercise his right to designate a recipient, the funds are disbursed as the distribution committee may direct. The distribution committee also has the power to replace the trustee for breach of fiduciary duty or failure to earn a reasonable rate of return on the trust principal.

LAW

Section 170(b)(1)(D)(iii) of the Code describes an organization to which an individual may make a charitable contribution subject to the 50 percent deduction limitation set forth in section 170(b)(1). Included in section 170(b)(1)(D)(iii) is a private foundation all of the contributions to which are pooled in a common fund and which would be described in section 509(a)(3) but for the right of any substantial contributor or the spouse of a substantial contributor to designate annually the recipients, from among organizations described in section 509(a)(1), of the income attributable to the donor's contribution to the fund, and but for the right to direct (by deed or will) the payment, to an organization described in section 509(a)(1), of the corpus in the common fund attributable to the donor's contribution. Additionally, all of the income of the common fund is required to be (and is) distributed to one or more organizations described in section 509(a)(1) not later than the 15th day of the third month after the close of the taxable year in which the income is realized by the fund. Finally, all of the corpus attributable to any donor's contribution to the fund is required to be (and is) distributed to one or more such organizations not later than one year after the donor's death or after the death of the donor's surviving spouse if the spouse has the right to designate the recipients of such corpus.

Section 509(a)(3) of the Code describes a suporting organization as one which—

(A) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in section 509(a)(1) or (2).

(B) is operated, supervised, or controlled by or in connection with one or more organizations described in section 509(a)(1) or (2), and

(C) is not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in section 509(a)(1) or (2).

Section 1.509(a)-4(d)(2) of the Income Tax Regulations provides that the "specified organizations" referred to in section 509(a)(3)(A) of the Code may be specified by class rather than by name if the supporting organization is operated, supported, or controlled by a publicly supported organization and if the organization's articles require that it be operated to benefit one or more organizations that are designated by class, and which includes such publicly supported organization.

Section 1.509(a)-4(g) of the regulations provides that the term "operated, supervised, or controlled by" presupposes a substantial degree of direction over the policies, programs, and activities of a supporting organization by one or more publicly supported organizations. The relationship required is comparable to that of a parent and subsidiary where the subsidiary is under the direction of, and accountable or responsible to, the parent organization.

Section 1.509(a)-4(j)(1) of the regulations provides that an organization will be considered "controlled," for purposes of section 509(a)(3)(C) of the Code, if any substantial contributor has the right to designate annually the recipients, from among the publicly supported organizations, of the income attributable to his contribution to the supporting organization.

ANALYSIS

In this case, the trust does not specify by name the publicly supported organization on whose behalf it is to be operated. Rather, the trust is required by the terms of its governing instrument to distribute all of its income to organizations that are publicly supported organizations under section 509(a)(1) of the Code. The community trust falls within this class of organizations. Therefore, under section 1.509(a)-4(d)(2) of the regulations, in order for the trust to be described in section 509(a)(3), but for the rights retained by the donors, it must be operated, supervised, or controlled by the community trust within the meaning of section 1.509(a)-4(g).

The distribution committee of the community trust has the power to replace the trustee of the trust for breach of fiduciary duty or failure to earn a reasonable rate of return on the trust principal. Also, if a donor does not exercise his right to designate a recipient, the funds are disbursed as the distribution committee directs. These powers over the trust are sufficient to establish the relationship required by section 1.509(a)-4(g) of the regulations. Therefore, the trust is "operated, supervised, or controlled by" the community trust.

The donor's right to designate recipients, however, constitutes "control" by substantial contributors for purposes of section 509(a)(3)(C) of the Code. Therefore, the organization is controlled by disqualified persons within the meaning of section 509(a)(3)(C).

HOLDING

The trust meets the requirements of sections 509(a)(3)(A) and (B) of the Code, and would meet the requirements of section 509(a)(3)(C) but for the right of the donors to designate recipients. Accordingly, since the trust would be an organization described in section 509(a)(3) but for the right of the donors to designate recipients, it is an organization described in section 170(b)(1)(D)(iii).

Section 174.—Research and Experimental Expenditures

26 CFR 1.174-2: Definition of research and experimental expenditures.

Research and experimental expenses; environmental impact studies. A public utility company conducted, and paid another organization to conduct, environmental impact studies to support its application to state regulatory agencies to expand its generating facilities. The expenses are not research and experimental expenditures within the meaning of section 174 of the Code. However, if not chargeable to a capital account, the expenses are deductible business expenses.

Rev. Rul. 80-245

ISSUE

Are the taxpayer's expenditures for environmental impact studies prepared in connection with the expansion of its facilities research and experimental expenditures within the meaning of section 174 of the Internal Revenue Code?

FACTS

In 1978, the taxpayer, a public utility company, planned expansion of its facilities for generating electricity. The taxpayer conducted various studies needed to support its application to be filed with state regulatory agencies for a construction permit to expand its facilities.

Because the taxpayer's expansion involved both the construction of a nuclear power plant and the installation of an ultra high voltage electric transmission line, the state regulatory agencies required that the taxpayer conduct several types of environmental impact studies for site selection. The studies measured specific site condi-

tions and the resulting environmental impact of the construction and operation of the expanded facilities. Part of the studies were conducted directly by the taxpayer. The taxpayer used a research organization to conduct the remainder of the studies on its behalf.

During 1978, several studies were conducted either by the taxpayer or on its behalf. The studies identified suitable locations for the plant, ascertained the socio-economic impact of the plant on the surrounding community, ascertained the impact of the facility on the terrestrial ecology of the proposed site, considered the commercial disposition of fly ash waste generated by an alternative coal powered plant in order to meet state environmental standards, predicted noise levels at the construction site, considered the impact of construction and operation of the facilities on the aquatic environment of the inland streams located on two of the sites, and projected the air pollution and radiation emissions of the coal powered and nuclear powered facilities.

LAW AND ANALYSIS

Section 174 of the Code allows a taxpayer to treat research or experimental expenditures paid or incurred by the taxpayer during the taxable year in connection with the taxpayer's trade or business as expenditures that are deductible.

Section 1.174-2(a)(1) of the Income Tax Regulations provides that the term "research and experimental expenditures" as used in section 174 of the Code means expenditures incurred in connection with the taxpayer's trade or business that represent research and development costs in the experimental or laboratory sense. The term includes generally all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned. The term does not include expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising or promotions.

Section 1.174-2(a)(2) of the regulations provides that research and experimental expenditures include not only costs paid or incurred by the taxpayer for research and experimentation undertaken directly by the taxpayer, but also to expenditures paid or incurred for research or experimentation carried on in behalf of the taxpayer by another person or organization.

Rev. Rul. 67–401, 1967–2 C.B. 123, holds that expenses for legal and accounting work incurred by the taxpayer in obtaining a federal income tax ruling and a determination from a regulatory commission regarding the effect of a research and development project on the taxpayer's rate structure are not deductible as research and experimental expenditures under section 174(a) of the Code.

Rev. Rul. 73–275, 1973–1 C.B. 134, holds that the cost of the taxpayer's product engineering department to develop and design a specially-built automated manufacturing system for a customer's specific order at the taxpayer's risk are deductible as research and experimental expenditures within the meaning of section 174 of the Code even though each product design results in the production of only one machine system.

In the present situation, the taxpayer conducted extensive studies in support of its application to expand its facilities for generating electricity. The studies were not incidental to the development of an experimental or pilot model, a plant process, a product, a formula, an invention or similar property. The facilities to be expanded by the taxpayer did not involve an experimental or pilot project. Rather, the studies represented a search for the effect of the construction on the surrounding environment to support the taxpayer's application with various regulatory agencies to expand its facilities.

HOLDING

The taxpayer's expenditures for environmental impact studies prepared in connection with the expansion of its facilities are not research and experimental expenditures within the meaning of section 174 of the Code. Whether such expenses are capital expenditures will depend upon the facts of the particular case. The expenses, if not chargeable to a capital account, are ordinary and necessary business expenses deductible under section 162(a).

Section 191.—Amortization of Certain Rehabilitation Expenditures for Certified Historic Structures

Whether payments received pursuant to the National Historic Preservation Act of 1966 are includible in the gross incomes of the recipients. See Rev. Rul. 80-330, page 29.

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26 CFR 1.191-1: Amortization of certain rehabilitation costs for certified historic structures.

T.D. 7700

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; PART 7.—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1976

Amortization of Certain Rehabilitation Costs for Certified Historic Structures

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to amortiza-

tion of certain rehabilitation expenditures for certified historic structures. Changes to the applicable tax law were made by the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1] and the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1]. The regulations affect all persons desiring to amortize such rehabilitation expenditures and provide them with the guidance needed to comply with the law.

DATE: The regulations are effective for additions to capital account after June 14, 1976, and before June 15, 1981.

FOR FURTHER INFORMATION CONTACT: H. B. Hartley of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC 20224, Attention: CC:LR:T, 202-566-3287 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On August 30, 1978, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1) and the Temporary Income Tax Regulations under the Tax Reform Act of 1976 (26 CFR Part 7), all under section 191 of the Internal Revenue Code of 1954 ("Code") (43 FR 38731). The amendments were proposed to conform the regulations to section 2124 (a) (1) and (3) (B) of the Tax Reform Act of 1976 (90 Stat. 1916).

Technical amendments were made to section 191 of the Code by section 701(f) (1), (2), and (7) of the Revenue Act of 1978 (92 Stat. 2900, 2903). These statutory amendments made by the Revenue Act of 1978 were only technical changes and prescribe rules favorable to taxpayers. For this reason and because there is a need for immediate guidance for taxpayers, the relevant provisions of the Administrative Procedure Act (5 U.S.C. 553) requiring further notice of proposed rulemaking, opportunity for public participation, and delay in effective date are found to be inapplicable to changes to the August 1978 proposed regulations necessitated by these statutory changes.

A public hearing on the proposed regulations was held on March 15, 1979. After consideration of all written and oral comments regarding the proposed amendments, final regulations are adopted by this Treasury decision.

PROVISIONS OF THE REGULATIONS

Under section 191, owners of historic structures certified by the Secretary of the Interior may elect to amortize the amortizable basis attributable to costs incurred in certified rehabilitation of these structures. If this election is made, the rehabilitation costs are amortized over a 60-month period rather than depreciated over their actual useful life. Amortization deductions under section 191 may not be claimed if any part of the costs of the certified rehabilitation are deducted under any other provision of the Internal Revenue Code. However, allowable depreciation deductions of the basis of the historic structure, exclusive of the rehabilitation costs, may be continued during the amortization period. If an election involving the historic structure is made under section 191, no election may be made under section 167(o).

The election is available to owners, life tenants, and certain lessees of certified historic structures. In general, these persons may amortize only those expenditures made while they own (or lease) the property and only those expenditures for rehabilitation of an existing historic structure.

In the event of a disposition of the property, part or all of the amounts deducted under section 191 may be recaptured as ordinary income. In addition, the difference between rapid amortization and straight-line depreciation (based on the actual useful life of the structure) may be subject to the minimum tax.

All costs of a certified rehabilitation are generally amortizable. However, costs attributable to nondepreciable portions of a certified historic structure (where only part of the structure is used in a trade or business or for the production of income) and costs of new construction associated with a certified rehabilitation are not amortizable.

To elect the 60-month amortization, the taxpayer indicates that the election is being made as directed on the taxpayer's return for the taxable year in which falls the first month of the amortization period chosen pursuant to section 191(a). The election may be made after a request has been made for, but before, certification of the project by the Department of the Interior. If the election is made before final certification is received, proof of certification is to be submitted with the first tax return filed by the taxpayer after receipt of the certification. If proof of certification is not submitted within 30 months after commencement of the amortization period, the taxpayer may be asked to agree to an extension of time for assessment of additional tax for the period for which amortization deductions are claimed.

Once made, the election may be discontinued at any time by filing written notice with the taxpayer's income tax return for the year in which amortization is to cease.

ADDITIONAL CONSIDERATIONS

These regulations are needed in order to provide guidance to the public as well as to government employees responsible for the implementation of section 191 of the Code. Considering both the direct and indirect effects of these regulations, it is believed that they satisfactorily implement section 2124(a) (1) and (3) of the Tax Reform Act of 1976 [Pub. L. 94-455,

1976-3 C.B. (Vol. 1) 1, 392], as amended by section 701(f)(1), (2), and (7) of the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1, 134]. Evaluation of the effectiveness of the regulations after issuance will be based upon comments received from offices within the Internal Revenue Service and the Treasury Department, the Department of the Interior, other government agencies, and the public.

PUBLIC COMMENTS

Twenty-five comments were received in response to the proposed regulations. As a general matter, these comments pointed out that the proposed regulations did not reflect changes made in the law by the Revenue Act of 1978. The technical amendments made by that Act (which became law after publication of the proposed regulations) have been incorporated at the appropriate places throughout the regulations. See, for example, § 1.191-1(b)(3) on the relation of section 191 to other Code provisions, § 1.191-1(c)(2)(vi) on rules for lessees, § 1.191-1(e) on the relation of section 191 to the minimum tax, and §§ 1.191-2(a) and (b) for amended definitions of "certified historic structure" and "registered historic district." One comment urged permitting separate amortization periods to be established for any expenditures made during a given month. This suggestion was not adopted since section 167, which applies if section 191 is not elected, requires the presence of a component part of a structure for depreciation to be allowable. This rule has been restated in § 1.191-1(b)(1)(i) to remove any doubt concerning whether a component part is required for a separate amortization period to be established. Another comment requested express provisions governing demolition undertaken as part of certified rehabilitation. New § 1.191-1(b)(4) and § 1.191-2(e)(7) have been added to provide specific rules on demolition. Under new § 1.191-1(b)(4), if an historic structure is expanded to the site of another demolished historic structure by certified rehabilitation, section 191 treatment is still available despite the provisions of section 167(n). Portions of the rehabilitated historic structure actually on the demolition site would, however, be subject to the limitations of section 167(n). This position was adopted because it is believed that the requirement that the rehabilitation be certified by the Secretary of the Interior will insure protection of all structures intended to be protected by section 167(n). Two comments requested clarification of the rule contained in the proposed regulations making certain transferees of certified historic structures eligible for section 191 treatment. Section 1.191-1(b)(6) was amended to clarify that, if amortization deductions are discontinued during the 60-month period, the remaining depreciable life of the structure is determined at time amortization ceases. Section 1.191-1(c)(2)(iii) was amended to indicate that transferees at the completion of rehabilitation are eligible for section 191 treatment even where the structure was not taken out of service during rehabilitation. Another change to § 1.191-1(c)(2)(iii) clarifies that, for a transferee to elect section 191, the transfer to him must occur before the property is placed in service after rehabilitation, even though the transferor could elect to delay amortization deductions until the first month of the following taxable year and had in fact claimed no amortization deductions at the time of the transfer. In response to other requests, § 1.191-1(c)(viii) was amended to accord treatment as lessees to all concessionaires where Federal government restrictions prevent leasing the property. Two comments requested extension of section 191 treatment to ships that are individually listed on the National Register of Historic Places whether or not they are permanently anchored so as to become real property. This suggestion was not adopted because section 191, as is true of all of section 2124 of the Tax Reform Act of 1976 is applicable only to real property. See § 1.191-2(c). Some comments expressed confusion as to the meaning of a "reconstruction" of an historic structure which is excluded from section 191 treatment. This term had been used because it is used in Interior Department guidelines. To eliminate this confusion, however, § 1.191-2(d) was amended to substitute the term "reproduction" for "reconstruction." Thus, "reproductions" of historic structures are excluded from section 191 treatment. Section 1.191-2(e)(1) was expanded in response to comments which revealed a misunderstanding of the respective roles of the Internal Revenue Service and the Department of the Interior in implementing section 191. That paragraph now expressly states that the Interior Department certifies that standards of historic character are met while the Internal Revenue Service determines other rules governing eligibility for section 191 treatment. Section 48 on investment tax credits for rehabilitated buildings contains a requirement that 75 percent of the existing exterior walls of a structure remain after rehabilitation. Similarly, regulations under 167(k) state that if one or more outer walls and the internal structural framework of a building are replaced, expenditures are generally attributable to new construction. In response to the comments and to provide more consistent rules throughout the Code, § 1.191-2(e)(5) now contains a comparable rule. Section 1.191-2(e)(5) was also amended to indicate that buildings may be disassembled and reassembled and a part of certified rehabilitation because this is a frequent rehabilitation technique. In response to a request from the Department of the Interior, new §§ 1.191-2(e)(6) and (7) were added to provide rules on costs of relocating structures and demolition expenses incurred as part of certified rehabilitation. One comment questioned the rule on when

additions to capital account are made which is contained in § 1.191-2(e)(8). To provide more nearly equal treatment for rehabilitations begun before June 14, 1976, and those ending after June 14, 1981, § 1.191-2(e)(8) was changed to permit amortization of costs attributable to completed components of rehabilitations still in progress on June 14, 1981. A conforming paragraph, § 1.191-3(b)(4), was added to permit elections to be made after June 14, 1981, for expenditures attributable to these completed components.

DRAFTING INFORMATION

The principal author of these regulations was H. B. Hartley of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, amendments to the regulations (26 CFR Parts 1 and 7), are hereby adopted as set forth below.

INCOME TAX REGULATIONS (26 CFR Part 1)

Paragraph 1. The following new sections are added immediately after § 1.190-3.

§ 1.191-1. Amortization of certain rehabilitation costs for certified historic structures.

(a) *In general.* Section 191 allows an owner of a certified historic structure who rehabilitates that structure to elect to amortize over a 60-month period certain expenditures attributable to certified rehabilitation. The election may be made only if the certified historic structure (as defined in § 1.191-2(a)) and the improvements made are otherwise of a character subject to depreciation under section 167. In general, only those rehabilitation expenditures which result in additions to capital account after June 14, 1976, and before June 15, 1981, are eligible for this special amortization procedure. To qualify for the election, the rehabilitation must be certified by the Secretary of the Interior to the Internal Revenue Service as consistent with the historic character of the structure. See § 1.191-2(d) for the definition of certified rehabilitation. Along with the amortization deductions, the taxpayer may continue otherwise allowable depreciation deductions of the basis of the structure, exclusive of rehabilitation costs which are a part of the amortizable basis (as defined in § 1.191-2(e)).

(b) *Allowance of deduction*—(1) *Determination of amortization period*—(i) *General rule.* The taxpayer may elect to begin the 60-month amortization period with the month following the month in which the amortizable basis is acquired, or with the first month of the succeeding taxable year. Generally amortizable basis must be acquired after June 14, 1976, and before June 15, 1981. For purposes of this section, the month in which the amortizable basis is acquired is the latest of the month in which the work (or a component part of the work) is completed, the month in which costs are added to capital account, or the month in which depreciation deductions under section 167 would be first allowable with respect to the structure. See, however, § 1.191-2(e)(8) for special rules for certified rehabilitations in part occurring outside the effective period of section 191. No amortization deduction may be claimed before a building is used (or held for use) in a trade or business or for the production of income.

(ii) *Multiple amortization periods.* After a structure is eligible for depreciation, a separate amortization period may be established for each month's expenditures and completed work as that portion of the rehabilitation is placed in service in a depreciable use. The completed work for which a separate amortization period is established must, however, be an identifiable separate component of the entire project and not simply progress payments upon partial completion of overall rehabilitation activities. For example, a single structure could have a series of amortization periods based upon the component parts of the work completed and expenditures made for those component parts during each month in which the certified rehabilitation is in progress if the structure were already depreciable before completion of the rehabilitation activities. Alternatively, the taxpayer may treat his entire amortizable basis as acquired upon completion of the entire rehabilitation project rather than allocating amounts to each month in which the costs of component parts could have been added to basis. This treatment applies although rehabilitation extends over more than one taxable year, if there is no interruption in rehabilitation activities. If the taxpayer chooses to delay amortization deductions until completion of an entire project, then depreciation deductions with respect to any portion of the rehabilitation expenditures are treated as not allowable until the completion.

(2) *Amount of deduction.* The allowable deduction for each month is determined by dividing the amortizable basis as of the last day of the month by the number of months (including the current month) which remain in the 60-month amortization period. This calculation is repeated for each month of the 60-month period to determine each month's allowable amount of amortization deduction.

(3) *Relation to section 167(o) and other provisions.* If an election involving a certified historic structure is made under section 191, no election may be made under section 167(o) either for the same rehabilitation or for any subsequent rehabilitation of the same structure undertaken by the taxpayer making an election under section

191. Additionally, no election is permitted under section 191 if depreciation deductions or credits against tax based upon any part of the costs qualifying for amortization under section 191, are at any time claimed (or allowable (under any depreciation or other provision of the Internal Revenue Code of 1954. However, this limitation with respect to investment tax credits under section 18 applies only to structures placed in service after October 31, 1978. If section 191 treatment is timely elected on a structure placed in service after October 31, 1978, the investment tax credit under section 38 is considered not to have been allowable with respect to that structure.

(4) *Expansions of rehabilitated structures to sites of demolished structures.* If a certified rehabilitation results in expansion of a certified historic structure to the site of a separate certified historic structure which is demolished as part of the rehabilitation, section 191 treatment is not available with respect to any expenditures attributable to that demolition or to any expenditures attributable to portions of the rehabilitated historic structure actually located on the demolition site. (See § 1.191-2(e)(7).) Subject to this restriction, however, section 191 treatment is available for expenditures for certified rehabilitation of the remaining historic structure which form a part of amortizable basis under § 1.191-2(e). See section 167(n) for special rules on depreciation of structures on sites previously occupied by certified historic structures and section 280B for rules on demolition costs.

(5) *Depreciation upon notice to discontinue amortization deductions.* If the taxpayer chooses to discontinue amortization deductions, the unamortized rehabilitation costs are added to the adjusted basis of the structure as of the first day of the month for which the notice to discontinue amortization deductions is effective. Deductions for depreciation of the structure under section 167 may then be computed on the resulting adjusted basis beginning at that time and are based on the estimated remaining useful life of the rehabilitated structure, determined as of the date amortization deductions cease.

(6) *Examples.* The provisions of this paragraph (b) may be illustrated by the following examples:

Example (i). A, a calendar-year taxpayer, secured the necessary certifications from the Secretary of the Interior and began rehabilitation of a 100-year-old townhouse previously rented as a one-family dwelling, in order to convert it into two equally-sized apartments. In June 1977, the exterior work was completed, and A paid his contractor the cost of $20,000. Apartment #1 was completed and rented in September, and the cost of $40,000 was paid. In November, Apartment #2 was finished and rented, and A paid the cost of $47,500. A elects to use the 60-month amortization allowed under section 191. A chooses to establish separate amortization periods for each of these phases of the work, each period beginning at the earliest possible date. These periods and the amortizable basis for each period are as follows:

Apartment No. 1, and Allocable Portion of Exterior, beginning October 1, 1977, $50,000 basis.

Apartment No. 2, and Allocable Portion of Exterior, beginning December 1, 1977, $57,500 basis.

If A had chosen to do so, A could have selected an amortization period for the entire amortizable basis of $107,500 beginning on December 1, 1977, or January 1, 1978.

Example (ii). B owns a 19th Century warehouse building which is listed in the National Register. In a certified rehabilitation B converted the building into a small shopping mall at a cost of $480,000. The rehabilitation was begun in January 1977, and was completed, placed in service, and paid for in November 1977. B elected to claim amortization deductions under section 191 and to begin the amortization period in December 1977. B's allowable amortization deductions are $8,000 per month, computed as follows:

December 1977: $480,000 amortizable basis/60 months in period = $8,000 deduction.

January 1978: $472,000 amortizable basis/59 months in period = $8,000 deduction.

(c) *Person to claim deduction—* (1) *In general.* Except as otherwise provided in this paragraph (c)—

(i) Only the owner of a fee-simple interest in a certified historic structure and the site on which the structure is located may elect to amortize certified rehabilitation costs; and

(ii) The electing owner must have acquired ownership of the property before commencement of rehabilitation activities, the costs of which are to be amortized.

An electing owner need not have owned the property before commencement of all rehabilitation activities. Where the property is not acquired before rehabilitation begins, however, only those costs incurred subsequent to the acquisition of ownership of the site and structure may be considered for purposes of amortization deductions under section 191.

(2) *Exceptions and special rules—* (i) *Life tenant and remainderman.* For purposes of section 191, the holder of a life estate in property is considered to own the property. A remainderman taking the property on the death of the life tenant is permitted to amortize only those rehabilitation costs which are incurred for improvements begun following termination of all preceding interests in the property and paid by the remainderman.

(ii) *Owners of joint or undivided interests in historic structures.* Joint tenants, tenants by the entirety, tenants in common, and owners of other joint or undivided interests in a certified historic structure may, under section 191, amortize expenditures made for certified rehabilitation. The right of any one such owner to make an election under section 191 is not dependent upon any other co-owner making such an election. Each electing owner's amortizable basis consists of the full amount of expenditures actually made by that individual owner for certified rehabilitation. See paragraph (c)(2)(v) of this section for rules on partnerships.

(iii) *Certain transferees of historic structures.* If expenditures for certified rehabilitation are in fact made by the owner of a certified historic structure, and if one or more transferees then acquire the ownership of the rehabilitated structure directly from that owner before the structure is placed in

service in its rehabilitated use, the transferees, solely for purposes of section 191, may be treated as having made the rehabilitation expenditures at the later of the time the structure is acquired or the rehabilitation is completed. Transferees acquiring structures in transfers occurring after the structure is placed in service after its rehabilitation but before the first day of the following taxable year, are not eligible for section 191 treatment, because depreciation deductions for rehabilitation costs are allowable to the transferor before the transfer. The amount of rehabilitation expenditures treated as made by the transferees under this subdivision (iii) is the lesser amount of—

(A) The rehabilitation expenditures actually made before the date on which the transferee acquired ownership of the structure, or

(B) The portion of the transferee's cost or other basis for the property (determined according to the rules of section 167) which is attributable to rehabilitation expenditures made before the date on which the transferee acquired ownership of the structure.

(iv) *Estates and trusts.* The amortization deduction provided by section 191 is allowable to estates and trusts; see sections 642(f) and 1.642(f)-1.

(v) *Partnerships.* Partnerships owning certified historic structures may elect to amortize expenditures for certified rehabilitations made by the partnerships. Any election for partnership property must be made by the partnership and not by the partners individually.

(vi) *Lessees of historic structures.* A lessee of an historic structure (including a structure which is not depreciable to the lessor) which is certified by the Secretary of the Interior and which is used by the lessee in a depreciable use can elect under section 191 to amortize rehabilitation expenditures actually made by the lessee. A lessee can make an election under section 191 only if the remaining term of the lease equals or exceeds both a period of 30 years and the actual useful life of the improvements constituting the certified rehabilitation. The lessee's remaining lease term is measured as of the date on which the full certified rehabilitation is completed. Under section 191(f)(2), renewal periods are not treated as part of the remaining lease term. However, if, before the date on which the full rehabilitation is completed, the lessee becomes obligated for periods beyond the current term of the lease to the same extent that the lessee is obligated during the current term, those additional periods are considered to be part of the current lease term and not renewal periods.

(vii) *Concessionaires from governmental entities.* For purposes of section 191 and this section, holders of concession contracts on properties owned by the Federal government or by any State or local government who do not lease the property because of express Federal government restrictions, are, nevertheless, considered to be lessees.

(d) *Recapture.* If a taxpayer disposes of property for which the taxpayer has claimed amortization deductions under section 191, part or all of any gain on the disposition may be recaptured as ordinary income under the applicable provisions of the Code.

(e) *Minimum tax on preference income under section 56.* Amortization deductions under section 191 are items of tax preference for purposes of the minimum tax to the extent the deductions exceed the amount that may be claimed under straight-line depreciation using the actual useful life of the property. See section 57(a)(2). For special rules for elevators and escalators, see section 57(a)(1).

§ 1.191-2 Definitions and special rules.

(a) *Certified historic structure.* A certified historic structure is a building or other structure which is of a character subject to depreciation under section 167 and is either—

(1) Listed in the National Register of Historic Places, or

(2) Located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district.

Under section 191, a structure is considered to be of a character subject to depreciation only if its first use following completion of certified rehabilitation is a use in a trade or business or for the production of income.

(b) *Registered historic district.* A registered historic district is—

(1) A district listed in the National Register of Historic Places, or

(2) A district designated under a statute (including an ordinance) of a State (or local government), but only if the Secretary of the Interior certifies that—

(i) The statute contains criteria which achieve the purpose of preserving historically significant buildings; and

(ii) The district meets substantially all of the requirements for districts to be listed in the National Register of Historic Places.

(c) *Structure.* A structure is a specific building or other man-made construction which constitutes depreciable real property under section 167 of the Code. The term structure does not include ships, other vessels, aircraft, railway cars, or other construction which does not constitute real property even though the other items are listed in the National Register of Historic Places. The term structure also does not include site work or other related items associated with the building or other construction. Examples of structures include rental housing, office buildings, lighthouses, hotels, factories, and bridges.

(d) *Certified rehabilitation.* A certified rehabilitation consists of improvements to or restoration of an existing certified historic structure, which the

Secretary of the Interior certifies to be consistent with Interior Department standards for rehabilitation. Reproduction (as opposed to restoration) of an historic structure is not a certified rehabilitation even in cases where the reproduction is listed in the National Register upon its completion since it does not enhance the historic value of an existing historic structure.

(e) *Amortizable basis*—(1) *In general.* The amortizable basis of a certified historic structure consists of any otherwise depreciable additions to the capital account of the structure during the effective period of section 191. See § 1.191-2(e)(8) for rules on the time amounts are added to capital account and on the effective period of section 191. Only amounts expended by the electing person directly for rehabilitation of existing historic structures are part of amortizable basis. Amortizable basis does not include new construction even though the certification of rehabilitation by the Secretary of the Interior certifies that the entire project is consistent with Interior Department standards and makes no distinction between rehabilitation of the existing historic structure and new construction relating to the historic structure. Amortizable basis also does not include certain additions which do not meet the requirements of paragraphs (d) and (e) of this section even though such additions are considered under local law to be rehabilitation. For purposes of section 191, architectural and engineering fees, real estate commissions, site survey fees, legal expenses, insurance premiums, developers' fees, and other construction-related costs are a part of amortizable basis. Any costs for which a deduction is claimed under any other section of the Code or for which specific provision is made in another section of the Code (such as section 189 on construction period interest and taxes or section 266 on carrying charges) are not a part of amortizable basis. Any costs which must be added to the basis of land associated with the historic structure, rather than depreciated under section 167, are not a part of the amortizable basis.

(2) *Partially depreciable property.* A certified historic structure may be depreciable only in part, as, for example, a private residence which includes a separate rental apartment. In such case, only that portion of the costs of the certified rehabilitation which is attributable to the portion of the total structure that is depreciable propery under section 167 is a part of amortizable basis. The determination of the portion of the expenditures which is included in amortizable basis is made according to the rules of section 167. The remaining certified rehabilitation costs must be added to the nondepreciable portion of the basis of the historic structure.

(3) *Rehabilitations which include new construction.* If a rehabilitation project only partially qualifies for amortization deductions because a portion of the project is new construction (as defined in this paragraph (e)), the apportionment rules of section 167 apply to determine the amount of the taxpayer's amortizable basis. For example, the cost of a single heating system used both for a rehabilitated historic structure and for a nonhistoric new wing added thereto would be apportioned between the amortizable rehabilitation costs and nonamortizable new construction costs.

(4) *Modernization of existing structure included.* Expenditures for structural modernization of an existing historic structure, which are made in a rehabilitation certified by the Secretary of the Interior to be consistent with the historic character of the structure, are a part of amortizable basis. Examples of such expenditures include the costs of modern plumbing and electrical wiring and fixtures, heating and air conditioning systems, elevators, escalators, and improvements required by local building or fire codes. The addition of an attached facility exclusively for elevators, fire stairs, or barrier-free access will also be considered rehabilitation, if the construction of elevators, fire stairs, or barrier-free access within the existing structure is prohibited by the Secretary of the Interior as destructive of the historic character of the structure. Carpeting, draperies, office equipment, furniture (even where it is built in), nonpermanent (demountable) walls or partitions, and other similar items of personal property are not a part of amortizable basis.

(5) *New construction excluded.* Expenditures attributable to new construction associated with a certified rehabilitation are not a part of amortizable basis. Whether expenditures are attributable to the rehabilitation of an existing structure, or are attributable to new construction, will be determined upon the basis of all the facts and circumstances. Expenditures will generally be considered attributable to rehabilitation if the foundation and outer walls of the existing building are retained and the costs are attributable to work done within that existing framework. Where the internal structural framework of a building is replaced and one or more outer walls are also replaced, all expenditures are normally attributable to new construction even though the construction may qualify as rehabilitation under local law. The internal structural framework and outer walls are not considered to have been replaced if they are disassembled and reassembled as part of rehabilitation so long as the reassembled framework and outer walls consist of at least 75% of materials original to that structure. Except as otherwise provided in this paragraph (e), any expansion of the existing structure is considered new construction even if the expansion consists of the reproduction of portions of the structure which no longer existed when rehabilitation was started. For example, the addition of a new story to an existing building is new construction. Likewise, related construction such as a garage,

sidewalk, or parking lot (or the addition of landscaping) will not be considered rehabilitation even though the related construction may be physically attached to the historic structure.

(6) *Relocation of certified historic structures.* Costs attributable to relocation of an existing certified historic structure (other than costs that are not depreciable under section 167) are included in amortizable basis if the relocation is expressly approved by the Secretary of the Interior.

(7) *Rehabilitations which include expenditures for demolition.* Expenditures attributable to demolition of a portion of an existing certified historic structure as part of certified rehabilitation are included in amortizable basis. However, costs attributable to demolition of related facilities not forming a part of the existing certified historic structure, or to demolition of separate certified historic structures as part of an overall rehabilitation plan, are not included in amortizable basis. For a special rule on costs attributable to demolition of certified historic structures, see section 280B, and for rules limiting depreciation and amortization deductions for structures constructed or used in whole or in part on the site of a demolished certified historic structure, see section 167(n) and § 1.191-1(b)(4).

(8) *Time when amounts are added to capital account.* Under section 191, expenditures are treated as added to capital account at the time they are actually made (paid or accrued). However, amortizable basis includes only expenditures attributable to component parts of the structure completed before June 15, 1981. Therefore, expenditures for improvements completed after June 14, 1981, are not a part of the taxpayer's amortizable basis even though they may have been paid or accrued prior to that date. In the case of a single and continuous rehabilitation project all of which is certified by the Secretary of the Interior, expenditures for rehabilitation begun before June 14, 1976, but completed and charged thereafter, are a part of the taxpayer's amortizable basis. However, even where there is a single and continuous rehabilitation project, expenditures made for any component part of the improvements completed and charged before June 14, 1976, are not a part of the taxpayer's amortizable basis.

§ 1.191-3 Time and manner of making election.

(a) *In general.* Under section 191(b), an election by the taxpayer (including a partnership) to claim amortization deductions with respect to a certified historic structure is made by so electing at the appropriate place on the taxpayer's return for each year in which amortization deductions are claimed. Additionally, in any year in which falls the first month of a 60-month amortization period selected pursuant to § 1.191-1(b), the amount of amortizable basis from which deductions are to be claimed during that 60-month period must be entered at the appropriate place on the return. If an election is made for more than one certified historic structure, the amount of amortizable basis for each structure must be separately entered on the return.

(b) *Special rules*—(1) *Letters of certification.* A copy of the letter of certification issued by the Secretary of the Interior qualifying each certified rehabilitation must be submitted with taxpayer's return on which an election to amortize rehabilitation expenditures for any structure is first made. If final certification of a rehabilitation has not been issued by the Secretary of the Interior by the date of the election, a copy of the first page of the application for certification of the completed rehabilitation work must be attached to the return.

(2) *Certifications not issued and failure to submit proof of certification.* If final certification of rehabilitation has not been issued at the time amortization deductions begin, the electing party must submit a copy of that certification with the first income tax return filed after the receipt by the taxpayer of the certification. If the required notice of certifications is not received by the Internal Revenue Service within 30 months after the date of the commencement of the 60-month amortization period, the electing taxpayer may be requested to consent to an agreement under section 6501(c)(4) extending the period of assessment for any tax relating to the time for which amortization deductions are claimed.

(3) *Election of multiple amortization periods for a single structure.* If the taxpayer elects a separate amortization period for each month in which rehabilitation expenditures for a single structure are made and component work completed, the taxpayer must combine all such elections for periods beginning in one taxable year in a single election, and must enter on the return the total amount of amortizable basis from which deductions are first claimed in that year. If multiple amortization periods are selected for a single structure to commence in different taxable years, a copy of the letter certifying the rehabilitation must be attached to each return on which a deduction for a separate amortization period is first claimed.

(4) *Elections to begin amortization deductions after June 14, 1981.* Notwithstanding the rules of § 1.191-1(b)(1)(i), expenditures for component parts of a rehabilitation project which is not completed and placed in service until after June 14, 1981, are included in amortizable basis if the component parts are completed and the expenditures are added to capital account under § 1.191-2(e)(8) by that date. Amortization deductions for the costs of such component parts are allowable beginning with the month in which the entire rehabilitation would qualify under § 1.191-1(b)(1), but for the ex-

piration of section 191 on June 14, 1981.

(c) *Notice to discontinue amortization*—(1) *In general.* A notice to discontinue amortization deductions as provided by section 191(c) may be made at any time during the amortization period. This notice is made by a statement attached to the return of the taxpayer filed for the taxable year in which falls the first month for which the election terminates. In the case of a partnership, the statement is to be attached to the partnership return. The statement must specify the month as of the beginning of which the taxpayer chooses to discontinue amortization deductions. The statement must be filed with the taxpayer's income tax return for the year in which amortization is to cease. In addition, the statement must contain a description clearly identifying the certified historic structure and rehabilitation with respect to which the taxpayer elects to discontinue the amortization deduction. In the case of multiple amortization periods relating to the same structure, an election to discontinue any amortization deductions terminates all amortization periods that have been established. If final certification of the rehabilitation has been issued, a copy of the letter of certification must be attached to the taxpayer's return. If, at the time of the election to discontinue amortization deductions, final certification has not been issued, the taxpayer must submit a copy of the first page of the application for that certification and must submit a copy of the letter of certification with the next succeeding tax return after its receipt. If the required certification has not been issued and 30 months or more have elapsed since amortization deductions under section 191 were first claimed, the taxpayer may be requested to consent to an agreement under section 6501(c)(4) extending the period of assessment for any tax relating to the time for which amortization deductions were claimed.

(2) *Notification by Secretary of the Interior.* For purposes of this paragraph (c), notification to the Secretary or his delegate from the Secretary of the Interior that he has notified the owner of the historic structure that the structure or the rehabilitation no longer meets the requirements for certification has the same effect as notice from the taxpayer electing to terminate amortization deductions as of the first day of the month following the month that the structure or rehabilitation ceased to meet the requirements of section 191.

Par. 2. Section 1.642(f)-1 is amended to read as follows:

§ 1.642(f)-1 Amortization deductions.

An estate or trust is allowed amortization deduction with respect to an emergency facility as defined in section 168(d), with respect to a certified pollution control facility as defined in section 169(d), with respect to qualified railroad rolling stock as defined in section 184(d), with respect to certified coal mine safety equipment as defined in section 187(d), with respect to on-the-job training and child-care facilities as defined in section 188(b), and with respect to certain rehabilitations of certified historic structures as defined in section 191, in the same manner and to the same extent as in the case of an individual. However, the principles governing the apportionment of the deductions for depreciation and depletion between fiduciaries and the beneficiaries of an estate or trust (see sections 167(h) and 611(b) and the regulations thereunder) shall be applicable with respect to such amortization deductions.

TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1976

(26 CFR Part 7)

Par. 3. Section 7.191-1 is deleted.

This Treasury decision is issued under the authority contained in sections 191 and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1916, 92 Stat. 2900, 68A Stat. 917, 26 U.S.C. 191, 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved May 15, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 4, 1980, 8:45 a.m., and published in the issue of the Federal Register for June 6, 1980, 45 F.R. 38050)

Part VII.—Additional Itemized Deductions for Individuals

Section 213.—Medical, Dental, Etc., Expenses

26 CFR 1.213-1: Medical, dental, etc., expenses.
(Also Section 262; 1.262-1.)

Medical expense; visual display audio equipment for television sets. The extra cost of a specially equipped television set that provides deaf individuals with a visual display of the audio portion of television programs and the cost of an adaptor for a conventional television set that performs the same function are medical expenses.

Rev. Rul. 80-340

ISSUE

Is the cost of special equipment that displays the audio portion of television programs as subtitles on the screen of a television set an expense for medical care for purposes of the deduction allowed by section 213 of the Internal Revenue Code?

FACTS

Through the use of special equipment, television programming can be understood by the deaf. The equipment displays the audio portion of television programs as subtitles on the

screen of a television set. Two types of equipment are available. One is a small self-contained unit that can be attached to any conventional television set. The other is a conventional color television set in which the equipment is incorporated during manufacture and for which the cost is more than for the same model color television set that does not contain the equipment.

LAW AND ANALYSIS

Section 262 of the Code provides that, except as otherwise expressly provided, no deduction is allowed for personal, living, or family expenses.

Section 213(a) of the Code allows as a deduction the amount, not compensated for by insurance or otherwise, by which the amount of the expenses paid during the taxable year for medical care of the taxpayer, the taxpayer's spouse, and dependents, exceeds three percent of adjusted gross income.

Section 213(e) of the Code provides that the term "medical care" means amount paid for the diagnosis, care, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.

Section 1.213-1(e)(1)(ii) of the Income Tax Regulations provides that deductions for expenditures for medical care allowable under section 213 of the Code are confined strictly to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness. An expenditure that is merely beneficial to the general health of an individual is not an expenditure for medical care.

Section 1.213-1(e)(1)(iii) of the regulations provides that a capital expenditure that is related only to the sick person and is not related to permanent improvement or betterment of property, if it otherwise qualifies as an expenditure for medical care, is deductible.

Rev. Rul. 71-48, 1971-1 C.B. 99, holds that the cost of specialized equipment that enables a deaf taxpayer to communicate effectively over a regular telephone by means of converted teletype signals is deductible as a medical expense.

Rev. Rul. 75-318, 1975-2 C.B. 88, holds that a taxpayer who purchased braille books and magazines for the taxpayer's child may deduct as expenses for medical care the portion of the purchase price that exceeds the price for regular printed editions.

Rev. Rul. 66-80, 1966-1 C.B. 57, holds that the cost of hand controls and other equipment specially adopted to permit the operation or use of an automobile by a physically handicapped individual and the cost of a mechanical device used to lift and place the individual in an automobile are deductible as medical expenses under section 213 of the Code.

HOLDING

In view of the foregoing, both the cost of the self-contained unit that can be attached to any conventional television set and the excess of the cost of the specially-equipped color television set over the cost of the same model conventional color television set are expenses for medical care for purposes of the deduction allowed by section 213 of the Code.

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26 CFR 1.213-1: Medical, dental, etc., expenses.

Standard mileage rate for computing the allowable deduction for the cost of operating an automobile in connection with transportation for medical care. See Rev. Proc. 80-32, page 767.

Section 216.—Deduction of Taxes, Interest, and Business Depreciation by Cooperative Housing Corporation Tenant-Stockholder

26 CFR 1.216-1: Amounts representing taxes and interest paid to cooperative housing corporation.

Cooperative housing corporation; tenant-occupant protected by rent control laws. An otherwise qualifying cooperative housing corporation is not precluded from meeting the requirements of section 216(b)(1)(B) of the Code by state and local rent control laws that prevent a purchaser of shares from obtaining occupancy of a unit until the current tenant-occupant voluntarily vacates the unit or breaches the lease and is dispossessed.

Rev. Rul. 80-299

ISSUE

Does a corporation meet the requirement of section 216(b)(1)(B) of the Internal Revenue Code, under the circumstances described below?

FACTS

A partnership owned an apartment building that is subject to state and local rent control laws under which a tenant-occupant is entitled to a renewal of the tenant's lease prior to its termination. Thus, the tenant may continually renew the lease. The building was transferred to a corporation organized by the partnership in exchange for stock that the partnership offered for sale to the tenants and to the general public. Of the total number of shares available for sale, different blocks of shares were allocated to each apartment unit. The purchaser of a block of shares is entitled to a proprietary lease of the allocable apartment unit.

The proprietary lease received by a nonoccupant purchaser of shares is subject to the rights under the rent control laws of the tenant in occupancy. That is, a purchaser of a unit that is occupied may obtain occupancy only if the tenant-occupant voluntarily vacates the unit or breaches the obligations and is involuntarily dispossessed. The purchaser becomes a lessee under the proprietary lease, and, if the tenant-occupant remains in possession, a sublessor with respect to the tenant-occupant.

A minority of the tenant-occupants

purchased blocks of stock in the corporation and received leases from the corporation for the allocable apartment units. The remaining tenant-occupants did not purchase stock. This stock was sold by the partnership to purchasers who are not able to occupy the allocable apartment units because they are occupied by tenant-occupants who are protected by the rent control laws.

LAW AND ANALYSIS

Section 216(b)(1)(B) of the Code provides that the term "cooperative housing corporation" means a corporation in which, among other things, each of the stockholders is entitled, solely by reason of the stockholder's ownership of stock in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by the corporation.

Section 1.216-1(d)(2) of the Income Tax Regulations provides that each stockholder of the corporation must be entitled to occupy for dwelling purposes an apartment in a building or a unit in a housing development owned or leased by such corporation. The stockholder is not required to occupy the premises. The right as against the corporation to occupy the premises is sufficient. Such right must be conferred on each stockholder solely by reason of the stockholder's ownership of stock in the corporation; that is, the stock must entitle the owner thereof either to occupy the premises or to a lease of the premises. The fact that the right to continue to occupy the premises is dependent upon the payment of charges to the corporation in the nature of rentals or assessments is immaterial.

Section 216(b)(1)(B) of the Code and regulations thereunder require only that the stockholder have a right by reason of the stockholder's ownership of stock either to occupy the premises or to a lease of the premises and such right as against the corporation is all that is needed. Actual occupancy is not required.

In this case, a nonoccupant stockholder is entitled to a proprietary lease solely by reason of ownership of stock in the corporation and such lease confers occupancy rights upon the stockholder as against the corporation. Therefore, it is not material that the stockholder is precluded from actual occupancy of an apartment because it is occupied by a tenant whose lease is protected by the rent control laws.

A tenant-occupant who purchased stock in the corporation is also entitled to a proprietary lease that confers occupancy rights upon the tenant-occupant, notwithstanding the fact that the tenant-occupant may also have a right to occupy the apartment under the rent control laws. As to the occupant-shareholder, who possesses occupancy rights by reason of the occupant-stockholder's stock ownership, the occupancy rights conferred by the rent control laws are immaterial.

HOLDING

The corporation meets the requirements of section 216(b)(1)(B) of the Code.

Section 217.—Moving Expenses

26 CFR 1.217-2: Deduction for moving expenses paid or incurred in taxable years beginning after December 31, 1969.

Simplified, optional method that may be used for computing deductions for the costs of operating a passenger automobile for moving expense purposes. See Rev. Proc. 80-32, page 767.

Section 219.—Retirement Savings

26 CFR 1.219-1: Deduction for retirement savings.
(Also Sections 408, 409, 4974; 1.408-1, 1.409-1, 54.4974-1.)

T.D. 7714 [1]

TITLE 26.—INTERNAL REVENUE—CHAPTER I, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953, SUBCHAPTER D, PART 54—PENSION EXCISE TAXES

Individual retirement arrangements

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to individual retirement arrangements (IRA's—individual retirement accounts, individual retirement annuities or retirement bonds). Changes to the applicable tax law were made by the Employee Retirement Income Security Act of 1974 [Pub. L. 93-406, 1974-3 C.B. 1]. These regulations provide necessary guidance to the public for compliance with the law, and affect individuals who maintain IRA's and institutions which sponsor IRA's.

DATE: The regulations are generally effective for taxable years beginning after December 31, 1974.

FOR FURTHER INFORMATION CONTACT: William D. Gibbs of the Employee Plans and Exempt Organizations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:LR:T) (202-566-3430) (not a toll-free number).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On February 21, 1975, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 219, 402, 403 and 408 of the Internal Revenue Code of 1954 (40 F.R. 7661). A new part, containing regulations under Code sections 4973 and 4974 (26 CFR Part 54), was also proposed. A correction notice was

[1] This publication of the Treasury Decision contains the complete text of the amendments to the regulations. The instructions for modifying the notices of proposed rulemaking have been omitted.

published in the Federal Register on March 5, 1975 (40 F.R. 10187). A supplemental notice was published on November 19, 1975 (40 F.R. 53593). A notice which withdrew and reproposed part of the notice of February 21, 1975 was published in the Federal Register on March 23, 1979 (44 F.R. 17754). The amendments were proposed to conform the regulations to section 2002 of the Employee Retirement Income Security Act of 1974 (88 Stat. 958) [supra, at 127]. These final regulations, in general, do not reflect changes and additions made to the tax law by the Tax Reform Act of 1976 (90 Stat. 1520) [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1], the Revenue Act of 1978 (92 Stat. 2763) [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1], and the Act of October 14, 1978 (P.L. 95-458, 92 Stat. 1255) [1978-2 C.B. 367]. Thus, these final regulations do not deal with the extension of the period for making individual retirement plan contributions under sections 219(c)(3) and 220(c)(4), the deduction of excess contributions in a subsequent year for which there is an unused limitation under sections 219(c)(5) and 220(c)(6), the additional period to rectify certain excess contributions under section 408(d)(5), and the allowance of rollovers on a more frequent basis under section 408(d)(3)(B).

Due to numerous statutory changes made to sections 402 and 4973 since the publication of the first notice, proposed regulations under those sections have been withdrawn and will be reproposed at a later date.

SPECIAL EFFECTIVE DATE FOR ROLLOVERS

If an individual engages in a transaction described in section 408(d)(3)(A)(i) (relating to rollover contributions) on or before April 15, 1976, the first such transaction by the individual on or before April 15, 1976, will not be taken into account for purposes of applying the three year limitation rule of section 408(d)(3)(B) in effect for taxable years beginning before January 1, 1978.

TEMPORARY REGULATIONS SUPERSEDED

Section 11.408(a)(2)-1 of the Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974 is superseded by § 1.408-2(b)(2).

DRAFTING INFORMATION

The principal author of this regulation was William D. Gibbs of the Employee Plans and Exempt Organizations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, the following amendments to the regulations are hereby adopted:

INCOME TAX REGULATIONS (26 CFR Part 1)

Paragraph 1. The folowing new sections are added immediately after § 1.218.0:

§ 1.219-1 Deduction for retirement savings.

(a) *In general.* Subject to the limitations and restrictions of paragraph (b) and the special rules of paragraph (c)(3) of this section, there shall be allowed a deduction under section 62 from gross income of amounts paid for the taxable year of an individual on behalf of such individual to an individual retirement account described in section 408(a), for an individual retirement annuity described in section 408(b), or for a retirement bond described in section 409. The deduction described in the preceding sentence shall be allowed only to the individual on whose behalf such individual retirement account, individual retirement annuity, or retirement bond is maintained. The first sentence of this paragraph shall apply only in the case of a contribution of cash. A contribution of property other than cash is not allowable as a deduction under this section. In the case of a retirement bond, a deduction will not be allowed if the bond is redeemed within 12 months of its issue date.

(b) *Limitations and restrictions*—(1) *Maximum deduction.* The amount allowable as a deduction under section 219(a) to an individual for any taxable year cannot exceed an amount equal to 15 percent of the compensation includible in the gross income of the individual for such taxable year, or $1,500, whichever is less.

(2) *Restrictions*—(i) *Individuals covered by certain other plans.* No deduction is allowable under section 219(a) to an individual for the taxable year if for any part of such year—

(A) He was an active participant in—

(*1*) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a),

(*2*) An annuity plan described in section 403(a),

(*3*) A qualified bond purchase plan described in section 405(a), or

(*4*) A retirement plan established for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing, or

(B) Amounts were contributed by his employer for an annuity contract described in section 403(b) (whether or not the individual's rights in such contract are nonforfeitable).

(ii) *Contributions after age 70½.* No deduction is allowable under section 219(a) to an individual for the taxable year of the individual, if he has attained the age of 70½ before the close of such taxable year.

(iii) *Rollover contributions.* No de-

duction is allowable under section 219 for any taxable year of an individual with respect to a rollover contribution described in section 402(a)(5), 402(a)(7), 403(a)(4), 403(b)(8), 408(d)(3), or 409(b)(3)(C).

(3) *Amounts contributed under endowment contracts.* (i) For any taxable year, no deduction is allowable under section 219(a) for amounts paid under an endowment contract described in § 1.408-3(e) which is allocable under subdivision (ii) of this subparagraph to the cost of life insurance.

(ii) For any taxable year, the cost of current life insurance protection under an endowment contract described in paragraph (b)(3)(i) of this section is the product of the net premium cost, as determined by the Commissioner, and the excess, if any, of the death benefit payable under the contract during the policy year beginning in the taxable year over the cash value of the contract at the end of such policy year.

(iii) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). A, an individual who is otherwise entitled to the maximum deduction allowed under section 219, purchases, at age 20, an endowment contract described in § 1.408-3(e) which provides for the payment of an annuity of $100 per month, at age 65, with a minimum death benefit of $10,000, and an annual premium of $220. The cash value at the end of the first policy year is 0. The net premium cost, as determined by the Commissioner, for A's age is $1.61 per thousand dollars of life insurance protection. The cost of current life insurance protection is $16.10 ($1.61 × 10). A's maximum deduction under section 219 with respect to amounts paid under the endowment contract for the taxable year in which the first policy year begins is $203.90 ($220 — $16.10).

Example (2). Assume the same facts as in example (1), except that the cash value at the end of the second policy year is $200 and the net premium cost is $1.67 per thousand for A's age. The cost of current life insurance protection is $16.37 ($1.67 × 9.8). A's maximum deduction under section 219 with respect to amounts paid under the endowment contract for the taxable year in which the second policy year begins is $203.63 ($220 — $16.37).

(c) *Definitions and special rules—*

(1) *Compensation.* For purposes of this section, the term "compensation" means wages, salaries, professional fees, or other amounts derived from or received for personal service actually rendered (including, but not limited to, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, and bonuses) and includes earned income, as defined in section 401(c)(2), but does not include amounts derived from or received as earnings or profits from property (including, but not limited to, interest and dividends) or amounts not includible in gross income.

(2) *Active participant.* For the definition of active participant, see § 1.219-2.

(3) *Special rules.* (i) The maximum deduction allowable under section 219(b)(1) is computed separately for each individual. Thus, if a husband and wife each has compensation of $10,000 for the taxable year and they are each otherwise eligible to contribute to an individual retirement account and they file a joint return, then the maximum amount allowable as a deduction under section 219 is $3,000, the sum of the individual maximums of $1,500. However, if, for example, the husband has compensation of $20,000, the wife has no compensation, each is otherwise eligible to contribute to an individual retirement account for the taxable year, and they file a joint return, the maximum amount allowable as a deduction under section 219 is $1,500.

(ii) Section 219 is to be applied without regard to any community property laws. Thus, if, for example, a husband and wife, who are otherwise eligible to contribute to an individual retirement account, live in a community property jurisdiction and the husband alone has compensation of $20,000 for the taxable year, then the maximum amount allowable as a deduction under section 219 is $1,500.

(4) *Employer contributions.* For purposes of this chapter, any amount paid by an employer to an individual retirement account or for an individual retirement annuity or retirement bond constitutes the payment of compensation to the employee (other than a self-employed individual who is an employee within the meaning of section 401(c)(1) includible in his gross income, whether or not a deduction for such payment is allowable under section 219 to such employee after the application of section 219(b). Thus, an employer will be entitled to a deduction for compensation paid to an employee for amounts the employer contributes on the employee's behalf to an individual retirement account, for an individual retirement annuity, or for a retirement bond if such deduction is otherwise allowable under section 162.

§ 1.219-2 Definition of active participant.

(a) *In general.* This section defines the term "active participant" for individuals who participate in retirement plans described in section 219(b)(2). Any individual who is an active participant in such a plan is not allowed a deduction under section 219(a) for contributions to an individual retirement account.

(b) *Defined benefit plans*—(1) *In general.* Except as provided in subparagraphs (2), (3) and (4) of this paragraph, an individual is an active participant in the defined benefit plan if for any portion of the plan year ending with or within such individual's taxable year he is not excluded under the eligibility provisions of the plan. An individual is not an active participant in a particular taxable year merely because the individual meets the plan's eligibility requirements during a plan year beginning in that particular taxable year but ending in a later taxable year of the individual. However, for purposes of this section, an individual is deemed not to satisfy the eligibility provisions for a particular plan year if his compensation is less than the minimum amount of com-

pensation needed under the plan to accrue a benefit. For example, assume a plan is integrated with Social Security and only those individuals whose compensation exceeds a certain amount accrue benefits under the plan. An individual whose compensation for the plan year ending with or within his taxable year is less than the amount necessary under the plan to accrue a benefit is not an active participant in such plan.

(2) *Rules for plans maintained by more than one employer.* In the case of a defined benefit plan described in section 413(a) and funded at least in part by service-related contributions, *e.g.,* so many cents-per-hour, an individual is an active participant if an employer is contributing or is required to contribute to the plan an amount based on that individual's service taken into account for the plan year ending with or within the individual's taxable year. The general rule in paragraph (b)(1) of this section applies in the case of plans described in section 413(a) and funded only on some non-service-related unit, *e.g.,* so many cents-per-ton of coal.

(3) *Plans in which accruals for all participants have ceased.* In the case of a defined benefit plan in which accruals for all participants have ceased, an individual in such a plan is not an active participant. However, any benefit that may vary with future compensation of an individual provides additional accruals. For example, a plan in which future benefit accruals have ceased, but the actual benefit depends upon final average compensation will not be considered as one in which accruals have ceased.

(4) *No accruals after specified age.* An individual in a defined benefit plan who accrues no additional benefits in a plan year ending with or within such individual's taxable year by reason of attaining a specified age is not an active participant by reason of his participation in that plan.

(c) *Money purchase plan.* An individual is an active participant in a money purchase plan if under the terms of the plan employer contributions must be allocated to the individual's account with respect to the plan year ending with or within the individual's taxable year. This rule applies even if an individual is not employed at any time during the individual's taxable year.

(d) *Profit-sharing and stock-bonus plans*—(1) *In general.* This paragraph applies to profit-sharing and stock bonus plans. An individual is an active participant in such plans in a taxable year if a forfeiture is allocated to his account as of a date in such taxable year. An individual is also an active participant in a taxable year in such plans if an employer contribution is added to the participant's account in such taxable year. A contribution is added to a participant's account as of the later of the following two dates: the date the contribution is made or the date as of which it is allocated. Thus, if a contribution is made in an individual's taxable year 2 and alocated as of a date in individual's taxable year 1, the later of the relevant dates is the date the contribution is made. Consequently, the individual is an active participant in year 2 but not in year 1 as a result of that contribution.

(2) *Special rule.* An individual is not an active participant for a particular taxable year by reason of a contribution made in such year allocated to a previous year if such individual was an active participant in such previous year by reason of a prior contribution that was allocated as of a date in such previous year.

(e) *Employee contributions.* If an employee makes a voluntary or mandatory contribution to a plan described in paragraphs (b), (c) or (d) of this section, such employee is an active participant in the plan for the taxable year in which such contribution is made.

(f) *Certain individuals not active participants.* For purposes of this section, an individual is not an active participant under a plan for any taxable year of such individual for which such individual elects, pursuant to the plan, not to participate in such plan.

(g) *Retirement savings for married individuals.* The provisions of this section apply in determining whether an individual or his spouse is an active participant in a plan for purposes of section 220 (relating to retirement savings for certain married individuals).

(h) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). The X Corporation maintains a defined benefit plan which has the following rules on participation and accrual of benefits. Each employee who has attained the age of 25 or has completed one year of service is a participant in the plan. The plan further provides that each participant shall receive upon retirement $12 per month for each year of service in which the employee completes 1000 hours of service. The plan year is the calendar year. B, a calendar-year taxpayer, enters the plan on January 2, 1980, when he is 27 years of age. Since B has attained the age of 25, he is a participant in the plan. However, B completes less than 1000 hours of service in 1980 and 1981. Although B is not accruing any benefits under the plan in 1980 and 1981, he is an active participant under section 219(b)(2) because he is a participant in the plan. Thus, B cannot make deductible contributions to an individual retirement arrangement for his taxable years of 1980 and 1981.

Example (2). The Y Corporation maintains a profit-sharing plan for its employees. The plan year of the plan is the calendar year. C is a calendar-year taxpayer and a participant in the plan. On June 30, 1980, the employer makes a contribution for 1980 which is allocated on July 31, 1980. In 1981 the employer makes a second contribution for 1980, allocated as of December 31, 1980. Under the general rule stated in § 1.219-2(d)(1), C is an active participant in 1980. Under the special rule stated in § 1.219-2(d)(2), however, C is not an active participant in 1981 by reason of that contribution made in 1981.

(i) *Effective date.* The provisions set forth in this section are effective for taxable years beginning after December 31, 1978.

Par. 2. Paragraph (d)(4) of § 1.408-1 is redesignated as paragraph (d)(4) of § 1.408-6, which is added below.

Par. 3. The following new sections are added immediately after § 1.407-1:

§ 1.408-1 General rules.

(a) *In general.* Section 408 prescribes rules relating to individual retirement accounts and individual retirement annuities. In addition to the rules set forth in §§ 1.408-2 and 1.408-3, relating respectively to individual retirement accounts and individual retirement annuities, the rules set forth in this section shall also apply.

(b) *Exemption from tax.* The individual retirement account or individual retirement annuity is exempt from all taxes under subtitle A of the Code other than the taxes imposed under section 511, relating to tax on unrelated business income of charitable, etc., organizations.

(c) *Sanctions*—(1) *Excess contributions.* If an individual retirement account or individual retirement annuity accepts and retains excess contributions, the individual on whose behalf the account is established or who is the owner of the annuity will be subject to the excise tax imposed by section 4973.

(2) *Prohibited transactions by owner or beneficiary of individual retirement account*—(i) Under section 408(e)(2), if, during any taxable year of the individual for whose benefit any individual retirement account is established, that individual or the individual's beneficiary engages in any transaction prohibited by section 4975 with respect to such account, such account ceases to be an individual retirement account as of the first day of such taxable year. In any case in which any individual retirement account ceases to be an individual retirement account by reason of the preceding sentence as of the first day of any taxable year, section 408(d)(1) applies as if there were a distribution on such first day in an amount equal to the fair market value (on such first day) of all assets in the account (on such first day). The preceding sentence applies even though part of the fair market value of the individual retirement account as of the first day of the taxable year is attributable to excess contributions which may be returned tax-free under section 408(d)(4) or 408(d)(5).

(ii) If the trust with which the individual engages in any transaction described in subdivision (i) of this subparagraph is established by an employer or employee association under section 408(c), only the employee who engages in the prohibited transaction is subject to disqualification of his separate account.

(3) *Prohibited transaction by person other than owner or beneficiary of account.* If any person other than the individual on whose behalf an individual retirment account is established or the individual's beneficiary engages in any transaction prohibited by section 4975 with respect to such account, such person shall be subject to the taxes imposed by section 4975.

(4) *Pledging account as security.* Under section 408(e)(4), if, during any taxable year of the individual for whose benefit an individual retirement account is established, that individual uses the account or any portion thereof as security for a loan, the portion so used is treated as distributed to that individual.

(5) *Borrowing on annuity contract.* Under section 408(e)(3), if during any taxable year the owner of an individual retirement annuity borrows any money under or by use of such contract, the contract ceases to be an individual retirement annuity as of the first day of such taxable year. See § 1.408-3(c).

(6) *Premature distributions.* If a distribution (whether a deemed distribution or an actual distribution) is made from an individual retirement account, or individual retirement annuity, to the individual for whose benefit the account was established, or who is the owner of the annuity, before the individual attains age 59½ (unless the individual has become disabled within the meaning of section 72(m)(7)), the tax under Chapter 1 of the Code for the taxable year in which such distribution is received is increased under section 408(f)(1) or (f)(2). The increase equals 10 percent of the amount of the distribution which is includible in gross income for the taxable year. Except in the case of the credits allowable under section 31, 39, or 42, no credit can be used to offset the increased tax described in this subparagraph. See, however, § 1.408-4(c)(3).

(d) *Limitation on contributions and benefits.* An individual retirement account or individual retirement annuity is subject to the limitation on contributions and benefits imposed by section 415 for years beginning after December 31, 1975.

(e) *Community property laws.* Section 408 shall be applied without regard to any community property laws.

§ 1.408-2 Individual retirement accounts.

(a) *In general.* An individual retirement account must be a trust or a custodial account (see paragraph (d) of this section). It must satisfy the requirements of paragraph (b) of this section in order to qualify as an individual retirement account. It may be established and maintained by an individual, by an employer for the benefit of his employees (see paragraph (c) of this section), or by an employee association for the benefit of its members (see paragraph (c) of this section).

(b) *Requirements.* An individual retirement account must be a trust created or organized in the United States (as defined in section 7701(a)(9)) for the exclusive benefit of an individual or his beneficiaries. Such trust must be maintained at all times as a domestic trust in the United States. The instrument creating the trust must be in writing and the following requirements must be satisfied.

(1) *Amount of acceptable contributions.* Except in the case of a contribution to a simplified employee pension described in section 408(k) and a rollover contribution described in section 408(d)(3), 402(a)(5), 402(a)(7), 403(a)(4), 403(b)(8) or 409(b)(3)(C), the trust instrument must provide that contributions may not be accepted by the trustee for the taxable year in excess of $1,500 on behalf of any individual for whom the trust is maintained. An individual retirement account maintained as a simplified employee pension may provide for the receipt of up to $7,500 for a calendar year.

(2) *Trustee.* (i) The trustee must be a bank (as defined in section 401(d)(1) and the regulations thereunder) or another person who demonstrates, in the manner described in paragraph (b)(2)(ii) of this section, to the satisfaction of the Commissioner, that the manner in which the trust will be administered will be consistent with the requirements of section 408 and this section.

(ii) A person may demonstrate to the satisfaction of the Commissioner that the manner in which he will administer the trust will be consistent with the requirements of section 408 only upon the filing of a written application to the Commissioner of Internal Revenue, Attention: E:EP, Internal Revenue Service, Washington, D.C. 20224. Such application must meet the applicable requirements of the regulations under section 401(d)(1), relating to nonbank trustees of pension and profit-sharing trusts benefiting owner-employees.

(iii) Section 11.408(a)(2)-1 of the Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974 is superseded by this subparagraph (2).

(3) *Life insurance contracts.* No part of the trust funds may be invested in life insurance contracts. An individual retirement account may invest in annuity contracts which provide, in the case of death prior to the time distributions commence, for a payment equal to the sum of the premiums paid or, if greater, the cash value of the contract.

(4) *Nonforfeitability.* The interest of any individual on whose behalf the trust is maintained in the balance of his account must be nonforfeitable.

(5) *Prohibition against commingling.* (i) The assets of the trust must not be commingled with other property except in a common trust fund or common investment fund.

(ii) For purposes of this subparagraph, the term "common investment fund" means a group trust created for the purpose of providing a satisfactory diversification of investments or a reduction of administrative expenses for the individual participating trusts, and which group trust satisfies the requirements of section 408(c) (except that it need not be established by an employer or an association of employees) and the requirements of section 401(a) in the case of a group trust in which one of the individual participating trusts is an employees' trust described in section 401(a) which is exempt from tax under section 501(a).

(iii) For purposes of this subparagraph, the term "individual participating trust" means an employee's trust described in section 401(a) which is exempt from tax under section 501(a) or a trust which satisfies the requirements of section 408(a) provided that in the case of such an employees' trust, such trust would be permitted to participate in such a group trust if all of the other individual participating trusts were employees' trusts described in section 401(a) which are exempt from tax under section 501(a).

(6) *Distribution of interest.* (i) The trust instrument must provide that the entire interest of the individual for whose benefit the trust is maintained must be distributed to him in accordance with paragraph (b)(6)(ii) or (iii) of this section.

(ii) Unless the provisions of paragraph (b)(6)(iii) of this section apply, the entire interest of the individual must be actually distributed to him not later than the close of his taxable year in which he attains age 70½.

(iii) In lieu of distributing the individual's entire interest as provided in paragraph (b)(6)(ii) of this section, the interest may be distributed commencing not later than the taxable year described in such paragraph (b)(6)(ii). In such case, the trust must expressly provide that the entire interest of the individual will be distributed to the individual and the individual's beneficiaries, in a manner which satisfies the requirements of paragraph (b)(6)(v) of this section, over any of the following periods (or any combination thereof)—

(A) The life of the individual,

(B) The lives of the individual and spouse,

(C) A period certain not extending beyond the life expectancy of the individual, or

(D) A period certain not extending beyond the joint life and last survivor expectancy of the individual and spouse.

(iv) The life expectancy of the individual or the joint life and last survivor expectancy of the individual and spouse cannot exceed the period computed by use of the expected return multiples in § 1.72-9, or, in the case of payments under a contract issued by an insurance company, the period computed by use of the mortality tables of such company.

(v) If an individual's entire interest is to be distributed over a period described in paragraph (b)(6)(iii) of this section, beginning in the year the individual attains 70½ the amount to be distributed each year must be not less than the lesser of the balance of the individual's entire interest or an amount equal to the quotient obtained by dividing the entire interest of the individual in the trust at the beginning of such year (including amounts not in the individual retirement account at

the beginning of the year because they have been withdrawn for the purpose of making a rollover contribution to another individual retirement plan) by the life expectancy of the individual (or the joint life and last survivor expectancy of the individual and spouse (whichever is applicable)), determined in either case as of the date the individual attains age 70 in accordance with paragraph (b)(6)(iv) of this section, reduced by one for each taxable year commencing after the individual's attainment of age 70½. An annuity or endowment contract issued by an insurance company which provides for non-increasing payments over one of the periods described in paragraph (b)(6)(iii) of this section beginning not later than the close of the taxable year in which the individual attains age 70½ satisfies this provision. However, no distribution need be made in any year, or a lesser amount may be distributed, if beginning with the year the individual attains age 70½ the aggregate amounts distributed by the end of any year are at least equal to the aggregate of the minimum amounts required by this subdivision to have been distributed by the end of such year.

(vi) If an individual's entire interest is distributed in the form of an annuity contract, then the requirements of section 408(a)(6) are satisfied if the distribution of such contract takes place before the close of the taxable year described in subdivision (ii) of this subparagraph, and if the individual's interest will be paid over a period described in subdivision (iii) of this subparagraph and at a rate which satisfies the requirements of subdivision (v) of this subparagraph.

(vii) In determining whether paragraph (b)(6)(v) of this section is satisfied, all individual retirement plans maintained for an individual's benefit (except those under which he is a beneficiary described in section 408(a)(7)) at the close of the taxable year in which he reaches age 70½ must be aggregated. Thus, the total payments which such individual receives in any taxable year must be at least equal to the amount he would have been required to receive had all the plans been one plan at the close of the taxable year in which he attained age 70½.

(7) *Distribution upon death.* (i) The trust instrument must provide that if the individual for whose benefit the trust is maintained dies before the entire interest in the trust has been distributed to him, or if distribution has been commenced as provided in paragraph (b)(6) of this section to the surviving spouse and such spouse dies before the entire interest has been distributed to such spouse, the entire interest (or the remaining part of such interest if distribution thereof has commenced) must, within 5 years after the individual's death (or the death of the surviving spouse) be distributed or applied to the purchase of an immediate annuity for this beneficiary or beneficiaries (or the beneficiary or beneficiaries of the surviving spouse) which will be payable for the life of such beneficiary or beneficiaries (or for a term certain not extending beyond the life expectancy of such beneficiary or beneficiaries) and which annuity contract will be immediately distributed to such beneficiary or beneficiaries. A contract described in the preceding sentence is not includible in gross income upon distribution. Section 1.408-4(e) provides rules applicable to the taxation of such contracts. The first sentence of this paragraph (b)(7) shall have no application if distributions over a term certain commenced before the death of the individual for whose benefit the trust was maintained and the term certain is for a period permitted under paragraph (b)(6)(iii) (C) or (D) of this section.

(ii) Each such beneficiary (or beneficiary of a surviving spouse) may elect to treat the entire interest in the trust (or the remaining part of such interest if distribution thereof has commenced) as an account subject to the distribution requirements of section 408(a)(6) and paragraph (b)(6) of this section instead of those of section 408(a)(7) and paragraph (b)(7) of this section. Such an election will be deemed to have been made if such beneficiary treats the account in accordance with the requirements of section 408(a)(6) and paragraph (b)(6) of this section. An election will be considered to have been made by such beneficiary if either of the following occurs: (A) any amounts in the account (including any amounts that have been rolled over, in accordance with the requirements of section 408(d)(3)(A)(i), into an individual retirement account, individual retirement annuity, or retirement bond for the benefit of such individual) have not been distributed within the appropriate time period required by section 408(a)(7) and paragraph (b)(7) of this section; or (B) any additional amounts are contributed to the account (or to the account, annuity, or bond to which the beneficiary has rolled such amounts over, as described in (1) above) which are subject, or deemed to be subject, to the distribution requirements of section 408(a)(6) and paragraph (b)(6) of this section.

(8) *Definition of beneficiaries.* The term "beneficiaries" on whose behalf an individual retirement account is established includes (except where the context indicates otherwise) the estate of the individual, dependents of the individual, and any person designated by the individual to share in the benefits of the account after the death of the individual.

(c) *Accounts established by employers and certain association of employees*—(1) *In general.* A trust created or organized in the United States (as defined in section 7701(a)(9)) by an employer for the exclusive benefit of his employees or their beneficiaries, or by an association of employees for the exclusive benefit of its members or their beneficiaries, is treated as an individual retirement

account if the requirements of paragraphs (c)(2) and (c)(3) of this section are satisfied under the written governing instrument creating the trust. A trust described in the preceding sentence is for the exclusive benefit of employees or members even though it may maintain an account for former employees or members and employees who are temporarily on leave.

(2) *General requirements.* The trust must satisfy the requirements of paragraphs (b)(1) through (7) of this section.

(3) *Special requirement.* There must be a separate accounting for the interest of each employee or member.

(4) *Definitions*—(i) *Separate accounting.* For purposes of paragraph (c)(3) of this section, the term "separate accounting" means that separate records must be maintained with respect to the interest of each individual for whose benefit the trust is maintained. The assets of the trust may be held in a common trust fund, common investment fund, or common fund for the account of all individuals who have an interest in the trust.

(ii) *Employee association.* For purposes of this paragraph and section 408(c), the term "employee association" means any organization composed of two or more employees, including, but not limited to, an employee association described in section 501(c)(4). Such association may include employees within the meaning of section 401(c)(1). There must be, however, some nexus between the employees (*e.g.*, employees of same employer, employees in the same industry, etc.) in order to qualify as an employee association described in this subdivision (ii).

(d) *Custodial accounts.* For purposes of this section and section 408(a), a custodial account is treated as a trust described in section 408(a) if such account satisfies the requirements of section 408(a) except that it is not a trust and if the assets of such account are held by a bank (as defined in section 401(d)(1) and the regulations thereunder) or such other person who satisfies the requirements of paragraph (b)(2)(ii) of this section. For purposes of this chapter, in the case of a custodial account treated as a trust by reason of the preceding sentence, the custodian of such account will be treated as the trustee thereof.

§ 1.408-3 Individual retirement annuities.

(a) *In general.* An individual retirement annuity is an annuity contract or endowment contract (described in paragraph (e)(1) of this section) issued by an insurance company which is qualified to do business under the law of the jurisdiction in which the contract is sold and which satisfies the requirements of paragraph (b) of this section. A participation certificate in a group contract issued by an insurance company described in this paragraph will be treated as an individual retirement annuity if the contract satisfies the requirements of paragraph (b) of this section; the certificate of participation sets forth the requirements of paragraphs (1) through (5) of section 408(b); the contract provides for a separate accounting of the benefit allocable to each participant-owner; and the group contract is for the exclusive benefit of the participant owners and their beneficiaries. For purposes of this title, a participant-owner of a group contract described in this paragraph shall be treated as the owner of an individual retirement annuity. A contract will not be treated as other than an individual retirement annuity merely because it provides for waiver of premium on disability. An individual retirement annuity contract which satisfies the requirements of section 408(b) need not be purchased under a trust if the requirements of paragraph (b) of this section are satisfied. An individual retirement endowment contract may not be held under a trust which satisfies the requirements of section 408(a). Distribution of the contract is not a taxable event. Distributions under the contract are includible in gross income in accordance with the provisions of § 1.408-4(e).

(b) *Requirements*—(1) *Transferability.* The annuity or the endowment contract must not be transferable by the owner. An annuity or endowment contract is transferable if the owner can transfer any portion of his interest in the contract to any person other than the issuer thereof. Accordingly, such a contract is transferable if the owner can sell, assign, discount, or pledge as collateral for a loan or as security for the performance of an obligation or for any other purpose his interest in the contract to any person other than the issuer thereof. On the other hand, a contract is not to be considered transferable merely because the contract contains: a provision permitting the individual to designate a beneficiary to receive the proceeds in the event of his death, a provision permitting the individual to elect a joint and survivor annuity, or other similar provisions.

(2) *Annual premium.* Except in the case of a contribution to a simplified employee pension described in section 408(k), the annual premium on behalf of any individual for the annuity or the endowment contract cannot exceed $1,500. Any refund of premiums must be applied before the close of the calendar year following the year of the refund toward the payment of future premiums or the purchase of additional benefits.

(3) *Distribution.* The entire interest of the owner must be distributed to him in the same manner and over the same period as described in § 1.408-2(b)(6).

(4) *Distribution upon death.* If the owner dies before the entire interest has been distributed to him, or if distribution has commenced to the

surviving spouse, the remaining interest must be distributed in the same manner, over the same period, and to the same beneficiaries as described in § 1.408-2(b)(7).

(5) *Nonforfeitability.* The entire interest of the owner in the annuity or endowment contract must be nonforfeitable.

(6) *Flexible premium.* (Reserved)

(c) *Disqualification.* If during any taxable year the owner of an annuity borrows any money under the annuity or endowment contract or by use of such contract (including, but not limited to, pledging the contract as security for any loan), such contract will cease to be an individual retirement annuity as of the first day of such taxable year, and will not be an individual retirement annuity at any time thereafter. If an annuity or endowment contract which constitutes an individual retirement annuity is disqualified as a result of the preceding sentence, an amount equal to the fair market value of the contract as of the first day of the taxable year of the owner in which such contract is disqualified is deemed to be distributed to the owner. Such owner shall include in gross income for such year an amount equal to the fair market value of such contract as of such first day. The preceding sentence applies even though part of the fair market value of the individual retirement annuity as of the first day of the taxable year is attributable to excess contributions which may be returned tax-free under section 408(d)(4) or 408(d)(5).

(d) *Premature distribution tax on deemed distribution.* If the individual has not attained age 59½ before the beginning of the year in which the disqualification described in paragraph (c) of this section occurs, see section 408(f)(2) for additional tax on premature distributions.

(e) *Endowment contracts*—(1) *Additional requirements for endowment contracts.* No contract providing life insurance protection issued by a company described in paragraph (a) of this section shall be treated as an endowment contract for purposes of this section if—

(i) Such contract matures later than the taxable year in which the individual in whose name the contract is purchased attains the age of 70½;

(ii) Such contract is not for the exclusive benefit of such individual or his beneficiaries;

(iii) Premiums under the contract may increase over the term of the contract;

(iv) When all premiums are paid when due, the cash value of such contract at maturity is less than the death benefit payable under the contract at any time before maturity;

(v) The death benefit does not, at some time before maturity, exceed the greater of the cash value or the sum of premiums paid under the contract;

(vi) Such contract does not provide for a cash value;

(vii) Such contract provides that the life insurance element of such contract may increase over the term of such contract, unless such increase is merely because such contract provides for the purchase of additional benefits;

(viii) Such contract provides insurance other than life insurance and waiver of premiums upon disability; or

(ix) Such contract is issued after November 6, 1978.

(2) *Treatment of proceeds under endowment contract upon death of individual.* In the case of the payment of a death benefit under an endowment contract upon the death of the individual in whose name the contract is purchased, the portion of such payment which is equal to the cash value immediately before the death of such individual is not excludable from gross income under section 101(a) and is treated as a distribution from an individual retirement annuity. The remaining portion, if any, of such payment constitutes current life insurance protection and is excludable under section 101(a). If a death benefit is paid under an endowment contract at a date or dates later than the death of the individual, section 101(d) is applicable only to the portion of the benefit which is attributable to the amount excludable under section 101(a).

§ 1.408-4 Treatment of distributions from individual retirement arrangements.

(a) *General rule*—(1) *Inclusion in income.* Except as otherwise provided in this section, any amount actually paid or distributed or deemed paid or distributed from an individual retirement account or individual retirement annuity shall be included in the gross income of the payee or distributee for the taxable year in which the payment or distribution is received.

(2) *Zero basis.* Notwithstanding section 1015(d) or any other provision of the Code, the basis (or investment in the contract) of any person in such an account or annuity is zero. For purposes of this section, an assignment of an individual's rights under an individual retirement account or an individual retirement annuity shall, except as provided in § 1.408-4(g) (relating to transfer incident to divorce), be deemed a distribution to such individual from such account or annuity of the amount assigned.

(b) *Rollover contribution*—(1) *To individual retirement arrangement.* Paragraph (a)(1) of this section shall not apply to any amount paid or distributed from an individual retirement account or individual retirement annuity to the individual for whose benefit the account was established or who is the owner of the annuity if the entire amount received (including the same amount of money or any other property) is paid into an individual retirement account, annuity (other than an endowment contract), or bond created for the benefit of such in-

dividual not later than the 60th day after the day on which he receives the payment or distribution.

(2) *To qualified plan.* Paragraph (a)(1) of this section does not apply to any amount paid or distributed from an individual retirement account or individual retirement annuity to the individual for whose benefit the account was established or who is the owner of the annuity if—

(i) No amount in the account or no part of the value of the annuity is attributable to any source other than a rollover contribution from an employees' trust destribed in section 401(a) which is exempt from tax under section 501(a) or a rollover contribution from an annuity plan described in section 403(a) and the earnings on such sums, and

(ii) The entire amount received (including the same amount of money and any other property) represents the entire amount in the account and is paid into another such trust or plan (for the benefit of such individual) not later than the 60th day after the day on which the payment or distribution is received.

This subparagraph does not apply if any portion of the rollover contribution described in paragraph (b)(2)(i) of this section is attributable to an employees' trust forming part of a plan or an annuity under which the individual was an employee within the meaning of section 401(c)(1) at the time contributions were made on his behalf under the plan.

(3) *To section 403(b) contract.* [Reserved]

(4) *Frequency limitation.* (i) For taxable years beginning on or before December 31, 1977, paragraph (b)(1) of this section does not apply to any amount received by an individual from an individual retirement account, annuity or bond if at any time during the 3-year period ending on the day of receipt, the individual received any other amount from an individual retirement account, annuity or bond which was not includible in his gross income because of the application of paragraph (b)(1) of this section.

(ii) [Reserved]

(c) *Excess contributions returned before due date of return*—(1) *Excess contribution.* For purposes of this paragraph, excess contributions are the excess of the amounts contributed to an individual retirement account or paid for an individual retirement annuity during the taxable year over the amount allowable as a deduction under section 219 or 220 for the taxable year.

(2) *General rule.* (i) Paragraph (a)(1) of this section does not apply to the distribution of any excess contribution paid during a taxable year to an account or annuity if: the distribution is received on or before the date prescribed by law (including extensions) for filing the individual's return for such taxable year; no deduction is allowed under section 219 or section 220 with respect to the excess contribution; and the distribution is accompanied by the amount of net income attributable to the excess contribution as of the date of the distribution as determined under subdivision (ii).

(ii) The amount of net income attributable to the excess contributions is an amount which bears the same ratio to the net income earned by the account during the computation period as the excess contribution bears to the sum of the balance of the account as of the first day of the taxable year in which the excess contribution is made and the total contribution made for such taxable year. For purposes of this paragraph, the term "computation period" means the period begining on the first day of the taxable year in which the excess contribution is made and ending on the date of the distribution from the account.

(iii) For purposes of paragraph (c)(2)(ii), the net income earned by the account during the computation period is the fair market value of the balance of the account immediately after the distribution increased by the amount of distributions from the account during the computation period, and reduced (but not below zero) by the sum of: (A) the fair market value of the balance of the account as of the first day of the taxable year in which the excess contribution is made and (B) the contributions to the account made during the computation period.

(3) *Time of inclusion.* (i) For taxable years beginning before January 1, 1977, the amount of net income determined under subparagraph (2) is includible in the gross income of the individual for the taxable year in which it is received. The amount of net income thus distributed is subject to the tax imposed by section 408(f)(1) for the year includible in gross income.

(ii) [Reserved]

(4) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. On January 1, 1975, A, age 55, who is a calendar-year taxpayer, contributes $1,500 to an individual retirement account established for his benefit. For 1975, A is entitled to a deduction of $1,400 under section 219. For 1975, A does not claim as deductions any other items listed in section 62. A's gross income for 1975 is $9,334. On April 1, 1976, $107 is distributed to A from his individual retirement account. As of such date, the balance of the account is $1,498 [$1,605 — $107]. There were no other distributions from the account as of such date. The net amount of income earned by the account is $105 [$1,498 + $107 — (0 + $1,500)]. The net income attributable to the excess contribution is $7. [$105 × ($100/$1,500)]. A's adjusted gross income for 1975 is his gross income for 1975 ($9,334) reduced by the amount allowable to A as a deduction under section 219 ($1,400), or $7,934. A will include the $7 of the $107 distributed on April 1, 1976, in his gross income for 1976. Further, A will pay an additional income tax of $.70 for 1976 under section 408(f)(1).

(d) *Deemed distribution*—(1) *General rule.* In any case in which an individual retirement account ceases to be an individual retirement account by reason of the application of section 408(e)(2), paragraph (a)(1) of this section shall apply as if there were

a distribution on the first day of the taxable year in which such account ceases to be an individual retirement account of an amount equal to the fair market value on such day of all of the assets in the account on such day. In the case of a deemed distribution from an individual retirement annuity, see § 1.408-3(d).

(2) *Using account as security.* In any case in which an individual for whose benefit an individual retirement account is established uses, directly or indirectly, all or any portion of the account as security for a loan, paragraph (a)(1) of this section shall apply as if there were distributed on the first day of the taxable year in which the loan was made an amount equal to that portion of the account used as security for such loan.

(e) *Distribution of annuity contracts.* Paragraph (a)(1) of this section does not apply to any annuity contract which is distributed from an individual retirement account and which satisfies the requirements of paragraphs (b)(1), (3), (4) and (5) of section 408. Amounts distributed under such contracts will be taxable to the distributee under section 72. For purposes of applying section 72 to a distribution from such a contract, the investment in such contract is zero.

(f) *Treatment of assets distributed from an individual retirement account for the purchase of an endowment contract.* Under section 408(e)(5), if all, or any portion, of the assets of an individual retirement account are used to purchase an endowment contract described in § 1.408-3(e) for the benefit of the individual for whose benefit the account is established—

(1) The excess, if any, of the total amount of assets used to purchase such contract over the portion of the assets attributable to life insurance protection shall be treated as a rollover contribution described in section 408(d)(3), and

(2) The portion of the assets attributable to life insurance protection shall be treated as a distribution described in paragraph (a)(1) of this section, except that the provisions of section 408(f) shall not apply to such amount.

(g) *Transfer incident to divorce*—(1) *General rule.* The transfer of an individual's interest, in whole or in part, in an individual retirement account, individual retirement annuity, or a retirement bond, to his former spouse under a valid divorce decree or a written instrument incident to such divorce shall not be considered to be a distribution from such an account or annuity to such individual or his former spouse; nor shall it be considered a taxable transfer by such individual to his former spouse notwithstanding any other provision of Subtitle A of the Code.

(2) *Spousal account.* The interest described in this paragraph (g) which is transferred to the former spouse shall be treated as an individual retirement account of such spouse if the interest is an individual retirement account; an individual retirement annuity of such spouse if such interest is an individual retirement annuity; and a retirement bond of such spouse if such interest is a retirement bond.

§ 1.408-5 Annual reports by trustees or issuers.

(a) *In general.* The trustee of an individual retirement account or the issuer of an individual retirement annuity shall make annual calendar year reports concerning the status of the account or annuity. The report shall contain the information required in paragraph (b) and be furnished or filed in the manner and time specified in paragraph (c).

(b) *Information required to be included in the annual reports.* The annual calendar year report shall contain the following information for transactions occurring during the calendar year—

(1) The amount of contributions;

(2) The amount of distributions;

(3) In the case of an endowment contract, the amount of the premium paid allocable to the cost of life insurance;

(4) The name and address of the trustee or issuer; and

(5) Such other information as the Commissioner may require.

(c) *Manner and time for filing.* (1) The annual report shall be furnished to the individual on whose behalf the account is established or in whose name the annuity is purchased (or the beneficiary of the individual or owner). The report shall be furnished on or before the 30th day of June following the calendar year for which the report is required.

(2) The Commissioner may require the annual report to be filed with the Service at the time the Commissioner specifies.

(d) *Penalties.* Section 6693 prescribes penalties for failure to file the annual report.

(e) *Effective date.* This section shall apply to reports for calendar years after 1978.

(f) *Reports for years prior to 1979.* For years prior to 1979, a trustee or issuer shall make reports in the time and manner as the Commissioner requires.

Par. 4. There is inserted after § 1.408-5 a new section, § 1.408-6, and paragraph (d)(4)(x) and (xi) of this new section as redesignated by paragraph 2 of this Treasury decision is revised to read as set forth below:

§ 1.408-6 Disclosure statements for individual retirement arrangements.

(a) *In general*—(1) *General rule.* Trustees and issuers of individual retirement accounts and annuities are, under the authority of section 408(i), required to provide disclosure statements. This section sets forth these requirements.

(2) [Reserved]

(b) [Reserved]

(c) [Reserved]

(d) *Requirements.* (1) [Reserved]
(2) [Reserved]
(3) [Reserved]
(4) *Disclosure statements.* * * *

(x) This section shall be effective for disclosure statements and copies of governing instruments mailed, or delivered without mailing, after February 14, 1977.

(xi) This section does not reflect the amendments made by section 1501 of the Tax Reform Act of 1976 (90 Stat. 1734) [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1, 210] relating to retirement savings for certain married individuals.

Par. 5. There are added after § 1.408-6 the following new sections:

§ 1.408-7 Reports on distributions from individual retirement plans.

(a) *Requirement of report.* The trustee of an individual retirement account or the issuer of an individual retirement annuity who makes a distribution during any calendar year to an individual from such account or under such annuity shall make a report on Form W-2P (in the case of distributions that are not total distributions) or Form 1099R (in the case of total distributions), and their related transmittal forms, for such year. The return must show the name and address of the person to whom the distribution was made, the aggregate amount of such distribution, and such other information as is required by the forms.

(b) *Amount subject to this section.* The amounts subject to reporting under paragraph (a) include all amounts distributed or made available to which section 408(d) applies.

(c) *Time and place for filing.* The report required under this section for any calendar year shall be filed after the close of that year and on or before February 28 of the following year with the appropriate Internal Revenue Service Center.

(d) *Statement to recipients.* (1) Each trustee or issuer required to file Form 1099R or Form W-2P under this section shall furnish to the person whose identifying number is (or should be) shown on the forms a copy of the form.

(2) Each statement required by this paragraph to be furnished to recipients shall be furnished to such persons after November 30 of the year of the distribution and on or before January 31 of the following year.

(e) *Effective date.* This section is effective for calendar years beginning after December 31, 1977.

§ 1.409-1 Retirement bonds.

(a) *In general.* Section 409 authorizes the issuance of bonds under the Second Liberty Bond Act the purchase price of which would be deductible under section 219. Section 409 also prescribes the tax treatment of such bonds. See paragraph (b) of this section.

(b) *Income tax treatment of bonds* —(1) *General rule.* Except as provided in subparagraph (2) of this paragraph, the entire proceeds upon redemption of a retirement bond described in section 409(a) shall be included in the gross income of the taxpayer entitled to such proceeds. If a bond has not been tendered for redemption by the registered owner before the close of the taxable year in which he attains age 70½, he must include in his gross income for such taxable year the amount of the proceeds he would have received if the bond had been redeemed at age 70½. The provisions of sections 72 and 1232 do not apply to a retirement bond.

(2) *Exemptions.* (i) If a retirement bond is redeemed within 12 months after the issue date, the proceeds are excluded from gross income if no deduction is allowed under section 219 on account of the purchase of such bond. For definition of issue date, see 31 CFR § 346.1(c).

(ii) If a retirement bond is redeemed after the close of the taxable year in which the registered owner attains age 70½ the proceeds from the redemption of the bond are excludable from the gross income of the registered owner or his beneficiary to the extent that such proceeds were includible in the gross income of the registered owner for such taxable year.

(iii) If a retirement bond is surrendered for reissuance in the same or lesser face amount, the difference between current redemption value of the bond surrendered for reissuance and the current surrender value of the bond reissued is includible in the gross income of the registered owner.

(3) *Basis.* The basis of a retirement bond is zero.

(c) *Rollover.* The first sentence of paragraph (b)(1) of this section shall not apply in any case in which a retirement bond is redeemed by the registered owner before the close of the taxable year in which he attains the age of 70½ if he transfers the entire amount of the proceeds of such redemption to—

(1) An individual retirement account described in section 408(a) or an individual retirement annuity described in section 408(b) (other than an endowment contract described in § 1.408-3(e)), or

(2) An employees' trust which is described in section 401(a) which is exempt from tax under section 501 (a), or an annuity plan described in section 403(a), for the benefit of the registered owner,

on or before the 60th day after the day on which he received the proceeds of such redemption. This subparagraph shall not apply in the case of a transfer to a trust or plan described in (c)(2) unless no part of the purchase price of the retirement bond redeemed is attributable to any source other than a rollover contribution from such an employees' trust or annuity plan (other than an annuity plan or employees' trust forming part of a plan under which the individual was an employee within the meaning of section 401(c)(1) at the time contribu-

tions were made on his behalf under the plan).

(d) *Additional tax.* (1) *Early redemption.* Except as provided in paragraph (2) of this paragraph, under section 409(c) if a retirement bond is redeemed by the registered owner before he attains age 59½, his tax under chapter 1 of the Code is increased by an amount equal to 10 percent of the proceeds of the redemption includible in his gross income for the taxable year. Except in the case of the credits allowable under sections 31, 39, or 42, no credit can be used to offset the tax described in the preceding sentence.

(2) *Limitations.* Subparagraph (1) of this paragraph shall not apply if—

(i) During the taxable year of the registered owner in which a retirement bond is redeemed, the registered owner becomes disabled within the meaning of section 72(m)(7), or

(ii) A retirement bond is tendered for redemption in accordance with paragraph (b)(2)(i) of this section.

MISCELLANEOUS EXCISE TAXES

(26 CFR Part 54)

Par. 6. The following regulations are added immediately before § 54.4975-6:

§ 54.4974-1 Excise tax on accumulations in individual retirement accounts or annuities.

(a) *General rule.* A tax equal to 50 percent of the amount by which the minimum amount required to be distributed from an individual retirement account or annuity described in section 408 during the taxable year of the payee under paragraph (b) of this section exceeds the amount actually distributed during the taxable year is imposed by section 4974 on the payee.

(b) *Minimum amount required to be distributed.* For purposes of this section, the minimum amount required to be distributed is the amount required under § 1.408-2(b)(6)(v) to be distributed in the taxable year described in paragraph (a) of this section.

(c) *Examples.* The application of this section may be illustrated by the following examples.

Example (1). In 1975, the minimum amount required to be distributed under § 1.408-2(b)(6)(v) to A under his individual retirement account is $100. Only $60 is actually distributed to A in 1975. Under section 4974, A would have an excise tax liability of $20 [50% of ($100 — $60)].

Example (2). Although no distribution is required under § 1.408-2(b)(6)(v) to be made in 1986, H, a married individual born on February 1, 1921, who has established and maintained an individual retirement account, decides to begin receiving distributions from the account beginning in 1986. H's wife, W, was born on March 6, 1921. H and W are calendar year taxpayers. H decides to receive his interest in the account over the joint life and last survivor expectancy of himself and his wife. On January 1, 1986, the balance in H's account is $10,000; H and W, based on their nearest birthdates, are 65; and the joint life and last survivor expectancy of H and his wife is 22.0 years (see Table II of § 1.72-9). His annual payments during the following years (none of which were required) were determined by dividing the balance in the account on the first day of each year by the joint life and last survivor expectancy reduced by the number of whole years elapsed since the distributions were to commence.

Date	Life expectancy minus whole years elapsed	Account Balance at beginning of each year	Annual payment
1-1-86	22.0	$10,000	$455
1-1-87	21.0	$10,118	$482
1-1-88	20.0	$10,214	$511
1-1-89	19.0	$10,285	$541
1-1-90	18.0	$10,329	$574
1-1-90	17.0	$10,340	$608

For 1986, 1987, 1989, and 1990, the amount required to be distributed under § 1.408-2(b)(6)(v) is zero. Thus, H would have no excise tax liability under section 4974 for these years. In 1991, the year H attains age 70½, the amount required to be distributed from the account under § 1.408-2(b)(6)(v) is $565, determined by dividing $10,340 (the account balance as of January 1, 1991) by 18.3 years (the joint life and last survivor expectancy of H and W, assuming they are both still living, as of January 1, 1991). If W should die after December 31, 1990, the joint life and last survivor expectancy determined on January 1, 1991 (18.3 years) would not be redetermined. Because the amount distributed from the account in 1991 ($608) exceeds the amount required to be distributed from the account in 1991 ($565), H has no excise tax liability under section 4974 for 1991.

Example (3). Assume the same facts as in example (2) except that W dies in 1988. For 1988, 1989, and 1990, the amount required to be distributed under § 1.408-2(b)(6)(v) is zero. Thus, H would have no excise tax liability under section 4974 for these years. In 1991, the amount required to be distributed under § 1.408-2(b)(6)(v) is $855, determined by dividing $10,340 (the account balance as of January 1, 1991) by 12.1 years (the life expectancy of H as of January 1, 1991). Because the amount distributed from the account in 1991 ($608) is less than the amount required to be distributed from the account in 1991 ($855), H has an excise tax liability of $123.50 under section 4974 for 1991 [50% of ($855 — $608)].

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved July 18, 1980.

EMIL M. SUNLEY,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 7, 1980, 8:45 a.m., and published in the issue of the Federal Register for August 8, 1980, 45 F.R. 52782; correction notice published in the issue of the Federal Register for August 26, 1980, 45 F.R. 56802)

Part VIII.—Special Deductions for Corporations

Section 243.—Dividends Received by Corporations

26 CFR 1.243-1: Deduction for dividends received by corporations.

Whether the writing of a call option by a taxpayer on stock held by such taxpayer will reduce the holding period required by section 246(c)(1)(A) of the Code for purposes of the allowance of the deduction for dividends received provided by section 243 of the Code. See Rev. Rul. 80-238, page 96.

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26 CFR 1.243-2: Special rules for certain distributions.

Whether the holding of Rev. Rul. 70-597, 1970-2 C.B. 146 that dividends paid by a regulated investment company out of net short-term capital gains qualify for the 85

percent dividends received corporate deduction under section 243 of the Code, subject to the limitations under 854, is correct; and whether unexercised option gains realized by a regulated investment company are excluded from gross income for purposes of section 854(b). See Rev. Rul. 80-345, page 204.

Section 246.—Rules Applying to Deductions for Dividends Received

26 CFR 1.246-3: Exclusion of certain dividends.
(Also Section 243; 1.243-1.)

Call option; dividends received deduction; holding period. The writing of a call option by a domestic corporation on stock held by the corporation does not reduce the holding period that is required by section 246(c)(1)(A) of the Code for purposes of the deduction for dividends received provided by section 243.

Rev. Rul. 80-238

ISSUE

Does the writing of a "call" option by a taxpayer on stock held by the taxpayer reduce the holding period required by section 246(c)(1)(A) of the Internal Revenue Code for purposes of the allowance of the deduction for dividends received provided by section 243 of the Code?

FACTS

The taxpayer, a domestic corporation engaged in an insurance business, purchases regularly traded common stock of other domestic corporations for investment purposes. In order to earn additional income, the taxpayer writes "call" options on such stock within 15 days of their purchase. The taxpayer receives immediate payment for these options and, in return, provides buyers with the right, for a specified period of time, to demand delivery of the underlying stock at a stated price. For example, the taxpayer purchased stock at $110 per share and sold call options on this stock at $10 per share that could be exercised within six months of purchase, with the striking price for the stock fixed at $130. At the time that the taxpayer wrote the options, the market price of the stock had risen from $110 to $120 per share.

LAW AND ANALYSIS

Section 243 of the Code allows a corporation a deduction for certain amounts received as dividends from a domestic corporation.

Section 246(c)(1)(A) provides that no deduction shall be allowed under section 243 in respect of any dividend on any share of stock that is sold or otherwise disposed of in any case in which the taxpayer has held such share for 15 days or less.

The flush language of section 246(c)(3) of the Code and the Income Tax Regulations thereunder provide that, for purposes of section 246(c)(1)(A), the taxpayer's holding period in stock shall be appropriately reduced (in the manner provided in the regulations) for any interval (during such period) in which the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of substantially identical stock or securities.

Neither the Code nor the regulations specifically mentions call options. Therefore, it is necessary to determine whether the sale of such options is equivalent to any of the transactions listed in flush language.

The sale of a call option does not create in the seller an option to sell the underlying stock since consummation of the stock sale is under control of the person to whom the call was sold. *See* Rev. Rul. 58-234, 1958-1 C.B. 279. Furthermore, the sale of a call option is not a short sale since it is the sale of the right to acquire stock rather than the sale of the stock itself. *See Provost v. United States*, 269 U.S. 443 (1925), T.D. 3811, V-1 C.B. 417 (1926). Finally, although the writing of a call option on stock owned could be deemed to be a contractual obligation to sell, the legislative history of section 246(c) indicates that, for purposes of section 246(c)(3), it is not.

The flush language of section 246(c)(3) was enacted to reduce a taxpayer's holding period for any interval during which the taxpayer is in both a "long" and a "short" position. S. Rep. No. 1983, 85th Cong., 2nd Sess. 28-9 (1958), 1958-3 C.B. 922, 949-50. This insures that the taxpayer is at the risk of the market for the entire holding period. *See* section 1.246-3(d)(2) of the Income Tax Regulations.

The writing of call options on stock owned affords the writer no protection against loss, beyond the option price received, in the event the underlying stock declines in value. Therefore, since the writing of these options does not place the writer in a risk-free position, it does not come within the intendment of the statute. Such considerations, however, are not applicable to "in-the-money" call options, that is, call options that are sold with a striking price below the market price of the underlying stock on the date that the option is written, since in such a situation the exercise of such options may be virtually guaranteed and the element of risk is either greatly reduced or eliminated.

HOLDING

The writing of a call option by a taxpayer on stock held by the taxpayer does not reduce the holding period required by section 246(c)(1)(A) of the Code for purposes of the allowance of the deduction for dividends received provided by section 243.

Part IX.—Items Not Deductible

Section 262.—Personal, Living, and Family Expenses

26 CFR 1.262-1: Personal, living and family expenses.

Deductibility of an airline pilot's expenditures on tuition and fees for an aviation program, where the expenses are directly

reimbursed by veterans' benefit payments. See Rev. Rul. 80-173, page 60.

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26 CFR 1.262-1: Personal, living, and family expenses.

Whether the cost of special decoding equipment that displays the audio portion of television programs as subtitles on a television screen is an expense for medical care. See Rev. Rul. 80-340, page 81.

Section 263.—Capital Expenditures

26 CFR 1.263(a)-1: Capital expenditures; in general.
(Also Sections 165, 7805; 1.165-1, 301.7805-1.)

Oil and gas leases; acquisition fees; option fees. The tax treatment of fees paid by taxpayers for assistance in participating in programs to acquire noncompetitive federal oil and gas leases in two situations is discussed. The transactions are incomplete in the year the programs are begun in each situation and the taxpayers do not recognize gain or loss in that year. Amounts allocable to the rights or options to sell fractional lease interests are not part of the basis of any lease acquired but are capital expenditures. Rev. Rul. 77-395 modified and clarified; Rev. Rul. 71-191 distinguished.

Rev. Rul. 80-176

ISSUES

1. Under the circumstances described below, are the fees paid by the taxpayers, *A* and *B*, for assistance in participating in programs to acquire federal oil and gas leases capital expenditures?

2. Is the cost of an option to sell a fractional interest in all leases acquired as part of the program properly treated as a reduction of the amount realized from the subsequent sale of a fractional interest in any leases acquired?

FACTS

A and *B* are individual investors that use the cash receipts and disbursements method of accounting and file their federal income tax returns on a calendar year basis. *A* and *B* desired to participate in the federal program for the noncompetitive leasing of government lands for oil and gas exploration and development, administered by the Bureau of Land Management (BLM).

In awarding leases under the noncompetitive program, BLM utilizes its simultaneous filing procedure, which provides all applicants with an equal chance to obtain leases on federal lands available for re-leasing. Applications to lease designated parcels must be submitted, signed, completed, and accompanied by a nonrefundable $10 filing fee. An applicant may file only one application for each numbered parcel on the list, but the applicant may make as many filings as there are available parcels.

Rather than file applications directly with BLM, in October 1976, *A* and *B* elected to participate in separate federal oil and gas lease acquisition programs offered by corporation *X*. For both programs *X* provided expert geological advice on United States Government land available for noncompetitive leasing, timely and accurate filing of offers to lease approved lands on behalf of the applicants, and payment of the filing fees to BLM.

Situation 1: Upon entering the program *A* paid *X* a fee of $100*x*. In return *X* was required to file on *A*'s behalf a monthly minimum of 10*y* lease applications for a 12-month period. *A* simultaneously purchased, for $10*x*, a 12-month option that required *X*, at *A*'s request, to purchase, for $50*x*, a specified fractional interest in all leases awarded to *A* as a result of the drawings. In relation to the total cost of the program to *A*, *X*'s allocation between the fee and option was reasonable. In January 1977 *A* was awarded its only lease under the program and exercised the option in October 1977.

Situation 2: For a 12-month period beginning in October 1976, *B* participated in a federal oil and gas lease acquisition program offered by *X* that was similar to the program *A* participated in. However, instead of paying a lump-sum fee of $100*x* and $10*x* for the put option, *B* elected to pay a monthly fee of $10*x*. This fee was due before the first day of each month in which *B* elected to participate in the program. *X* was required to file, on *B*'s behalf, a minimum of 10*y* lease applications in each month that *B* elected to participate in the program.

X did not offer *B* an option in writing that required *X* to purchase a specified fractional interest in all leases awarded to *B* as a result of the drawings. However, *B* knew that each person who had participated in *X*'s program for 12 consecutive months had received at least one lease and that *X* had made a practice of offering to purchase for $75*x* a specified fractional interest in all leases acquired by persons who participated in this monthly program for a minimum of 12 consecutive months. A reasonable allocation of the total cost ($120*x*) of the program to *B* would be $108*x* to the lease application filing service and $12*x* to *X*'s practice of offering to purchase for $75*x* a specified fractional interest in all leases acquired by participants. In reliance on this practice, *B* participated in the program each month for 12 consecutive months. In February 1977, *B* was awarded its only lease. In October 1977, *X* offered to purchase, and *B* agreed to sell, for $75*x*, a specified fraction of this lease.

LAW AND ANALYSIS

Section 263(a) of the Internal Revenue Code provides that deductions are not allowable for capital expenditures.

Section 165(a) of the Code provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 165(c)

provides that, in the case of an individual, the deduction under section 165(a) shall be limited to losses incurred in a trade or business; incurred in any transaction entered into for profit, though not connected with a trade or business; or arising from a casualty or theft.

Section 1.165-1(b) of the Income Tax Regulations provides that to be allowable as a deduction under section 165(a) of the Code, a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year.

Section 1.165-2 of the regulations provides that there shall be allowed as a deduction under section 165(a) of the Code, for the taxable year in which actually sustained, a loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, when such business or transaction is discontinued or such property is permanently discarded from use therein.

Rev. Rul. 67-141, 1967-1 C.B. 153, states that fees paid by an applicant rendered in connection with the acquisition of federal noncompetitive oil and gas leases are not deductible expenses and must be capitalized as part of the cost of the leases acquired and are recoverable through depletion.

Rev. Rul. 71-191, 1971-1 C.B. 77, provides that in cases in which a lease is not acquired, the fees paid for services rendered in connection with the attempted acquisition of noncompetitive government oil and gas leases are deductible under section 165(a) of the Code.

Rev. Rul. 77-395, 1977-2 C.B. 80, considers a program similar to that under consideration except that if no leases are acquired, the filing service company would assign a lease to the taxpayer and then buy it back for the option price. Rev. Rul. 77-395 concludes that because the services were rendered in connection with an integrated arrangement under which the investor was to acquire at least one lease on federal lands, all of the amounts expended, including the option fee, must be capitalized as part of the one assigned lease acquired by the taxpayer in that ruling. In that ruling, the taxpayer sustained a loss upon reassignment of the lease, which was recognized under section 1231(a) of the Code.

In *Larsen v. Commissioner,* 66 T.C. 478 (1976), *acq.,* 1977-2 C.B. 1, taxpayers incurred various expenses in seeking to acquire oil and gas leases in two project areas. Taxpayers acquired some leases but were unsuccessful in attempts to acquire other leases. The tax court concluded that expenses incurred in unsuccessfully attempting to lease specific acreage from a specific landowner constituted losses deductible under section 165(a) and (c) of the Code.

Rev. Rul. 71-521, 1971-2 C.B. 313, discusses the treatment, for federal income tax purposes, of premiums paid by an individual taxpayer for the purchase of a "put" option contract for sales of stock. The purchase of a put is a transaction entered into without respect to any particular share of stock and its cost should be carried to a deferred account as a capital expenditure made in an incomplete transaction entered into for profit. If the taxpayer exercises the put, the cost of the put is offset against the sum received for the sale of stock. Although Rev. Rul. 71-521 is connected with an option involving stock, the transaction in the instant revenue ruling is of a similar nature because it involves the purchase of an option to sell an interest in an oil and gas lease property for a specified amount within a certain period of time.

Situation 1: *A*'s participation in *X*'s program is a single transaction because it was a contract for a specified number of filings during a 12-month period for a lump sum. The transaction remained open until completion of the last filing to which *A* was entitled under the program. Until all filings were completed, there was no closed and completed transaction; therefore, the treatment of the cost cannot be fixed until it is determined whether one or more leases are acquired.

Under the BLM simultaneous filing procedure, an individual can expect to have its application chosen at few, if any, public drawings. However, the multiple filings on *A*'s behalf under *X*'s program improved *A*'s opportunity of acquiring a lease. *A* paid a lump sum for a specified number of filings during the 12-month period, and the cost of the program is a capital cost of the leases successfully acquired. *Larsen v. Commissioner* is distinguishable since there the overall success rate in acquiring leases depended on various factors peculiar to each negotiation and was not affected solely by the number of separate leasing opportunities.

In the instant case, a lease was acquired in 1977 as a result of the drawings. Therefore, the cost of the services rendered in connection with the acquisition must be capitalized as part of the cost of the lease. No loss under section 165(a) of a Code is allowable in 1976 because the transaction was not complete as of the end of 1976. Rev. Rul. 71-191 is distinguishable because there the facts do not specify that the transaction occurred in more than one year.

Situation 2: As in *Situation 1,* the multiple filings on *B*'s behalf under *X*'s program improved *B*'s opportunity of acquiring a lease. In addition, the tacit agreement by *X* to buy a specified fractional interest in all leases acquired by *B* was conditioned on *B*'s monthly participation for 12 consecutive months. If *B* participated for this period, *B* could substantially reduce the cost of participation because *B* would recover at least five-eighths of its payments to *X* when *B* sold the specified interest to *X*. This recovery

feature combined with *X*'s practice of awarding at least one lease to each person participating for 12 consecutive months and the effect of multiple filings shows that *B*'s participation in the 12-month program is a single transaction under which monthly payments are made for *X*'s services during the entire 12-month period. Thus, following the same rationale as in *Situation 1*, the transaction remained open until the completion of the last filing in which *B* was required to participate to be eligible for *X*'s practice of offering to purchase the specified fraction of any leaseholds *B* acquired. Until the filings are completed, there is no closed and completed transaction. Therefore, the treatment of the costs cannot be fixed until it is determined whether one or more leases are acquired.

HOLDINGS

Situation 1

1. The fee paid by *A* in the taxable year 1976 to participate in a program to acquire federal oil and gas leases is a capital expenditure includable in the basis of the single lease acquired in 1977. Furthermore, no part of such fee is allowable as a deduction in taxable year 1976 because the transaction was incomplete since all the applications had not been filed.

2. Upon the exercise of the option to sell *X* a fractional interest in the lease acquired, *A* will recognize gain or loss measured by the difference between the amount received for the fractional interest reduced by the cost of the option and the portion of the basis in the lease allocable to such fractional interest.

Situation 2

1. Nine *x* dollars of each monthly fee paid by *B* in the taxable years 1976 and 1977 to participate in a program to acquire federal oil and gas leases are capital expenditures includable in the basis of the single lease acquired in 1977. Furthermore, no part of such fee is allowable as a deduction in taxable year 1976 because the transaction was incomplete since all applications had not been filed.

2. Upon the sale of the specified fractional interest in the lease acquired, *B* will recognize gain or loss measured by the difference between the amount received from the fractional interest reduced by the $12*x* allocable to *X*'s practice of offering to purchase a specified fractional interest and that portion of the basis in the lease allocable to such fractional interest.

Whether such gain or loss, in both *Situation 1* and *Situation 2* is subject to the provisions of sections 1221 or 1231 of the Code requires a factual determination of the holding period, and whether, in the hands of the participant, such leases were properly regarded as property used in the trade or business or as investment property.

EFFECT ON OTHER REVENUE RULINGS

Consistent with Rev. Rul. 71-521, and this revenue ruling, Rev. Rul. 77-395 is modified to the extent that in the first situation, the option fee and, in the second situation, the amount allocated to the taxpayer's understood right to sell a fractional interest in any lease acquired, is not a part of the basis of the leasehold. Further, Rev. Rul. 77-395 is clarified with respect to the application of section 1231(a) of the Code to the loss incurred by *A* and *B;* specifically, to determine if section 1231(a) applies, a factual determination must be made as to the length of the holding period and the purpose for which the taxpayer held the lease. Also, Rev. Rul. 71-191 is distinguished.

PROSPECTIVE APPLICATION

Pursuant to the authority contained in section 7805(b) of the Code, the conclusion of this revenue ruling that the cost of the option is not to be added to the basis of the oil and gas properties when such properties are acquired will not be applied adversely to taxpayers who acquire oil and gas properties under written agreements of the type described in Rev. Rul. 77-395 that were entered into prior to July 7, 1980, the date of publication in the Internal Revenue Bulletin.

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26 CFR 1.263(a)-1: Capital expenditures; in general.
(Also 1.263(c)-1.)
(Also Section 612; 1.612-4.)

Oil and gas drilling expense; COST well. Several oil companies formed a consortium to drill a Continental Offshore Stratigraphic Test (COST) well, and shared the information developed from the drilling. The purpose of the well was to obtain geological information to be used in determining whether to bid on Government oil and gas leases. The drilling expenses are not intangible drilling and development costs subject to the elective provisions of sections 1.263(c)-1 and 1.612-4(a) of the regulations; they are capital expenditures allocable to any leases that may be acquired based on information obtained from the well.

Rev. Rul. 80-342

ISSUE

What is the proper income tax treatment of expenditures for drilling a Continental Offshore Stratigraphic Test well, under the circumstances described below?

FACTS

Fifteen oil companies formed a consortium and received a permit from the United States Geological Survey (USGS) to drill a Continental Offshore Stratigraphic Test (COST) well off the east coast of the United States in 1978.

The site for drilling the COST well was determined on the basis of geo-

physical information obtained by the consortium from the interpretation of seismic data gathered under a previous permit from the USGS. Each member of the consortium capitalized its aliquot share of the amount paid for such seismic work to the area or areas of interest identified by the member in accordance with Rev. Rul. 77-188, 1977-1 C.B. 76.

The purpose of drilling the COST well was to obtain geological information on an offshore area that the United States Government was expected to open for leasing in the near future. The COST well was drilled outside the previously identified areas of interest (off stucture) for the purpose of obtaining more information about such areas of interest. The COST well is expected to identify source beds that may have generated oil and gas and to determine the thickness and nature of reservoir rocks having the potential for containing oil and gas. Information gathered in drilling the COST well is also very useful in verifying the geophysical interpretation of the seismic data previously gathered. This information is useful to the members of the consortium when the area is offered for lease.

Under the terms of the permit held by the consortium, any oil or gas that may be discovered in drilling the COST well remains the property of the Government. Also, under the terms of the permit, the USGS and each member of the consortium will share in the geological information developed in drilling the well. This information is proprietary to the members of the consortium for 10 years or until the Government grants a lease within 50 miles of the COST well, whichever is sooner. If a lease is granted within 50 miles of the COST well during the 10 year proprietary period, the geological information developed in drilling the COST well will be made available to the public by the USGS 60 days after such lease is granted.

In this case the 15 companies comprising the consortium paid 150x dollars each, for the right to participate in drilling the COST well and sharing the geological information developed therefrom. A drilling contractor was hired and the well was drilled in 1978. After the well was completed, the borehole was permanently plugged and abandoned as required by the terms of the permit.

Each member of the consortium and the USGS received a copy of the geological information developed in drilling the well. No lease was granted by the Government within 50 miles of the well in 1978 or 1979.

LAW AND ANALYSIS

Section 263(a) of the Internal Revenue Code provides that no deduction shall be allowed for capital expenditures. Section 263(c) states that, notwithstanding subsection (a), regulations shall be prescribed that grant an option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells.

Section 1.263(c)-1 of the Income Tax Regulations provides that the rules relating to the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells are found under section 1.612-4.

Section 1.612-4(a) of the regulations provides that in accordance with the provisions of section 263(c) of the Code, intangible drilling and development costs incurred by an operator (one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under lease or any other form of contract granting working or operating rights) in the development of oil and gas properties may at the operator's option be chargeable to capital or to expense. This option applies to all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas.

The consortium is neither the lessee nor owner of the property on which the COST well is drilled. Neither it nor the members of the consortium have an operating or working interest in the property. Furthermore, the COST well was drilled to obtain geological information and not for the production of oil and gas. Thus, the drilling costs paid or incurred by the members of the consortium do not come under the elective provisions of section 1.263(c)-1 and 1.612-4(a) of the regulations.

Rev. Rul. 77-188 holds that geological and geophysical exploration expenditures are allocable to the cost of the property or properties acquired or retained.

The consortium had the COST well drilled to obtain geological information on an offshore area on which they expect the Bureau of Land Management to permit interested parties to bid for leases on which the lessees may drill for oil and gas deposits. The knowledge gained from such geological information is used by the individual members of the consortium in making their decisions to bid on certain tracts offered for lease in the general area of the COST well, and in verifying their interpretation of previously gathered geophysical data. Thus, the geological exploration expenditures for drilling the COST well are paid or incurred by members of the consortium for the purpose of obtaining and accumulating data that will serve as a basis for the acquisition or retention of an oil and gas property. Such exploration expenditures are capital in nature and are not deductible as ordinary and necessary business expenses. *See Louisiana Land and Exploration Co.*, 7 T.C. 507 (1946), *aff'd on other issues*, 161 F.2d 842 (5th Cir. 1947); *Schermerhorn Oil Corporation*, 46 B.T.A. 151 (1942); *G. E. Cotton*, 25 B.T.A. 866 (1932); *C. M. Nusbaum*, 10

B.T.A. 664 (1928); and *Seletha O. Thompson*, 9 B.T.A. 1342 (1928).

HOLDING

The expenditures for drilling the COST wells are not intangible drilling and development costs subject to the elective provisions of section 1.263(c)-1 and section 1.612-4(a) of the regulations. However, similar to the exploration expenditures discussed in Rev. Rul. 77-188, the 150*x* dollars paid to drill the COST well is a capital expenditure. If any member of the consortium is successful in obtaining a lease or leases on the areas of interest to which the information obtained from drilling the COST well is allocable, the 150*x* dollars paid by such member is allocable to such lease or leases. However, any member of the consortium that is unsuccessful in acquiring a lease to which the geological information applies and abandons the area of interest as a potential source of mineral production may deduct the 150*x* dollars or an allocable portion thereof under the provisions of section 165 of the Code in the taxable year in which the abandonment occurs.

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26 CFR 1.263(a)-1: Capital expenditures; in general.

Treatment of material and installation costs paid for by a railroad taxpayer for replacement of private and public railway road crossings over the taxpayer's railroad track. Also, whether the retirement-replacement method of accounting for depreciation of the railway road crossings is permissible. See Rev. Rul. 80-187, page 19.

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26 CFR 1.263(a)-2: Examples of capital expenditures.

Whether the cost of moving a building is a capital expenditure. See Rev. Rul. 80-356, page 47.

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26 CFR 1.263(c)-1: Intangible drilling and development costs in the case of oil and gas wells.

Whether the expenditures incurred in drilling a Continental Offshore Stratigraphic Test well are subject to the elective provisions of section 263(c) of the Code and section 1.612-4(a) of the regulations. See Rev. Rul. 80-342, page 99.

Section 265.—Expenses and Interest Relating to Tax-Exempt Income

26 CFR 1.265-2: Interest relating to tax-exempt income.

Whether section 265(2) of the Code will be applied to disallow deductions for interest paid by commercial banks on certain time deposits made by a state when such deposits are made for a specific period of time and are secured by pledges of tax exempt obligations. See Rev. Proc. 80-55, page 849.

Section 274.—Disallowance of Certain Entertainment, Etc., Expenses

26 CFR 1.274-5: Substantiation requirements.
(Also Section 162; 1.162-17.)

Travel expenses; reimbursement; mileage allowances. With respect to expenses paid or incurred after 1979, mileage allowances not exceeding 20 cents per mile for transportation paid by employers to employees will satisfy the substantiation and adequate accounting requirements of sections 1.162-17(b) and 1.274-5 of the regulations; Rev. Rul. 80-62 modified.

Rev. Rul. 80-203

This revenue ruling modifies Rev. Rul. 80-62, 1980-1 C.B. 63, with respect to the mileage allowance for transportation paid by employers to employees.

The sixth paragraph of Rev. Rul. 80-62 is amended to read as follows:

If a fixed mileage allowance not exceeding 20 cents per mile is used by an employer in payment of an employee's ordinary and necessary expenses of transportation while traveling away from home and the elements of time, place, and business purpose of the travel are substantiated in accordance with paragraphs (b)(2) and (c) (other than subparagraph (2)(iii)(a) thereof) of section 1.274-5 of the regulations, such an allowance shall be deemed as satisfying with respect to such travel amounts, the substantiation requirements of section 1.274-5(c) and the adequate accounting requirements of section 1.274-5(e). Also, if an employer grants an allowance not exceeding 20 cents per mile to an employee for ordinary and necessary transportation expenses not involving travel away from home, such an arrangement shall be considered to be an accounting to the employer within the meaning of section 1.162-17(b). However, an employer may grant an additional allowance for parking fees and tolls attributable to the traveling and transportation expenses as separate items.

This amendment is effective with respect to expenses paid or incurred after December 31, 1979.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 80-62 is modified.

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26 CFR 1.274-5: Substantiation requirements.

Simplified, optional method for computing allowable deductions for the cost of operating an automobile for business purposes. See Rev. Proc. 80-32, page 767.

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26 CFR 1.274-5: Substantiation requirements.

Whether a taxpayer who participates in a training program of the taxpayer's employer is considered "away from home" and may accordingly exclude per diem amounts from gross income. See Rev. Rul. 80-212, page 58.

Subchapter C.—Corporate Distributions and Adjustments
Part I.—Distribution by Corporations
Subpart A.—Effects on Recipients

Section 301.—Distributions of Property

26 CFR 1.301-1: Rules applicable with respect to distribution of money and other property.

"Stapled," "paired," or "back-to-back" stock; valuation. Factors are

set forth that should be considered, in addition to those in Rev. Rul. 59-60, in valuing the stock of a subsidiary corporation that is distributed to the shareholders of the former parent and that can be sold only with the stock of the distributing corporation; Rev. Rul. 59-60 amplified.

Rev. Rul. 80-213

SECTION 1. PURPOSE

The purpose of this revenue ruling is to provide information and guidance to taxpayers, Internal Revenue Service personnel, and others concerned with the valuation for federal tax purposes, of stock of a subsidiary corporation that is distributed to the shareholders of the former parent and can be sold only with the stock of the distributing corporation. Such stock is referred to as "stapled," "paired" or "back-to-back" stock.

SEC. 2. BACKGROUND

There are variations in the methods by which stapling arrangements are created, but they generally have the following features in common: (a) An existing domestic corporation organizes a new foreign affiliate to conduct business in a foreign country. The affiliate is usually organized in a country with lower tax rates than the United States or that offers other tax advantages. (b) The affiliate issues the same number of shares as the parent company has outstanding. (c) The shares of the affiliate are distributed ratably to the shareholders of the domestic corporation. (d) The shares of the two companies are stapled or paired so that they can be transferred only as a unit. (e) There is generally a close association in the operations of the two companies.

The distribution by the parent of the subsidiary stock to the parent's shareholders under these circumstances is a distribution of property to the shareholders within the meaning of section 301(a) of the Internal Revenue Code and will be includable in the gross incomes of the parent's shareholders as a dividend distribution to the extent provided in section 301(c) and section 316. Rev. Rul. 54-140, 1954-1 C.B. 116. Also, see *Wilkinson v. Commissioner,* 29 T.C. 421 (1957), *nonacq.,* 1960-2 C.B. 8.

SEC. 3. NATURE OF THE PROBLEM

In many instances the stock of the distributing company is publicly traded on one of the organized exchanges or in the over-the-counter market. Therefore, market quotations are available for the stock of the distributing company prior to the distribution and for the stapled stock after the distribution. There are no market transactions solely in the stock of the distributed corporation. Consequently, some other measure of its value must be used.

Rev. Rul. 59-60, 1959-1 C.B. 237, outlines and reviews in general, the approach, methods and factors to be considered in valuing shares of capital stock of closely held corporations. The methods discussed therein also apply to the valuation of corporate stocks in which market quotations are either unavailable or are so infrequent that they do not reflect fair market value. Rev. Rul. 68-609, 1968-2 C.B. 327, points out that the general approach, methods, and factors outlined in Rev. Rul. 59-60, as modified, are equally applicable to valuations of corporate stocks for income and other tax purposes as well as for estate and gift tax purposes and apply in determining the fair market value of business interests.

Although Rev. Rul. 59-60 does not provide specific rules for stapled stock, it does provide general guidelines for valuing such stock of the distributed corporation. There are factors surrounding the formation of the distributed corporation, the distribution of its shares, its continued operation, and the sale of its stock that are not encountered in valuing the stock of a typical closely held corporation. A proper analysis of fair market value of stapled stock requires the consideration of all relevant facts and circumstances.

SEC. 4. VALUATION CONSIDERATIONS

The following factors, in addition to those mentioned in Rev. Rul. 59-60, should be considered in valuing stapled stock.

.01 Valuation of securities is, in essence, a prophecy as to the future and must be based on facts available and the prospective economic conditions as of the valuation date. Because the future of the distributed and distributing corporation will be closely associated by the stapling of the stock of the two corporations, the history and experience of the distributing corporation in conducting the same or similar business of the distributed corporation should be considered.

.02 In reviewing the prior earnings of the distributed company in operating the business either as a division or a subsidiary, adjustments must be made to the earnings to account for changes that will result because of the change in status. The distributed company may not be subject to United States laws in general and may no longer be subject to federal income taxes.

.03 When the subsidiary is a foreign corporation, consideration should be given to the corporation laws of the host country, the political stability of the host country and the countries in which the company operates, the possibility of changes in the rate of exchange, and restrictions on the transfer of funds. Consideration should also be given to the fact that the management of the distributing company weighed these factors along with other advantages and disadvantages in arriving at the decision to conduct business under this form of organization.

.04 The quality, experience, and reputation of the company are important factors in the valuation of a business. Where the distributed company proposes to carry on a business on much the same basis as had existed

prior to the distribution, consideration should be given to the good will and going concern value developed by the distributing company and also whether the management of the distributed company will be composed of largely the same persons as had existed prior to the realignment. Consideration should also be given to the possibility of the distributed company being able to call upon personnel of the distributing company for specialized areas of expertise.

.05 Any financial assistance in the form of direct loans, surety arrangements, or performance guarantees from the distributing company would tend to place the distributed company in a more favorable position than if it were to exist as an operationally independent entity.

.06 Whether the distributed company is to assume any existing contracts or is to be assigned contracts from any particular customers or in any particular geographical area should be noted.

.07 If the distributed company meets stock exchange listing requirements only by virtue of the stapling arrangement, this enhanced marketability is a valuation factor to be considered.

.08 In most instances, the best measure of the value of closely held stock is found in the prices at which the stock of companies engaged in the same or a similar line of business are selling in a free and open exchange. When stock is valued by this approach it is generally necessary to adjust the preliminary value in recognition that the shares of the comparative companies are publicly traded while the shares to be valued are not.

Where the stock of the distributing corporation is registered prior to the distribution, the stapled shares can be publicly traded after the distribution with the stock of the distributing corporation. Therefore, no discount for lack of marketability is appropriate in that instance.

SEC. 5. EFFECT ON OTHER DOCUMENTS

Rev. Rul. 59-60, as modified by Rev. Ruls. 65-193, 1965-2 C.B. 370, and 68-609, 1968-2 C.B. 327, and as amplified by Rev. Rul. 77-287, 1977-2 C.B. 319, is further amplified.

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26 CFR 1.301-1: Rules applicable with respect to distributions of money and other property.
(Also Sections 304, 351; 1.304-2, 1.351-2.)

Transfer of assets to new corporation; stock for cash and stock. An individual who owned all the stock of a corporation transferred the stock to a new corporation in exchange for all of its stock and cash that was borrowed from a bank. Subsequent to the transfer the new corporation repaid the loan with funds received from the first corporation. The cash received by the individual constitutes a dividend from the old corporation to the extent provided in section 301 of the Code.

Rev. Rul. 80-239

ISSUE

Does section 301(c) of the Internal Revenue Code apply to the transaction described below?

FACTS

Individual *A* owned all of the stock of corporation *X*, which is engaged in a profitable manufacturing business. Over the years, *X* has accumulated substantial earnings and profits but had never paid a dividend. *A* decided to broaden the business operations of *X* into other unrelated manufacturing endeavors, and to this end *A* determined that a holding company would be necessary to oversee and control a multifaceted operation. *A* also wanted to initiate some new business ventures as a sole proprietor but did not have the necessary cash without withdrawing funds from *X*. To accomplish these objectives, *A* transferred the stock of *X* to *Y*, a newly created corporation. In exchange, therefor, *A* received the stock of *Y* and 100,000*x* dollars that *Y* had borrowed from a bank. The obligation of *Y* to the bank was guaranteed by *X* and secured by a pledge of the *X* stock to be received pursuant to the overall transaction. Subsequent to the transaction, *Y* repaid the bank loan with funds received from *X*.

LAW, ANALYSIS, AND HOLDING

Section 351(a) of the Code provides, in part, that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

Section 368(c) of the Code provides that the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Section 351(b)(1) of the Code provides that if section 351 (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then gain (if any) to such recipient will be recognized, but not in excess of the money received, plus the fair market value of such other property received. Under section 351(b)(1), the other property or money is treated as received by the shareholder in part or full payment in exchange for the assets transferred. Section 351(b)(2) provides that no loss will be recognized.

Section 1.351-2(d) of the regulations refers to section 301 of the Code with respect to the taxation of dividends where a distribution by a cor-

poration of its stock in connection with an exchange subject to section 351(a) has the effect of the distribution of a taxable dividend.

Section 1.301-1(1) of the regulations provides that a distribution to shareholders with respect to their stock is within the terms of section 301 of the Code although it takes place at the same time as another transaction if the distribution is in substance a separate transaction whether or not connected in a formal sense.

Section 304(a)(1) of the Code provides, in part, that where one or more persons are in control, as defined in section 304(c), of each of two corporations and, in return for property, one of the corporations acquires stock in the other corporation from the person or persons so in control, the property received will be treated under section 302 as a distribution in redemption of stock of the corporation acquiring such stock. Section 304(c) provides, in part, that control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock.

Section 351 of the Code applies to the transfer by *A* of the *X* stock to *Y* in exchange for the *Y* stock because *A* was in control of *Y* (as defined in section 368(c)) immediately after the exchange. It must be determined, however, whether section 351(b) or section 304(a)(1) applies to the cash received by *A* from *Y* in the transaction.

A distribution of the cash directly by *X* to *A* would have been a distribution within the terms of section 301 of the Code. Although in the present case the cash distribution was arranged to be made by newly-organized *Y* corporation, this part of the transaction was in substance a disguised dividend distribution from *X* to *A*. The characterization of a distribution is not necessarily determinative for tax purposes and may be recharacterized to accord with the substance of a transaction. See *Waterman Steamship Corp. v. Commissioner*, 430 F.2d 1185 (5th Cir. 1970). Thus, the receipt of the 100,000*x* dollars by *A* is not governed under the provisions of section 351(b)(1) of the Code. See sections 1.351-2(d) and 1.301-1(1) of the regulations. Also, the provisions of section 304(a)(1) do not have any application to this situation since the substance of the transaction involves no actual receipt by *A* of "property" (cash) that is required to be distributed by *Y*, the acquiring-transferee corporation.

A distribution by one person (*X*) cannot be transformed for tax purposes into a distribution by another (*Y*) by using the latter as a conduit through which to pass the 100,000*x* dollars. Consequently, *A* will be treated as having received a dividend of 100,000*x* dollars from *X* to the extent provided in section 301 of the Code. See *Gold v. Commissioner*, T.C.M. 1958-2. Also see *Minesota Tea Co. v. Helvering*, 302 U.S. 609 (1938), Ct. D. 1305, 1938-1 C.B. 288, and *Higgins v. Smith*, 308 U.S. 473 (1940), Ct. D. 1434, 1940-1 C.B. 127.

Compare Rev. Bul. 80-240, page 116, this Bulletin, for tax treatment where the transferor borrowed money to purchase the stock transferred and the transferee corporation assumed the indebtedness.

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26 CFR 1.301-1: Rules applicable with respect to distributions of money and other property.
(Also Section 305; 1.305-1.)

Distribution of stock rights from subsidiary to parent's shareholders. A wholly owned subsidiary issued nontransferable subscription rights to purchase stock in the subsidiary to the shareholders of its parent. As the parent expected, an active "when-issued" market developed for the stock of the subsidiary at a market price in excess of the subscription price. The transaction is treated as a nontaxable distribution from the subsidiary to the parent under section 305(a) of the Code that is followed by a distribution of property from the parent to its shareholders. The constructive distribution by the parent is taxable to the shareholders, subject to the provisions of section 301, on the date of distribution, rather than on the date the rights are exercised.

Rev. Rul. 80-292

ISSUE (1). Whether a direct issuance by a subsidiary corporation (*S*) of nontransferable rights to acquire *S* stock to the shareholders of its parent corporation (*P*) should be treated, for federal income tax purposes, as a nontaxable distribution of stock rights by *S* to *P* under section 305(a) of the Internal Revenue Code followed by a distribution of property by *P* to its shareholders under section 301.

ISSUE (2). If the transaction is so viewed, whether the constructive distribution by *P* to its shareholders is taxable under section 301 of the Code on the date the nontransferable rights to purchase stock are constructively distributed by *P*, or on the date that the shareholder of *P* exercises the rights to purchase the subsidiary's stock.

FACTS

P corporation is engaged in manufacturing and *P*'s stock is traded on a national securities exchange. *P* owns all of the stock of *S* corporation. *S* was recently created to engage in a new and relatively speculative business enterprise that was unrelated to *P*'s manufacturing business except that *P*'s manufactured end-product goods will be utilized in *S*'s operations. The management of *P* and *S* desired to obtain additional equity capital for *S*'s operations by offering to the shareholders of *P* an oportunity to obtain 17 percent of the outstanding stock of *S* with *P* retaining the remaining 83 percent of

S's stock. The plan was declared effective on January 3, 1978, and called for *S* to directly issue nontransferable subscription rights to subscribe to its stock to the *P* shareholders on a pro rata basis. One right to purchase one share of *S* common stock was to be issued for each seven shares of *P* common stock held by a shareholder at the close of business on the record date of January 20, 1978. Each right was exercisable at a price of 15 dollars. The rights were mailed by *S* to the *P* shareholders after close of business on the record date, and were exercisable by the payment of the 15 dollar subscription price by close of business on February 10, 1979.

When the plan for the issuance of the rights became effective on January 3, 1978, as was expected by *P*, shares of *S* stock started trading on a "when-issued" basis on the over-the-counter market, and 3 days later, on January 6, 1978, shares of *S* started trading on a "when-issued" basis at an average price of 35 dollars on a national stock exchange. On this market and exchange, a *P* shareholder could, and some did, enter into a contract with another person to sell, at the 35 dollar per share market price, to that person shares of *S* that the *P* shareholder would receive upon exercise of the right to acquire such stock by payment of the 15 dollar subscription price.

LAW

Section 305(a) of the Code provides the general rule that gross income does not include the amount of any distribution of the stock of a corporation made by such corporation with respect to its stock. Section 305(d)(1) provides that for purposes of section 305(a) the term "stock" includes rights to acquire stock.

Section 301(a) of the Code provides that a distribution of property (as defined in section 317(a)) with respect to a corporation's stock shall be treated as provided in section 301(c). Section 317(a) provides that the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock). Section 301(c) provides that the portion of the distribution that constitutes a dividend (as defined in section 316) shall be included in gross income; section 301(b) provides that the amount of such a distribution, to a noncorporate distributee, is the fair market value of the property received.

ANALYSIS

ISSUE (1). The subscription rights issued by *S* appear to represent merely an offer by *S* to the *P* shareholders to purchase *S* stock that was made because those shareholders are likely purchasers of *S* stock since they own *P* stock. However, because of the corporate-shareholder relationship of the parties, a question arises as to whether the form of the transaction should determine its characterization for federal income tax purposes. In *Baumer v. United States,* 580 F.2d 863 (5th Cir. 1978) a corporation granted, without business purpose and for nominal consideration, a valuable option to purchase corporate property to the son of the corporation's sole shareholder. The United States Court of Appeals held that the form of the transaction would not control and that the transaction resulted in a constructive dividend to the father and a gift by the father to the son in the amount of the constructive dividend.

Similarly, in the present transaction the value of the rights to purchase *S* stock received only by the *P* shareholders, without any consideration, was significant. The value of the right was evidenced by the fact that the *S* stock was trading at an average price, during the exercise period, which substantially exceeded the 15 dollar subscription price. If *S* had distributed rights to purchase its stock to *P* and *P* in turn distributed those rights, without consideration, to the *P* shareholders, the distribution to the *P* shareholders would be a taxable distribution of property, within the meaning of section 317(a), under section 301. See Rev. Rul. 70-521, 1970-2 C.B. 72. Consequently, considering *P*'s control over *S* it is appropriate to view the transaction, for federal income tax purposes, as a distribution of stock rights by *S* to *P* under section 305(a) of the Code followed by a distribution of property, within the meaning of section 317(a), in the form of stock rights to purchase *S* stock by *P* to its shareholders subject to the provisions of section 301, especially since this view is consistent with the economic realities of the transaction.

HOLDING

ISSUE (1). The transaction will be viewed, for federal income tax purposes, as a nontaxable distribution of stock rights, within the meaning of section 305(d)(1) of the Code, by *S* to *P* under section 305(a), followed by a distribution of property by *P*, within the meaning of section 317(a), to its shareholders subject to the provisions of section 301.

ANALYSIS

ISSUE (2). Prior to enactment of the 1954 Code, the Supreme Court of the United States held that a corporation's issuance of rights to purchase stock of another corporation did not constitute a dividend, and instead amounted to an offer that could result in dividend treatment only when the offer was accepted by exercise. *Palmer v. Commissioner,* 302 U.S. 63 (1937), 1937-2 C.B. 251. Following enactment of the 1954 Code, the Supreme Court indicated that it has not been authoritatively settled whether an issue of rights to acquire stock of another corporation at less than fair market value itself constitutes a dividend, or whether the dividend occurs only on the exercise of the right. *Commissioner v. Gordon,* 391 U.S. 83 (1968), 1968-2 C.B. 148.

In Rev. Rul. 70-521, the Service concluded that since under the revised 1954 Code treatment of corporate distributions, rights to acquire stock in a corporation other than the distributing corporation are "property" within the meaning of section 317(a) of the Code, a distribution of such rights is taxable as provided under section 301 (c) as of the time of distribution. Thus, the *Palmer* doctrine would not be applied so as to avoid ordinary dividend taxation on the distribution of transferable rights to acquire stock of another corporation on the date of distribution. *Redding v. Commissioner,* Docket Nos. 79-1775, 79-1776 (7th Cir., Aug. 25, 1980). Similarly, while the rights to acquire *S* stock in the instant case were nontransferable, as was expected by the management of *P,* a trading market for these rights developed immediately on the "when-issued" market upon the effective date of the plan. Further, under the facts and circumstances of the instant transaction the "nontransferable" nature of the rights has no effect on the conclusion that the rights to acquire *S* stock are property.

Since the constructive issuance by *P* of the stock rights to purchase *S* stock involves a distribution of property other than cash, the fair market value of the rights distribution in the instant case is determined, pursuant to section 1.301-1(b) of the Income Tax Regulations, as of the date that the rights were actually distributed on January 20, 1978. Section 1.301-1(b) further provides that the date of distribution of property other than cash is determined without regard to whether such date is the same as that on which the distribution is includible in the shareholder's gross income. Thus, January 20, 1978, the date on which *P* distributed the stock rights, is the date on which the fair market value of these rights is determined even if they are not includible in the gross income of a *P* shareholder on that date.

HOLDING

ISSUE (2). The constructive distribution by *P* to its shareholders of nontransferable rights to purchase *S* stock is a distribution of property on the date of distribution (January 20, 1978), taxable as provided in section 301(c) of the Code. The amount distributed to an individual shareholder of *P* upon receipt of each right to purchase a share of *S* stock is the fair market value of each right on the date of distribution. See section 301(b)(1)(A). The amount distributed to a domestic corporate shareholder of *P* is the lesser of the fair market value of the rights distributed or the adjusted basis of the property in the hands of *P*. See section 301(b)(1)(B).

Section 302.—Distributions in Redemption of Stock

26 CFR 1.302-4: Termination of shareholder's interest.

Whether *Y*'s distribution of *Z* securities to its public shareholders in exchange for all of their *Y* stock qualifies as a complete termination under section 302(b)(3) of the Code. See Rev. Rul. 80-285, page 119.

Section 304.—Redemption Through Use of Related Corporations

26 CFR 1.304-2: Acquisition by related corporation (other than subsidiary).

Whether section 304(a)(1) of the Code applies to cash received by a transferor in the formation of a new holding company. See Rev. Rul. 80-239, page 103.

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26 CFR 1.304-2: Acquisition by related corporation (other than subsidiary).

Whether section 304(a)(1) of the Code applies where a transferor borrowed money to purchase the stock transferred to a newly created corporation that assumes such indebtedness. See Rev. Rul. 80-240, page 116.

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26 CFR 1.304-2: Acquisition by related corporation (other than subsidiary).

Whether a ruling may be issued that section 304(a)(1) of the Code is inapplicable when a newly created corporate transferee assumes a liability incurred in a transaction similar to that described in Rev. Rul. 80-240. See Rev. Proc. 80-34, page 768.

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24 CFR 1.304-3: Acquisition by a subsidiary.
(Also Section 1012; 1.1012-1.)

Parent's stock purchased by subsidiary; basis. The purchase of a parent corporation's stock from its sole shareholder by its subsidiary will not result in a constructive distribution to the parent. The parent's adjusted basis in the subsidiary's stock will remain the same as it was prior to the transaction, and the subsidiary, under section 1012 of the Code, will have a basis in the parent's stock acquired in the transaction equal to the amount paid. Rev. Rul. 69-261 modified.

Rev. Rul. 80-189

ISSUE

Whether a parent corporation is in receipt of a constructive distribution from its subsidiary when the subsidiary purchases the parent's stock from a third party.

FACTS, LAW, AND ANALYSIS

In Rev. Rul. 69-261, 1969-1 C.B. 94, *S* corporation purchased for cash some of the stock of *P* corporation, its sole shareholder, from a third party, *A*, the sole shareholder of *P*. Section 304(a)(2) of the Internal Revenue Code provides that, for purposes of sections 302 and 303, if in return for property, a subsidiary acquires stock of its parent from a shareholder of the parent, such property will be treated as a distribution in redemption of the stock of the parent. Section 304(b)(2)(B) provides that in such a case, the determination of the amount that is a dividend will be made as if the property were distributed by the subsidiary to the parent and immediately thereafter distributed by the parent. Rev. Rul. 69-261 holds that the amount received by *A* is a constructive dividend to *A*.

Rev. Rul. 69-261 further holds that the amount deemed distributed by *S* to *P*, by operation of section 304(b)(2)(B) of the Code, is a constructive dividend to *P* under section 301. This position was sustained by the United States Tax Court in *Union Bankers Insurance Co. v. Commissioner,* 64 T.C. 807 (1975), and by the United States District Court in *Broadview Lumber Co. v. United States,* Civil Nos. 73 F 104, 105 (N.D. Ind., Oct. 15, 1975). However, the Tax Court reversed its position in the case of *Webb v. Commisioner,* 67 T.C. 293 (1976), *aff'd per curiam,* 572 F.2d 135 (5th Cir. 1978), reasoning that section 304(b)(2)(B) is directed only toward adjusting the earnings and profits of the parent for the purpose of determining the amount that is a dividend to the shareholder, and has nothing to do with determining the parent corporation's income. Later, the Tax Court in *Virginia Materials Corp. v. Commissioner,* 67 T.C. 372 (1976), *aff'd without opinion* (4th Cir., June 20, 1978) reached a similar decision. Further, the District Court in *Broadview Lumber* was reversed on this issue on appeal, 561 F.2d 698 (7th Cir., 1977).

HOLDING

The Internal Revenue Service will follow the decisions in *Webb, Broadview Lumber,* and *Virginia Materials* on this issue. Consequently, *P* is not in receipt of a constructive distribution from *S* when *S* purchases *P*'s stock from a third party.

P's adjusted basis in *S*'s stock will remain the same as it was prior to the transaction, and *S*, under section 1012 of the Code, will have a basis in *P*'s stock acquired in the transaction equal to the amount paid therefor.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 69-261 is modified to the extent that it holds that *P* is in receipt of a constructive dividend by operation of section 304(b)(2)(B).

Section 305.—Distributions of Stock and Stock Rights

26 CFR 1.305-1: Stock dividends.

Whether a subsidiary corporation's direct issuance to the shareholders of its parent corporation of rights to acquire a portion of the subsidiary corporation's stock should, in part, be treated as a distribution of stock rights from the subsidiary to the parent, which is nontaxable under section 305(a), followed by a distribution of these rights by the parent to its shareholders under section 301. See Rev. Rul. 80-292, page 104.

Subpart B.—Effects on Corporation

Section 311.—Taxability of Corporation on Distribution

26 CFR 1.311-1: General.
(Also Section 1001; 1.1001-1.)

Redemption of stock; appreciated property; plan of sale. A corporation issued preferred stock for cash with the intent of later redeeming the stock for appreciated property. The transaction was merely a prearranged plan to avoid the tax on the sale of the property, and the nonrecognition of gain provisions of section 311(a) of the Code did not apply.

Rev. Rul. 80-221

ISSUE

Whether the nonrecognition of gain provisions of section 311(a) of the Internal Revenue Code apply where a corporation issues its "preferred stock" for cash for the purpose of redeeming the "stock" from the purchaser with appreciated property owned by the corporation.

FACTS

Corporation *X* is engaged in a manufacturing business and owned a piece of vacant land which it originally acquired for use in its manufacturing business. *X* abandoned its plans for the use of the land in its business. The land had an adjusted basis of 100*x* dollars and a fair market value of 10,000*x* dollars. *Y*, an unrelated corporation, offered to purchase the land at its fair market value of 10,000*x* dollars. However, *X*, in order to avoid the recognition of gain on the sale of the land, entered into the following transaction with *Y*. On March 31, 1979, *Y* purchased for 10,000*x* dollars one share of 10,000*x*-dollar-par-value nonvoting "preferred stock" of *X*. This share of "stock" called for payment of a quarterly cumulative dividend of 300*x* dollars. The "stock" was redeemable at the option of the shareholder 13 months after issuance solely by the transfer of legal title and possession of the land to the shareholder. However, if an event occurred that would excuse *X* from transferring title to *Y* (such as a condemnation of the land by the state), *X* would be required to redeem the "stock" with a payment of 10,000*x* dollars in cash. The "stock" was also callable by *X* under the same terms 14 months after issuance.

X was entitled to full use and possession of the land while the "stock" was outstanding, but could not waste, sell, or otherwise dispose of the land. *X* was liable for the real estate taxes on the property during the period the "stock" was outstanding. The real estate taxes on the land were nominal. On March 31, 1979, *Y* gave 10,000*x* dollars to *X* in exchange for this one share of *X* "preferred stock." The fair market value of the land on that date was 10,000*x* dollars.

On May 1, 1980, 13 months after the issuance of the "preferred stock", *Y*, who had received no dividends on the "preferred stock," demanded redemption of the share of "preferred stock." *Y* received a deed transferring legal title to the land to *Y*. *Y* also received 1,200*x* dollars in cash for the accrued quarterly dividends on the stock. The value of the "stock" during the 12-month period immediately prior to the distribution in redemption thereof represented at least 10 percent in value of all the outstanding stock of *X* during that period. *Y* had no other interest in *X*.

LAW AND ANALYSIS

Section 61(a)(3) of the Code states that gross income includes gains derived from dealings in property. Section 1001(a) provides, in part, that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain. Section 311(a) provides, in part, that except as provided in subsection (d), no gain or loss shall be recognized to a corporation on a distribution, with respect to its stock or property. Section 311(d)(1) provides that a corporation shall recognize gain if it distributes appreciated property in redemption of its stock. However, section 311(d)(2)(A) provides that the exception of section 311(d)(1) to the general rule of nonrecognition of section 311(a) will not apply if the redemption is (1) a distribution in complete redemption of all of the stock of a shareholder, who (2) for the 12-month period immediately prior to the distribution (3) holds at least 10 percent in value of the outstanding stock of the distributing corporation.

The form of the transaction in this case (a purchase of *X* stock by *Y* followed by a redemption of this stock with *X* distributing the vacant land to *Y* in full payment in exchange therefor) was chosen solely for the purpose of attempting by the application of section 311(a) of the Code, to avoid the tax on the gain that otherwise would have been recognized to *X*. *Y* had no interest in acquiring "stock" ownership in *X*, and *Y* did so only to accommodate the tax avoidance motives of *X*. *Y*'s objectives were solely to purchase the land from *X*, and *X*'s objectives were to sell the land to *Y*. *Y*'s "stock" ownership in *X* was transitory and was not intended to represent a normal shareholder interest. Rather, the "stock" represented *Y*'s right to receive the land at a specified time and to receive payment for giving *X* the purchase price of the land prior to *Y* receiving title to the land.

The two steps of the transaction of the purchase of the "stock" and its "redemption" for the land were part of a prearranged integrated plan and may not be considered independently of each other for federal income tax purposes. See Rev. Rul. 70-140, 1970-1 C.B. 73, which concluded that the transfer by an individual of assets of proprietorship, pursuant to an integrated plan, followed by the corporation's acquisition by an unrelated corporation did not qualify under the nonrecognition provisions of section 351 and that gain or loss was recognized under section 1001. Compare *Idol v. Commissioner,* 38 T.C. 444, *aff'd,* 319 F.2d 647 (6th Cir 1963), in which section 311(a) of the Code was held not to apply to a redemption of stock that had been acquired solely for the purpose of having it redeemed by the distribution of appreciated assets. In *Bush Brothers and Co. v. Commissioner,* 73 T.C. No. 37 (1979), the United States Tax Court stated that the nonrecognition provisions of section 311(a) of the Code were not intended to apply to transactions that are motivated primarily by tax avoidance and without any substantial business purpose.

HOLDING

Section 311(a) of the Code is not applicable to the subject transaction, and gain is recognized to *X* on the sale of the land to *Y* under section 1001.

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26 CFR 1.311-1: General.

Stock redeemed for property; liabilities in excess of basis. Computation of gain to be recognized under section 311(c) of the Code on a corporation's distribution of property with respect to its stock is made on an individual, asset-by-asset basis rather than on an aggregate basis. This application is illustrated by various situations in which such distributions are made in complete termination of a shareholder's interest in the corporation.

Rev. Rul. 80-283

ISSUE

Does section 311(c) of the Internal Revenue Code apply to distributed assets individually or in the aggregate in the situations described below?

FACTS

Situation 1:

Individuals *A* and *B* owned equally all the outstanding stock of *X* corporation. In a redemption qualifying under section 302(b)(3) of the Code, *A*'s interest in *X* was completely terminated. As consideration for the surrender of stock, *X* distributed to *A* two items of property: property I having an adjusted basis of 200*x* dollars and a fair market value of 400*x* dollars and property II having an adjusted basis of 300*x* dollars and a fair market value of 600*x* dollars. A mortgage encumbering property I to the extent of 250*x* dollars was assumed by *A* in connection with the distribution. In light of the complete termination exception of section 311(d)(2)(A), section 311(d)(1), relating to redemptions using appreciated property, has no application here.

Situation 2:

The facts are identical to those in *Situation 1* except that the assumed liability of 250*x* dollars does not specifically encumber either of the distributed assets.

Situation 3:

The facts are identical to those in *Situation 1* except that *A* assumes, in addition to the 250*x* dollar mortgage encumbering property I, an additional liability of 250*x* dollars that does not specifically encumber either of the distributed assets.

LAW AND ANALYSIS

Section 1.311-1(d) of the Income Tax Regulations provides, in part, that if the distributed property subject

to a liability is not a capital asset in the hands of the distributing corporation, the gain is taxable as gain from the sale of a noncapital asset. Because characterization of the recognized gain is thus to be done on an asset by asset basis, it is reasonable to infer that Congress intended computation of such gain to be done on that basis as well.

A similar inference can be drawn from section 357(c). That provision, like section 311(c), became law as part of the Internal Revenue Code of 1954. Furthermore, section 357(c) also provides for gain recognition when liabilities associated with transferred property exceed the basis of that property. Unlike section 311(c), however, section 357(c) confronts and resolves the question of individual or aggregate by specifying that

> [i]f the *sum* of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the *total* of the adjusted basis of the property transferred . . ., then the excess shall be considered as a gain . . . (Emphasis added.)

See Treas. Reg. § 1.357-2(a). Consequently, given the simultaneous enactment and similar mechanics of the two sections, it can be inferred that Congress, in omitting such language from section 311(c), was manifesting its intention that the contrary or asset by asset approach be used.

Accordingly, the computation of gain under section 311(c) should be done on an asset by asset basis. Furthermore, so that this approach may be consistently applied, liabilities assumed in connection with section 311 (c) distributions but not related to any of the distributed property should be allocated among all such property according to relative fair market value. *Compare* Rev. Rul. 55-79, 1955-1 C.B. 370.

HOLDINGS

Situation 1:

X has a recognizable gain of $50x$ dollars under section 311(c). This represents the excess of the $250x$ dollar mortgage assumed by A over the $200x$ dollar adjusted basis of property I in the hands of X.

Situation 2:

X has no recognizable gain under section 311(c). Since $400x$ dollars, or 40 percent of the total fair market value of $1{,}000x$ dollars, is attributable to property I, 40 percent of the unrelated liability of $250x$ dollars, or $100x$ dollars, is allocable to that property and 60 percent, or $150x$ dollars, to property II. Therefore, with respect to both properties, adjusted basis exceeds the allocated liability and no gain results.

Situation 3:

X has a recognizable gain of $150x$ dollars under section 311(c). The liability allocation under *Situation 2* is combined with the specific encumbrance of *Situation 1* to give property I a total computation liability of $350x$ dollars ($100x$ dollars plus $250x$ dollars). The distribution thus results in a $150x$ gain to X ($350x$ dollars liability less $200x$ dollars adjusted basis) with respect to property I and no gain to X ($300x$ dollars adjusted basis less $150x$ dollars liabiilty) with respect to property II.

Subpart C.—Definitions; Constructive Ownership of Stock

Section 318.—Constructive Ownership of Stock

26 CFR 1.318-1: Constructive ownership of stock; introduction.

Whether the constructive ownership rules of section 318 apply to determine whether a decedent possessed voting control over transferred stock, for purposes of section 2036. See Rev. Rul. 80-346, page 271.

Part II.—Corporate Liquidations
Subpart A.—Effects on Recipients

Section 331.—Gain or Loss to Shareholders in Corporate Liquidations

26 CFR 1.331-1: Corporate liquidations. (Also Section 451; 1.451-2.)

Liquidating distribution; constructive receipt; surrender of shares. A domestic corporation, pursuant to a plan of complete liquidation, notified its shareholders that they would be entitled to receive a distribution in liquidation upon surrender of their shares of stock after a given date. All the corporation's liabilities had been discharged, its assets had been reduced to cash, and there was no likelihood that the liquidation would not be consummated. A cash method individual shareholder is in constructive receipt of the liquidating distribution as of the date the distribution first becomes payable.

Rev. Rul. 80-177

ISSUE

Is a shareholder of a liquidating corporation under the circumstances described below in receipt of the liquidating distribution at the time the distribution first becomes payable rather than on the date it is actually received by the shareholder upon surrender of his stock?

FACTS

Pursuant to a plan of complete liquidation adopted by a domestic corporation, each shareholder was notified prior to February 15, 1978, that he would be entitled to receive a distribution in liquidation upon surrender of his shares of stock at any time after March 1, 1978. As of March 1, 1978, all of the corporation's liabilities had been discharged and its assets had been reduced to cash, and events had progressed to such a point that there was no likelihood that the liquidation would not be consummated. Under the circumstances, the shareholders' rights "as shareholders" were effectively terminated when the distribution first became payable, rather than upon the shareholders' actual receipt when they surrendered their stock. All that the shareholders had

to do was turn in their shares and receive their money. Under local law the surrender of their stocks did not cause them to relinquish any rights which would constitute a "substantial limitation or restriction" on receipt of the money within the meaning of section 1.451-2(a) of the Income Tax Regulations.

The taxpayer, a United States person who had been a shareholder of the corporation for several years prior to 1978, used the cash receipts and disbursements method of accounting and filed federal income tax returns on the basis of a calendar year. In January 1979, the taxpayer surrendered all of the shares of stock to the corporation and received a single liquidating distribution in complete liquidation on that date.

LAW AND ANALYSIS

Section 331 of the Code provides the general rule that amounts distributed in complete liquidation of a corporation will be treated as in full payment in exchange for the stock. Neither section 331 nor the regulations thereunder set forth rules for determining when a distribution is received by the shareholder. The legislative history of section 331 indicates that its purpose was to characterize a liquidating distribution as an exchange (before the enactment in 1924 of the predecessor of section 331 such a distribution had been treated as a dividend) and there is no indication that Congress was concerned with establishing rules as to when a liquidating distribution is received by a shareholder. S. Rep. No. 398, 68th Cong., 1st Sess. 11-12 (1924), 1939-1 (Part 2) C.B. 266, 274 and H.R. Rep. No. 179, 68th Cong., 1st Sess. 11 (1924), 1939-1 (Part 2) C.B. 241, 249. Thus, all rules applicable to the receipt of income, including the constructive receipt doctrine, are applicable in determining when a liquidating distribution is received by a shareholder under section 331. However, with regard to the requirement of section 337(a) that all of the assets of a corporation be distributed in complete liquidation (less assets retained to meet claims) within the 12-month period beginning on the date of adoption of a plan of complete liquidation, see *Vern Realty, Inc. v. Commissioner,* 58 T.C. 1005, 1012 (1972), *aff'd.,* Civil No. 73-1030 (1st Cir. April 26, 1973), in which it was indicated that such requirement is not met unless the corporation actually distributes all of its assets within the 12-month period.

Section 451(a) of the Code provides that the amount of any item of gross income will be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-1(a) of the Income Tax Regulations provides that gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Section 1.451-1(a) also provides that under the cash receipts and disbursements method of accounting, the amount is includible in gross income when actually or constructively received.

Section 1.451-2(a) of the regulations provides that income, although not actually reduced to a taxpayer's possession, is constructively received by the taxpayer in the taxable year during which it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time, or so that the taxpayer could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, section 1.451-2(a) further provides that income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

In the present case, the liquidating distribution was payable March 1, 1978. There was no doubt that the liquidation would be consummated and that the distribution would be made since all liabilities had been discharged, the assets had been reduced to cash, and events had advanced to such a point that there was no likelihood that the liquidation would not be consummated. Furthermore, under the circumstances, the shareholders' rights "as shareholders" were effectively terminated when the distribution first became payable, rather than upon the shareholders' actual receipt when they surrendered their stock, since all they had to do was present the certificates and receive their money. The requirement that the certificates had to be presented for payment of the distribution is indistinguishable from the presentation of a pass book for crediting of interest earned on a savings account, and it did not represent a substantial restriction on the shareholders' right to the money under section 1.451-2 of the regulations. Since the shareholder used the cash receipts and disbursements method of accounting, and filed federal income tax returns on the basis of a calendar year, this item of income should have been included in gross income in 1978, the year the distribution was constructively received and not in 1979 when it was actually received.

HOLDING

Under the facts and circumstances of this case, the shareholder was in constructive receipt of the liquidating distribution on March 1, 1978, the time the distribution first became payable.

Section 334.—Basis of Property Received in Liquidations

26 CFR 1.334-1: Basis of property received in liquidations.

Liquidations; subsidiary; basis of assets. A personal holding com-

pany "purchased," within the meaning of section 334(b)(3) of the Code, all of the stock of a corporation having a wholly owned subsidiary on September 30, 1975, liquidated the parent on December 31, 1976, and liquidated the subsidiary on January 3, 1977. The personal holding company "purchased" the stock of the subsidiary on the date of liquidation of the parent. The "purchase" of the stock of the subsidiary did not occur within the 12-month period specified in section 334(b)(2)(B), and the basis in the subsidiary's assets to the personal holding company is determined under section 334(b)(1).

Rev. Rul. 80-358

ISSUE

Is the parent's (*P*) basis in a subsidiary's (*T*) assets received in a complete liquidation within the meaning of section 332(b) of the Internal Revenue Code determined with reference to section 334(b)(1) or section 334(b)(2)?

FACTS

S is a corporation engaged in a service business. For many years *S* has owned all of the stock of *T*, a corporation engaged in the same business as *S*. On September 30, 1975, *P*, a holding company, purchased, within the meaning of section 334(b)(3) of the Code, all of the outstanding stock of *S* for cash from an unrelated seller, with *T* remaining a wholly owned subsidiary of *S*. On December 31, 1976, *P*, pursuant to a plan of liquidation, completely liquidated *S* within the meaning of sections 332(b) and 334(b)(2), thus directly acquiring all of the stock of *T*. The basis of the stock of *T* in the hands of *P* was determined under section 334(b)(2). On January 3, 1977, *P*, pursuant to a plan of liquidation adopted on that date, liquidated *T*, within the meaning of section 332(b), and received *T*'s assets.

LAW AND ANALYSIS

The basis of assets received by a corporation upon the liquidation of another corporation within the meaning of section 332(b) of the Code is generally a carryover basis under section 334(b)(1). However, an exception to this general rule is contained in section 334(b)(2), which provides that the basis of assets so received in complete liquidation will be determined with reference to the adjusted basis of the parent corporation in the stock of the liquidated subsidiary, provided the requirements of section 334(b)(2) are met. One of these requirements, contained in section 334(b)(2)(B), is that stock of the distributing corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), must have been acquired by the distributee by purchase during a specific 12-month period. For this purpose, the term "purchase" is defined in section 334(b)(3), which provides:

> (3) Purchase defined.—For purposes of paragraph (2)(B), the term "purchase" means any acquisition of stock, but only if—
>
> (A) the basis of the stock in the hands of the distributee is not determined (i) in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired, or (ii) under section 1014(a) (relating to property acquired from a decedent),
>
> (B) the stock is not acquired in an exchange to which section 351 applies; and
>
> (C) the stock is not acquired from a person the ownership of whose stock would, under section 318(a) be attributed to the person acquiring such stock.
>
> Notwithstanding subparagraph (C) of this paragraph, for purposes of paragraph (2)(B), the term "purchase" also means an acquisition of stock from a corporation when ownership of such stock would be attributed under section 318(a) to the person acquiring such stock, if the stock of such corporation by reason of which such ownership would be attributed was acquired by purchase (within the meaning of the preceding sentence).

Section 318(a) of the Code provides that for the purposes of those provisions of Subchapter C of the Code to which the rules in this section are expressly made applicable, if 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, that person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.

In the present case, immediately prior to *P*'s liquidation of *S* and acquisition of the stock of *T*, *P* owned all the stock of *S*. *P* therefore acquired the stock of *T* from a corporation (*S*) whose ownership of the *T* stock was attributable to *P* under section 318(a) of the Code. Moreover, *P* had acquired the stock of *S* by purchase, within the meaning of section 334(b)(3), from an unrelated seller. *P*'s acquisition of the stock of *T* therefore qualified as a purchase within the meaning of the second sentence of section 334(b)(3). The issue of whether *P*'s basis in the *T* stock is determined under section 334(b)(1) or section 334(b)(2) thus depends upon whether *P*'s purchase of the requisite 80 percent of the *T* stock occurred during the 12-month period specified in section 334(b)(2)(B).

Section 334(b)(2)(B)(ii) of the Code specifies that if any of the stock of the distributing corporation (*T*) was acquired in an acquisition which is a purchase within the meaning of the second sentence of section 334(b)(3), then the 12-month period within which the 80 percent ownership of the stock of the distributing corporation (*T*) must be acquired by the distributee (*P*) begins on the date on which the distributee is first considered under section 318(a) as owning stock owned by the corporation (*S*) from which such acquisition was made.

P was first considered under section

318(a) of the Code as owning stock of *T* on September 30, 1975, the date upon which *P* acquired the stock of *S*. However, *P*'s "purchase" (within the meaning of section 334(b)(3)) of the stock of *T* did not occur until December 31, 1976, the date upon which the liquidation of *S* occurred. Therefore, *P*'s "purchase" of the requisite amount of the stock of *T* did not occur within the 12-month period specified by section 334(b)(2)(B).

HOLDING

P's basis in *T*'s assets received by *P* in complete liquidation of *T* is determined under section 334(b)(1) of the Code.

Subpart B.—Effects on Corporation

Section 337.—Gain or Loss on Sales or Exchanges in Connection With Certain Liquidations

26 CFR 1.337-6: Information to be filed.

T.D. 7722

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Election in certain liquidation for involuntary conversions

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to the election to extend the 12-month period for certain corporate liquidations where there is an involuntary conversion. Changes to the applicable tax law were made by the Act of November 10, 1978, Pub. L. 95-628, 1978-2 C.B. 435. The regulations provide necessary guidance to the public as to the time and manner for making the election.

DATE: The regulations are effective for dispositions of involuntarily converted property occurring after November 10, 1978.

FOR FURTHER INFORMATION CONTACT: Lawrence M. Axelrod of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:LR:T) (202-566-3458) (not a toll-free call).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On January 30, 1980, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 337 of the Internal Revenue Code of 1954 (45 FR 6800). The amendments were proposed to conform the regulations to section 4 of the Act of November 10, 1978 (92 Stat. 3628). A public hearing was neither requested nor held. After consideration of the one comment received regarding the proposed amendments, those amendments are adopted as revised by this Treasury decision.

Under section 337(e) of the Code, a liquidating corporation that qualifies under section 337(a) may elect to treat the disposition of involuntarily converted property, that occurred within 60 days preceding the date a plan of liquidation is adopted, as a sale or exchange occurring within the 12-month period beginning on that date. If the election is made, no gain or loss from any involuntary conversion during the 60-day period is recognized. H.R. Rep. No. 95-645, 95th Cong., 2d Sess. 7 (1978). Under section 337(e)(3), the Secretary is authorized to prescribe regulations specifying the time and manner in which the election is made.

The notice proposed that a corporation could elect the application of section 337(e) by adding a sentence to a statement, presently required under § 1.337-6, expressly electing to apply section 337(e). The notice further proposed that the statement would have to be filed with a timely filed original return of the electing corporation.

After considering the comment received, it was determined that the election should not be made with the statement presently required under § 1.337-6. The Service has ruled that a corporation will not be denied the benefit of section 337(a), for failure to report the information required by § 1.337-6, because section 337(a) is not an elective provision but is mandatory for transactions that meet the statutory requirements (Rev. Rul. 65-30, 1965-1 C.B. 155). On the other hand, section 337(e) is elective. If the corporation fails to make an election under that section, it will not receive the benefit. Furthermore, the return of the liquidating corporation, for the taxable year for which certain information is required under § 1.337-6, may not be the return for the taxable year for which gain (or loss) is reportable for property involuntarily converted during the 60-day period described in section 337(e)(2). Lastly, since section 337(e) was enacted as a relief provision, it seemed harsh to deny a liquidating corporation the benefit of that provision simply because the corporation failed to make the election with the original return.

Accordingly, the final regulations provide that a corporation must file with its return or amended return, for the earliest taxable year for which income (or loss) attributable to involuntarily converted property would otherwise be reportable, a statement that it elects the application of section 337(e) to such property converted during the 60-day period described in section 337(e)(2). The statement must include a general description of all property involuntarily converted during that period.

DRAFTING INFORMATION

The principal author of this regulation is Lawrence M. Axelrod of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

Section 1.337-6 is amended by adding a new paragraph (c) at the end to read as follows:

§ 1.337-6 Information to be filed.

* * * * *

(c) *Election under section 337(e).* (1) Section 337(e) applies to a disposition of converted property (within the meaning of section 1033(a)(2)(E)(ii)) occurring after November 10, 1978, but only if a proper election is made.

(2) To make the election—

(i) A liquidating corporation must file a statement that it elects 337(e) for all of its property involuntarily converted during the 60-day period described in section 337(e)(2).

(ii) The statement must be filed with its return or amended return for the earliest taxable year for which income (or loss) would otherwise be reportable for such conversions.

(iii) The statement must include the name of the liquidating corporation, its taxpayer identification number, a general description of the property, and the date or dates of the conversions. The general description of the property should be sufficient to apprise the Commissioner as to which business and which assets were involuntarily converted. The requirement that a general description of the property be provided is not intended to impose on the taxpayer the burden of listing each item of property destroyed. For example, assume a fire, which destroys a men's clothing store and all the contents therein, precipitates the adoption of a plan of liquidation. A satisfactory statement would set forth the date of the fire, the location of the store, and that furniture, fixtures, inventory, and records of a men's clothing store were destroyed.

(3) If, following the filing of an election under section 337(e), a liquidating corporation fails to satisfy the requirements for a complete liquidation under section 337(a), the corporation must file an amended return reporting any gain or loss that was not recognized by reason of its election under section 337(e).

This Treasury decision is issued under the authority contained in sections 337(e) and 7805 of the Internal Revenue Code of 1954 (92 Stat. 3628, 68A Stat. 917; 26 U.S.C. 337(e), 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved September 16, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 30, 1980, 8:45 a.m., and published in the issue of the Federal Register for October 1, 1980, 45 F.R. 64906)

Part III.—Corporate Organizations and Reorganizations
Subpart A.—Corporate Organizations

Section 351.—Transfer to Corporation Controlled by Transferor

26 CFR 1.351-1: Transfer to corporation controlled by transferor.
(Also Section 482; 1.482-1.)

Controlled corporations; transfers; accounts payable and accounts receivable. An individual transferred all of the assets and liabilities of a sole proprietorship, which included accounts payable and accounts receivable, to a new corporation in exchange for all of the corporate stock. Both the individual prior to the transfer and the new corporation used the cash method of accounting. There was a valid business purpose for the transfer, and the individual had neither accumulated the accounts receivable nor prepaid any of the accounts payable in anticipation of the incorporation. The transfer is an exchange qualifying under section 351 of the Code.

Rev. Rul. 80-198

ISSUE

Under the circumstances described below, do the nonrecognition of gain or loss provisions of section 351 of the Internal Revenue Code apply to a transfer of the operating assets of an ongoing sole proprietorship (including unrealized accounts receivable) to a corporation in exchange solely for the common stock of a corporation and the assumption by the corporation of the proprietorship liabilities?

FACTS

Individual *A* conducted a medical practice as a sole proprietorship, the income of which was reported on the cash receipts and disbursements method of accounting. *A* transferred to a newly organized corporation all of the operating assets of the sole proprietorship in exchange for all of the stock of the corporation, plus the assumption by the corporation of all of the liabilities of the sole proprietorship. The purpose of the incorporation was to provide a form of business organization that would be more conducive to the planned expansion of the medical services to be made available by the business enterprise.

The assets transferred were tangible assets having a fair market value of $40,000 and an adjusted basis of $30,000 and unrealized trade accounts receivable having a face amount of

$20,000 and an adjusted basis of zero. The liabilities assumed by the corporation consisted of trade accounts payable in the face amount of $10,000. The liabilities assumed by the corporation also included a mortgage liability, related to the tangible property transferred, of $10,000. *A* had neither accumulated the accounts receivable nor prepaid any of the liabilities of the sole proprietorship in a manner inconsistent with normal business practices in anticipation of the incorporation. If *A* had paid the trade accounts payable liabilities, the amounts paid would have been deductible by *A* as ordinary and necessary business expenses under section 162 of the Code. The new corporation continued to utilize the cash receipts and disbursements method of accounting.

LAW AND ANALYSIS

The applicable section of the Code is section 351(a), which provides that no gain or loss shall be recognized when property is transferred to a corporation in exchange solely for stock and securities and the transferor is in control (as defined by section 368(c)) of the transferee corporation immediately after the transfer.

In *Hempt Bros., Inc. v. United States*, 490 F.2d 1172 (3rd Cir. 1974), *cert. denied*, 419 U.S. 826 (1974), the United States Court of Appeals for the Third Circuit held, as the Internal Revenue Service contended, that a cash basis transferee corporation was taxable on the monies it collected on accounts receivable that had been transferred to it by a cash basis partnership in a transaction described in section 351(a) of the Code. The corporate taxpayer contended that it was not obligated to include the accounts receivable in income; rather the transferor partnership should have been taxed on the stock the partnership received under the assignment of income doctrine which is predicated on the well established general principle that income be taxed to the party that earned it.

The court in *Hempt Bros.* solved the conflict between the assignment of income doctrine and the statutory nonrecognition provisions of section 351 of the Code by reasoning that if the cash basis transferor were taxed on the transfer of the accounts receivable, the specific congressional intent reflected in section 351(a) that the incorporation of an ongoing business should be facilitated by making the incorporation tax free would be frustrated.

The facts of the instant case are similar to those in *Hempt Bros.* in that there was a valid business purpose for the transfer of the accounts receivable along with all of the assets and liabilities of *A*'s proprietorship to a corporate transferee that would continue the business of the transferor. Further, *A* had neither accumulated the accounts receivable nor prepaid any of the account payable liabilities of the sole proprietorship in anticipation of the incorporation, which is an indication that, under the facts and circumstances of the case, the transaction was not designed for tax avoidance.

HOLDING

The transfer by *A* of the operating assets of the sole proprietorship (including unrealized accounts receivable) to the corporation in exchange solely for the common stock of the corporation and the assumption by the corporation of the proprietorship liabilities (including accounts payable) is an exchange within the meaning of section 351(a) of the Code. Therefore, no gain or loss is recognized to *A* with respect to the property transferred, including the accounts receivable. For transfers occurring on or after November 6, 1978 (the effective date of the Revenue Act of 1978, Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1, 88, with respect to sections 357(c)(3) and 358(d)(2) of the Code) the assumption of the trade accounts payable that would give rise to a deduction if *A* had paid them is not, pursuant to section 357(c)(3), considered as an assumption of a liability for purposes of sections 357(c)(1) and 358(d). See Rev. Rul. 80-199, this page, this Bulletin, for transfers occurring before November 6, 1978, which holds that trade accounts payable transferred to a corporation in a transaction to which section 351(a) applies are not liabilities for the purposes of sections 357(c) and 358(d) if the transferor of the accounts payable could have deducted the amounts paid in satisfaction thereof under section 162 if the transferor had paid these amounts in satisfaction of the payables prior to the exchange. The corporation, under the cash receipts and disbursements method of accounting, will report in its income the account receivables as collected, and will be allowed deductions under section 162 for the payments it makes to satisfy the assumed trade accounts payable when such payments are made.

A's basis in the stock received in the exchange of property for stock under section 358(a)(1) of the Code is $20,000 which is calculated by decreasing *A*'s $30,000 basis in the assets transferred by the $10,000 mortgage liability under sections 358(a)(1)(A)(ii) and 358(d)(1). No adjustment to such basis is made under section 358(a)(1)(A)(ii) because of the assumption by the corporation of the $10,000 in accounts payable inasmuch as the general rule of section 358(d)(1), which requires the basis in the stock received to be decreased by the liabilities assumed, does not apply by reason of section 358(d)(2), which provides that section 358(d)(1) does not apply to the amount of any liabilities defined in section 357(c)(3) such as accounts payable that would have been deductible by *A* as ordinary and necessary business expenses under section 162 in the taxable year paid if *A* had paid these liabilities prior to the exchange. See Rev. Rul. 80-199, with respect to transfers which have occurred before November 6, 1978 (the

date of the enactment of the Revenue Act of 1978).

LIMITATIONS

Section 351 of the Code does not apply to a transfer of accounts receivable which constitute an assignment of an income right in a case such as *Brown v. Commissioner*, 40 B.T.A. 565 (1939), *aff'd* 115 F.2d 337 (2d Cir. 1940). In *Brown*, an attorney transferred to a corporation, in which he was the sole owner, a one-half interest in a claim for legal services performed by the attorney and his law partner. In exchange, the attorney received additional stock of the corporation. The claim represented the corporation's only asset. Subsequent to the receipt by the corporation of the proceeds of the claim, the attorney gave all of the stock of the corporation to his wife. The United States Court of Appeals for the Second Circuit found that the transfer of the claim for the fee to the corporation had no purpose other than to avoid taxes and held that in such a case the intervention of the corporation would not prevent the attorney from being liable for the tax on the income which resulted from services under the assignment of income rule of *Lucas v. Earl*, 281 U.S. 111 (1930). Accordingly, in a case of a transfer to a controlled corporation of an account receivable in respect of services rendered where there is a tax avoidance purpose for the transaction (which might be evidenced by the corporation not conducting an ongoing business), the Internal Revenue Service will continue to apply assignment of income principles and require that the transferor of such a receivable include it in income when received by the transferee corporation.

Likewise, it may be appropriate in certain situations to allocate income, deductions, credits, or allowances to the transferor or transferee under section 482 of the Code when the timing of the incorporation improperly separates income from related expenses. See *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962), where a farming operation was incorporated in a transaction described in section 351(a) after the expenses of the crop had been incurred but before the crop had been sold and income realized. The transferor's tax return contained all of the expenses but none of the farming income to which the expenses related. The United States Court of Appeals for the Ninth Circuit held that the expenses could be allocated under section 482 to the corporation, to be matched with the income to which the expenses related. Similar adjustments may be appropriate where some assets, liabilities, or both, are retained by the transferor and such retention results in the income of the transferor, transferee, or both, not being clearly reflected.

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26 CFR 1.351-1: Transfer to corporation controlled by transferor.

Controlled corporations; transfers; intracompany account payable. A corporation that operated its business in two separate divisions transferred all of the assets of one division to a new corporation in exchange for all of the new corporation's stock. There were valid business reasons for the transfer, and at the time of the transfer there was an intracompany account payable due from the division whose assets were transferred. The original corporation received "other property" within the meaning of section 351(b) of the Code and must recognize gain in the amount of the account payable.

Rev. Rul. 80-228

ISSUE

In the facts described below, did *X* corporation receive "other property" from *Y* corporation within the meaning of section 351(b) of the Internal Revenue Code?

FACTS

X corporation operated its business in two entirely separate divisions ("Division 1" and "Division 2"), keeping a separate bank account and a separate set of books for each division. Each division also maintained an intracompany account in their respective books of account and transactions between the two divisions were recorded therein. For valid business reasons *X* organized a new corporation, *Y*. All the assets of Division 2 were transferred by *X* to *Y* at net book value in exchange for all of the stock of *Y*. At the time of the transfer, the intracompany account payable due to Division 1 from Division 2 was 100*x* dollars. On its opening balance sheet *Y* listed an account payable to *X* of 100*x* dollars and *X*, conversely, listed an account receivable from *Y* of 100*x* dollars. Within one year after the transfer the account payable of *Y* was paid in full to *X*.

LAW AND ANALYSIS

The nonrecognition provisions of 351(a) of the Code provide that where property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control of the corporation, no gain or loss is recognized in the transaction. If, however, in addition to stock or securities, "other property" is received by the transferor, the transferor must recognize gain on the exchange but not in excess of the fair market value of the "other property" received pursuant to section 351(b).

It is a well established principle of tax law that short-term notes and other evidences of indebtedness received in a reorganization constitute "other property." See *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2nd Cir. 1932), XII-1 C.B. 164 and *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933), XII-1 C.B. 161.

When *Y* was organized as a separate corporation, and an account payable from *Y* to *X* was established (and, correlatively, an account receivable was reflected by *X* on its books), a real liability on the part of *Y* (and a real asset on the part of *X*) came into being. The intracompany account payable (and the intracompany account receivable) did not simply "carry over" to the books of *Y*. Instead, *X* received something other than merely the stock of *Y*.

In the instant case the account receivable to *X* from *Y* was a note or other evidence of indebtedness received by *X* in a section 351 transaction and it constituted "other property" for purposes of section 351(b) of the Code. This is due to the fact that the preincorporation intracompany accounts could not have given rise to a debtor-creditor relationship between *X* and *Y* because *X* could not, prior to incorporation of *Y*, have been liable for a debt to itself. The intracompany accounts were mere bookkeeping entries by *X*, a single corporation, to show the activities of separate divisions for internal accounting purposes.

In *Wham Construction Company, Inc. v. United States,* Civil No. 72-689 (D.S.C., Feb. 16, 1976), *aff'd* Civil No. 76-2047 (4th Cir. 1979), on facts similar to those set forth above, the District Court, in holding for the taxpayer, determined that the account receivable represented a mere loan to the new subsidiary from the transferor for which the transferor received only a return of capital. In its affirmance of the District Court's decision in *Wham*, the Court of Appeals reasoned that where there was but one transferor and where the transferee corporation had no assets other than those derived from the transferor, it found it difficult to conceive of a concept wherein the transferor, as a result of the transaction, received anything which it did not have prior to the incorporation. However, the facts indicate that there was indisputably no borrowing from a bank by the new subsidiary, nor was there any loan from the transferor to the new subsidiary subsequent to the incorporation of the new subsidiary. The Court of Appeals also ignored the fact that prior to the incorporation of the new subsidiary there was no debt owed by it to the transferor.

Consequently, the Internal Revenue Service will not follow the decision of the United States Court of Appeals for the Fourth Circuit in *Wham.*

HOLDING

X did receive "other property" in the form of the 100*x* dollar account receivable and, pursuant to section 351(b) of the Code, must recognize gain in that amount.

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26 CFR 1.351-1: Transfer to corporation controlled by transferor.
(Also Sections 304, 357; 1.304-2, 1.357-1.)

Transfer of assets to new corporation; liabilities assumed. In order to acquire indirect ownership of a bank through a bank holding company and to satisfy the appropriate banking rules and regulations, an individual borrowed money from an unrelated financial institution to acquire 90 percent of the bank's stock and acquired the remaining stock with personal funds. The individual then formed a new bank holding company and immediately transferred all of the bank's stock to it in exchange for all of the holding company's stock and the holding company's assumption of the individuals' acquisition indebtedness. Section 351(a) of the Code applies to the transfer, the individual is treated as a mere intermediate agent employed solely to satisfy non-tax rules and regulations, and the assumption of the indebtedness is disregarded.

Rev. Rul. 80-240

ISSUE

Does section 351(a) of the Internal Revenue Code apply to the transaction described below?

FACTS

X is a corporation engaged in the general banking business that has solely common stock outstanding. In order to acquire indirect ownership of *X* through a bank holding company and to satisfy the appropriate banking rules and regulations, *A*, an individual who previously owned no *X* stock, devised the following plan. *A* first borrowed money from an unrelated financial institution *B* to acquire ninety percent of the *X* stock, pledging the *X* stock as security. *A* acquired the remaining 10 percent of *X* stock with his personal funds. *A* then formed *Y*, a new corporation, to be operated as a bank holding company, and immediately transferred all the *X* stock to Y. In exchange therefor, *Y* issued to *A* all of its stock and assumed the indebtedness incurred by *A*. The assumption by *Y* was done with the agreement of *B* and operated to release *A* from any liability with respect to the borrowed funds.

LAW AND ANALYSIS
AND HOLDING

Section 351(a) of the Code provides, in part, that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the Code.

Section 368(c) of the Code provides that the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent

of the total number of shares of all other classes of stock of the corporation.

Section 304(a)(1) of the Code provides, in part, that where one or more persons are in control, as defined in section 304(c), of each of two corporations and, in return for property, one of the corporations acquires stock in the other corporation from the person or persons so in control, the property received will be treated under section 302 as a distribution in redemption of stock of the corporation acquiring such stock. Section 304(c) provides, in part, that control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock.

Section 357(a) provides, in part, that, except as provided in sections 357(b) and (c), if (1) the taxpayer receives property that would be permitted to be received under section 351 without the recognition of gain if it were the sole consideration, and (2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability, then such assumption or acquisition shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351.

Section 351 of the Code applies to the transfer by *A* of the *X* stock to *Y* in exchange for the *Y* stock because *A* was in control of *Y* (as defined in section 368(c)) immediately after the exchange. It must be determined, however, whether section 357(a) or section 304(a)(1) applies to the assumption by *Y* of the indebtedness incurred by *A* in the transaction.

If *A* had first formed *Y* and then had caused *Y* to borrow money from *B* so that *Y* would have directly acquired the 90 percent of the shares of *X* stock, there would have been no need for an assumption of the indebtedness by *Y*. In substance, there was no plan or intention for *A* to either own the *X* stock, or to repay the loan proceeds which were used to acquire that stock. Thus, for federal income tax purposes, *A* will be treated for this part of the transaction as a mere intermediate agent employed solely to satisfy non-tax related rules and regulations and the assumption of the indebtedness will be disregarded. See *Ciaio v. Commissioner*, 47 T.C. 447 (1967), *acq.*, 1967-2 C.B. 2 and *Fox v. Harrison*, 145 F.2d 521 (7th Cir. 1944). Consequently, neither section 357(a) of the Code nor section 304(a)(1) have any application to the transaction since there is no assumption of a liability and also no "property" is distributed by *Y*, the acquiring-transferee corporation, within the meaning of section 304(a)(1).

Compare Rev. Rul. 80-239, page 103, this Bulletin, for tax treatment where a transferor received cash in addition to stock of the transferee corporation.

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26 CFR 1.351-1: Transfer of corporation controlled by transferor.

Transfer to controlled corporation; continuity of interest. Section 351(a) of the Code does not apply to an individual's exchange of the 14 percent of the stock of a corporation owned by the individual for the preferred stock of a newly formed subsidiary of another corporation as part of a plan for the subsidiary's parent to acquire all the stock of the first corporation.

Rev. Rul. 80-284

ISSUE

Will nonrecognition treatment under section 351(a) of the Internal Revenue Code be accorded to a transfer of 14 percent of the stock of a corporation (*T*) to another corporation (*S*) in exchange for *S* stock as part of a plan whereby *S* acquires the remaining 86 percent of the *T* stock for cash?

FACTS

T, a manufacturing corporation, had outstanding 1,000*x* shares of capital stock. The fair market value of *T* was 100,000*x* dollars, and the fair market value of each share of its outstanding stock was 100*x* dollars. *T*'s president and chairman of the board, *A*, owned 140*x* shares of its capital stock (14 percent). The remaining 860*x* shares of *T*'s capital stock (86 percent) were publicly held. *P*, a large publicly traded corporation unrelated to *T*, wished to purchase the stock of *T* and thereafter to have *T*'s business continued by a wholly owned subsidiary. While the other shareholders of *T* were willing to accept cash for their *T* stock, *A*, who was of an advanced age and who had a very low basis in his 140*x* shares, was unwilling to sell the *T* stock for cash because the sale would result in recognition of taxable gain.

In order to accommodate *A*'s wish to avoid recognition of gain, *P* and *A* agreed in January, 1980, to organize a new corporation, *S*, for the purpose of acquiring and holding all of the stock of *T*. Several months later, pursuant to the agreement, *P* transferred 86,000*x* dollars in cash together with other property to *S* solely in exchange for all of *S*'s common stock, and *A* transferred his 140*x* shares of *T* stock to *S* solely in exchange for all of *S*'s preferred stock. It was intended that this transaction would be a tax-free exchange under section 351(a) of the Code. Thereafter, and as part of the overall plan, *S* organized a new corporation, *D*, by transferring the 86,000*x* dollars in cash to *D* solely in exchange for all of *D*'s stock. *D* was then merged into *T* under applicable state law, and pursuant thereto each share of *T* stock, except those shares transferred by *A* to *S*, was surrendered in exchange for 100*x* dollars in cash. The *T* stock acquired by *D* for cash was cancelled and, pursuant to state law, each share of *D* stock was converted into stock of *T*. Although *S*

could theoretically have acquired the remaining 86 percent of the *T* stock directly from the *T* shareholders for cash, the acquisition was made pursuant to the state merger laws because this method was more expeditious and convenient. *T* remains in existence as an operating company, and *S* remains in existence as a holding company.

LAW AND ANALYSIS

Section 351(a) of the Code provides that no gain or loss is recognized if persons who control a corporation transfer property to the corporation solely in exchange for stock or securities. Section 351(a) is an exception to the general rule that gain or loss must be recognized on any sale or exchange of property. See section 1.1002-1(b) of the Income Tax Regulations, which states that exceptions to the general rule (including section 351(a)) "are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule."

Thus, while *A*'s exchange of common stock for preferred stock may satisfy all of the literal requirements of section 351 of the Code, it does not follow that Congress meant to cover such an exchange, even though "the facts answer the dictionary definition of each term used in the statute." See *Helvering v. Gregory,* 69 F.2d 809, 810 (2nd Cir. 1934) (Hand, J.), *aff'd,* 293 U.S. 465 (1935), Ct. D. 911, XIV-1 C.B. 193 (1935).

Section 351(a) of the Code is intended to apply to "certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture." *Portland Oil Co. v. Commissioner,* 109 F.2d 479, 488 (1st Cir. 1940), *cert. denied,* 310 U.S. 650 (1940). See also Rev. Rul. 73-472, 1973-2 C.B. 114. On the other hand, section 351(a) is not intended to apply to transactions that sufficiently resemble a sale so that gain is recognized in a popular and economic sense. Thus, the issue presented is whether, in terms of economic substance, there has been a mere change in the form of investment or a cashing in of that investment.

A's exchange of common stock for preferred stock is an integral part of a larger transaction. In the larger transaction, *P,* acting through its subsidiary *S,* acquires all the stock of an unrelated third corporation *T.* Thus, viewed from the perspective of all the parties, the larger transaction fits a pattern common to acquisitive reorganizations. Contrast Rev. Rul. 57-190, 1957-1 C.B. 121, and Rev. Rul. 57-464, 1957-2 C.B. 244 (which describe transfers to a controlled corporation as part of a larger transaction that fits a pattern common to divisive reorganizations).

A well-established continuity of interest test applies to acquisitive reorganizations. See section 1.368-1(b) of the Regulations and Rev. Rul. 66-224, 1966-2 C.B. 114. The object of the continuity of interest test is to identify acquisitive transactions that sufficiently resemble a sale so gain is recognized in the ordinary business sense. See *Roebling v. Commissioner,* 143 F.2d 810, 812 (3rd Cir. 1944), *cert. denied,* 323 U.S. 773 (1944).

Under the continuity of interest test, a substantial portion of the consideration paid must consist of stock in the acquiring corporation. See *Southwest Natural Gas Co. v. Commissioner,* 189 F.2d 332, 334 (5th Cir. 1951), *cert. denied,* 342 U.S. 860 (1951). If an acquisitive transaction fails the continuity of interest test, then the transaction as a whole sufficiently resembles a sale so all the parties recognize gain in the ordinary business sense.

The larger acquisitive transaction in which *S* obtains the stock of *T* fails the continuity of interest test. It follows that the transaction as a whole sufficiently resembles a sale so all the parties (including *A*) recognize gain in the ordinary business sense. Because section 351 of the Code is not intended to apply where gain is recognized in the ordinary business sense, *A*'s exchange is not within the "underlying assumptions and purposes" of section 351. See section 1.1002-1(b) of the regulations.

No other conclusion would be consistent with the history and purpose of continuity of interest. In a series of decided cases, the courts have denied nonrecognition treatment to acquisitive transactions that lacked continuity of interest. See, *e.g.,* in addition to the cases cited above, *LeTulle v. Scofield,* 308 U.S. 415 (1940), Ct. D. 1432, 1940-1 C.B. 151, *Pinellas Ice & Cold Storage Co. v. Commissioner,* 287 U.S. 462 (1933), Ct. D. 630, XII-1 C.B. 161 (1933), and *Cortland Speciality Co. v. Commissioner,* 60 F.2d 937 (2d Cir. 1932), *cert. denied,* 288 U.S. 599 (1933). The defect in each case was entirely one of substance; the transaction at issue satisfied all of the technical requirements for nonrecognition under the satutory provisions that were directly relevant. A defect of this kind cannot be remedied by means that are essentially formal. In particular it cannot be remedied merely by rearranging the form of an acquisitive transaction so that the technical requirements of section 351 of the Code are satisfied, but without altering the substance of the transaction.

In this ruling, the facts reveal an acquisitive transaction which does not meet the continuity of interest test and thus is equivalent to a sale. Accordingly, although the technical requirements of section 351(a) of the Code are satisfied, the transaction is beyond

the underlying assumptions and purposes of section 351(a). Therefore, its substance as a sale remains the same, and the transaction will be treated as a taxable exchange. Compare Rev. Rul. 80-285, this page, this Bulletin, which reaches the same result when assets, instead of stock, are acquired under similar circumstances.

HOLDING

A's exchange of capital stock in *T* for preferred stock in *S* does not qualify for nonrecognition treatment under section 351(a) of the Code, and gain is therefore recognized on the exchange.

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26 CFR 1.351-1: Transfer to corporation controlled by transferor.
(Also Section 302; 1.302-4.)

Transfer to controlled corporation; continuity of interest. Section 351(a) of the Code does not apply to a corporation's transfer of all its assets to a newly organized corporation for securities and all the voting preferred stock of the new corporation as part of a plan of the new corporation's parent to acquire all the assets of the first corporation.

Rev. Rul. 80-285

ISSUE

Will nonrecognition treatment under section 351(a) of the Internal Revenue Code be accorded to a transfer of all of the assets of a corporation (*Y*) to another corporation (*Z*) in exchange for *Z* stock and *Z* securities, where, as part of the plan, *Y* redeems 81 percent of its stock for the *Z* securities?

FACTS

Y, a manufacturing corporation, had outstanding 1,000*x* shares of capital stock. The fair market value of *Y* was 100,000*x* dollars, and the fair market value of each share of its outstanding stock was 100*x* dollars. *Y*'s president and chairman of the board, *A*, owned 190*x* shares of its capital stock (19 percent). The remaining 810*x* shares of *Y*'s capital stock (81 percent) were publicly held. *X*, a large publicly traded corporation unrelated to *Y*, wished to purchase all of the assets of *Y* and thereafter to have *Y*'s business continued by a wholly owned subsidiary. While the other shareholders of *Y* were willing to accept cash or securities for their *Y* stock, *A*, who was of an advanced age and who had a very low basis in his 190*x* shares, was unwilling to sell the *Y* stock for cash or securities because the sale would result in recognition of taxable gain. The public shareholders of *Y* are unrelated to *A*, within the meaning of section 318 of the Code.

In order to accommodate *A*'s wish to avoid recognition of gain, *X* and the *Y* shareholders agreed in January, 1980, to have *X* and *Y* organize a new corporation, *Z*, for the purpose of acquiring and holding all of the assets of *Y*. Several months later, pursuant to the agreement, *X* transferred 81,000*x* dollars in cash together with other property to *Z* solely in exchange for all of *Z*'s common stock, and *Y* transferred all of its assets to *Z* solely in exchange for all of *Z*'s voting preferred stock and *Z* securities. It was intended that this transaction would qualify as an exchange under section 351 of the Code. Thereafter, and as part of the overall plan, *Y* redeemed all of its stock (81 percent) held by its public shareholders for the *Z* securities. All transfers and exchanges were at fair market value. The value of the property and cash transferred by *X* to *Z* was over 80 times the value of the property transferred by *Y* to *Z*. Therefore, the *Z* common stock received by *X* in the exchange comprised over 80 percent of the total combined voting power of all classes of *Z* stock entitled to vote. *Z* remains in existence as an operating company, and *Y* remains in existence as a wholly owned holding company of *A*. After all of the exchanges occurred, *Z* owned all of the assets of *Y*, *X* owned all of the *Z* common stock, *Y* owned all of the *Z* voting preferred stock, *A* owned all of the *Y* stock, and the *Y* public shareholders received all of the *Z* securities in exchange for their *Y* stock.

LAW AND ANALYSIS

Section 351(a) of the Code provides that no gain or loss is recognized if persons who control (within the meaning of section 368(c)) a corporation transfer property to the corporation solely in exchange for stock or securities. Section 351(a) is an exception to the general rule that gain or loss must be recognized on any sale or exchange of property. See section 1.1002-1(b) of the Income Tax Regulations, which states that exceptions to the general rule (including section 351(a)) "are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule."

Thus, while *Y*'s exchange of assets for voting preferred stock and *Z* securities may satisfy all of the literal requirements of section 351 of the Code, it does not follow that Congress meant to cover such an exchange, even though "the facts answer the dictionary definition of each term used in the statute." See *Helvering v. Gregory*, 69 F.2d 809, 810 (2nd Cir. 1934) (Hand, J.), *aff'd*, 293 U.S. 465 (1935), Ct. D. 911, XIV-1 C.B. 193 (1935).

Section 351(a) of the Code is intended to apply to "certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the

theoretical gain, or closed out a losing venture." *Portland Oil Co. v. Commissioner,* 109 F.2d 479, 488 (1st Cir. 1940), *cert. denied,* 310 U.S. 650 (1940). See also Rev. Rul. 73-472, 1973-2 C.B. 114. On the other hand, section 351(a) is not intended to apply to transactions that sufficiently resemble a sale so that gain is recognized in a popular and economic sense. Thus, the issue presented is whether, in terms of economic substance, there has been a mere change in the form of investment or a cashing in of that investment.

Y's transfer of assets for voting preferred stock and *Z* securities is an integral part of a larger transaction. In the larger transaction, *X,* acting through its subsidiary, *Z,* acquires all the assets of an unrelated third corporation, *Y.* Thus, viewed from the perspective of all the parties, the larger transaction fits a pattern common to acquisitive reorganizations. Contrast Rev. Rul. 57-190, 1957-1 C.B. 121, and Rev. Rul. 57-464, 1957-2 C.B. 244 (which describe transfers to a controlled corporation as part of a larger transaction that fits a pattern common to divisive reorganizations).

A well-established continuity of interest test applies to acquisitive reorganizations. See section 1.368-1(b) of the regulations and Rev. Rul. 66-224, 1966-2 C.B. 114. The object of the continuity of interest test is to identify acquisitive transactions that sufficiently resemble a sale so gain is recognized in the ordinary business sense. See *Roebling v. Commissioner,* 143 F.2d 810, 812 (3rd Cir. 1944), *cert. denied,* 323 U.S. 773 (1944).

Under the continuity of interest test, a substantial portion of the consideration paid must consist of stock in the acquiring corporation. See *Southwest Natural Gas Co. v. Commissioner,* 189 F.2d 332, 334 (5th Cir. 1951), *cert. denied,* 342 U.S. 860 (1951). If an acquisitive transaction fails the continuity of interest test, then the transaction as a whole sufficiently resembles a sale so all the parties recognize gain in the ordinary business sense.

The larger acquisitive transaction in which *Z* obtains all of the assets of *Y,* and the public shareholders receive *Z* securities for their 81 percent interest in *Y,* fails the continuity of interest test. It follows that the transaction as a whole sufficiently resembles a sale so all of the exchanging parties (including *Y*) recognize gain in the ordinary business sense. Because section 351 of the Code is not intended to apply where gain is recognized in the ordinary business sense, *Y*'s exchange is not within the "underlying assumptions and purposes" of section 351. See section 1.1002-1(b) of the regulations.

No other conclusion would be consistent with the history and purpose of continuity of interest. In a series of decided cases, the courts have denied nonrecognition treatment to acquisitive transactions that lacked continuity of interest. See, *e.g.,* in addition to the cases cited above, *LeTulle v. Scofield,* 308 U.S. 415 (1940), Ct. D. 1432, 1940-1 C.B. 151, *Pinellas Ice & Cold Storage Co. v. Commissioner,* 287 U.S. 462 (1933), Ct. D. 630, XII-1 C.B. 161 (1933), and *Cortland Specialty Co. v. Commissioner,* 60 F.2d 937 (2nd Cir. 1932), *cert. denied,* 288 U.S. 599 (1933). The defect in each case was entirely one of substance; the transaction at issue satisfied all of the technical requirements for nonrecognition under the statutory provisions that were directly relevant. A defect of this kind cannot be remedied by means that are essentially formal. In particular it cannot be remedied merely by rearranging the form of an acquisitive transaction so that the technical requirements of section 351 of the Code are satisfied, but without altering the substance of the transaction.

In this ruling, the facts reveal an acquisitive transaction which does not meet the continuity of interest test and thus is equivalent to a sale. Accordingly, although the technical requirements of section 351(a) of the Code are satisfied, the transaction is beyond the underlying assumptions and purposes of section 351(a). Therefore, its substance as a sale remains the same, and the transaction will be treated as a taxable exchange. Compare Rev. Rul. 80-284, page 8, this Bulletin, which reaches the same result when stock, instead of assets, is acquired under similar circumstances.

Y redeemed its stock (within the meaning of section 317(b) of the Code) held by its public shareholders for *Z* securities at fair market value. Since each such shareholder's interest in *Y* was completely terminated, each exchange qualifies as a redemption within the meaning of section 302(b)(3). Therefore, section 302(a) applies to the gain realized on the exchange by each public shareholder. See Rev. Rul. 79-273, 1979-2 C.B. 125, for a similar result where a redemption and statutory merger are used to acquire stock.

HOLDING

Y's exchange of all of its assets for *Z* voting preferred stock and *Z* securities does not qualify for nonrecognition treatment under section 351(a) of the Code, and gain is therefore recognized on the exchange. *X*'s exchange of cash and property for *Z* common stock qualifies for nonrecognition of gain or loss under section 351(a), since *X* controls over 80 percent of the total combined voting power of all classes of stock of *Z* entitled to vote, and at least 80 percent of the total number of shares of all other classes of *Z* stock (since there were none), immediately after the transfer. See Rev. Rul. 68-43, 1968-1 C.B. 146.

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26 CFR 1.351-1: Transfer to corporation controlled by transferor.

Whether in a section 351 incorporation the term "liabilities" as used in sections 357 and 358(d) of the Code prior to amendment by the Revenue Act of 1978 on November 6, 1978, includes accounts payable deductible under section 162 of the Code. See Rev. Rul. 80-199, page 122.

26 CFR 1.351-1: Transfer to corporation controlled by transferor.

Whether the nonrecognition of gain provisions of section 351 of the Code apply to a domestic person's transfer of the properties of its foreign branch that were used predominantly without the United States to a foreign corporation solely in exchange for all of the stock of such corporation. See Rev. Rul. 80-246, page 125.

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26 CFR 1.351-1: Transfer to corporation controlled by transferor.

Whether a transferor bank must consider as a reduction in eligible loans outstanding at the beginning of the year of transfer, that portion of the bank's loans transferred in a section 351 transaction in calculating the maximum addition to the reserve for losses on loans at the end of the taxable year of transfer for purposes of section 585(b)(2)(A) of the Code and section 1.585-2(b)(1)(ii)(A) of the regulations. See Rev. Rul. 80-270, page 200.

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26 CFR 1.351-1: Transfer to corporation controlled by transferor.

Whether a limited partnership interest that is transferred in a section 351 exchange is transferred subject to its share of partnership liabilities for purposes of sections 357(c) and 358(d) of the Code. See Rev. Rul. 80-323, page 124.

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26 CFR 1.351-2: Receipt of property.

Whether section 351(b) of the Code applies to cash received by a transferor in the formation of a new holding company. See Rev. Rul. 80-239, page 103.

Subpart B.—Effects on Shareholders and Security Holders

Section 355.—Distribution of Stock and Securities of a Controlled Corporation

26 CFR 1.355-1: Distribution of stock and securities of controlled corporation. (Also Section 482; 1.482-2.)

Controlled corporations; split-off; active business requirement. Rev. Rul. 79-394 is amplified to hold that the wholly owned subsidiary corporation whose stock was to be distributed in the transaction described in that ruling would satisfy the active business requirement of section 355(b) of the Code even if the related corporations were not reimbursed for the services performed by their officers and employees for the subsidiary. In the absence of reimbursement, section 482 would be applicable to allocate income and deductions among the corporations to reflect an arm's length charge for the services.

Rev. Rul. 80-181

ISSUE

Whether the active trade or business requirement of section 355(b) of the Internal Revenue Code is satisfied if the wholly owned subsidiary corporation in the transaction described in Rev. Rul. 79-394, 1979-2 C.B. 141, does not reimburse related corporations for the use of their employees and officers in the conduct of the subsidiary's real estate activities.

ANALYSIS

In Rev. Rul. 79-394 a corporation (*P*) owned all of the stock of another corporation (*Y*) for more than 5 years, and during that period *Y* was engaged in renting real estate to unrelated third parties. *Y*'s business required considerable day to day management and operational functions and also involved acquiring, renovating, refurbishing, and servicing the real estate which it leased. *Y* had no salaried employees, but its activities were performed by employees of another corporation (*X*), which was wholly owned by *P*, who were under the supervision and control of *Y*'s officers who were also officers of *P* and *X*. *Y* reimbursed *X* for the services performed by *X*'s employees, and *Y* also reimbursed *P* and *X* for the services performed by their officers. *P* then proposed to distribute the *Y* stock to one of its (*P*'s) shareholders in a transaction intended to meet the requirements of section 355 of the Code, which, if satisfied, would make the distribution nontaxable to the *P* shareholders. After the distribution, *Y* would directly employ most of those employees who had worked on *Y*'s behalf prior to the distribution.

In considering the issue of whether before the distribution *Y* was engaged in the conduct of an active trade or business within the meaning of section 355(b) of the Code, Rev. Rul. 79-394 states that the presence or absence of formal employment of employees (other than officers) by the controlled corporation (or the distributing corporation) is only one factor to be considered in the determination under section 355(b). Rev. Rul. 79-394 concludes that the scope of *Y*'s management and operation activities was sufficient to distinguish these activities from a passive investment in real estate, even though it had no salaried employees prior to the distribution, and holds that the active trade or business requirement of section 355(b) was satisfied under these circumstances.

The fact that *Y* reimbursed *X* and *P* for the services performed by their employees and officers in connection with *Y*'s rental activities was one of the factors in favor of concluding that *Y* was engaged in the conduct of an active trade or business within the meaning of section 355(b) of the Code, and the absence of reimbursement is a negative factor in this determination. However, *Y*'s failure to reimburse *X* and *P* for the services performed by their employees and officers would not materially change the nature of *Y*'s predistribution management and operational activities, especially since *Y* would continue to supervise and control *X*'s employees in the conduct of these activities. Moreover, the fact that these services were performed by employees of *X*, which was wholly owned by *Y*'s parent (*P*), is significant in determining whether an active business was conducted by the distributing or controlled corporation during the five-year period prior to the distribution. Compare Rev. Rul. 73-234, 1973-1 C.B. 180; Rev. Rul. 73-236, 1973-1

C.B. 183; and Rev. Rul. 73-237, 1973-1 C.B. 184.

HOLDING

The active trade or business requirement of section 355(b) of the Code is satisfied even though *Y* does not reimburse *P* and *X* for the use of their employees and officers in the conduct of *Y*'s real estate activities.

If *Y* did not reimburse *X* and *P* for the services rendered to *Y* by the employees of *X* and the officers of *X* and *P*, then section 482 of the Code would be applicable to allocate income to *X* and *P* in an amount equal to an arm's length charge, pursuant to section 1.482-1(b) and section 1.482-2(b) of the Income Tax Regulations, for the services rendered by the employees of *X* and the officers of *X* and *P* to *Y*. In addition, *Y* would then be entitled to a deduction under section 162 provided the amounts deemed paid by *Y* to *X* and *P* for the services rendered represent ordinary and necessary business expenses to *Y*.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 79-394 is amplified.

Section 357.—Assumption of Liability

26 CFR 1.357-1: Assumption of liability.

Whether a ruling may be issued that section 357(a) of the Code is inapplicable when a newly created corporate transferee assumes a liability incurred in a transaction similar to that described in Rev. Rul. 80-240. See Rev. Proc. 80-34, page 768.

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26 CFR 1.357-1: Assumption of liability.

Whether section 357(a) of the Code applies where a transferor borrowed money to purchase the stock transferred to a newly created corporation that assumes such indebtedness. See Rev. Rul. 80-240, page 116.

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26 CFR 1.357-2: Liabilities in excess of basis.
(Also Sections 351, 358, 7805; 1.351-1, 1.358-3, 301.7805-1.)

Reorganizations; liabilities assumed exceeding assets. Accounts payable that were transferred to a corporation in a section 351 exchange prior to the enactment of the Revenue Act of 1978 and that would have been deductible by the transferor if paid are not liabilities for purposes of sections 357(c) and 358(d) of the Code; Rev. Rul. 69-442 revoked.

Rev. Rul. 80-199

ISSUE

Whether the term "liabilities" as used in sections 357 and 358(d) of the Internal Revenue Code prior to amendment by the Revenue Act of 1978, Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1, 88, on November 6, 1978, includes accounts payable deductible under section 162 of the Code.

FACTS

Individual *A* conducted a small contracting business as a sole proprietorship, the income of which was reported on the cash receipts and disbursements method of accounting. On January 1, 1978, *A* transferred to a newly organized corporation all of the assets of the sole proprietorship in exchange for all of the stock of the corporation, plus the assumption by the corporation of all of the liabilities of the sole proprietorship, in a transaction that met the requirements of section 351(a) of the Code. The transactor did not lack a business purpose. The assets transferred were tangible assets having a fair market value of $20,000 and an adjusted basis of $10,000, and accounts receivable having a fair market value of $30,000 and an adjusted basis of zero dollars. The liabilities assumed by the corporation consisted solely of accounts payable of the sole proprietorship in the face amount of $20,000. The accounts would have been deductible by *A* as ordinary and necessary business expenses under section 162 if *A* had paid them. The new corporation continued to utilize the cash receipts and disbursements method of accounting.

LAW AND ANALYSIS

The applicable sections of the Code are 351, relating to nonrecognition in a transfer to a corporation controlled by the transferor; 357, relating to assumption of liability; 358, relating to basis to distributees; and 362, relating to basis to corporations.

Section 357(a) provides, in part, as a general rule that the assumption of liabilities on the part of a corporate transferee in connection with a section 351 exchange, or the acquisition by the transferee of property subject to a liability in such an exchange, shall not be treated as a receipt of money or other property by the transferor.

Section 357(c)(1) prior to amendment by the Revenue Act of 1978 provides, in part, that in the case of an exchange to which section 351 applies if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

Section 358(a)(1) of the Code provides, in part, that in the case of an exchange to which section 351 applies the basis of the property permitted to be received under section 351 without the recognition of gain or loss shall be the same as that of the property exchanged (A) decreased by (i) the fair market value of any other property (except money) received by the taxpayer, (ii) the amount of money received by the taxpayer, and (iii) the amount of loss to the taxpayer which was recognized on such exchange, and (B) increased by (i) the amount which was treated as a dividend, and (ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

Section 358(d) of the Code prior to

the amendment by the Revenue Act of 1978 provides that if as part of the consideration to the taxpayer, another party to the exchange, assumed a liability of the taxpayer, or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.

Since the adjusted basis of the assets transferred by *A* to the corporation was $10,000 and the accounts payable assumed by the corporation was $20,000, the primary question for consideration is whether the transfer of the assets and liabilities of *A*'s sole proprietorship to the corporation results in gain under section 357(c) of the Code. In *Raich v. Commissioner,* 46 T.C. 604 (1966), the Tax Court of the United States directed its attention to such a question in a case where the taxpayer transferred assets of a business conducted as a sole proprietorship, the income from which was reported on the cash receipts and disbursements method of accounting, to a newly formed corporation in exchange for all of the stock of the corporation plus the assumption by the corporation of all of the liabilities of the sole proprietorship (trade accounts payable and notes payable) in a transaction meeting the requirements of section 351(a). The court held that the trade accounts receivable had a zero basis, and that since the total liabilities, consisting primarily of trade accounts payable, assumed by the corporation were in excess of the adjusted basis of all of the assets transferred, the taxpayer (transferor) incurred a gain under section 357(c) (as it existed prior to the amendment by the Revenue Act of 1978). In Rev. Rul. 69-442, 1969-2 C.B. 53, the Service indicated that it would follow the decision in *Raich v. Commissioner* and apply section 357 (c) to other situations involving similar facts.

In *Focht v. Commissioner,* 68 T.C. 223 (1977), *acq.,* page 1, this Bulletin, the taxpayer, in 1970, transferred to a newly-formed corporation all of the assets of a business conducted as a sole proprietorship, the income of which was reported on the cash receipts and disbursements method of accounting, in exchange for all of the stock of the corporation plus an assumption by the corporation of all of the liabilities of the sole proprietorship in a transaction meeting the requirements of section 351(a) of the Code. These liabilities consisted of the liabilities actually assumed by the corporation as well as liabilities to which certain of the property transferred was subject. The liabilities assumed by the corporation consisted primarily of trade accounts payable. The Internal Revenue Service treated all of the liability obligations including the accounts payable as liabilities within the meaning of section 357(c), and determined that the taxpayer incurred a gain, by reason of section 357(c), in the amount by which the liabilities assumed by the corporation exceeded the adjusted basis of the assets transferred. The Tax Court of the United States held that an obligation should not be treated as a liability, under sections 357 and 358(d), to the extent that its payment would have been deductible (under section 162) if made by the transferor. The court held that section 357(c) did not apply to the account payable liabilities for this reason and overruled its prior decision in *Raich* on this point.

The Service will follow the decision in *Focht.*

HOLDING

No gain is realized by *A* on the exchange of property for stock by reason of section 357(c) of the Code because the accounts payable assumed by the corporation would have been deductible by *A* as ordinary and necessary business expenses under section 162 in the taxable year paid if *A* had paid these liabilities prior to the exchange. *A*'s basis in the stock received in the exchange of property for stock under section 358(a)(1) is the $10,000 basis that *A* had in the property transferred to the corporation. No adjustment to such basis is made under section 358 (a)(1)(A)(ii) because of the assumption by the corporation of the $20,000 in accounts payable inasmuch as section 358(d) does not apply to the accounts payable. Likewise, no adjustment to such basis is made under section 358(a)(1)(B)(ii) because section 357(c) does not apply to the accounts payable.

Transactions which occur on or after November 6, 1978 will be governed by sections 357(c) and 358(d) as amended by the Revenue Act of 1978.

COURT DECISIONS THAT THE INTERNAL REVENUE SERVICE WILL NOT FOLLOW

The Service will not follow the rationale of the decision of the United States Court of Appeals for the Ninth Circuit in *Thatcher v. Commissioner,* 533 F.2d 1114 (9th Cir. 1976) which involved a transaction similar to the facts of this revenue ruling. The court agreed with the Service that the transferors must recognize gain under section 357(c) of the Code on the incorporation transfer, but the court also concluded that the transferor should receive a deduction for trade accounts payable discharged by the transferee corporation to the extent of the accounts receivable or the gain recognized under section 357(c), whichever is less.

The Service also will not follow the rationale of the decision of the United States Court of Appeals for the Second Circuit in *Bongiovanni v. Commissioner,* 470 F.2d 921 (2d Cir. 1972), involving a similar transaction and which held that the term "liabilities," as used in section 357(c) of the Code, did not include all liabilities which are included for accounting purposes, but was meant to apply only to what might be called "tax" liabilities, that is, liens in excess of tax costs, particularly mortgages encumbering

property transferred in an exchange within the meaning of section 351. The above mentioned language offers no clear guidance as to the meaning of the terms "accounting" liabilities and "tax" liabilities or to making a distinction between them. For example, to the extent that the *Bongiovanni* decision could be interpreted as suggested by Footnote 6 in *Thatcher* as holding that "liabilities" for the purpose of section 357(c) means only "the excess of *secured* debts over the transferor's adjusted basis in the assets transferred" (italics supplied), the Service would view such an interpretation as being unduly restrictive of the term "liabilities."

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 69-442 is revoked.

Further, this revenue ruling is not to be relied upon for an interpretation of the term "liability" for any provision of the Code or Income Tax Regulations thereunder, other than sections 357 or 358(d), because in *Focht* the Tax Court properly limited its interpretation of the term to those sections.

SECTION 7805(b) OF THE CODE

Pursuant to the authority contained in section 7805(b) of the Code, this revenue ruling will not be applied to a transferee corporation that, pursuant to section 362(a)(1) of the Code, increased the basis of the property acquired in a transaction to which section 351 applied by the amount of the gain recognized by the transferor on such transfer under section 357(c) and Rev. Rul. 69-442. Thus, a transferee corporation will not be required to reduce the basis in the property received by the amount of such gain recognized by the transferor unless a claim for refund or credit relating to the gain is filed by the transferor because of the revocation of Rev. Rul. 69-442.

26 CFR 1.357-2: Liabilities in excess of basis.
(Also Sections 351, 358, 741, 751, 752; 1.351-1, 1.358-1, 1.741-1, 1.751-1, 1.752-1.)

Transfer to controlled corporation; limited partnership interest; partnership liabilities. A limited partnership interest that is transferred in a transaction qualifying under section 351 of the Code is transferred subject to its share of partnership liabilities for purposes of sections 357(c) and 358(d). The transferor recognizes gain to the extent that the transferor's share of partnership liabilities exceeds the adjusted basis of the interest transferred.

Rev. Rul. 80-323 [1]

ISSUE

Is a limited partnership interest that is transferred in a section 351 exchange transferred subject to its share of partnership liabilities for purposes of sections 357(c) and 358(d) of the Internal Revenue Code?

FACTS

P, a widely held corporation, is engaged directly and through *S*, its wholly owned subsidiary, in the business of acquiring film rights and exhibiting motion pictures. *S* is the general partner in a limited partnership also engaged in acquiring film rights and exhibiting motion pictures. The limited partnership was formed and began business activities in 1971. In its operation, the limited partnership has incurred bona fide indebtedness. At all times since the inception of the limited partnership, the fair market value of its assets has exceeded the sum of its liabilities. In many instances, however, the share of nonrecourse partnership liabilities allocated to a limited partner exceeds the limited partner's adjusted basis of the partnership interest.

For valid business reasons, an offer was made to the limited partners to transfer their partnership interests to Newco, a corporation to be organized for the purpose of the offer, in exchange for Newco stock. Limited partners holding, in total, a 35 percent interest in the partnership's capital and profits accepted the offer. No Newco stock other than the shares to be issued pursuant to the offer will be issued. The proposed transaction will qualify as a transfer of property to a controlled corporation within the meaning of section 351 of the Code.

The principal production of motion picture property owned by the partnership began before September 11, 1975.

LAW AND ANALYSIS

Section 741 of the Code provides that in the case of a sale or exchange of an interest in a partnership gain or loss will be recognized to the transferor partner. However, section 1.741-1(c) of the Income Tax Regulations refers to section 351 for nonrecognition of gain or loss upon the transfer of a partnership interest to a corporation controlled by the transferor.

Section 351(a) of the Code provides that no gain or loss will be recognized if property is transferred to a corporation solely in exchange for its stock and immediately after the exchange the transferor or transferors are in control of the corporation. Under section 357(c), if the sum of the amount of liabilities assumed by the corporation and the amount of liabilities to which the property is subject exceeds the transferor's total adjusted basis of the property transferred, then the excess will be considered as gain from the sale or exchange of a capital asset or of property that is not a capital asset, as the case may be.

Section 1.752-1(e) of the regulations provides that where none of the partners has any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without

[1] Also released as News Release IR-80-114, dated October 30, 1980.

the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) of the Code in the same proportion as they share the profits.

Section 1.752-1(d) of the regulations provides that where there is a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships. For example, if a partner sells his interest in a partnership for $750 cash and at the same time transfers to the purchaser his share of partnership liabilities amounting to $250, the amount realized by the seller on the transaction is $1,000.

Each transferring limited partner's share of partnership nonrecourse liabilities shall be considered as a liability to which the partnership interest is subject for purposes of section 357(c). Consequently, each such limited partner will recognize gain as provided in section 357(c) of the Code to the extent that the partner's share of nonrecourse partnership liabilities exceeds the adjusted basis of the interest transferred. That gain will be ordinary or capital pursuant to the application of sections 741 and 751.

As provided in section 358(d) of the Code, the amount of the liabilities to which each transferred partnership interest is subject will be treated as money received by the transferor partner on the exchange, and, therefore, pursuant to section 358(a)(1), the basis in the Newco stock received will be the same as the basis of the partnership interest exchanged therefor, decreased by the share of the partnership liabilities allocated to the partnership interest and increased by the gain recognized, if any.

HOLDING

Each partnership interest exchanged for Newco stock will be transferred subject to its share of partnership liabilities, and gain will be recognized to the extent that each partner's share of partnership liabilities exceeds the adjusted basis of the interest transferred.

The holding in this ruling does not preclude the application of section 357(b) of the Code, if warranted.

Section 358.—Basis to Distributees

26 CFR 1.358-1: Basis to distributees.

Whether section 358(d) of the Code applies to accounts payable liabilities which could have been deducted under section 162 if paid by a transferor in a section 351 exchange who had utilized the cash receipts and disbursements method of accounting. See Rev. Rul. 80-199, page 122.

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26 CFR 1.358-1: Basis to distributees.

Whether a limited partnership interest that is transferred in a section 351 exchange is transferred subject to its share of partnership liabilities for purposes of sections 357(c) and 358(d) of the Code. See Rev. Rul. 80-323, page 124.

Subpart D.—Special Rules; Definitions

Section 367.—Foreign Corporations

26 CFR 7.367(a)-1: Ruling requests under section 367 relating to certain transfers involving a foreign corporation.
(Also Sections 351, 904; 1.351-1.)

Transfer of foreign branch with losses; recapture of loss. The amount of gain that a domestic corporation must recognize as ordinary foreign source income pursuant to Rev. Rul. 78-201 on the incorporation of its foreign branch that had incurred annual losses since its creation is reduced by the amount of taxable income realized and recognized by the domestic corporation under section 904(f)(3)(A) of the Code, on the transfer of assets to the new foreign corporation; Rev. Rul. 78-201 amplified.

Rev. Rul. 80-246

ISSUE

Is the amount of gain that a domestic transferor (*P*) must recognize as ordinary foreign source income on the incorporation of its foreign branch operations, pursuant to Rev. Rul. 78-201, 1978-1 C.B. 91, because of losses incurred by the foreign operations prior to incorporation, reduced by the amount of taxable income realized and recognized to *P*, under section 904(f)(3)(A) of the Internal Revenue Code, upon the transfer of the branch assets to the new foreign corporation?

FACTS

P is a domestic corporation that is engaged in the manufacture and sale of plastic components for radio and television manufacturers in the United States. In 1977 *P* commenced these same activities in country *A* as a branch operation. For each of *P*'s calendar taxable years, 1977, 1978, and 1979, the country *A* branch had a loss of 100*x* dollars (or a total of 300*x* dollars for this period) as a result of deductions taken by *P* under section 167 and certain other sections of the Code, for expenses incurred by its branch operations in country *A*. *P* had no other foreign operations and no other revenue, or losses, from sources without the United States during this period. In each of the years 1977, 1978, and 1979, the country *A* branch losses reduced the amount of *P*'s income subject to federal income tax.

On January 1, 1980, *P* transferred the property used by the country *A* branch to a new country *A* corporation (Newco) in exchange for all of the Newco stock and Newco's assumption of *P*'s liabilities attributable to its country *A* branch.

The fair market value of, and *P*'s basis in, the assets transferred exceeded the sum of the liabilities assumed, plus the amount of the liabilities to which the tranfserred assets were subject. The excess of the fair market value of such

property (assets transferred plus liabilities assumed) over *P*'s adjusted basis therein exceeds *P*'s overall foreign loss. Newco will continue to conduct the business that *P* conducted in country *A*. The foreign transferee, Newco, will not be engaged in a trade or business in the United States within the meaning of section 864 of the Code, and will have no income from sources within the United States within the meaning of section 861. The transfer of assets in exchange for stock would have fulfilled all of the requirements of section 351 had the transferee, Newco, been a domestic corporation. Furthermore, the transfer met the requirements of section 3.02(1) of Rev. Proc. 68-23, 1968-1 C.B. 821 (relating to transfers of property to foreign corporations). Within 183 days of the beginning of the transfer *P* requested a ruling from the Internal Revenue Service that the transaction was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes within the meaning of section 367(a)(1).

P agreed to recognize as gain on the transfer an amount of ordinary foreign source income equal to the sum of the country *A* branch losses previously incurred, pursuant to Rev. Rul. 78-201. However, *P* requested that this amount be reduced by the amount of taxable income it would realize and recognize, under section 904(f)(3)(A) of the Code, because of the transfer of its branch property to Newco.

LAW AND ANALYSIS

In Rev. Rul. 78-201 a domestic corporation operated a branch in a foreign country. The domestic corporation incurred losses in connection with its branch that reduced its worldwide income subject to federal income tax. The domestic corporation transferred the assets of its branch to a newly formed corporation in the foreign country in exchange for all of its stock. Income subsequently earned by the new corporation will therefore not be included in the domestic corporation's worldwide income subject to federal income tax. Since the transfer thus gives rise to a potential mismatching of related income and losses, Rev. Rul. 78-201 required the United States transferor (the domestic corporation) to recognize as gain on the transfer an amount of ordinary foreign source income equal to the sum of the branch losses previously incurred, as a condition for obtaining a ruling that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes within the meaning of section 367(a)(1) of the Code. Further, there was not an overall foreign loss, within the meaning of section 904, in Rev. Rul. 78-201.

In the instant case the losses incurred by the country *A* branch operations prior to its incorporation were taken into account by *P* and reduced the amount of *P*'s income subject to federal income tax. As a result of the incorporation of *P*'s country *A* branch operations, the income to be produced by these operations, that is indirectly attributable to the losses, will not be taken into account by *P*, and, thus, will not increase the amount of *P*'s worldwide income subject to federal income tax. The effect of the incorporation will therefore be a mismatching of revenue, deductions, and credits, when income is finally produced. Accordingly, *P* must recognize as gain on the transfer, pursuant to Rev. Rul. 78-201, an amount of ordinary foreign source income equal to the sum of the branch A losses previously incurred ($300*x*), in order for *P*'s exchange of property for Newco stock not to be in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes within the meaning of section 367(a)(1) of the Code. This income must be recognized as ordinary foreign source income by *P* for its taxable year in which the transfer occurred (1980).

Section 904(f)(1) of the Code provides, generally, that where an overall loss from foreign operations reduces United States tax on United States source income of the taxpayer, the tax benefit derived from this loss is recaptured when the taxpayer subsequently derives income from the foreign operations. In general, the recapture is accomplished by treating a portion of subsequently derived foreign income as taxable income from United States sources. Section 904(f)(3)(A) provides, generally, that for purposes of applying section 904(f)(1), when property that was used predominantly outside of the United States in a trade or business is disposed of, the overall foreign losses not previously recaptured under section 904(f)(1) will be recaptured in an amount equal to the lesser of the remaining losses or the excess of the fair market value of such property over its adjusted basis. This is accomplished by treating the gain realized on the disposition as taxable income from sources without the United States which section 904(f)(1) then treats as income from sources within the United States. Section 904(f)(3)(B)(i) provides that a disposition includes a sale or exchange of property whether or not gain or loss is recognized on the transfer.

In the instant case, *P* is required, therefore, to include in its taxable income for its 1980 taxable year, as income from sources within the United States, the amount specified in section 904(f)(3)(A) of the Code. Since *P*'s overall foreign loss (300*x* dollars) was less than the amount realized on the transfer of the branch assets, and since the transfer constituted a disposition, *P* must realize and recognize 300*x* dollars in taxable income, for 1980, as foreign source income under section 904(f)(3)(A), and treat that amount as income from sources within the United States, pursuant to section 904(f)(1).

Section 904(f)(3)(A) of the Code and Rev. Rul. 78-201 operate independently of one another. To the extent there is an overlap of Rev. Rul. 78-201 and section 904(f)(3)(A), their effect on the transfer should be

integrated in order to prevent double recapture.

HOLDING

The amount of gain that *P* must recognize as ordinary foreign source income (300*x* dollars, which is the sum of the branch losses) on the transfer of its branch assets to Newco in exchange for Newco stock, pursuant to Rev. Rul. 78-201, is reduced by the amount of taxable income realized and recognized by *P*, under section 904(f)(3)(A) of the Code, on the same transfer or disposition (300*x* dollars, which is the amount of the overall foreign loss).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 78-201 is amplified.

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26 CFR 7.367(a)-1: Ruling requests under section 367 relating to certain transfers involving a foreign corporation.

Transfer of foreign branch with losses; abandonment of certain assets. Losses that must be recaptured under Rev. Rul. 78-201, as a result of the incorporation of a foreign branch operation, include expenses directly related to branch property not transferred but abandoned as worthless; Rev. Rul. 78-201 amplified.

Rev. Rul. 80-247

ISSUE

Do the losses recaptured under Rev. Rul. 78-201, 1978-1 C.B. 91, pursuant to incorporation of a branch operation, include expenses directly related to branch property not transferred but abandoned as worthless?

FACTS

P is a domestic corporation that is engaged in the exploration, development, and sale of mineral properties in the United States. *P* owns certain mineral properties in country *A*. In 1977 *P* commenced business operations in country *A*. These operations were carried on by a branch that *P* established in country *A*.

Beginning in 1977, deductions were taken by *P* under section 167 and certain other sections of the Code for expenses incurred by its branch operations. Because of these deductions the country *A* branch sustained losses of $100*x* in 1977, 1978, and 1979 (a total of $300*x*). *P*'s taxable income from sources within the United States was $1,000*x* each year for 1977 through 1979, and the branch *A* losses reduced *P*'s worldwide taxable income for these years. During each of the three years *P*'s other foreign branches had income in excess of the losses of the branch in country *A*.

On January 1, 1980, *P* transferred certain assets of its country *A* branch to Newco, a corporation newly created under the laws of country *A*, solely in exchange for all of Newco's stock. The assets transferred consisted of certain equipment and those mineral properties located in country *A* that were expected to produce income in excess of expenses starting in 1982. The mineral properties of *P*'s country *A* branch that had no commercial value were not transferred and will be abandoned as worthless. Expenses of $200*x* were directly attributable to the branch *A* properties transferred. Expenses of $100*x* were directly attributable to the branch *A* properties not transferred.

The fair market value of, and *P*'s basis in, the assets transferred exceeded the sum of the liabilities to which the transferred assets were subject. No liabilities were assumed. Newco will continue to conduct the business that *P* conducted in country *A*. The foreign transferee, Newco, will not be engaged in a trade or business in the United States within the meaning of section 864 of the Code, and will have no income from sources within the United States within the meaning of section 861. The transfer of assets in exchange for stock would have fulfilled all of the requirements of section 351 had the transferee, Newco, been a domestic corporation. Furthermore, the transfer met the requirements of section 3.02(1) of Rev. Proc. 68-23, 1968-1 C.B. 821. Within 183 days of the beginning of the transfer *P* requested a ruling from the Internal Revenue Service that the transaction was not in pursuance of a plan of tax avoidance within the meaning of section 367(a)(1).

LAW AND ANALYSIS

Section 367(a)(1) of the Code provides that if, in connection with any exchange described in section 351, there is a transfer of property by a United States person to a foreign corporation, for purposes of determining the extent to which gain shall be recognized on such transfer, a foreign corporation shall not be considered to be a corporation unless, pursuant to a request filed no later than the close of the 183rd day after the beginning of such transfer, it is established to the satisfaction of the Secretary that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes.

Section 351(a) of the Code provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

Rev. Proc. 68-23 sets forth guidelines to be used by taxpayers and their representatives in connection with requests for rulings required under section 367 of the Code in respect of certain types of transactions involving foreign corporations. Section 3.02(1) of Rev. Proc. 68-23 relates to transfers to foreign corporations controlled by domestic transferors and provides that such a transfer of property will ordinarily receive favorable consideration where the transferred property is to be devoted by the transferee foreign corporation to the active conduct, in any foreign country, of a trade or business.

It is contemplated that the transferee foreign corporation, in addition to the active conduct of a trade or business, will have need for a substantial investment in fixed assets in such business.

Section 2.02 of Rev. Proc. 68-23 provides, however, that in reviewing each request for ruling to determine whether a favorable section 367 ruling should be issued under the guidelines, the Service reserves the right to issue an adverse ruling if, based on all the facts and circumstances of a case, it is determined that the taxpayer has not established that tax avoidance is not one of the principal purposes of the transaction.

P's transfer of certain of its mineral properties to Newco solely in exchange for all of Newco's stock is an exchange described in section 351 of the Code, but unless it is established under section 367(a)(1) that the transfer to Newco was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes, Newco will not be considered to be a corporation for purposes of section 351. Since the nonrecognition of gain provisions of section 351 apply only if Newco is considered to be a corporation, failure to satisfy section 367(a)(1) would therefore result in recognition of any gain realized by *P* on the transfer.

In Rev. Rul. 78-201 a domestic corporation operated a branch in a foreign country. The domestic corporation incurred losses in connection with its branch that reduced its worldwide income subject to federal income tax. The domestic corporation transferred the assets of its branch to a newly formed corporation in the foreign country in exchange for all of its stock. Income subsequently earned by the new corporation will therefore not be included in the domestic corporation's worldwide income subject to federal income tax. Since the transfer thus gives rise to a potential mismatching of related income and loss, Rev. Rul. 78-201 required the United States transferor (the domestic corporation) to recognize as gain on the transfer an amount of ordinary foreign source income equal to the sum of the branch losses previously incurred, as a condition for obtaining a ruling that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes within the meaning of section 367(a)(1) of the Code. Further, if the transferor recognizes the amount set forth in Rev. Rul. 78-201 as gain, then the transferor's basis in the stock received, and the corporation's basis in the property received from the transferor, will each be increased by the amount of gain recognized to the transferor pursuant to sections 358(a)(1) and 362(a), respectively, since the transaction qualifies as an exchange to which section 351 applies. Rev. Rul. 78-201 indicates that the domestic corporation operated a single branch and a single business in the foreign country, that the business of the branch had incurred the losses, and that it was the business of the branch that was being incorporated.

In the instant case the losses that *P* incurred in connection with its mineral exploration, development, and property sales business in country *A* had reduced the amount of *P*'s worldwide income subject to federal income tax. As a result of the incorporation of *P*'s country *A* business (that is, all properties that were not to be abandoned), the income to be produced by *P*'s country *A* business will not be taken into account by *P*, and thus will not increase the amount of *P*'s worldwide income subject to federal income tax.

P's mineral exploration, development, and property sales business in country *A* was a complete business operation in itself, and that business and the losses incurred by that business were unrelated to *P*'s other worldwide business operations. Although the branch *A* properties that were transferred directly incurred losses of $200*x* and the branch *A* properties to be abandoned directly incurred losses of $100*x*, *P*'s branch *A* was comprised of both the properties that were transferred and the properties that were not transferred. *P* effectively incorporated the entire branch *A* business. It was the business, and not the specific parcels of property, that incurred the losses.

HOLDING

Pursuant to Rev. Rul. 78-201, *P* must recognize as gain on the transfer an amount of ordinary foreign source income equal to the sum of the country *A* branch losses previously incurred (that is, $300*x*) in order for *P*'s exchange of property for Newco stock not to be deemed to be in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes within the meaning of section 367(a)(1) of the Code. This income must be recognized as ordinary foreign source income by *P* for its taxable year in which the transfer occurred (1980).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 78-201 is amplified.

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26 CFR 7.367(a)-1: Ruling requests under section 367 relating to certain transfers involving a foreign corporation.

Incorporation of foreign partnership; losses; U.S. partners; section 367 ruling. The amount of ordinary foreign source income that domestic partners are required to include in their income upon the incorporation of their foreign partnership is limited to the amount of losses incurred by the partnership after the domestic partners acquired their partnership interests; Rev. Rul. 78-201 amplified.

Rev. Rul. 80-293

ISSUE

Upon a foreign partnership's incorporation of its business, is the amount of ordinary foreign source income that United States persons are required to

include in their income in accordance with Rev. Rul. 78-201, 1978-1 C.B. 91, limited to the amount of losses incurred by the partnership after United States persons purchased their partnership interests?

FACTS

P, a foreign partnership that was organized 10 years ago, was engaged in the farming business on land in foreign country *Z*. *A*, *B*, *C*, and *X* own percentage interests in *P* of 63, 7, 10, and 20, respectively, the percentage interests being in both capital and profits. *A* and *B* are individuals and are United States residents, *C* is a nonresident alien individual, and *X* is a domestic corporation. *A* and *B* acquired their partnership interests in 1977, in a bona fide purchase, from unrelated parties who were United States residents. *X* and *C* acquired their partnership interests when *P* was originally formed.

P decided to incorporate its farming business in country *Z* to benefit from certain tax incentives in country *Z*. Accordingly, in 1978, *P* transferred all of the assets associated with its farming business to *Y*, a newly-formed country *Z* corporation, solely in exchange for all of the stock of *Y* and *Y*'s assumption of all of the liabilities associated with the farming business. The fair market value of, and *P*'s basis in, its assets transferred to *Y* exceeded the sum of the liabilities assumed by *Y*. *P* remained in existence and retained certain export licenses and the stock of *Y*.

Prior to 1977, *P* incurred net losses that were passed through as deductions to the partners and reduced their basis in the partnership and their other income. For the period subsequent to the purchase of the partnership interests by *A* and *B*, *P* had net profits which were included in income by *A*, *B*, and *X* in proportion to their respective interests.

The transfer of assets in exchange for stock would have fulfilled all of the requirements of section 351 of the Code had the transferee been a domestic corporation. The transfer met the requirements of section 3.02(1) of Rev. Proc. 68-23, 1968-1 C.B. 821. Further, within 183 days of the beginning of the transfer the taxpayer requested a ruling from the Internal Revenue Service that the transaction was not in pursuance of a plan of tax avoidance within the meaning of section 367.

LAW AND ANALYSIS

The applicable Code sections are section 351(a), relating to the nonrecognition of gain or loss on the transfer of property to a corporation controlled by the transferor, and section 367 (a)(1), relating to the requirement that a ruling be obtained that an exchange described in section 351 is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes in order for a foreign corporation to be considered a corporation for purposes of determining gain on the transfer.

The applicable sections of the Temporary Income Tax Regulations are section 7.367(a)-1(b)(3)(i), which provides that a "transfer described in section 367(a)(1)" of the Code is a transfer of property made by a United States person, directly or indirectly, to a foreign corporation in connection with an exchange described in section 351, and section 7.367(a)-1(b)(3)(iii), which provides that a transfer by a foreign partnership in which a United States person holds an interest shall be considered to have been made by any such United States person who realizes gain or other income (whether or not recognized) on account of the transfer.

Pursuant to section 7.367(a)-1(b)(3)(iii) of the Temporary Regulations, *A*, *B*, and *X* are considered to have made the transfer of property to *Y* that *P* made. Since the transfer is described in section 351 of the Code and the transfer of property was made indirectly by a United States person (*A*, *B*, and *X*) to a foreign corporation (*Y*), the transfer is described in section 367(a)(1). Unless it is established that the transfer to *Y* was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes, then, pursuant to section 367(a)(1), *Y* will not be considered to be a corporation for purposes of determining gain recognized on the transfer. The transfer of property to *Y* qualifies for nonrecognition of gain to *P* under section 351 (thus no gain is passed through to the partners) if *Y* is considered to be a corporation.

Rev. Rul. 78-201 required the United States transferor to include in income an amount of ordinary foreign source income (the sum of branch losses previously incurred) as a condition for obtaining a ruling that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes within the meaning of section 367 (a)(1) of the Code. In the instant situation, the acquisition by *A* and *B* in 1977, through a taxable sale, of their 70 percent interest in *P*'s capital and profits created a new partnership for federal income tax purposes. See section 708(b)(1)(B) of the Code. Since *P* had only net profits during the period subsequent to the purchase of their partnership interests by *A* and *B*, those partners did not have any partnership losses from *P* prior to the incorporation.

X acquired its partnership interest in *P* 10 years ago. The losses incurred by the foreign farming business of *P* prior to 1977, and prior to its incorporation, were taken into account by *X* in proportion to its partnership interest and reduced the amount of *X*'s worldwide income subject to federal income tax. As a result of the incorporation of the foreign farming business of *P*, the income to be produced by these operations will not be taken into account by *X*, and thus will not increase the amount of *X*'s worldwide income subject to federal income tax. Accordingly, the transfer by *P* of all of the

assets associated with its farming business to *Y* will be deemed not to be in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes within the meaning of section 367(a)(1) of the Code only if *X* (who is considered to be a transferor by application of section 7.367(a)-1(b)(3)(iii) of the Temporary Regulations), pursuant to Rev. Rul. 78-201, recognizes as gain on the transfer an amount of ordinary foreign source income equal to its proportionate share of the sum of the foreign country *Z* losses previously incurred by *P*.

HOLDING

Since *P* incurred only net profits after *A* and *B* became partners in a taxable sale or exchange, and thus *A* and *B* were unable to utilize *P*'s net losses, Rev. Rul. 78-201 does not require *A* and *B* to include the sum of *P*'s prior losses in their income as ordinary foreign source income. However, since *X* utilized *P*'s net losses, Rev. Rul. 78-201 requires *X* to recognize as gain on the transfer an amount of ordinary foreign source income equal to *X*'s proportionate share of the sum of the foreign country *Z* losses previously incurred by *P* as a condition for obtaining a ruling under section 367(a)(1) of the Code. In addition, *X*'s basis in *P*, *P*'s basis in the *Y* stock, and *Y*'s basis in the assets received are increased by the amount of gain that *X* recognizes, pursuant to Rev. Rul. 78-201, on the transfer.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 78-201 is amplified.

Subchapter D.—Deferred Compensation, etc.
Part I.—Pension, Profit-Sharing, Stock Bonus Plans, etc.
Subpart A.—General Rule

Section 401.—Qualified Pension, Profit-Sharing, and Stock Bonus Plans

26 CFR 1.401-1: Qualified pension, profit-sharing and stock bonus plans.

(Also Sections 404, 1372; 1.404(a)-9, 1.1372-1.)

Profit-sharing; small business corporation; contributions from accumulated profits. The profit-sharing plan of an electing small business corporation does not fail to qualify merely because the plan document permits contributions to the plan from the corporation's accumulated profits as determined under generally accepted accounting principles, even though these amounts have previously been taxed to the shareholders under section 1373 of the Code. Such contributions are deductible under section 404(a)(3). Rev. Rul. 71-257 superseded.

Rev. Rul. 80-252

The purpose of this Revenue Ruling is to restate under current law Rev. Rul. 71-257, 1971-1 C.B. 131. The issues presented are (1) whether the profit-sharing plan of an electing small business corporation will fail to qualify because the plan document allows contributions to the plan to be made from accumulated profits (when there are no current profits) and (2) whether these contributions are deductible under section 404(a)(3) of the Internal Revenue Code.

A corporation that was an electing small business corporation as defined in section 1371(b) of the Code for each year of its existence established in its first year of existence a trusteed profit-sharing plan that meets the requirements of sections 401 and 1379. The plan provides that employer contributions will be made out of current or accumulated profits in an amount equal to 15 percent of the total compensation of participants.

As determined under its method of accounting, which reflected generally accepted accounting principles and practices, for each of its first two years the corporation had a profit. In each of the first two years, the employer made contributions to the profit-sharing trust in an amount equal to 15 percent of the participants' total compensation, which was less than the profit for each of the years. By the close of the second plan year, the corporation had $25,000 in accumulated profits under its method of accounting. This amount also represented income that had previously been taxed to the shareholders in accordance with section 1373 of the Code but not distributed to them. For its third year (without regard to any contribution to its profit-sharing trust) the corporation incurred a loss of $5,000. Nonetheless, the employer contributed $15,000 to the profit-sharing trust, representing 15 percent of the participants' total compensation.

Section 401(a) of the Code sets forth the basic requirements which the trust of a profit-sharing plan must meet in order to constitute a qualified trust. Section 1.401-1(b)(1)(ii) of the Income Tax Regulations provides that a profit-sharing plan within the meaning of section 401 of the Code is a plan established and maintained by an employer to provide for the participation in the employer's profits by employees or their beneficiaries.

Section 404(a)(3) of the Code provides limits on the deductible contributions to a qualified profit-sharing trust.

Section 1.1372-1(c) of the regulations provides in part that, to the extent not inconsistent with subchapter S, other provisions of chapter 1 of the Code apply to an electing small business corporation in the same manner as they would if no election had been made.

Rev. Rul. 66-174, 1966-1 C.B. 81, holds that a profit-sharing plan will not fail to qualify under section 401 of the Code merely because it provides that contributions shall be made from current profits and accumulated earned surplus, as determined under generally accepted accounting principles and practices, without regard to whether the employer has current or

accumulated earnings and profits for federal income tax purposes.

An electing small business corporation's profit-sharing plan likewise will not fail to qualify because it provides that contributions to the plan may be made from accumulated, as well as current, profits, as determined under generally accepted accounting principles and practices, even though the accumulated profits represent income that previously had been taxed to the shareholders under section 1373 of the Code and thus are not considered accumulated profits for federal income tax purposes.

Under its method of accounting, the electing small business corporation in this example had accumulated profits that exceeded the sum of the loss plus the contribution to the profit-sharing plan for the third year. Thus, this corporation had profits from which it could contribute to its profit-sharing plan for the third year, despite having incurred a loss in that year. Also, because the plan does not fail to qualify, the corporation is entitled to deduct its contributions to the extent provided by section 404(a)(3) of the Code.

Accordingly, the profit-sharing plan of the electing small business corporation does not fail to qualify because the plan document permits contributions to the plan to be made from current or accumulated profits, and the contributions to the plan are deductible as provided by section 404(a)(3) of the Code.

Rev. Rul. 71-257 is superseded because the position stated therein is restated under current law in this revenue ruling.

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26 CFR 1.401-1: Qualified pension, profit-sharing, and stock bonus plans.

Normal retirement age; distribution before or at retirement. A profit-sharing plan will not fail to qualify merely because it provides for a normal retirement age of less than 65 years and for distribution of benefits at the time of that lesser age, whether or not the participant retires at that time; Rev. Ruls. 69-414 and 71-147 superseded.

Rev. Rul. 80-276

The purpose of this revenue ruling is to restate the position of Rev. Rul. 69-414, 1969-2 C.B. 59 and Rev. Rul. 71-147, 1971-1 C.B. 116, in view of enactment of the Employee Retirement Income Security Act of 1974, Pub. L. 93-406, 1974-3 C.B. 1.

The issue in Rev. Rul. 69-414 and Rev. Rul. 71-147 is whether a profit-sharing plan will fail to qualify under section 401(a) of the Internal Revenue Code because of the provisions described below.

The plan, which otherwise meets the requirements for qualification under section 401(a) of the Code, provides that the normal retirement age is 55 and that each participant retiring at age 55 will receive a complete distribution of his or her interest under the plan. Employees in the particular industry involved customarily retire at age 65.

The plan also provides that a participant who does not plan to retire at age 55 may irrevocably elect, before age 55, to receive a complete distribution of his or her interest under the plan at age 55. If an employee continues in the employment of the employer after age 55, the plan provides that the employee will continue to share in the contributions to the plan in the same manner as before age 55.

Section 1.401-1(b)(1)(ii) of the Income Tax Regulations states that a qualified profit-sharing plan must provide for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death or severance of employment.

Section 411(a)(8) of the Code provides that, for purposes of section 411, "normal retirement age" means the earlier of (1) the time a plan participant attains normal retirement age under the plan, or (2) the later of (a) the time a plan participant attains age 65, or (b) the 10th anniversary of the time a plan participant commenced participation in the plan.

The attainment of a stated age in a profit-sharing plan is merely one of several events that may be designated as fixing the time for making distributions from the plan. In view of the definition of normal retirement age found in section 411(a)(8) of the Code, and in the absence of any statutory prohibition or limitation, a profit-sharing plan may specify any age for distribution of benefits and, also, any age for normal retirement if it is less than the later of age 65 or the 10th anniversary of the time a plan participant commenced participation in the plan. See Rev. Rul. 78-120, 1978-1 C.B. 117, for the rules applicable to a pension plan. There is no requirement that the attainment of the stated age coincide with retirement or severance of employment in order to entitle a participant to a distribution from a profit-sharing plan.

Accordingly, this profit-sharing plan will not fail to qualify under section 401(a) of the Code because it provides for a normal retirement age of less than 65 and for distribution of benefits at the normal retirement age, whether or not the participant retires at that time.

Rev. Rul. 69-414 and Rev. Rul. 71-147 are superseded because the positions set forth therein are restated under current law in this Revenue Ruling.

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26 CFR 1.401-1: Qualified pension, profit-sharing, and stock bonus plans.

Plan funded solely by employees. A defined contribution pension plan established by an employer may be a qualified plan under section 401 of the Code even though the only

contributions are those made by the employees; Rev. Ruls. 54-152 and 66-205 superseded.

Rev. Rul. 80-306

The purpose of this revenue ruling is to restate the position in Rev. Rul. 54-152, 1954-1 C.B. 149, and Rev. Rul. 66-205, 1966-2 C.B. 119, in view of the amendment of section 401(a) of the Internal Revenue Code by the Employee Retirement Income Security Act of 1974, Pub. L. 93-406, 1974-3 C.B. 1.

The issue in the two revenue rulings is whether a pension plan will fail to qualify under section 401(a) of the Code merely because no contributions are made by the employer so that the pension plan is funded by employee contributions only.

An employer established a defined contribution pension plan under which the only contributions are employee contributions. The contributions are deducted from each employee's wages paid by the employer at the rate of (x) cents per hour worked. Benefits under the plan are distributed only upon the death, disability, retirement, or separation from service of an employee.

Section 401(a)(1) of the Code generally provides, in part, that a pension plan of an employer may qualify under section 401(a) if contributions are made by the employer, or employees, or both for the purpose of distributing to such employees or their beneficiaries the corpus and the income of the fund in accordance with the plan.

Thus, a pension plan established and maintained by an employer may be funded by either employer or employee contributions, or both, so long as the plan is not one established by the unilateral action of employees.

Accordingly, the defined contribution pension plan will not fail to qualify under section 401(a) of the Code merely because contributions are only made by employees.

Similarly, a defined benefit pension plan (whether or not the employer retains a liability to provide the plan benefits to the extent the employee contributions are insufficient) will not fail to qualify under section 401(a) of the Code merely because no employer contributions are made under the plan.

This revenue ruling does not deal with whether the employee contributions will of themselves satisfy the minimum funding requirements of section 412 of the Code to the extent such requirements apply.

Rev. Rul. 54-152 and Rev. Rul. 66-205 are superseded because the positions stated therein are restated under current law in this revenue ruling.

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26 CFR 1.401-1: Qualified pension, profit-sharing, and stock bonus plans.

Duplication of benefits; rehired participants. A defined benefit plan that does not contain any provisions to prevent duplication of benefits for rehired participants will not fail to qualify under section 401(a) of the Code merely because it provides benefits for some participants that duplicate the benefits already provided for those participants under the same plan; Rev. Rul. 62-139 modified and Rev. Ruls. 56-213, 70-126, and 72-531 revoked.

Rev. Rul. 80-349

The Service has reconsidered Rev. Ruls. 56-213, 1956-1 C.B. 194; 70-126, 1970-1 C.B. 95; 72-531, 1972-C.B. 221; and 62-139, 1962-2 C.B. 123. All of these revenue rulings deal with whether a pension plan will fail to satisfy the requirements of section 401(a) of the Internal Revenue Code merely because it provides benefits for some participants that duplicate the benefits already provided for those participants under the same plan or the plan of a prior employer.

Employer M maintains a defined benefit pension plan that provides for a normal retirement benefit equal to 50 percent of final average pay. The plan does not contain any provisions to prevent a duplication of benefits for rehired participants. Thus, it is possible for an individual who had previously been a participant, separated from service, and received payment for his or her entire nonforfeitable interest, to reenter the plan upon being rehired and receive the entire "50 percent of pay" normal retirement benefit without offset for the previous payments.

Rev. Rul. 56-213 dealt with a plan that permitted reinstatement of former participants and concluded that if the terms of the plan were uniformly applied and the full actuarial equivalent of the amount already vested in the participant was deducted from the benefit to be paid on account of the new participation, then the qualification of the plan would not be adversely affected.

Rev. Rul. 70-126 dealt with the issue under consideration and concluded that so long as the provisions did not discriminate within the meaning of section 401(a)(4) of the Code and did not result in a duplication of benefits, the providing of benefits for reinstated participants would not adversely affect the qualification of the plan under section 401(a). Although this ruling dealt with a situation where there was no duplication of benefits, the ruling stated that this characteristic was necessary to support the conclusion.

Rev. Rul. 62-139 dealt with the discrimination issue relative to allowing prior service credit to be used for eligibility and benefit purposes, and concluded, among other things, that prior service credit could not be used if the prior service had resulted in vested pension rights for the employee.

Rev. Rul. 72-531 also dealt with prior service credit and held that a plan that provides credit for service with the employee's immediate prior employer must contain a provision to preclude duplication of benefits if the plan is to be qualified under section 401(a).

There is no provision in the Code or

in the Income Tax Regulations which specifically prohibits duplication of benefits. However, section 1.401-1(b)(1)(i) of the regulations defines a pension plan, within the meaning of section 401(a), as a plan established and maintained by an employer to provide definitely determinable benefits to employees after retirement.

Rev. Rul. 74-385, 1974-2 C.B. 130, provides that, in the case of a defined benefit plan, the definitely determinable benefit requirement of section 1.401-1(b)(1)(i) of the regulations is satisfied where the benefits for each participant can be computed in accordance with an express formula contained in the plan that is not subject to the discretion of the employer. The benefit formula contained in the plan described in this ruling satisfies the requirements of Rev. Rul. 74-385.

Accordingly, the pension plan of Employer M will not fail to qualify under section 401(a) of the Code merely because it provides benefits for some participants which duplicate the benefits already provided for those participants under the same plan.

This revenue ruling does not deal with whether duplication of benefits under a plan as described will violate the prohibition against discrimination as provided under section 401(a)(4) of the Code, or provide benefits in excess of the limits of section 415 of the Code.

Rev. Ruls. 56-213, 70-126, and 72-531 are revoked; and Rev. Rul. 62-139 is modified only to the extent that it required non-duplication of benefits.

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26 CFR 1.401-1: Qualified pension, profit-sharing, and stock bonus plans.

Voluntary employee contributions. An employee benefit plan will not fail to qualify under section 401(a) of the Code merely because it permits total voluntary employee contributions equal to 10 percent of the employee's compensation for all years since the employee became a plan participant; Rev. Ruls. 59-185 and 69-217 superseded.

Rev. Rul. 80-350

The purpose of this revenue ruling is to restate Rev. Rul. 59-185, 1959-1 C.B. 86, and Rev. Rul. 69-217, 1969-1 C.B. 115, under current law.

The issue in these two revenue rulings is whether an employee benefit plan will fail to qualify under section 401(a) of the Internal Revenue Code merely because it permits total voluntary employee contributions equal to 10 percent of the employee's aggregate compensation for all years since the employee became a participant under the plan.

A corporation established an employee benefit plan that in addition to the benefit derived from employer contributions, provided the additional retirement benefit that can be purchased with the participant's voluntary contributions and the earnings thereon. Voluntary contributions may be made in any year so long as the total of such contributions for all years does not exceed 10 percent of the aggregate compensation received for all years since the employee became a participant under the plan. Employee contributions and earnings thereon are nonforfeitable.

The tax advantages provided under a qualified employee plan were not intended by Congress to be extended to unlimited contributions by employees made primarily to escape tax on the increments thereon. However, where the purpose of a voluntary contribution feature in a plan is to encourage savings by participants, such feature is acceptable provided the contributions are kept within reasonable bounds. In this respect, employee contributions are deemed to be reasonable if they do not exceed 10 percent of the employee's aggregate compensation for all years since becoming a participant. Of course, the additional amounts voluntarily contributed by the employees must be used only for the purpose of providing benefits to the individual contributor in addition to the benefits provided by the employer's contributions.

Accordingly, the employee benefit plan in this case will not fail to qualify, under section 401(a) of the Code, merely because it permits total voluntary employee contributions equal to 10 percent of the employee's aggregate compensation for all years since the employee became a participant thereunder.

This revenue ruling does not provide guidance with respect to whether any voluntary employee contributions will result in a violation of section 415 of the Code.

Rev. Ruls. 59-185 and 69-217 are superseded because the positions stated therein are restated under current law in this revenue ruling.

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26 CFR 1.401-3: Requirements as to coverage.

Whether an employee who is given the title "assistant secretary-treasurer" is an officer for purposes of section 401(a)(3) and (4) of the Code. See Rev. Rul. 80-314, page 152.

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26 CFR 1.401-4: Discrimination as to contributions or benefits.
(Also Section 411; 1.411(d)-2.)

Termination; asset allocation; discrimination; defined benefit plan. Guidelines and examples are provided for determining if an asset allocation is discriminatory under section 401(a)(4) of the Code upon the termination of a defined benefit plan; Rev. Ruls. 55-60, 59-241, and 65-294 superseded.

Rev. Rul. 80-229

SECTION 1. PURPOSE

The revenue ruling provides guidelines for determining whether an asset allocation is discriminatory within the meaning of section 401(a)(4) of the Internal Revenue Code upon

the termination of a defined benefit plan. The ruling supersedes Rev. Rul. 55-60, 1955-1 C.B. 37, Rev. Rul. 59-241, 1959-2 C.B. 118, and Rev. Rul. 65-294, 1965-2 C.B. 136.

SEC. 2. BACKGROUND INFORMATION

Section 401(a)(4) of the Code provides that contributions or benefits under the plan shall not discriminate in favor of employees who are officers, shareholders or highly compensated.

Section 411(d)(2) and (d)(3) of the Code provides certain vesting standards regarding prohibited discrimination, which are also qualification standards, in the event of plan termination.

Section 1.401-4(c) of the Income Tax Regulations provides restrictions on the distribution of assets for certain employees in the event of early termination of the plan. Section 1.401-4(c)(1) of the regulations provides that the Commissioner may determine that such restrictions are not necessary to prevent prohibited discrimination in the event of an early plan termination.

Section 4044(a) of Title IV of the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. 93-406, 1974-3 C.B. 1, sets forth the rules applicable to the allocation of assets to participants and beneficiaries by priority categories in the event of the termination of a defined benefit plan.

Under section 4044(b)(4) of ERISA and section 1.411(d)-2(a)(2)(ii) of the regulations, assets that would otherwise be allocated pursuant to paragraphs (4)(B), (5) and (6) of section 4044(a) of ERISA may be required to be reallocated to the extent necessary to avoid discrimination within the meaning of section 401(a)(4) of the Code. Further, section 1.411(d)-2(e) of the regulations provides that assets in excess of the early termination limits may be reallocated to avoid discrimination.

SEC. 3. ASSETS NOT LESS THAN PRESENT VALUE OF ACCRUED BENEFIT

In the case of a terminating plan in which the value of plan assets as of the date of termination is not less than the present value of all accrued benefits (whether or not nonforfeitable) as of such date, a distribution of assets to each participant equal to the present value of that participant's accrued benefit will not be discriminatory within the meaning of section 401(a)(4) of the Code if the formula for computing benefits as of the date of termniation would not be discriminatory had the plan not terminated. All present values and the value of plan assets are computed using assumptions that are acceptable to satisfy section 4044 of ERISA.

If the assets as of the date of termination exceed the present value of the accrued benefits (whether or not nonforfeitable) as of such date, the plan will not be considered discriminatory if such excess reverts to the employer or is applied to increase benefits in a nondiscriminatory manner. One method of applying the assets to increase benefits in a nondiscriminatory manner is to amend the plan to provide a new benefit structure such that (1) the benefit structure would not be discriminatory if the plan were not terminated and (2) the present value of the revised accrued benefits (whether or not nonforfeitable) as of the date of termination equals the value of plan assets, and to distribute assets equal to the present value of the revised accrued benefits. The new benefit structure must satisfy other requirements of the law such as sections 411(d)(6) and 415 of the Code.

The guidelines provided by this section may be applied whether or not the termination would otherwise invoke the early termination restrictions described in section 1.401-4(c) of the regulations.

The guidelines described in this section may be illustrated by the following examples:

EXAMPLE 1. A plan provides a benefit of 10% of the first $5,000 of compensation plus 47½% of compensation in excess of $5,000. Such plan satisfies the requirements of Rev. Rul. 71-446, 1971-2 C.B. 187, and is fully integrated. As of the date of termination the assets equal $100,000 and the present value of the accrued benefits (whether or not nonforfeitable) equals $80,000. The plan distributes the $100,000 by providing each participant with assets equal to 125% of the present value of such participant's accrued benefit (whether or not nonforfeitable).

Distributing assets equal to 125% of the present value of the accrued benefits is tantamount to amending the plan by multiplying each of the terms of the benefit formula by 125% and distributing the present value of the accrued benefits. The revised formula would be 12.5% of the first $5,000 of compensation plus 59.375% of compensation in excess of $5,000. The revised formula is discriminatory in an ongoing plan because the formula fails to integrate properly. (See Rev. Rul. 71-446.) Accordingly, such distribution is discriminatory.

EXAMPLE 2. The facts are the same as in Example 7 except that the distribution is revised as follows: By a separate actuarial computation it is determined that a nonintegrated increase in the benefit formula of 1% of all compensation would increase the present value of the accrued benefits by $4,000. The plan has surplus assets of $20,000 ($100,000 of assets as of the date of termination less $80,000, the present value of accrued benefits as of such date). Therefore, an increase of each of the terms of the benefit formula by 5%

($20,000 surplus)
($ 4,000 present value of accrued benefit for each 1% increase in benefit formula)

will produce a benefit formula that

would be nondiscriminatory in an ongoing plan and whose present value of the accrued benefits (whether or not nonforfeitable) equals the value of plan assets. The benefit formula is therefore revised to provide 15% of the first $5,000 and 52½% of compensation in excess of $5,000, and assets equal to the revised present value of the accrued benefits may be distributed without causing discrimination.

SEC. 4. ASSETS LESS THAN PRESENT VALUE OF ACCRUED BENEFITS

.01 Applicability—This section applies to the termination of a defined benefit plan in which the value of plan assets as of the date of termination is less than the present value of all accrued benefits (whether or not nonforfeitable) as of such date whether or not the restrictions of section 1.401-4(c) of the regulations apply.

.02 General Rules—The following guidelines apply in testing for discrimination in the case of a plan described in subsection .01 with respect to which the benefit structure, if the plan were not terminated, would not be discriminatory under section 401 (a) (4) of the Code.

(1) Except as provided in paragraph (4), the assets of a plan are allocated in accordance with sections 4044(a) (1), (2), (3), and (4) (A) of ERISA.

(2) Subject to the requirements of paragraph (1), the assets shall be allocated, to the extent possible, so that the rank and file employees receive from the plan at least the same proportion of the present value of their accrued benefits (whether or not nonforfeitable) as employees who are officers, shareholders, or highly compensated.

(3) Notwithstanding any other paragraph, in the case of assets restricted by section 1.401-4(c) of the regulations, assets may be reallocated to the extent necessary to help satisfy paragraph (2).

(4) In the case of a plan establishing subclasses within the meaning of section 4044(b) (6) of ERISA, the assets within any paragraph of section 4044(a) of ERISA may be reallocated within such paragraph to the extent that such reallocation helps to satisfy paragraph (2).

(5) Subject to paragraphs (1), (2), (3), and (4), the assets shall be allocated in accordance with section 4044 (a) (4) (B), (5), and (6) of ERISA.

.03 Examples—The guidelines described in subsection .02 are illustrated by the following examples:

Example 1. A plan described in subsection .01 which provided benefits on an ongoing basis as of the date of termination that were not discriminatory within the meaning of section 401 (a) (4) of the Code, terminates. The plan has two employees: *A*, an officer of the company, and *B*, a rank and file employee. The value of plan assets as of the date of termination is $130,000 which would, without regard to this section, be allocated to the employees under section 4044(a) of ERISA as follows:

Paragraph of section 4044(a) of ERISA	Allocation to Employee *A*	Allocation to Employee *B*
(3)	$120,000	0
(4) (A)	0	0
(5)	10,000	0
(6)	0	0
	$130,000	

The present value of *A*'s and *B*'s accrued benefit on the date of termination, whether or not nonforfeitable, is $240,000 and $60,000, respectively. The limits described in section 1.401-4 (c) of the regulations do not apply.

The proposed distribution described in section 4044(a) of ERISA would not satisfy section 4.02(2) of this revenue ruling because (1) employees who are officers, shareholders or highly compensated would receive 54% ($130,000)/($240,000) of the present value of their accrued benefit whether or not nonforfeitable and the rank and file employees would receive 0% and (2) there are assets in paragraphs (4) (B), (4) or (6) of section 4044(a) of ERISA to be reallocated to minimize the discrimination. The $10,000 allocated in paragraph (5) to *A* should be reallocated to *B*. *A* would then receive $120,000 (50% of the present value of his accrued benefits whether or not nonforfeitable) and *B* would receive $10,000 (16⅔% of the present value of his accrued benefits whether or not nonforfeitable). This distribution would be deemed nondiscriminatory because the assets have, in accordance with section 4.02(2) of this revenue ruling, been allocated to the extent possible to preclude discrimination.

Example 2. The facts are the same as in Example 1 except the early termination restrictions described in section 1.401-(4) (c) would limit the assets to be allocated to *A* to $100,000. It is proposed to distribute $120,000 to *A* and $10,000 to *B*.

The proposed distribution does not satisfy section 4.02(3) of this revenue ruling because (1) the assets allocated to officers, shareholders, and highly compensated are 50% of the present value of their accrued benefits and the assets allocated to the rank and file employees are 16⅔% of the present value of their accrued benefits and (2) there are assets that are restricted by section 1.401-4(c) of the regulations that may be allocated to preclude discrimination. If an additional $16,000 were allocated to *B* so that *A* would receive $104,000 (43⅓% of the present value of his accrued benefit) and *B* would receive $26,000 (43⅓% of the present value of his accrued benefit) the distribution would be nondiscriminatory even though *A* is receiving $104,000 and the limits described in section 1.401-4(c) would otherwise limit his benefits to $100,000.

Example 3. A plan described in sub-

section .01, which provides benefits on an ongoing basis that are not discriminatory within the meaning of section 401(a)(4) of the Code, is terminated. The plan has two employees: *A*, a shareholder employer whose benefits are not nonforfeitable, and *B*, a rank and file employee whose entire benefits are nonforfeitable. When the assets are allocated in accordance with section 4044(a) of ERISA only *B* receives an asset allocation. It is proposed to reallocate the assets to provide both *A* and *B* with the same proportion of the present value of their accrued benefits whether or not nonforfeitable.

The proposed reallocation is not permitted. Because the rank and file employees are receiving at least the same percentage of the present value of their accrued benefits as the employees who are officers, shareholders, or highly compensated, there is no discrimination within the meaning of section 401(a)(4) of the Code and no reallocation under section 4.02(2), (3), or (4) of this revenue ruling and section 4044(b)(4) of ERISA is permissible. The assets, in accordance with section 4.02(1) and (5) should be allocated in accordance with section 4044(a) of ERISA.

SEC. 5. EFFECT ON OTHER RULINGS

Rev. Ruls. 55-60, 59-241 and 65-294 are superseded.

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26 CFR 1.401-4: Discrimination as to contributions or benefits.
(Also Section 410; 1.410(b)-1.)

Discrimination; mandatory employee contribution plan. A mandatory employee contribution plan offered to all employees that operates to deny participation to lower paid employees or to deprive lower paid employees of benefits at least as high as the benefits provided for higher paid employees in proportion to compensation, after considering differentials permitted under the requirements for integration with social security, may result in discrimination within the meaning of section 410(b)(1) or 401(a)(4) of the Code; Rev. Rul. 72-58 superseded.

Rev. Rul. 80-307

The purpose of this revenue ruling is to restate the position of Rev. Rul. 72-58, 1972-1 C.B. 111, in view of the amendment of section 401(a) of the Internal Revenue Code by the Employee Retirement Income Security Act of 1974, Pub. L. 93-406, 1974-3 C.B. 1.

The issue in Rev. Rul. 72-58 is whether mandatory employee contributions under a qualified plan may result in discrimination within the meaning of section 410(b)(1) or 401(a)(4) of the Code under the circumstances described below.

Section 410(b)(1) of the Code requires that a qualified plan cover either a certain percentage of an employer's employees or a classification of employees that does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

If a mandatory employee contribution plan is offered to all employees, but the contributions required of the employee-participants are burdensome, some of the lower paid employees may not participate because of such requirement. In such event the plan may not meet the coverage requirements of section 410(b)(1) of the Code.

Section 401(a)(4) of the Code requires that a qualified plan must provide either benefits or contributions which do not discriminate in favor of employees who are officers, shareholders, or highly compensated.

In cases where the plan provides for optional rates of contributions by employees, and employer contributions or the benefits are geared to the employee contributions in such a way that a higher rate of employee contributions will result in larger benefits from employer contributions, the employee contributions may similarly result in discrimination within the meaning of section 401(a)(4) of the Code, because the employer-derived benefits favor those who are highly compensated.

Accordingly, mandatory employee contributions may operate either to deny participation to lower paid employees or to deprive lower paid employees of benefits at least as high in proportion to compensation as are provided for higher paid employees, after taking into account differentials permitted under the requirements for integration with social security benefits. Thus, mandatory employee contributions may result in discrimination within the meaning of sections 410(b)(1) or 401(a)(4) of the Code.

Although Rev. Rul. 72-58 provided that, generally, discrimination would not result if the rate of mandatory employee contributions did not exceed six percent of compensation, discrimination may result even in that case.

The principles stated herein also apply to a plan described in section 410(c) of the Code.

Rev. Rul. 72-58 is superseded because the position stated therein is restated under current law in this revenue ruling.

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26 CFR 1.401-4: Discrimination as to contributions or benefits.

Discrimination; deferred compensation included in benefit base. An employer adopted a voluntary deferred-payment plan that allows electing employees to defer 5 percent of their compensation earned in any year. The employer also adopted a pension plan that takes into account all compensation for computing benefits, including amounts deferred under the first plan. The inclusion of the deferred amounts in computing benefits may result in discrimination prohibited under section 401(a)(4) of the Code only if the proportion of compensation deferred by rank-

and-file employees participating in the second plan is less than that of highly paid employees participating in the plan. Rev. Ruls. 69-145 and 71-225 superseded.

Rev. Rul. 80-359

The purpose of this revenue ruling is to restate the positions in Rev. Rul. 69-145, 1969-1 C.B. 126, and Rev. Rul. 71-225, 1971-1 C.B. 124, under current law.

The issue in the revenue rulings is whether a pension plan that determines benefits under the circumstances described below may fail to satisfy section 401(a)(4) of the Internal Revenue Code.

An employer adopted a nonqualified, deferred-payment arrangement for its employees. Under the arrangement any employee of the employer may elect, before the beginning of any taxable year, to defer, until retirement, the receipt of 5 percent of the compensation earned in that year. The deferred amounts are allocated to the employee's account as nonforfeitable credits. The employer has not made any contributions to fund the deferred-payment arrangement.

In the same year, the employer also adopted a pension plan for its employees. The plan provides that all compensation will be considered as the base for purposes of computing benefits regardless of the deferment of payment of any part of such compensation.

Section 401(a)(4) of the Code provides that a plan will satisfy that section if the contributions or benefits under the plan do not discriminate in favor of employees who are officers, shareholders, or highly compensated. However, section 401(a)(5) provides that a plan will not be considered discriminatory merely because the contributions or benefits of or on behalf of the employees under the plan bear a uniform relationship to the total compensation or the basic or regular rate of compensation of such employees.

The amounts credited under an unfunded, deferred payment, under which the amounts will not be paid until retirement, are not considered compensation for the purposes of section 401(a)(5) of the Code. Therefore, such deferred amounts may not be used under a qualified plan to compute the employees' benefits if it results in discrimination prohibited under section 401(a)(4). However, these amounts may be used under a qualified plan if they do not result in prohibited discrimination.

In this case, if the proportion of compensation deferred under the unfunded arrangement by rank-and-file employees participating in the qualified plan equals or exceeds that deferred by employees participating in the qualified plan who are officers, shareholders, or highly compensated, the basis for computing benefits does not cause prohibited discrimination.

On the other hand, if in the plan under consideration only a few of the lower paid employees elected to participate under the unfunded deferred-payment arrangement, the use of the amounts credited under the unfunded arrangement benefits primarily the highly paid employees and, therefore, the plan in operation may result in discrimination prohibited under section 401(a)(4) of the Code.

Accordingly, the use of deferred amounts and current compensation as the basis for computing benefits will not automatically cause the plan to fail to satisfy section 401(a)(4) of the Code. However, the basis of benefits may, in operation, result in failure to satisfy section 401(a)(4).

This revenue ruling does not deal with whether the nonqualified deferred-payment arrangement may fail to satisfy the funding requirements of Part 3 of Title I of the Employee Retirement Income Security Act of 1974, Pub. L. 93-406, 1974-3 C.B. 1.

This revenue ruling does not consider whether the basis of benefits for the pension plan may result in a violation of the limits of section 415 of the Code.

Rev. Ruls. 69-145 and 71-225 are superseded because the positions stated therein are restated under current law in this revenue ruling.

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26 CFR 1.401-4: Discrimination as to contributions or benefits.

Whether an employee who is given the title "assistant secretary-treasurer" is an officer for purposes of section 401(a)(4) of the Code. See Rev. Rul. 80-314, page 152.

Section 402.—Taxability of Beneficiary of Employees' Trust

26 CFR 1.402(a)-1: Taxability of beneficiary under a trust which meets the requirements of section 401(a).
(Also Section 72; 1.72-11.)

Distributions; employer's stock; net unrealized appreciation; taxability. A qualified profit-sharing plan provides for the purchase of the employer's stock from employer and employee contributions and reinvestment of dividends. Upon an employee's separation from service, the plan provides for a distribution of the employer's stock attributable to the employee's contributions and to a portion of the reinvested dividends. An explanation is provided of the taxability of the distribution of appreciated stock under the plan. Rev. Rul. 67-165 superseded.

Rev. Rul. 80-258

The purpose of this revenue ruling is to restate, under current law, Rev. Rul. 67-165, 1967-1 C.B. 89.

Rev. Rul. 67-165 discusses the taxability of distributions of stock of the employer corporation, pursuant to an exempt employees' profit-sharing plan, under the circumstances described below.

An employer corporation established a qualified profit-sharing plan under section 401(a) of the Internal Revenue Code and contributed fifty cents

out of profits for each dollar contributed to the trust by an employee-participant. The plan provided that all contributions were to be invested in common stock of the employer corporation. Dividends received on such stock were also invested in the corporation's common stock.

The interest of each employee in the trust was represented by units allocated to his or her account. Units credited to an employee's account as a result of his or her own contributions were known as member-units. Units credited to an employee's account as a result of the corporation's contributions were known as employer-units. Both member-units and employer-units included stock that was attributable to reinvested cash dividends received by the trust represented by units already credited to an employee's account. Therefore, any employee who withdrew his or her member-units withdrew some shares that were, and some that were not, attributable to the employee's own contributions.

Upon separation from the service of the employer, an employee could withdraw all of the member-units credited to the account. Employer-units were not subject to withdrawal at such time but, rather, had to be left in the employee's account until the employee attained age 65. All withdrawals were paid in full shares of the corporation's common stock, to the extent possible, with any balance being paid in cash.

Section 402(a)(1) of the Code provides that "the amount actually distributed or made available to any distributee" by an exempt employees' trust shall be taxable to him or her in the year in which so distributed or made available under section 72 (relating to annuities). Section 402(a)(1) excludes from the amount actually distributed or made available to any distributee the "net unrealized appreciation in securities of the employer corporation attributable to the amount contributed by the employee." Special tax treatment is accorded lump-sum distributions as defined in section 402(e)(4).

Thus, the net unrealized appreciation attributable to employee contributions will be excluded from the distributee's gross income. The net unrealized appreciation which is not attributable to employee contributions will be included in gross income except to the extent excluded by section 72(e)(1)(B) of the Code. That section provides that if any amount is not received as an annuity, then such amount shall be included in gross income but only to the extent that it (when added to amounts previously received which were excludable from gross income) exceeds the aggregate consideration paid.

In determining the amount of net unrealized appreciation that is attributable to the amount contributed by the employee for purposes of section 402(a)(1) of the Code, section 1.402(a)-1(b)(3)(ii) of the Income Tax Regulations provides that the amount contributed by the employee for the purchase of securities shall be solely the portion of his or her actual contributions properly allocable to such securities and shall not include any part of the increment in the trust expended for such securities.

Section 1.402(a)-1(b)(2)(i) of the regulations provides that the amount of net unrealized appreciation in securities of the employer corporation which are distributed by the trust is the excess of the market value of such securities at the time of distribution over the cost or other basis of such securities to the trust. Section 1.402(a)1(b)(3)(iii) states that the amount of the net unrealized appreciation which is attributable to the employee's contribution is that proportion of the net unrealized appreciation which the employee's contributions allocable to such securities bear to the cost or other basis to the trust of the securities.

In applying section 1.402(a)-1(b)(3)(iii) of the regulations to a distribution of securities of the employer which were purchased partially with employee contributions and partially with increments in the trust, the amount of net unrealized appreciation attributable to the employee's contributions is the amount of appreciation which bears the same relationship to the total net unrealized appreciation in such securities as the part of the cost of such securities paid with the employee's contributions bears to the total cost of the securities.

The remainder of the fair market value of the securities distributed is includible in the distributee's gross income under section 72(e)(1)(B) of the Code to the extent it exceeds the employee's contributions as defined in section 72(f). The effect of this computation is to include in the gross income of the distributee the increments of the trust used to purchase the stock plus that portion of the net unrealized appreciation allocable thereto. Amounts thus included in gross income are to be considered part of the basis of the securities in the hands of the distributee for purposes of determining gain or loss on their subsequent disposition.

Under the facts presented, the employee may withdraw only his or her member-units upon separation from the service of the employer prior to age 65. Such withdrawal does not constitute a lump-sum distribution within the meaning of section 402(e)(4) of the Code.

Accordingly, the employee is entitled to exclude from gross income under section 402(a)(1) of the Code only that portion of the total net unrealized appreciation that is allocable to the part of the stock purchased with his or her own contributions. The remainder of the fair market value of the securities distributed is includible in the gross income of the distributee under section 72(e)(1)(B) to the

extent it exceeds the employee's contributions as defined in section 72(f).

Rev. Rul. 67-165 is superseded because the position set forth therein is restated, under current law, in this revenue ruling.

Section 404.—Deduction for Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred-Payment Plan

26 CFR 1.404(a)-1: Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan; general rule.

Contributions; short taxable year. Rules are provided for determining the limitation on contributions to a qualified pension plan under section 404 of the Code for a short taxable year by an employer that has consistently determined the deductible limit for each taxable year on the basis of the plan year beginning in such taxable year; Rev. Ruls. 55-428 and 56-672 amplified.

Rev. Rul. 80-267

SECTION 1. PURPOSE

This revenue ruling provides rules for determining the deductible limit under section 404 of the Internal Revenue Code, as amended by the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. 93-406, 1974-3 C.B. 1, in the case of a short taxable year where the employer has consistently determined the deductible limit for each taxable year on the basis of the plan year beginning in such taxable year.

SEC. 2. BACKGROUND AND GENERAL INFORMATION

Section 404(a)(1)(A) of the Code provides general guidelines governing the deductibility of contributions to qualified pension plans.

Section 404(a)(1)(D) of the Code provides that any amount paid in a taxable year in excess of the amount deductible in such year shall be deductible in the succeeding years in order of time to the extent of the difference between the amount paid and deductible in each such succeeding year and the maximum amount deductible for such year.

Prior to the enactment of ERISA, Rev. Rul. 55-428, 1955-2 C.B. 230, together with Rev. Rul. 56-672, 1956-2 C.B. 295, provided that in the case of a short taxable year, the employer may take as a deduction a pro rata portion of both the normal cost and 10 percent of the cost of past service or supplemental benefits as of the date such benefits were provided under the plan.

Section 404(a)(1) of the Code, as amended by ERISA, changes the method for determining the deductible limits in several ways. These changes affect the deductible limit in a short taxable year.

SEC. 3. GENERAL RULE

In the case of a short taxable year, where the employer has consistently determined the deductible limit for each taxable year on the basis of the plan year beginning in the taxable year and where the plan year begins in the short taxable year, the employer may determine the deductible limit by the Weighted Average Method or the Special Allowance Method as described below.

Once a method is selected, the employer must consistently apply that method in determining the deductible limit.

SEC. 4. WEIGHTED AVERAGE METHOD

.011 Under the Weighted Average Method, where the deduction is being claimed in the short taxable year under section 404(a)(1)(A)(ii) or (iii) of the Code, the deductible limit in the short taxable year is the product of the deductible limit otherwise applicable under such section and the tax year ratio (the number of months in the short taxable year divided by 12).

.012 For subsequent taxable years, the deductible limit is the weighted average of the deductible limits for the plan year ending within the taxable year and for the plan year commencing in that taxable year. This amount is computed by adding—

(1) The deductible limit for the plan year ending within the taxable year multiplied by the difference between 1 and the tax year ratio as defined in section 4.011, and

(2) The deductible limit for the plan year commencing within the taxable year multiplied by the tax year ratio.

The deductible limits referred to in section 4.012(1) and (2) are the limits as determined under section 404(a)(1)(A)(i), (ii), or (iii), whichever is applicable.

.021 Under the Weighted Average Method, where the deduction in the short taxable year is being claimed under section 404(a)(1)(A)(i) of the Code, the deductible limit in the short taxable year equals the sum of—

(1) The debit balance (if any) in the funding standard account as of the end of the previous plan year (without regard to the alternative minimum funding standard account) increased with interest to the end of the short taxable year, and

(2) The tax year ratio multiplied by the excess (if any) of the amount necessary to satisfy the minimum funding requirements for the plan year beginning in the short taxable year (including interest charges and credits only to the end of the short taxable year) over the amount determined in section 4.021(1).

.022 Under the Weighted Average Method, for the first taxable year after the short taxable year, where the deduction in the short taxable year was claimed under section 404(a)(1)(A)(i) of the Code, the deductible limit is the sum of—

(1) The amount which is necessary to satisfy the minimum funding requirements for the plan year beginning

in the short taxable year, and which was not deductible in the short taxable year, and

(2) The tax year ratio multiplied by the deductible limit determined under section 404(a)(1)(A)(i), (ii) or (iii) of the Code (whichever is applicable) attributable to the plan year beginning in the taxable year.

.023 For subsequent taxable years, the deductible limit is the weighted average, as computed under section 4.012, of the deductible limit determined for the plan year ending within the taxable year and the deductible limit determined for the plan year commencing within the taxable year.

SEC. 5. SPECIAL ALLOWANCE METHOD

Under the Special Allowance Method the deductible limit under section 404(a)(1)(A)(i), (ii), and (iii) of the Code for a short taxable year is the same as under the Weighted Average Method. However, under the Special Allowance Method, the deductible limit in all of the taxable years following the short taxable year equals the sum of the deductible limit for the plan year beginning in such taxable year plus (if the contribution for the short year exceeded the deductible limit for such year) a special allowance. The special allowance is ten percent of the special allowance amount.

To compute the special alowance amount, subtract the deductible limit determined under the Special Allowance Method for the short taxable year from the lesser of (1) the amount necessary to satisfy the minimum funding requirement for the plan year beginning in the short taxable year or (2) the employer contribution made for the short taxable year. This special allowance can be used only for the first ten taxable years after the short taxable year.

SEC. 6. ADDITIONAL INFORMATION

With the approval of the Secretary of the Treasury as required under section 446(e) of the Code, the employer may determine the deductible limit under the End of Plan Year Method. Under this method, the employer (1) takes no deduction for plan costs in the short taxable year and (2) changes the method for determining the deductible limit so that the limit is determined for the plan year ending within the taxable year.

SEC. 7. EXAMPLE

For the taxable year beginning January 1, 1977, an employer has changed its annual accounting period from the taxable year ending December 31, creating a short taxable year ending May 31. The employer has consistently deducted amounts contributed in a taxable year for the cost attributable to the plan year beginning in such taxable year. For the short period January 1, 1977 to May 31, 1977, the employer intends to contribute the amount necessary to satisfy the minimum funding standard provided by Code section 412(a) for the plan year beginning April 1, 1977.

The minimum required contribution for the plan year beginning April 1, 1977, is $100,000, and there is no debit balance in the funding standard account as of March 31, 1977. If the taxable year were not a short year, the deductible limit determined under section 404(a)(1)(A)(ii) of the Code would be $110,000.

The deductible limit under section 404(a)(1)(A)(i) of the Code for the short taxable year January 1, 1977—May 31, 1977, is $41,667 ($0, the debit balance for the previous year + [($100,000, the minimum required contribution — $0) × 5/12]). The deductible limit under section 404(a)(1)(A)(ii) is $45,833 ($110,000 × 5/12).

If the employer contributes $100,000 and the End of Plan Year Method is not elected, the amount contributed in excess of the deductible limit in the short taxable year ($54,167) is considered a contribution carryover within the meaning of section 404(a)(1)(D) of the Code for a future taxable year.

For the plan year beginning April 1, 1978, the minimum required contribution is $110,000 and the deductible limit for the taxable year June 1, 1977—May 31, 1978, determined under section 404(a)(1)(A)(ii) of the Code (without regard to the fact that the previous taxable year was a short year) is $150,000. However, a special allowance amount is also calculated.

The special allowance amount ($54,167) is the excess of the lesser of (1) the amount necessary to satisfy the minimum funding requirement for the plan year beginning in the short taxable year ($100,000) or (2) the employer contribution in the short taxable year ($100,000), over the deductible limit determined under the Special Allowance Method for the short taxable year which is the greater of the deductible limit determined under section 404(a)(1)(A)(i) of the Code ($41,667) or the deductible limit determined under section 404(a)(1)(A)(ii) of the Code ($45,833). Therefore, the maximum deductible amount under section 404(a)(1)(A)(ii) of the Code is determined using either method below:

(1) Weighted Average Method: $126,667 [($110,000 × 7/12) + ($150,000 × 5/12)]

(2) Special Allowance Method: $155,417 [$150,000 + (10% × $54,167)]

SEC. 8. EFFECT ON OTHER REVENUE RULINGS

Rev. Ruls. 55-428 and 56-672 are amplified.

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26 CFR 1.404(a)-9: Contributions of an employer to an employees' profit-sharing or stock bonus trust that meets the requirements of section 401(a); application of section 404(a)(3)(A).

Whether the profit-sharing plan of an electing small business corporation will

fail to qualify because the plan document allows contributions to the plan to be made from accumulated profits (when there are no current profits), and whether the contributions are deductible under section 404(a)(3) of the Code. See Rev. Rul. 80-252, page 130.

Section 408.—Individual Retirement Accounts

(Also Section 165; 26 CFR 1.165-1.)

Individual retirement programs; loss on total distribution. An individual received the cash surrender value of an individual retirement account (IRA) annuity, which had been purchased three months earlier, as a total distribution under section 408(d)(4) of the Code that was less than the individual's cost of the annuity. The individual may not claim an ordinary loss deduction on the difference between the cost and the cash surrender value.

Rev. Rul. 80-268

Advice has been requested whether a taxpayer has a deductible loss on investments purchased with amounts contributed to an individual retirement account (IRA), as described in sections 408 and 409 of the Internal Revenue Code, under the circumstances set forth below.

A, a calendar year taxpayer under age 59½, purchased an individual retirement annuity in June of 1978 for $1,500, the maximum amount allowable as a deduction under section 219(b)(1) of the Code. *A* revoked this annuity three months later upon joining a company and participating immediately in its qualified pension plan. *A* received a total distribution from the annuity of $1,300, the cash surrender value to which *A* was entitled under the terms of the policy. *A* did not claim a deduction for 1978 under section 219, but did deduct the excess of the investment in the contract ($1,500) over the amount received upon surrender of the contract ($1,300) as an ordinary loss.

Section 165(c)(2) of the Code provides, in part, that an individual shall be allowed to deduct any loss sustained during the taxable year in any transaction entered into for profit.

Revenue Ruling 61-201, 1961-2 C.B. 46, illustrates the circumstances under which an individual may claim a deduction on his or her federal income tax return for a loss sustained upon the cashing in of an annuity for its surrender value. This ruling states that the original purchaser of a single premium refund annuity contract may claim an ordinary loss deduction if the individual's basis in the contract, subject to certain adjustments, exceeds the amount received upon surrender of the contract.

Sections 219 and 220 of the Code set forth the restrictions on an individual's eligibility to claim a deduction on the federal income tax return for amounts contributed to an individual retirement annuity described in section 408(b).

Section 408 of the Code establishes the requirements which annuities must meet in order to maintain their status as IRA's, and section 408(d) specifies the taxability of amounts distributed from IRA's.

As provided by section 408(d)(1) of the Code, any amount paid out of an IRA (unless otherwise excepted) is to be included in an individual's gross income for the year in which received. Section 408(d)(1) also provides that, notwithstanding any other provision of Title 26 of the United States Code, the basis of an individual in an IRA is zero.

Section 408(d)(4) of the Code provides one exception to the taxability provisions of section 408(d)(1). Section 408(d)(4) states that section 408(d)(1) shall not apply to the distribution of a contribution made during the year to an IRA, to the extent that the contribution exceeds the amount allowable as a deduction under section 219 or 220, if the following conditions are met: (1) the distribution is received on or before the day on which the individual is required to file his or her Federal income tax return for such year; (2) no deduction is allowed under section 219 or 220 for the excess contribution; and (3) the distribution is accompanied by any net income attributable to the excess contribution. Thus, an individual who utilizes the withdrawal provisions of section 408(d)(4) is relieved from the requirement of section 408(d)(1) that all amounts distributed from an IRA be included in gross income.

A was not eligible to maintain an IRA for 1978, so no amount was allowable as a deduction under section 219 of the Code on *A*'s Federal income tax return for that year. Therefore, *A*'s contributions to the IRA were excess contributions within the meaning of section 408(d)(4). The requirement of section 408(d)(1) that all amounts be included in gross income did not apply to the distribution from the IRA because *A* utilized the provisions of section 408(d)(4) to withdraw the entire balance from the IRA before the date for filing *A*'s tax return. Thus, *A* was not required to include in gross income the distribution from the annuity.

Section 408(d)(1) of the Code, however, precluded *A* from establishing a basis in the contract. As a result, no loss was incurred when *A* cashed in the annuity for its surrender value.

Accordingly, *A* is not entitled to an ordinary loss deduction on *A*'s 1978 Federal income tax return.

26 CFR 1.408-1: General rules.

Regulations relating to individual retirement arrangements. See T.D. 7714, page 83.

Section 409.—Retirement Bonds

26 CFR 1.409-1: Retirement bonds.

Regulations relating to individual retirement arrangements. See T.D. 7714, page 83.

Subpart B.—Special Rules

Section 410.—Minimum Participation Standards

26 CFR 1.410(a)-4: Maximum age conditions and time of participation.

Eligibility; plan provisions. Examples illustrate whether plan provisions that describe the date of eligibility for plan participation meet the eligibility requirements of section 410(a)(4) of the Code.

Rev. Rul. 80-360

Advice has been requested whether the plans described below meet the requirements regarding commencefent of plan participation of section 410(a)(4) of the Internal Revenue Code and section 1.410(a)-4(b) of the Income Tax Regulations.

Plan 1. A plan provides that an employee is eligible to participate in the plan on the first day of the first plan year beginning after the employee's employment commencement date. The plan has no other requirements for participation.

Plan 2. A calendar year plan sets minimum service requirements regarding eligibility for plan participation as the completion of at least one hour of service (as defined in section 2530.200b-2(a) of the Department of Labor Regulations) in each of six calendar months after the employee's employment commencement date. An employee who has not separated from service may enter the plan on the first day of the first plan year beginning after completion of this service. The plan designates 12-consecutive-month periods beginning on the first anniversary of an employee's employment commencement date and succeeding anniversaries thereof as the eligibility computation period after the initial eligibility computation period.

Plan 3. A calendar year plan provides that an employee who has satisfied the minimum age and service requirements of section 410(a)(1)(A) of the Code is eligible to participate in the plan on the first day of the first plan year beginning after the date such requirements are met.

Plan 4. A calendar year defined benefit plan provides that an employee may enter the plan on the first semiannual entry date following attainment of age 25 and completion of one year of service.

Section 410(a)(1)(A) of the Code states that, in general, a qualified plan may not, as a condition of plan participation, require that an employee complete a period of service with the employer extending beyond the date on which the employee attains age 25 or completes one year of service, whichever is later. Section 410(a)(1)(B) sets forth special eligibility guidelines for 1) plans which provide 100 percent vesting after three years of service, and 2) plans maintained by certain specified employers.

Section 410(a)(3)(A) of the Code defines the term "year of service" as a 12-month period during which an employee has completed at least 1,000 hours of service.

Section 410(a)(4) of the Code provides that employees who have met the applicable minimum age and service requirements of section 410(a)(1) and who otherwise are eligible must be allowed to participate in the plan no later than the earlier of 1) the first day of the first plan year beginning after the date on which the employee satisfies these requirements, or 2) the date six months after these conditions are met, unless the employee separates from service prior to such date.

For purposes of section 410(a)(1) of the Code, a "break in service" is defined in section 411(a)(6)(A) as a calendar year, plan year, or other 12-consecutive-month period designated by the plan (and not prohibited under regulations prescribed by the Secretary of Labor) during which the participant has not completed more than 500 hours of service.

Section 1.410(a)-4(b) of the regulations provides that if the separated employee returns to service after the time described in section 410(a)(4) of the Code, without incurring a one-year break in service, the employee must commence participation immediately upon the return. Example (3) of section 1.410(a)-4(b) of the regulations describes a situation wherein an employee who separates from service with a vested benefit and then incurs a break in service must be allowed to participate in the plan as of the date of reemployment so long as the employee completes a year of service after his or her return. A plan similarly must accommodate the reentry of certain employees who have satisfied the applicable minimum age and service requirements but who separate from service prior to one of the participation dates referred to in this section (whichever date is applicable). If such an employee later returns after one of these dates, without incurring a one-year break in service, the employee must be allowed to participate in the plan as of his or her return to service.

Section 2530.202-2(a) of the Department of Labor Regulations states that, for purposes of section 410(a)(1)(A)(ii) of the Code, the initial eligibility computation period that a plan must use is the 12-consecutive-month period beginning on the employee's employment commencement date. An employee's employment commencement date is the first day for which the employee is entitled to be credited with an hour of service (as described in section 2530.200b-2(a)(1) of the Department of Labor Regulations) for an employer maintaining the plan.

Section 2530.202-2(b) of the Department of Labor Regulations defines eligibility computation periods after the initial eligibility computation period. According to this section, a plan may, in general, choose one of two methods in measuring years of service for purposes of eligibility to participate after the initial eligibility computation period. The plan may

designate the 12-consecutive month periods beginning on the first anniversary of an employee's employment commencement date and succeeding anniversaries thereof as the eligibility computation period after the initial eligibility computation period. Alternatively, a plan may, subject to certain restrictions, designate plan years beginning with the plan year which includes the first anniversary of an employee's employment commencement date as the eligibility computation period after the initial eligibility computation period.

These criteria are applied to the plans described above as follows:

Plan 1. For plans meeting the requirements of section 410(a)(1)(A) of the Code, section 410(a)(4) permits a maximum waiting period of six months after completion of one year of service for employees who are age 25 or over. This plan ensures that an employee always will be able to participate in the plan within a 12-month period after his or her date of employment.

Accordingly, this plan will not fail to satisfy the requirements of section 410(a)(4) (provided the plan also accommodates the immediate reentry exceptions set forth in section 1.410(a)-4(b) of the regulations, as described above.)

Plan 2. These plan provisions will not always permit an employee to participate within the period mandated by section 410(a)(4) of the Code, as illustrated by the following example.

A comences employment on January 2, 1978. On May 29, 1978, *A* separates from service after having completed over 1,000 hours of service. *A* returns to full-time work for this employer on July 2, 1979. *A* completes six months of employment that July and is thus allowed to participate in the plan as of January 1, 1980.

In the above example, the latest date by which *A* should have been allowed to participate is July 2, 1979, six months after *A* completed one year of service (as defined in section 410(a)(3)(A) of the Code.) The break-in-service provisions of section 410(a)(5) do not allow *A's* hours of service completed in 1978 to be disregarded, for purposes of eligibility to participate, because *A* did not incur a break in service in either the initial eligibility computation period (January 2, 1978 to January 1, 1979) or in *A's* subsequent eligibility computation period (January 2, 1979 to Janunary 1, 1980.)

Accordingly, this plan will not satisfy the requirements of section 410(a)(4) of the Code.

Plan 3. The plan's single annual entry date violates the requirements of section 410(a)(4) of the Code because operation of the provision will not ensure that an employee always will be eligible to participate within six months of attaining age 25 and completing one year of service. An employee, for instance, who had attained age 25 and completed one year of service on January 2 would be prevented from participating in the plan until the following January 1.

Accordingly, this plan fails to satisfy the requirements of section 410(a)(4) of the Code.

Plan 4. Two semi-annual entry dates are not sufficient to allow the plan to comply with the requirements of section 1.410(a)-4(b) of the regulations, as is evidenced by the following example.

B, after working ten years, separates from service in 1979 with a vested benefit. On March 3, 1984, *B* returns to employment that is covered by the plan and is allowed to resume plan participation on July 1 of that year.

In the above example, the employee's prior service may not be disregarded because *B* had a vested benefit upon separation from service. Thus, the plan may not postpone *B*'s participation until July 1 but, rather, must allow *B*, to participate as of his or her return on March 3, 1984 (subject to *B*'s completion of a year of service after returning to work for this employer.)

Accordingly, this plan will not meet the requirements of section 410(a)(4) of the Code unless it also provides for the reentry of vested employees who return after a break in service (and who complete a year of service after returning) and of certain employees who separate from service and later return to work without incurring a one-year break in service.

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26 CFR 1.410(a)-7: Elapsed time.

T.D. 7703

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Elapsed time method of crediting service of employees under qualified plans

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to the elapsed time method of crediting service of employees under qualified plans. Changes in the applicable tax law were made by the Employee Retirement Income Security Act of 1974 [Pub. L. 93-406, 1974-3 C.B. 1]. These regulations provide necessary guidance to the public for compliance with the law, and affect all qualified plans which elect to use the elapsed time method of crediting service of employees.

DATE: The regulations have varying effective dates, the earliest of which, for plans not in existence on January 1, 1974, is plan years beginning after September 2, 1974.

FOR FURTHER INFORMATION CONTACT: Kirk F. Maldonado of the Employee Plans and Exempt Orga-

nizations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:LR:T) (202-566-3430) (not a toll-free number).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On December 28, 1976, the Department of Labor published in the Federal Register a proposed amendment to the Minimum Standards for Employee Pension Benefit Plans (29 CFR § 2530.200b-9) under sections 202, 203, and 204 of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 853). Section 2530.200b-9 was published both as a temporary regulation effective immediately, and as a proposed regulation on which public comments were solicited.

Section 101 of the Reorganization Plan No. 4 of 1978 (43 FR 47713) transferred jurisdiction over the subject matter of this regulation from the Secretary of Labor to the Secretary of the Treasury.

Section 106 of the Reorganization Plan requires that the Secretary of the Treasury notify the Secretary of Labor before any regulations are issued on certain subject matters, listed therein, if the regulations would significantly impact on or substantially affect collectively bargained plans. This Treasury decision affects sections 410(a)(3) and 411(a)(5) and (6) of the Code, which are subject matters listed in section 106. The Secretary of the Treasury is also prohibited from issuing such regulations unless, within 100 calendar days after this notice is given, the Secretary of Labor certifies that he has no objection or fails to respond. These requirements of section 106 have been satisfied.

Although numerous comments were submitted on this regulation, a public hearing was neither requested nor held. After consideration of all the comments submitted regarding the proposed amendment, the amendment is adopted as revised by this Treasury decision.

OVERVIEW

The elapsed time method is an alternative method of crediting the service of employees for purposes of determining eligibility to participate, vesting, and benefit accrual. Under the elapsed time method, the amount of service to be credited to an individual is not determined by the number of hours worked in a particular year, but rather, with reference to the total period of time which elapses while that individual is employed by the employer or employers maintaining the plan. Accordingly, the rules regarding breaks in service contained in Code sections 410(a)(5) and 411(a)(6) are recast in this regulation in a manner compatible with the elapsed time concepts.

TRANSFERS BETWEEN METHODS OF CREDITING SERVICE

Section 1.410(a)-7(f)(1) provides the rules for plans using the general method of crediting service for some classes of employees, and the elapsed time method of crediting service for other classes of employees. This provision has been changed as a result of comments so that employees transferring from the general method class to the elapsed time method class will receive the greater of the credit they would receive under the elapsed time method for the entire year in which the transfer occurs, or the service they were credited with under the general method as of the date of the transfer.

Section 1.410(a)-7(f)(2) provides the rules applicable when an employee transfers from a plan using either the general method of crediting service or the elapsed time method, to a plan using the other method. This provision has been changed as a result of comments so that an employee's service required to be credited under the transferee plan will be determined under the rules for transfers within a plan that uses different methods of crediting service for different classes of employees.

Some of the plans in existence may be required to be amended to conform with the new rules of the final regulations. Those plans which may have to be amended are those which use the elapsed time method for crediting the service of some classes of employees and the general method for other classes. Also such plans are required to be amended only if they provide for partial years of service for purposes of benefit accrual.

Because the changes in the final regulations may require plan amendments, a transitional rule is provided for the provisions of paragraph (f) of § 1.410(a)-7. For plans in existence on June 17, 1980, the provisions of paragraph (f) apply to plan years beginning after December 31, 1983.

MISCELLANEOUS

Certain changes of a clerical nature and for the purpose of clarity are made in these final regulations. No substantive change is intended by the deletion in the final regulations of the citations to the "mirror image" provisions of Title I of ERISA. Also, certain conforming changes to the Income Tax Regulations are made on account of this regulation.

DRAFTING INFORMATION

The principal author of these regulations is Kirk F. Maldonado of the Employee Plans and Exempt Organizations Division of the Office of the Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing this regulation, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, the following amendments to the regulations are hereby adopted:

Paragraph 1. Section 1.410(a)-1 is amended by redesignating paragraph (b)(7) and (b)(8) as (b)(8) and (b)(9), respectively, and by adding a new paragraph (b)(7) to read as follows:

§ 1.410(a)-1 Minimum participation standards; general rules.

* * * * *

(b) *Organization of regulations relating to minimum participation standards.* * * *

(7) *Elapsed time.* Section 1.410(a)-7 provides rules under section 410 and 411 relating to the elapsed time method of crediting years of service.

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Par. 2. Section 1.410(a)-4(b)(1) is revised by deleting "Department of Labor Regulations" and inserting in lieu thereof "§ 1.410(a)-7".

Par. 3. Section 1.410(a)-5(a) is revised by deleting from the second sentence "elapsed time,".

Par. 4. Section 1.410(a)-7 is added at the appropriate place to read as follows:

§ 1.410(a)-7 Elapsed time.

(a) *In general*—(1) *Introduction to elapsed time method of crediting service.* (i) 29 CFR § 2530.200b-2 sets forth the general method of crediting service for an employee. The general method is based upon the actual counting of hours of service during the applicable 12-consecutive-month computation period. The equivalencies set forth in 29 CFR § 2530.200b-3 are also methods for crediting hours of service during computation periods. Under the general method and the equivalencies, an employee receives a year's credit (in units of years of service or years of participation) for a computation period during which the employee is credited with a specified number of hours of service. In general, an employee's statutory entitlement with respect to eligibility to participate, vesting and benefit accrual is determined by totalling the number of years' credit to which an employee is entitled.

(ii) Under the alternative method set forth in this section, by contrast, an employee's statutory entitlement with respect to eligibility to participate, vesting and benefit accrual is not based upon the actual completion of a specified number of hours of service during a 12-consecutive-month period. Instead, such entitlement is determined generally with reference to the total period of time which elapses while the employee is employed (*i.e.*, while the employment relationship exists) with the employer or employers maintaining the plan. The alternative method set forth in this section is designed to enable a plan to lessen the administrative burdens associated with the maintenance of records of an employee's hours of service by permitting each employee to be credited with his or her total period of service with the employer or employers maintaining the plan, irrespective of the actual hours of service completed in any 12-consecutive-month period.

(2) *Overview of the operation of the elapsed time method.* (i) Under the elapsed time method of crediting service, a plan is generally required to take into account the period of time which elapses while the employee is employed (*i.e.*, while the employment relationship exists) with the employer or employers maintaining the plan, regardless of the actual number of hours he or she completes during such period. Under this alternative method of crediting service, an employee's service is required to be taken into account for purposes of eligibility to participate and vesting as of the date he or she first performs an hour of service within the meaning of 29 CFR § 2530.200b-2(a)(1) for the employer or employers maintaining the plan. Service is required to be taken into account for the period of time from the date the employee first performs such an hour of service until the date he or she severs from service with the employer or employers maintaining the plan.

(ii) The date the employee severs from service is the earlier of the date the employee quits, is discharged, retires or dies, or the first anniversary of the date the employee is absent from service for any other reason (*e.g.*, disability, vacation, leave of absence, layoff, etc.). Thus, for example, if an employee quits, the severance from service date is the date the employee quits. On the other hand, if an employee is granted a leave of absence (and if no intervening event occurs), the severance from service date will occur one year after the date the employee was first absent on leave, and this one year of absence is required to be taken into account as service for the employer or employers maintaining the plan. Because the severance from service date occurs on the earlier of two possible dates (*i.e.*, quit, discharge, retirement or death *or* the first anniversary of an absence from service for any other reason), a quit, discharge, retirement or death within the year after the beginning of an absence for any other reason results in an immediate severance from service. Thus, for example, if an employee dies at the end of a four-week absence resulting from illness, the severance from service date is the date of death, rather than the first anniversary date of the first day of absence for illness.

(iii) In addition, for purposes of eligibility to participate and vesting under the elapsed time method of crediting service, an employee who has severed from service by reason of a quit, discharge or retirement may be entitled to have a period of time of 12 months or less taken into account by the employer or employers maintaining the plan if the employee returns to service within a certain period of time and performs an hour of service within the meaning of 29 CFR § 2530.200b-2(a)(1). In general, the period of time during which the employee must return to service begins on the date the employee severs from service as a result of a quit, discharge or retirement and ends on the first

anniversary of such date. However, if the employee is absent for any other reason (*e.g.*, layoff) and then quits, is discharged or retires, the period of time during which the employee may return and receive credit begins on the severance from service date and ends one year after the first day of absence (*e.g.*, first day of layoff). As a result of the operation of these rules, a severance from service (*e.g.*, a quit), or an absence (*e.g.*, layoff) followed by a severance from service, never results in a period of time of more than one year being required to be taken into account after an employee severs from service or is absent from service.

(iv) For purposes of benefit accrual under the elapsed time method of crediting service, an employee is entitled to have his or her service taken into account from the date he or she begins to participate in the plan until the severance from service date. Periods of severance under any circumstances are not required to be taken into account. For example, a participant who is discharged on December 14, 1980 and rehired on October 14, 1981 is not required to be credited with the 10 month period of severance for benefit accrual purposes.

(3) *Overview of certain concepts relating to the elapsed time method*—(i) *In general.* The rules with respect to the elapsed time method of crediting service are based on certain concepts which are defined in paragraph (b) of this section. These concepts are applied in the substantive rules contained in paragraphs (c), (d), (e), (f) and (g) of this section. The purpose of this subparagraph is to summarize these concepts.

(ii) *Employment commencement date.* (A) A concept which is necessary in order to credit service accurately under any service crediting method is the establishment of a starting point for crediting service. The employment commencement date, which is the date on which an employee first performs an hour of service within the meaning of 29 CFR § 2530.200b-2(a)(1) for the employer or employers maintaining the plan, is used to establish the date upon which an employee must begin to receive credit for certain purposes (*e.g.*, eligibility to participate and vesting).

(B) In order to credit accurately an employee's total service with an employer or employers maintaining the plan, a plan also may provide for an "adjusted" employment commencement date (*i.e.*, a recalculation of the employment commencement date to reflect noncreditable periods of severance) or a reemployment commencement date as defined in paragraph (b)(3) of this section. Fundamentally, all three concepts rely upon the performance of an hour of service to provide a starting point for crediting service. One purpose of these three concepts is to enable plans to satisfy the requirements of this section in a variety of ways.

(C) The fundamental rule with respect to these concepts is that any plan provision is permissible so long as it satisfies the minimum standards. Thus, for example, although the rules of this section provide that credit must begin on the employment commencement date, a plan is permitted to "adjust" the employment commencement date to reflect periods of time for which service is not required to be credited. Similarly, a plan may wish to credit service under the elapsed time method as discrete periods of service and provide for a reemployment commencement date. Certain plans may wish to provide for both concepts, although it is not a requirement of this section that plans so provide.

(iii) *Severance from service date.* Another fundamental concept of the elapsed time method of crediting service is the severance from service date, which is defined as the earlier of the date on which an employee quits, retires, is discharged or dies, or the first anniversary of the first date of absence for any other reason. One purpose of the severance from service date is to provide the endpoint for crediting service under the elapsed time method. As a general proposition, service is credited from the employment commencement date (*i.e.*, the starting point) until the severance from service date (*i.e.*, the endpoint). A complementary purpose of the severance from service date is to establish the starting point for measuring a period of severance from service in order to determine a "break in service" (see paragraph (a)(3)(v) of this section). A third purpose of such date is to establish the starting point for measuring the period of time which may be required to be taken into account under the service spanning rules (see paragraph (a)(3)(vi) of this section).

(iv) *Period of service.* A third elapsed time concept is the use of the "period of service" rather than the "year of service" in determining service to be taken into account for purposes of eligibility to participate, vesting and benefit accrual. For purposes of eligibility to participate and vesting, the period of service runs from the employment commencement date or reemployment commencement date until the severance from service date. For purposes of benefit accrual, a period of service runs from the date that a participant commences participation under the plan until the severance from service date. Because the endpoint of the period of service is marked by the severance from service date, an employee is credited with the period of time which runs during any absence from service (other than for reason of a quit, retirement, discharge or death) which is 12 months or less. Thus, for example, a three week absence for vacation is taken into account as part of a period of service and does not trigger a severance from service date.

(v) *Period of severance.* A period of severance begins on the severance from service date and ends when an employee returns to service with the

employer or employers maintaining the plan. The purpose of the period of severance is to apply the statutory "break in service" rules to an elapsed time method of crediting service.

(vi) *Service spanning.* Under the elapsed time method of crediting service, a plan is required to credit periods of service and, under the service spanning rules, certain periods of severance of 12 months or less for purposes of eligibility to participate and vesting. Under the first service spanning rule, if an employee severs from service as a result of quit, discharge or retirement and then returns to service within 12 months, the period of severance is required to be taken into account. Also, a situation may arise in which an employee is absent from service for any reason other than quit, discharge, retirement or death and during the absence a quit, discharge or retirement occurs. The second service spanning rule provides in that set of circumstances that a plan is required to take into account the period of time between the severance from service date (*i.e.*, the date of quit, discharge or retirement) and the first anniversary of the date on which the employee was first absent, if the employee returns to service on or before such first anniversary date.

(4) *Organization and applicability.* (i) The substantive rules for crediting service under the elapsed time method with respect to eligibility to participate are contained in paragraph (c), the rules with respect to vesting are contained in subparagraph (d), and the rules with respect to benefit accrual are contained in paragraph (e). The format of the rules is designed to enable a plan to use the elapsed time method of crediting service either for all purposes or for any one or combination of purposes under sections 410 and 411. Thus, for example, a plan may credit service for eligibility to participate purposes by the use of the general method of crediting service set forth in 29 CFR § 2530.200b-2 or by the use of any of the equivalencies set forth in 29 CFR § 2530.200b-3, while the plan may credit service for vesting and benefit accrual purposes by the use of the elapsed time method of crediting service.

(ii) A plan using the elapsed time method of crediting service for one or more classifications of employees covered under the plan may use the general method of crediting service set forth in 29 CFR § 2530.200b-2 or any of the equivalencies set forth in 29 CFR § 2530.200b-3 for other classifications of employees, provided that such classifications are reasonable and are consistently applied. Thus, for example, a plan may provide that part-time employees are credited under the general method of crediting service set forth in 29 CFR § 2530. 200b-2 and full-time employees are credited under the elapsed time method. A classification, however, will not be deemed to be reasonable or consistently applied if such classification is designed with an intent to preclude an employee or employees from attaining his or her statutory entitlement with respect to eligibility to participate, vesting or benefit accrual. For example, a classification applied so that any full-time employee credited with less than 1,000 hours of service during a given 12-consecutive-month period would be considered part-time and subject to the general method of crediting service rather than the elapsed time method would not be reasonable.

(iii) Notwithstanding paragraph (a)(4)(i) and (ii) of this section, the use of the elapsed time method for some purposes or the use of the elapsed time method for some employees may, under certain circumstances, result in discrimination prohibited under section 401(a)(4), even though the use of the elapsed time method for such purposes, and for such employees, is permitted under this section.

(5) *More than one employer plans.* For special rules for computing years of service in the case of a plan maintained by more than one employer, see 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(b) *Definitions*—(1) *Employment commencement date.* For purposes of this section, the term "employment commencement date" shall mean the date on which the employee first performs an hour of service within the meaning of 29 CFR § 2530.200b-2(a)(1) for the employer or employers maintaining the plan.

(2) *Severance from service date.* For purposes of this section, a "severance from service" shall occur on the earlier of—

(i) The date on which an employee quits, retires, is discharged or dies; or

(ii) The first anniversary of the first date of a period in which an employee remains absent from service (with or without pay) with the employer or employers maintaining the plan for any reason other than quit, retirement, discharge or death, such as vacation, holiday, sickness, disability, leave of absence or layoff.

(3) *Reemployment commencement date.* For purposes of this section, the term "reemployment commencement date" shall mean the first date, following a period of severance from service which is not required to be taken into account under the service spanning rules in paragraphs (c)(2)(iii) and (d)(1)(iii) of this section, on which the employee performs an hour of service within the meaning of 29 CFR § 2530.200b-2(a)(1) for the employer or employers maintaining the plan.

(4) *Participation commencement date.* For purposes of this section, the term "participation commencement date" shall mean the date a participant first commences participation under the plan.

(5) *Period of severance.* For purposes of this section, the term "period of severance" shall mean the period of

time commencing on the severance from service date and ending on the date on which the employee again performs an hour of service within the meaning of 29 CFR § 2530.200b-2(a)(1) for an employer or employers maintaining the plan.

(6) *Period of service*—(i) *General rule.* For purposes of this section, the term "period of service" shall mean a period of service commencing on the employee's employment commencement date or reemployment commencement date, whichever is applicable, and ending on the severance from service date.

(ii) *Aggregation rule.* Unless a plan provides in some manner for an "adjusted" employment commencement date or similar method of consolidating periods of service, periods of service shall be aggregated unless such periods may be disregarded under section 410(a)(5) or 411(a)(4).

(iii) *Other federal law.* Nothing in this section shall be construed to alter, amend, modify, invalidate, impair or supersede any law of the United States or any rule or regulation issued under such law. Thus, for example, nothing in this section shall be construed as denying an employee credit for a "period of service" if credit is required by a separate federal law. Furthermore, the nature and extent of such credit shall be determined under such law.

(c) *Eligibility to participate*—(1) *General rule.* For purposes of section 410(a)(1)(A), a plan generally may not require as a condition of participation in the plan that an employee complete a period of service with the employer or employers maintaining the plan extending beyond the later of—

(i) The date on which the employee attains the age of 25; or

(ii) The date on which the employee completes a one-year period of service.

See the regulations under section 410(a) (relating to eligibility to participate).

(2) *Determination of one-year period of service.* (i) For purposes of determining the date on which an employee satisfies the service requirement for initial eligibility to participate under the plan, a plan using the elapsed time method of crediting service shall provide that an employee who completes the 1-year period of service requirement on the first anniversary of his employment commencement date satisfies the minimum service requirement as of such date. In the case of an employee who fails to complete a one-year period of service on the first anniversary of his employment commencement date, a plan which does not contain a provision permitted by section 410(a)(5)(D) (rule of parity) shall provide for the aggregation of periods of service so that a one-year period of service shall be completed as of the date the employee completes 12 months of service (30 days are deemed to be a month in the case of the aggregation of fractional months) or 365 days of service.

(ii) For purposes of section 410(a)(1)(B)(i), a "3-year period of service" shall be deemed to be "3 years of service."

(ii) *Service spanning rules.* In determining a 1-year period of service for purposes of initial eligibility to participate and a period of service for purposes of retention of eligibility to participate, in addition to taking into account an employee's period of service, a plan shall take into account the following periods of severance—

(A) If an employee severs from service by reason of a quit, discharge or retirement and the employee then performs an hour of service within the meaning of 29 CFR § 2530.200b-2(a)(1) within 12 months of the severance from service date, the plan is required to take into account the period of severance; and

(B) Notwithstanding paragraph (c)(2)(iii)(A) of this service, if an employee severs from service by reason of a quit, discharge or retirement during an absence from service of 12 months or less for any reason other than a quit, discharge, retirement or death, and then performs an hour of service within the meaning of 29 CFR § 2530.200b-2(a)(1) within 12 months of the date on which the employee was first absent from service, the plan is required to take into account the period of severance.

(iv) For purposes of determining an employee's retention of eligibility to participate in the plan, a plan shall take into account an employee's entire period of service unless certain periods of service may be disregarded under section 410(a)(5) of the Code.

(v) *Example.* Employee W, age 31, completed 6 months of service and was laid off. After 2 months of layoff, W quit. Five months later, W returned to service. For purposes of eligibility to participate, W was required to be credited with 13 months of service (8 months of service and 5 months of severance). If, on the other hand, W had not returned to service within the first 10 months of severance (*i.e.*, within 12 months after the first day of layoff), W would be required to be credited with only 8 months of service.

(3) *Entry date requirements*—(i) *General rule.* For purposes of section 410(a)(4), it is necessary for a plan to provide that any employee who has satisfied the minimum age and service requirements, and who is otherwise entitled to participate in the plan, commences participation in the plan no later than the earlier of—

(A) The first day of the first plan year beginning after the date on which such employee satisfied such requirements, or

(B) The date six months after the date on which he satisfied such requirements,

unless such employee was separated from service before the date referred to in subdivision (i)(A) or (B), whichever is applicable. See the regulations under section (a) (relating to eligibility to participate).

(ii) *Separation from service*—(A) *Definition.* For purposes of this section, the term "separated from service" in-

cludes a severance from service or an absence from service for any reason other than a quit, discharge, retirement or death, regardless of the duration of such absence. Accordingly, if an employee is laid off for a period of six weeks, the employee shall be deemed to be "separated from service" during such period for purposes of the entry date requirements.

(B) *Application.* A period of severance which is taken into account under the service spanning rules in paragraph (c)(2)(iii) of this section or an absence of 12 months or less may result in an employee satisfying the plan's minimum service requirement during such period of time. In addition, once an employee satisfies the plan's minimum service requirement, either before or during such period of time, such period of time may contain an entry date applicable to such employee. In the case of an employee whose period of severance is taken into account and such period contains an entry date applicable to the employee, he or she shall be made a participant in the plan (if otherwise eligible) no later than the date on which he or she ended the period of severance. In the case of an employee whose period of absence contains an entry date applicable to such employee, he or she, no later than the date such absence ended, shall be made a participant in the plan (if otherwise eligible) as of the first applicable entry date which occurred during such absence from service.

(iii) *Examples.* For purposes of the following examples, assume that the plan provides for a minimum age requirement of 25 and a minimum service requirement of one year, and provides for semi-annual entry dates.

(A) Employee A, age 35, worked for 10 months in a job classification covered under the plan, became disabled for nine consecutive months and then returned to service. During the period of absence, A completed a 1-year period of service and passed a semi-annual entry date after satisfying the minimum service requirement. Accordingly, the plan is required to make A a participant no later than his return to service effective as of the applicable entry date.

(B) Employee B, after satisfying the minimum age and service requirements, quit work before the next semi-annual entry date, and then returned to service before incurring a 1-year period of severance, but after such semi-annual entry date. Employee B is entitled to become a participant immediately upon his return to service effective as of the date of his return.

(4) *Break in service.* For purposes of applying the break in service rules under section 410(a)(5)(B) and (C), the term "1-year period of severance" shall be substituted for the term "1-year break in service." A 1-year period of severance shall be determined on the basis of a 12-consecutive-month period beginning on the severance from service date and ending on the first anniversary of such date, provided that the employee during such 12-consecutive-month period does not perform an hour of service within the meaning of 29 CFR § 2530.200b-2(a)(1) for the employer or employers maintaining the plan.

(5) *One-year hold-out*—(i) *General rule.* (A) For purposes of section 410(a)(5)(C), in determining the period of service of an employee who has incurred a 1-year period of severance, a plan may disregard the employee's period of service before such period of severance until the employee completes a 1-year period of service after such period of severance.

(B) *Example.* Assume that a plan provides for a minimum service requirement of 1 year and provides for semi-annual entry dates, but does not contain the provisions permitted by section 410(a)(5)(D) (relating to the rule of parity). Employee G, age 40, completed a seven-month period of service, quit and then returned to service 15 months later, thereby incurring a 1-year period of severance. After working four months, G was laid off for nine months and then returned to work again. Although the plan may hold employee G out from participation in the plan until the completion of a 1-year period of service after the 1-year (or greater) period of severance, once the 1-year hold-out is completed, the plan is required to provide the employee with such statutory entitlement as arose during the 1-year hold-out. Accordingly, employee G satisfied the 1-year hold-out requirement as of the eighth month of layoff, and G is entitled to become a participant in the plan immediately upon his return to service after the nine-month layoff effective as of the first applicable entry date occurring after the date on which he satisfied the 1-year of service requirement (*i.e.*, the first applicable entry date after the first month of layoff). See the regulations under section 410(a) (relating to eligibility to participate).

(6) *Rule of parity*—(i) *General rule.* For purposes of section 410(a)(5)(D), in the case of a participant who does not have any nonforfeitable right under the plan to his accrued benefit derived from employer contributions and who incurs a 1-year period of severance, a plan, in determining an employee's period of service for purposes of section 410(a)(1), may disregard his period of service if his latest period of severance equals or exceeds his prior periods of service, whether or not consecutive, completed before such period of severance. See the regulations under section 410(a) (relating to eligibility to participate).

(ii) In determining whether a completely nonvested employee's service may be disregarded under the rule of parity, a plan is not permitted to apply the rule until the employee incurs a 1-year period of severance. Accordingly, a plan may not disregard a period of service of less than one year until an employee has incurred a period of severance of at least one year.

(iii) *Example.* Assume that a plan provides for a minimum service requirement of one year and provides for the rule of parity. An employee works for three months, quits and then is rehired 10 months later. Such employee is entitled to receive 13 months of credit for purposes of eligibility to participate and vesting (see the service spanning rules). Although the period of severance exceeded the period of service, the three months of service may not be disregarded because no 1-year period of severance occurred.

(d) *Vesting*—(1) *General rule.* (i) For purposes of section 411(a)(2), relating to vesting in accrued benefits derived from employer contributions, a plan which determines service to be taken into account on the basis of elapsed time shall provide that an employee is credited with a number of years of service equal to at least the number of whole years of the employee's period of service, whether or

not such periods of service were completed consecutively.

(ii) In order to determine the number of whole years of an employee's period of service, a plan shall provide that nonsuccessive periods of service must be aggregated and that less than whole year periods of service (whether or not consecutive) must be aggregated on the basis that 12 months of service (30 days are deemed to be a month in the case of the aggregation of fractional months) or 365 days of service equal a whole year of service.

(iii) *Service spanning rules.* In determining a participant's period of service for vesting purposes, a plan shall take into account the following periods of severance—

(A) If an employee severs from service by reason of a quit, discharge or retirement and the employee then performs an hour of service within the meaning of 29 CFR §2530.200b-2(a)(1) within 12 months of the severance from service date, the plan is required to take into account the period of severance; and

(B) Notwithstanding paragraph (d)(1)(iii)(A) of this section, if an employee severs from service by reason of a quit, discharge or retirement during an absence from service of 12 months or less for any reason other than a quit, discharge, retirement or death, and then performs an hour of service within the meaning of 29 CFR § 2530.200b-2(a)(1) within 12 months of the date on which the employee was first absent from service, the plan is required to take into account the period of severance.

(iv) For purposes of determining an employee's nonforfeitable percentage of accrued benefits derived from employer contributions, a plan, after calculating an employee's period of service in the manner prescribed in this paragraph, may disregard any remaining less than whole year, 12-month or 365-day period of service. Thus, for example, if a plan provides for the statutory five to fifteen year graded vesting, an employee with a period (or periods) of service which yield 5 whole year periods of service and an additional 321-day period of service is twenty-five percent vested in his or her employer-derived accrued benefits (based solely on the 5 whole year periods of service).

(2) *Service which may be disregarded.* (i) For purposes of section 411(a)(4), in determining the nonforfeitable percentage of an employee's right to his or her accrued benefits derived from employer contributions, all of an employee's period or periods of service with an employer or employers maintaining the plan shall be taken into account unless such service may be disregarded under paragraph (d)(2)(ii) of this section.

(ii) For purposes of paragraph (d)(2)(i) of this section, the following periods of service may be disregarded—

(A) The period of service completed by an employee before the date on which he attains age 22;

(B) In the case of a plan which requires mandatory employee contributions, the period of service which falls within the period of time to which a particular employee contribution relates, if the employee had the opportunity to make a contribution for such period of time and failed to do so;

(C) The period of service during any period for which the employer did not maintain the plan or a predecessor plan;

(D) The period of service which is not required to be taken into account by reason of a period of severance which constitutes a break in service within the meaning of paragraph (d)(4) of this section;

(E) The period of service completed by an employee prior to January 1, 1971, unless the employee completes a period of service of at least 3 years at any time after December 31, 1970; and

(F) The period of service completed before the first plan year for which this section applies to the plan, if such service would have been disregarded under the plan rules relating to breaks in service in effect at that time.

See the regulations under section 411(a) (relating to vesting).

(3) *Seasonal industry.* [Reserved.]

(4) *Break in service.* For purposes of applying the break in service rules, the term "1-year period of severance" shall be substituted for the term "1-year break in service." A 1-year period of severance shall be a 12-consecutive-month period beginning on the severance from service date and ending on the first anniversary of such date, provided that the employee during such 12-consecutive-month period fails to perform an hour of service within the meaning of 29 CFR § 2530.200b-2(a)(1) for an employer or employers maintaining the plan.

(5) *One-year hold-out.* For purposes of section 411(a)(6)(B), in determining the nonforfeitable percentage of the right to accrued benefits derived from employer contributions of an employee who has incurred a 1-year period of severance, the period of service completed before such period of severance is not required to be taken into account until the employee has completed a 1-year period of service after his return to service. See the regulations under section 411(a) (relating to vesting).

(6) *Vesting in pre-break accruals.* For purposes of section 411(a)(6)(C), a "1-year period of severance" shall be deemed to constitute a "1-year break in service." See the regulations under section 411(a) (relating to vesting).

(7) *Rule of parity*—(i) *General rule.* For purposes of section 411(a)(6)(D), in the case of an employee who is a nonvested participant in employer-derived benefits at the time he incurs a 1-year period of severance, the period of service completed by such participant before such period of severance is not required to be taken into account for purposes of determining the vested percentage of his or her right to employer-derived benefits

if at such time the consecutive period of severance equals or exceeds his prior periods of service, whether or not consecutive, completed before such period of severance. See the regulations under section 411(a) (relating to vesting).

(e) *Benefit accrual.* (1) For purposes of section 411(b), a plan may provide that a participant's service with an employer or employers maintaining the plan shall be determined on the basis of the participant's total period of service beginning on the participation commencement date and ending on the severance from service date.

(2) Under section 411(b)(3)(A), a defined benefit pension plan may determine an employee's service for purposes of benefit accrual on any basis which is reasonable and consistent and which takes into account all service during the employee's participation in the plan which is included in a period of service required to be taken into account under section 410 (a)(5) (relating to service which must be taken into account for purposes of determining an employee's eligibility to participate). A plan which provides for the determination of an employee's service with an employer or employers maintaining the plan on the basis permitted under paragraph (e)(1) of this section will be deemed to meet the requirements of section 411 (b)(3)(A), provided that the plan meets the requirements of 29 CFR § 2530.204-3, relating to plans which determine an employee's service for purposes of benefit accrual on a basis other than computation periods. Specifically, under 29 CFR § 2530.204-3, it must be possible to prove that, despite the fact that benefit accrual under such a plan is not based on computation periods, the plan's provisions meet at least one of the three benefit accrual rules of section 411(b)(1) under all circumstances. Further, 29 CFR § 2530.204-3 prohibits such a plan from disregarding service under section 411(b)(3)(C) (which would otherwise permit a plan to disregard service performed by an employee during a computation period in which the employee is credited with less than 1,000 hours). See the regulations under section 411(b) (relating to benefit accrual).

(f) *Transfers between methods of crediting service*—(1) *Single plan.* A plan may provide that an employee's service for purposes of eligibility to participate, vesting or benefit accrual shall be determined on the basis of computation periods under the general method set forth in 29 CFR § 2530.200 b-2 for certain classes of employees but under the alternative method permitted under this section for other classes of employees if the plan provides as follows—

(i) In the case of an employee who transfers from a class of employees whose service is determined on the basis of computation periods to a class of employees whose service is determined on the alternative basis permitted under this section, the employee shall receive credit for a period of service consisting of—

(A) A number of years equal to the number of years of service credited to the employee before the computation period during which the transfer occurs; and

(B) The greater of *(1)* the period of service that would be credited to the employee under the elapsed time method for his service during the entire computation period in which the transfer occurs, or *(2)* the service taken into account under the computation periods method as of the date of the transfer.

In addition, the employee shall receive credit for service subsequent to the transfer commencing on the day after the last day of the computation period in which the transfer occurs.

(ii) In the case of an employee who transfers from a class of employees whose service is determined on the alternative basis permitted under this section to a class of employees whose service is determined on the basis of computation periods—

(A) The employee shall receive credit, as of the date of the transfer, for a number of years of service equal to the number of 1-year periods of service credited to the employee as of the date of the transfer, and

(B) The employee shall receive credit, in the computation period which includes the date of the transfer, for a number of hours of service determined by applying one of the equivalencies set forth in 29 CFR § 2530.200b-3(e)(1) to any fractional part of a year credited to the employee under this section as of the date of the transfer. Such equivalency shall be set forth in the plan and shall apply to all similarly situated employees.

(2) *More than one plan.* In the case of an employee who transfers from a plan using either the general method of determining service on the basis of computation periods set forth in 29 CFR § 2530.200b-2 or the method of determining service permitted under this section to a plan using the other method of determining service, all service required to be credited under the plan to which the employee transfers shall be determined by applying the rules of paragraph (f)(1) of this section.

(g) *Amendments to change method of crediting service.* A plan may be amended to change the method of crediting service for any purpose or for any class of employees between the general method set forth in 29 CFR § 2530.200b-2 and the method permitted under this section, if such amendment contains provisions under which each employee with respect to whom the method of crediting service is changed is treated in the same manner as an employee who transfers from one class of employees to another under paragraph (f)(1) of this section.

(h) *Transitional rule.* For plans in existence on June 17, 1980, the provisions of paragraph (f) of this sec-

tion are effective for plan years beginning after December 31, 1983.

Par. 5. Section 1.411(a)-5(b) is revised by deleting from suparagraphs (1)(iii) and (2) "Department of Labor regulations" and inserting in lieu thereof "§ 1.410(a)-7".

Par. 6. Section 1.411(a)-6(c)(1)(iii) is revised by deleting from the second sentence "Department of Labor Regulations" and inserting in lieu thereof "§ 1.410(a)-7".

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved June 2, 1980

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 16, 1980, 8:45 a.m., and published in the issue of the Federal Register for June 17, 1980, 45 F.R. 40979)

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26 CFR 1.410(b)-1: Minimum coverage requirements.
(Also Section 401; 1.401-3, 1.401-4.)

Discrimination; coverage; officer acting in nominal capacity. An employee who was given the title of assistant secretary-treasurer merely to qualify the employee to sign checks in the absence of superior officers and to affix and attest to the corporate seal when necessary and who actually performed these duties on only a few occasions but otherwise had no voice in the management or administration of the corporation is not considered an officer for purposes of sections 401(a)(4) and 410(b) of the Code; Rev. Rul. 68-300 superseded.

Rev. Rul. 80-314

The purpose of this revenue ruling is to restate Rev. Rul. 68-300, 1968-1 C.B. 159, in view of the enactment of the Employee Retirement Income Security Act of 1974, Pub. L. 93-406, 1974-3 C.B. 1.

The issue in Rev. Rul. 68-300 is whether an employee is an officer within the purview of sections 401(a)(4) and 410(b) of the Internal Revenue Code under the circumstances stated below.

An employee in the parts department of a company was given the title of assistant secretary-treasurer to qualify such employee to sign checks, in the absence of superior officers of the corporation, and to affix and attest to the corporate seal when necessary. The employee executed documents in such employee's official capacity on a few occasions but otherwise had no voice in the management or administration of the corporation.

Sections 401(a)(4) and 410(b) of the Code set forth certain coverage and benefit or contribution requirements that are intended to assure that an employee benefit plan will not be qualified if it discriminates in favor of employees who are officers, shareholders, or highly compensated.

The status of officers should be determined upon the basis of all the facts including, for example, the source of their authority, the term for which elected or appointed, and the nature and extent of their duties. As generally accepted in connection with corporations, the term "officer" means an administrative executive who is in regular and continued service. It implies continuity of service and excludes those employed for a special and single transaction.

The facts in this case indicate that the employee's administrative duties are nominal and are exercised in a substitute capacity on some occasions.

Accordingly, the employee is not considered an officer within the purview of sections 401(a)(4) and 410(b) of the Code. However, such an employee, although not included in the officer group, may be a shareholder or a highly compensated employee.

The principles and conclusion stated herein are applicable to those plans described in section 410(c) of the Code.

Rev. Rul. 68-300 is superseded because the position stated therein is restated under current law in this revenue ruling.

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26 CFR 1.410(b)-1: Minimum coverage requirements.

Coverage; participation waived by low-paid employee. A pension plan established by an employer to cover its two employees—a highly compensated officer and a low-paid secretary—does not meet the coverage requirements of section 410(b) of the Code if the secretary waives the right to participate in the plan; Rev. Rul. 73-340 superseded.

Rev. Rul. 80-351

The purpose of this revenue ruling is to restate the position in Rev. Rul. 73-340, 1973-2 C.B. 134, in view of the enactment of the Employee Retirement Income Security Act of 1974, Pub. L. 93-406, 1974-3 C.B. 1.

The issue in Rev. Rul. 73-340 is whether a pension plan meets the coverage requirements of section 401(a)(3) of the Internal Revenue Code (now section 410(b)) in a case where one of the two employees of a corporation, a low-paid secretary, waives eligibility under the plan thereby leaving only a highly paid officer as a plan participant.

A corporation established a pension plan which provided benefits for all employees who completed one year of service. At the time the plan was established the corporation had two employees, both of whom were eligible to participate in the plan. One was a highly compensated officer and the other was a low-paid secretary.

On the day after the plan was adopted, the secretary signed a state-

ment waiving all rights to participate in the plan.

Section 410(b) of the Code provides "percentage" and "classification" tests for plan eligibility which a plan must satisfy in order to qualify under section 401(a). Generally, under these tests a plan will satisfy the eligibility requirements if it benefits either: (A) 70 percent or more of all employees, or 80 percent or more of all employees who are eligible to benefit under the plan if 70 percent or more of employees are eligible to benefit under the plan, or (B) such employees as qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of employees who are officers, shareholders, or highly compensated.

Although the plan in this case was designed to make all employees of the employer with one year of service eligible to benefit thereunder, the waiver executed by the secretary resulted in participation by only the officer. Under these circumstances, the percentage coverage requirements of section 410(b)(1)(A) of the Code were not satisfied. Furthermore, since the officer-employee was favored as against the corporation's only low-paid employee, the discrimination prohibited by the alternative coverage requirements of section 410(b)(1) was present. This discrimination was not eliminated by the low-paid employee's waiver of the right to receive benefits.

Accordingly, this pension plan does not meet the coverage requirements of section 410(b) of the Code.

Rev. Rul. 73-340 is superseded because the position stated therein is restated under current law in this revenue ruling.

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26 CFR 1.410(b)-1: Minimum coverage requirements.

Whether mandatory employee contributions under an employee benefit plan may result in discrimination within the meaning of sections 410(b)(1)(B) or 401(a)(4) of the Code. See Rev. Rul. 80-307, page 136.

Section 411.—Minimum Vesting Standards

26 CFR 1.411(d)-2: Termination or partial termination; discontinuance of contributions.

Qualification; employer contributions suspended; nonforfeiture of rights deferred. A profit-sharing plan that provides that nonforfeitability of participants' accounts during a period in which employer contributions are suspended will occur only when the aggregate contributions drop below an amount equal to three percent of aggregate covered compensation since the inception of the plan does not meet the requirements of section 411(d)(3) of the Code; Rev. Rul. 71-94 superseded.

Rev. Rul. 80-277

The purpose of this revenue ruling is to restate the position in Rev. Rul. 71-94, 1971-1 C.B. 125 in view of the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. 93-406, 1974-3 C.B. 1.

The issue in Rev. Rul. 71-94 is whether a profit-sharing plan that contains the provisions described below meets the requirements concerning discontinuance of contributions under section 401(a)(7) of the Internal Revenue Code. The relevant portion of that section is now contained in section 411(d)(3) of the Internal Revenue Code as amended by ERISA.

The plan provides as follows: (a) the board of directors of the employer-corporation shall determine each year the amount of employer contributions to be made for such year; (b) if such board shall fail to make a determination, a contribution shall be made by the employer in accordance with a schedule of percentages which vary in proportion to the net-profit bracket into which the employer's profits fall for the year; (c) employer contributions will be considered completely discontinued if (and only if) at any time the aggregate of all contributions previously made drops below an amount equal to three percent of the aggregate of the covered compensation of participants since the inception of the plan; and (d) if a complete discontinuance, as defined in (c), is found to exist and the board fails to authorize a contribution sufficient to satisfy the minimum limitation of three percent of covered compensation, then the amounts credited to the participants' accounts are to become nonforfeitable.

Section 411(d)(3) of the Code provides that a trust shall not constitute a qualified trust unless the plan of which such trust is a part provides that, upon the termination or partial termination, or, in the case of a plan to which section 412 of the Code (relating to minimum funding standards) does not apply, upon the complete discontinuance of contributions under the plan, the rights of all affected employees to the benefits accrued to the date of such event, to the extent then funded, are nonforfeitable.

As pointed out in section 1.411(d)-2(d)(1) of the Income Tax Regulations a complete discontinuance of contributions may occur although some amounts are contributed by the employer under the plan if such amounts are not substantial enough to reflect the intent on the part of the employer to continue to maintain the plan. On the other hand, a suspension of contributions under the plan is a temporary cessation of contributions that may, or may not, ripen into a discontinuance. The determination of whether a discontinuance of contributions has occurred under a profit-sharing plan should be made with regard to all the facts and circumstances. This section also states that among the factors to be considered in determining whether a suspension constitutes a discontinuance are: (1) whether the employer may merely be calling an actual discontinuance of contributions a suspension of such contributions in order to avoid

the requirement of full vesting as in the case of a discontinuance, or for any other reason; (2) whether contributions are recurring and substantial; and (3) whether there is any reasonable probability that the lack of contributions will continue indefinitely.

In determining whether a suspension of contributions has ripened into a complete discontinuance for the purpose of requiring nonforfeitability of rights as required by section 411 (d) (3) of the Code, a conclusion cannot be based solely on the relationship between aggregate employer contributions and aggregate covered compensation during the prior operation of the plan. The factors to be considered under the regulations may not be ruled out in advance by the plan provisions.

Under the plan in this case, nonforfeitability will occur only when the aggregate contributions drop below an amount equal to three percent of aggregate covered compensation. Such conditions might not arise for a period of years after contributions have actually been completely discontinued if, for example, contributions made prior to suspension have been made at a substantially higher rate.

Accordingly, this profit-sharing plan does not meet the requirements of section 411(d)(3) of the Code.

Rev. Rul. 71-94 is superseded because the position stated therein has been restated in this revenue ruling.

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26 CFR 1.411(d)-2: Termination or partial termination; discontinuance of contributions.

Whether an asset allocation is discriminatory under section 401(a)(4) of the Code upon the termination of a defined benefit plan. See Rev. Rul. 80-229, page 133.

Section 412.—Minimum Funding Standards

Minimum funding; supplementary plan. An employee benefit plan that provides benefits that merely supplement benefits paid to the employees covered by a qualified defined benefit plan must consider the participants of the qualified plan in applying the minimum funding standards of section 302 of ERISA.

Rev. Rul. 80-315

Advice has been requested regarding how the minimum funding standards of section 412 of the Internal Revenue Code and section 302 of the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. 93-406, 1974-3 C.B. 1, 38, apply under the circumstances described below, to a plan which provides benefits which merely supplement benefits paid to employees covered by a qualified defined benefit plan.

Corporation *B* maintains Plan *Y*, a qualified defined benefit plan. *B* established Plan *X*, an employee benefit plan within the meaning of section 3(2) of ERISA, *supra* at 2, which provides that employees who receive benefits under Plan *Y* will also receive benefits supplementing their benefits under Plan *Y* to reflect post-retirement cost-of-living increases. In addition, Plan *X* provides a social security supplement, as described in section 1.411 (a)-7(b)(4) of the Income Tax Regulations. Plan *X* contains no other provisions indicating which employees are considered participants or how benefits under Plan *X* accrue and vest. Plan *X* is subject to the minimum funding requirements of section 302 of ERISA.

Section 412 of the Code and section 302 of ERISA describe the minimum funding standards applicable to most pension plans. Section 412 applies only to certain qualified pension plans, and under section 4 of ERISA section 302 applies, in general, to most employee pension benefit plans. Consequently, certain pension plans which are not subject to the qualification requirements of the Code, or which do not satisfy those requirements, must, nevertheless, comply with the minimum funding standards of section 302 of ERISA.

The minimum funding standard imposed by section 412 of the Code or section 302 of ERISA requires that a determination be made of which employees are covered by the plan and, therefore, may be entitled to receive benefits according to the terms of the plan.

Plan *X* specifies only that benefits will be paid by Plan *X* to supplement benefits received under Plan *Y*. Although benefits from Plan *X* are thus paid in conjunction with those of Plan *Y*, Plan *X* and Plan *Y* are nevertheless considered distinct plans. As such, the minimum funding requirements are determined separately for each. However, absent any specific plan provisions specifying participants, the participants in Plan *Y* are also the participants in Plan *X*. This treatment is necessary to satisfy the requirement that the plan provisions may not impose, directly or indirectly, a minimum age or service requirement, that does not independently satisfy section 202 (a) of ERISA, *supra* at 22. See section 1.410(a)-(3)(e)(1) of the Income Tax Regulations.

Accordingly, Plan *X* must consider the participants of Plan *Y* in applying the minimum funding standards of section 302 of ERISA.

Automatic approval for certain changes in funding methods for defined benefit plans. See Rev. Proc. 80-50, page 816.

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26 CFR 1.412(b)-5: Election of the alternative amortization method of funding.

T.D. 7702

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Election of Alternative Amortization Method of Funding Certain Pension Plans

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to the procedure for electing an alternative amortization method of funding certain pension plans. These regulations implement section 1013(d) of the Employee Retirement Income Security Act of 1974 [Pub. L. 93-406, 1974-3 C.B. 1, 92], and provide necessary guidance to the public for compliance with the Internal Revenue Code of 1954, as amended. The regulations would affect certain multiemployer pension plans which were in existence on January 1, 1974.

DATES: The regulations are effective generally for plan years beginning after 1975, but earlier (or later) in the case of some plans as provided by section 1017 of the Employee Retirement Income Security Act of 1974.

FOR FURTHER INFORMATION CONTACT: Mr. Russell Greenblatt of the Employee Plans and Exempt Organizations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:LR:T) (202-566-3544, not a toll-free call).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On November 23, 1979, proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 412 of the Internal Revenue Code of 1954 were published in the Federal Register (44 FR 67178). The amendments were proposed to conform the regulations to section 1013(d) of the Employee Retirement Income Security Act of 1974 (ERISA) (Pub. L. 93-406, 88 Stat. 923). One comment concerning the proposed regulations was received. No public hearing was requested or held.

EXPLANATION OF PROVISIONS

Section 412 of the Internal Revenue Code of 1954, added by section 1013 of ERISA, provides minimum funding requirements with respect to certain pension plans. These requirements include the maintenance of a minimum funding standard account, to which is charged (among other items), in accordance with section 412(b)(2)(B), an amount necessary to amortize in equal annual installments the plan's unfunded past service liability.

With respect to certain multiemployer plans which were in existence on January 1, 1974, section 1013(d) of ERISA allows an election by the plan to fund certain unfunded past service liability on the basis of an equal annual percentage of the aggregate pay of all participants of the plan in lieu of the level dollar charges referred to above. This alternative amortization method applies to the amount of unfunded past service liability which exists as of the date 12 months after the date on which section 412 first applies to the plan.

The regulations prescribe the means by which certain multiemployer plans can elect the alternative amortization method. The multiemployer plans to which this election is available are those plans which (a) on January 1, 1974, had contributions under the plan based on a percentage of pay, (b) have actuarial assumptions with respect to pay which are reasonably related to past and projected experience, and (c) have rate of interest under the plan which are determined on the basis of reasonable actuarial assumptions. The election consists of the attachment of a statement to the annual report required under section 6058(a) for the plan year for which the election is made, stating that the alternative method is being adopted. Advance approval from the Internal Revenue Service is not required. The alternative method must be adopted on or before the deadline for filing the annual report corresponding to the last plan year beginning before January 1, 1982. If the election is made after the first plan year to which section 412 applies, recomputation of the contributions due in the prior years (to which section 412 applied) will be necessary.

COMMENTS ON THE PROPOSED REGULATIONS

The one written comment submitted concerned proposed § 1.412-5(d). That provision construes section 1013(d)(2) of ERISA, which establishes minimum charges to the funding standard account for a plan year by a plan making the election. Under the proposed regulations, these minimum charges equal the interest on certain past service liabilities, determined as of the date 12 months after the date on which section 412 first applies to the plan.

The comment recommended that the determination of the minimum charges should also take into account additional liabilities generated by plan amendments after the initial 12-month period, and interest thereon. The Treasury Department does not regard this suggestion as a reasonable construction of the statute, as the election provided by section 1013(d)(1) applies only to the unfunded past service liability existing as of the date 12 months after section 412 first became applicable to the plan.

Accordingly, the proposed regulations are adopted without change.

DRAFTING INFORMATION

The principal author of these regulations is Mr. Russell Greenblatt of the Employee Plans and Exempt Organizations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of amendments to the regulations

The following amendments to 26 CFR Part 1 are hereby adopted:

§ 1.412(b)-5 Election of the alternative amortization method of funding.

(a) *Alternative amortization method in general.* Section 1013(d) of the Employee Retirement Income Security Act of 1974 provides an alternative method which may be used by certain multiemployer plans (as defined in section 414(f)) which were in existence on January 1, 1974, for funding certain unfunded past service liability. The multiemployer plans which may elect to use this alternative method are those plans (1) under which, on January 1, 1974, contributions were based on a percentage of pay, (2) which use actuarial assumptions with respect to pay that are reasonably related to past and projected experience, and (3) which use rates of interest that are determined on the basis of reasonable actuarial assumptions. The unfunded past service liability to which this method applies is that amount existing as of the date 12 months after the date on which section 412 first applies to the plan. The alternative method allows the plan to fund this liability over a period of 40 plan years by charging the funding standard account with an equal annual percentage of the aggregate pay of all participants in the plan instead of the level dollar charges required under section 412 (b)(2)(B). Paragraphs (b), (c), (d) and (e) of this section contain procedural rules for electing this alternative method.

(b) *Election procedure.* To elect the alternative amortization method, a multiemployer plan must attach a statement to the annual report required under section 6058(a) for the plan year for which the election is made, stating that the alternative method for funding unfunded past service liability is being adopted. Advance approval from the Internal Revenue Service is not required. The alternative method must be adopted on or before the last day prescribed for filing the annual report corresponding to the last plan year beginning before January 1, 1982.

(c) *Charges to which the alternative amortization method is applicable.* Once elected, the alternative amortization method is applicable to the unfunded past service liability existing as of the date 12 months after the date on which section 412 first applies to the plan. This results in charges to the funding standard account which are in lieu of—

(1) Charges required under clause (i) of section 412(b)(2)(B), and

(2) Charges required under clause (iii) of section 412(b)(2)(B) if the plan amendments referred to in such clause result in a net increase in the unfunded past service liability existing as of the date 12 months after the date on which section 412 first applies to the plan. Such charges generally will arise only with respect to plan amendments adopted in the first plan year to which section 412 applies.

If the election is made on an annual report corresponding to a plan year after the first plan year to which section 412 applies, recomputation of the contributions due in the prior years (to which section 412 applied) will be necessary.

(d) *Limitation.* The sum of the charges described in this paragraph may not be less than the interest on the unfunded past service liabilities described in section 412(b)(2)(B)(i) and (iii), determined as of the date 12 months after the date on which section 412 first applies to the plan.

(e) *Reporting requirements.* Each annual report required by section 6058 (a) and periodic report of the actuary required by section 6059 must include all additional information relevant to the use of the alternative amortization method as may be required by the applicable forms and the instructions for such forms.

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805), and section 1013(d)(1) of ERISA (88 Stat. 923).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved May 30, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 12, 1980, 8:45 a.m., and published in the issue of the Federal Register for June 13, 1980, 45 F.R. 40113)

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26 CFR 1.412(i)-1: Certain insurance contract plans.

T.D. 7706 [1]

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Exception for certain insurance contract plans from minimum funding standards.

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to an exception for certain pension plans funded exclusively by insurance contracts from the minimum funding standards. Changes in the applicable tax law were made by the Employee Retirement Income Security Act of 1974 [Pub. L. 93-406, 1974-3 C.B. 1].

[1] This publication of the Treasury Decision contains the complete text of the amendments to the regulations. The instructions for modifying the notice of proposed rulemaking have been omitted.

These regulations provide necessary guidance to the public for compliance with the law and affect employees covered by those plans.

DATE: For plans in existence on January 1, 1974, the regulations are effective for plan years beginning after December 31, 1975. For plans not in existence on January 1, 1974, the regulations are effective for plan years beginning after September 2, 1974.

FOR FURTHER INFORMATION CONTACT: Richard J. Wickersham of the Employee Plans and Exempt Organizations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:LR:T) (202-566-3250) (not a toll-free number).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On February 6, 1975, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 412(i) of the Internal Revenue Code of 1954 (40 F.R. 5535). The amendments were proposed in order to conform the regulations to section 1013(a) of the Employee Retirement Income Security Act of 1974 (88 Stat. 914) and section 301(b) of such Act (88 Stat. 869). A public hearing was neither requested nor held on these proposed regulations. After consideration of all comments regarding the proposed amendments those amendments are adopted as revised by this Treasury decision.

INSURANCE CONTRACT PLANS

Section 412 of the Code prescribes minimum funding standards which are generally applicable to defined benefit plans. Under section 412(h)(2) of the Code, any insurance contract plan described in section 412(i) of the Code for a plan year is not subject to the minimum funding requirements of section 412 for that plan year. Section 412(i) of the Code sets forth certain specified requirements which such a plan must meet to qualify for this exception from the minimum funding requirements. Section 412(i) provides further that a plan funded exclusively by the purchase of group insurance contracts which is determined under regulations to have the same characteristics as an individual insurance contract plan will be treated as a plan described in section 412(i).

PAYMENT OF LOAD FACTORS

Section 412(i) of the Code and § 1.412(i)-1(b)(2)(i) and (c)(2)(i) of the regulations, as proposed, require that an insurance contract plan be funded exclusively by the purchase of insurance contracts. The final regulations make it clear that this requirement is not violated by payments which are made in order to satisfy certain minimum vesting requirements with respect to accrued benefits derived from employee contributions. Thus, for example, it will be permissible for an employer to pay the "load factor" on insurance contracts in order for the plan to meet the requirement (set forth in section 411 of the Code) that an employee must be 100 percent vested in the accrued benefit derived from his own contributions.

PREMIUM PAYMENTS

Section 412(i) states that the insurance contract plan must provide for level annual premium payments. The final regulations clarify this requirement. Employees who cease their participation in the plan may pay premiums on their own behalf if the contracts are distributed to them upon their termination of employment. The level annual payment applies only to the premiums on the insurance contracts. Consequently, it is permissible for the insurance company to apply such items as experience gains and dividends against premiums due on the contracts without violating this requirement.

LAPSES AND LOANS

The final regulations have expanded on the requirements necessary for a plan to be reinstated after a lapse in premium payments. Reinstatement must occur prior to the time any participant's benefits would be reduced because of the lapse.

Another requirement in the proposed regulations is the prohibition of policy loans on the insurance contracts issued under the plan. The final regulations provide that an application of funds by the issuer to pay premiums due on the contracts will not be considered policy loans for purposes of this prohibition if certain conditions are satisfied.

OTHER CHANGES

The final regulations make it clear that an insurance contract plan may be funded by a combination of individual and group contracts if certain requirements are satisfied. A clarifying change was made to the final regulations to make it clear that the group contracts are being compared to individual contracts which have been approved for sale in the relevant state.

DRAFTING INFORMATION

The principal author of these proposed regulations was Richard J. Wickersham of the Employee Plans and Exempt Organizations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, the following amendments to 26 CFR Part 1 are hereby adopted:

§ 1.412(i)-1 Certain insurance contract plans.

(a) *In general.* Under section 412

(h)(2) of the Internal Revenue Code of 1954, as added by section 1013(a) of the Employee Retirement Income Security Act of 1974 (88 Stat. 914) (hereinafter referred to as "the Act"), an insurance contract plan described in section 412(i) for a plan year is not subject to the minimum funding requirements of section 412 for that plan year. Consequently, if an individual or group insurance contract plan satisfies all of the requirements of paragraph (b)(2) or (c)(2) of this section, whichever are applicable, for the plan year, the plan is not subject to the requirements of section 412 for that plan year. The effective date for section 412 of the Code is determined under section 1017 of the Act. In general, in the case of a plan which was not in existence on January 1, 1974, this section applies for plan years beginning after September 2, 1974, and in the case of a plan in existence on January 1, 1974, to plan years beginning after December 31, 1975.

(b) *Individual insurance contract plans.* (1) An individual insurance contract plan is described in section 412(i) during a plan year if the plan satisfies the requirements of paragraph (b)(2) of this section for the plan year.

(2) The requirements of this subparagraph are:

(i) The plan must be funded exclusively by the purchase from an insurance company or companies (licensed under the law of a State or the District of Columbia to do business with the plan) of individual annuity or individual insurance contracts, or a combination thereof. The purchase may be made either directly by the employer or through the use of a custodial account or trust. A plan shall not be considered to be funded otherwise than exclusively by the purchase of individual annuity or individual insurance contracts merely because the employer makes a payment necessary to comply with the provisions of section 411(c)(2) (relating to accrued benefit from employee contributions).

(ii) The individual annuity or individual insurance contracts issued under the plan must provide for level annual, or more frequent, premium payments to be paid under the plan for the period commencing with the date each individual participating in the plan became a participant and ending not later than the normal retirement age for that individual or, if earlier, the date the individual ceases his participation in the plan. Premium payments may be considered to be level even though items such as experience gains and dividends are applied against premiums. In the case of an increase in benefits, the contracts must provide for level annual payments with respect to such increase to be paid for the period commencing at the time the increase becomes effective. If payment commences on the first payment date under the contract occurring after the date an individual becomes a participant or after the effective date of an increase in benefits, the requirements of this subdivision will be satisfied even though payment does not commence on the date on which the individual's participation commenced or on the effective date of the benefit increase, whichever is applicable. If an individual accrues benefits after his normal retirement age, the requirements of this subdivision are satisfied if payment is made at the time such benefits accrue. If the provisions required by this subdivision are set forth in a separate agreement with the issuer of the individual contracts, they need not be included in the individual contracts.

(iii) The benefits provided by the plan for each individual participant must be equal to the benefits provided under his individual contracts at his normal retirement age under the plan provisions.

(iv) The benefits provided by the plan for each individual participant must be guaranteed by the life insurance company, described in paragraph (b)(2)(i) of this section, issuing the individual contracts to the extent premiums have been paid.

(v) Except as provided in the following sentence, all premiums payable for the plan year, and for all prior plan years, under the insurance or annuity contracts must have been paid before lapse. If the lapse has occurred during the plan year, the requirements of this subdivision will be considered to have been met if reinstatement of the insurance policy, under which the individual insurance contracts are issued, occurs during the year of the lapse and before distribution is made or benefits commence to any participant whose benefits are reduced because of the lapse.

(vi) No rights under the individual contracts may have been subject to a security interest at any time during the plan year. This subdivision shall not apply to contracts which have been distributed to participants if the security interest is created after the date of distribution.

(vii) No policy loans, including loans to individual participants, on any of the individual contracts may be outstanding at any time during the plan year. This subdivision shall not apply to contracts which have been distributed to participants if the loan is made after the date of distribution. An application of funds by the issuer to pay premiums due under the contracts shall be deemed not to be a policy loan if the amount of the funds so applied, and interest thereon, is repaid during the plan year in which the funds are applied and before distribution is made or benefits commence to any participant whose benefits are reduced because of such application.

(c) *Group insurance contract plans.* (1) A group insurance contract plan is described in section 412(i) during a plan year if the plan satisfies the requirements of subparagraph (2) for the plan year.

(2) The requirements of this subparagraph are:

(i) The plan must be funded exclusively by the purchase from an insur-

ance company or companies, described in paragraph (b)(2)(i) of this section, of group annuity or group insurance contracts, or a combination thereof. The purchase may be made either directly by the employer or through the use of a custodial account or trust. A plan shall not be considered to be funded otherwise than exclusively by the purchase of group annuity or group insurance contracts merely because the employer makes a payment necessary to comply with the provisions of section 411(c)(2) (relating to accrued benefit derived from employee contributions).

(ii) In the case of a plan funded by a group insurance contract or a group annuity contract the requirements of paragraph (b)(2)(ii) of this section must be satisfied by the group contract issued under the plan. Thus, for example, each individual participant's benefits under the group contract must be provided for by level annual, or more frequent, payments equivalent to the payments required to satisfy such paragraph. The requirements of this subdivision will not be satisfied if benefits for any individual are not provided for by level payments made on his behalf under the group contract.

(iii) The group annual or group insurance contract must satisfy the requirements of clauses (iii), (iv), (v), (vi), and (vii) of paragraph (b)(2). Thus, for example, each participant's benefits provided by the plan must be equal to his benefits provided under the group contract at his normal retirement age.

(iv)(A) If the plan is funded by a group annuity contract, the value of the benefits guaranteed by the insurance company issuing the contract under the plan with respect to each participant under the contract must not be less than the value of such benefits which the cash surrender value would provide for that participant under any individual annuity contract plan satisfying the requirements of paragraph (b) and approved for sale in the State where the principal office of the plan is located.

(B) If the plan is funded by a group insurance contract, the value of the benefits guaranteed by the insurance company issuing the contract under the plan with respect to each participant under the contract must not be less than the value of such benefits which the cash surrender value would provide for that participant under any individual insurance contract plan satisfying the requirements of paragraph (b) and approved for sale in the State where the principal office of the plan is located.

(v) Under the group annuity or group insurance contract, premiums or other consideration received by the insurance company (and, if a custodial account or trust is used, the custodian or trustee thereof) must be allocated to purchase individual benefits for participants under the plan. A plan which maintains unallocated funds in an auxiliary trust fund or which provides that an insurance company will maintain unallocated funds in a separate account, such as a group deposit administration contract, does not satisfy the requirements of this subdivision.

(d) *Combination of plans.* A plan which is funded by a combination of individual contracts and a group contract shall be treated as a plan described in section 412(i) for the plan year if the combination, in the aggregate, satisfies the requirements of this section for the plan year.

Sec. 412(i), 7805 of the Internal Revenue Code of 1954 (88 Stat. 919 and 68A Stat. 917, (26 U.S.C. 412(i) and 7805)).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved June 24, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 15, 1980, 8:45 a.m., and published in the issue of the Federal Register for July 16, 1980, 45 F.R. 47675)

Section 415.—Limitations on Benefits and Contributions Under Qualified Plans

Benefits; limitations; actuarial adjustments; defined benefit plans. Adjustments made in accordance with reasonable assumptions, including those in accordance with the rules in Rev. Rul. 71-446, Rev. Rul. 76-47, or the proposed revenue ruling in Announcement 78-96, will meet the requirements for making actuarial adjustments required in applying the limitations on benefits under section 415(b)(1) of the Code.

Rev. Rul. 80-253

This revenue ruling provides guidance for making the actuarial adjustments required in applying the limitations on benefits provided by section 415(b)(1) of the Internal Revenue Code.

Section 415(b)(1) of the Code provides maximum dollar and percentage of compensation limitations on the benefits that may be provided by a defined benefit plan.

Section 415(b)(2) of the Code provides for actuarial equivalent adjustments in applying these limitations if benefits are in a form other than a straight life annuity or if plan benefits commence before age 55.

These actuarial equivalent adjustments must be made on the basis of reasonable actuarial assumptions.

For this purpose, adjustments made in accordance with the rules enunciated in Rev. Rul. 76-47, 1976-1 C.B. 109, or Rev. Rul. 71-446, 1971-2 C.B. 187, or the proposed revenue ruling published in Announcement 78-96, 1978-23 I.R.B. 42 are deemed to be made on the basis of reasonable actuarial assumptions.

Part II.—Certain Stock Options

Section 421.—General Rules

26 CFR 1.421-8: General rules.

Federal income tax consequences of the acquisition of stock pursuant to the exercise of a nonqualified stock option where payment is made with shares of the same corporation's stock that were previously acquired pursuant to the exercise of a qualified stock option. See Rev. Rul. 80-244, page 234.

Section 422.—Qualified Stock Options

26 CFR 1.422-1: Qualified stock options—general rules.

Federal income tax consequences of the acquisitition of stock pursuant to the exercise of a nonqualified stock option where payment is made with shares of the same corporation's stock that were previously acquired pursuant to the exercise of a qualified stock option. See Rev. Rul. 80-244, page 234.

Section 425.—Definitions and Special Rules

26 CFR 1.425-1: Definitions and special rules applicable to statutory options.

Federal income tax consequences of the acquisition of stock pursuant to the exercise of a nonqualified stock option where payment is made with shares of the same corporation's stock that were previously acquired pursuant to the exercise of a qualified stock option. See Rev. Rul. 80-244, page 234.

Subchapter E.—Accounting Periods and Methods of Accounting
Part I.—Accounting Periods

Section 441.—Period for Computation of Taxable Income

26 CFR 1.441-1: Period for computation of taxable income.
(Also Section 442; 1.442-1.)

Accounting periods; nonresident alien's first taxable year. A nonresident alien individual engaged in a trade or business in the U.S. may, for the individual's first federal tax return, elect a fiscal year accounting period without obtaining the prior approval of the Commissioner.

Rev. Rul. 80-352

ISSUE

Can a nonresident alien individual, in the individual's first federal income tax return, adopt a fiscal year accounting period for federal income tax purposes without obtaining the prior approval of the Commissioner of Internal Revenue?

FACTS

A, a nonresident alien individual and citizen of country *Z*, is engaged in a trade or business within the United States. During the first year this trade or business was conducted in the United States *A* received income effectively connected with the conduct of such trade or business. *A* had always kept books and records that established a calendar year accounting period for the purpose of filing income tax returns with Country *Z*. However, from the beginning of *A*'s trade or business within the United States, *A* kept books and records of *A*'s business operations in the United States that adequately and clearly reflect income on the basis of a fiscal year beginning April 1 and ending March 31. Prior to the commencement of *A*'s trade or business in the United States, *A* had never been required by any provisions of the internal revenue laws or regulations to file any federal income tax return, statement, or other document with the Internal Revenue Service. *A*'s first federal income tax return was filed on the basis of a fiscal year ending March 31. *A* did not apply for permission to use a fiscal year accounting period.

LAW AND ANALYSIS

Section 441(a) of the Internal Revenue Code provides that taxable income shall be computed on the basis of the taxpayer's taxable year.

Section 441(b) of the Code provides that the term "taxable year" means (1) the taxpayer's annual accounting period, if it is a calendar year or a fiscal year, or (2) the calendar year, if section 441(g) applies.

Section 441(c) of the Code provides that the term "annual accounting period" means the annual period on the basis of which the taxpayer regularly computes income in keeping books.

Section 441(g) of the Code provides that, except as provided in Section 443, the taxpayer's taxable year shall be the calendar year if the taxpayer keeps no books, does not have an annual accounting period, or has an annual accounting period, but such period does not qualify as a fiscal year.

Section 442 of the Code provides that if a taxpayer changes the annual accounting period, the new accounting period shall become the taxpayer's taxable year only if the change is approved by the Secretary. For purposes of this subtitle, section 442 further provides, if a taxpayer to whom section 441(g) applies adopts an annual accounting period (as defined in section 441(c)) other than a calendar year, the taxpayer shall be treated as having changed the annual accounting period.

Section 7701(a)14 of the Code provides that the term "taxpayer" means any person subject to any internal revenue tax.

Section 1.441-1(b)(3) of the Income Tax Regulations provides that a new taxpayer may adopt any taxable year that meets the requirements of section 441 of the Code without obtaining prior approval.

Section 1.441-1(g)(3) of the regulations provides that records that are sufficient to reflect income adequately and clearly on the basis of an annual accounting period will be regarded as keeping books.

Section 1.442-1(a)(1) of the regulations provides that a new taxpayer who adopts an annual accounting period as provided in section 441 of the Code need not secure the permission of the Commissioner under section 442 and this section.

Section 1.442-1(a)(2) of the regulations provides that if section 441(g) of the Code applies to a taxpayer, the adoption of a fiscal year will be treated as a change in the annual accounting period under section 442. Therefore, such fiscal year can become the taxpayer's taxable year only with the approval of the Commissioner.

Prior to the commencement of *A*'s trade or business in the United States, *A* had never been required by any provision of internal revenue laws or regulations to file a return or any equivalent document with the Service. Therefore, although *A* was in existence, *A* was not a United States taxpayer. When *A* began *A*'s trade or business in the United States, *A* was required to file a federal income tax return for the first time and was, therefore, a new taxpayer within the meaning of sections 1.441-1(b)(3) and 1.442-1(a)(2) of the regulations. Furthermore, at that time *A* maintained books and records that adequately and clearly reflected income on the basis of a fiscal year ending March 31 to comply with the requirement of section 1.441-(g)(3).

HOLDING

A, in *A*'s first federal income tax return, may adopt a fiscal year accounting period ending March 31 without the prior approval of the Commissioner.

Section 442.—Change of Annual Accounting Period

26 CFR 1.442-1: Change of annual accounting period.

Whether a nonresident alien individual engaged in a trade or business in the United States for the first time is a "new taxpayer" for federal income tax purposes. See Rev. Rul. 80-352, page 160.

Part II.—Methods of Accounting
Subpart A.—Methods of Accounting in General

Section 446.—General Rule for Methods of Accounting

26 CFR 1.446-1: General rule for methods of accounting.

(Also Sections 471, 472, 481; 1.471-1, 1.472-1, 1.481-1.)

LIFO; freight-in added to cost of inventory; accounting method. A taxpayer's change in the cost computation of its LIFO inventory to include the cost of freight-in is a change in method of accounting under section 446 of the Code that requires the consent of the Secretary. The exclusion of the cost of freight-in from the cost of inventory does not warrant disallowance of the LIFO election.

Rev. Rul. 80-190

ISSUES

(1) Is the taxpayer's change in the cost computation of its last-in, first-out (LIFO) inventory to include the cost of freight-in a change in method of accounting under section 446 of the Internal Revenue Code that requires the advance consent of the Secretary?

(2) Does the taxpayer's exclusion of the cost of freight-in from the cost of its merchandise warrant disallowance or termination of the taxpayer's LIFO election?

FACTS

The taxpayer uses the accrual method of accounting. In 1974, the taxpayer adopted the LIFO inventory method provided in section 472 of the Code. In valuing its inventory at cost, the taxpayer consistently used the purchase price of the merchandise carried on its books, but the taxpayer excluded the cost of freight-in. The taxpayer instead, deducted the amount of freight-in for the taxable year in which it was incurred. In 1979, the taxpayer determined that the cost of freight-in should be included in the cost of its merchandise for purposes of valuing its inventory pursuant to section 1.471-3(b) of the Income Tax Regulations. In 1979, the taxpayer unilaterally changed the manner for determining the value of its inventory to include the cost of freight-in without securing the consent of the Commissioner.

LAW AND ANALYSIS

Section 472(b)(2) of the Code provides that goods inventoried under the last-in, first-out (LIFO) method are inventoried at cost.

Section 1.471-3(b) of the regulations provides that in the case of merchandise purchased since the beginning of the taxable year, cost means the invoice price less trade or other discounts. To this net invoice price should be added transportation charges incurred in acquiring possession of the goods.

Section 446(e) of the Code provides that a taxpayer who changes its method of accounting on the basis of which it regularly computes its income in keeping its books shall secure the consent of the Secretary of the Treasury before computing its taxable income under the new method.

Section 1.446-1(e)(2)(ii)(a) of the regulations provides that a change of accounting method includes a change in the overall plan of accounting for gross income or deductions, as well as a change in any material item within the plan, and a method of accounting is not established for an item unless there is a pattern of consistent treatment. A material item is defined as any item that involves the proper time for the inclusion of the item in income or the taking of a deduction.

Section 1.446-1(e)(2)(ii)(c) of the regulations provides that a change in the treatment of any material item used in an overall plan for identifying or valuing inventory is a change of accounting method.

Rev. Proc. 79-23, 1979-1 C.B. 564, sets forth the types of situations that warrant disallowance or termination of a taxpayer's LIFO election. In addition, in that revenue procedure certain situations have been identified that do not warrant a disallowance or termination of a LIFO election. Section 3.01(c) of Rev. Proc. 79-23 provides that the failure by the taxpayer to value its LIFO inventory at cost for federal income tax purposes, for the year pre-

ceding the year of the LIFO election, and all subsequent taxable years may warrant the disallowance or termination of a LIFO election. However, in determining cost for the year of the LIFO election and any subsequent year, the failure to include (or exclude) an item of cost, such as in accordance with the full absorption inventory rules of section 1.471-11 of the regulations, will not warrant disallowance or termination.

Rev. Rul. 77-134, 1977-1 C.B. 132 states that the Internal Revenue Service will not follow the decision in *Korn Industries, Inc. v. United States*, 532 F.2d 1352 (Ct. Cl 1976). The United States Court of Claims held in that case that the taxpayer's change in its standard cost computation for finished goods to include 14 cost elements, where previously only 11 had been included, was not a change of accounting method but rather the correction of a mathematical or posting error. Rev. Rul. 77-134 holds that in *Korn Industries, Inc.* the taxpayer has changed its method of accounting under section 446 of the Code and such a change requires the consent of the Secretary.

Rev. Rul. 77-134 also states that if a taxpayer has consistently treated an item of income or expense in a particular manner, any change from that consistent treatment is a change of accounting method regardless of whether the consistent treatment was a proper method of accounting.

In the present situation, the taxpayer's exclusion of an item of cost (freight-in) for purposes of valuing the merchandise in its inventory established a consistent pattern of treating the cost of freight-in and the cost of the merchandise. The freight-in cost that was excluded by the taxpayer prior to 1979 in valuing its inventory is a material item because it involves the proper timing of an item of expense that is used in the overall plan for valuing the taxpayer's inventory.

Freight-in as provided in section 1.471-3 of the regulations is an item of cost. Its inclusion or exclusion in valuing the taxpayer's inventory is another example along with the full absorption rules mentioned in section 3.01(c) of Rev. Proc. 79-23 that will not warrant disallowance or termination of the taxpayer's LIFO election.

HOLDINGS

(1) The taxpayer's change in the cost computation of its LIFO inventory to include the cost of freight-in is a change in method of accounting under section 446 of the Code and the regulations thereunder, and such a change requires the consent of the Secretary. See section 1.446-1(e) of the regulations. When the Commissioner approves a change in method of accounting, both the opening and closing inventory in the year of change are placed on the new method. To the extent the opening inventory in the year of change exceeds the closing inventory at the end of the year preceding the year of change, there is an adjustment under section 481 solely by reason of the change to prevent an amount from being duplicated. The section 481 adjustment is taken into account in determining taxable income in the manner determined by the Commissioner in accordance with Rev. Proc. 70-27, 1970-2 C.B. 509, as clarified by Rev. Proc. 75-18, 1975-1 C.B. 687.

(2) The taxpayer's exclusion of the cost of freight-in from the cost of its merchandise alone does not warrant the disallowance or termination of the taxpayer's LIFO election.

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26 CFR 1.446-1: General rule for methods of accounting.

Procedures for requesting consent to change method of accounting. See Rev. Proc. 80-51, page 818.

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26 CFR 1.446-1: General rule for methods of accounting.

Tax treatment of retired recovered mass asset materials from an electric utility's distribution and transmission systems. See Rev. Rul. 80-311, page 5.

Subpart B.—Taxable Year for Which Items of Gross Income Included

Section 451.—General Rule for Taxable Year of Inclusion

26 CFR 1.451-1: General rule for taxable year of inclusion.

Public utilities; fuel adjustment charges; when includible in income. A public utility that uses the accrual method of accounting is authorized to include fuel adjustment charges in its customers' bills for natural gas. The charges may be adjusted every six months and are based on estimated sales for the period they are in effect, but they are intended to recover the increased fuel costs for the preceding six-month period. The utility must include the fuel adjustment charges in gross income as part of the selling price of gas sold during the period the charges are in effect.

Rev. Rul. 80-308

ISSUE

When must a public utility company that uses the accrual method of accounting include in its gross income its increased fuel costs that are passed through to the utility's customers over a 6-month cycle by a fuel adjustment charge?

FACTS

M is a natural gas company that files its federal income tax return on a calendar year basis using the accrual method of accounting. The rates for natural gas charged by *M* to its customers are regulated by the Federal Energy Regulatory Commission (FERC). The FERC determines the amount of any increase in *M*'s rates based upon, among other things, 12 months of actual increased operating expenses, adjusted for any known changes that will occur within the following 9 months. This 12-month period is called the "base period." Generally a FERC rate increase does not become effective until

about 10 months after the end of the base period. *M* does not receive payment until it delivers gas to its customers and bills them. Thus, under the normal rate-making process, *M* cannot recover any increased costs until a considerable time after they are incurred. This delay is often referred to as "regulatory lag."

Because of regulatory lag and unusual increases in the cost of gas, the FERC authorized a special method for *M* to recover its increased gas costs charged by *M*'s suppliers by inserting a "purchased gas adjustment" (PGA) clause in *M*'s tariff. Under the PGA clause *M* can adjust its rates every 6 months to recover its increased gas costs during that period (first six months). This adjustment (fuel adjustment charge) is based on estimated sales and is in addition to the normal rate *M* is otherwise authorized to charge its customers. It is effective for the succeeding full 6-month period (second six months). Any overcollections or undercollections resulting from the fuel adjustment charges must be included in the calculation of the next 6 months' fuel adjustment charge (third six months). Thus, the PGA clause has significantly reduced regulatory lag for *M*'s increased gas costs.

For financial reporting purposes *M* defers the increased gas costs for the first six months until the second six months, the period during which it includes the fuel adjustment charges in its customers' bills. For income tax purposes *M* deducts the increased gas costs in the year the gas is delivered to its customers, the first six months. See Rev. Rul. 75-407, 1975-2 C.B. 197. For financial reporting and income tax purposes *M* includes the fuel adjustment charges in its gross income when they are added to a customer's bill as part of the selling price of fuel sold during the 6 months the fuel adjustment charge is in effect, the second six months.

LAW

Section 451(a) of the Internal Revenue Code provides that the amount of any item of gross income is included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income this amount is to be properly accounted for as of a different period.

Section 1.451-1(a) of the Income Tax Regulations provides that under an accrual method of accounting income is includable in gross income when all the events have occurred that fix the right to receive the income and its amount can be determined with reasonable accuracy.

All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. See *Schlude v. Commissioner,* 372 U.S. 128 (1963), Ct. D. 1879, 1963-1 C.B. 99 and Rev. Rul. 79-195, 1979-1 C.B. 177.

Rev. Rul. 63-182, 1963-2 C.B. 194 discusses a situation in which a natural gas distributor using the accrual method of accounting receives a refund from its supplier because of a retroactive decrease in the price of previously purchased gas. The refund was the result of a settlement agreement reached between the distributor and its supplier and was conditioned upon approval by the Federal Power Commission (FPC). The distributor was required by the FPC to adjust its gas charges to its customers to reflect any decrease in its price paid for gas. The distributor passed the refund on to its customers by adjusting their gas bills over the 12 months following receipt of the refund by offsetting or crediting the refund against future charges.

Rev. Rul. 63-182 concludes that the distributor's liability to make refunds to its customers was established on the date the FPC issued its order approving the rate settlement agreement entered into by the distributor and its supplier and not over the 12-month period during which the customer's gas bills are being adjusted.

ANALYSIS

The fuel adjustment charge is an addition to the normal approved billing rate that *M* uses to bill its customers. It is intended to permit *M* to recover its increased gas costs sooner than the normal billing-rate process allows. Although the fuel adjustment charge is calculated by reference to the increased cost of gas purchased by *M* during the first six months, it is not a charge that is a part of the selling price of this gas. Rather, it is an adjustment to the selling price of gas that is sold during the 6 months the fuel adjustment charge is in effect, the second six months.

M is authorized by the PGA clause to adjust its rates every six months when it incurs increased gas costs. *M* must make additional sales in the future in order to recover, or to have the right to recover, the increased costs represented by the fuel adjustment charge. Accordingly, the "all events test" under section 1.451-1(a) of the regulations is not met until *M* sells gas during the 6 months the fuel adjustment clause is in effect.

In Rev. Rul. 63-182 the taxpayer was required to make refunds to its customers when the FPC issued its order approving the settlement agreement. Although the taxpayer chose to make the refunds by adjusting its customers' bills over 12 months, the taxpayer's liability to its customers was unconditional upon the FPC's approval of the agreement. The liability was fixed at that time and not contingent upon the taxpayers having future sales. Thus, the "all events test" was met upon approval of the settlement agreement by the FPC.

HOLDING

A public utility company that uses the accrual method of accounting must include fuel adjustment charges that are applied as part of the rate charged for future sales in its gross income as part of the selling price of fuel sold

during the specific 6-month period the fuel adjustment charge is in effect.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 63-182 is distinguished.

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26 CFR 1.451-1: General rule for taxable year of inclusion.
(Also Sections 61, 166; 1.61-1, 1.166-1.)

Interest on uncollectible loan; accrual method. An accrual method taxpayer must include in gross income for the taxable year in which a loan payable to the taxpayer becomes uncollectible the interest that accrues on the loan for the part of that year prior to the time the loan becomes uncollectible. If the accrued interest subsequently becomes uncollectible, the taxpayer may be entitled to a bad debt deduction under section 166 of the Code.

Rev. Rul. 80-361

ISSUE

When may a creditor-taxpayer suspend the accrual of interest income on a loan that becomes uncollectible during the taxable year?

FACTS

M, a domestic corporation, is a calendar year taxpayer that uses the accrual method of accounting. *M* made a secured loan to *A* in 1975. During 1975 and through the major part of 1976, *A*'s financial condition was such that the interest on the loan obligation to *M* was collectible. During the latter part of 1976, however, due to sudden and severe financial reverses, *A* became insolvent, and, as a consequence, the debt became uncollectible. Shortly thereafter, *A* defaulted on the loan. The security was sufficient to satisfy only the principal amount of the indebtedness.

APPLICABLE LAW AND ANALYSIS

Section 1.451-1(a) of the Income Tax Regulations provides that under an accrual method of accounting, income is includible in gross income when all events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

Rev. Rul. 72-100, 1972-1 C.B. 122, as clarified by Rev. Rul. 74-607, 1974-2 C.B. 149, states that the right to receive interest income becomes fixed ratably over the period of the loan so long as all events have accrued to fix the right to receive income and the amount thereof can be fixed with reasonable accuracy.

A fixed right to a determinable amount does not require accrual, however, if the income item is uncollectible when the right to receive the item arises. *Jones Lumber Co. v. Commissioner,* 404 F.2d 764 (6th Cir. 1968).

When an income item is properly accrued and subsequently becomes uncollectible, a taxpayer's remedy is by way of deduction rather than through elimination of the accrual. Moreover, this rule is applicable even when the item is accrued and becomes uncollectible during the same taxable year. *Spring City Foundry Co. v. Commissioner,* 292 U.S. 182 (1934), Ct.D. 829, XIII-1 C.B. 28 (1934). Also *Atlantic Coast Line Railroad Co. v. Commissioner,* 31 B.T.A. 730, 751 (1934), *acq.,* XIV-2 C.B. (1935).

HOLDINGS

The interest, the right to which became fixed during that part of 1976 prior to *A*'s insolvency, accrued as such right arose and therefore must be included in the gross income of *M* for that year. To the extent that the accrued interest subsequently became uncollectible because of *A*'s insolvency, *M* is entitled to treat the accrued interest as a bad debt pursuant to section 166 of the Code, provided the requirements of that section are satisfied.

The interest, the right to which became fixed during that part of 1976 after A's insolvency, did not properly accrue, since the interest was uncollectible at the time such right arose, Therefore, such interest need not be included in the gross income of *M* for 1976.

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26 CFR 1.451-2: Constructive receipt of income.
(Also Sections 61, 163, 461; 1.61-7, 1.163-1, 1.461-1.)

Interest; "reverse mortgage loan"; when deducted and when included. Interest on a "reverse mortgage loan" that is added monthly to the outstanding loan balance as it accrues is neither includible in a cash method lender's gross income nor deductible by a cash method borrower at the time it is added.

Rev. Rul. 80-248

ISSUES

When is interest on a "reverse mortgage loan" includible in the gross income of a lender and deductible by a borrower under the circumstances described below?

FACTS

A state permits various kinds of lending institutions located within the state to make reverse mortgage loans to individuals who own their own homes, which they occupy as their principal residence. A reverse mortgage loan is secured by a mortgage on the borrower's principal residence. A reverse mortgage loan is one in which the lending institution commits itself to a principal amount, not to exceed 80 percent of the appraised value of the property, which is paid to the borrower in installments over a period of months or years. Repayment of the loan is due when the principal amount has been fully paid to the borrower, the residence that secures the loan is sold, the borrower dies, or the borrower ceases to use the home as the borrower's principal residence. The loan agreement may provide that interest will be added to the outstanding

loan balance monthly as it accrues. The outstanding loan balance is the current amount of money owed by the borrower to the lending institution and includes the total of the installments paid by the lender to date, the total accrued interest if any to date, and any other charges, such as taxes and insurance, paid to date by the lender upon the borrower's failure to make such payment. The primary purpose of the reverse mortgage loan is to enable elderly persons with limited incomes to remain in their homes.

A lending institution made a reverse mortgage loan to an individual who qualified for such a loan. The loan agreement provides that interest will be added to the outstanding loan balance monthly as it accrues. Both the lender and the borrower use the cash receipts and disbursements method of accounting.

LAW AND ANALYSIS

(1) Section 451 of the Internal Revenue Code provides that the amount of any item of gross income is includible in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-(a) of the Income Tax Regulations provides that income is includible in gross income for the taxable year in which it is actually or constructively received by the taxpayer, unless it is includible in a different year in accordance with the taxpayer's method of accounting.

Section 1.451-2(a) of the regulations provides that income although not actually reduced to a taxpayer's possession is constructively received by the taxpayer in the taxable year during which it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time, or so that the taxpayer could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

In this case, the loan agreement provides that interest will be added to the outstanding loan balance monthly as it accrues. However, this interest is not received by the bank, nor is it available to be drawn upon by the bank. Therefore, the bank is not in actual or constructive receipt of the interest when it is added to the outstanding loan balance.

(2) Section 163(a) of the Code allows as a deduction all interest paid or accrued within the taxable year on indebtedness.

Section 461(a) of the Code provides that the amount of any allowable deduction shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(1) of the regulations provides that, under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid.

If a taxpayer who uses the cash receipts and disbursement method of acounting owes interest on an obligation and gives a note to the creditor to cover the interest, the taxpayer has not paid the interest for federal income tax purposes. The payment occurs when the taxpayer pays the interest in cash or by transferring property. See *McAdams v. Commissioner*, 15 T.C. 231 (1950), *aff'd* 198 F.2d 54 (5th Cir. 1952); *Bramer v. Commissioner*, 6 T.C. 1027 (1946), *aff'd* 161 F.2d 185 (3rd Cir. 1947). See also Rev. Rul. 76-135, 1976-1 C.B. 114, which states that actual payments of cash are required as a basis for any deductions allowable to a taxpayer who uses the cash receipts and disbursements method of accounting.

HOLDINGS

The interest is includible in the lender's gross income when it is actually or constructively received by the lender and is deductible by the borrower when it is actually paid by the borrower. Actual or constructive receipt or payment does not occur when the interest is added to the outstanding loan balance. Therefore, the interest is neither includible in the lender's gross income nor deductible by the borrower at that time.

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26 CFR 1.451-2: Constructive receipt of income.
(Also Section 61; 1.61-2.)

Gross income; stock appreciation rights; year includible. A corporation grants to its key employees stock appreciation rights that entitle them to a cash payment for each right exercised equal to the excess of the fair market value of a share of the corporation's common stock on the date of exercise over the fair market value of a share on the date the right is granted. The rights cannot be exercised before one year, and if they are not exercised within five years, they are deemed exercised on the fifth anniversary of the grant. At that time, the employee will be paid the amount of the appreciation. Payments received for the stock appreciation rights are includible in gross income in the year the rights are exercised.

Rev. Rul. 80-300

ISSUE

When is an employee in receipt of income because of the grant to the employee of a stock appreciation right?

FACTS

A corporation adopted a plan under which key employees of the corpora-

tion are granted stock appreciation rights (SAR's). An SAR entitles the employee to a cash payment equal to the excess of the fair market value of one share of the common stock of the corporation on the date of the exercise of the SAR over the fair market value of a share on the date the SAR was granted to the employee. An employee need not own any stock of the corporation to receive an SAR, and SAR's are granted without cost to the employee. To exercise an SAR, an employee must notify the corporation in writing. No SAR is exercisable before one year, and if not exercised by the employee within five years, the SAR's will be deemed to have been exercised on the fifth anniversary of the grant. At that time, the amount of the stock appreciation will automatically be paid to the employee. SAR's are not traded on an established market, and are nonassignable and nontransferable by the grantees.

In 1975, the corporation granted 10 SAR's to *A*, an employee of the corporation. On the date of the grant, the fair market value of the corporation's common stock was 30*x* dollars a share. In 1980, *A* exercised the SAR's when the fair market value of a share of the corporation's stock was 80*x* dollars. *A* received 500*x* dollars.

LAW AND ANALYSIS

Section 61 of the Internal Revenue Code provides that, except as otherwise provided, income means all income from whatever source derived.

Section 451(a) of the Code provides that the amount of any item of gross income is includible in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period.

Section 1.451-2(a) of the Income Tax Regulations provides that income, although not actually reduced to a taxpayer's possession, is constructively received in the taxable year during which it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time, or so that the taxpayer could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

The courts and the Internal Revenue Service have recognized that a requirement of surrender or forfeiture of a valuable right is a sufficient restriction to make inapplicable the doctrine of constructive receipt. See *Hales v. Commissioner,* 40 B.T.A. 1245 (1939), *acq.,* 1940-1 C.B. 2. See also Rev. Rul. 58-230, 1958-1 C.B. 204, which holds that a requirement of a six-month suspension from participation in an employees' profit sharing plan upon an employee's withdrawal of the employer's contributions and earnings thereon, and the employee's consequent loss of the benefit of the employer's contributions that would have been made for the six-month period, is a substantial limitation that precludes constructive receipt of the withdrawable amounts.

The forfeiture of a valuable right is a substantial limitation that precludes constructive receipt of income. The employee's right to benefit from further appreciation of stock, in this case, without risking any capital is a valuable right. However, once the employee exercises the stock appreciation rights, the employee loses all chance of further appreciation with respect to that stock and the amount payable becomes fixed and available without limitation. Accordingly, an employee will be in receipt of income on the date the SAR's are exercised.

HOLDING

An employee who possesses stock appreciation rights is not in constructive receipt of income by virtue of the appreciation of the employer's stock. The cash payment to which the employee is entitled is includible in gross income in the year a stock appreciation right is exercised. Thus, in the example above, the employee must include in gross income 500*x* dollars in 1980 because the SAR's were exercised in that year.

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26 CFR 1.451-2: Constructive receipt of income.

Whether a shareholder of a liquidating corporation, who is an individual that uses the cash receipts and disbursements method of accounting, is in receipt of the liquidating distribution, under the circumstances described, at the time the distribution first becomes payable, rather than on the date it is actually received by the shareholder upon surrender of his stock. See Rev. Rul. 80-177, page 109.

Section 453.—Installment Method

26 CFR 1.453-1: Installment method of reporting income.
(Also Section 121; 1.121-1.)

Residence; installment sale; election; gross profit. A taxpayer who realized a gain on the sale of a principal residence elected to exclude the gain under section 121 of the Code and elected to use the installment method of reporting income from the sale. In determining the amount of each installment payment that is reportable under the installment method of accounting, gross profit in the formula provided in section 453(a)(1) is the amount of the gain that is not excludable from gross income.

Rev. Rul. 80-249

ISSUE

How is the amount of each installment payment that is reportable under the installment method of accounting determined when the taxpayer elects to exclude gain pursuant to section 121 of the Internal Revenue Code?

FACTS

During the taxable year, the tax-

payer sold the taxpayer's principal residence for $300,000. The taxpayer's adjusted basis in the residence was $140,000 and the realized gain from the sale was $160,000 ($300,000 sales price less $140,000 adjusted basis).

The taxpayer satisfied the requirements of section 121 of the Code and made an election under that section to exclude from gross income $100,000 of the gain from the sale. The transaction satisfied the requirements of section 453(b), and the taxpayer also elected to report the taxable gain using the installment method of accounting provided by section 453. The taxpayer does not intend to purchase another principal residence, and therefore, section 1034 is not applicable.

LAW AND ANALYSIS

Section 453(b) of the Code permits a taxpayer to report certain qualifying gains from the sale or other disposition of real property on the installment method of accounting in the manner prescribed in section 453(a). Section 453(a)(1) provides for reporting as income in each taxable year the proportion of the installment payments actually received in that year which the gross profit realized or to be realized bears to the total contract price.

Section 1.453-1(b) of the Income Tax Regulations provides that gross profit, in the case of the sale of real property, means the selling price less the adjusted basis as defined in section 1011 of the Code and the regulations thereunder.

Rev. Rul. 75, 1953-1 C.B. 83, and Rev. Rul. 65-155, 1965-1 C.B. 356, involve the use of the installment method in situations in which there is a partial nonrecognition of gain pursuant to the provisions of section 1034 of the Code, relating to gain on the sale of a principal residence, and section 1031(b), relating to gain from exchanges not solely in kind. In those revenue rulings, the recognized gain is substituted for the gross profit for purposes of determining the amount of each installment that is includible in gross income.

In the instant case, as in Rev. Rul. 75 and Rev. Rul. 65-155, only a portion of the realized gain on the sale is includible in gross income.

HOLDING

For purposes of determining the amount of each installment payment that is reportable under the installment method of accounting, gross profit in the formula provided in section 453(a)(1) of the Code is the amount of the gain that is not excludable from gross income under section 121. Thus, the taxpayer in this case must report as income in each year an amount equal to one fifth ($60,000/$300,000) of the installment payments received in that year.

Subpart C.—Taxable Year for Which Deductions Taken

Section 461.—General Rule for Taxable Year of Deduction

26 CFR 1.461-1: General rule for taxable year of deduction.

Oil and gas leases; removal of offshore platforms and well. A corporation using the accrual method of accounting entered into long-term offshore oil and gas leases with the federal government under which the corporation was required to remove the platforms and well fixtures upon abandonment of the wells or termination of the leases. The corporation may deduct the costs of removing the platforms and well fixtures only in the taxable year during which the removal services are performed by the corporation or by a separate contractor.

Rev. Rul. 80-182

ISSUE

When may a taxpayer using the accrual method of accounting deduct the cost of removing offshore platforms and well fixtures installed pursuant to a long-term oil and gas lease with the federal government?

FACTS

Situation 1

X is a corporation that files its federal income tax return on a calendar year basis using the accrual method of accounting. During 1978 *X* entered into offshore oil and gas leases with the federal government. The leases provide that *X* is obligated to remove offshore platforms and well fixtures used in the drilling operation upon *X*'s abandonment of the wells or on termination of the leases. The typical offshore lease has a duration of 20 years or more. *X* installed the offshore platforms and well fixtures in 1978 and in its federal income tax return for the year deducted the estimated cost of removing them. *X* will perform all services incidental to removing the offshore platforms and well fixtures.

Situation 2

The facts are the same as *Situation 1* except that instead of *X* performing the removal services it contracts with *Y*, an unrelated corporation, to perform them.

LAW AND ANALYSIS

Section 461 of the Internal Revenue Code provides that the amount of any deduction shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2) of the Income Tax Regulations provides that under an accrual method of accounting an expense is deductible for the taxable year in which (1) all the events have occurred that determine the fact of the liability and (2) the amount thereof can be determined with reasonable accuracy. If the taxpayer is to be entitled to a deduction in 1978 for the cost of removing the platforms and fixtures, both of these conditions must be satisfied.

The specific question is whether the

existence during a taxable year of a contractual obligation requiring a taxpayer to incur a deductible expense at some time in the future is sufficient to permit the accrual of such expenditure under section 1.461-1(a)(2) of the regulations even though the contractually mandated services have not been rendered by either the taxpayer or a third-party contractor at the end of the taxable year.

An accrual basis obligor is not permitted to deduct an expense stemming from a bilateral contractual arrangement, that is, mutual promises, prior to the performance of the contracted for services by the obligee. See *Levin v. Commissioner,* 21 T.C. 996 (1954), *aff'd* 219 F.2d 588 (3rd Cir. 1955) and *Amalgamated Housing Corporation v. Commissioner,* 37 B.T.A. 817 (1938), *aff'd per curiam,* 108 F.2d 1010 (2nd Cir. 1940). The taxpayer obligor, through the vehicle of a bare contractual obligation, has incurred no liability but has merely agreed to become liable to pay in the event the future services called for are performed. The liability under the contract is contingent upon performance. All events are not fixed within the meaning of section 1.461-1(a)(2) of the regulations until the required performance is rendered.

In *National Bread Wrapping Machine Co. v. Commissioner,* 30 T.C. 550 (1958), the taxpayer was denied a deduction for guaranteed installation services for machines sold but uninstalled. The court held that although the taxpayer was obligated to render installation services, until the installation services were rendered there was no definite liability on the part of the taxpayer to pay any amount to any person. The liability was contingent until performance occurred. See also *Spencer, White and Prentis Inc. v. Commissioner,* 144 F.2d 45 (2nd Cir. 1944), *cert. denied,* 323 U.S. 780 (1944), in which the taxpayer was denied a deduction for the estimated cost of future restoration work that the taxpayer was obligated to perform under a construction contract.

In both *Situation 1* and *2, X* has a contractual obligation under its lease with the federal government to remove the platforms and fixtures. In *Situation 1,* as *X*'s employees perform the services required to remove the platforms and fixtures the fact of the liability will become fixed. In *Situation 2, X*'s liability to *Y* for removing the platforms and fixtures is contingent on *Y*'s performance. As *Y* performs the actual removal services the fact of the liability will become fixed and *X* will be entitled to deduct the cost of the removal services actually performed by *Y*. The fact that *X* is contractually liable for the cost of the entire removal services does not entitle it to deduct the cost of such services before they are performed.

HOLDING

A taxpayer using the accrual method of accounting may deduct the costs of removing offshore platforms and well fixtures installed pursuant to a long-term oil and gas lease with the federal government in the taxable years during which the removal services are performed. This same conclusion results whether the removal services are performed by the taxpayer or a third-party contractor.

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26 CFR 1.461-1: General rule for taxable year of deduction.

Deductions; workmen's compensation. The Service will not follow the decisions of the Court of Appeals in *Crescent Wharf and Warehouse Company* and *Wien Consolidated Airlines, Inc.*, which held that an employer's liability for workmen's compensation is deductible in the year of an employee's death or injury even if the amount of the liability is contingent upon the occurrence of certain subsequent events; Rev. Rul. 70-262 amplified.

Rev. Rul. 80-191

ISSUE

Whether the Internal Revenue Service will follow the decisions of the United States Court of Appeals for the 9th Circuit in *Crescent Wharf and Warehouses Company v. Commissioner,* 518 F.2d 772 (9th Cir. 1975), *rev'g and rem'g* 59 T.C. 751 (1973), and *Wien Consolidated Airlines, Inc. v. Commissioner,* 528 F.2d 735 (9th Cir. 1976), *aff'g* 60 T.C. 13 (1973), *nonacq.,* 1978-1 C.B. 3, with regard to when workmen's compensation expenses are deductible.

LAW AND ANALYSIS

In *Crescent* the taxpayer-employer was required to compensate its employees for certain injuries suffered by them in the course of their employment. One of the elements of the taxpayer's liability was the cost of necessary medical treatment. Another element of liability was compensation for disability. The taxpayer treated the liability as fixed when an employee was injured and accrued (deducted) the estimated cost of medical treatment and disability compensation. The court held that the deduction was allowable at this time if the amount could be determined with reasonable accuracy.

In *Wien,* which involved the same situation considered in Rev. Rul. 70-262, 1970-1 C.B. 122, the taxpayer-employer was liable for workmen's compensation benefits to spouses and minor children of employees killed in the course of their employment. The spouse was entitled to payments until death or remarriage, the children until death or their nineteenth birthday. The taxpayer accrued (deducted) the total amounts estimated to be payable when an employee was killed, rather than deducting each year only the amounts that actually became due. The court held, contrary to Rev. Rul. 70-262, that deduction for the children's benefits was allowable, but that deduction for the spouse's benefits was

not determinable with reasonable accuracy and therefore not allowable.

The Supreme Court of the United States in *Brown v. Helvering*, 291 U.S. 193 (1934), Ct. D. 786, XIII-1 C.B. 223 (1934), dealt with the question of whether an insurance agent that uses the accrual method of accounting to report commission income on premiums for multi-year insurance contracts written in the taxable year can claim a current deduction on account of contract cancellations expected to occur in later years. The taxpayer computed the ratio of cancellations to premiums based on its experience for the 5-year period preceding the taxable year and used that ratio as the basis for the current deduction. The Court rejected this basis for claiming a deduction by an accrual basis taxpayer because the liability of the taxpayer for expected future cancellations was not fixed and absolute. In respect to no particular policy written within the year could it be known that it would be cancelled in a future year. Nor could it be known that a definite percentage of all the policies would be cancelled in the future years. The event necessary to create a liability was a cancellation, not the premium payment, and since the cancellation was not certain to occur, the liability was contingent. If a liability is contingent, the expense that it represents cannot accrue and a deduction therefor is not allowable.

The 9th Circuit in the *Crescent* and *Wien* decisions did not follow the *Brown* holding that a contingent liability does not generate an accruable expense even though the amount of such expense is determinable in the aggregate with reasonable accuracy.

In *Crescent*, the taxpayer-employer was liable for the cost of medical treatment only if medical treatment was received by an employee. If the employee never received treatment, the mere fact of injury would not be enough to establish liability. Similarly, the taxpayer was liable for disability payments only if the employee was absent from work for a required period.

In *Wien*, the taxpayer was liable to the spouse of an employee for death benefits only if (1) the spouse was alive, and (2) the spouse had not remarried. Each condition had to be satisfied for each taxable year in order for the taxpayer to be liable for that year. The fact, alone, of the employee's death would not be enough to establish liability, since if the spouse remarries or dies, the employer will clearly not be liable for further benefits. Similarly, the taxpayer was liable to a child of an employee for death benefits only if the child was alive.

HOLDING

The Service will not follow *Crescent* and *Wien* and will continue to disallow deductions for workmen's compensation expenses that are not based on a fixed liability.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 70-262 is amplified.

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26 CFR 1.461-1: General rule for taxable year of deduction.

Bank; Comptroller of the Currency's semiannual assessment. A calendar year, accrual method bank may not accrue on December 31 the semiannual assessment that the bank is required to pay to the Comptroller of the Currency on or before January 31 for the 6-month period beginning January 1.

Rev. Rul. 80-230

ISSUE

May a bank that uses an accrual method of accounting on a calendar year basis accrue on December 31, 1978, the semiannual assessment required to be paid to the Comptroller of the Currency on or before January 31, 1979, for the 6-month period beginning January 1, 1979?

FACTS

The taxpayer, a bank subject to the jurisdiction of the Comptroller of the Currency, uses an accrual method of accounting for reporting its income on a calendar year basis.

The provisions of 12 U.S.C.A. section 482 (Supp. 1979), which governs the assessment of national banks by the Comptroller of the Currency, provides that:

> The expense of the examinations . . . shall be assessed by the Comptroller of the Currency upon national banks in proportion to their assets or resources. The assessments may be made more frequently than annually at the discretion of the Comptroller of the Currency. The annual rate of such assessment shall be the same for all national banks except that banks examined more frequently than twice in one calendar year shall, in addition, be assessed the expense of these additional examinations.

Section 8.2 (chapter 1 of Bank and Banking Regulations, 12 CFR section 8.2) provides that each national bank and each district bank shall pay to the Comptroller of the Currency on or before January 31 and July 31 of each year a semiannual assessment fee for the 6 month period beginning 30 days before each payment date. Each semiannual assessment is based upon the total assets shown in the bank's quarterly "Consolidated Report of Condition (Including Domestic and Foreign Subsidiaries)" most recently preceding the payment date. Each bank subject to the jurisdiction of the Comptroller of the Currency on the date of the second or fourth condition reports is subject to the full assessment for the next 6 month period without proration for any reason.

The semiannual assessment return for the first 6 months of 1979, based on the condition reports submitted for the fourth reporting period ending December 31, 1978, was prepared by the taxpayer and sent to the Comptroller of the Currency with the required payment on January 30, 1979.

LAW AND ANALYSIS

Section 1.461-1(a)(2) of the Income Tax Regulations provides that under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred that determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.

The semiannual assessment for the first 6 months of 1979 is based upon the total assets reported by the taxpayer on its Consolidated Report of Condition (Including Domestic and Foreign Subsidiaries), filed for the reporting period ending December 31, 1978. The semiannual assessment is not due and payable in 1978 even though the amount thereof can be determined with reasonable accuracy as of the last day of business in 1978.

Generally, under section 1.461-1(a)(2) of the regulations, all the events have occurred that determine the fact of the liability when (1) the event fixing the liability, whether that be the required performance or other event, occurs, or (2) payment therefore is due, whichever happens earliest. Although the semiannual assessment is based upon the December 31, 1978, report of condition, it is not payable until January 31, 1979, and is for the 6-month period beginning January 1, 1979. Thus, all the events that determine the fact of liability for this semiannual assessment occur as of January 1, 1979, and have not yet occurred as of December 31, 1978.

HOLDING

A bank that uses an accrual method of accounting for reporting its income on a calendar year basis may not accrue on December 31, 1978, the semiannual assessment required to be paid to the Comptroller of the Currency on or before January 31, 1979, for the 6-month period beginning January 1, 1979.

26 CFR 1.461-1: General rule for taxable year of deduction.

"Pay by phone" account; when deductible. The date to be used in determining when allowable deductions may be taken by a cash method taxpayer using a "pay by phone" account is the date the financial institution paid the amount, as reported on a monthly statement sent to the taxpayer.

Rev. Rul. 80-335

ISSUE

What is the date of payment when a taxpayer uses a "pay by phone" account maintained at a financial institution to pay creditors?

FACTS

A, who uses the cash receipts and disbursements method of accounting, maintains a "pay by phone" account with *M*, a financial institution, whereby *A*, by telephoning *M*, can authorize *M* to make payments to *A*'s creditors as *A*'s agent. According to the agreement between *A* and *M*, if *A* calls *M* before noon on a weekday that is not a holiday, *M* will pay the bill that afternoon. If the call is made after noon or on a weekend or holiday, the bill will be paid on the next working day. *M* pays the bills by charging *A*'s account and either mailing checks to the creditors, transferring funds to the creditors' accounts if the creditors maintain them with *M*, or actually delivering checks to the creditors. At the end of the month, *M* mails to *A* a statement listing all the payments *M* has made for *A* during that month. The statement lists the names of the creditors, the amounts of the payments, the dates of the mailings, transfers or deliveries, and the balance remaining in *A*'s account.

LAW AND ANALYSIS

Section 461 of the Internal Revenue Code provides the general rule that the amount of any allowable deduction shall be taken for the taxable year that is the proper year under the method of accounting used by the taxpayer in computing taxable income.

Section 1.461-1(a)(1) of the Income Tax Regulations provides that under the cash receipts and disbursements method of accounting, amounts representing allowable deductions are taken into account for the taxable year in which paid.

If a taxpayer, who uses the cash receipts and disbursements method of accounting, mails checks to creditors, the taxpayer is entitled to allowable deductions therefor on the day the checks are placed in the mail, provided the checks are subsequently paid by the bank. *Estate of Witt v. Fahs,* 160 F. Supp. 521 (S.D. Fla. 1956).

If the taxpayer, who uses the cash receipts and disbursements method of accounting, authorizes payment by the taxpayer's agent, payment occurs on the date the agent, on behalf of the taxpayer, delivers a check to the payee. See *Commissioner v. Bradley,* 56 F.2d 728 (6th Cir. 1932). In the present case *M* is acting as the agent of *A*, and therefore, if *M* mails checks to *A*'s creditors, transfers funds to creditors' accounts, or actually delivers checks to creditors, the payments are made on the date of the mailings, transfers, or deliveries, as the case may be.

HOLDING

The date reported by *M* on the monthly statement indicating when payment was made is the date of payment by *A* for purposes of determining when an allowable deduction may be taken.

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26 CFR 1.461-1: General rule for taxable year of deduction.

When interest on a reverse mortgage loan is deductible by a borrower who uses the cash receipts and disbursements method of accounting. See Rev. Rul. 80-248, page 164.

Subpart D.—Inventories

Section 471.—General Rule for Inventories

26 CFR 1.471-1: Need for inventories.

Whether a taxpayer's change in the cost computation of its last-in, first-out (LIFO) inventory to include the cost of freight-in is a change in method of accounting under section 446 of the Code that requires the advance consent of the Secretary, and whether the exclusion of the cost of freight-in from the cost of its merchandise warrants disallowance or termination of the taxpayer's LIFO election. See Rev. Rul. 80-190, page 161.

Section 472.—Last-In, First-Out Inventories

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The January 1980 Bureau of Labor Statistics price indexes are acceptable for use by department stores employing the retail inventory and last-in, first-out inventory methods of valuing inventories for taxable years of 12 months ended December 31, 1979, and January 31, 1980.

Rev. Rul. 80-214

The following price indexes for January 1980 published by the Bureau of Labor Statistics on March 4, 1980, for use by department stores employing the retail inventory and last-in, first-out inventory methods are accepted by the Internal Revenue Service pursuant to section 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 72-21, 1972-1 C.B. 745, for appropriate application to inventories for taxable years of 12 months ended December 31, 1979, and January 31, 1980.

Indexes are given on a national basis for the store total, for 20 major groups of departments, and for two special combinations—soft and durable goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, paints, and wallpaper, as well as contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100)

	Department group	January 1979	January 1980	Percentage Change from January 1979 to January 1980[1]
I	Piece Goods	316.0	335.0	6.0
II	Domestics and Draperies	388.3	406.0	4.6
III	Women's and Children's Shoes	454.3	486.5	7.1
IV	Men's and Boys' Shoes	543.9	599.3	10.2
V	Infants' Wear	358.0	378.8	5.8
VI	Women's Underwear	297.5	317.7	6.8
VII	Women's and Girls' Hosiery	185.3	193.8	4.6
VIII	Women's and Girls' Accessories	356.8	374.7	5.0
IX	Women's Outerwear and Girls' Wear	322.3	326.4	1.3
X	Men's Clothing	408.6	406.8	—.4
XI	Men's Furnishings	349.4	374.6	7.2
XII	Boys' Clothing and Furnishings	345.0	365.1	5.8
XIII	Jewelry	495.2	605.4	22.3
XIV	Notions	368.1	393.2	6.8
XV	Toilet Articles and Drugs	412.5	442.5	7.3
XVI	Furniture and Bedding	411.8	441.4	7.2
XVII	Floor Covering	330.1	348.9	5.7
XVIII	Housewares	537.4	590.3	9.8
XIX	Major Appliances	192.4	203.1	5.6
XX	Radio and Television	113.5	115.1	1.4
	Groups I—XV: Soft Goods	370.6	390.1	5.3
	Groups XVI—XX: Durable Goods	350.2	375.6	7.3
	Store Total	364.4	385.4	5.8

[1] Absence of a minus sign before percentage change in this column signifies price increase.

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The July 1980 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods of valuing inventories for taxable years of 12 months ended June 30, 1980, and July 31, 1980.

Rev. Rul. 80-344

The following price indexes for July 1980 published by the Bureau of Labor Statistics on August 29, 1980, for use by department stores employing the retail inventory and last-in, first-out inventory methods, are accepted by the Internal Revenue Service pursuant to section 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 72-21, 1972-1 C.B. 745, for appropriate application to inventories for taxable years of 12 months ended June 30, 1980, and July 31, 1980.

Indexes are given on a national basis for the store total, for 20 major groups of departments, and for two special combinations—soft and durable

goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, paints, and wallpaper, as well as contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS

(January 1941 = 100)

Department Group		*July 1979*	*July 1980*	*Percent Change from July 1979 to July 1980* [1]
I	Piece Goods	327.7	366.1	11.7
II	Domestics and Draperies	402.0	437.1	8.7
III	Women's and Children's Shoes	468.8	500.8	6.8
IV	Men's and Boys' Shoes	577.9	616.7	6.7
V	Infants' Wear	367.9	408.5	11.0
VI	Women's Underwear	307.5	334.1	8.7
VII	Women's and Girls' Hosiery	189.1	201.8	6.7
VIII	Women's and Girls' Accessories	362.4	383.2	5.7
IX	Women's Outerwear and Girls' Wear	318.9	323.0	1.3
X	Men's Clothing	405.5	404.6	—.2
XI	Men's Furnishings	355.6	389.1	9.4
XII	Boys' Clothing and Furnishings	363.8	380.5	4.6
XIII	Jewelry	518.4	688.3	32.8
XIV	Notions	382.6	406.0	6.1
XV	Toilet Articles and Drugs	426.1	465.8	9.3
XVI	Furniture and Bedding	423.8	460.1	8.6
XVII	Floor Covering	336.6	364.8	8.4
XVIII	Housewares	559.5	620.2	10.8
XIX	Major Appliances	199.6	208.8	4.6
XX	Radio and Television	113.5	115.8	2.0
	Groups I—XV: Soft Goods	377.6	405.2	7.3
	Groups XVI—XX: Durable Goods	360.7	390.8	8.3
	Store Total	372.2	400.6	7.6

[1] Absence of a minus sign before percentage change in this column signifies price increase.

26 CFR 1.472-1: Last-in, first-out inventories.

Whether a taxpayer's change in the cost computation of its last-in, first-out (LIFO) inventory to include the cost of freight-in is a change in method of accounting under section 446 of the Code that requires the advance consent of the Secretary, and whether the exclusion of the cost of freight-in from the cost of its merchandise warrants disallowance or termination of the taxpayer's LIFO election. See Rev. Rul. 80-190, page 161.

Part III.—Adjustments

Section 481.—Adjustments Required by Changes in Method of Accounting

26 CFR 1.481-1: Adjustments in general.

Procedures for determining the adjustment period when consent to change a method of accounting is granted. See Rev. Proc. 80-51, page 818.

26 CFR 1.481-1: Adjustments in general.

Whether a taxpayer's change in the cost computation of its last-in, first-out (LIFO) inventory to include the cost of freight-in is a change in method of accounting under section 446 of the Code that requires the advance consent of the Secretary, and whether the exclusion of the cost of freight-in from the cost of its merchandise warrants disallowance or termination of the taxpayer's LIFO election. See Rev. Rul. 80-190, page 161.

Section 482.—Allocation of Income and Deductions Among Taxpayers

26 CFR 1.482-1: Allocation of income and deductions among taxpayers.

Whether the timing of an incorporation transaction under section 351 of the Code may improperly separate income from related expenses such that the Internal Revenue Service can make an allocation between taxpayers so as to match income with expenses. See Rev. Rul. 80-198, page 113.

26 CFR 1.482-1: Allocation of income and deductions among taxpayers.

The effect of a reduction in the amount of foreign income tax paid by a foreign subsidiary following an allocation of income under section 482 of the Code on the computation of the domestic parent's section 902 deemed paid foreign tax credit. See Rev. Rul. 80-231, page 219.

26 CFR 1.482-2: Determination of taxable income in specific situations.

Whether section 482 of the Code would be applicable to allocate income from one subsidiary to another subsidiary and their common parent in an amount equal to an arm's length charge for services rendered by the employees of the second subsidiary and the parent to the first subsidiary. See Rev. Rul. 80-181, page 121.

Subpart F.—Exempt Organizations
Part I.—General Rule

Section 501.—Exemption from Tax on Corporations, Certain Trusts, Etc.

Hospital service organization; purchasing; legal title. An organization that otherwise qualifies as a cooperative hospital service organization within the meaning of section 501(e) of the Code, that buys

hospital equipment for its patron hospitals, and that holds legal title to the equipment while the hospitals repay a commercial lender for the loan used to purchase the equipment is operated solely to perform the service of "purchasing" within the meaning of section 501(e)(1)(A).

Rev. Rul. 80-316

ISSUE

Is the organization described below, which otherwise qualifies for exemption from federal income tax as a cooperative hospital service organization described in section 501(e) of the Internal Revenue Code, operated solely to perform the service of "purchasing" within the meaning of section 501(e)(1)(A)?

FACTS

The organization buys hospital equipment from suppliers when requested to do so by one or more of its patron hospitals that constitute its governing body and operate it on a cooperative basis. However, it holds legal title to the equipment while a patron hospital, which as the equitable owner of the equipment, pays the principal and interest payments on the equipment. Such payments are transmitted to a commercial lender whose funds were used by the organization to finance the buying of the equipment. Each patron hospital makes payments only on the equipment it is buying.

LAW AND ANALYSIS

Section 501(e) of the Code defines a cooperative hospital service organization, and treats it as described in section 501(c)(3) for purposes of exemption from federal income tax under section 501(a).

Section 501(e)(1)(A) of the Code provides that a cooperative hospital service organization may perform on a centralized basis the service of "purchasing" which, if performed by a hospital exempt from federal income tax under section 501(c)(3), would constitute performance of the hospital's exempt purpose.

Although the organization described above holds legal title to the equipment it purchases for its patron hospitals, that arrangement is used merely as a convenience to its patron hospitals that are the beneficial owners of and solely responsible for paying for the equipment.

HOLDING

The organization described above is operated solely to perform the service of "purchasing" within the meaning of section 501(e)(1)(A) of the Code and, because it otherwise qualifies as a cooperative hospital service organization described in section 501(e), is exempt from federal income tax under section 501(a).

APPLICATION INSTRUCTIONS

Even though an organization considers itself within the scope of this revenue ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(e) of the Code. See section 1.501(a)-1 of the Income Tax Regulations. In accordance with the instructions to Form 1023, the application should be filed with the District Director of Internal Revenue for the key district indicated therein.

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26 CFR 1.501(a)-1: Exemption from taxation.

Whether amounts paid to a section 501(c)(3) organization that are earmarked for use in influencing legislation can be deducted under section 170 of the Code as a charitable contribution. See Rev. Rul. 80-275, page 69.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Adoption agency; placement of foreign orphans. A nonprofit organization that arranges the placement of orphan children from foreign countries in the homes of adoptive parents in the United States is operated exclusively for charitable purposes.

Rev. Rul. 80-200

ISSUE

Is the nonprofit organization that provides for the placement of orphan children from foreign countries in the manner described below operated exclusively for charitable purposes within the meaning of section 501(c)(3) of the Internal Revenue Code?

FACTS

A nonprofit organization, which otherwise qualifies for exemption under section 501(c)(3) of the Code, was formed for the purpose of arranging for the placement of orphan children living in foreign countries with adoptive parents living in the United States. It receives applications from residents of the United States who desire to adopt a foreign-born orphan child, and conducts an investigation to determine whether the applicants are qualified as adoptive parents. It also locates, by means of its contacts with agencies and institutions in foreign countries, orphan children who are available for adoption in the United States.

The organization makes all the necessary arrangements for and pays the expenses of the child's departure and travel to the United States. It also handles all required administrative and legal proceedings, and it assumes financial responsibility for each child until the adoption proceedings have been completed. Its primary sources of support are fees paid by the adoptive parents and contributions from the general public.

LAW AND ANALYSIS

Section 501(c)(3) of the Code provides for exemption from federal in-

come tax of organizations organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense.

The term "charitable," in its generally accepted legal sense, includes the care of orphans.

By arranging for the placement and adoption of orphans the organization is engaged in charitable activities.

HOLDING

An organization that arranges for the placement of orphan children from foreign countries in homes of adoptive parents living in the United States, in the manner described above, is operated exclusively for charitable purposes and is exempt from federal income tax under section 501(c)(3) of the Code.

APPLICATION INSTRUCTIONS

Even though an organization considers itself within the scope of this revenue ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. See sections 1.501(a)-1 and 1.508-1(a) of the regulations. In accordance with the instructions to Form 1023, the application should be filed with the District Director of Internal Revenue for the key district indicated therein.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Promoting sports for children. An otherwise qualifying organization that is formed to develop, promote, and regulate a sport for individuals under 18 years of age by organizing local and statewide competitions, promulgating rules, organizing officials, presenting seminars, distributing a newsletter, and otherwise encouraging growth of the sport qualifies for exemption under section 501(c)(3) of the Code; Rev. Rul. 70-4 distinguished.

Rev. Rul. 80-215

ISSUE

Does a nonprofit organization that develops, promotes, and governs a sport for individuals under 18 years of age in a particular state, under the circumstances described below, qualify for exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code?

FACTS

The organization, which otherwise qualifies for exemption under section 501(c)(3) of the Code, was formed to develop, promote, and regulate a sport for junior players, and to promote sportsmanlike competition for junior players in a particular state. The organization is comprised of affiliated individual associations, clubs, leagues, and teams. Each club may be comprised of any number of teams. Each team, represented by one coach, votes to elect one person from its club to be a member of the organization for two years.

The organization organizes local and state-wide competition for individuals under 18 years of age; promulgates rules; organizes officials; and presents seminars for players, coaches, and referees. The organization provides a framework for protests, appeals, and procedures. It also distributes a newsletter, and otherwise encourages the growth of the sport throughout the state.

LAW AND ANALYSIS

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense and includes the advancement of education and the promotion of social welfare by organizations designed to combat juvenile delinquency.

Trusts created for the purpose of promoting sports for children have been upheld as charitable on the basis of either combatting juvenile delinquency or advancing education. *Restatement (Second) Trusts* (1959), section 374(n); IV *Scott on Trusts* (3d ed. 1967), section 374-6A; Bogert, *Trusts and Trustees* (2d ed. 1964), section 379.

By developing, promoting, and regulating a sport for individuals under 18 years of age, under the circumstances described above, the organization combats juvenile delinquency by providing a recreational outlet for the young people. See Rev. Rul. 65-2, 1965-1 C.B. 227, which provides, in part, that an organization that is organized and operated for the purpose of teaching a particular sport to children by holding clinics conducted by qualified instructors and by providing free instruction, equipment, and facilities is combatting juvenile delinquency within the meaning of section 501(c)(3) of the Code.

Additionally, the organization promotes the education of the children by providing a format for educational activities. Thus, its activities are charitable in its generally accepted legal sense.

Rev. Rul. 70-4, 1970-1 C.B. 126, which holds that an organization engaged in promoting and regulating a sport for amateurs is not exempt under section 501(c)(3) of the Code, but is exempt under section 501(c)(4), is distinguishable because that organization directed its activities to all members of the general public without regard to age. The subject organization limits its activities to individuals under 18 years of age.

HOLDING

An organization that develops, promotes, and governs a sport for individuals under 18 years of age, under the circumstances described above, qualifies for exemption from federal income tax under section 501(c)(3) of the Code.

APPLICATION INSTRUCTIONS

Even though an organization considers itself within the scope of this revenue ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. See sections 1.501(a)-1 and 1.508-1 (a) of the regulations. In accordance with the instructions to Form 1023, the application should be filed with the District Director of Internal Revenue for the key district indicated therein.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 70-4 is distinguished.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Litigation of environmental issues. An otherwise qualifying organization that was formed to protect and restore environmental quality and whose principal activity consists of instituting litigation as a party plaintiff to enforce environmental legislation is operated exclusively for charitable purposes and qualifies for exemption under section 501(c)(3) of the Code.

Rev. Rul. 80-278

ISSUE

Is an organization that institutes and maintains environmental litigation as a party plaintiff, under the circumstances described below, operated exclusively for charitable purposes within the meaning of section 501(c)(3) of the Internal Revenue Code?

FACTS

The organization, which otherwise qualifies for exemption under section 501(c)(3) of the Code, was organized for the purpose of protecting and restoring environmental quality. Its activities include educational activities within the meaning of section 501 (c)(3). Its principal activity, however, consists of instituting litigation as a party plaintiff under state and federal environmental legislation. Typical of its litigation is a suit it filed against a local manufacturer and the state environmental protection agency. The organization sought thereby to enjoin the manufacturer from emitting certain air contaminants from its plant in violation of the state air-quality legislation and to require the state agency to enforce that legislation.

The organization does not have its own staff of attorneys and does not provide legal representation to others. Instead, it employs private attorneys to represent it in bringing and maintaining environmental litigation. Such lawsuits are not brought in cases where a substantial purpose is to benefit a private party or interest. The organization's litigation program is financed through membership dues and contributions from the public.

LAW AND ANALYSIS

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in section 501(h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

Section 1.501(c)(3)-1(a) of the Income Tax Regulations provides that an organization cannot be exempt under section 501(c)(3) of the Code unless it meets both an organizational and operational test. That is, the organization must be both organized and operated exclusively for charitable purposes.

In determining whether an organization meets the operational test, the issue is whether the particular activity undertaken by the organization is appropriately in furtherance of the organization's exempt purpose, not whether that particular activity in and of itself would be considered charitable. Moreover, the fact that the activity reflects a particular viewpoint or opinion on a controversial issue does not preclude the organization from qualifying for exemption under section 501(c)(3) of the Code. See section 1.501(c)(3)-1(d)(2) of the regulations. Two organizations having the same charitable purpose may both be recognized as exempt even though their viewpoints on the subject may differ, and they may be undertaking differing, even conflicting, means to accomplish that charitable objective. See *Restatement (Second) of Trusts*, section 374, comment 1 (1959). The law of charity provides no basis for weighing or evaluating the objective merits of specific activities carried on in furtherance of a charitable purpose, if those activities are reasonably related to the accomplishment of the charitable purpose, and are not illegal or contrary to public policy.

Therefore, in making the determination of whether an organization's activities are consistent with exemption under section 501(c)(3) of the Code, the Service will rely on a three-part test. The organization's activities will be considered permissible under section 501(c)(3) if:

(1) The purpose of the organization is charitable;

(2) the activities are not illegal, contrary to a clearly defined and established public policy, or in conflict with express statutory restrictions; and

(3) the activities are in furtherance of the organization's exempt purpose and are reasonably related to the accomplishment of that purpose.

It is generally recognized that efforts to preserve and protect the natural environment for the benefit of the public constitute a charitable purpose within the meaning of section 1.501(c)(3)-1(d)(2) of the regulations. The promotion of conservation and protection of natural resources has been recognized by Congress as serving a broad public benefit. See, *e.g.*, the National Environmental Policy Act of 1969, 42 U.S.C. section 4321 (1976). See also Rev. Rul. 76-204, 1976-1 C.B. 152, and the authorities cited therein. Thus, the organization's overall purpose is charitable.

Second, the organization's program of environmental litigation as party plaintiff clearly is not illegal, contrary to a clearly defined and established public policy, or violative of express statutory limitations, including the restrictions contained in section 501(c)(3) of the Code prohibiting inurement of net earnings, substantial legislative activities, and participation or intervention in political campaigns.

In fact, Congress has provided for private litigation to enforce federal laws in numerous environmental statutes. See, *e.g.*, the authorization for private suits to enforce the Clean Air Act, 42 U.S.C.A. section 7604 (1979); see also the citizen suit provision of the Federal Water Pollution Control Act Amendments of 1972, 33 U.S.C. section 1365 (1976). These provisions indicate Congressional approval of private litigation as a desirable and appropriate means of enforcing environmental statutes. Many state statutes contain similar provisions. In some instances, litigation under such a statute serves to assist the government in enforcing the statute. In other cases, the litigation facilitates judicial review of important issues and ensures that the statute is correctly interpreted and administered. See also *Alyeska Pipeline Service Co. v. Wilderness Society*, 421 U.S. 240, 271 (1975).

In view of the above authorities, it is also clear that the organization's litigation activities are a reasonable means of accomplishing its exempt purposes. Accordingly, the organization's activities meet the third part of the test; that is, its program of litigation as party plaintiff under state and federal environmental statues furthers the organization's exempt purposes and is reasonably related to the accomplishment of the charitable purposes for which the organization was formed.

Compare the facts of this ruling with the three situations in which the Service has previously recognized organizations that engage in litigation as being described in section 501(c)(3): (1) legal aid societies providing legal assistance to indigents (Rev. Rul. 69-161, 1969-1 C.B. 149); (2) organizations operated to defend human and civil rights secured by law (Rev. Rul. 73-285, 1973-2 C.B. 174); and (3) public interest law firms providing legal representation on issues of significant public interest (Rev. Rul. 75-74, 1975-1 C.B. 152, Rev. Rul. 75-75, 1975-1 C.B. 154, Rev. Rul. 75-76, 1975-1 C.B. 154, Rev. Rul. 76-5, 1976-1 C.B. 146, Rev. Proc. 71-39, 1971-2 C.B. 575, and Rev. Proc. 75-13, 1975-1 C.B. 662). These types of organizations generally have staff attorneys providing legal representation to outside clients or groups, as distinguished from the organization itself being the plaintiff in litigation.

HOLDING

An organization that institutes and maintains environmental litigation as party plaintiff, under the circumstances described above, is operated exclusively for charitable purposes and qualifies for exemption from federal income tax under section 501(c)(3) of the Code.

APPLICATION INSTRUCTIONS

Even though an organization considers itself within the scope of this revenue ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. See sections 1.501(a)-1 and 1.508-1(a) of the regulations. In accordance with the instructions to Form 1023, the application should be filed with the District Director of Internal Revenue for the key district indicated therein.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Mediation of international environmental disputes. An otherwise qualifying organization that engages in legal research concerning various means of adjusting and resolving international environmental disputes and arranges for, and participates in, the resolution of such disputes through mediation is exempt under section 501(c)(3) of the Code.

Rev. Rul. 80-279

ISSUE

Does an organization that conducts mediation of international environmental disputes, under the circumstances described below, qualify for exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code?

FACTS

The organization, which otherwise qualifies for exemption under section 501(c)(3) of the Code, was formed for the purposes of engaging in legal research concerning various means of adjusting and resolving international environmental disputes, and arranging for and participating in the resolution of such disputes through the use of

mediation. An international environmental dispute might arise, for example, in a situation where undesirable environmental conditions in one country are caused by industrial emissions originating in a neighboring country. Such disputes cannot generally be dealt with satisfactorily under the laws of any one country or under existing international law.

The organization conducts research to ascertain the potential for mediation to resolve certain international environmental disputes. Their research includes the identification of the issues under dispute, the assessment of the willingness of the parties to submit the dispute to mediation, and the making of an offer to conduct the mediation using its own staff of mediators and technical experts or to seek mediators acceptable to both parties.

The results of the organization's research and mediation activities are made known to the public by means of lectures and published articles and interviews. The organization's primary sources of income are grants from foundations and U.S. government agencies. The organization also receives fees for its mediation services from the parties involved, but these fees are set at or below cost.

LAW AND ANALYSIS

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(a) of the Income Tax Regulations provides that an organization cannot be exempt under section 501(c)(3) of the Code unless it meets both an organizational and operational test. That is, the organization must be both organized and operated exclusively for charitable purposes.

In determining whether an organization meets the operational test, the issue is whether the particular activity undertaken by the organization is appropriately in furtherance of the organization's exempt purpose, not whether that particular activity in and of itself would be considered charitable. Moreover, the fact that the activity reflects a particular viewpoint or opinion on a controversial issue does not preclude the organization from qualifying for exemption under section 501(c)(3) of the Code. See section 1.501(c)(3)-1(d)(2) of the regulations. Two organizations having the same charitable purpose may both be recognized as exempt even though their viewpoints on the subject may differ, and they may be undertaking differing, even conflicting, means to accomplish that charitable objective. See *Restatement (Second) of Trusts*, section 374, comment 1 (1959). The law of charity provides no basis for weighing or evaluating the objective merits of specific activities carried on in furtherance of a charitable purpose, if those activities are reasonably related to the accomplishment of the charitable purpose, and are not illegal or contrary to public policy.

Therefore, in making the determination of whether an organization's activities are consistent with exemption under section 501(c)(3) of the Code, the Service will rely on a three-part test. The organization's activities will be considered permissible under section 501(c)(3) if:

(1) The purpose of the organization is charitable;

(2) the activities are not illegal, contrary to a clearly defined and established public policy, or in conflict with express statutory restrictions; and

(3) the activities are in furtherance of the organization's exempt purpose and are reasonably related to the accomplishment of that purpose.

See Rev. Rul. 80-278, page 175, this Bulletin.

It is generally recognized that efforts to preserve and protect the natural environment for the benefit of the public constitute a charitable purpose within the meaning of section 1.501(c)(3)-1(d)(2) of the regulations. The promotion of conservation and protection of natural resources has been recognized by Congress as serving a broad public benefit. See, *e.g.*, the National Environmental Policy Act of 1969, 42 U.S.C. section 4321 (1976). See also Rev. Rul. 76-204, 1976-1 C.B. 152, and the authorities cited therein. Thus, the organization's overall purpose is charitable.

In addition, the organization's program of environmental mediation clearly is not illegal, contrary to a clearly defined and established public policy, or violative of express statutory limitations. Further, it is a form of private action that is clearly desirable in terms of the implementation of the existing public policy regarding preservation and protection of the environment. See *Alyeska Pipeline Service Co. v. Wilderness Society*, 421 U.S. 240, 271 (1975). Thus, the organization's program of arranging for and participating in environmental mediation on the international level is an appropriate means of implementing environmental policy and is reasonably related to the accomplishment of the charitable purpose for which the organization was formed.

HOLDING

An organization that conducts mediation of international environmental disputes, under the circumstances described above, qualifies for exemption from federal income tax under section 501(c)(3) of the Code.

APPLICATION INSTRUCTIONS

Even though an organization considers itself within the scope of this revenue ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. See sections 1.501(a)-1 and 1.508-1(a) of the regulations. In accordance with the instructions to Form 1023, the application should be filed with the District Director of Internal Revenue for the key district indicated therein.

26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Political activity; newsletter publication. Certain publications of congressional incumbents' voting records on selected issues in a nonpartisan newsletter do not constitute participation or intervention in any political campaign within the meaning of section 501(c)(3) of the Code; Rev. Rul. 78-248 amplified.

Rev. Rul. 80-282

ISSUE

Would the publication of a newsletter, by an organization otherwise described in section 501(c)(3) of the Internal Revenue Code, containing the voting records of congressional incumbents on selected issues, in the manner described below, constitute participation or intervention in any political campaign within the meaning of section 501(c)(3)?

FACTS

The organization is exempt from federal income tax under section 501(c)(3) of the Code. The organization engages in a number of different educational and charitable activities. As one of its activities, the organization maintains an office that monitors and reports on legislative, judicial, administrative, and other governmental activities and developments considered to be of important social interest. As part of the office's activities, it distributes a monthly newsletter to interested members and others, who together number only a few thousand nationwide.

The monthly newsletter contains expressions of the organization's views on a broad range of legislative, judicial, and administrative issues it considers significant. In discussing a particular issue, the reader is sometimes encouraged to contact various governmental officials to express his or her views on the issue.

As soon as practical after the close of each congressional session, the organization intends to publish in an issue of its newsletter a summary of the voting records of all incumbent Members of Congress on selected legislative issues important to it, together with an expression of the organization's position on those issues. Each member's votes will be reported in a way which illustrates whether he or she voted in accordance with the organization's position on the issue. The newsletter is politically non-partisan, and will not contain any reference to or mention of any political campaigns, elections, candidates, or any statements expressly or impliedly endorsing or rejecting any incumbent as a candidate for public office. No mention will be made of an individual's overall qualification for public office, nor will there be any comparison of candidates that might be competing with the incumbents in any political campaign. The voting records of all incumbents will be presented and candidates for reelection will not be identified. The newsletter will point out the limitations of judging the qualifications of an incumbent on the basis of a few selected votes and will note the need to consider such unrecorded matters as performance on subcommittees and constituent service.

Publication usually will occur after congressional adjournment and will not be geared to the timing of any federal election. The newsletter will be distributed to the usual subscribers, and will not be targeted toward particular areas in which elections are occurring.

LAW

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation, and which do not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

Section 1.501(c)(3)-1(c)(3)(i) of the Income Tax Regulations states that an organization is not operated exclusively for one or more exempt purposes if it is an "action" organization. Section 1.501(c)(3)-1(c)(3)(iii) defines an "action" organization as an organization that participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office. The regulations further provide that activities that constitute participation or intervention in a political campaign on behalf of or in opposition to a candidate include, but are not limited to, the publication or distribution of written statements or the making of oral statements on behalf of or in opposition to such a candidate.

ANALYSIS

Whether an organization is participating or intervening, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office depends upon all of the facts and circumstances of each case. Certain "voter education" activities conducted in a non-partisan manner may not constitute prohibited political activities under section 501(c)(3) of the Code. Other so-called "voter education" activities, however, may be proscribed by the statute. Rev. Rul. 78-248, 1978-1 C.B. 154, sets forth several situations illustrating when an organization has or has not engaged in prohibited political activities within the meaning of section 501(c)(3).

In *Situation 3* of Rev. Rul. 78-248, the organization prepared a questionnaire to all candidates for major public offices that contained questions evidencing a bias on certain issues and made the responses generally avail-

able to the public during an election campaign. It was considered to be participating in prohibited political campaign activity. In *Situation 4* of Rev. Rul. 78-248, an organization primarily concerned with land conservation matters published a compilation of incumbents' voting records on selected land conservation issues and widely distributed it to the electorate during an election campaign. It was held that by concentrating on a narrow range of issues and widely distributing the publication among the electorate during an election campaign, the organization was participating in a prohibited political activity.

In this case the format and content of the publication are not neutral, since the organization reports each incumbent's votes and its own views on selected legislative issues and indicates whether the incumbent supported or opposed the organization's view. On the other hand, the voting records of all incumbents will be presented, candidates for reelection will not be identified, no comment will be made on an individual's overall qualifications for public office, no statements expressly or impliedly endorsing or rejecting any incumbent as a candidate for public office will be offered, no comparison of incumbents with other candidates will be made, and the organization will point out the inherent limitations of judging the qualifications of an incumbent on the basis of certain selected votes by stating the need to consider such unrecorded matters as performance on subcommittees and constituent service.

In view of the foregoing, other factors must be examined to determine whether in the final analysis the organization is participating or intervening in a political campaign.

In the instant case, the organization will not widely distribute its compilation of incumbents' voting records. The publication will be distributed to the organization's normal readership who number only a few thousand nationwide. This will result in a very small distribution in any particular state or congressional district. No attempt will be made to target the publication toward particular areas in which elections are occurring nor to time the date of publication to coincide with an election campaign.

In view of these facts, *Situations 3 and 4* of Rev. Rul. 78-248 are distinguishable from the present case, and the organization will not be considered to be engaged in prohibited political campaign activity.

HOLDING

The publication of a newsletter, by an organization otherwise described in section 501(c)(3) of the Code, containing the voting records of Congressional incumbents on selected issues, in the manner described above, will not constitute participation or intervention in any political campaign within the meaning of section 501 (c)(3).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 78-248 is amplified.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals. (Also Section 170; 1.170A-1.)

Foreign exchange program. An otherwise qualifying organization that was formed to foster the cultural and educational development of children by arranging for and participating in the temporary exchange of children between families of a foreign country and the U.S. qualifies for exemption under section 501(c)(3) of the Code. Fees paid by the participating families equal to the cost of travel and insurance and the expenses incurred on behalf of the foreign child while living in the U.S. family's household are not charitable contributions under section 170. However, contributions from a participating family that exceed the fair market value of services received from the program are deductible. Rev. Rul. 67-327 distinguished.

Rev. Rul. 80-286

ISSUE

Does an organization that operates an exchange program for children of the United States and a foreign country, under the circumstances described below, qualify for exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code?

FACTS

The organization, which otherwise qualifies for exemption under section 501(c)(3) of the Code, was formed in the United States to encourage and foster cultural and educational development of children by arranging for and participating in the exchange of children, on a temporary basis, between responsible families of a particular foreign country and the United States. To accomplish this purpose, the organization arranges for an American family to exchange one of its children for a child from a family that resides in the foreign country. The organization solicits applications from interested families in both countries, selects and matches qualified families, arranges for transportation to and from the respective countries, and provides a bilingual escort to travel with the children between countries. The organization interviews all applicants and selects those families for the program that can provide stable home environments and suitable cultural experiences for the children.

Families participating in the organization's exchange program are required to pay a fee equal to the cost of travel and the cost of health, accident, and baggage insurance. The organization also receives income from grants and contributions.

LAW AND ANALYSIS

Section 501(c)(3) of the Code pro-

vides for the exemption from federal income tax of organizations organized and operated exclusively for charitable and educational purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense. Such term includes the advancement of education.

Rev. Rul. 65-191, 1965-2 C.B. 157, considers a nonprofit organization organized for the purposes of extending hospitality to foreign visitors and students, promoting cultural and educational programs, and providing an environment for social contact between American citizens and foreign visitors and students, which maintains and operates a hospitality or community center. Rev. Rul. 65-191 holds that the provision of a community center for the mingling of foreign students and visitors with one another and with American citizens is charitable within the meaning of section 501(c)(3) of the Code.

Rev. Rul. 68-165, 1968-1 C.B. 253, holds that a domestic nonprofit corporation that joins with a counterpart group in a country in Latin America to promote student and cultural exchanges and to provide technical and material assistance for self-help projects designed to improve living conditions of underprivileged people in Latin America qualifies for exemption under section 501(c)(3) of the Code. Specifically, Rev. Rul. 68-165 holds that promoting student and cultural exchanges helps improve the capabilities of the individual and, thus, is educational.

Like the organizations in Rev. Rul. 65-191 and Rev. Rul. 68-165, the organization in this case is facilitating student and cultural exchanges and, thus, is engaging in a charitable activity. Also, by promoting the exchange of children between families in the United States and families in a foreign country, which allows the children to undergo an educational experience through participation in the everyday activities of families in a foreign country, the organization is promoting education. See Rev. Rul. 69-400, 1969-2 C.B. 114.

The organization in this case is distinguishable from the one described in Rev. Rul. 67-327, 1967-2 C.B. 187, wherein an organization whose sole purpose and activity was to arrange group tours for students and faculty members of a university was held to be not exempt under section 501(c)(3) of the Code.

HOLDING

An organization that operates an exchange program for children of the United States and a foreign country, under the circumstances described above, is operated exclusively for charitable and educational purposes and thus qualifies for exemption from federal income tax under section 501(c)(3) of the Code.

APPLICATION INSTRUCTIONS

Even though an organization considers itself within the scope of this revenue ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. See sections 1.501(a)-1 and 1.508-1(a) of the regulations. In accordance with the instructions to Form 1023, the application should be filed with the District Director of Internal Revenue for the key district indicated therein.

DEDUCTIBILITY OF CHARITABLE CONTRIBUTIONS

Section 170(a) of the Code provides that there shall be allowed as a deduction, subject to certain limitations, any charitable contribution, as defined in section 170(c), payment of which is made within the taxable year. Section 170(c)(2)(B) defines a charitable contribution to include a contribution or gift to or for the use of a corporation organized and operated exclusively for educational purposes.

Although the term "contribution" is not defined either in the Code or in the Income Tax Regulations, it is well established judicially that in order to be deductible under section 170 of the Code, a contribution must qualify as a gift in the common law sense of being a voluntary transfer of property without consideration. To the extent a transferor receives or can expect to receive, for the money or property he or she transfers, a financial or economic benefit, as distinguished from the incidental benefit that inures to a donor as a member of the general public, then no deduction under section 170 is allowable. *Singer v. United States*, 449 F. 2d 413 (Ct. Cl. 1971); Rev. Rul. 67-246, 1967-2 C.B. 104; Rev. Rul. 76-185, 1976-1 C.B. 60.

Accordingly, the fees paid by families participating in the exchange program are not deductible as charitable contributions under section 170 of the Code. Further, the expenses incurred by a participating United States family contributing to the support, maintenance and cultural enrichment of the foreign child while the child is a member of the United States family's household for the exchange duration are not deductible as charitable contributions under section 170.

However, contributions from members of the general public, as well as contributions from a family that exceed the fair market value of services received from the family's participation in the exchange program, will be deductible under section 170 of the Code in the manner and to the extent provided therein.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 67-327 is distinguished.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Genealogical research; public interest. A genealogical society that

(1) opens its membership to all persons in a particular area, (2) provides instruction in genealogical research techniques to its members and to the general public, but does not research genealogies for its members, (3) conducts research projects and makes the results available to the state historical society, (4) provides materials for libraries and community displays, and (5) promotes various other related activities for the public qualifies for exemption under section 501(c)(3) of the Code; Rev. Rul. 80-302 distinguished.

Rev. Rul. 80-301

ISSUE

May a genealogical society whose membership is open to all persons in a particular area and which provides instruction in genealogical research techniques qualify for exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code?

FACTS

The organization is a genealogical society whose membership is open to all interested persons in a particular geographical area. The society provides instruction in genealogical research techniques to both members and the general public through monthly lectures held in a meeting room donated by the community center. It distributes instructional manuals, sponsors tours of historical museums, donates books and other research materials on genealogy to the area's public library, maintains a display board in a community center listing the early pioneers from the area, and conducts a free genealogical speakers bureau. It also conducts various historical genealogical research projects the results of which are made available to the state historical society. The society does not conduct genealogical research for its members. Rather, its members research genealogies independently using the society's research materials. The organization also provides assistance to beginners.

The society's income is derived from membership dues and contributions. Its expenses include the costs of printing, postage, display boards, books, and other miscellaneous items.

LAW AND ANALYSIS

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for educational purposes.

Section 1.501(c)(3)-1(d)(3) of the Income Tax Regulations provides that the term "educational" includes the instruction or training of the individual for the purpose of developing his capabilities and the instruction of the public on subjects useful to the individual and beneficial to the community.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest.

The Callaway Family Association, Inc. v. Commissioner, 71 T.C. 340 (1978), held that a family association formed as a nonprofit organization to study immigration to and migration within the United States by focusing on its own family history and genealogy does not qualify for exemption under section 501(c)(3) of the Code. The association's activities included researching the genealogy of its members for the ultimate purpose of publishing a family history. The court stated that the association's family genealogical activities were not insubstantial and were not in furtherance of an exempt purpose. Rather, they served the private interests of the members. Thus, the association was not operated exclusively for exempt purposes. See also *Benjamin Price Genealogical Association v. United States,* Civil No. 78-2117 (D.D.C., April 26, 1979).

Rev. Rul. 71-580, 1971-2 C.B. 235, holds that a nonprofit organization formed by members of a particular family to compile genealogical research data on the family in order to perform religious ordinances of the religious denomination to which the family members belong is exempt from federal income tax under section 501(c)(3) of the Code.

Rev. Rul. 80-302, page 182, this Bulletin, holds that a genealogical society whose primary activity is the compilation of genealogical data for members of a particular family does not qualify for exemption from federal income tax under section 501(c)(3) of the Code.

Here, the society is educating the individual and the community generally when it conducts lectures, sponsors public displays and museum tours, provides written materials to instruct members of the general public on genealogical research, and compiles the area's pioneer history. Thus, the society instructs the public on subjects useful to the individual and beneficial to the community within the meaning of section 1.501(c)(3)-1(d)(3) of the regulations.

Unlike the organizations described in the *Callaway* and *Price* cases, and in Rev. Rul. 80-302, the society does not conduct research for its members and does not focus its activities on any one family. Rather, its activities include all interested members in the geographical area, and seek to develop a better understanding of the history of the area. Thus, the society is operated for a public rather than a private interest, within the meaning of section 1.501(c)(3)-1(d)(1)(ii) of the regulations.

HOLDING

A nonprofit organization whose membership is open to all persons in a particular area and which provides instruction in genealogical research techniques in the manner described above is operated exclusively for educational purposes and, thus, qualifies for ex-

emption from federal income tax under section 501(c)(3) of the Code.

APPLICATION INSTRUCTIONS

Even though an organization considers itself within the scope of this revenue ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. See sections 1.501(a)-1 and 1.508-1 (a) of the regulations. In accordance with the instructions to Form 1023, the application should be filed with the District Director of Internal Revenue for the key district indicated therein.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 80-302 is distinguished.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Genealogical research; private interest. An organization that (1) limits its membership to descendants of a particular family, (2) compiles family genealogical research data for use by its members for reasons other than to conform to the religious precepts of the family's denomination, (3) presents the data to designated libraries, (4) publishes volumes of family history, and (5) promotes social activities among family members does not qualify for exemption under section 501(c)(3) of the Code; Rev. Ruls. 71-580 and 80-301 distinguished.

Rev. Rul. 80-302

ISSUE

Does the organization described below, which conducts genealogical activities primarily for members of a particular family, qualify for exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code?

FACTS

The organization was formed to locate, acquire, restore, and preserve all available genealogical records of a particular family. Membership in the organization is limited to lineal or legal descendants of the family.

The organization's primary activity is the compilation of genealogical data on its members. This data is recorded and documented, held for use by members, and presented to designated libraries. Copies of the genealogical data are made available for a fee to any interested individuals, generally family members, who request such data. The organization utilizes the data in preparing and publishing volumes of family history. Other activities of the organization include holding periodic reunions for family members and sponsoring an occasional social activity.

The genealogical data is not developed for the express purpose of conforming to the religious precepts of the denomination to which family members belong.

Income is derived from fees charged for the reproducing, shipping, and handling of genealogical data and from contributions raised at social functions.

LAW

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable or educational purposes.

Section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest.

Section 1.501(c)(3)-1(d)(3) of the regulations defines the term "educational" as including the instruction or training of the individual for the purpose of improving or developing his capabilities, or the instruction of the public on subjects useful to the individual and beneficial to the community.

Rev. Rul. 71-580, 1971-2 C.B. 235, holds that a nonprofit organization formed by members of a particular family to compile genealogical research data on the family in order to perform religious ordinances of the religious denomination to which the family members belong is exempt from federal income tax under section 501(c)(3) of the Code.

Rev. Rul. 80-301, page 180, this Bulletin, holds that a genealogical society whose membership is open to all persons in a particular area and that provides instruction in genealogical research techniques is operated exclusively for educational purposes and qualifies for exemption under section 501(c)(3) of the Code.

The Callaway Family Association, Inc. v. Commissioner, 71 T.C. 340 (1978), held that a family association formed as a nonprofit organization to study immigration to and migration within the United States by focusing on its own family history and genealogy does not qualify for exemption under section 501(c)(3) of the Code. The association's activities included researching the genealogy of its members for the ultimate purpose of publishing a family history. The court stated that the association's family genealogical activities were not insubstantial and were not in furtherance of an exempt purpose. Rather, they served the private interests of the members. Thus, the association was not operated exclusively for exempt purposes. See also *Benjamin Price Genealogical Association v. United States,* Civil No. 78-2117 (D.D.C., April 26, 1979).

ANALYSIS

Compilation, publication, preservation, and distribution of genealogical data has some educational value to the individual members. However, when

these activities are primarily limited to one particular family the activities do not advance education to benefit the public interest within the meaning of section 1.501(c)(3)-1(d)(1)(ii) of the regulations. Any benefit to the general public is merely incidental to the private benefit accruing to family members.

Similar to the organizations described in the *Callaway* and *Price* cases, the instant organization is formed primarily for members of a particular family who focus in on their own genealogy with limited public orientation. The Supreme Court in *Better Business Bureau v. United States*, 326 U.S. 279 (1945), held that the presence of a single non-educational purpose, if substantial in nature, will destroy exemption regardless of the number of truly educational purposes. Since more than an insubstantial part of the organization's activities are in furtherance of private interests it is not operated exclusively for educational purposes. Such activity is not insubstantial and is not in furtherance of an exempt purpose under section 501(c)(3) of the Code.

Rev. Rul. 80-301 is distinguishable from the instant case because the organization described therein provided instruction in genealogical research techniques to any interested member of the general public. On the other hand, the instant organization was formed to compile genealogical data on and promote social activities among its family members, and its membership is limited to members of a particular family.

Rev. Rul. 71-580 is also distinguishable because the genealogical research data in the instant ruling is not compiled in order to perform religious ordinances in accord with the precepts of the religious denomination to which the family members belong.

Compare Rev. Rul. 67-8, 1967-1 C.B. 142, which holds that an organization formed to bring the members of a particular family into closer association through social activities revolving around matters of common genealogical and historical interest may qualify for exemption under section 501(c)(7) of the Code.

HOLDING

An organization that conducts genealogical activities primarily for members of a particular family, under the circumstances described above, does not qualify for exemption from federal income tax under section 501(c)(3) of the Code.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 71-580 and Rev. Rul. 80-301 are distinguished.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Hospital; organization formed to construct, maintain, and operate or lease. An otherwise qualifying nonprofit organization that was created to construct, maintain, and operate or lease a public hospital and related facilities for the benefit of a city and the surrounding communities is operated exclusively for charitable purposes and qualifies for exemption under section 501(c)(3) of the Code.

Rev. Rul. 80-309

ISSUE

Is the nonprofit organization described below, which otherwise qualifies for exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code, operated exclusively for charitable purposes?

FACTS

The organization was created to construct, maintain, and operate or lease a public hospital and related facilities. After construction of these facilities, the organization's only activity has been to lease such facilities to an association exempt from federal income tax under section 501(c)(3) of the Code. The lessee operates the facilities and pays as consideration an amount sufficient only to retire the organization's indebtedness incurred to finance the hospital and meet the organization's administrative expenses. Trustees of the lessee association make up the lessor organization's entire board of directors.

The articles of incorporation provide that the organization's purpose is to provide hospital facilities for city *Y* and the surrounding communities. The articles also provide that all of the organization's assets will be transferred, without consideration, to city *Y* when all indebtedness has been paid. City *Y* has agreed to accept title at such time.

With minor exceptions, the organization's income is derived from the lease payments and disbursements are made for administrative expenses and retirement of indebtedness.

LAW AND ANALYSIS

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations states that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense.

In the general law of charity, the promotion of health is considered to be a charitable purpose. *Restatement (Second), Trusts*, secs. 368, 372; *IV Scott on Trusts* (3d ed. 1967), secs. 368, 372.

The organization, by building and leasing a public hospital and related facilities to an exempt charitable association, which operates the facilities, for an amount sufficient only to retire indebtedness and meet necessary operating expenses, is furthering the charitable purpose of promoting the health

of the community. *See* Rev. Rul. 73-313, 1973-2 C.B. 174; *see also* Rev. Rul. 69-631, 1969-2 C.B. 119.

HOLDING

The organization as described above is operated exclusively for charitable purposes and, thus, qualifies for exemption from federal income tax under section 501(c)(3) of the Code.

APPLICATION INSTRUCTIONS

Even though an organization considers itself within the scope of this revenue ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. See sections 1.501(a)-1 and 1.508-1(a) of the regulations. In accordance with the instructions to Form 1023, the application should be filed with the District Director of Internal Revenue for the key district indicated therein.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary or educational purposes, or for the prevention of cruelty to children or animals.

Whether a nonprofit lawyer referral service qualifies for exemption from federal income tax under section 501(c)(3) of the Code. See Rev. Rul. 80-287, page 185.

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26 CFR 1.501(c)(4)-1: Civic organizations and local associations of employees.

Recreational facility; restricted use. The Service will not follow the *Eden Hall Farm* decision, which held that an organization providing recreational facilities for employees of selected corporations qualifies as a social welfare organization under section 501(c)(4) of the Code.

Rev. Rul. 80-205

ISSUE

Will the Internal Revenue Service follow the decision in *Eden Hall Farm v. United States,* 389 F. Supp. 858 (W.D. Pa. 1975), which held that an organization providing recreational facilities to the employees of selected corporations qualifies for exemption from federal income tax as a social welfare organization described in section 501(c)(4) of the Internal Revenue Code?

FACTS

The organization was formed to carry out the provisions of the will of a former employee of the *X* corporation. Management of the organization was vested in a board of three trustees, all of whom were required to be employees of the *X* corporation. The organization's activities have consisted of maintaining and operating guest and recreational facilities on a farm near the community in which the *X* corporation is located.

In its initial years of operation, the organization's facilities were made available only to employees of the *X* corporation. In subsequent years, the facilities were opened to guests of *X* corporation's employees, employees of other selected corporations, and guests of these other employees. During the years considered by the district court, the facilities were used predominantly by employees of *X* corporation.

The district court found that the organization's provision of recreational facilities served a recognized community need and that the organization qualified as a social welfare organization under section 501(c)(4) of the Code. With respect to the organization's restrictions on the use of its facility, the court found that the restrictions were consistent with the capacity of the facilities and provided a means of limiting use of the facilities to those who met the organization's requirements. Thus, the court concluded that the organization was not operated for the benefit of *X* corporation or its employees.

LAW AND ANALYSIS

Section 501(c)(4) of the Code provides for the exemption from federal income tax of civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

Section 1.501(c)(4)-1(a)(2)(i) of the Income Tax Regulations provides that an organization is operated for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community.

The regulations clearly require, and prior revenue rulings have recognized, that an organization claiming exemption under section 501(c)(4) of the Code must operate for the benefit of the community as a whole rather than for the benefit of a limited group. Compare Rev. Rul. 78-69, 1978-1 C.B. 156, which holds that an organization providing rush hour commuter bus service to all residents of a community qualifies for exemption under section 501(c)(4), with Rev. Rul. 55-311, 1955-1 C.B. 72, which holds that a local association of employees operating a bus primarily for the convenience of its members does not so qualify. Also compare Rev. Rul. 62-167, 1962-2 C.B. 142, which holds that an organization retransmitting television signals for the benefit of an entire community qualifies for exemption under section 501(c)(4), with Rev. Rul. 54-394, 1954-2 C.B. 131, which holds that an organization providing television on a cooperative basis does not qualify.

There is no requirement that a section 501(c)(4) organization provide equal benefits to every member of the community. The organization described in Rev. Rul. 78-69 that provides rush hour commuter bus service benefits only those individuals who have a need for that service. Similarly, an organization providing a particular type of recreational facility benefits only those who enjoy that type of recreation. Such limitations are inherent in the activities that are undertaken to promote the social welfare.

In the instant case, however, the

organization imposed limitations on the use of its facility other than those that were inherent in the nature of the facility. By restricting use of the facility to employees of selected corporations and their guests, the organization is primarily benefiting a private group rather than primarily benefiting the common good and general welfare of the community.

It is the position of the Internal Revenue Service that organizations restricting their benefits in this way do not qualify for exemption as organizations described in section 501(c)(4) of the Code. Organizations of this type primarily benefit the individuals or private groups that are allowed to use the facility and any benefit to the community or promotion of the social welfare of the community is purely incidental.

HOLDING

The Internal Revenue Service will not follow the decision in *Eden Hall Farm v. United States.* It is the position of the Service that an organization providing recreational facilities to the employees of selected corporations does not qualify for exemption from federal income tax as a social welfare organization under section 501(c)(4) of the Code.

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26 CFR 1.501(c)(4)-1: Civic organizations and local associations of employees.

Tenants' rights. A nonprofit organization that promotes the legal rights of tenants in a particular community and occasionally initiates litigation to contest the validity of legislation adversely affecting tenants may qualify for exemption under section 501(c)(4) of the Code as a social welfare organization; Rev. Rul. 73-306 distinguished.

Rev. Rul. 80-206

ISSUE

May an organization formed to promote the legal rights of all tenants in a particular community and occasionally to initiate litigation to contest the validity of legislation that adversely affects tenants qualify for exemption from federal income tax under section 501(c)(4) of the Internal Revenue Code as a social welfare organization?

FACTS

The organization was formed to promote the legal rights of tenants in a particular community. To accomplish this objective, it publishes a newsletter and conducts public meetings dealing with matters of concern to tenants. It also operates an information center that provides tenants with answers concerning their rights and obligations under lease agreements with their landlords. In order to present the views of tenants with respect to laws and regulations that affect them, the organization regularly testifies before administrative and legislative bodies. Occasionally, the organization initiates litigation to contest the validity of legislation it feels will adversely affect tenants in the county.

LAW AND ANALYSIS

Section 501(c)(4) of the Code provides for the exemption from federal income tax of civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

Section 1.501(c)(4)-1(a)(2)(i) of the Income Tax Regulations provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterments and social improvements.

Rev. Rul. 73-306, 1973-2 C.B. 179, holds that a nonprofit organization formed to represent member-tenants of an apartment complex in negotiations with landlords, in litigation, and before local and federal regulatory agencies with respect to matters of mutual concern to the tenants does not qualify for exemption under section 501(c)(4) of the Code.

Rev. Rul. 73-306 is distinguishable because in that revenue ruling the organization's activities are directed primarily toward benefitting its member-tenants rather than, as in the instant case, all tenants in the community.

By promoting the legal rights of tenants in a particular community under the circumstances described above, the organization is promoting the common good and general welfare of the people of the community.

HOLDING

A nonprofit organization that promotes the legal rights of all tenants in a particular community and occasionally initiates litigation to contest the validity of legislation adversely affecting tenants may qualify for exemption under section 501(c)(4) of the Code as a social welfare organization.

APPLICATION INSTRUCTIONS

Even though an organization considers itself within the scope of this revenue ruling, it must file an application on Form 1024, Application for Recognition of Exemption Under Section 501(a) or for Determination Under Section 120, in order to be recognized by the Service as exempt under section 501(c)(4) of the Code. See section 1.501(a)-1 of the regulations. In accordance with the instructions to Form 1024, the application should be filed with the District Director of Internal Revenue for the key district indicated therein.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 73-306 is distinguished.

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26 CFR 1.501(c)(6)-1: Business leagues, chambers of commerce, real estate boards, and boards of trade.
(Also Section 501; 1.501(c)(3)-1.)

Lawyer referral service. A nonprofit lawyer referral service arranges at the request of any member of the public an initial half-hour appointment for a nominal charge with a lawyer whose name is on an approved list maintained by the organization. Any further contact between the lawyer and the client is arranged without the involvement of the organization. The referral service is not exempt under section 501(c)(3) of the Code, but is exempt as a business league under section 501(c)(6). Rev. Ruls. 61-170 and 74-308 distinguished.

Rev. Rul. 80-287

ISSUE

Does a nonprofit lawyer referral service qualify for exemption from federal income tax under either section 501(c)(3) or section 501(c)(6) of the Internal Revenue Code?

FACTS

The organization is a nonprofit corporation created by several bar associations in a metropolitan area to provide a lawyer referral service. The lawyer referral service aids persons who do not have an attorney by helping them to select one. Any member of the public in need of an attorney may visit or call the organization. The individual's problem is screened in order to categorize the area of law involved. From a list of attorneys maintained by the organization, an attorney specializing in the appropriate area of law is selected from within the geographic area preferred by the client. The organization arranges an appointment for the individual with the attorney. This initial appointment is for a minimum of one-half hour and the individual is asked to pay a nominal fee substantially less than the normal fee charged for a half-hour appointment. The attorney subsequently remits this fee to the organization. Any additional services performed by the attorney after the initial appointment are governed by a normal lawyer-client contractual relationship with which the organization has no connection.

Any attorney who is a member of one of the local bar associations may apply to the organization to have his or her name placed on the organization's referral list. Attorneys must apply annually to be listed. Applicants are required to show how long they have been practicing law, whether they are or have been subject to disciplinary procedures, what their areas of legal competence are, and whether they are covered by malpractice insurance. They must agree to leave open a specified number of hours each month for referral clients. If an application is approved by the organization, the attorney pays a fee and is thereupon listed on the organization's attorneys' panel. About 20 percent of the members of the local bar associations appear on the organization's list each year.

In addition to the referral fee, the organization also imposes a nominal service charge of one dollar upon all those who make use of its services. Any operating deficits are defrayed by the local bar associations.

LAW AND ANALYSIS

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(a) of the Income Tax Regulations states that to be tax exempt, an organization must be both organized and operated exclusively for one or more exempt purposes specified in section 501(c)(3) of the Code.

Section 1.501(c)(3)-1(d)(2) of the regulations states that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense. It includes relief of the poor and distressed or of the underprivileged, and promotion of social welfare by organizations designed to eliminate prejudice and discrimination or to defend human and civil rights secured by law.

Section 501(c)(6) of the Code provides for the exemption from federal income tax of business leagues not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(6)-1 of the regulations defines a business league as an association of persons having a common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. That regulation also states that a business league's activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons.

Rev. Rul. 71-505, 1971-2 C.B. 232, holds that a city bar association is not exempt from federal income tax under section 501(c)(3) of the Code. The association conducted a number of activities primarily directed at the promotion and protection of the practice of law. These activities were found not to be in furtherance of charitable or educational purposes. That ruling relied in part on the principle, expressed in *Better Business Bureau of Washington, D.C., Inc. v. United States*, 326 U.S. 279 (1945), Ct. D. 1650, 1945 C.B. 375, that the presence of a single nonexempt purpose, if substantial in nature, will preclude exemption regardless of the number or importance of statutorily exempt purposes. The same result was reached in Rev. Rul. 71-504, 1971-2 C.B. 231, which involved a city medical society carrying on substantial activities directed at promotion of the medical profession.

It is a clearly established principle of the law of charity that a purpose is not charitable unless it is directed to the public benefit. Not every purpose which is beneficial to the community, however, is deemed charitable. As a general rule, providing services of an

ordinary commercial nature in a community, even though the undertaking is conducted on a nonprofit basis, is not regarded as conferring a charitable benefit on the community unless the service directly accomplishes one of the established categories of charitable purposes.

In this case, the lawyer referral service does not directly accomplish any of the established categories of charitable purposes. The program is open to all members of the community and, thus, is not operated exclusively for the relief of the poor, distressed, or underprivileged. The organization's activities are directed toward assisting individuals in obtaining preventive or remedial legal services covering the gamut of everyday legal problems and, as such, are not specifically designed to eliminate prejudice or discrimination or to defend human and civil rights secured by law. Therefore, the lawyer referral service does not confer a charitable benefit on the community.

Although the lawyer referral service provides some public benefit, a substantial purpose of the program is promotion of the legal profession. This is a noncharitable purpose, and, in accordance with section 1.501(c)(3)-1(a) of the regulations and the *Better Business Bureau* case, it precludes exemption under section 501(c)(3) of the Code. Thus, the organization is not exempt from federal income tax under section 501(c)(3).

Operation of the lawyer referral service in the manner described does, however, promote the common business interest of the legal profession within the metropolitan area. The principal purpose of the program is to introduce individuals to the use of the legal profession in the hope that they will enter into lawyer-client relationships on a paying basis as a result of the experience. To achieve this purpose, individuals pay only a nominal fee, substantially below the normal rates for a half-hour appointment. The program encourages people unfamiliar with lawyers to form the habit of seeking professional help, provides middle income persons an opportunity to present their legal problems to a reputable attorney for a modest fixed fee, and combats the notion that only certain persons can afford legal assistance. Thus, the organization's activities are designed to improve conditions within the legal profession as a whole as distinguished from performing particular services for individuals within the meaning of section 1.501(c)(6)-1 of the regulations. Therefore, the organization qualifies for exemption from federal income tax under section 501(c)(6) of the Code.

Rev. Rul. 61-170, 1961-2 C.B. 112, and Rev. Rul. 74-308, 1974-2 C.B. 168, which hold that organizations referring persons to nurses and to tow truck operators, respectively, are not exempt under section 501(c)(6) of the Code are distinguishable. Unlike those organizations, which serve primarily to locate customers for their members, this organization provides more than a mere business referral service that is simply a convenience and economy to members of the legal profession. Rather, in the manner described above, this organization serves to improve the image and functioning of the legal profession as a whole.

HOLDING

The separately incorporated nonprofit lawyer referral service qualifies for exemption from federal income tax as a business league described in section 501(c)(6) of the Code. It does not, however, qualify for exemption as a charitable organization described in section 501(c)(3).

APPLICATION PROCEDURES

Even though an organization considers itself within the scope of this revenue ruling, it must file an application on Form 1024, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(6) of the Code. See section 1.501(a)-1 of the regulations. In accordance with the instruction to Form 1024, the application should be filed with the District Director of Internal Revenue for the key district indicated therein.

EFFECT ON PRIOR REVENUE RULINGS

Rev. Ruls. 61-170 and 74-308 are distinguished.

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26 CFR 1.501(c)(6)-1: Business leagues, chambers of commerce, real estate boards, and boards of trade.

Broadcasting rights; professional tournaments. The status of an organization exempt under section 501(c)(6) of the Code created to promote interest in, elevate the standards of, and conduct tournaments in, a certain professional sport will not be adversely affected merely because its primary support is derived from the sale of television broadcasting rights to the tournaments it conducts; Rev. Rul. 58-502 clarified.

Rev. Rul. 80-294

ISSUE

Is the exempt status of an organization described in section 501(c)(6) of the Internal Revenue Code adversely affected when its primary source of support is income derived from the sale of broadcasting rights?

FACTS

The organization was formed to promote interest in a particular sport, to elevate the standards of the sport as a profession, and to sponsor and conduct tournaments for the encouragement of its members. The organization's membership is open to all professional players of the sport in the United States. The organization has been recognized as exempt from federal income tax under section 501(c)(6) of the Code.

Among its activities, the organization conducts apprentice programs, annual conventions and merchandise shows, and tournaments. Its support is

derived primarily from the sale of television broadcasting rights to its tournaments. Other support is from membership dues, penalties, and apprentice fees. Its expenses are for salaries, administrative costs of its programs, and tournament costs, including prizes and awards.

LAW AND ANALYSIS

Section 1.501(c)(6)-1 of the Income Tax Regulations provides that a business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It also provides that the activities of the organization should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons.

Rev. Rul. 58-502, 1958-2 C.B. 271, describes an association, exempt under section 501(c)(6) of the Code, which was formed to promote and conserve the best interest and true spirit of a game and which accomplishes its exempt purposes by the sponsoring and conducting of championship tournaments and the incidental sale of radio and television broadcasting rights. Rev. Rul. 58-502 implies that unless the amount of income received by the association from the sale of broadcasting rights is relatively insignificant, the sale of broadcasting rights would not serve the association's exempt purposes.

Here, the organization's tournament activities are similar to those of an organization described in Rev. Rul. 58-502, with the exception that the organization's primary source of support is the sale of broadcasting rights.

The sponsorship of tournaments and the sale of broadcasting rights with respect thereto by the organization directly promotes the interests of those engaged in the sport by encouraging participation in the sport and by enhancing awareness by the general public of the sport as a profession. The amount of income derived from the sale of broadcasting rights is not, by itself, determinative of whether the activity furthers the purposes specified in section 501(c)(6) of the Code. Thus, under the circumstances described above, sponsoring tournaments and selling broadcasting rights are activities directly related to exempt purposes, notwithstanding the amount of income received.

HOLDING

An organization exempt from federal income taxes under section 501(c)(6) of the Code will not adversely affect its exempt status if its primary source of support is derived from the sale of broadcasting rights to the sports tournaments it conducts.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 58-502 is clarified to remove the implication that the sale of television broadcasting rights to an organization's tournaments furthers exempt purposes within the meaning of section 501(c)(6) of the Code only when the amount of income derived therefrom is insignificant in amount.

Also, see Rev. Rul. 80-295, page 194, this Bulletin, and Rev. Rul. 80-296, page 195, this Bulletin.

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26 CFR 1.501(c)(13)-1: Cemetery companies and crematoria.

T.D. 7698

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Exemption From Taxation of Certain Cemetery Companies and Crematoria; Exempt Title Holding Companies

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations under sections 501(c)(2) and 501(c)(13) of the Internal Revenue Code of 1954, relating to exempt title holding companies and to exempt cemetery companies and crematoria, respectively. These regulations make clerical changes in the regulations under section 501(c)(2), so as to reflect the revision of section 514 by the Tax Reform Act of 1969 (Pub. L. 91-172, 83 Stat. 543) [1969-3 C.B. 10] and to reflect changes made in section 501(c)(13) by the Act of December 31, 1970 (Pub. L. 91-618, 84 Stat. 1855) [1971-1 C.B. 539], exempting certain crematoria from the corporate income tax. The regulations under section 501(c)(13) also clarify the standards for exemption from income tax and help identify when certain transfers to cemetery companies and crematoria are in exchange for equity interests rather than for debt obligations. Furthermore, the regulations correct two clerical errors contained in Treasury Decision 7229 [1973-1 C.B. 265], published December 21, 1972, relating to unrelated debt-financed income of certain tax-exempt organizations. These regulations provide necessary guidance to the public for compliance with these Acts, and affect certain title holding companies and certain cemetery companies and crematoria that are exempt from taxation.

DATE: The regulations are effective for various taxable years as specified in the regulations.

FOR FURTHER INFORMATION CONTACT: Harry Beker of the Employee Plans and Exempt Organizations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:EE) (202-566-6212) (not a toll-free call).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On July 8, 1975, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 501(c)(2) and 501(c)(13) of the Internal Revenue Code of 1954 (40 FR 28613). The amendments were proposed to conform the regulations to the Tax Reform Act of 1969 (83 Stat. 543) and to the Act of December 31, 1970 (84 Stat. 1855). On November 29, 1978, the Federal Register published proposed amendments to the proposed regulations under section 501(c)(13) (43 FR 55797). A public hearing was held on March 29, 1979. After consideration of all comments regarding the proposed amendments, those amendments are adopted, as revised, by this Treasury decision.

The comments received with respect to the proposed amendments generally concerned three issues relating to exempt cemetery companies and crematoria. First, it was recommended that § 1.501(c)(13)-1(a) be revised to permit mutual cemeteries to be exempt even if operated for profit. As proposed on July 8, 1975, § 1.501(c)(13)-1(a) makes it clear that only nonprofit mutual cemetery companies would be exempt. It has been concluded that the phrase "or which are not operated for profit" was added to section 501(c)(13) not as a separate qualification for exemption, but to take care of mutual cemetery companies that would not be operating "exclusively" for the benefit of members because of additional charitable activities, such as the burial of paupers. Additional support for this position is contained in section 170(c)(5), the counterpart to section 501(c)(13) for purposes of charitable contributions. Section 170(c)(5) reflects the emphasis placed by Congress on the "quasi charitable" nature of the type of organizations intended to be exempt under section 501(c)(13) by providing that only contributions to nonprofit mutual cemetery companies and nonprofit cemetery corporations are deductible. Accordingly, no change has been made to § 1.501(c)(13)-1(a) in the final regulations.

Second, it was recommended that § 1.501(c)(13)-1(c)(1), relating to the issuance of preferred stock, be withdrawn or substantially modified so that the use of preferred stock could continue to be available to tax-exempt cemeteries and crematoria. As proposed on November 29, 1978, § 1.501(c)(13)-1(c)(1) provides that a cemetery company or crematorium which issues preferred stock on or after November 28, 1978, will not be exempt from income tax. It has been concluded that the rule which permitted the issuance of preferred stock was inconsistent with the requirement of section 501(c)(13) that no part of the net earnings of an organization otherwise described in that section may inure to the benefit of any private shareholder or individual. The amendments, however, recognize the continued exempt status of cemeteries and crematoria which, prior to November 28, 1978, issued preferred stock meeting certain restrictions. The general prohibition on the issuance of preferred stock has been retained.

The comments relating to preferred stock also suggested that, if the amendment barring the use of preferred stock is adopted, § 1.501(c)(13)-1(c)(2) (the transitional rule) should be modified to include a clause protecting those cemeteries and crematoria which, prior to November 28, 1978, were in the process of issuing such stock. This recommendation has been adopted in new § 1.501(c)(13)-1(c)(3) which provides that a cemetery company or crematorium shall not fail to be exempt solely because it issues preferred stock on or after November 28, 1978, if such stock meets certain restrictions and is issued pursuant to a plan which had been reduced to writing and adopted prior to November 28, 1978.

Third, it was recommended that § 1.501(c)(13)-1(d) be revised to indicate that where the vendor of property to a cemetery company does not control the cemetery, tax-exempt status should not be denied merely because the payments do not take the form of a traditional debt obligation. As proposed on July 8, 1975, § 1.501(c)(13)-1(d) provides that a cemetery company or crematorium is not exempt from income tax if property is transferred to such organization in exchange for an equity interest so long as the equity interest remains outstanding.

Section 1.501(c)(13)-1(d) previously listed several factors that would be considered in determining whether a bona fide debt obligation existed. The factors previously listed have been eliminated and paragraph (d) now simply provides that no person may have any interest in the net earnings of a tax-exempt cemetery company or crematorium, including any interest that constitutes equity under section 385 or the regulations thereunder.

Finally, minor technical clarifications have been made to reflect the fact that section 501(c)(13) does not grant exemption but merely describes organizations which are exempt under section 501(a).

DRAFTING INFORMATION

The principal author of these regulations is Harry Beker of the Employee Plans and Exempt Organizations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

Paragraph 1. Section 1.501(c)(2)-1(a) is amended to read as follows:

§ 1.501(c)(2)-1 Corporations organized to hold title to property for exempt organizations.

(a) A corporation described in section 501(c)(2) and otherwise exempt from tax under section 501(a) is taxable upon its unrelated business taxable income. For taxable years beginning before January 1, 1970, see § 1.511-2(c)(4). Since a corporation described in section 501(c)(2) cannot be exempt under section 501(a) if it engages in any business other than that of holding title to property and collecting income therefrom, it cannot have unrelated business taxable income as defined in section 512 other than income which is treated as unrelated business taxable income solely because of the applicability of section 512(a)(3)(C); or debt financed income which is treated as unrelated business taxable income solely because of section 514; or certain interest, annuities, royalties, or rents which are treated as unrelated business taxable income solely because of section 512(b)(3)(B)(ii) or (13). Similarly, exempt status under section 501(c)(2) shall not be affected where certain rents from personal property leased with real property are treated as unrelated business taxable income under section 512(b)(3)(A)(ii) solely because such rents attributable to such personal property are more than incidental when compared to the total rents received or accrued under the lease, or under section 512(b)(3)(B)(i) solely because such rents attributable to such personal property exceed 50 percent of the total rents received or accrued under the lease.

* * * * *

Par. 2. Section 1.501(c)(13) is deleted.

Par. 3. Section 1.501(c)(13)-1 is amended to read as follows:

§ 1.501(c)(13)-1 Cemetery companies and crematoria.

(a) *Nonprofit mutual cemetery companies.* A nonprofit cemetery company may be entitled to exemption if it is owned by and operated exclusively for the benefit of its lot owners who hold such lots for bona fide burial purposes and not for the purpose of resale. A mutual cemetery company which also engages in charitable activities, such as the burial of paupers, will be regarded as operating in conformity with this standard. Further, the fact that a mutual cemetery company limits its membership to a particular class of individuals, such as members of a family, will not affect its status as mutual so long as all the other requirements of section 501(c)(13) are met.

(b) *Nonprofit cemetery companies and crematoria.* Any nonprofit corporation, chartered solely for the purpose of the burial, or (for taxable years beginning after December 31, 1970) the cremation of bodies, and not permitted by its charter to engage in any business not necessarily incident to that purpose, is exempt from income tax, provided that no part of its net earnings inures to the benefit of any private shareholder or individual.

(c) *Preferred stock*—(1) *In general.* Except as provided in subparagraph (3) of this paragraph, a cemetery company or crematorium is not described in section 501(c)(13) if it issues preferred stock on or after November 28, 1978.

(2) *Transitional rule for preferred stock issued prior to November 28, 1978.* In the case of preferred stock issued prior to November 28, 1978, a cemetery company or crematorium which issued such stock shall not fail to be exempt from income tax solely because it issued preferred stock which entitled the holders to dividends at a fixed rate, not exceeding the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, if its articles of incorporation require:

(i) That the preferred stock be retired at par as rapidly as funds therefor become available from operations, and

(ii) That all funds not required for the payment of dividends upon or for the retirement of preferred stock be used by the company for the care and improvement of the cemetery property.

The term "legal rate of interest" shall mean the rate of interest prescribed by law in the State of incorporation which prevails in the absence of an agreement between contracting parties fixing a rate.

(3) *Transitional rule for preferred stock issued on or after November 28, 1978.* In the case of preferred stock issued on or after November 28, 1978, a cemetery company or crematorium shall not fail to be exempt from income tax if its articles of incorporation and the preferred stock meet the requirements of subparagraph (2) and if such stock is issued pursuant to a plan which has been reduced to writing and adopted prior to November 28, 1978. The adoption of the plan must be shown by the acts of the duly constituted responsible officers and appear upon the official records of the cemetery company or crematorium.

(d) *Sales to exempt cemetery companies and crematoria.* Except as provided in paragraph (c)(2) or (c)(3) of this section (relating to transitional rules for preferred stock), no person may have any interest in the net earnings of a tax-exempt cemetery company or crematorium. Thus, a cemetery company or crematorium is not exempt from tax if property is transferred to such organization in exchange for an interest in the net earnings of the organization so long as such interest remains outstanding. An interest in a cemetery or crematorium that constitutes an equity interest within the meaning of section 385 will be considered an interest in the net earnings of the cemetery. However, an interest in a cemetery company or crematorium that does not constitute an equity in-

terest within the meaning of section 385 may nevertheless constitute an interest in the net earnings of the organization. Thus, for example, a bond or other evidence of indebtedness issued by a cemetery company or crematorium which provides for a fixed rate of interest but which, in addition, provides for additional interest payments contingent upon the revenues or income of the organization is considered an interest in the net earnings of the organization. Similarly, a convertible debt obligation issued by a cemetery company or crematorium after July 7, 1975, is considered an interest in the net earnings of the organization.

Par. 4. Section 1.514(c)-1 is amended by striking out from the second sentence of paragraph (f) "section 221(d)(3) (12 U.S.C. 1715(d)(3)) or section 236 (12 U.S.C. 1715x-1)" and inserting in lieu thereof "section 221(d)(3) (12 U.S.C. 1715(l)(d)(3)) or section 236 (12 U.S.C. 1715z-1)".

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved April 25, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 20, 1980, 8:45 a.m., and published in the issue of the Federal Register for May 21, 1980, 45 F.R. 33971)

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26 CFR 1.501(d)-1: Religious and apostolic associations or corporations.

Whether Rev. Rul. 77-290, 1977-2 C.B. 26, is applicable to members of an organization described in section 501(d) of the Code. See Rev. Rul. 80-332, page 34.

Section 503.—Requirements for Exemption

26 CFR 1.503(b)-1: Prohibited transactions.

Prohibited transaction; loan to employer-grantor; inadequate security. A qualified employees' trust made a loan to the employer-grantor and received in return a demand note bearing a reasonable rate of interest together with a chattel mortgage on personal property then or in the future owned by the grantor. The property was not identified and the mortgage was not recorded as soon as practicable. The loan was not adequately secured and constitutes a prohibited transaction within the meaning of section 503(b)(1) of the Code. Rev. Rul. 66-324 superseded.

Rev. Rul. 80-269

The purpose of this revenue ruling is to restate, under current law, the position in Rev. Rul. 66-324, 1966-2 C.B. 230.

The issue in Rev. Rul. 66-234 is whether a loan made by an employees' trust, under the circumstances described below, constitutes a prohibited transaction within the meaning of section 503 of the Internal Revenue Code.

An employees' trust meeting the requirements of section 401(a) of the Code and exempt from federal income tax under section 501(a) was established as part of a plan referred to in section 4975(g)(3).

The trustee of the qualified employees' trust made a loan to the employer-grantor and received in return a demand note bearing a reasonable rate of interest together with a chattel mortgage on personal property then or in the future owned by the grantor. The personal property was to have a fair market value at least equal to the amount of the loan. No identification was given of the property, and the mortgage was not recorded with the county clerk until approximately 18 months after the loan was made. Immediately after the making of this loan, the aggregate amount loaned by the trust to the employer exceeded 25 percent of the value of all assets of the trust.

Section 503(a)(1)(B) of the Code states that an organization described in section 401(a) which is referred to in section 4975(g)(2) or (3) shall not be exempt from taxation under section 501(a) if it has engaged in a prohibited transaction after March 1, 1954.

Section 503(b)(1) of the Code provides that, for purposes of that section, the term "prohibited transaction" means any transaction in which an organization subject to the provisions of that section lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to the creator of such organization (if a trust). In this case, the creator of the section 401(a) organization was the employer.

Section 1.503(b)-1(b)(1) of the Income Tax Regulations defines the term "adequate security" to mean something in addition to and supporting a promise to pay, which is so pledged to the organization that it may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, the value and liquidity of which security is such that it may reasonably be anticipated that loss of principal or interest will not result from the loan.

Section 503(f) of the Code provides that section 503(b)(1) shall not apply to a loan made to the employer by an employees' trust described in section 401(a) if the loan bears a reasonable rate of interest and certain conditions are met. One such condition is that immediately after the making of the loan, the aggregate amount lent by the trust to the employer, without the receipt of adequate security, must not exceed 25 percent of the value of all assets of the trust.

The provisions of local law in the employer's jurisdiction stipulate that a mortgage of personal property is void as against creditors of the mortgagor, subsequent purchasers, and encumbrancers of the property, for value,

unless filed in the office of the county clerk where the property mortgaged is situated. Thus, a chattel mortgage, until filed, is enforceable only between the parties, and the rights of intervening third parties without knowledge of the unrecorded mortgage may weaken the value of such security.

In view of the foregoing circumstances it is necessary, in order to satisfy the requirements of the regulations, that the chattel mortgage be recorded as soon as practicable, and the personal property be specifically identifiable.

The chattel mortgage was not recorded as soon as practicable, and the personal property was not specifically identifiable. Therefore, the loan was not adequately secured and the circumstances of the loan made it ineligible for the exception provisions of section 503(f) of the Code.

Accordingly, the loan constitutes a prohibited transaction within the meaning of section 503(b)(1) of the Code.

Rev. Rul. 66-324 is superseded because the position stated therein is updated and restated in this revenue ruling.

Part II.—Private Foundations

Section 508.—Special Rules With Respect to Section 501(c)(3) Organizations

26 CFR 1.508-1: Notices.
(Also Section 1.9100-1.)

Application for exemption; when exempt. An organization that is organized and operated exclusively for charitable purposes and is not a private foundation applied for recognition of its exempt status six years after it was incorporated. During its first three taxable years the organization's gross receipts were less than $15,000. During the fourth year its gross receipts for that year and the preceding two taxable years were greater than $15,000. The organization is not exempt under section 501(c)(3) of the Code from the beginning of its fourth year until the date it filed the required notice. Consideration will be given in applying the Commissioner's discretionary authority under section 1.9100-1 of the regulations to extend the time for satisfying the notice requirement.

Rev. Rul. 80-259

ISSUE

In the situation described below, what effect does the application of section 508(a) of the Internal Revenue Code have on the effective dates of exempt status of an organization otherwise described in section 501(c)(3)?

FACTS

The organization is organized and operated exclusively for charitable purposes within the meaning of section 501(c)(3) of the Code, and is not a private foundation within the meaning of section 509(a). It was incorporated on January 1, 1973, and files returns on a calendar year basis. On March 1, 1979, it applied to the Internal Revenue Service for recognition of exempt status under section 501(c)(3). Its gross receipts during the years 1973 through 1979 were as follows:

Taxable Year Ending	*Gross Receipts*
1973	$ 3,600
1974	2,900
1975	400
1976	12,600
1977	76,400
1978	96,200
1979	142,400

LAW

Section 508(a) of the Code provides, with certain exceptions, that an organization organized after October 9, 1969, shall not be treated as an organization described in section 501(c)(3) unless it gives notice to the Secretary that it is applying for recognition of such status within the time prescribed by the regulations for giving such notice.

Section 508(c)(1)(B) of the Code provides that the provisions of section 508(a) shall not apply to any organization that is not a private foundation (as defined in section 509(a)) and the gross receipts of which in each taxable year are normally not more than $5,000.

Section 1.508-1(a)(2)(i) of the Income Tax Regulations provides that the notice referred to in section 508(a) of the Code must be filed within 15 months from the end of the month in which an organization was organized. Such notice is filed by submitting a properly completed and executed Form 1023, Application for Recognition of Exemption.

Section 1.508-1(a)(3)(ii) of the regulations provides that the gross receipts of an organization are normally not more than $5,000 if—

(a) During the first taxable year of the organization the organization has received gross receipts of $7,500 or less;

(b) During its first two taxable years the aggregate gross receipts received by the organization are $12,000 or less; and

(c) In the case of an organization which has been in existence for at least three taxable years, the aggregate gross receipts received by the organization during the immediately preceding two taxable years plus the current year are $15,000 or less.

The regulations further provide that if an organization fails to meet the requirements of (a), (b), or (c), then the organization shall be required to file the required notice described in section 508(a) of the Code within 90 days after the end of the period described in (a), (b), or (c), in lieu of the period prescribed in section 1.508-1(a)(2)(i). Thus, for example, if an organization meets the $7,500 requirement of (a) for its first taxable year, but fails to meet the $12,000 requirement of (b) for the period ending with its second taxable year, then the organization shall meet the notification requirement if it files such notification within 90 days after the close of its second taxable year. If an organization that has been in existence at least three

taxable years meets the requirements of (a), (b), and (c) with respect to all prior taxable years, but fails to meet the requirements of (c) with respect to the current taxable year, the notification requirements shall not apply with respect to its prior years. In such a case, the organization shall not be treated as described in section 501(c)(3) for a period beginning with such current taxable year and ending when such notice is given under section 508(a)(2).

ANALYSIS

The organization's aggregate gross receipts during the taxable years ending in 1973, 1974, and 1975 were $6,900. Therefore, the organization was not required to file an application for recognition of exemption within 90 days after the end of its 1975 taxable year. Accordingly, the organization is exempt under section 501(c)(3) of the Code, effective for the period beginning on January 1, 1973, and ending on December 31, 1975.

The organization's aggregate gross receipts during the taxable years ending in 1974, 1975, and 1976 were $15,900. Accordingly, the exception set forth in section 1.508-1(a)(3)(ii)(c) of the regulations does not apply, and the organization was required to file an application for recognition of exemption within 90 days after the end of its 1976 taxable year.

Due to the fact that the organization failed to file its application within the required time period, it is not exempt under section 501(c)(3) of the Code during the period beginning on January 1, 1976, and ending on February 28, 1979, because it did not satisfy the notification requirement of section 508(a). However, the organization is exempt under section 501(c)(3), effective as of March 1, 1979, the date on which the required notice was given.

HOLDING

The organization is not exempt under section 501(c)(3) of the Code during the period beginning on January 1, 1976, and ending on February 28, 1979, because it did not satisfy the notification requirement of section 508(a). However, the organization is exempt under section 501(c)(3) for the period beginning on January 1, 1973, and ending on December 31, 1975, and is also exempt effective as of March 1, 1979, the date on which the required notice was given.

In addition, the organization may qualify for exemption under section 501(c)(4) of the Code for the period it is not exempt under section 501(c)(3). See Rev. Rul. 80-108, 1980-1 C.B. 119, which holds that an organization that otherwise qualifies for exemption under both sections 501(c)(3) and 501(c)(4), but that did not file for recognition of exemption under section 501(c)(3) within 15 months from the end of the month in which it was organized as required by section 1.508-1(a)(2)(i) of the regulations, may be exempt under section 501(c)(4) from the date of its inception.

APPLICATION FOR EXTENSIONS OF THE TIME FOR FILING NOTICE UNDER SECTION 508(a)

The Service will give consideration to applying the Commissioner's discretionary authority under section 1.9100-1 of the regulations to extend the time for satisfying the notice requirement of section 508(a) of the Code.

Under section 1.9100-1 of the regulations the Commissioner has discretion, upon a showing of good cause by a taxpayer, to grant a reasonable extension of time fixed by the regulations for making an election or application for relief in respect of tax under subtitle A of the Internal Revenue Code, provided:

(1) the time for making the election or application is not expressly prescribed by the statute;

(2) the request for the extension is filed with the Commissioner within a period of time the Commisioner considers reasonable under the circumstances; and

(3) it is shown to the Commissioner's satisfaction that granting the extension will not jeopardize the Government's interests.

Rev. Proc. 79-63, 1979-2 C.B. 578, sets forth information and representations that must be furnished by the taxpayer and some factors that will be taken into consideration in determining whether such extensions will be granted. Also, see section 3.02 of Rev. Proc. 80-24, 1980-1 C.B. 658, for the applicable procedures to be followed in making a request.

Section 509.—Private Foundation Defined

26 CFR 1.509(a)-4: Supporting organizations.

Private foundations; supporting organization; control of board by disqualified person. An organization that is exempt under section 501(c)(3) of the Code makes distributions to a university. The organization is controlled by a four member board of directors, one of whom is a substantial contributor to the organization and a disqualified person. Two other directors are employees of a corporation, also a disqualified person, in which more than 35 percent of the voting power is owned by the substantial contributor. The remaining director is chosen by the university. None of the directors has a veto power. The organization is not a supporting organization within the meaning of section 509(a)(3).

Rev. Rul. 80-207

ISSUE

Is an organization which makes distributions to a university, under the circumstances described below, a supporting organization within the meaning of section 509(a)(3) of the Internal Revenue Code if it is controlled by a disqualified person and the employees of a disqualified person?

FACTS

The organization is exempt from

federal income tax under section 501 (c)(3) of the Code. Its purpose is to make distributions to a university described in section 509(a)(1) and section 170(b)(1)(A)(ii).

The organization is controlled by a four member board of directors. One of these directors is a substantial contributor to the organization. Two other directors are employees of a business corporation of which more than 35 percent of the voting power is owned by the substantial contributor. The remaining director is chosen by the university. None of the directors has a veto power over the organization's actions.

LAW AND ANALYSIS

Section 509(a)(3)(C) of the Code provides that in order to qualify as other than a private foundation under section 509(a)(3), an organization may not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in section 509(a)(1) or (2).

Section 4946 provides that the term "disqualified person" includes a substantial contributor to an organization, and a corporation of which a substantial contributor owns more than 35 percent of the total combined voting power.

Section 1.509(a)-4(j) of the Income Tax Regulations provides that a supporting organization will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of such persons is 50 percent or more of the total voting power of the organization's governing body or if one or more of such persons has the right to exercise veto power over the actions of the organization. However, all pertinent facts and circumstances will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization.

Because only one of the organization's directors is a disqualified person and neither the disqualified person nor any other director has a veto power over the organization's actions, the organization is not directly controlled by a disqualified person under section 1.509(a)-4(j) of the regulations. However, in determining whether an organization is indirectly controlled by one or more disqualified persons, one circumstance to be considered is whether a disqualified person is in a position to influence the decisions of members of the organization's governing body who are not themselves disqualified persons. Thus, employees of a disqualified person will be considered in determining whether one or more disqualified persons controls 50 percent or more of the voting power of an organization's governing body.

Two of the organization's four directors are also employees of a corporation that is itself a disqualified person because more than 35 percent of its voting power is owned by a disqualified person. Because a majority of its board of directors consists of a disqualified person and employees of a disqualified person, the organization is indirectly controlled by disqualified persons within the meaning of section 509(a)(3)(C) of the Code.

HOLDING

Since the organization is controlled by a disqualified person and the employees of a disqualified person, under the circumstances described above, it is not a supporting organization within the meaning of section 509(a)(3) of the Code.

Part III.—Taxation of Business Income of Certain Exempt Organizations

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Section 512.—Unrelated Business Taxable Income

26 CFR 1.512(b)-1: Modifications.

Whether an exempt school's furnishing of its tennis facilities in two described situations is unrelated trade or business under section 513 and if so, whether income from these activities is excluded from unrelated business taxable income as rent from real property under section 512(b)(3). See Rev. Rul. 80-297, page 196.

26 CFR 1.512(b)-1: Modifications.

Whether an exempt university's leasing of its stadium to a professional football team is unrelated trade or business under section 513 and, if so, whether amounts from this activity are excluded from unrelated business taxable income as rent from real property under section 512(b)(3). See Rev. Rul. 80-298, page 197.

Section 513.—Unrelated Trade or Business

26 CFR 1.513-1: Definition of unrelated trade or business.

Unrelated trade or business; broadcasting rights; amateur athletic events. The sale of television and radio broadcasting rights to an independent producer by an exempt organization created as a national governing body for amateur athletics is not unrelated trade or business under section 513 of the Code.

Rev. Rul. 80-295

ISSUE

Under the circumstances described below, is the sale of exclusive broadcasting rights to athletic events by an organization exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code unrelated trade or business within the meaning of section 513?

FACTS

The organization was created as a national governing body for amateur athletics to promote systematic physical exercise and education, to foster interest in amateur sports among the public at large, and to encourage widespread public participation in athletics and recreational sports.

The organization sponsors, supervises, and regulates programs in a number of different amateur sports. It also arranges for and coordinates open competition for amateur athletes at the local, state, regional, and national levels.

The organization receives income each year from the sale of exclusive

television and radio broadcasting rights to an independent producer, who contracts with a commercial network to broadcast many of the athletic events sponsored, supervised, and regulated by the organization.

LAW AND ANALYSIS

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of an organization for income or funds or the use it makes of the profits derived) to the exercise or performance by an organization of its exempt function.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is "substantially related" only if the production or distribution of the goods or the performance of the service from which the gross income is derived contributes importantly to the accomplishment of the purposes for which exemption is granted.

The broadcasting of the organization's sponsored, supervised, and regulated athletic events promotes the various amateur sports, fosters widespread public interest in the benefits of its nationwide amateur athletic program, and encourages public participation. Therefore, the organization's sale of broadcasting rights and the resultant broadcasting of its athletic events contributes importantly to the accomplishment of its exempt purposes.

HOLDING

The sale of exclusive broadcasting rights, under the circumstances described above, is substantially related to the purpose constituting the basis for the organization's exemption and, therefore, is not unrelated trade or business within the meaning of section 513 of the Code.

See Rev. Rul. 80-294, page 187, and Rev. Rul. 80-296, this page, this Bulletin.

26 CFR 1.513-1: Definition of unrelated trade or business.

Unrelated trade or business; broadcasting rights; athletic event. The sale of broadcasting rights to a national radio and television network by an organization created by a regional collegiate athletic conference made up of universities to hold an annual athletic event is not unrelated trade or business under section 513 of the Code.

Rev. Rul. 80-296

ISSUE

Is the sale of broadcasting rights to an annual intercollegiate athletic event by an organization exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code unrelated trade or business within the meaning of section 513?

FACTS

The organization was created by a regional collegiate athletic conference, made up of universities exempt under section 501(c)(3) of the Code, for the purpose of conducting an annual competitive athletic game between the champion of the conference and another collegiate team. The annual game generates income from various sources including admission charges and the sale of exclusive broadcasting rights to a national radio and television network.

LAW AND ANALYSIS

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of an organization for income or funds or the use it makes of the profits derived) to the exercise or performance by an organization of its exempt function.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is "substantially related" only if the production or distribution of the goods or the performance of the service from which the gross income is derived contributes importantly to the accomplishment of the purposes for which exemption is granted. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

College and university athletic organizations that promote certain aspects of athletic competition have generally been held to be educational and thus exempt from federal income tax. An athletic program is considered to be an integral part of the educational process of a university, and activities providing necessary services to student athletes and coaches further the educational purposes of the university. See Rev. Rul. 67-291, 1967-2 C.B. 184. See also Rev. Rul. 64-275, 1964-2 C.B. 142.

The Service has traditionally taken the position that income from paid admissions to college and university athletic events, regardless of the number of persons in attendance or the amount of paid admissions, is not taxable as income from unrelated trade or business because the events themselves are related to the educational purposes of the colleges and universities. This position is consistent with the following language contained in the Committee Reports on the Revenue Act of 1950, in which the predecessor to section 513 of the Code was enacted:

> Athletic activities of schools are substantially related to their educational functions. For example, a university would not be taxable on income derived from a basketball tournament sponsored by it, even where the teams were composed of students from other schools. (H.R. Rep. No. 2319, 81st Cong., 2d Sess. 37, 109 (1950), 1950-2 C.B. 380, 458.)
>
> Of course, income of an educational organization from charges for admissions to football games would not be deemed to be income from an unrelated business, since its athletic activities are substantially related to its athletic program. (S. Rep. No. 2375, 81st Cong., 2d Sess. 29, 107 (1950), 1950-2 C.B. 483, 505.)

On the basis of the facts and circumstances presented in this case the edu-

cational purposes served by intercollegiate athletic activities are identical whether conducted directly by individual universities or by their regional athletic conference. Also, the educational purposes served by exhibiting a game before an audience that is physically present and exhibiting the game on television or radio before a much larger audience are substantially similar. Therefore, the sale of the broadcasting rights and the resultant broadcasting of the game contributes importantly to the accomplishment of the organization's exempt purposes.

HOLDING

The sale of broadcasting rights, under the circumstances described, is substantially related to the purpose constituting the basis for the organization's exemption and is not unrelated trade or business within the meaning of section 513 of the Code.

See Rev. Rul. 80-294, page 187, and Rev. Rul. 80-295, page 194, this Bulletin.

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26 CFR 1.513-1: Definition of unrelated trade or business.
(Also Section 512; 1.512(b)-1.)

Unrelated trade or business; school leasing tennis facilities. An exempt school that uses its tennis facilities for ten weeks in the summer as a public tennis club operated by employees of the school's athletic department is engaged in unrelated trade or business, and the income earned is not excludable from unrelated business taxable income as rent from real property. If the school leases the tennis facilities for a fixed fee to an unrelated individual who operates a tennis club for the public, the school is still engaged in unrelated trade or business, but the lease income is excluded from unrelated business taxable income as rent from real property. Rev. Rul. 76-402 amplified.

Rev. Rul. 80-297

ISSUE

In the two situations described below, is a school's furnishing of its tennis facilities unrelated trade or business under section 513 of the Internal Revenue Code and, if so, is income from these activities excluded from unrelated business taxable income as rent from real property under section 512 (b) (3)?

FACTS

SITUATION 1.—TENNIS CLUB RUN BY A SCHOOL'S EMPLOYEES

A school is exempt from federal income tax under section 501(c)(3) of the Code and is classified as an educational organization described in section 170(b)(1)(A)(ii). The school's purposes are limited to those involving the advancement of education. The school's facilities include tennis courts and dressing rooms, which are employed during the regular academic year in the school's educational programs. For ten weeks during the summer the school operates a tennis club. For a fee, the general public is invited to join the club and thereby use the school's tennis courts and dressing rooms during designated periods. Two employees of the school's athletic department conduct the affairs of the club, including collecting membership fees and scheduling court time. The net income of the club is used for the exempt purposes of the school.

SITUATION 2.—TENNIS CLUB RUN BY A PROFESSIONAL USING SCHOOL FACILITIES

This Situation is the same as *Situation 1*, except that the school merely makes the facilities available to an unrelated individual for ten weeks at a fixed fee which does not depend, in whole or in part, on the income or profits derived from the leased property. The individual forms a tennis club and hires employees to administer the affairs of the club. Under a contract with the school, the individual must repair any damage to the facilities beyond normal wear and tear at the end of the ten weeks.

LAW

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt under section 501(c)(3).

Section 512(a) of the Code defines "unrelated business taxable income" as the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less certain deductions, but with modifications provided in section 512(b). For purposes of determining unrelated business taxable income, section 512 (b)(3) excludes rents from real property.

Section 513(a) of the Code defines "unrelated trade or business" of an exempt organization as 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 under section 501.

Section 513(c) of the Code provides that the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services.

Section 1.512(b)-1(c)(5) of the Income Tax Regulations provides that rents from real property, for purposes of the exclusion from unrelated business taxable income, do not include payments for the use or occupancy of rooms or other space where services are also rendered to the occupant, such as for the use or occupancy of rooms in hotels, boarding houses, or apartment houses furnishing hotel services, or for the use or occupancy of space in parking lots or warehouses. Generally, services are considered rendered to the oc-

cupant if they are for his or her convenience and are not those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The regulation further provides that supplying maid service constitutes such service, whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, and the collection of trash, are not considered services rendered to the occupant.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is "related" to exempt purposes, in the relevant sense, only when the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513 of the Code only if the causal relationship is a substantial one. Section 1.513-1(d)(2) further provides that for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Rev. Rul. 76-402, 1976-2 C.B. 177, considered an exempt school that provides tennis courts, furnished dormitory rooms, linens, maid service, meals, and dining facilities to an individual for use by the individual in conducting a summer tennis camp. Rev. Rul. 76-402 assumed that the income was taxable as income from an unrelated trade or business under section 513 of the Code and was not excludable from unrelated business taxable income under section 512(b)(3) and section 1.512(b)-1(c)(5) of the regulations as rent from real property.

ANALYSIS AND HOLDINGS

In this case, by furnishing tennis facilities in the above described situations, the school is performing services for the production of income, which constitutes a trade or business under section 513 of the Code. Since the school furnishes its tennis facilities during ten weeks of the year, it is engaging in a trade or business regularly carried on within the meaning of section 512. The exempt purposes of the school are limited to those involving the advancement of education. Furnishing tennis facilities in the manner described is not an activity that furthers the educational purposes of a school. Thus, this activity does not have a substantial causal relationship to the achievement of the school's exempt purposes, as required by section 1.513-1(d)(2) of the regulations. Accordingly, the school's furnishing of its tennis facilities in the above described situations is unrelated trade or business under section 513.

In *Situation 1*, as in Rev. Rul. 76-402, the school furnishes more than just its facilities. It operates the tennis club through its own employees, who perform substantial services for the participants in the tennis club. Accordingly, income from the school's furnishing of its tennis facilities through the operation of a tennis club in the manner described is not excluded from unrelated business taxable income as rent from real property under section 512(b)(3) of the Code and section 1.512(b)-1(c)(5) of the regulations.

In *Situation 2*, the school furnishes its tennis facilities to an unrelated individual without services and for a fixed fee which does not depend in whole or in part on the income or profits derived from the leased property. Unlike *Situation 1*, where the school itself provided services, the unrelated club operator hires employees to administer the affairs of the club. Accordingly, income from the school's furnishing of its tennis facilities through an individual operator is excluded from unrelated business taxable income as rent from real property under section 512(b)(3) of the Code and section 1.512(b)-1(c)(5) of the regulations.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 76-402 is amplified.

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26 CFR 1.513-1: Definition of unrelated trade or business.
(Also Section 512; 1.512(b)-1.)

Unrelated trade or business; university leasing stadium. An exempt university that leases its stadium to a professional football team for several months of the year and provides the utilities, grounds maintenance, and dressing room, linen, and stadium security services is engaged in unrelated trade or business. Further, the university's income from the lease is not excluded from unrelated business taxable income as rent from real property.

Rev. Rul. 80-298

ISSUE

Under the circumstances described below, is a university's leasing of its stadium to a professional football team unrelated trade or business under section 513 of the Internal Revenue Code and, if so, is income from this activity excluded from unrelated business taxable income as rent from real property under section 512(b)(3)?

FACTS

The university is exempt from federal income tax under section 501(c)(3) of the Code, and has been classified as an educational organization described in section 170(b)(1)(A)(ii). The university's facilities include a stadium, which it uses in its physical education program and intramural and intercollegiate sports program. In addition to the stadium's use in connection with the university's educational activities, for a fixed fee, the university permits a professional football team to use the stadium for practice during several months of the year. Under a lease agreement, in addition to heat, light, and water, the univer-

sity is responsible for maintaining the playing surface and all other grounds maintenance. It also provides dressing room, linen, and stadium security services for the professional team. Security services include crowd and traffic control, guarding the stadium and maintaining the privacy of practice sessions.

LAW

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt under section 501(c)(3).

Section 512(a) of the Code defines "unrelated business taxable income" as the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less certain deductions, but with modifications provided in section 512(b). For purposes of determining unrelated business taxable income, section 512(b)(3) excludes rents from real property.

Section 513(a) of the Code defines "unrelated trade or business" of an exempt organization as 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 under section 501.

Section 513(c) of the Code provides that the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services.

Section 1.512(b)-1(c)(5) of the Income Tax Regulations provides that rents from real property, for purposes of the exclusion from unrelated business taxable income, do not include payments for the use or occupancy of rooms or other space where services are also rendered to the occupant, such as for the use or occupancy of rooms in hotels, boarding houses, or apartment houses furnishing hotel services, or for the use or occupancy of space in parking lots or warehouses. Generally, services are considered rendered to the occupant if they are for his or her convenience and are not those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The regulation further provides that supplying maid service constitutes such service, whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, and the collection of trash, are not considered services rendered to the occupant.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is "related" to exempt purposes, in the relevant sense, only when the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513 of the Code only if the causal relationship is a substantial one. Section 1.513-1(d)(2) further provides that for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Rev. Rul. 76-402, 1976-2 C.B. 177, considered an exempt school that provides tennis courts, furnished dormitory rooms, linens, maid service, meals, and dining facilities to an individual for use by the individual in conducting a summer tennis camp. Rev. Rul. 76-402 assumed that the income was taxable as income from an unrelated trade or business under section 513 of the Code and was not excludable from unrelated business taxable income under section 512(b)(3) and section 1.512(b)-1(c)(5) of the regulations as rent from real property.

ANALYSIS AND HOLDINGS

In this case, by leasing its stadium in the manner described, the university is performing services for the production of income, which constitutes a trade or business under section 513(c) of the Code. Since the university leases its stadium during several months of the year, it is engaging in a trade or business regularly carried on within the meaning of section 512. The exempt purposes of the university are limited to those involving the advancement of education. Leasing a stadium to a professional football team in the manner described is not an activity that furthers the educational purposes of a university. Thus, this activity does not have a substantial causal relationship to the achievement of the university's exempt purposes, as required by section 1.513-1(d)(2) of the regulations. Accordingly, the university's leasing of its stadium is unrelated trade or business under section 513.

Additionally, providing extensive grounds and playing field maintenance, dressing room linens, and stadium and dressing rooms, pursuant to the lease, the university, like the school in Rev. Rul. 76-402, is furnishing substantial services for the convenience of the lessee that go beyond those usually rendered in connection with the rental of space for occupancy only. Accordingly, income from the university's leasing of its stadium to a professional football team is not excluded from unrelated business taxable income as rent from real property under section 512(b)(3) of the Code and section 1.512(b)-1(c)(5) of the regulations.

See Rev. Rul. 76-402, for another example of the computation of unrelated business taxable income where amounts are from dual use of facilities and personnel..

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26 CFR 1.513-5: Certain bingo games not unrelated trade or business.

T.D. 7699 [1]

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Treatment of proceeds from bingo games

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the treatment of proceeds from bingo games conducted by tax-exempt organizations. Changes in the applicable tax law were made by the Act of October 21, 1978 [Pub L. 95-502, 1978-2 C.B. 393, 395]. The regulations provide tax-exempt organizations with the guidance needed to comply with that Act and would affect tax-exempt organizations that conduct bingo games.

DATE: The regulations are effective for taxable years beginning after December 31, 1969.

FOR FURTHER INFORMATION CONTACT: Charles Kerby of the Employee Plans and Exempt Organizations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:EE-180-78 (202-566-3422) (not a toll-free number).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On August 28, 1979, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 513 and 527 of the Internal Revenue Code of 1943 (44 F.R. 50361). The amendments were proposed to conform the regulations to sections 301 and 302 of the Act of October 21, 1978 (92 Stat. 1702). Three comments were received from the public. No hearing was held. After consideration of all comments, the proposed regulations under section 513 are adopted as revised by this Treasury decision. The proposed amendments to the regulations under section 527 remain as proposed regulations. It is intended that the proposed amendments will be adopted by the Treasury decision to be published with respect to the proposed regulation under section 527 that were published in the Federal Register on November 24, 1976 (41 F.R. 51840).

COMMENTS ON THE PROPOSED REGULATIONS

Two of the three comments received from the public objected to Example (1)(ii) of § 1.513-5(c)(3) of the proposed regulations. That example illustrates § 1.513-5(c)(1) of the proposed regulations and provides that where the laws of a State prohibit all forms of gambling activity, including bingo games, a bingo game conducted by a tax-exempt organization in the State constitutes unrelated trade or business regardless of whether, or to what degree, the State law is enforced. The commentators suggested that bingo should not be considered an illegal activity if State gambling statutes are not generally enforced against tax-exempt organizations that conduct bingo games.

To determine whether bingo is illegal in a given State, the Internal Revenue Service must necessarily look to State statutes and decisions of the State courts interpreting those statutes. It would not be appropriate for the Internal Revenue Service to independently determine that a statute proscribing gambling is, nevertheless, not the law of the State. In the legislative history of the Act of October 21, 1978, Congress specified that the requirement of section 513(f)(2) that an organization not conduct bingo games in violation of State or local law was "designed to ensure that no Federal tax benefit is provided for activities which are conducted illegally." H. Rep. No. 95-1608, 95th Cong., 2nd Sess. 6 (1978), 1978-2 C.B. 395, 397. Accordingly, the final regulations are not materially different from the proposed regulations on this point.

The other comment received from the public suggested that the regulations contain a clear, concise example of a bingo game that would be excluded from the term "unrelated trade or business" under section 513(f). The final regulations contain such an example. In addition, the examples in the final regulations have been clarified.

DRAFTING INFORMATION

The principal author of this regulation is Charles Kerby of the Employee Plans and Exempt Organizations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in matters of substance and style.

Adoption of amendments to the regulations

Accordingly, the following amendments to the regulations are hereby adopted:

§ 1.513-5 Certain bingo games not unrelated trade or business.

(a) *In general.* Under section 513(f), and subject to the limitations in paragraph (c) of this section, in the case of an organization subject to the tax imposed by section 511, the term "unrelated trade or business" does not include any trade or business that consists of conducting bingo games (as defined in paragraph (d) of this section).

[1] This publication of the Treasury Decision contains the complete text of the amendments to the regulations. The instructions for modifying the notice of proposed rulemaking have been omitted.

(b) *Exception.* The provisions of this section shall not apply with respect to any bingo game otherwise excluded from the term "unrelated trade or business" by reason of section 513(a)(1) and § 1.513-1(e)(1) (relating to trades or businesses in which substantially all the work is performed without compensation).

(c) *Limitations*—(1) *Bingo games must be legal.* Paragraph (a) of this section shall not apply with respect to any bingo game conducted in violation of State or local law.

(2) *No commercial competition.* Paragraph (a) of this section shall not apply with respect to any bingo game conducted in a jurisdiction in which bingo games are ordinarily carried out on a commercial basis. Bingo games are "ordinarily carried out on a commercial basis" within a jurisdiction if they are regularly carried on (within the meaning of § 1.513-1(c)) by for-profit organizations in any part of that jurisdiction. Normally, the entire State will constitute the appropriate jurisdiction for determining whether bingo games are ordinarily carried out on a commercial basis. However, if State law permits local jurisdictions to determine whether bingo games may be conducted by for-profit organizations, or if State law limits or confines the conduct of bingo games by for-profit organizations to specific local jurisdictions, then the local jurisdiction will constitute the appropriate jurisdiction for determining whether bingo games are ordinarily carried out on a commercial basis.

(3) *Examples.* The application of this paragraph is illustrated by the examples that follow. In each example, it is assumed that the bingo games referred to are operated by individuals who are compensated for their services. Accordingly, none of the bingo games would be excluded from the term "unrelated trade or business" under section 513(a)(1).

Example (1). Church Z, a tax-exempt organization, conducts weekly bingo games in State O. State and local laws in State O expressly provide that bingo games may be conducted by tax-exempt organizations. Bingo games are not conducted in State O by any for-profit businesses. Since Z's bingo games are not conducted in violation of State or local law and are not the type of activity ordinarily carried out on a commercial basis in State O, Z's bingo games do not constitute unrelated trade or business.

Example (2). Rescue Squad X, a tax-exempt organization, conducts weekly bingo games in State M. State M has a statutory provision that prohibits all forms of gambling including bingo games. However, that law generally is not enforced by State officials against local charitable organizations such as X that conduct bingo games to raise funds. Since bingo games are illegal under State law, X's bingo games constitute unrelated trade or business regardless of the degree to which the State law is enforced.

Example (3). Veterans' organizations Y and X, both tax-exempt organizations, are organized under the laws of State N. State N has a statutory provision that permits bingo games to be conducted by tax-exempt organizations. In addition, State N permits bingo games to be conducted by for-profit organizations in city S, a resort community located in county R. Several for-profit organizations conduct nightly bingo games in city S. Y conducts weekly bingo games in city S. X conducts weekly bingo games in county R. Since State law confines the conduct of bingo games by for-profit organizations to city S, and since bingo games are regularly carried on there by those organizations, Y's bingo games conducted in city S constitute unrelated trade or business. However, X's bingo games conducted in county R outside of city S do not constitute unrelated trade or business.

(d) *Bingo game defined.* A bingo game is a game of chance played with cards that are generally printed with five rows of five squares each. Participants place markers over randomly called numbers on the cards in an attempt to form a preselected pattern such as a horizontal, vertical, or diagonal line, or all four corners. The first participant to form the preselected pattern wins the game. As used in this section, the term "bingo game" means any game of bingo of the type described above in which wagers are placed, winners are determined, and prizes or other property is distributed in the presence of all persons placing wagers in that game. The term "bingo game" does not refer to any game of chance (including, but not limited to, keno games, dice games, card games, and lotteries) other than the type of game described in this paragraph.

(e) *Effective date.* Section 513(f) and this section apply to taxable years beginning after December 31, 1969.

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved April 21, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 20, 1980, 8:45 a.m., and published in the issue of the Federal Register for May 21, 1980, 45 F.R. 33969)

Part VI.—Political Organizations

Section 527.—Political Organizations

Whether disbursements from an officeholder's office account are deductible and whether the transfer of surplus campaign funds to the office account is includible in gross income. See Rev. Rul. 80-331, page 29.

Subchapter H.—Banking Institutions
Part I.—Rules of General Application to Banking Institutions

Section 585.—Reserves for Losses on Loans of Banks

26 CFR 1.585-2: Addition to reserve. (Also Section 351; 1.351-1.)

Banks; bad debt reserves; additions; section 351 transfer of loans. A bank that transferred a portion of its loans outstanding to another bank in a transaction qualifying under section 351 of the Code must consider the transferred loans as a reduction in eligible loans outstanding at the beginning of the year of transfer in calculating the

maximum addition to its reserve for losses on loans at the end of the taxable year of transfer under section 585(b)(2)(A).

Rev. Rul. 80-270

ISSUE

What adjustment must be made by a transferor bank to the amount of its eligible loans outstanding for purposes of computing the maximum addition to the reserve for bad debts under section 585(b)(2)(A) of the Internal Revenue Code for a taxable year in which a section 351 transfer of loans outstanding has occurred?

FACTS

On April 1, 1978, *Y*, a commercial bank that uses the accrual method of accounting, transferred a portion of its loans outstanding ($100x$ dollars) to *Z* (also a commercial bank) in exchange for stock of *Z* in a tax free transfer qualifying under section 351 of the Code. *Y* also reduced its related reserve for losses on these loans ($5x$ dollars). Thus, pursuant to section 358, *Y*'s basis in the stock received is equal to the face amount of the loans transferred to *Z* less the reserve relating to the loans transferred ($100x - 5x = 95x$). *Y* accomplished the reduction in the reserve for losses on loans by reducing its initial reserve for losses for the taxable year by an amount equal to the amount of the reserve transferred ($5x$ dollars). *Z* established a reserve for losses on loans in the amount of $5x$ dollars with respect to the loans it received. This amount was not considered as an addition to the reserve for losses on loans by *Z* for the taxable year 1978, or for any taxable year thereafter.

Y and *Z* compute their reserves for losses on loans under section 585 of the Code and the regulations thereunder. *Y* and *Z* used the "percentage method" for computing the maximum reasonable reserve addition for 1978, as set forth in section 585(b)(2)(A) and section 1.585-2(b)(1)(ii) of the Income Tax Regulations. In addition, *Y* has consistently taken the maximum addition allowable in computing all prior additions to its reserve for losses on loans.

LAW AND ANALYSIS

In *Nash v. United States,* 398 U.S. 1 (1970), Ct. D. 1941, 1970-1 C.B. 72, the Supreme Court held that a reserve for bad debts is not includible in income when accounts receivable are transferred to a controlled corporation in exchange for securities equal in value to the accounts receivable less the bad debt reserve. As a result of the *Nash* decision, Rev. Rul. 78-280, 1978-2 C.B. 139, sets forth the method for determining the transferor's basis in the accounts receivable. An accrual basis transferor using the reserve method must reduce the basis of the transferred accounts receivable and the amount of the reserve. However, Rev. Rul. 78-280 does not describe the method by which a transferor bank computes its maximum addition to its reserve under section 585 of the Code.

Section 585 of the Code sets forth the rules for calculating the reasonable reserve addition for a bank, as defined in section 581. Section 585(b)(2) describes the "percentage method" of calculating the reasonable reserve addition. Pursuant to this method, the proper amount necessary to increase the balance of the reserve is the amount necessary to increase the balance of the reserve for losses on loans (at the close of the taxable year) to the allowable percentage of eligible loans outstanding at such time. For 1978 the allowable percentage was 1.2 percent, pursuant to section 585(b).

Section 1.585-2(b)(1)(ii)(A) of the regulations sets forth the manner for determining the amount of the maximum reasonable addition to the reserve for losses on loans under the "percentage method" for a taxable year when a bank's reserve for losses on loans at the close of its base year, as defined in section 585(b)(2), is less than the allowable percentage for the taxable year (here 1.2 percent) multiplied by the eligible loans outstanding at the close of the base year. One factor making up the annual reserve addition is "an amount attributable to an increase in the amounts of eligible loans outstanding." Section 1.585-2(b)(1)(ii)(A)(3).

The purpose of section 585 of the Code is to allow an addition to the reserve for bad debts for the increase in eligible loans at the end of the taxable year. In the instant case, *Y* may transfer the accounts receivable ($100x$ dollars) and reduce its reserve ($5x$ dollars), and *Z* may set up outstanding loans ($100x$ dollars) and set up a reserve for losses ($5x$ dollars). When the reserves of *Y* and *Z* are considered together the proper tax result is obtained for this transaction. However, for *Y* to compute its maximum addition to the reserve under section 1.585-2(b)(1)(ii) of the regulations correctly at the end of the year in which these loans were transferred, it must reduce the amount of loans outstanding at the beginning of the year by the amount of such loans transferred in the section 351 transfer in order to make the proper computation under section 1.585-2(b)(1)(ii)(A).

HOLDING

A transferor bank must consider as a reduction in eligible loans outstanding at the beginning of the year of transfer, that portion of the bank's loans transferred in a section 351 transaction in calculating the maximum addition to the reserve for losses on loans at the end of the taxable year of transfer for purposes of section 585(b)(2)(A) of the Code and section 1.585-2(b)(1)(ii)(A) of the regulations.

Subchapter I.—Natural Resources
Part I.—Deductions

Section 612.—Basis for Cost Depletion

26 CFR 1.612-4: Charges to capital and to expense in case of oil and gas wells.

Whether the expenditures incurred in drilling a Continental Offshore Stratigraphic Test well are subject to the option provided for in section 263(c) of the Code and section 1.612-4(a) of the regulations. See Rev. Rul. 80-342, page 99.

Section 613.—Percentage Depletion

26 CFR 1.613-4: Gross income from the property in the case of minerals other than oil and gas.

Depletion; gross income from mining; transportation in excess of 50 miles. A domestic corporation is engaged in mining a mineral for export in a foreign country that required the location of processing facilities in an area that is more than 50 miles from the point of extraction to encourage economic development of the area. The corporation derived economic benefit by developing the processing facilities in the required area. The transportation of the mineral in excess of 50 miles from the point of extraction to the processing facilities is "mining" within the meaning of section 613(c)(2) of the Code.

Rev. Rul. 80-183

ISSUE

Does the taxpayer's transportation in excess of 50 miles qualify as "mining" within the meaning of section 613(c)(2) of the Internal Revenue Code?

FACTS

Corporation *X* is incorporated in the United States and does business in foreign country *R*. *X* is engaged in mining mineral *y* for export.

Mineral *y* is drilled, blasted, and loaded with power shovels directly into railroad cars for shipment to a port 90 miles away from the mine.

The railroad and port facilities are owned by *R*.

At the port, the ore is crushed, dried, and either stockpiled in covered storage areas or loaded directly in ships for ocean transportation to markets.

R required location of the crushing and drying facilities at the port to encourage economic development of the port area. *X* derived the following economic advantages by developing the processing facilities at the port: During the rainy season, *X* would not have to ship ore in covered cars or re-dry the ore when it reached port as it would if the facilities were located at the mine. The lower mean annual temperature at the port is more conducive to operations there than at the mine site. By locating at the port, the crushing and drying facilities could be constructed simultaneously with the mine development, accelerating the start-up of actual production of the mineral. Other efficiencies in the overall operation would be increased because fuel and other supplies would not have to be reshipped to the mine from the port.

LAW AND ANALYSIS

Section 613(c)(2) of the Code provides that the term "mining" includes that portion of the transportation of ores from the point of extraction from the ground to the plant or mills in which the treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills. See also section 1.613-4(d)(3)(i) of the Income Tax Regulations.

Section 1.613-4(h) of the regulations provides that the application to treat as mining transportation in excess of 50 miles must include a statement setting forth in detail the facts concerning physical and other requirements that prevented the construction and operation at a place nearer to the point of extraction from the ground.

In this case the mineral is extracted and shipped by rail to the port, a distance in excess of fifty miles, for the application of crushing and drying processes that are recognized in section 613(c)(4)(I) of the Code and section 1.613-4(f)(5) of the regulations as mining. Therefore, transportation of the mineral for fifty miles is mining.

The control that *R* had over the location and magnitude of mining operations and the other reasons given fulfilled the "physical and other reasons" requirement for performing the crushing and drying at the port.

HOLDING

In this case, the transportation of the mineral *y* in excess of fifty miles is mining.

26 CFR 1.613-5: Taxable income from the property.

Percentage depletion; taxable income from property; damages. Damages paid as a result of a breach of contract suit by a mineowner who was unable to deliver the mineral required by the contract because of a decrease in production are not deductible from gross income from mining for purposes of computing percentage depletion.

Rev. Rul. 80-317

ISSUE

Is the amount of damages paid by the taxpayer deductible from gross income from mining in computing the taxable income from mining pursuant to section 613 of the Internal Revenue Code under the circumstances described below?

FACTS

A entered into a contract with *B*, an unrelated purchaser of mineral mined

from *A*'s mine. The contract provided for the sale and delivery to *B* of a specified amount of *A*'s production each year for 5 years. *A* delivered the mineral to *B* for the first 2 years. After that, *A* was unable to deliver any mineral to *B* because of a decrease in production. Therefore, *B* had to acquire the mineral from other sources. *B* sued *A* for breach of contract and was awarded *x* dollars as damages.

LAW AND ANALYSIS

Section 611(a) of the Code provides that in the case of mines there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion according to the peculiar circumstances in each case, made under regulations prescribed by the Secretary. In the case of certain natural deposits, section 613 provides that the allowance for depletion shall be a specified percentage of the gross income from the property. Such allowance for depletion shall not exceed 50 percent of the taxpayer's taxable income from the property.

Section 613(c)(1) of the Code defines the term "gross income from the property," in the case of a property other than an oil or gas well, as the gross income from mining.

Section 1.613-4(a) of the Income Tax Regulations defines the term "gross income from mining" as that amount of income attributable to the extraction of ores or mineral from the ground and the application of mining processes, including mining transportation.

Section 1.613-5(a) of the regulations defines the term "taxable income from the property," as used in section 613, to mean "gross income from the property" less all allowable deductions that are attributable to mining processes with respect to which depletion is claimed.

In *Island Creek Coal Co. v. Commissioner,* 382 F.2d 35 (4th Cir. 1967), the Fourth Circuit determined that premiums paid for business interruption insurance were not deductible for percentage depletion purposes because the relationship of the processes of extraction and mining treatment was too remote. Income received from business interruption insurance is also not includible in gross income from mining because the receipts are not occasioned by the production of a mineral with consequent depletion of that mineral deposit but are paid in lieu of lost profits. *Guthrie v. United States,* 323 F.2d 142 (6th Cir. 1963). Similarly, amounts received in settlement of a breach of contract are not includible in gross income from mining. Rev. Rul. 77-57, 1977-1 C.B. 166.

Rev. Rul. 60-74, 1960-1 C.B. 253, provides that charitable contributions made by mining corporations which are deductible under section 170 of the Code need not be deducted in computing taxable income from the property, but payments to charitable organizations which constitute ordinary and necessary business expenses attributable to the mineral property must be deducted in computing the limitation on the percentage depletion allowance.

In the instant case, the payment of damages for breach of contract is not attributable to mining processes. The expenditure was not an ordinary and necessary cost of extracting and mining a depletable mineral product and was not related to production of income from an extracted mineral. Rather than a cost of production of a mineral, the payment of damages was occasioned by the lack of production.

HOLDING

The amount of damages paid by *A* is not deductible from gross income from mining in computing taxable income from the property for percentage depletion purposes of section 613.

Subchapter K.—Partners and Partnerships
Part I.—Determination of Tax Liability

Section 707.—Transactions Between Partner and Partnership

26 CFR 1.707-1: Transactions between partner and partnership.

Partner; receipt of guaranteed payment; capitalized by partnership. A guaranteed payment, within the meaning of section 707(c) of the Code, that is received by a partner as a finder's fee, is includible in the partner's gross income in the year of receipt, even though the partnership must capitalize and amortize the expense.

Rev. Rul. 80-234

ISSUE

Is the full amount of a guaranteed payment under section 707(c) of the Internal Revenue Code includible in the gross income of a partner in the year of receipt, under the circumstances described below?

FACTS

A is a partner in partnership *X*. In 1979, pursuant to an agreement between *A* and *X*, *A* received 500*x* dollars as a "finder's fee" for obtaining acceptable applicants for loans. The finder's fee is a part of the acquisition cost of the loans that must be capitalized and amortized over the lives of the loans made to the applicants. See Rev. Rul. 57-400, 1957-2 C.B. 520. *A* included in gross income for 1979, an amount equal to that amount of the expense amortized by *X* in 1979. *X* reports its income on a calendar year basis.

LAW AND ANALYSIS

Section 707(c) of the Code provides that to the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).

Section 1.707-1(c) of the Income Tax Regulations provides that a partner must include such payments as

ordinary income for the partner's taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. The partnership must capitalize the expenditure and is recovering the cost through amortization over the life of the asset. *A* is relying on section 1.707-1(c) of the regulations to include in gross income in 1979, only the amount equal to that being deducted by the partnership in 1979. This statement in section 1.707-1(c) relates to section 706(a) of the Code, which is a timing provision only. In this regard, the Tax Court of the United States in *Cagle v. Commissioner,* 539 F.2d 409, 414 N. 7 (5th Cir. 1976), *aff'g* 63 T.C. 86, 95 (1974) commented on the purposes underlying section 1.707-1(c):

> We think that all Congress meant was that guaranteed payments should be included in the recipient partner's income in the partnership taxable year ending with or within which the partner's taxable year ends and in which the tax accounting treatment of the transaction is determined at the partnership level.

See also S. Rept. No. 94-938 (Conf. Rep.), 94th Cong., 2d Sess. 93 (1976), 1976-3 C.B. 131.

This language merely reflects the application of the aggregate rather than the entity approach to the question of timing for inclusion of these amounts in the partner's gross income. The amount received as a finder's fee is includible in the partner's gross income under section 61 of the Code. Section 1.707-1(c) of the regulations does not permit a partner to defer inclusion of any portion of the payment received simply because the partnership that paid or accrued the expense must capitalize and amortize the expense.

HOLDING

The taxpayer *A* cannot apportion the amount received, but must include in gross income in 1979 the 500*x* dollars received in that year as a finder's fee.

Part II.—Contributions, Distributions, and Transfers
Subpart A.—Contributions to a Partnership

Section 722.—Basis of Contributing Partner's Interest

26 CFR 1.722-1: Basis of contributing partner's interest.

Whether the liability created by a written obligation given as part of the purchase price for a partnership interest is included in the basis of the partnership interest. See Rev. Rul. 80-235, page 229.

Subpart C.—Transfers of Interest in a Partnership

Section 741.—Recognition and Character of Gain or Loss on Sale or Exchange

26 CFR 1.741-1: Recognition and character of gain or loss on sale or exchange.

Whether a limited partnership interest that is transferred in a section 351 exchange is transferred subject to its share of partnership liabilities for purposes of sections 357(c) and 358(d) of the Code. See Rev. Rul. 80-323, page 124.

Subpart D.—Provisions Common to Other Subparts

Section 751.—Unrealized Receivables and Inventory Items

26 CFR 1.751-1: Unrealized receivables and inventory items.

Whether a limited partnership interest that is transferred in a section 351 exchange is transferred subject to its share of partnership liabilities for purposes of sections 357(c) and 358(d) of the Code. See Rev. Rul. 80-323, page 124.

Section 752.—Treatment of Certain Liabilities

26 CFR 1.752-1: Treatment of certain liabilities.

Whether a limited partnership interest that is transferred in a section 351 exchange is transferred subject to its share of partnership liabilities for purposes of sections 357(c) and 358(d) of the Code. See Rev. Rul. 80-323, page 124.

Part III.—Definitions

Section 761.—Terms Defined

26 CFR 1.761-2: Exclusion of certain unincorporated organizations from the application of all or part of subchapter K of Chapter 1 of the Code.

Whether the election to be excluded from the application of subchapter K, Chapter 1, of the Code will cause the recapture provisions of section 47(a) to be triggered where a partnership was created by the acquisition of a utility company's undivided interest in section 38 property by a tax exempt cooperative. See Rev. Rul. 80-219, page 18.

Subchapter L.—Insurance Companies
Part IV.—Provisions of General Application

Section 842.—Foreign Corporations Carrying on Insurance Business

Whether the federal income tax or federal excise tax applies to premiums paid to a foreign insurance company conducting a surplus lines insurance business in the United States. See Rev. Rul. 80-225, page 318.

Subchapter M.—Regulated Investment Companies and Real Estate Investment Trusts
Part I.—Regulated Investment Companies

Section 854.—Limitations Applicable to Dividends Received from Regulated Investment Company

26 CFR 1.854-1: Limitations applicable to dividends received from regulated investment company.
(Also Sections 116, 243, 7805; 1.116-1, 1.243-2, 301.7805-1.)

Regulated investment companies; dividends; short-term capital gains and unexercised stock options. Short-term capital gains from the sale of stock or securities and unexercised options gains are not excludable from the gross income of a regulated investment company for purposes of section 854(b) of the Code; Rev. Rul. 70-597 modified.

Rev. Rul. 80-345

ISSUES

I. Are short term capital gains from the sale or other disposition of stock or securities excluded from the gross income of a regulated investment company for purposes of section 854(b) of

the Internal Revenue Code? If not, is the holding of Rev. Rul. 70-597, 1970-2 C.B. 146 that dividends paid by a regulated investment company out of net short-term capital gains qualify for the $100 dividends received individual exclusion under section 116 and the 85 percent dividends received corporate deduction under section 243, subject to the limitations under section 854, correct?

II. Are unexercised option gains realized by a regulated investment company excluded from gross income for purposes of section 854(b) of the Code?

FACTS

The taxpayer is a regulated investment company within the meaning of subchapter M (sections 851-855) of the Code.

Situation I

The taxpayer engages in the sale and other disposition of stock and securities that result in net short-term capital gains that are recognized by the taxpayer for federal income tax purposes. These gains are includible in the taxpayer's gross income under section 61 and are distributed to its shareholders as ordinary income. A regulated investment company's capital gain dividends, defined in section 852(b)(3)(C) of the Code, may only be paid from net capital gain, which is defined in section 1222(11) as the excess of net long-term capital gain over net short-term capital loss for the year. Thus, short-term capital gains are not includible in the taxpayer's capital gain dividends.

Situation II

The taxpayer writes options on stock held in its stock portfolio and sells the options on a national securities exchange. In some instances, the holder of an option permits the option to lapse. In other instances, the taxpayer terminates its obligation for an option it has written by buying an identical option. The termination of the taxpayer's obligation by the purchase of an identical option is called a closing transaction. In either of the above situations, the options are considered as not having been exercised. Gains from unexercised stock options are includible in the taxpayer's gross income under section 61 of the Code.

LAW

Section 854(b)(1) of the Code provides that in the case of a dividend received from a qualifying regulated investment company (other than a capital gain dividend to which section 854(a) applies), if the aggregate dividends received by the regulated investment company for the taxable year during which it paid such dividend are less than 75 percent of its gross income, then, in computing the section 116 exclusion and the section 243 deduction, there shall be taken into account only that portion of the dividend that bears the same ratio to the amount of such dividend as the aggregate dividends received by the regulated investment company during such taxable year bear to its gross income for such taxable year.

Section 854(b)(4)(A) of the Code provides that for purposes of section 854(b), the term "gross income" does not include gain from the sale or other disposition of stock or securities.

ANALYSIS

Situation I

By enacting section 854(b) of the Code, Congress intended to place the shareholders of a regulated investment company in roughly the same position concerning the benefits of sections 116 and 243 as persons investing directly in a taxable corporation instead of through the medium of a regulated investment company. This intent is reflected in section 854(b)(4)(B), excluding dividends received from foreign corporations from the term "aggregate dividends received," and otherwise restricting that term by reference to section 116. S. Rep. No. 1622, 83rd Cong., 2d Sess. 104 (1954), states:

> [Y]our committee has defined dividend income to the investment company so as to exclude dividends which would not be entitled to the dividends-received . . . exclusion in the hands of an individual shareholder. It appears to your committee that it is inappropriate to allow the shareholder of a regulated investment company to treat as a dividend for purposes of the . . . exclusion amounts distributed by the investment companies from sources such as dividends paid by foreign corporations, which if received directly by the shareholder would not be eligible for such treatment.

The 75 percent test and the apportionment formula in section 854(b)(1) of the Code are provisions designed to achieve rough equivalence of treatment under sections 116 and 243 between regulated investment company shareholders and direct investors. The shareholders of a taxable corporation are allowed the section 116 exclusion or the section 243 deduction so as to limit the multiple taxation of corporate earnings. However, a considerable part of a distribution paid by a regulated investment company may represent nondividend income that has not previously been taxed and that, like dividend income, is passed through tax free to the shareholders of a qualifying regulated investment company. To restrict the use of sections 116 and 243 if the regulated investment company has a large proportion of nondividend income, Congress devised section 854(b)(1).

> [I]f more than 25 percent of the income of the regulated investment company is from interest or other nondividend income, both the dividends-received deduction for corporations and the dividend exclusion . . . for individuals . . . are to be available *only on the portion of the regulated investment company's distributions which actually represents dividend income.* If less than 25 percent of the company's income is from interest or other nondividend income, the dividend . . . allowances will apply to the entire distribution by the regulated investment company. Capital-gain dividends distributed by regulated investment companies will not be eligible for either corporate or individual dividend allowances.

S. Rep. No. 1622, at 103-04 (emphasis added); *accord*, H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 74 (1954).

Applying the definition of gross income in section 854(b)(4)(A) of the Code literally to short-term capital gains from the sale or other disposition of stock or securities, such gains would be excluded from gross income for purposes of section 854(b). Hence, they would be disregarded in applying the 75 percent test and the apportionment formula that must be used if the 75 percent test is not met. This would defeat congressional intent because it would give regulated investment company shareholders a substantial tax advantage over direct investors with respect to such gains.

If the regulated investment company's income consisted solely of dividends and such short-term capital gains, the 75 percent test would be met (because gross income would equal aggregate dividends received), no apportionment would be required, and the entire distribution by the regulated investment company would qualify under section 116 of the Code and section 243. This would be the result no matter what portion of the distribution represented such gains, given a literal interpretation of section 854(b)(4)(A).

For example, if the regulated investment company had gross income under section 61 of the Code consisting solely of $100*x* of qualifying dividends and $100*x* of short-term capital gains from the sale or other disposition of stock or securities, and such gains were excluded from gross income for purposes of section 854(b)(1), the ratio of aggregate dividends received to gross income would be 100 percent ($100*x* dividend income / $100*x* gross income), which is greater than 75 percent, so all of this income (when distributed by the regulated investment company) would be eligible for the exclusion under section 116 and the deduction under section 243. On the other hand, if such gains were included in gross income, an apportionment would be required because the ratio would be 50 percent ($100*x* dividend income / $200*x* gross income). As a result of the apportionment, $100*x* ($200*x* gross income times 50 percent), the amount of qualifying dividend income received by the regulated investment company, would be the amount eligible under sections 116 and 243.

If the regulated investment company also had other forms of income, for example, interest, an apportionment might be required under a literal interpretation of section 854(b)(4)(A) of the Code. However, the amount of the distribution determined under the apportionment formula to be eligible for the exclusion under section 116 of the Code and the deduction under section 243 would at least partially reflect short-term capital gains from the sale or other disposition of stock or securities, in direct conflict with the underscored language quoted from the committee reports. This would not happen if the short-term capital gains were included in gross income.

Section 854(b)(4)(A) of the Code should be read in conformity with congressional intent. That provision should be interpreted to exclude only long-term capital gains from the sale or other disposition of stock or securities from gross income for purposes of section 854(b). Such gains are distributed as capital gain dividends and are not part of the distribution to which the 75 percent test and the apportionment formula relate. "All statutes must be construed in the light of their purpose. A literal reading of them which would lead to absurd results is to be avoided when they can be given a reasonable application consistent with their words and with the legislative purpose." *Haggar Co. v. Helvering*, 308 U.S. 389, 394 (1940), Ct. D. 1433, 1940-1 C.B. 237.

Situation II

Under section 1234(b) of the Code, the grantor of an option in property must treat gain or loss from any closing transaction with respect to the option, or gain on the lapse of the option, as short-term capital gain or loss.

The regulated investment company in the present case has gains from closing transactions in options, and lapses of options it has written. Under section 1234(b) of the Code, these unexercised option gains are short-term capital gains. As discussed in Situation I, only long-term capital gains from the sale or other disposition of stock or securities are excludable from gross income under section 854(b).

HOLDINGS

I. Short-term capital gains from the sale or other disposition of stock or securities are not excluded from gross income for purposes of section 854(b) of the Code. Therefore, the holding of Rev. Rul. 70-597 that dividends paid by a regulated investment company out of net short-term capital gains qualify for the $100 dividend received individual exclusion under section 116 and the 85 percent dividends received corporate deduction under section 243, subject to the limitations of section 854, is modified.

However, if a regulated investment company has short-term capital losses, in addition to short-term capital gains, represented in its net short-term capital gains, gross income for purposes of section 854(b) of the Code should be reduced by the amount of the short-term capital losses. For example, suppose the regulated investment company has $200*x* dividends, $200*x* of short-term capital gains, and $100*x* of short-term capital losses, and distributed all $300*x* of its net income. Gross income for purposes of section 854(b), after adjustment for the short-term capital loss, would be $300*x* ($400*x*—$100*x*), so the ratio of aggregate dividends received to gross income would be 66⅔ percent. Using the apportionment formula (because the 75 percent test is not met), $200*x* ($300*x* times

66⅔ percent) would be eligible for sections 116 and 243 treatment.

II. Unexercised option gains realized by a regulated investment company are not excluded from gross income for purposes of section 854(b) of the Code.

PROSPECTIVE APPLICATION

Pursuant to the authority contained in section 7805(b) of the Code, the conclusions in this revenue ruling will not be applied adversely to distributions by a regulated investment company out of net short-term capital gains realized from the sale or other disposition of stock or securities purchased by the regulated investment company before December 15, 1980.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 70-597, 1970-2 C.B. 146, involved a regulated investment company with two classes of stock, namely, income shares and capital shares. Holders of the income shares were to receive all distributions of net income from the investment portfolio, and all capital gains were to be allocated to the capital shares. Net short-term capital gains were to be paid to the capital shareholders to the extent necessary to satisfy the 90 percent distribution requirement of section 852(a)(1) of the Code. Rev. Rul. 70-597 concluded that distributions paid out of net short-term capital gains with respect to the capital shares would be eligible for sections 116 and 243 treatment, subject to the limitations of section 854.

Rev. Rul. 70-597 is modified to state that a distribution paid out of net short-term capital gains with respect to the capital shares would qualify for the exclusion under section 116 of the Code and the deduction under section 243 if, but only if, the aggregate dividends received by the regulated investment company for the taxable year during which it paid such distribution constitute at least 75 percent of its gross income (including short-term capital gains from the sale or other disposition of stock or securities), and the other requirements of section 854 (b) are satisfied.

Part II.—Real Estate Investment Trust

Section 856.—Definition of Real Estate Investment Trust

26 CFR 1.856-2: Limitations.

Real estate investment trust; hypothecation loans. An otherwise qualifying real estate investment trust makes nonrecourse "hypothecation loans" to developers of commercial real estate. The loans are secured by first mortgage notes on commercial real property owned by third parties that are assigned to the trust. Until maturity of the hypothecation loans, the trust collects all payments on the mortgage notes, retains interest due from the hypothecation borrower, and remits the balance to such borrower. The interest received by the trust meets the requirements of section 856(c)(3)(B) of the Code, and the hypothecation loans held by the trust are "real estate assets" under section 856(c)(5) and (6)(B).

Rev. Rul. 80-280

ISSUES

1. Is interest received, under the circumstances described below, "interest on obligations secured by mortgages on real property" within the meaning of section 856(c)(3)(B) of the Internal Revenue Code?

2. Are the hypothecation loans described below, "real estate assets" within the meaning of section 856 (c)(5) and (6)(B)?

FACTS

M, an unincorporated trust, otherwise qualifying as a real estate investment trust under section 856 of the Code, engages in lending activities, including the making of "hypothecation loans" to developers of commercial real estate. The terms of the hypothecation loans made by *M* range between one and seven years with interest payable monthly and principal due upon maturity. Repayment of such loans is secured by assignment to *M* of first mortgage notes owned by the hypothecation borrowers. The first mortgage notes are secured by commercial real property owned by unrelated third parties and have terms of from 15 to 40 years.

The mortgage notes given as security for *M*'s loans are endorsed by *M*'s borrowers in *M*'s favor without recourse and delivered to *M*. The hypothecation loans are also nonrecourse except for the security of the mortgage notes assigned as collateral. *M* requires sufficient collateral to assure that the balances of the hypothecation loans never exceed 80 percent of the unpaid balance of the notes assigned as security. Under the agreement with *M*'s hypothecation borrowers, *M* collects all amounts payable by the original mortgagors, retains interest due from the hypothecation borrower out of the payments, and remits the balance to the hypothecation borrower. *M* reendorses the mortgage notes (without recourse) and redelivers them to the hypothecation borrowers following full repayment of principal and interest due on the hypothecation loans.

As holder of the mortgage notes, *M* is able to enforce payment in its own name if an original mortgagor should default. *M*'s only security for the hypothecation loans is the mortgaged property if an original mortgagor defaults. In the event of such a default, *M* has the same rights as the original mortgagee to force a sale of the mortgaged property and satisfy the obligation of the hypothecation borrower out of the sales proceeds.

LAW AND ANALYSIS

Section 856(c)(3)(B) of the Code provides that a corporation, trust, or association shall not be considered a real estate investment trust for any taxable year unless at least 75 percent of its gross income (excluding gross in-

come from prohibited transactions) is derived from certain sources, including interest on obligations secured by mortgages on real property or on interests in real property.

Section 856(c)(5) of the Code requires that at the close of each quarter of a real estate investment trust's taxable year, at least 75 percent of the trust's assets must be represented by certain assets including real estate assets.

Section 856(c)(6)(B) of the Code provides that the term "real estate assets" means real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other real estate investment trusts that meet the requirements of sections 856 through 860.

The security for the hypothecation loans made by *M* is the mortgage notes of the unrelated third parties. Therefore, the hypothecation loans are obligations secured by mortgages on real property and are interests in mortgages on real property.

HOLDINGS

1. The interest received by *M* from the hypothecation loans is "interest on obligations secured by mortgages on real property or on interests in real property" with the meaning of section 856(c)(3)(B) of the Code.

2. The hypothecation loans held by *M* are "real estate assets" within the meaning of section 856(c)(5) and (6)(B) of the Code.

Subchapter N.—Tax Based on Income From Sources Within or Without the United States
Part I.—Determination of Sources of Income

Section 861.—Income From Sources Within the United States

26 CFR 1.861-5: Rentals and royalties. (Also Sections 871, 1441; 1.871-7, 1.1441-1.)

Income source; royalties for U.S. patent rights; paid by foreign corporation. An individual who is a citizen and resident of a foreign country with which the U.S. has no income tax convention licensed the U.S. rights on a patent to a U.S. corporation for use in the U.S. The patent royalties paid to the individual are subject to U.S. tax, and the Netherlands corporation is required to withhold the tax from the royalties.

Rev. Rul. 80-362

ISSUE

Are royalties paid for the use of a patent in the United States, under the circumstances described below, subject to United States tax?

FACTS

A, a citizen and resident of a country other than the United States or the Netherlands, licenses the United States rights on a patent to *X*, a Netherlands corporation. *X* is a bona fide corporation unrelated to *A*. *X* agrees to pay *A* a fixed royalty each year in return for the patent license. *X* relicenses the patent to *Y*, a United States corporation, for use in the United States. *Y* agrees to pay *X* royalties based on the number of units produced by *Y* each year under the patent. *X*'s fixed royalty to *A* is not contingent upon the receipt of royalties from *Y*. *A*'s royalty income is not effectively connected with the conduct of a trade or business within the United States within the meaning of section 871(b) of the Internal Revenue Code.

Article IX(1) of the United States-Netherlands Income Tax Convention, T.D. 5778, 1950-1 C.B. 92, as amended by the United States-Netherlands Supplementary Income Tax Convention, 1967-2 C.B. 472, provides that royalties paid to a resident or corporation of the Netherlands shall be exempt from tax by the United States. There is no income tax convention between *A*'s country of residence and the United States.

LAW AND ANALYSIS

Section 861(a)(4) of the Code provides that royalties for the privilege of using a patent in the United States are treated as income from sources within the United States.

Section 871(a)(1)(A) of the Code imposes a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income.

Section 1.871-7(b) of the Income Tax Regulations provides that royalties, including royalties for the use of a patent, constitute fixed or determinable annual or periodical income to which the 30-percent tax rate imposed by section 871(a)(1)(A) applies.

Section 1441(a) of the Code provides that all persons, in whatever capacity acting, having the control, receipt, custody, disposal or payment of any of the items of income specified in section 1441(b) (to the extent that any of such items constitute gross income from sources within the United States), of any nonresident individual shall deduct and withhold from such items a tax equal to 30 percent thereof.

Section 1.1441-2(a) of the regulations provides that royalties are included in the items of income enumerated under section 1441(b) of the Code.

In the present factual situation, the royalties from *Y* to *X* are exempt from United States tax under Article IX(1) of the Convention. However, the royalties from *X* to *A* are not exempt from taxation by the United States because there is no income tax convention between *A*'s country of residence and the United States providing for such an exemption. Since the royalties from *X* to *A* are paid in consideration for the privilege of using a patent in the United States, they are treated as income from sources within the United

States under section 861(a)(4) of the Code and are subjec to United States income taxation under section 871(a)(1)(A).

HOLDING

Royalties paid by *X* to *A* are subject to United States tax at the 30-percent rate pursuant to section 871(a)(1)(A) of the Code. *X*, under section 1441(a), is required to withhold from the royalties paid to *A* a tax equal to 30 percent of such royalties.

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26 CFR 1.861-8: Computation of taxable income from sources within the United States and from other sources and activities. (Also Sections 904, 907; 1.904-1.)

Foreign tax credit limitation; allocation of expenses to income source. A domestic corporation that operates domestic oil refineries and an unrelated worldwide wholesale business purchases and refines its own crude oil and sells the refined oil products in the U.S. and abroad. For purposes of computing the foreign tax credit limitation, expenses incurred in preparing certain refinery reports required by federal law must be allocated to a class of income that consists of both U.S. and foreign source income from the sale of the refined oil products. If the corporation does not sell refined oil outside the U.S., the expenses would be allocable to a class of income that consists solely of U.S. source income from the sale of the corporation's refined oil products.

Rev. Rul. 80-288

ISSUE

In computing the limitation under section 904(a) of the Internal Revenue Code in the situations described below, are expenses incurred by the taxpayer in preparing reports required by a federal agency allocable to a class of gross income consisting solely of gross income from sources within the United States under section 861(b) of the Code?

FACTS

Situation (1). Taxpayer is a domestic corporation that owns and operates domestic oil refineries and an unrelated worldwide, non-oil wholesale business. Taxpayer purchases and refines its own crude oil and then sells the refined oil products both in the United States and abroad. Taxpayer does not purchase or refine any crude oil within a United States possession.

For the current taxable year taxpayer has United States source gross income of $8,000*x* from the sale of its refined oil products in the United States, foreign source gross income of $2,000*x* from the sale of such products abroad, United States source gross income of $2,000*x* from its wholesale business, and foreign source gross income from the wholesale business of $1,200*x*.

In the process of refining crude oil, taxpayer's refineries discharge processed waste water and non-contact cooling water. Federal law requires taxpayer to file periodic reports with a government agency on the steps taken by taxpayer to control the amount of pollutants in these discharges. In preparing these reports taxpayer incurs technical expenses (biological, chemical, and engineering), general and administrative expenses, and supervisory expenses, in the amount of $50*x*. The amount of these expenses is not affected by whether taxpayer has any foreign source gross income. Taxpayer does not incur any legal or accounting expenses in preparing these reports. *See* section 1.861-8(e)(5) of the Income Tax Regulations for the allocation rules for legal and accounting expenses.

For purposes of computing its foreign tax credit limitation under section 904 of the Code, taxpayer allocates all of the $50*x* to its gross income from the sale of refined oil products within the United States.

Situation (2). The facts are the same as in Situation (1), except that taxpayer is not engaged in the business of selling refined oil products outside the United States and thus will not have any gross income from foreign sources currently from the sale of such products.

LAW AND ANALYSIS

Section 904(a) of the Code limits the amount of the foreign tax credit to the same proportion of United States income tax against which credit is taken that the taxpayer's taxable income from sources without the United States bears to its entire income for the same taxable year.

Section 907(b) of the Code provides that section 904 shall be applied separately with respect to foreign oil related income (FORI). FORI includes income derived from sales of refined oil products outside the United States or its possessions.

Section 861(b) of the Code states that there shall be deducted from certain specified items of gross income from sources within the United States the expenses properly apportioned or allocated thereto and a ratable part of any expenses which cannot definitely be allocated to some item or class of gross income.

Section 1.861-8(a)(2) of the regulations requires a taxpayer to allocate deductions to a class of gross income.

Section 1.861-8(b)(1) of the regulations states that the gross income to which a specific deduction is definitely related is the "class of gross income." Classes of gross income are not predetermined but must be determined on the basis of the deductions to be allocated.

Section 1.861-8(b)(2) of the regulations states the general rule that a deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived.

Section 1.861-8(b)(3) of the regulations permits a taxpayer to allocate deductions that are supportive in nature (such as overhead, general and administrative, and supervisory expenses) under an alternative allocation rule. The alternative rule provides that deductions that are supportive in nature may relate to other deductions that can more readily be allocated to gross income. In such instances, these supportive deductions may be allocated and apportioned along with the deductions to which they relate.

Section 1.861-8(b)(3) of the regulations also provides that supportive deductions may be allocated to a class of gross income under the general rule of section 1.861-8(b)(2), by stating that it would be equally acceptable to attribute supportive deductions on some reasonable basis directly to the activities or property that generate, have generated, or could reasonably have been expected to generate the gross income.

Section 1.861-8(c)(1) of the regulations provides that when a deduction has been allocated to a class of gross income that is included in one statutory grouping and the residual grouping, the deduction must be apportioned between the statutory grouping and the residual grouping. One of the methods described for apportioning expenses is comparing the amount of gross income in the statutory grouping with the amount in the residual grouping. If, however, the class of gross income to which a deduction has been allocated is included in its entirety in either a single statutory grouping or the residual grouping, there is no need to apportion that deduction.

A statutory grouping is gross income from a specific source or activity that must first be determined in order to arrive at taxable income from this specific source or activity under an operative section such as section 904(a) of the Code. Gross income from other activities or sources represent the residual grouping of gross income. *See* section 1.861-8(a)(4) of the regulations.

Section 1.861-8(f)(1)(iv)(D) of the regulations provides that the rules of section 1.861-8 apply in determining the amount of foreign oil related income.

Under section 904(a) of the Code as applied separately under section 907(b), the statutory grouping is foreign source gross income from the sale of refined oil products and the residual grouping is United States source gross income from the sale of refined oil products. *See* sections 1.861-8(a)(4) and (f)(1)(i) of the regulations.

Situation (1). The 50x$ of reporting expenses are incurred solely as a result of taxpayer's operation of refineries in the United States and not as a result of taxpayer's wholesale business. Thus, under section 1.861-8(b)(2) of the regulations, these reporting expenses are definitely related and therefore allocable to all of taxpayer's gross income from the sale of taxpayer's refined oil products. It would not be acceptable for taxpayer to allocate these expenses to a class of gross income under the alternative rule of section 1.861-8(b)(3) of the regulations.

Since the class "gross income from the sale of taxpayer's refined oil products" consists of gross income from the sale of such products in both the United States and in foreign countries, taxpayer must apportion the 50x$ of reporting expenses within the class between the statutory grouping, gross income from sources without the United States, and the residual grouping, gross income from sources within the United States, in computing its foreign tax credit limitation under section 904 of the Code as applied separately under section 907(b). An acceptable method for taxpayer to apportion its reporting expenses under the facts in this situation is by comparing the amount of gross income in the statutory grouping ($2,000$x$) with the amount on the residual grouping ($8,000$x$). *See* section 1.861-8(c)(1)(vi) of the regulations. Under this method 10x$ of reporting expenses will be apportioned to the statutory grouping, foreign source gross income from the sale of refined oil products, and the remaining 40x$ will be apportioned to the residual grouping, gross income from United States sources from the sale of such products, computed as follows:

$$\$50x \times \frac{\$2{,}000x}{(\$2{,}000x + \$8{,}000x)} = \$10x$$

$$\$50x \times \frac{\$8{,}000x}{(\$2{,}000x + \$8{,}000x)} = \$40x$$

Situation (2). The result is the same as in situation (1), except that taxpayer will have no foreign source gross income from the sale of its refined oil products. Thus, under section 1.861-8(c)(1) of the regulations, no apportionment of the 50x$ of reporting expenses is necessary since the entire expense is attributable to the residual grouping, gross income from United States sources from sale of taxpayer's refined oil products.

HOLDING

In computing the limitation under section 904(a) of the Code, expenses incurred by the taxpayer in preparing reports required by a federal agency are in situation (1) allocable under section 861(b) of the Code to a class of gross income that consists of both United States source gross income and foreign source gross income from the sale of taxpayer's refined oil products, and in situation (2) allocable under section 861(b) to a class of gross income that consists solely of United States source gross income from the sale of taxpayer's refined oil products.

Section 864.—Definitions

26 CFR 1.864-2: Trade or business within the United States.

Whether the Federal income tax or Federal excise tax applies to premiums paid to a foreign insurance company conducting a surplus lines insurance business in the United States. See Rev. Rul. 80-225, page 318.

Part II.—Nonresident Aliens and Foreign Corporations
Subpart A.—Nonresident Alien Individuals

Section 871.—Tax on Nonresident Alien Individuals

26 CFR 1.871-1: Classification and manner of taxing alien individuals.

Whether advance rulings or determination letters will ordinarily be issued to classify aliens as resident or nonresident under section 871 of the Code and the regulations thereunder. See Rev. Proc. 80-38, page 771.

26 CFR 1.871-7: Taxation of nonresident alien individuals not engaged in U.S. business.

Whether royalties paid by a Netherlands corporation that relicenses a patent for use in the United States to the licensor of the patent, an individual who is a citizen and resident of a country other than the United States or the Netherlands, are subject to the 30 percent tax imposed by section 871(a)(1)(A) of the Code. See Rev. Rul. 80-362, page 208.

Subpart B.—Foreign Corporations

Section 881.—Tax on Income of Foreign Corporations Not Connected with United States Business

26 CFR 1.881-1: Taxation of foreign corporations not engaged in U.S. business. (Also Sections 1441, 1442, 4371; 1.1441-2, 1.1442-1, 46.4371-2.)

Foreign insurance company; no U.S. agent; reinsurance of U.S. risks. A foreign insurance company, which is not engaged in the conduct of trade or business in the U.S., reinsures risks that were initially assumed by other insurance companies and that are located in the U.S. The policies are neither signed nor countersigned in the U.S. by any officer or agent of the foreign insurance company. The premiums paid on such policies are subject to the excise tax imposed by section 4371(3) of the Code. The premiums received are not subject to either taxation under section 881 or withholding under section 1442. I.T. 1359 and I.T. 3061 amplified and superseded.

Rev. Rul. 80-222

ISSUE

Are the insurance premiums received by *M* under the circumstances described below subject to taxation under section 881 of the Internal Revenue Code, in light of the position stated in I.T. 1359, I-1 C.B. 292 (1922), with respect to the taxability of certain insurance premiums?

FACTS

M is a foreign casualty insurance company organized under the laws of country *X*. Its principal business is the reinsurance of risks initially assumed by other insurance companies, some of which are risks located in the United States and are, therefore, United States risks within the meaning of section 861(a)(7) of the Code. The policies issued by *M* for the reinsurance of these risks are neither signed nor countersigned in the United States by any officer or agent of *M*. *M* is not otherwise engaged in the conduct of any insurance business in the United States within the meaning of section 842 or the conduct of any trade or business in the United States within the meaning of section 864(b). The policies of reinsurance referred to above are subject to the excise tax imposed by section 4371(3).

LAW AND ANALYSIS

Section 881(a) of the Code imposes a tax of 30 percent of the amount received by foreign corporations from sources within the United States as premiums and other fixed or determinable annual or periodical income to the extent such amount is not effectively connected with the conduct of a trade or business within the United States.

Section 1442 of the Code provides for the withholding from foreign corporations of a 30-percent tax in the same manner and on the same items of income as is provided in section 1441.

Section 1441(a) of the Code requires all persons paying any of the items of income listed in subsection (b) to any nonresident alien individual that constitutes gross income from sources within the United States to deduct and withhold a tax of 30 percent from such items. Subsection (b) includes in the list of these income items "premiums" and "other fixed or determinable annual or periodical income."

Section 4371 of the Code imposes a tax of a specified percentage of the premiums paid on each policy of insurance or reinsurance issued by a foreign insurer or reinsurer covering a United States risk. However, such policies that are signed or countersigned by an insurer's officer or agent in a state or the District of Columbia, within which the insurer is authorized to do business, are specifically excepted by section 4373(1) from the imposition of this excise tax.

I.T. 1359 concludes that insurance premiums received from insuring United States risks by foreign insurance companies not engaged in the conduct of any trade or business in the United States are not fixed or determinable and, thus, are not subject to withholding under the predecessor of section 1442 of the Code. See also I.T. 3061, 1937-1 C.B. 114. I.T. 1359 gives two reasons for this conclusion: (1) Congress, in enacting the withholding provisions, intended to require withholding on only those kinds of gross income items having a high content of net income, but insurance premiums do not have this high content of net income and often yield a loss; and (2) the impracticability of collecting an income tax on premiums from which little net income, if any, is derived was one reason Congress retained the stamp tax (Revenue Act of 1918, Title *XI*, Schedule A, paragraph 15, the predecessor of the section 4371 excise tax) on premiums received by insurance companies not engaged in a trade or business in the United States.

The legislative history of the stamp tax supports the result reached in I.T. 1359. Its history demonstrates that Congress did not believe that any income tax, including a withholding tax, was applicable to insurance premiums paid to foreign insurance companies not engaged in a trade or business in the United States. Thus, in order to eliminate the competitive imbalance created by the fact that such foreign insurance companies, unlike their domestic competitors, were not subject to any United States income tax, Congress imposed the stamp tax on premiums received by such foreign insurance companies. *See* 61 Cong. Rec. 7180-81 (1921); Hearings on H.R. 7378 Before the Senate Finance Comm. (Vol. 1), 77th Cong., 1st Sess. 121-22 (1942); H.R. Rep. No. 2333, 77th Cong., 1st Sess. 61 (1942), 1942-2 C.B. 372, 420.

Subsequent to the publication of I.T. 1359, Congress has taken legislative action with respect to the taxation of insurance premiums received by foreign insurance companies that is consistent with the conclusion reached in I.T. 1359. Congress, aware of I.T. 1359's holding for many years, has consistently reenacted both the insurance and withholding tax provisions without altering the result in I.T. 1359. *See,* e.g., Message From the President of the United States (Exhibit VIII), Doc. No. 140, 87th Cong., 1st Sess. 289-290 (1961), which restates the rationale of I.T. 1359 and notes that a 30-percent withholding tax on the premiums "would destroy a normal and essential channel of insurance business, which is important to the American economy where only a foreign company is equipped to handle the risk."

In the Revenue Act of 1962, Pub. L. 87-834, 1962-3 C.B. 111, Congress added section 952 to the Code, which treats income not effectively connected with the conduct of a trade or business in the United States and derived from the insurance of United States risks by a controlled foreign corporation as "subpart F income" that is taxable currently to certain United States shareholders of such corporations. This section was added on the assumption that the 30-percent withholding tax did not apply to such insurance premium income. This treatment was considered necessary in order to prevent tax avoidance schemes that would not have been possible if such premiums were subject to the 30-percent tax imposed by section 881(a). *See* H.R. Rep. No. 1447, 87th Cong., 2d Sess. 60 (1962), 1962-3 C.B. 405, 464; 108 Cong. Rec. 5305 (1962).

These actions taken by Congress without any attempt to reverse the longstanding position stated in I.T. 1359 indicate that I.T. 1359 correctly states the tax law applicable to the premiums under consideration. *See United States v. Correll,* 389 U.S. 299, 305-06 (1967), 1968-1 C.B. 64.

HOLDING

The insurance premiums received by *M* under the circumstances described above are not subject to taxation under section 881 of the Code and, therefore, are not subject to the withholding of tax under section 1442.

EFFECT ON OTHER DOCUMENTS

I.T. 1359 and I.T. 3061 are amplified and superseded since the position stated therein is restated under current law in this revenue ruling.

Section 882.—Tax on Income of Foreign Corporations Connected with United States Business

26 CFR 1.882-1: Taxation of foreign corporations engaged in U.S. business or of foreign corporations treated as having effectively connected income.

Whether, in computing its U.S. taxable income, a U.K. corporation with a permanent establishment in the U.S. is entitled to deduct the U.K. income tax paid attributable to operations of its U.S. permanent establishment. See Rev. Rul. 80-243, page 413.

Section 892.—Income of Foreign Governments and of International Organizations

26 CFR 1.892-1: Income of foreign governments.
(Also Sections 911, 912, 913, 3121; 5b.-911-1, 1.912-1, 5b.913-2, 31.3121(a)-1.)

Taiwan Relations Act. The tax implications of the Taiwan Relations Act are discussed.

Rev. Rul. 80-208

ISSUES

(1) Are the Internal Revenue Code provisions that are applicable to foreign governments applicable to Taiwan?

(2) Is the American Institute in Taiwan (the Institute) exempt from United States taxation?

(3) How are employees of the Institute treated for federal income tax purposes?

LAW AND HOLDINGS

(1) Section 4(a) of the Taiwan Relations Act (the Act), Pub. L. No. 96-8, 1979-1 C.B. 459, provides that the laws of the United States shall apply with respect to Taiwan in the manner that the laws of the United States applied with respect to Taiwan prior to January 1, 1979.

Section 4(c) of the Act provides that for all purposes the Congress approves the continuation in force of all treaties and all other international agreements, including multilateral conventions, entered into by the United States and the governing authorities on Taiwan, which were in force between them on December 31, 1978, unless and until terminated in accordance with law.

Thus, all laws, including the Internal Revenue Code, treaties, international agreements, and conventions between the United States and Taiwan that were in force on December 31, 1978, are continued in force unless and until terminated by law.

(2) Section 8 of the Act provides that the Institute, its property, and its income are exempt from all taxation imposed by the United States or any state or local taxing authority of the United States, except to the extent provided for in section 11(a)(3) of the Act relating to the Federal Insurance Contributions Act (FICA), which may apply to certain employees of the Institute. The FICA provisions will apply for Institute employees, who before becoming Institute employees were employees of any agency of the United States covered by FICA and upon termination of their Institute employment are entitled to reemployment or reinstatement with such agency, since section 11(a)(3) of the Act requires that such employees have their benefits (including FICA benefits) continued during their Institute employment.

(3) Section 11(d)(1) of the Act provides that for purposes of sections 911 and 913 of the Code amounts paid by the Institute to its employees shall not be treated as earned income. Also, amounts received by employees of the Institute shall not be included in gross income, and shall be exempt from taxation, to the extent that they are equivalent to amounts received by civilian officers and employees of the Government of the United States as allowances and benefits that are exempt from taxation under section 912.

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26 CFR 1.892-1: Income of foreign governments.

T.D. 7707

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Income of foreign governments

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to the taxation of income of foreign governments. These regulations provide guidance for taxing foreign sovereigns on their income from commercial activities within the United States.

EFFECTIVE DATE: The regulations are generally effective for income of a foreign government from commercial activities within the United States derived after July 22, 1980.

FOR FURTHER INFORMATION CONTACT: Donald K. Duffy of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:LR:T (LR-106-75), 202-566-4336.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On August 15, 1978, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 892 of the Internal Revenue Code of 1954 (43 FR 36111). The amendments were proposed to clarify existing regulations which neither define the term "foreign government" nor establish the types of income excluded from gross income and exempted from taxation. The proposed amendments define a foreign government to include only integral parts and controlled entities of a foreign sovereign. The proposed amendments generally provide that income derived by a foreign government from commercial activities in the United States is not income of a foreign government for purposes of the exemption under section 892.

The proposed amendments in effect provide that if a foreign sovereign separately owns and controls an entity which is not an integral part and which does not constitute a "controlled entity", such an entity is taxed on all of its commercial and noncommercial income under appropriate Internal Revenue Code provisions. The amendments define the term "controlled entity", and in most respects the definition parallels the requirements of Rev. Rul. 75-298, 1975-2 C.B. 290, relating to certain organizations created by foreign governments that are eligible for the section 892 exemption.

The Federal Register published a notice of a public hearing on November 6, 1978 (43 FR 51648). The hearing was held on January 23, 1979.

After consideration of all relevant matters presented by interested persons regarding the proposed amendments, they are adopted as revised by this Treasury decision.

This document also reserves paragraph (c)(2)(i)(*d*) and (*e*) of § 1.892-1. These paragraphs will provide rules for determining whether loans or net leases are to be considered investments. A notice of proposed rulemaking is tbeing published contemporaneously with this Treasury decision setting forth those rules.

DISTINCTION BETWEEN INTEGRAL PARTS AND SEPARATE ENTITIES

Comments from the public questioned whether it was appropriate to draw a distinction between integral parts and separate entities of a foreign sovereign under § 1.892-1(b) for purposes of the definition of the term "foreign government". Section 1.892-1(b) is revised in the final regulations. The revision places less emphasis on both the form of the entity that exercises foreign governmental authority and the extent of its commercial activity in the United States.

PENSION PLANS

One comment suggested clarification of the treatment of pension plans for employees of a foreign government.

Final regulations adopt this suggestion and § 1.892-1(b)(4) provides that certain pension plans qualify for the section 892 exemption even though

plan assets are segregated in a separate fund or trust.

EFFECTIVE DATE

Several comments suggested that the effective date be completely prospective. Final regulations adopt this suggestion but also provide retroactivity in cases where no adverse tax consequences arise. Rev. Rul. 75-298 will not apply if these regulations apply.

COMMERCIAL ACTIVITIES

The definition of the term "commercial activities" has been revised. The proposed regulations provide that obtaining and holding net leases on property is a commercial activity. This proposed rule with respect to net leases on real property is withdrawn. A further notice of proposed rulemaking relating to these leases is being published contemporaneously with this Treasury decision.

The final regulations rely generally on the character of an activity, rather than on whether or not the income from the activity is effectively connected with the conduct of a trade or business in the United States, in determining that a particular activity is a commercial activity.

DRAFTING INFORMATION

The principal author of these regulations is Jason R. Felton of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations in matters of both substance and style.

Adoption of amendments to the regulations

After consideration of all relevant matters presented by interested persons regarding the proposed amendments to the regulations under section 892, the following amendments are hereby adopted:

Paragraph 1. Section 1.892-1 is amended as follows:

1. The title to § 1.892-1 is revised.

2. Paragraph (a) is deleted and in lieu thereof new paragraphs (a) through (h) are added.

3. Paragraphs (b)(1) and (2) are redesignated as paragraphs (a) and (b), respectively, of a new § 1.892-2. The amended § 1.892-1 and new § 1.892-2 read as follows:

§ 1.892-1 Income of foreign governments.

(a) *Manner of taxing*—(1) *In general.* Section 892 provides, in general, that the income of a foreign government from sources within the United States is excluded from gross income and exempt from taxation. Paragraph (b) of this section defines a foreign government. In particular it describes the extent to which either an integral part of a foreign sovereign or an entity created by a foreign sovereign will be treated as a foreign government for purposes of section 892. To the extent that income is derived by such an integral part or entity of a foreign sovereign which does not qualify as a foreign government as defined in paragraph (b) of this section, the income is subject to taxation in accordance with appropriate Internal Revenue Code provisions.

(2) *Foreign government exemption.* The income derived by an integral part or controlled entity of a foreign sovereign from investments in the United States in stocks, bonds, or other securities, owned by such integral part or controlled entity, or from interest on deposits in banks of moneys belonging to such integral part or controlled entity, or from any other investment source within the United States, is generally treated as income of a foreign government, which is not included in gross income and is exempt from taxation.

(3) *Foreign government exemption not available.* (i) Income derived by an integral part or controlled entity of a foreign sovereign from commercial activities in the United States is not income of a foreign government for purposes of the exemption from taxation provided in section 892. These amounts are included in income and taxed under appropriate Internal Revenue Code provisions.

(ii) Income derived by an entity created by a foreign sovereign that does not qualify as a controlled entity of the foreign sovereign under paragraph (b)(3) of this section is included in the gross income of the entity and taxed under appropriate Internal Revenue Code provisions.

(b) *Foreign government defined*—(1) *Classes of a foreign government.* For purposes of this section, a foreign government consists only of integral parts or controlled entities of a foreign sovereign to the extent not engaged in commercial activities in the United States.

(2) *Integral part.* An integral part of a foreign sovereign is any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country. The net earnings of the governing authority must be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person. It does not include any individual who is a sovereign, official, or administrator acting in a private or personal capacity.

(3) *Controlled entity.* An entity which is separate in form from a foreign sovereign or otherwise constitutes a separate juridical entity is a controlled entity if it satisfies the following requirements:

(i) It is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities;

(ii) It is organized under the laws of the foreign sovereign by which owned;

(iii) Its net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and

(iv) Its assets vest in the foreign sovereign upon dissolution.

The term "controlled entity" does not include any entity owned and controlled by more than one foreign sovereign. Thus, a foreign financial organization organized and wholly owned and controlled by several foreign sovereigns to foster economic, financial, and technical cooperation between various foreign nations is not a controlled entity for purposes of this section.

(4) *Pension trust.* A pension trust established exclusively for employees, or former employees, of a foreign government is a controlled entity if it meets the following requirements:

(i) The funds that comprise the trust are managed by trustees who are employees of, or persons appointed by, the foreign government; and

(ii) The trust forming a part of the pension plan provides for definitely determinable benefits (defined benefit plan) so that it may be concluded that the income of the trust satisfies the obligations of the foreign government to participants under the plan, rather than inuring to the benefit of a private person.

(5) *Political subdivision and transnational entity.* The rules that apply to a foreign sovereign apply to political subdivisions of a foreign country and to transnational entities. A transnational entity is an organization created by more than one foreign sovereign that has broad powers over external and domestic affairs of all participating foreign countries stretching beyond economic subjects to those concerning legal relations and transcending state or political boundaries.

(c) *Characteristization of activities*—(1) *Commercial activities.* Except as provided in paragraph (c)(2) of this section, all activities conducted in the United States which are ordinarily conducted with a view towards the current or future production of income (whether or not such income is from sources within the United States) are commercial activities. For example, leases on real or personal property, other than holding lease described in paragraph (c)(2)(i) of this section, is a commercial activity.

(2) *Activities that are not commercial.*

(i) *Investments.* Investments in the United States in stocks (whether or not a controlling interest investment), bonds, or other securities, loans, net leases on real property, land which is not producing income (other than on its sale or from an investment in net leases on real property), or the holding of deposits in banks are not commercial activities. Consideration of all of the facts and circumstances will determine whether an activity with respect to property described in this paragraph (c)(2)(i) constitutes an investment. The following principles apply in making such a determination;

(*a*) An activity undertaken as a dealer will not be an investment for purposes of this paragraph (c)(2)(i).

(*b*) An activity will not cease to be an investment solely because of the volume of transactions of that activity or because of other unrelated activities.

(*c*) Except in the case of holding stock, an activity will not be an investment merely because the income derived from the activity is not effectively connected with the conduct of a trade or business in the United States. For example, a loan made by a bank, loan company, or similar financial business (open in the United States to the general public) does not constitute an investment.

(*d*) [RESERVED — Rules for loans]

(*e*) [RESERVED—Rules for net leases on real property]

(ii) *Cultural events.* Performances and exhibitions within the United States of amateur athletic events and events devoted to the promotion of the arts by cultural organizations are not commercial activities.

(iii) *Purchasing.* The mere purchase of goods in the United States for use of the foreign sovereign is not a commercial activity.

(iv) *Activities other than trade or business.* For purposes of this paragraph, a particular activity in the United States that does not constitute the conduct of a trade or business in the United States under section 864(b) will be deemed not to be a commercial activity. This paragraph (c)(2)(iv) does not apply if the activity in any year or period constitutes the conduct of a trade or business in the United States under section 864(b). This paragraph (c)(2)(iv) also does not apply to activities involving real property and leases of personal property.

(v) *Not for profit.* Activities that are not customarily attributable to or carried on by private enterprise for profit in the United States are not commercial activities. The fact that in some instances, Federal, State, or local governments of the United States also are engaged in the same or similar activity does not mean that the activity is one described in this paragraph (c)(2)(v). For example, even though the United States Government is engaged in the activity of operating a railroad, operating a railroad is not an activity described in this paragraph (c)(2)(v).

(d) *Other operative sections.* In determining whether income is from sources within or without the United States, see sections 861 through 863 and the regulations thereunder. For purposes of determining whether income is effectively connected with a trade or business, see section 864(c) and the regulations thereunder. For rules with respect to withholding of tax at source, see sections 1441 and 1442 and the regulations thereunder. For rules with respect to methods of accounting and accounting periods, see sections 446 and 441, respectively, and the regulations thereunder.

(e) *Filing of returns.* A return with

respect to income taxes under subtitle A shall be made by a foreign sovereign, controlled entity, political subdivision, or a transnational entity with respect to certain amounts included in gross income. See section 6012.

(f) *Relationship of section 892 to certain Code sections*—(1) *Section 893.* The term "foreign government" referred to in section 893 (relating to the exemption for compensation of employees of foreign governments) has the same meaning as given such term in paragraph (b) of this section.

(2) *Section 895.* A foreign central bank of issue (as defined in § 1.895-1 (b)) that fails to qualify for the exemption from tax provided by this section may nevertheless be exempt from tax on the items of income described in section 895. Thus, a foreign central bank of issue that is not wholly owned and controlled by a foreign sovereign, although not qualifying for exemption under this section, may be exempt under section 895 on the items of income enumerated in that section.

(3) *Section 883(b).* Section 892 and this section do not limit the exemption provided under section 883 (b), relating generally to the exemption of earnings derived by foreign participants from the ownership or operation of communications satellite systems.

(4) *Section 1442.* No withholding is required under sections 1441 and 1442 in the case of income exempt from taxation and not included in gross income under paragraph (a)(2) of this section.

(g) *Illustrations.* This section may be illustrated by the following examples:

Example (1). For 1981, the Office of the President of a foreign country makes investments of funds from the foreign sovereign's treasury in publicly traded stocks, bonds, and other securities, and interest bearing bank deposits. The Office of the President has also purchased in 1981 a hotel in the United States which is operated by a U.S. agent. None of the income from all of these activities inures to the benefit of the President (or any other official of the foreign country) in a private or personal capacity. The sovereign's investment activities do not constitute commercial activities under paragraph (c) of this section because the foreign sovereign has made investments in property described in paragraph (c)(2)(i) of this section. Income from these investments is exempt under paragraph (a)(2) of this section. Income derived from the operation of the hotel is subject to tax since the Office of the President is engaged in commercial activities in the United States by reason of its hotel operations and hence the income therefrom is not income of a foreign government under paragraph (a)(3)(i) of this section. By reason of section 864(c)(3) and § 1.864-4(b), this income is effectively connected for 1981 with the conduct of a trade or business within the United States by the Office of the President and is taxed under section 882.

Example (2). Pursuant to a general agreement on contracts, exchanges, and cooperation between the United States and a foreign country, the State Concert Bureau, a bureau of a foreign sovereign, entered into four separate contracts to be performed in 1981 with a U.S. corporation engaged in the business of promoting international cultural programs. Under the first contract, the State Concert Bureau agreed to send a singer and accompanists on tour for 3 weeks in the United States. Under the second contract, the Bureau agreed to send a conductor on tour for 4 weeks in the United States. Under the third contract, the Bureau agreed to send the State ensemble of folk dance on tour for 5 weeks in the United States. Under the fourth contract, the Bureau agreed to send the State ballet and opera troupe on tour for 6 weeks in the United States. The State Concert Bureau received approximately $80,000 from the performances and from the sale of programs from the tours. This income is exempt from taxation under paragraph (a)(2) of this section since the activities of the Bureau are not commercial activities under paragraph (c)(2)(ii) of this section. Although the performances themselves do not constitute commercial activities, they do constitute the conduct of a trade or business in the United States. As a result, income derived by the State Concert Bureau from sources within the United States from the tour groups' United States radio or television appearances, or from motion picture productions or record and tape recordings of United States performances does not qualify for the exclusion from commercial activities contained in paragraph (c)(2) of this section.

Example (3). In 1981, the Ministry of Culture of foreign country X enters into certain agreements with a U.S. corporation for the television broadcast in the United States of performances by the State ballet troupe during 1981. These performances occur in foreign country X. During 1981, the Ministry of Culture receives $300,000 in royalties and other fees under the terms of the agreement. Since the performances take place outside the United States, and since the activities are not commercial activities under paragraph (c)(2)(iv) of this section, the income from the performances is income of a foreign government and is exempt from taxation under paragraph (a)(2) of this section.

Example (4). (a) In 1981, foreign sovereign Y organizes under its law M Corp. as a wholly owned and controlled government corporation under the auspices of the Ministry of Industry and Tourism. M Corp. engages in the purchasing in the United States of grain and other agricultural goods for free distribution to the poor in country Y. In addition, when purchases of grain exceed demand in foreign country Y (which rarely occurs), M Corp. engages in the sale of grain in the United States. M Corp. also engages in the trading of commodities futures (not for its own account) through a resident broker. Foreign sovereign Y and M Corp. do not have an office or other fixed place of business in the United States through which or by the direction of which the transactions in commodities futures are effected. The purchasing and trading activities of M Corp. are not commercial activities under paragraph (c) of this section. M Corp. is a controlled entity under paragraph (b)(3) of this section. Income from these activities derived by M Corp. from sources within the United States is exempt from taxation under paragraph (a)(2) of this section. However, income derived by M Corp. from the sale of grain in the United States is a commercial activity under paragraph (c) of this section unless M Corp. is not engaged in a trade or business in the United States with respect to its sales activities (paragraph (c)(2)(iv) of this section).

(b) The facts are the same as in example (4)(a), except that in 1982, M Corp. opens an office in Washington, D.C., through which transactions of trading in commodities futures in the United States are effected. These activities are commercial activities under paragraph (c)(1) of this section since M Corp. is now considered to be engaged in a trade or business in the United States under section 864. Thus, paragraph (c)(2)(iv) of this section does not apply. Income from these trading activities is not income of a foreign government under paragraph (a)(3)(i) of this section.

(h) *Effective date.* This section applies to income derived by a foreign sovereign after July 22, 1980, unless the sovereign elects to have it apply to income derived before that date.

§ 1.892-2 Income of international organizations.

(a) *Exempt from a tax.* * * *

(b) *Income received prior to Presidential designation.* * * *

* * * * *

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved July 2, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 17, 1980, 3:51 p.m., and published in the issue of the Federal Register for July 22, 1980, 45 F.R. 48882)

Section 894.—Income Affected by Treaty

26 CFR 1.894-1: Income affected by treaty.

Whether section 1031 of the Tax Reform Act of 1976, which amended section 904 (a) of the Code to provide that the limitation on the foreign tax credit provided in section 901 shall be computed using only the overall method, supersedes the per-country limitation on the foreign tax credit provided in United States income tax treaties. See Rev. Rul. 80-201, page 221.

26 CFR 1.894-1: Income affected by treaty.

Whether the enactment of sections 901 (f) and 907 of the Code by section 601 of the Tax Reduction Act of 1975 supersedes inconsistent provisions of income tax treaties with foreign countries entered into prior to the enactment of these sections. See Rev. Rul. 80-223, below.

Part III.—Income From Sources Without the United States
Subpart A.—Foreign Tax Credit

Section 901.—Taxes of Foreign Countries and of Possessions of United States

26 CFR 1.901-1: Allowance of credit for taxes.
(Also Sections 894, 907, 7852; 1.894-1.)

Foreign tax credit; inconsistent provisions of treaties. The enactment of sections 901(f) and 907 of the Code by the Tax Reduction Act of 1975 supersedes inconsistent provisions of all income tax treaties.

Rev. Rul. 80-223

ISSUE

Does the enactment of sections 901 (f) and 907 of the Internal Revenue Code by the Tax Reduction Act of 1975, Pub. L. 94-12, 1975-1 C.B. 545, 561 (the "1975 Act") supersede inconsistent provisions of income tax treaties with foreign countries entered into prior to the enactment of these sections?

LAW AND ANALYSIS

Section 901(f) of the Code provides that the foreign tax credit is not allowable for certain payments made to foreign countries with respect to oil or gas in which the taxpayer has no economic interest and which is purchased or sold at a price that differs from the fair market value for such oil or gas.

Section 907 of the Code provides for a reduction of the amount of foreign income taxes paid or accrued with respect to foreign oil and gas extraction income and for the separate application of the credit limitation of section 904 to foreign oil related income and to other taxable income.

Section 7852(d) of the Code provides that no provision of the Code shall apply in any case in which its application would be contrary to any provision of a treaty in effect on the date of the enactment of the 1954 Code. This section indicates, in effect, that a mere inconsistency, without more, between a provision in a tax treaty and an amendment to the Code is not enough by itself to override the treaty provision. However, the general provision of section 7852(d) does not prevent Congress from passing legislation that, in effect, overrides a treaty provision.

Article *VI*, Clause 2 of the United States Constitution provides that both the laws of the United States and treaties shall be the supreme law of the land.

Sections 901(f) and 907 of the Code are not inconsistent with treaties that incorporate the foreign tax credit provisions of the Code as it may be amended from time to time or any treaty that provides for a per-country limitation but specifically indicates that changes in United States domestic law which do not eliminate the general principle of the foreign tax credit are not inconsistent with the treaty. *See* Article 20 of the United States-Poland Income Tax Convention, 1977-1 C.B. 416, 423. However, sections 901(f) and 907 of the Code are inconsistent with treaties that provide for foreign tax credits determined pursuant to the foreign tax credit provisions of the Code in effect as of dates specified in such treaties. *See* Article XV of the United States-Republic of Austria Income Tax Convention, 1957-2 C.B. 985, 990. Subsequent legislation amending the foreign tax credit provisions of the Code will normally not affect these treaties unless Congress clearly manifests an intention to do so.

Because treaties and acts of Congress are given equal weight by the Constitution as domestic law, Congress has the authority to overrule the effect of a treaty by subsequent legislation. When an act of Congress and a treaty relate to the same subject, the courts will endeavor to construe them so as to give effect to both, if this can be done without violating the language of either. The courts do not favor repudiation of an earlier treaty by implication and require clear indications that Congress, in enacting subsequent inconsistent legislation, meant to supersede the earlier treaty. *Head Money Cases,* 112 U.S. 580, 597-99 (1884); *United States v. Payne,* 264 U.S. 446, 448 (1924); *Menominee Tribe of Indians v. United States,* 391 U.S. 404, 413 (1967). An example of such a clear indication is the presence of subsequent inconsistent legislation together with a committee report indi-

cating that Congress intended such legislation to supersede the earlier treaty. In *Cook v. United States,* 288 U.S. 102 (1933), subsequent inconsistent legislation was held not to supersede an earlier treaty provision because neither the committee reports nor the debates on the subsequent legislation mentioned the earlier treaty. It is, therefore, necessary to examine the legislative history underlying the enactment of sections 901(f) and 907 of the Code for a clear indication from Congress as to whether it intended these sections to supersede any provision of treaties entered into prior to the enactment of these sections.

Sections 901(f) and 907 of the Code were enacted by Congress in section 601 of the 1975 Act. Neither the 1975 Act nor the committee reports and congressional debates accompanying the Act contain any language or discussion dealing with the effect of these sections on tax treaties. These provisions had previously been proposed as part of the Oil and Gas Energy Act of 1974 and again as part of the Energy Tax and Individual Relief Act of 1974. The committee reports on these provisions, as proposed, also do not discuss their effect on treaties. Thus, the effect of these sections was not considered in any of the legislative history leading up to the actual enactment of sections 901 (f) and 907 by the 1975 Act. Therefore, at the time of their enactment, Congress left no clear indication as to its intention with respect to the application of the new sections to treaties that do not incorporate the foreign tax credit provisions of the Code as amended from time to time.

Section 1031 of the Tax Reform Act of 1976, Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1, 96 (the "1976 Act") amended section 904 of the Code by repealing the per-country limitation. This amendment was inconsistent with treaties that provide for the per-country limitation by incorporating the foreign tax credit provisions of the Code in force as of dates specified in such treaties. However, the committee reports on this amendment express the clear intention of Congress to supersede these treaty provisions. See Rev. Rul. 80-201, page 221, this Bulletin.

In discussing the elimination of the per-country limitation the committee reports state that it is intended that all existing treaties are to be applied consistently with the amendment of section 904 by the 1976 Act. See *S. Rep. No. 94-938,* 94th Cong., 2d Sess. 237 (1976), 1976-3 C.B. (Vol. 3) 49, 275. In a footnote to this report (footnote 19) the committee states:

> The committee further intends that, *as in the case with other recent legislation modifying the foreign tax credit,* the amendments made by the committee's bill are to be used in computing the credit allowed under all treaties (emphasis added).

This same footnote also appears in *H.R. Rep. No. 94-658,* 94th Cong., 1d Sess. 226 (1976), 1976-3 C.B. (Vol. 2) 701, 918. This reference to "other recent legislation" indicates that when Congress passed sections 901(f) and 907 of the Code it intended to supersede any inconsistent treaty provisions. No other significant legislation affecting the foreign tax credit was passed by the 94th Congress through 1975.

Statutes are normally construed with reference to circumstances existing at the time of the passage of the statutes. Therefore, comments made by a *subsequent* Congress on the meaning of an *earlier* Congress are not considered part of the legislative history of the earlier act. *United States v. Wise,* 370 U.S. 405 (1962). They are entitled to consideration as a secondarily authoritative expression of expert opinion. *Waterman Steamship Corp. v. United States,* 381 U.S. 252 (1965), 1965-2 C.B. 465; *Pennsylvania Mutual Co. v. Ledever,* 252 U.S. 523 (1920).

However, in this case, it was the *same* Congress (the 94th Congress) that enacted sections 901(f) and 907 of the Code in the 1975 Act and then that commented on this enactment in its reports on the 1976 Act while amending sections 904 and 907. The closer in time that a later legislative comment is to the original enactment and the greater the continuity of the Congress, the more persuasive the comment may be considered to be. *Sioux Tribe of Indians v. United States,* 316 U.S. 317 (1942); *Tri-Lakes S. S. Co. v. Commissioner,* 146 F.2d 970 (6th Cir. 1945); *Associated Telephone & Telegraph Co. v. United States,* 306 F.2d 824 (2d Cir. 1962), *cert. denied,* 371 U.S. 950 (1962). In this case, the comments made in 1976 by the House Ways and Means Committee and the Senate Finance Committee were made by the *same* committees of the *same* Congress that passed the original versions of sections 901(f) and 907 in 1975.

If subsequent comments in committee reports of Congress about what it meant years earlier in enacting a law are made in conjunction with legislation amending the earlier law, and the amendatory legislation assumes the correctness of such comments, the comments are entitled to great weight in statutory construction. *Mount Sinai Hospital of Greater Miami, Inc. v. Weinberger,* 517 F.2d 329 (5th Cir. 1975). Although no amendments were made to section 901(f) of the Code by the 1976 Act, several amendments were made to section 907. Congress made these amendments on the assumption that section 907 supersedes all inconsistent treaty provisions. Moreover, since much of section 907 was amended or enacted by the 1976 Act, the statement in the committee reports that the amendments are to be used in computing the credit allowed under all treaties applies specifically to the amendments of section 907. There is no reason why Congress would intend part of section 907 to apply to all treaties but not the rest of section 907 or the integrally related section 901(f).

HOLDING

The enactment of sections 901(f) and 907 of the Code by the 1975 Act supersede inconsistent provisions of all income tax treaties, those in effect on

the date of the enactment of the 1954 Code as well as those in effect after this date.

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26 CFR 1.901-1: Allowance of credit for taxes.

Whether social security payments made to a foreign country under a totalization agreement are allowable as a credit. See Rev. Proc. 80-56, page 851.

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26 CFR 1.901-1: Allowance of credit for taxes.

Whether section 1031 of the Tax Reform Act of 1976, which amended section 904 (a) of the Code to provide that the limitation on the foreign tax credit provided in section 901 shall be computed using only the overall method, supersedes the per-country limitation on the foreign tax credit provided in United States income tax treaties. See Rev. Rul. 80-201, page 221.

Section 902.—Credit for Corporate Stockholder in Foreign Corporation

26 CFR 1.902-1: Credit for domestic corporate shareholder of a foreign corporation. (Also Section 482; 1.482-1.)

Foreign tax credit; allocation of income to domestic parent; tax deemed paid. The effect of a reduction in the amount of foreign income tax paid by a foreign subsidiary following an allocation of income under section 482 of the Code on the computation of its domestic parent corporation's deemed paid foreign tax credit under section 902 is discussed; Rev. Rul. 76-508 amplified.

Rev. Rul. 80-231

ISSUE

How does the reduction in the amount of foreign income tax paid by a foreign subsidiary following an allocation of income under section 482 of the Internal Revenue Code affect the computation of its domestic parent corporation's deemed paid foreign tax credit under section 902 of the Code in the circumstances described below?

FACTS

P, a domestic corporation, owns all of the voting stock of *S*, a foreign corporation organized under the laws of foreign country *Z*. Country *Z* does not have an income tax convention in force with the United States. *P* and *S* use the accrual method of accounting.

In 1977, *P* sold its products to *S* at a price below *P*'s normal charge to unrelated customers, so that *P* did not realize its normal profit. The Internal Revenue Service proposed an allocation of income under section 482 of the Code for 1977 to reflect an arm's length selling price. For 1977, *S* paid an 80*x* country Z income tax on reported income of 200*x*. Pursuant to the allocation of income under section 482, the Internal Revenue Service reduced *S*'s country *Z* income by 20*x* and increased *P*'s income by the same amount.

P received a dividend of 15*x* from *S* during 1977 out of *S*'s 1977 accumulated profits and claimed a deemed paid foreign tax credit under section 902 of the Code based on the amount of country *Z* taxes paid by *S* in 1977 before the income allocation. The 15*x* dividend was not excluded from *P*'s income under Rev. Proc. 65-17, 1965-1 C.B. 833, and *P* has not elected to compute *S*'s earnings and profits under section 964 of the Code.

LAW AND ANALYSIS

The applicable sections of the Code are 901 and 902. Subject to certain limitations, section 901 permits domestic corporations to claim a credit for income taxes paid or accrued to foreign countries. Under section 902, a domestic corporation owning at least 10 percent of the voting stock of a foreign corporation from which it receives dividends shall be deemed to have paid a specified portion of any creditable income tax paid or deemed paid to any foreign country on or with respect to the accumulated profits of such foreign corporation. The specified portion is in the ratio that the dividends bear to accumulated profits in excess of foreign income taxes.

Section 1.902-1(e)(1) of the Income Tax Regulations provides, in part, that the accumulated profits for any taxable year of a first-tier foreign corporation shall be the sum of the earnings and profits of such corporation for such year, and the foreign income taxes imposed on or with respect to the gains, profits, and income to which such earnings and profits are attributable.

United States principles for computing earnings and profits, not foreign principles, are used to determine the computation of accumulated profits for purposes of section 902. See *H.H. Robertson Co. v. Commissioner*, 59 T.C. 53, 78-79 (1972), *aff'd without opinion*, 500 F.2d 1399 (3d Cir. 1974); *Untermyer v. Commissioner*, 24 B.T.A. 906 (1931), *aff'd per curiam*, 59 F.2d 1004 (2d Cir. 1932), XII-1 C.B. 157 (1933), *cert. denied*, 287 U.S. 647 (1932). Accumulated profits under section 902 are determined on an annual basis. *H.H. Robertson Co. v. Commissioner*, at 78-79.

Foreign income taxes are generally attributed to a particular year in which such taxes are paid or accrued on or with respect to the foreign corporation's accumulated profits, pursuant to section 1.902-1(f) of the regulations.

Rev. Rul. 76-508, 1976-2 C.B. 225, concerns the allocation of income from a foreign subsidiary corporation to its domestic parent under section 482 of the Code. Rev. Rul. 76-508 holds that in such a case the Service can reduce the amount of foreign income taxes paid by the foreign subsidiary that qualify for use by the parent in computing the deemed paid foreign tax credit under section 902.

Under the facts of Rev. Rul. 76-508, the amount of foreign income taxes paid for purposes of section 902 of the Code is reduced because it is presumed that an amount has been paid to the foreign country that exceeds the amount required to be paid pursuant to such country's law and

that the amount of the non-required or voluntary overpayment will be refunded. (The word "contribution" as used with respect to overpayments of foreign taxes in Rev. Rul. 76-508 means a voluntary overpayment to the foreign country.)

Generally, for domestic corporations, the earnings and profits of an accrual method taxpayer for a given year are reduced by the amount of tax accrued. A subsequent tax refund increases earnings and profits for that given year, regardless of the year in which such refund is received. *See Sweets Company of America v. Commissioner,* 8 T.C. 1104, 1106 (1947), which indicates that adjustments to earnings and profits on account of mistaken or erroneous overpayments or underpayments of tax for prior years are made as of the years for which the tax was due (accrued).

Thus, a reduction in the amount of foreign income taxes accrued by the amount of a voluntary overpayment, in conjunction with the presumption that the overpayment will be refunded, has an effect on the foreign subsidiary's earnings and profits in the earlier year of accrual of the foreign tax liability. Voluntary overpayments that the foreign corporation has treated as a tax expense item must be treated as a reduction of tax expense in such earlier year. This will increase earnings and profits in excess of foreign income taxes in such earlier year by the amount of the overpayment that it is presumed will be refunded.

When the foreign country actually refunds the voluntary overpayment there is no effect on the earnings and profits or accumulated profits in excess of foreign income taxes (except for exchange rate differentials in certain situations) because the adjustment (increase) to earnings and profits and accumulated profits in excess of foreign income taxes has already taken place.

If it is established to the satisfaction of the Internal Revenue Service that under the provisions of the law of country *Z*, *S* did not pay an amount in excess of that required by such law, or *P* and *S* exhaust all effective and practical remedies and the foreign country does not refund the voluntary overpayment, the refund presumption will be rebutted and the amount of the voluntary overpayment will be treated as a tax expense item in the original year of *S*'s accrual of the foreign tax liability. *S*'s earnings and profits will then be reduced in the original year of *S*'s accrual of the foreign tax liability by the amount of the tax expense that is not refunded. If an income tax convention were in force between the United States and country *Z*, all effective and practical remedies would include requesting consideration of the matter by the United States competent authority.

If *P* and *S* fail to pursue all effective and practical remedies and do not establish that *S* has made payments as required by the law of country *Z*, and it is established that *S* cannot receive a refund of the voluntary overpayment (for example, because the statute of limitations has expired), the amount of foreign income taxes paid, as reduced because of the refund presumption, will not be increased by the amount of the voluntary overpayment.

Moreover, even if *P* and *S* exhaust all effective and practical remedies and country *Z* refuses to refund the voluntary overpayment, the amount of the foreign income taxes paid, as reduced by the refund presumption, will not be increased by the amount of the voluntary overpayment in certain egregious cases, such as where it is clear that *P* and *S* knew or should have known that, under the law of country *Z*, *S* would not have had to make the voluntary overpayment because *P* grossly underpriced its products by selling them to S at substantially below cost and the law of country *Z* provides for arm's length pricing in computing tax liability. Thus, in such a case the amount of foreign income taxes paid will not be increased by the amount of the voluntary overpayment even after the foreign taxing authority and courts refuse for procedural reasons to grant any income tax refund based on increasing the price paid from *S* to *P* pursuant to an appropriate section 482 arm's length allocation by the Service.

In cases where there is a failure to exhaust remedies and in the aforementioned egregious cases, where the foreign income taxes paid (as reduced by the refund presumption) will not be increased by the voluntary overpayment, earnings and profits will be reduced by the amount of the overpayment, but only for the subsequent year when the right to the refund becomes worthless—for example, for the year in which the foreign statute of limitations for such a refund expires. See *Schweppe v. Commissioner,* 8 T.C. 1224 (1947), *aff'd,* 168 F.2d 284 (9th Cir. 1948), regarding the adjustment to earnings and profits in the year an otherwise valid debt becomes worthless because of the expiration of the statute of limitations; and *Sweets Company of America,* which distinguishes for earnings and profits adjustment purposes a mistake situation (such as the deemed rebutted refund presumption) from a subsequent event situation (such as the expiration of the statute of limitations).

HOLDING

The reduction, pursuant to Rev. Rul. 76-508, in the amount of foreign income tax paid by a foreign subsidiary following an allocation of income under section 482 of the Code affects the computation of its domestic parent's section 902 deemed paid foreign tax credit in the following manner:

	Accumulated Profits (as defined in section 902(c)(1))	Foreign Income Taxes Paid	Accumulated Profits (—) Foreign Income Taxes Paid	Dividend	902 Credit (subject to section 904 limitation)
Year 1 before 482 allocation	200	80	120	15	$\frac{15}{120} \times 80 = 10$
Year 1 after 482 allocation of 20	180	72	108	15	$\frac{15}{108} \times 72 = 10$
Year 1 after a refund of the overpayment is obtained	180	72	108	15	$\frac{15}{108} \times 72 = 10$
Year 1 after exhaustion of administrative remedies and foreign government does not refund overpayment	180[1]	80[1]	100[1]	15	$\frac{15}{100} \times 80 = 12$[1]
Year 1 after failure to exhaust administrative remedies and taxpayer establishes no refund can be obtained (foreign statute of limitations runs in year 4)	180[2]	72[2]	108[2]	15	$\frac{15}{108} \times 72 = 10$

[1] In those situations in which taxpayer knew or should have known that it was not liable for overpayment of 8, foreign taxes paid will remain at 72 and accumulated profits will remain at 180 resulting in a 902 credit of 10; however, accumulated profits in the year that the statute of limitations runs, year 4, will be reduced by the overpayment of 8.

[2] Foreign income taxes paid remain at 72 on the assumption that had the taxpayer pursued its administrative remedies a refund of 8 would have been received; accumulated profits of the year that the statute of limitations runs, year 4, will be reduced by the overpayment of 8.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 76-508 is amplified.

Section 904.—Limitation on Credit

Whether sections 904(f)(3)(A) and 904(f)(1) recapture the remaining overall foreign loss when a domestic corporation transfers all of the properties of its foreign branch that were used predominantly without the United States to a newly formed foreign corporation solely in exchange for all of the stock of such corporation. See Rev. Rul. 80-246, page 125.

26 CFR 1.904-1: Limitation on credit for foreign taxes.
(Also Sections 894, 901, 7852; 1.894-1, 1.901-1.)

Foreign tax credit; limitation; tax treaties. The foreign tax credit per-country limitation provided in United States income tax treaties is superseded for taxable years beginning after 1976 by section 1031 of the Tax Reform Act of 1976, which provides for computation of the limitation using only the overall method.

Rev. Rul. 80-201

ISSUE

Does section 1031 of the Tax Reform Act of 1976, Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1, 96, which amended section 904(a) of the Internal Revenue Code to provide that the limitation on the foreign tax credit shall be computed using only the overall method, supersede the foreign tax credit per-country limitation provided in United States income tax treaties?

LAW AND ANALYSIS

Subject to certain limitations provided in section 904 of the Code, section 901(b) authorizes qualifying United States taxpayers to claim a foreign tax credit for the amount of any income tax paid or accrued to any foreign country or to any possession of the United States.

Prior to its amendment by the 1976 Act, section 904 of the Code provided for both a per-country and an overall limitation in computing the total amount of allowable foreign tax credit. However, section 1031 of the 1976 Act amended section 904 by repealing the per-country limitation.

The present section 904 is inconsistent with treaties that provide for the per-country limitation by incorporating the foreign tax credit provisions of the Code in force as of dates specified in such treaties and at such time the Code provided for the per-country limitation. *See* Article XV of United States-Republic of Austria Income Tax Convention, 1957-2 C.B. 985, 990.

The present section 904 is not inconsistent with other treaties, such as those treaties that incorporate the foreign tax credit provisions of the Code as it may be amended from time to time or any treaty that provides for a per-country limitation but specifically indicates that changes in United States domestic law which do not eliminate the general principle of the foreign tax credit are not inconsistent with the treaty. *See* Article 20 of the United States-Poland Income Tax Convention, 1977-1 C.B. 416, 423.

Section 7852(d) of the Code provides that no provision of the Code shall apply in any case where its application would be contrary to any treaty obligation in effect on the date of enactment of the 1954 Code. This section indicates, in effect, that a mere inconsistency, without more, between a provision in a tax treaty and an amendment to the Code is not enough by itself to repeal the treaty provision.

However, the general provision of section 7852(d) does not prevent Congress from passing legislation that, in effect, overrides a treaty provision.

Article VI, Clause 2 of the United States Constitution provides that both laws of the United States and treaties shall be the supreme law of the land.

Because treaties and acts of Congress are given equal weight by the Constitution as domestic law, Congress has the authority to overrule the effect of a treaty by subsequent legislation. When an act of Congress and a treaty relate to the same subject, the courts will endeavor to construe them so as to give effect to both, if this can be done without violating the language of either. The courts do not favor repudiation of an earlier treaty by implication and require clear indications that Congress, in enacting subsequent inconsistent legislation, meant to supersede the earlier treaty. *Head Money Cases,* 112 U.S. 580, 597-99 (1884); *United States v. Payne,* 264 U.S. 446, 448 (1924); *Menominee Tribe of Indians v. United States,* 391 U.S. 404, 413 (1967). An example of such a clear indication is the presence of subsequent inconsistent legislation together with a committee report indicating that Congress intended such legislation to supersede the earlier treaty. In *Cook v. United States,* 288 U.S. 102 (1933), subsequent inconsistent legislation was held not to supersede an earlier treaty provision because neither the committee reports nor the debates on the subsequent legislation mentioned the earlier treaty.

Not only is section 904, as amended by section 1031 of the 1976 Act, inconsistent wtih the aforementioned treaty provisions, but also the committee reports accompanying section 1031 express congressional intent to supersede those treaty provisions. For example, S. Rep. No. 94-938, 94th Cong., 2d Sess. 237 (1976), 1976-3 C.B. (Vol. 3) 49, 275, in discussing the elimination of the per-country limitation, states:

> It is the committee's intent that all existing treaties are to be applied consistently with this amendment by using the overall limitation in computing the allowable foreign tax credit.[19]

Footnote 19 adds the following:

> The committee further intends that . . . the amendments made by the committee's bill are to be used in computing the credit allowed all treaties.

This same language appears in H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 226 (1976), 1976-3 C.B. (Vol. 2) 918.

These passages indicate a clear Congressional intent to have this amendment in the Act supersede any conflicting foreign tax credit provisions in the treaties. In addition, the reference to "all treaties" in S. Rep. No. 94-938 indicates that Congress intended the repeal of the per-country limitation to be applicable to treaty obligations in effect on the enactment date of the 1954 Code, and thus subject to section 7852(d), as well as to subsequently adopted treaty obligations.

HOLDING

Section 1031 of the 1976 Act supersedes, for taxable years beginning after December 31, 1976, the foreign tax credit per-country limitation provided in United States income tax treaties.

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26 CFR 1.904-1: Limitation on credit for foreign taxes.

Whether, in computing the limitation under section 904(a) of the Code, as applied separately under section 907(b), the expenses incurred in preparing reports required by a federal agency are allocable to a class of gross income consisting solely of gross income from sources within the United States under section 861(b). See Rev. Rul. 80-288, page 209.

Section 906.—Nonresident Alien Individuals and Foreign Corporations

Whether, in computing its U.S. taxable income, a U.K. corporation with a permanent establishment in the U.S. is entitled to deduct the U.K. income tax paid attributable to operations of its U.S. permanent establishment. See Rev. Rul. 80-243, page 413.

Section 907.—Special Rules in Case of Foreign Oil and Gas Income

Whether the enactment of sections 901(f) and 907 of the Code by section 601 of the Tax Reduction Act of 1975 supersedes inconsistent provisions of income tax treaties with foreign countries entered into prior to the enactment of these sections. See Rev. Rul. 80-223, page 217.

Whether, in computing the limitation under section 904(a) of the Code, as applied separately under section 907(b), the expenses incurred in preparing reports required by a federal agency are allocable to a class of gross income consisting solely of gross income from sources within the United States under section 861(b). See Rev. Rul. 80-288, page 209.

Subpart B.—Earned Income of Citizens or Residents of United States

Section 911.—Income Earned by Individuals in Certain Camps

26 CFR 5b.911-1: Individuals qualifying for the exclusion.

Whether employees of the American Institute in Taiwan have earned income for purposes of this section. See Rev. Rul. 80-208, page 212.

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26 CFR 5b.911-2: Qualifying earned income.

Earned income; royalties. Royalties paid to a writer by a publisher for the transfer of property rights of the writer in the writer's products are earned income under section 911(b) of the Code; Rev. Rul. 71-315 modified.

Rev. Rul. 80-254

Rev. Rul. 71-315, 1971-2 C.B. 271, holds that royalties paid to a writer by a publisher for the transfer of property rights of the writer in the writer's products are not earned income within the meaning of section 911(b) of the Internal Revenue Code. Rev. Rul. 71-315 also provides that amounts received by a writer under a personal service contract to write weekly articles for a newspaper and to write a book are earned income within the meaning of section 911(b).

In *Tobey v. Commissioner,* 60 T.C. 227 (1973), *acq.* 1979-1 C.B. 1, the

United States Tax Court held that income from the sale of paintings created by the taxpayer is earned income under section 911 of the Code. See also Rev. Rul. 79-85, 1979-1 C.B. 246.

HOLDING

Because of the acquiescence in *Tobey,* the royalties paid to the writer in Rev. Rul. 71-315, by the publisher for the transfer of property rights of the writer in the writer's products are now considered to be earned income within the meaning of section 911(b) of the Code.

Rev. Rul. 71-315 correctly holds that amounts received by the writer under a contract to write weekly articles for a newspaper and to write a book are earned income under section 911(b).

Rev. Rul. 71-315 is modified.

Section 912.—Exemption for Certain Allowances

26 CFR 1.912-1: Exclusion of certain cost-of-living allowances.

Whether employees of the American Institute in Taiwan are exempt from taxation to the extent provided for in this section. See Rev. Rul. 80-208, page 212.

Section 913.—Deduction for Certain Expenses of Living Abroad

26 CFR 5b.913-2: Taxpayers qualifying for the deduction.

Whether employees of the American Institute in Taiwan have earned income for purposes of this section. See Rev. Rul. 80-208, page 212.

Subpart F.—Controlled Foreign Corporations

Section 954.—Foreign Base Company Income

26 CFR 1.954-2: Foreign personal holding company income.

T.D. 7704

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Exclusion from subpart F income of certain earnings of insurance companies

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final Income Tax Regulations under section 954(c)(3)(B) and (C) of the Internal Revenue Code of 1954, which provides an exclusion from subpart F income of certain earnings of insurance companies. Changes to the applicable tax law were made by the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1]. This document also makes certain related, clarifying changes to the regulations. These regulations provide necessary guidance to the public for compliance with the law and affect under subpart F of the Code each United States shareholder owning the stock of a controlled foreign corporation that is an insurance company.

EFFECTIVE DATE: The regulations are, where indicated, effective for taxable years of controlled foreign corporations beginning after December 31, 1975, and April 23, 1979, and for taxable years of United States shareholders whose taxable years end with or within those taxable years of the controlled foreign corporations.

FOR FURTHER INFORMATION CONTACT: Donald K. Duffy, of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:LR:T, 202-566-3458.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On April 23, 1979, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 954(c)(3) of the Internal Revenue Code of 1954 (44 FR 23883). The amendments were proposed to conform the regulations to section 1023 of the Tax Reform Act of 1976 (Pub. L. 94-455, 90 Stat. 1620) and to clarify existing regulations under section 954(c)(3)(B). A public hearing was not held since none was requested. After consideration of all relevant matters presented by interested persons regarding the proposed amendments, this Treasury decision adopts the amendments to the Income Tax Regulations set forth in this document.

DESCRIPTION OF REGULATIONS

Section 954(c)(3)(B) provides, in pertinent part, that foreign personal holding company income under subpart F does not include certain dividends, interest, and gains derived from investments made by a controlled foreign corporation which is an insurance company of its unearned premiums or reserves which are ordinary and necessary for the proper conduct of its insurance business. Income eligible for this exclusion must be received from a person other than a related person. Existing regulations under § 1.954-2(d)(3) fail to establish a rule for computation of the amount of the exclusion. Section 1.954-2(d)(3) as amended by this document corrects this omission and in effect provides that the maximum amount excludable is limited to a portion of eligible income derived from investment of that proportionate amount of a controlled foreign corporation's assets which is equal to its unearned premiums and reserves. The amendment defines eligible income as dividends, interest, and the excess of gains over losses from sales or exchanges of stock or securities, other than amounts taxed to United States shareholders under section 952(a)(1), relating to income derived from the insurance of United

States risks, and other than amounts received from related persons.

Section 1.954-2(d)(4) of the amendments with respect to section 954(c)(3)(C) reflects the enactment of section 1023 of the Tax Reform Act of 1976, which added an exclusion from foreign personal holding company income. This added exclusion parallels in many respects the exclusion under section 954(c)(3)(B) and § 1.954-2(d)(3). However, the maximum amount excludable is limited in effect to a portion of eligible income derived from investment of that proportionate amount of a controlled foreign corporation's assets which is equal to one-third of premiums earned on casualty insurance contracts which are not directly or indirectly attributable to the insurance or reinsurance of risks of related persons. Section 1.954-2(d)(4) of the proposed amendments defined eligible income as it was defined in proposed § 1.954-2(d)(3) reduced, however, by the income excluded under section 954(c)(3)(B) and § 1.954-2(d)(3).

COMMENTS FROM THE PUBLIC

Comments from the public questioned the methods for computing the exclusions under § 1.954-2(d)(3) and (4). Suggestions were made that if eligible income is defined in a way which does not take into account certain dividends, interest, and the excess of gains over losses from the sale or exchange of stock or securities, then a portion of the assets attributable to ineligible income should likewise not be taken into account in any exclusion formula. This suggestion fails to recognize that a portion of the unearned premiums or reserves under paragraph (d)(3) of § 1.954-2 and a portion of the one-third of earned premiums under paragraph (d)(4) of § 1.954-2, as the case may be, would also not be taken into account in any exclusion formula. The final regulations adopted by this document reflect the fact that a portion of a foreign insurance company's assets equal to its unearned premiums or reserves under section 954(c)(3)(B), or its earned premiums under section 954(c)(3)(C), is invested in assets which give rise to income which is either taken into account as subpart F income under other provisions (and hence is not taken into account under section 954(c)) or is not eligible for the exclusion from foreign personal holding company income under section 954(3)(B) or (C).

Some comments also suggested that the assets used in the exclusion formula under § 1.954-2(d)(3) and (4) should include only those assets which actually produce income. The final regulations adopt this suggestion.

The definition of the term "eligible income" under § 1.954-2(d)(4)(ii) of the proposed amendments is revised in response to comments. The final regulations define this term as it is defined in § 1.954-2(d)(3)(iv).

In response to other comments, the determination of the amount of the exclusion under § 1.954-2(d)(3) applies only for taxable years of controlled foreign corporations beginning after April 23, 1979. For taxable years beginning before that date, any reasonable method will be recognized.

Evaluation of the effectiveness of these regulations after issuance will be based upon comments received from the public and from offices within the Department of the Treasury and the Internal Revenue Service.

DRAFTING INFORMATION

The principal author of these regulations is Donald K. Duffy, of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of amendments to the regulations

After consideration of all relevant matters presented by interested persons regarding the proposed amendments to the regulations under section 954(c)(3), the following amendments to the regulations are hereby adopted:

Section 1.954-2 is amended by revising paragraph (d)(3)(i), by adding new subdivisions (iii), (iv), and (v) to paragraph (d)(3), and by adding a new subparagraph (4) to paragraph (d). These revised and added provisions read as set forth below:

§ 1.954-2 Foreign personal holding company income.

* * * * *

(d) *Certain income received from unrelated persons in the active conduct of a trade or business.* * * *

(3) *Dividends, interest, and gains on securities derived by insurance companies from investments of unearned premiums or reserves*—(i) *In general.* Foreign personal holding company income of a controlled foreign corporation which is an insurance company does not include certain income, determined under subdivision (iii) of this paragraph (d)(3), derived from investments made by the company of its unearned premiums or reserves which are ordinary and necessary for the proper conduct of its insurance business. Although the name, charter powers and subjection to the insurance laws of a foreign country are significant in determining the business which a controlled foreign corporation is authorized and intends to carry on, the character of the business actually done in the taxable year determines whether it is an insurance company for purposes of section 954(c)(3)(B). The term "unearned premium," as used in this paragraph (d)(3), means the amount which will cover the cost of carrying the insurance risk for the period for which the premium has been paid in advance.

* * * * *

(iii) *Amount of exclusion.* The maximum amount eligible for the exclusion under section 954(c)(3)(B) and subdivision (i) of this paragraph (d)(3) is an amount equal to the eligible income (as defined in subdivision (iv) of this paragraph (d)(3)) of a controlled foreign corporation which is an insurance company multiplied by a fraction. The numerator of the fraction is the mean of the corporation's unearned premiums or reserves described in subdivision (ii) of this paragraph (d)(3) at the beginning and end of its taxable year. The denominator of the fraction is the mean of the reserve assets held by the corporation at the beginning and end of its taxable year. Reserve assets are assets which may give rise to foreign personal holding company income described in section 954(c)(1) (without regard to modifications and adjustments under section 954(c)(3) and (4)). The amount of reserve assets attributable to real property and stock is determined on the basis of their fair market value. Any other reserve assets are taken into account on the basis of their adjusted basis for purposes of determining gain on their sale, exchange, or other disposition.

(iv) *Eligible income.* Eligible income equals the total amount of the dividends, interest, and the excess of gains over losses from sales or exchanges of stock or securities, reduced by the following amounts:

(A) The dividends, interest, and the excess of gains over losses described in this paragraph (d)(3)(iv) which are taxed under section 952(a)(1). See section 953 and § 1.953-1(a). This reduction is apportioned ratably between dividends and interest received from, and the excess of gains over losses from sales or exchanges to or with, related and unrelated persons (as defined in § 1.954-1(e)); and

(B) The dividends, interest, and the excess of gains over losses described in this paragraph (d)(3)(iv) which are received from, or derived from sales or exchanges to or with, related persons (as defined in § 1.954-1(e)(1)). The amount of the income described in this paragraph (d)(3)(iv)(B) which is received or derived from related persons does not include income described in subdivision (iv)(A) of this paragraph (d)(3) which is considered to be received or derived from related persons.

(v) *Effective date.* Subdivisions (iii) and (iv) of this paragraph (d)(3) apply to taxable years of controlled foreign corporations beginning after April 23, 1979, and for taxable years of United States shareholders whose taxable years end with or within those taxable years of the controlled foreign corporations. For taxable years of a controlled foreign corporation beginning before April 24, 1979, the amount of the exclusion under this paragraph (d)(3) may be determined under any reasonable method.

(4) *Dividends, interest, and gains on securities derived by insurance companies from investments of earned premiums*—(i) *In general.* Foreign personal holding company income of a controlled foreign corporation which is an insurance company does not include certain income, determined under subdivision (ii) of this paragraph (d)(4), derived from investments made by the corporation of an amount of its assets equal to one-third of certain of its earned premiums. For purposes of determining whether a controlled foreign corporation is an insurance company, see paragraph (d)(3)(i) of this section. This paragraph (d)(4) applies to taxable years of controlled foreign corporations beginning after December 31, 1975, and for taxable years of United States shareholders whose taxable years end with or within those taxable years of the controlled foreign corporations.

(ii) *Amount of exclusion.* The maximum amount eligible for the exclusion under section 954(c)(3)(C) and subdivision (i) of this paragraph (d)(4) is determined in the same manner, and with respect to the same amounts, as described in paragraph (d)(3)(iii) of this section with the following exception. The numerator of the fraction described in paragraph (d)(3)(iii) of this section is an amount equal to one-third of earned premiums. Subdivision (iii) of this paragraph (d)(4) defines the term "earned premiums."

(iii) *Earned premiums.* Earned premiums are premiums earned on insurance contracts (other than life insurance and annuity contracts) during the taxable year and which are described in section 832(b)(4), other than premiums which are directly or indirectly attributable to the insurance or reinsurance of risks of related persons (as defined in § 1.954-1(e)(1)). In determining whether premiums are directly or indirectly so attributable, see subdivision (iv) of this paragraph (d)(4).

(iv) *Insurance or reinsurance of risks of related persons.* A premium is directly or indirectly attributable to the insurance or reinsurance of a risk of a related person if the premium is derived by an insurance company from the assumption or sharing of the risk of a related person upon an insurance or reinsurance policy issued to or by the related person or from an arrangement by which all or part of the policy risk of a related person is in effect transferred directly or indirectly through an unrelated person to the insurance company. If an insurance company participates in an insurance or reinsurance pool, whether there is joint liability on the risk with a related person is not determinative of whether the insurance company insured or reinsured the risk of a related person. If a premium is attributable in part to the insurance or reinsurance of a risk of a related person, and in part to other risks, the amount of the premium is apportioned on a reasonable basis.

* * * * *

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue

Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved June 4, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 24, 1980, 8:45 a.m., and published in the issue of the Federal Register for June 25, 1980, 45 F.R. 42606)

Section 956.—Investment of Earnings in United States Property

26 CFR 1.956-2: Definition of United States property.
(Also Section 958; 1.958-2.)

T.D. 7712

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX: TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Investment in United States property by controlled foreign corporations

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to the exceptions to the definition of United States property under section 956(b)(2) of the Internal Revenue Code of 1954. Changes in the applicable tax law were made by the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1]. This document also contains final regulations under section 956(c) which affect the computation of the investment of earnings in United States property by controlled foreign corporations. The regulations provide the public with the guidance needed to comply with the provisions of the Tax Reform Act of 1976 as well as guidance with respect to the clarification of existing regulations. The final regulations affect controlled foreign corporations making certain investments in United States property and their United States shareholders.

DATE: The amendments in general apply to taxable years beginning after December 31, 1975 except that the amendment to § 1.956-2(c)(2) applies with respect to pledges made after September 8, 1980.

FOR FURTHER INFORMATION CONTACT: Jacob Feldman of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:LR:T, 202-566-3289, not a toll-free call.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On April 23, 1979, the Federal Register published proposed regulations under sections 956 and 958 of the Internal Revenue Code of 1954 (44 FR 23880). Amendments under sections 956(a), (b)(2), and 958 were proposed to conform the regulations to amendments made to the Code by section 1021 of the Tax Reform Act of 1976 (90 Stat. 1618). Amendments made under section 956(c) were intended to clarify existing regulations. A public hearing was held on October 30, 1979. After consideration of all comments regarding the proposed amendments, this Treasury decision is adopted.

DISCUSSION

The proposed amendments made changes to the regulations under sections 956(b) and 958 to conform the regulations to amendments made to the Code by section 1021 of the Tax Reform Act of 1976 (90 Stat. 1618). In addition, amendments were made to the regulations under section 956(c) to clarify existing regulations.

Proposed § 1.956-2(c)(2) dealing with indirect pledges or guarantees has been modified. Under the final regulations the pledge of stock of a controlled foreign corporation will be considered as an indirect pledge of the assets of the controlled foreign corporation only if at least 66⅔ percent of the voting power of the stock of the controlled foreign corporation is pledged and only if, in addition, the pledge of stock is accompanied by negative covenants or similar restrictions. This provision applies to pledges made after September 8, 1980.

Proposed § 1.956-2(c)(3) dealing with the facilitation of loans to shareholders has been eliminated. Although the Committee Report accompanying the Tax Reform Act of 1976 supports the position taken in the proposed regulations, a number of comments were received that the proposed section was too vague and could be misconstrued to cover situations not prohibited by section 956. Any need for specificity will be covered in rulings on particular facts. Examples (4) and (5) under proposed § 1.956-2(c)(3) have also been eliminated. Example (4) dealt with the operation of an effective date which has been modified and Example (5) dealt with the concept of facilitation.

A change was also made under proposed § 1.956-2(b)(1)(ix) in order to expand the concept of "when used" to include situations in which equipment has been purchased for use and not as yet used. Another change of a clarifying nature was made under § 1.956-2(b)(1)(ix) with respect to the definition of movable drilling rigs and other oil and gas exploration and exploitation equipment used on the continental shelf of the United States.

DRAFTING INFORMATION

The principal author of these regulations is Jacob Feldman of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel

from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, the following amendments to the regulations are hereby adopted:

Par. 1. Paragraph (b) of § 1.956-1 is amended by redesignating subparagraphs (2) and (3) as subparagraphs (3) and (4), respectively, and by adding new subparagraph (2) to read as set out below:

§ 1.956-1 Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.

* * * * *

(b) *Amount of a controlled foreign corporation's investment of earnings in United States property.* * * *

(2) *Aggregate amount of United States property.* For purposes of determining an increase in earnings invested in United States property for any taxable year beginning after December 31, 1975, the aggregate amount of United States property held by a controlled foreign corporation at the close of—

(i) Any taxable year beginning after December 31, 1975, and

(ii) The last taxable year beginning before January 1, 1976

does not include stock or obligations of a domestic corporation described in section 956(b)(2)(F) or movable property described in section 956(b)(2)(G).

Par. 2. Section 1.956-2 is amended as follows:

1. Paragraph (b)(1) is amended by revising subdivision (iii), by redesignating subdivision (viii) as subdivision (x), and by adding subdivisions (viii) and (ix) as set forth below.

2. Paragraph (c) is amended as follows:

a. Subparagraph (1) is amended by deleting "subparagraph (2)" from the first sentence and by inserting in lieu thereof "subparagraph (4)", and by deleting the last sentence and the examples.

b. Subparagraph (2) is redesignated as subparagraph (4) and new subparagraphs (2) and (3) are added to read as set forth below.

3. Paragraph (d)(1)(i) is revised by deleting "of paragraph (a)" from the first sentence, and by revising paragraph (d)(1)(i)(*b*) to read as set forth below.

4. Paragraph (d)(2) is revised by deleting "of paragraphs (a)(1)(iii) and (b)(1)(v)" from the first sentence.

§ 1.956-2 Definition of United States property.

(b) *Exceptions*—(1) *Excluded property.* * * *

(iii) Deposits with persons carrying on the banking business, unless the deposits serve directly or indirectly as a pledge or guarantee within the meaning of paragraph (c) of this section. See paragraph (e)(2) of § 1.956-1.

* * * * *

(viii) For taxable years beginning after December 31, 1975, the voting or nonvoting stock or obligations of an unrelated domestic corporation. For purposes of this subdivision, an unrelated domestic corporation is a domestic corporation which is neither a United States shareholder (as defined in section 951(b)) of the controlled foreign corporation making the investment, nor a corporation 25 percent or more of whose total combined voting power of all classes of stock entitled to vote is owned or considered as owned (within the meaning of section 958(b)) by United States shareholders of the controlled foreign corporation making the investment. The determination of whether a domestic corporation is an unrelated corporation is made immediately after each acquisition of stock or obligations by the controlled foreign corporations.

(ix) For taxable years beginning after December 31, 1975, movable drilling rigs or barges and other movable exploration and exploitation equipment (other than a vessel or an aircraft) which are used exclusively on the Continental Shelf (as defined in section 638) of the United States in the exploration for, development, removal or transportation of natural resources from or under ocean waters. Property of the kind described in this subdivision which is being constructed or is in storage or in transit within the United States meets the requirements of § 1.956-2(b)(1) defining excluded property if it is actually used on the Continental Shelf by the last day of the taxable year following the year of purchase, commencement of storage or commencement of transit, and has not been used by the taxpayer anyplace else. In general, the type of property which qualifies for the exception under this subdivision includes any movable property which would be entitled to the investment credit if used outside the United States in certain geographical areas of the Western Hemisphere pursuant to section 48(a)(2)(B)(x) (without reference to sections 49 and 50).

* * * * *

(c) *Treatment of pledges and guarantees*—(1) *General rule.* * * *

(2) *Indirect pledge or guarantee.* If the assets of a controlled foreign corporation serve at any time, even though indirectly, as security for the performance of an obligation of a United States person, then, for purposes of paragraph (c)(1) of this section, the controlled foreign corporation will be considered a pledgor or guarantor of that obligation. For this purpose the pledge of stock of a controlled foreign corporation will be considered as the indirect pledge of the assets of the corporation if at least 66⅔ percent

of the total combined voting power of all classes of stock entitled to vote is pledged and if the pledge of stock is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the corporation's discretion with respect to the disposition of assets and the incurrence of liabilities other than in the ordinary course of business. This paragraph (c)(2) applies only to pledges and guarantees which are made after September 8, 1980. For purposes of this paragraph (c)(2) a refinancing shall be considered as a new pledge or guarantee.

(3) *Illustrations.* The following examples illustrate the application of this paragraph (c):

Example (1). A, a United States person, borrows $100,000 from a bank in foreign country X on December 31, 1964. On the same date controlled foreign corporation R pledges its assets as security for A's performance of A's obligation to repay such loan. The place at which or manner in which A uses the money is not material. For purposes of paragraph (b) of § 1.956-1, R Corporation will be considered to hold A's obligation to repay the bank $100,000, and, under the provisions of paragraph (e)(2) of § 1.956-1, the amount taken into account in computing R Corporation's aggregate investment in United States property on December 31, 1964, is the unpaid principal amount of the obligation on that date ($100,000).

Example (2). The facts are the same as in example (1), except that R Corporation participates in the transaction, not by pledging its assets as security for A's performance of A's obligation to repay the loan, but by agreeing to buy for $100,000 at maturity the note representing A's obligation if A does not repay the loan. Separate arrangements are made with respect to the payment of the interest on the loan. The agreement of R Corporation to buy the note constitutes a guarantee of A's obligation. For purposes of paragraph (b) of § 1.956-1, R Corporation will be considered to hold A's obligation to repay the bank $100,000, and, under the provisions of paragraph (e)(2) of § 1.956-1, the amount taken into account in computing R Corporation's aggregate investment in United States property on December 31, 1964, is the unpaid principal amount of the obligation on that date ($100,000).

Example (3). A, a United States person, borrows $100,000 from a bank on December 10, 1981, pledging 70 percent of the stock of X, a controlled foreign corporation, as collateral for the loan. A and X use the calendar year as their taxable year. In the loan agreement, among other things, A agrees not to cause or permit X Corporation to do any of the following without the consent of the bank:

(a) Borrow money or pledge assets, except as to borrowings in the ordinary course of business of X Corporation;

(b) Guarantee, assume, or become liable on the obligation of another, or invest in or lend funds to another;

(c) Merge or consolidate with any other corporation or transfer shares of any controlled subsidiary;

(d) Sell or lease (other than in the ordinary course of business) or otherwise dispose of any substantial part of its assets;

(e) Pay or secure any debt owing by X Corporation to A; and

(f) Pay any dividends, except in such amounts as may be required to make interest or principal payments on A's loan from the bank.

A retains the right to vote the stock unless a default occurs by A. Under paragraph (c)(2) of this section, the assets of X Corporation serve indirectly as security for A's performance of A's obligation to repay the loan and X Corporation will be considered a pledgor or guarantor with respect to that obligation. For purposes of paragraph (b) of § 1.956-1, X Corporation will be considered to hold A's obligation to repay the bank $100,000 and under paragraph (e)(2) of § 1.956-1, the amount taken into account in computing X Corporation's aggregate investment in United States property on December 31, 1981, is the unpaid principal amount of the obligation on that date.

(d) *Definitions*—(1) *Meaning of "acquired".* (i) *Applicable rules.* For purposes of this section—

* * * * *

(*b*) Property which is an obligation of a United States person with respect to which a controlled foreign corporation is a pledgor or guarantor (within the meaning of paragraph (c) of this section) shall be considered acquired when the corporation becomes liable as a pledgor or guarantor or is otherwise considered a pledgor or guarantor (within the meaning of paragraph (c)(2) of this section); and

* * * * *

Par. 3. Section 1.958-2 is amended as follows:

1. The first sentence of paragraph (a) is revised as set out below.

2. Subparagraph (b)(3) is amended by adding a new sentence immediately after the first sentence as set forth below.

3. Subparagraph (d)(2) is amended by adding a new sentence immediately after the first sentence as set forth below.

§ 1.958-1 Constructive ownership of stock.

(a) *In general.* Section 958(b) provides that, for purposes of sections 951(b), 954(d)(3), 956(b)(2), and 957, the rules of section 318(a) as modified by section 958(b) and this section shall apply to the extent that the effect is to treat a United States person as a United States shareholder within the meaning of section 951(b), to treat a person as a related person within the meaning of section 954(d)(3), to treat the stock of a domestic corporation as owned by a United States shareholder of a controlled foreign corporation under section 956(b)(2), or to treat a foreign corporation as a controlled foreign corporation under section 957. * * *

(b) *Members of family.* * * *

(3) *Stock owned by nonresident alien individual.* * * * However, this limitation does not apply for purposes of determining whether the stock of a domestic corporation is owned or considered as owned by a United States shareholder under section 956(b)(2) and § 1.956-2(b)(1)(viii). * * *

(d) *Attribution to partnerships, estates, trusts, and corporations.* * * *

(2) *Limitation.* * * * This limitation does not apply for purposes of determining whether the stock of a domestic corporation is owned or considered as owned by a United States shareholder under section 956(b)(2) and § 1.956-2(b)(1)(viii). * * *

(This Treasury decision is issued under the authority contained in sections 956(c) and 7805 of the Internal Revenue Code of 1954 (76 Stat. 1017, 68A Stat. 917; 26 U.S.C. 956(c) and 26 U.S.C. 7805 respectively).)

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved July 18, 1980.

EMIL M. SUNLEY,
Assistant Secretary
of the Treasury.

(Filed by the Office of the Federal Register on August 6, 1980, 8:45 a.m., and published in the issue of the Federal Register for August 7, 1980, 45 F.R. 52373)

Section 958.—Rules for Determining Stock Ownership

26 CFR 1.958-2: Constructive ownership of stock.

Amendments to the regulations relating to exceptions to the definition of United States property under section 956 of the Code and computation of the investment of earnings in United States property by controlled foreign corporations. See T.D. 7712, page 226.

Part IV.—Domestic International Sales Corporations
Subpart B.—Treatment of Distributions to Shareholders

Section 995.—Taxation of DISC Income to Shareholders

26 CFR 1.995-2: Deemed distributions in qualified years.

Whether a corporation may compute the estimated tax under section 6655(d)(3)(iv) of the Code by placing its taxable income on an annualized basis for the appropriate period of months without taking into account any part of a constructive distribution deemed to be received on the last day of its taxable year. See Rev. Rul. 80-343, page 374.

Subchapter O.—Gain or Loss on Disposition of Property
Part I.—Determination of Amount of and Recognition of Gain or Loss

Section 1001.—Determination of Amount of and Recognition of Gain or Loss

26 CFR 1.1001-1: Computation of gain or loss.

Whether a corporation intent on selling its appreciated property can avoid recognition of gain under section 1001 of the Code by issuing its preferred stock to the prospective purchaser of the property and later effecting a redemption which, in form, was structured under the nonrecognition provisions of section 311(a). See Rev. Rul. 80-221, page 107.

Part II.—Basis Rules of General Application

Section 1011.—Adjusted Basis for Determining Gain or Loss

26 CFR 1.1011-1: Adjusted basis.

Whether the liability created by a note given as the purchase price for a synthetic oil converter is included in the partnership's basis in the converter and the liability created by a written obligation given as part of the purchase price for a partnership interest is included in the basis of the partnership interest. See Rev. Rul. 80-235, below.

Section 1012.—Basis of Property—Cost

26 CFR 1.1012-1: Basis of property. (Also Sections 38, 46, 48, 722, 1011; 1.38-1, 1.46-3, 1.48-1, 1.722-1, 1.1011-1.)

Basis; synthetic oil converter purchased for nonrecourse note; partnership. The liability created by an interest-bearing nonrecourse note given by a limited partnership as the total purchase price for a synthetic oil converter and payable out of the partnership's net cash flow may not be included in the partnership's basis in the converter for purposes of investment tax credits. The liability created by a limited partner's written obligation given as part of the purchase price for a partnership interest and payable only from cash distributions from the production activities of the partnership may not be included in the basis of the limited partnership interest.

Rev. Rul. 80-235

ISSUES

(1) Is the liability created by the Purchase Note given as the purchase price for a synthetic oil converter included in the partnership's basis in the converter for purposes of the investment tax credits?

(2) Is the liability created by the 180x dollar written obligation given as part of the purchase price for a partnership interest included in the basis of the partnership interest?

FACTS

A, an individual, claimed to have developed a process for the conversion of coal into synthetic fuel. This process has not been commercially tested. In 1979, *P*, a newly organized limited partnership, entered into an agreement whereby *A* is to construct and install the synthetic oil converter for a total purchase price of 18,000x dollars. In payment for the converter, *P* issued *A* a ten-year interest-bearing nonrecourse note in the principal amount of 18,000x dollars ("Purchase Note"). Principal and interest at 10 percent are payable out of *P*'s net cash flow, beginning on September 1, 1980. If net cash flow is inadequate to meet the annual installment, payment is not due until there is sufficient cash flow, but no later than 1990. The Purchase Note is secured only by the synthetic oil converter.

P has 100 limited partners. Each limited partner acquired its partnership interest for a total purchase price of 200x dollars, paid with 20x dollars in cash and a 180x dollar written obligation to repay a pro rata portion of the principal of the Purchase Note in six equal annual installments, with interest, starting September 1, 1980. Principal and interest on the written obligations, however, will be paid by the limited partners only from cash distributions from *P* that result from the production activities.

LAW AND ANALYSIS

Section 1011(a) of the Internal Revenue Code provides that, in general, the adjusted basis for determining gain or loss from the sale or disposition of property, whenever acquired, will be the basis determined under setcion 1012, adjusted as provided in section 1016.

Section 1012 of the Code provides that, in general, the basis of property will be its cost.

Section 722 of the Code provides that the basis of an interest in a partnership acquired by a contribution of

property, including money, to the partnership will be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution.

Section 38 of the Code allows a credit against federal income tax for qualified investment in "section 38 property" as defined in section 48(a)(1). Pursuant to section 48(l), for the period beginning on October 1, 1978 (and ending on December 31, 1982), any energy property, as defined in section 48(l)(2), will be treated as "section 38 property." The amount of the credit will be equal to the sum of the percentages, set forth in section 46(a)(2), of the qualified investment. Section 46(c) provides that the qualified investment is the aggregate of the applicable percentages, determined under section 46(c)(2), of the basis of each new section 38 property placed in service by the taxpayer during the taxable year.

Section 1.46-3(c)(1) of the Income Tax Regulations provides that the basis of any new section 38 property will be determined under the general rules for determining the basis of property and, therefore, the basis of property would generally be its cost.

An obligation, the payment of which is so speculative as to create a contingent liability, cannot be included in the basis of property. *Denver & Rio Grande Western R.R. Co. v. United States,* 505 F.2d 1266 (Ct. Cl. 1974); *Columbus and Greenville Railway Co. v. Commissioner,* 42 T.C. 834 (1964), *aff'd per curiam,* 358 F.2d 294 (5th Cir. 1966); *Albany Car Wheel Co. v. Commissioner,* 40 T.C. 831 (1963), *aff'd per curiam,* 333 F.2d 653 (2d Cir. 1964); Rev. Rul. 77-110, 1977-1 C.B. 58; and Rev. Rul. 78-29, 1978-1 C.B. 62. The Court of Appeals for the Third Circuit, in *Pierce Estates v. Commissioner,* 195 F.2d 475 (3d Cir. 1952), indicated that a liability is contingent of it is dependent upon the happening of a subsequent event, such as the earning of profits.

There must be adequate net cash flow before *P* has to make a payment of principal of the Purchase Note. Considering the nature of this new business and the fact that *A*'s process is commercially untested, among other factors, no realistic predictions can be made about the success of the converter and therefore the net cash flow of *P* for any year. Because payment under the Purchase Note is contingent upon future cash flow the Purchase Note is a contingent liability.

A limited partner's written obligation to repay a portion of the principal of the Purchase Note also is a contingent liability because it is nothing more than a mere promise to repay a contingent liability and its payment is contingent upon the receipt of cash distributions from *P*. Furthermore, the contribution of a partner's written obligation, its personal note, to the partnership does not increase the basis of the partner's interest under section 722 of the Code because the partner has a zero basis in the written obligation. Payments on the written obligation are added to the partner's basis in the partnership as the payments are actually made.

HOLDINGS

(1) The liability created by the Purchase Note may not be included in *P*'s basis in the synthetic oil converter for purposes of regular and energy investment credits.

(2) The liability created by the written obligation of a limited partner may not be included in the basis of the limited partnership interest.

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26 CFR 1.1012-1: Basis of property.

Whether a parent corporation is in receipt of a constructive distribution from its subsidiary when the subsidiary purchases the parent's stock from a third party and the effect, if any, that such transaction will have on the parent's adjusted basis in the subsidiary's stock and the determination of the subsidiary's basis in the parent's stock acquired in the transaction. See Rev. Rul. 80-189, page 106.

26 CFR 1.1012-1: Basis of property.

Treatment of a transfer of corporate stock by controlling shareholders to employees of the corporation. See Rev. Rul. 80-196, page 32.

Section 1016.—Adjustments to Basis

26 CFR 1.1016-3: Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913.

Automobiles used in a trade or business by employees or self-employed individuals. See Rev. Proc. 80-32, page 767.

Part III.—Common Nontaxable Exchanges

Section 1031.—Exchange of Property Held for Productive Use or Investment

26 CFR 1.1031(d)-1: Property acquired upon a tax-free exchange.

Federal income tax consequences of the acquisition of stock pursuant to the exercise of a nonqualified stock option where payment is made with shares of the same corporation's stock that were previously acquired pursuant to the exercise of a qualified stock option. See Rev. Rul. 80-244, page 234.

Section 1033.—Involuntary Conversions

26 CFR 1.1033(a)-2: Involuntary conversion into similar property, into money or into dissimilar property.

Nonrecognition of gain; timber damaged by storm; voluntary sale. The nonrecognition of gain provisions of section 1033(a) of the Code are applicable to proceeds received from the voluntary sale of timber downed by high winds, earthquake, or volcanic eruption when the proceeds are used to purchase other standing timber; Rev. Rul. 72-372 revoked.

Rev. Rul. 80-175

ISSUE

Reconsideration has been given to Rev. Rul. 72-372, 1972-2 C.B. 471, which deals with the application of the nonrecognition of gain provisions

of section 1033(a) of the Internal Revenue Code with respect to the proceeds received from a sale of timber downed by high winds.

FACTS

In Rev. Rul. 72-372 the taxpayer was the owner of timberland. As a result of a hurricane, a considerable number of trees were uprooted. The timber was not insured, and once downed, was subject to decay or being rendered totally worthless by insects within a relatively short period of time. The taxpayer was, however, able to sell the damaged timber and realized a gain from such sale. The proceeds of the sale were used to purchase other standing timber.

Rev. Rul. 72-372 holds that a gain from a voluntary sale of such timber under these circumstances does not qualify for nonrecognition of gain under section 1033(a) of the Code because there was no direct conversion into money nor was such sale precipitated by the threat or imminence of requisition or condemnation.

LAW AND ANALYSIS

Section 1033(a)(1) of the Code provides rules under which no gain is to be recognized where property is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted. Section 1.1033(a)-1(a) of the Income Tax Regulations provides that an involuntary conversion may be, among other things, the result of the destruction of property in whole or in part.

Section 1033(a)(2)(A) of the Code provides for the nonrecognition of gain if property is involuntarily converted into money and that money is invested within a specified period of time, in other property similar or related in service or use to the property so converted.

Section 1033(a)(2)(B) of the Code states the time period within which converted property must be replaced. That time period commences with the date of the disposition of the converted property. The term "disposition of the converted property" is defined by section 1033(a)(2)(E)(ii) to mean the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation. Thus, the term "disposition of the converted property" is defined for the purpose of establishing the beginning of the replacement period and not for the purpose of defining the term "involuntary conversion." Section 1.1033(a)-1(a) of the regulations defines the latter term to include the destruction of property. In the present case, the taxpayer's property was destroyed by a hurricane.

In *S. H. Kress and Co. v. Commissioner,* 40 T.C. 142, 153 (1963), *acq.,* 1965-1 C.B. 4 the Tax Court of the United States stated that the basic purpose of section 1033 of the Code is to allow the taxpayer to replace his property without realization of gain "where he is compelled to give up such property because of circumstances beyond his control." In *S & B Realty Co. v. Commissioner,* 54 T.C. 863, 871 (1970), *acq.,* 1970-2 C.B. xxi the court stated that "When Congress enacted sections 214(a)(12) and 234(a)(14) of the Revenue Act of 1921 [the predecessors of section 1033] it obviously intended to grant a measure of tax relief to those who were compelled by the specified circumstances to convert their property into cash." The involuntary conversion provisions allow recognition of gain to be postponed on the theory that the taxpayer was compelled to dispose of property and had no economic choice in the matter. The taxpayer in the instant case was compelled by the destruction of the timber to sell it for whatever the taxpayer could or suffer a total loss. Consequently, the facts of this case place it within the ambit of those circumstances contemplated by the provisions of section 1033.

Both the Internal Revenue Service and the Tax Court have considered this application of section 1033(a) of the Code to sales of property not threatened by requisition or condemnation. Rev. Rul. 54-395, 1954-2 C.B 143, holds that any gain from the sale of poisoned cattle at salvage value or in settlement of damage claims against manufacturers of contaminated feed pellets was subject to the involuntary conversion relief provisions. In *Masser v. Commissioner,* 30 T.C. 741 (1958), *acq.,* 1959-2 C.B. 5 the court considered this application of section 1033 to a sale of property that was part of an economic unit, a portion of which was sold under threat of condemnation. It found that the sale of both pieces of property constituted an involuntary conversion because it was no longer practical to use the remaining property for the purpose intended.

The present case and *Masser* share three common features. First, an event specified by the statute as one that may result in an involuntary conversion occurred. Second, that event rendered the property unfit or impractical for its intended use. Third, the property was sold and the proceeds invested in similar property. Furthermore, the argument for applying section 1033 of the Code to the instant case is stronger than in *Masser.* In the instant case, the property sold was the very property directly affected by the casualty while in *Masser* the property sold was only indirectly affected by the condemnation.

In *C. G. Willis, Inc. v. Commissioner,* 41 T.C. 468 (1964), the court considered the application of section 1033 of the Code to the proceeds from the sale of a partially damaged ship. The ship was repairable; however, the owners chose to sell the ship (at a gain) rather than make the necessary repairs. The proceeds from the sale, along with the insurance proceeds for the repair cost, were invested in a barge that would cover the same ports and carry the same kind of cargo as the damaged ship. The

ship owners claimed nonrecognition treatment for this transaction under the provisions of section 1033(a).

In denying the claim for nonrecognition treatment, the court stated that "Involuntary conversion, within the meaning of section 1033(a) of the Code, means that the taxpayer's property, through some outside force or agency beyond his control, is no longer useful or available to him for his purposes." The court concluded that "It cannot be said that the sale of the unrepaired ship was a result of its partial destruction. The sale was the result of a business decision by the owner that the money equivalent of the unrepaired ship would serve its business interests better."

In the present case, the downed timber was not repairable and was generally no longer useful to the taxpayer in the context of its original objective. The destruction caused by the hurricane forced the taxpayer to sell the downed timber for whatever price it could get. Unlike the situation in *Willis,* the sale of the downed timber was dictated by the damage caused by the hurricane.

HOLDING

Upon reconsideration of Rev. Rul. 72-372, and in light of the court decisions cited above, it is now the Service's position that the nonrecognition of gain provisions of section 1033 (a) of the Code are applicable with respect to the proceeds received from the sale of timber downed by high winds. The same treatment would be accorded if, for example, the timber in question was downed as a consequence of an earthquake or a volcanic eruption.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 72-372 is revoked.

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26 CFR 1.1033(f)-1: Condemnation of real property held for productive use in trade or business or for investment.

Involuntary conversions; severance-damage award reinvested; similar property. Part of a severance-damage award was used to demolish a building leased to retail stores and to construct a warehouse for lease in its place. The remaining part of the award was used to purchase another parcel of land and to construct an office building thereon. The business risks and responsibilities in managing the warehouse and office building were substantially similar to those under the leases with the retail stores. The investments constitute reinvestments in property similar or related in service or use for purposes of deferring the recognition of gain under section 1033 (a)(2)(A) of the Code.

Rev. Rul. 80-184

ISSUES

(1) May a taxpayer under section 1033(a)(2)(A) of the Internal Revenue Code defer the recognition of gain realized as a result of a severance-damage award for the part of such award used to demolish a building on the retained land that was leased to retail stores and to construct in its place a warehouse for lease?

(2) May a taxpayer under section 1033(a)(2)(A) of the Code defer the recognition of gain realized as a result of a severance-damage award for the part of such award used to purchase another parcel of land and to construct an office building for lease on it if the taxpayer retains the damaged land for which the severance-damage award was received?

FACTS

The taxpayer owned a parcel of land in a business district. The land contained a building owned by the taxpayer that was leased to retail stores.

The state condemned the entire frontage of the taxpayer's land for construction of a highway interchange. The state paid 1,000*x* dollars to the taxpayer for this condemnation. Of the 1,000*x* dollars paid to the taxpayer, 350*x* dollars was paid for the property actually taken by the state. The remaining 650*x* dollars represented severance damages to compensate the taxpayer because the rest of the taxpayer's land was no longer readily accessible and therefore was no longer suited to the business that had operated there.

Within the prescribed period of time set forth in section 1033(a)(2)(B) of the Code, the taxpayer used 500*x* dollars of the severance damages to demolish the existing building and construct a warehouse on the remaining land. The taxpayer leased the warehouse to a warehouse operator. It was not economically feasible or practical to invest any more funds in constructing additional rental structures on the remaining property. Therefore, the taxpayer used the 500*x* dollar balance of the condemnation award (which included 150*x* dollars of the 650*x* dollars severance damages) to acquire another parcel of land and to construct an office building on it that it leased to another person. The business risks and the taxpayer's responsibilities in the way of management, services and relations to the tenants under the leases involving the warehouse and the office building are substantially similar to the risks and responsibilities under the former leases involving the retail stores.

LAW AND ANALYSIS

Section 1033(a) of the Code provides that if property, as a result of a condemnation, is compulsorily or involuntarily converted into money, the gain (if any) shall be recognized except to the extent provided in section 1033(a)(2)(A).

Section 1033(a)(2)(A) of the Code provides that if during a specified period the taxpayer purchases other property similar or related in service or use to the property so converted, at the election of the taxpayer

the gain shall be recognized only to the extent that the amount realized on the conversion exceeds the cost of such other property.

Section 1033(g)(1) of the Code provides that for purposes of section 1033(a), if real property held for productive use in trade or business or for investment is (as the result of its seizure, requisition, or condemnation, or threat or imminence thereof) compulsorily or involuntarily converted, property of a like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted. The 350*x* dollars received for the land actually taken was invested in land and the construction of a building which is like-kind property, and the taxpayer can defer the recognition of gain attributable to these proceeds.

Severance damages are compensation in addition to the award paid for the property actually condemned when the value of the retained property has decreased as a result of the condemnation. Rev. Rul. 68-37, 1968-1 C.B. 359, provides that an award of severance damages reduces the basis of the retained property and any amount received in excess of basis is treated as gain.

The recognition of gain realized as a result of an award of severance damages may be deferred under section 1033(a)(2)(A) if, assuming the other requirements of section 1033 are met, the money reinvested restores the retained property to its former use. See, for example, Rev. Rul. 72-433, 1972-2 C.B. 470; Rev. Rul. 69-240, 1969-1 C.B. 199; Rev. Rul. 60-69, 1960-1 C.B. 294; Rev. Rul. 271, 1953-2 C.B. 36.

Issue 1

The specific question raised by Issue 1 is whether this part of the severance-damage award was used to restore the retained property to its former use or to change the use of the retained property.

Rev. Rul. 64-237, 1964-2 C.B. 319, provides that in considering whether replacement property acquired by an investor is similar in service or use to the converted property, attention will be directed primarily to the similarity in the relationship of the services or uses that the original and replacement properties have to the taxpayer-owner. In applying this test, a determination will be made as to whether the properties are of a similar service to the taxpayer, the nature of the business risks connected with the properties, and what such properties demand of the taxpayer in the way of management, services and relations to his tenants. *See also Liant Record, Inc. v. Commissioner,* 303 F.2d 326 (2d Cir. 1962).

In the owner-investor situation the important factor is the similarity in the taxpayer's relationship to the use of the original and replacement properties. This relationship can be sufficiently similar even though the use by the respective tenants changes. See, for example, Rev. Rul. 71-41, 1971-1 C.B. 223. However, the fact that the taxpayer leases both properties is not alone sufficient to justify nonrecognition of the gain because both properties might be leased yet represent materially different investments to the owner-investor. See Rev. Rul. 76-391, 1976-2 C.B. 243.

In the present situation, the taxpayer's risks and responsibilities remained substantially the same despite the change in the nature of the tenants. Therefore, the reinvestment of the severance damages in the retained property to demolish the building leased to retail stores and to construct in its place a warehouse for lease constitutes a reinvestment of the severance damages in property similar or related in service or use to the damaged property.

Issue 2

The remaining part of the severance-damage award was used to purchase another parcel of land and to improve that land by constructing an office building thereon. The business risks and the taxpayer's responsibilities under the leases involving the office building are substantially similar to the risks and responsibilities under the former leases involving the retail stores.

Rev. Rul. 72-433 indicates that if it is necessary for the taxpayer to purchase additional land in order to restore the volume of production that existed before the involuntary granting of an easement, such use of the proceeds will qualify as an investment in property similar or related in service or use. Similarly, in this case, the taxpayer could only restore his original rental capacity by purchasing additional land and constructing rental units thereon. Since the taxpayer restored the damaged land to its maximum similar or related use, the remaining part of the severance-damage award can be invested in other property to return the taxpayer to his pre-damage business position, and such property will be considered similar or related in service or use.

HOLDINGS

(1) Under section 1033(a)(2)(A) of the Code the taxpayer may defer the recognition of gain realized as a result of a severance-damage award for the part of such award used to demolish a building on the retained land that was leased to retail stores and to construct in its place a warehouse for lease.

(2) Under section 1033(a)(2)(A) of the Code the taxpayer may defer the recognition of gain realized as a result of a severance-damage award for the part of such award used to purchase another parcel of land and to construct an office building for lease on it even though the taxpayer

retains the damaged land for which the severance-damage award was received.

Section 1034.—Rollover of Gain on Sale of Principal Residence

26 CFR 1.1034-1: Sale or exchange of residence.

Residence; replacement period; suspension of running of time; Puerto Rico. An individual who is transferred to Puerto Rico for a two-year period does not qualify under section 1034(k) of the Code for the suspension of the running of the period of time within which a new residence must be purchased in order for the nonrecognition of gain provisions to apply to the gain from the sale of the individual's old residence.

Rev. Rul. 80-326

ISSUE

Does a taxpayer, under the circumstances described below, qualify under section 1034(k) of the Internal Revenue Code for the suspension of the running of the period of time within which a new residence must be purchased in order for the nonrecognition provisions of section 1034(a) to apply to the gain realized from the sale of an old residence?

FACTS

The taxpayer, a civilian employee of the federal government, was transferred to the Commonwealth of Puerto Rico for a two-year tour of duty. Prior to the transfer, the taxpayer sold the taxpayer's principal residence and realized a gain from the transaction. The taxpayer proposes to apply the nonrecognition provisions of section 1034(a) of the Code to the gain realized from the sale of the principal residence since the taxpayer plans to purchase a replacement residence at a cost in excess of the adjusted sales price of the old residence within 18 months after the completion of the taxpayer's tour of duty in the Commonwealth of Puerto Rico.

LAW AND ANALYSIS

Section 1034(a) of the Code provides that if property ("old residence") used by the taxpayer as a principal residence is sold by the taxpayer and, within a period beginning 18 months before the date of such sale and ending 18 months after such date, property ("new residence") is purchased and used by the taxpayer as a principal residence, gain (if any) from such sale shall be recognized only to the extent that the taxpayer's adjusted sales price (as defined in section 1034(b)) of the old residence exceeds the taxpayer's cost of purchasing the new residence.

Section 1034(k) of the Code provides that the running of any period of time specified in section 1034(a) shall be suspended during any time that the taxpayer (or the taxpayer's spouse if the old residence and the new residence are each used by the taxpayer and the taxpayer's spouse as their principal residence) has a tax home (as defined in section 913(j)(1)(B)) outside the United States after the date of the sale of the old residence; except that any such period of time as so suspended shall not extend beyond the date four years after the date of the sale of the old residence.

Section 913(j)(1)(B) of the Code provides that an individual shall not be treated as having a tax home in a foreign country for any period for which the taxpayer's abode is within the United States.

Section 913(j)(1)(E) of the Code provides that the term "United States," when used in a geographical sense, includes possessions of the United States.

Section 5b.913-3(d) of the Temporary Income Tax Regulations provides that the term "foreign country" means any territory under the sovereignty of a government other than that of the United States. It does not include a possession or territory of the United States.

For purposes of section 1034(k) of the Code the Commonwealth of Puerto Rico is treated as a possession or territory of the United States. Thus, an individual residing in Puerto Rico is not considered to have a tax home outside the United States within the meaning of that section. See section 7701(c), which provides that for purposes of the Internal Revenue Code the term "possession of the United States" generally includes the Commonwealth of Puerto Rico, and Rev. Rul. 78-23, 1978-1 C.B. 79, which holds that for purposes of section 274(h), relating to deductions of an individual for attending foreign conventions, the Commonwealth of Puerto Rico is treated as a possession of the United States.

HOLDING

The taxpayer does not qualify under section 1034(k) of the Code for the suspension of the running of the period of time within which a new residence must be purchased in order for the nonrecognition provisions of section 1034(a) to apply to the gain realized from the sale of the taxpayer's old residence.

Section 1036.—Stock for Stock of Same Corporation

26 CFR 1.1036-1: Stock for stock of the same corporation.
(Also Sections 83, 421, 422, 425, 1031; 1.83-7, 1.421-8, 1.422-1, 1.425-1, 1.1031(d)-1.)

Employee stock options; payment with stock. An explanation is provided of the federal income tax consequences of the acquisition of stock pursuant to the exercise of a nonqualified stock option and payment for the stock with identical shares of the corporation's stock that were previously acquired pur-

suant to the exercise of a qualified stock option.

Rev. Rul. 80-244

ISSUE

What are the federal income tax consequences of the acquisition of stock pursuant to the exercise of a nonqualified stock option, if payment for the stock is made with shares of the same corporation's stock that were previously acquired pursuant to the exercise of a qualified stock option?

FACTS

A corporation, whose outstanding stock consists of a single class of common stock, has a qualified stock option plan described in section 422 of the Internal Revenue Code and a nonqualified stock option plan. An optionee who exercises an option granted under the nonqualified plan may pay for the shares (1) in cash, (2) with previously acquired shares having a fair market value equal to the option price, or (3) with cash and previously acquired shares having a fair market value less than the option price.

On May 1, 1977, an employee of the corporation exercised a qualified stock option and acquired 1,000 shares of stock for $2x$ dollars. The fair market value of the stock steadily increased, and on July 1, 1979, when the employee exercised a nonqualified option (which was granted after April 21, 1969, and did not have a readily ascertainable fair market value when granted) for 2,000 shares of stock, the 1,000 shares of stock acquired pursuant to the qualified option had a fair market value of $6x$ dollars. The employee paid for the 2,000 shares of stock received pursuant to the nonqualified option with the 1,000 shares of identical stock acquired in 1977 when the employee exercised the qualified option. The nonqualified option price for the 2,000 shares of stock was $6x$ dollars; however, the fair market value was $12x$ dollars. Thus, the employee exchanged 1,000 shares of stock with a basis of $2x$ dollars and a fair market value of $6x$ dollars for 2,000 shares of stock with a fair market value of $12x$ dollars.

LAW

Section 421(a)(1) of the Code provides that if a share of stock is transferred to an individual in a transfer in respect of which the requirements of section 422(a) are met, no income results when the share is transferred to the individual upon the exercise of the option with respect to that share.

Section 422(a) of the Code provides that section 421(a) applies with respect to the transfer of a share of stock to an individual pursuant to the exercise of a qualified stock option if no disposition of the share is made by the employee within the three-year period beginning on the day after the day of the transfer of the share.

Section 1.421-8(b) of the Income Tax Regulations provides that a disposition of a share of stock, acquired by the exercise of a statutory option, before the expiration of the applicable holding period, makes section 421 of the Code inapplicable to the transfer of the share. The income attributable to the transfer is treated by the individual as income received in the taxable year in which the disposition occurs.

Section 1.421-8(b)(2) of the regulations provides that section 421 of the Code is not made inapplicable by a transfer before the expiration of the applicable holding period if the transfer is not a disposition of stock as defined in section 425(c).

Section 425(c) of the Code provides that the term "disposition" includes a sale, exchange, gift, or a transfer of legal title, but does not include an exchange to which section 1036 applies.

Section 1036(a) of the Code provides that no gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

Section 1031(d) of the Code provides that if property is acquired in an exchange described in section 1036(a), the basis shall be the same as that of the property exchanged.

Section 83(a) of the Code provides that, if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of (1) the fair market value of the property at the first time the rights of the person having the beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount (if any) paid for the property, is included in the gross income of the person who performed the services.

Section 83(e) of the Code provides that section 83 does not apply to the transfer of an option without a readily ascertainable fair market value. However, under section 1.83-7(a) of the regulations, if such option is exercised, section 83(a) applies to the transfer of property pursuant to the exercise, and the employee realizes compensation upon the transfer at the time and in the amount determined under section 83(a).

HOLDINGS

The exercise of the nonqualified stock option caused the realization of $6x$ dollars of income under section 83(a) of the Code.

(1) The exchange of $6x$ dollars in value of common stock (1,000 shares) for $6x$ dollars in value of common stock (1,000 shares) qualifies for nonrecognition of gain under section 1036 of the Code. Pursuant to section 1031(d), the employee-shareholder's basis in this 1,000 shares of stock received pursuant to the exercise of the nonqualified option is the same as the employee-shareholder's basis in the 1,000 shares of stock exchanged there-

for ($2x$ dollars). Therefore, a disposition within the meaning of section 425(c) did not occur because section 1036 applies to the exchange of the 1,000 shares of stock that were acquired in 1977 pursuant to the exercise of the qualified option, and the employee-shareholder did not receive income pursuant to section 1.421-8(b) of the regulations.

(2) The additional 1,000 shares of common stock received by the employee-shareholder are compensation for services under section 83(a) of the Code. Accordingly, the employee-shareholder must include in gross income the fair market value ($6x$ dollars) of the additional 1,000 shares of stock received pursuant to the exercise of the nonqualified stock option. The employee-shareholder's basis in the additional 1,000 shares of stock is the same as the amount included in gross income ($6x$ dollars).

Subchapter P.—Capital Gains and Losses
Part I.—Treatment of Capital Gains

Section 1202.—Deduction for Capital Gains

26 CFR 1.1202-1: Deduction for capital gains.
(Also Section 1375; 1.1375-1.)

Capital gain deduction; small business corporation; taxable year including November 1, 1978. An example of the computation of the capital gain deduction is provided for an electing small business corporation that had a taxable year that included November 1, 1978 and that had net capital gains both before and after that date.

Rev. Rul. 80-178

ISSUE

How is the capital gain deduction provided by section 1202 of the Internal Revenue Code determined under the circumstances described below?

FACTS

X, an electing small business corporation within the meaning of section 1371 of the Code, files its returns on a calendar year basis. In 1978 *X* had a net capital gain of $100x$ dollars, $60x$ dollars of which resulted from sales or exchanges prior to November 1, 1978. *X*'s taxable income (including capital gains) for 1978 was $80x$ dollars. *X*'s election under section 1372(a) has been in effect for each of its taxable years, and *X* did not have any long-term capital gain in 1978 attributable to property with a substituted basis. Thus, section 1378 does not apply.

LAW

Section 1202(a) of the Code provides that if for any taxable year a taxpayer other than a corporation has a net capital gain, 60 percent of the amount of the net capital gain shall be a deduction from gross income.

Section 1202(c)(1) of the Code provides that if for any taxable year beginning before November 1, 1978, and ending after October 31, 1978, a taxpayer other than a corporation has a net capital gain, the deduction under section 1202(a) shall be the sum of 60 percent of the lesser of the net capital gain for the taxable year, or the net capital gain taking into account only sales and exchanges after October 31, 1978, plus an amount computed in accordance with section 1202(c)(2), that is, 50 percent of the excess of the net capital gain for the taxable year, over the amount of net capital gain taken into account under section 1202(c)(1).

Section 1375(a)(1) of the Code provides that the amount includible in the gross income of a shareholder as dividends (including amounts treated as dividends under section 1375(b)) from an electing small business corporation during any taxable year of the corporation, to the extent that such amount is a distribution of property out of earnings and profits of the taxable years as specified in section 316(a)(2), shall be treated as a long-term capital gain to the extent of the shareholder's pro rata share of the corporation's net capital gain for such taxable year. For purposes of this paragraph, such net capital gain shall be deemed not to exceed the corporation's taxable income (computed as provided in section 1373(d)) for the taxable year.

Section 104(a)(2)(C) of the Technical Corrections Act of 1979, Pub. L. 96-222, 1980-1 C.B. 499, makes clear that for purposes of determining the proper period of the capital gain income taxable to a shareholder of an electing small business corporation, reference shall be made to when the gain was realized by the corporation.

HOLDING

In this case *X*'s taxable income for 1978 ($80x$ dollars) is less than *X*'s net capital gain ($100x$ dollars). Therefore pursuant to section 1375(a)(1) of the Code the amount of *X*'s net capital gain includible in the income of the shareholders is limited to $80x$ dollars. The $80x$ dollars of capital gain represents a pro rata portion of pre-November 1, 1978 gain and post-October 31, 1978 gain. $48x$ dollars $\left(\frac{60x}{100x} \times 80x = 48x\right)$ is pre-November 1, 1978 gain and $32x$ dollars $\left(\frac{40x}{100x} \times 80x = 32x\right)$ is post-October 31, 1978 gain for puropses of computing the capital gain deduction allowable to the shareholders of *X* under section 1202 of the Code.

Part III.—General Rules for Determining Capital Gains and Losses

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Section 1222.—Other Terms Relating to Capital Gains and Losses

26 CFR 1.1222-1: Other terms relating to capital gains and losses.

T.D. 7728 [1]

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; PART 3.—CAPITAL CONSTRUCTION FUND; SUBCHAPTER D, PART 53.—FOUNDATION EXCISE TAXES

Holding period required for treatment of long-term capital gain or long-term capital loss; changes in terms relating to transactions in capital assets

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to changes in the holding period required for gains or losses on transactions in capital assets to be treated as long-term capital gains or long-term capital losses and to changes in certain terms relating to transactions in capital assets. Changes to the applicable tax law were made by the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1]. The regulations affect the tax treatment of sales or exchanges of capital assets and provide the public with needed guidance.

DATES: The amendments pertaining to the change in the holding period from 6 months to 9 months are effective for taxable years beginning in 1977. The amendments pertaining to the change in the holding period from 9 months to 1 year are effective for taxable years beginning after December 31, 1977. The amendments pertaining to the new terms "capital gain net income" and "net capital gain" are effective for taxable years beginning after December 31, 1976.

[1] This publication of the Treasury Decision contains the complete text of the amendments to the regulations. The instructions for modifying the notice of proposed rulemaking have been omitted.

FOR FURTHER INFORMATION CONTACT: Claudine Ausness of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. (Attention: CC:LR:T (202-566-3459)).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On April 9, 1980, the Federal Register published proposed amendments to the Income Tax Regulations, the Regulations on Capital Construction Fund, and the Regulations on Foundation Excise Taxes (26 CFR Parts 1, 3, and 53) under numerous sections of the Internal Revenue Code of 1954 (45 FR 24205). These amendments were proposed to conform the regulations to sections 1402(a)(1) and (2), and 1901(a)(136)(A) and (B) of the Tax Reform Act of 1976 (90 Stat. 1731, 1787) [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1, 207, 263]. A public hearing was neither requested nor held. One written comment was received suggesting a technical amendment to the proposed regulation. The proposed amendments are adopted by this Treasury decision with one technical change.

EXPLANATION

Section 1402(b)(3) of the Tax Reform Act of 1976 [*supra* at 209] makes a technical amendment to section 631(a) (relating to gain or loss in the case of timber) by deleting the requirement that the holding period be satisfied before the beginning of the taxable year in which the timber was cut. Technical amendments are made to § 1.631(a)(4) and § 1.631-1(b)(1) to reflect this change.

The regulations adopted by this Treasury decision impose no new reporting burdens or recordkeeping requirements. Evaluation of the effectiveness of these regulations will be based upon comments received from members of Congress, offices within Treasury and the Internal Revenue Service, other governmental agencies, and the public.

DRAFTING INFORMATION

The principal author of these regulations is Claudine Ausness of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing these regulations, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, the following amendments to 26 CFR Parts 1, 3, and 53 are hereby adopted:

INCOME TAX REGULATIONS (26 CFR Part 1)

Paragraph 1. The following regulation sections are amended by substituting "1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977)" for "6 months" and "six months" each place "6 months" or "six months" appears in such regulation sections:

1. Section 1.123-1(a)(3).
2. Section 1.166-5(a)(2).
3. Section 1.170A-4(b)(1).
4. Section 1.272-1(b)(3).
5. Section 1.333-5(d)(1) and (d)(2).
6. Section 1.341-4(a).
7. Section 1.341-6(b)(2)(iii) and (b)(5).
8. Example (1) of § 1.357-2(b).
9. Section 1.421-5(a)(1), (c)(2), (d)(1) and (e).
10. Section 1.423-1(a)(1).
11. Section 1.424-1(a)(1)(i).
12. That portion of § 1-614-6(b) other than the example.
13. Section 1.631-1(a)(4), (b)(1) and (d)(4).

14. Section 1.631-2(a)(1), (a)(2), (b)(1), (c)(2), (d)(1), (d))(3)(i) and (d)(3)(iii).

15. Section 1.631-3(a)(1), (a)(2), (b)(1) and (c)(3).

16. Section 1.691(a)(3)(b)(1).

17. Section 1.702-1(a)(1) and (a)(2).

18. Section 1.817-2(b)(1)(i), (b)(3)(i) and (b)(3)(ii).

19. Section 1.852-4(b)(1), (b)(2)(i), (b)(3) and (d)(1).

20. Section 1.856-2(c)(1)(iii)(*a*).

21. Section 1.857-4(b) and (c)(1).

22. Section 1.1012-1(e)(3), (e)(4)(i) and (e)(4)(ii).

23. Section 1.1222-1(a) and (c).

24. Section 1.1223-1(j).

25. Section 1.1231-1(a), (b), (c)(1), (c)(2), (c)(5), (e)(1) and (e)(3).

26. Section 1.1232-1(a).

27. Section 1.1232-3(a)(1) and (b)(1)(ii).

28. Section 1.1233-1(a)(4), (c)(2), (c)(4), (c)(5) and (e).

29. Section 1.1234-2(a).

30. Section 1.1235-1(a).

31. Section 1.1235-2(d)(2).

32. Section 1.1245-4(a)(4).

33. Section 1.1247-3(b)(4) and (d)(1).

34. Section 1.1248-1(e)(3).

35. Section 1.1251-3(a)(1)(i)(*a*).

36. Section 1.1385-1(c)(2)(ii)(*a*).

Par. 2. Paragraphs (a)(2) and (b)(1)(i) of § 1.421-5, paragraph (k)(1)(i) of § 1.423-2, and paragraph (b)(1)(i) of § 1.424-2 are amended by substituting "1-year (6-month for taxable years beginning before 1977; 9-month for taxable years beginning in 1977)" for "6-month" each place "6-month" appears in such regulation sections.

Par. 3. Paragraph (e)(3) of § 1.1012-1 is amended by substituting "1-year (6-month for taxable years beginning before 1977; 9-month for taxable years beginning in 1977)" for "6-months" each place "6-months" appears in such paragraph.

Par. 4. The caption of paragraph (e)(3)(iii) of § 1.1012-1 is amended by substituting "*1-year*" for "*6-months*".

Par. 5. The caption of paragraph (d) of § 1.1247-3 is amended by substituting "*1 year*" for "*6 months.*"

Par. 6. The following regulation sections are amended by substituting "capital gain net income (net capital gain for taxable years beginning before January 1, 1977)" for "net capital gain" and "net capital gains" each place "net capital gain" or net "capital gains" appears in such regulation sections.

1. Section 1.381(c)(3)-1(c)(1), (d)(1), (d)(1)(ii), (d)(2), (e)(1), (e)(5), (e)(6), and (e)(7).

2. Section 1.852-10(b)(1).

3. Section 1.1202-1(a).

4. Section 1.1212-1(a)(2)(i), (a)(3)(ii), (a)(3)(iii)(*a*), and (a)(3)(iii)(*f*).

5. Section 1.1222-1(d)(1).

6. Section 1.1248-4(d)(5)(ii) and (g)(2).

7. Section 1.1502-4(d)(1)(ii).

8. Section 1.1502-11(a)(3).

9. Section 1.1502-15(a)(1).

10. Section 1.1502-21(f)(2).

11. Section 1.1502-22(a)(1), (c)(2)(i) and (d)(2)(i).

12. Section 1.1502-25(c)(2)(ii).

13. Section 1.1502-27(b)(2).

14. Section 1.1502-79(a)(3)(ii) and (b)(2)(i).

15. Section 1.1552-1(a)(1)(ii)(*b*).

Par. 7. The following regulation sections are amended by adding the parenthetical phrase "(capital gain net income for taxable years beginning after December 31, 1976)", directly after the phrases "net capital gain" and "net capital gains" each place the phrases "net capital gain" or "net capital gains" appears in such regulation sections:

1. Section 1.381(c)(3)-1(c)(4), (d)(4) and (e)(8).

2. Examples (3) and (5) of § 1.642(c)-3(c).

3. Example (2) of § 1.643(a)-6(b).

4. Examples (6), (7) and (8) of § 1.1211-1(b)(8).

5. Section 1.1212-1(a)(1)(i), examples (a), (b) and (c) of paragraph (a)(1)(ii), example (2) of paragraph (a)(2)(iii), examples (1), (2), (3), (4) and (5) of paragraph (a)(3)(iv), and example (7) of paragraph (b)(5).

6. Example (2) of § 1.1248-4(d)(5)(iii).

7. Examples (4) and (5) of § 1.1375-1(f).

8. Example (2) of § 1.1502-4(j).

9. Examples (1), (2), and (3) of § 1.1502-11(b)(6).

Par. 8. The captions of paragraphs (d)(1) and (e)(5) of § 1.381(c)(3)-1, of § 1.1502-22, and of paragraph (a)(1) of § 1.1502-22 are amended by substituting "*capital gain net income*" for "*net capital gain*" each place "*net capital gain*" appears in such captions.

Par. 9. The following regulation sections are amended by substituting "net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977)" for "net section 1201 gain" each place "net section 1201 gain" appears in such regulation sections:

1. Section 1.665(d)-1A(c)(2).

2. Section 1.1201-1(a)(1)(i), (a)(2)(i), (a)(4), (b)(1), (b)(2)(i), (b)(2)(ii)(*a*), (b)(2)(ii)(*b*), (e)(1) and (e)(2).

3. Section 1.1222-1(h).

4. Section 1.1348-2(d)(1).

Par. 10. The following regulation sections are amended by adding the parenthetical phrase "(net capital gain for taxable years beginning after December 31, 1976)" directly after the phrase "net section 1201 gain" each. place the phrase "net section 1201 gain" appears in such regulation sections:

1. Example (1) of §1.21-1(n).

2. Example (3) of § 1.514(b)-1(b)(1)(iii) and example (2) of paragraph (b)(3).

3. Section 1.1201-(a)(3)(i), (a)

(3)(ii)(*a*), (a)(3)(ii)(*b*), (a)(3)(iii), (a)(3)(iv), (b)(2)(iii) and examples (2), (3) and (4) of paragraph (g).

Par. 11. Example (1) of § 1.21-1(n) is amended by adding the parenthetical phrase "(net capital gain for taxable years beginning after December 31, 1976)" directly after the phrase "section 1201 gain".

Par. 12. Section 1.631-1 is amended as follows:

1. The first sentence of paragraph (a)(4) is amended by deleting the phrase "the beginning of the taxable year in which" and inserting in lieu thereof "when".

2. The first sentence of paragraph (b)(1) is amended by deleting the phrase "before the beginning of the taxable year" and inserting in lieu thereof "prior to when the timber is cut".

REGULATIONS ON CAPITAL CONSTRUCTION FUND
(26 CFR Part 3)

Par. 13. Paragraphs (c) and (d)(2) of § 3.4 are amended by substituting "1 year (6 months for taxable years beginning before 1977, 9 months for taxable years beginning in 1977)" for "6 months" each place "6 months" appears in such paragraphs.

REGULATIONS ON FOUNDATION EXCISE TAXES
(26 CFR Part 53)

Par. 14. Paragraphs (c)(1)(i) and (f)(1) of § 53.4940-1 are amended by substituting "capital gain net income (net capital gain for taxable years beginning before January 1, 1977)" for "net capital gain" each place "net capital gain" appears in such regulation section.

Par. 15. Example (2) of § 53.4940-1(f)(4) is amended by adding the parenthetical phrase "(capital gain net income for taxable years beginning after December 31, 1976)" directly after the phrase "net capital gain" each place the phrase "net capital gain" appears in such regulation section.

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved October 7, 1980.

EMIL M. SUNLEY,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 31, 1980, 8:45 a.m., and published in the issue of the Federal Register for November 3, 1980, 45 F.R. 72649).

Part IV.—Special Rules for Determining Capital Gains and Losses

Section 1237.—Real Property Subdivided for Sale

26 CFR 1.1237-1: Real property subdivided for sale.

Condominium conversions; capital gain v. ordinary income. Section 1237 of the Code does not apply to the conversion of rental units in an apartment building into condominiums and the sale of condominiums to the general public.

Rev. Rul. 80-216

ISSUE

Do the provisions of section 1237 of the Internal Revenue Code apply to the conversion of rental units in an apartment building into condominiums and the proposed sale of such units?

FACTS

In 1974, an individual taxpayer purchased land and a multi-unit apartment building situated on the land from an unrelated party. The apartments were rented and managed by the taxpayer until 1980, when they were converted to condominiums under applicable state law. No substantial improvements have been made to the land or the building. The taxpayer proposes to sell the condominium units to the general public.

The purchaser of a condominium unit will receive legal title in fee simple to a one-family unit in the multi-unit building coupled with ownership of an undivided interest in the land and all other parts of the building held in common with the other owners of the individual units.

The taxpayer has not previously held the apartment building for sale and does not currently hold any other real property for sale.

LAW AND ANALYSIS

Section 1237(a) of the Code provides that any lot or parcel that is part of a tract of real property in the hands of a taxpayer other than a corporation shall not be deemed to be held primarily for sale to customers in the ordinary course of trade or business at the time of sale solely because of the taxpayer having subdivided such tract for purposes of sale or because of any activity incident to such subdivision or sale if (1) such tract, or any lot or parcel thereof, had not previously been held by such taxpayer primarily for sale to customers in the ordinary course of trade or business and, in the same taxable year in which the sale occurs, such taxpayer does not so hold any other real property, (2) no substantial improvement that substantially enhances the value of the lot or parcel sold is made by the taxpayer on such tract while held by the taxpayer or is made pursuant to a contract of sale entered into between the taxpayer and the buyer, and (3) such lot or parcel, except in the case of real property acquired by inheritance or devise, is held by the taxpayer for a period of five years.

Section 1237(c) of the Code provides that the term "tract of real property" means a single piece of real property, except that two or more

pieces of real property shall be considered a tract if at any time they were contiguous in the hands of the taxpayer or if they would be contiguous except for the interposition of a road, street, railroad, stream, or similar property.

The terms lot or parcel that is part of a tract of real property contained in section 1237(a) of the Code refer only to land. Although section 1237 does permit certain improvements to a tract of real property without denying the application of its provisions to the subdivision and sale of lots and parcels from such tract, the provisions of section 1237 do not apply to the subdivision and sale of improvements. *See H.R. Rep. No. 1337,* 83d Cong., 2d Sess. A285 (1954).

HOLDING

The benefits of section 1237 of the Code do not apply to the conversion of the rental units in the apartment building into condominiums and the proposed sale of such condominium units to the general public.

Subchapter S.—Election of Certain Small Business Corporations as to Taxable Status

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Section 1372.—Election by Small Business Corporation

26 CFR 1.1372-1: Election by small business corporation.

Whether the profit-sharing plan of an electing small business corporation will fail to qualify because the plan document allows contributions to the plan to be made from accumulated profits (when there are no current profits), and whether the contributions are deductible under section 404(a)(3) of the Code. See Rev. Rul. 80-252, page 130.

Section 1374.—Corporation Net Operating Loss Allowed to Shareholders

26 CFR 1.1374-1: Net operating losses involving electing small business corporations.

Small business corporation; net operating loss; research and development agreement. Shareholders contributed cash to a small business corporation in exchange for stock, which was used as security to borrow, through nonrecourse notes, most of the cash contributed. The lender simultaneously sold the notes at face value to a research and development company that was hired by the small business corporation. For purposes of determining the limitation on a shareholder's net operating loss under section 1374(c) of the Code, the cash proceeds of a nonrecourse loan are not part of the basis of the stock received in exchange for such cash, because the various related steps of the financing arrangement are collapsed to show that no cash was actually advanced under the nonrecourse note.

Rev. Rul. 80-236

ISSUE

Are the proceeds received from the financing agreement described below to be included in the basis of stock of a shareholder of an electing small business corporation for purposes of computing a net operating loss allowed under section 1374(c)(2) of the Internal Revenue Code?

FACTS

In 1977, ten individuals formed *X*, a small business corporation, which elected under 1372(c) of the Code not to be subject to the tax imposed by Chapter 1 of the Code. In exchange for stock of *X*, each individual contributed $5,000 cash and $25,000 obtained by means of a financing agreement with *Y*, a commercial lending institution. The financing was evidenced by a nonrecourse note that was secured in part by each individual's stock in *X*.

In conjunction with and as an inducement and consideration for *Y*'s providing the $25,000 to each individual, *Z*, a corporation, agreed to purchase the nonrecourse notes from *Y* at a price equal to the unpaid balance of the notes plus accrued interest. As security for Z's obligation to purchase the notes from *Y*, *Z* delivered and assigned to *Y* a cerificate of deposit issued by *Y* to *Z* in the total amount of $250,000. Simultaneously with *Y*'s providing the $25,000 to each individual and *Z*'s agreement to purchase the nonrecourse notes from *Y*, *X* entered into a contract to have *Z* perform research and development on *X*'s behalf. The contract price for the research and development, all payable at the execution of the contract, was $300,000. *X* reported no income in 1977 and reported a net operating loss of $300,000.

LAW AND ANALYSIS

Section 1374(a) of the Code provides that a net operating loss of an electing small business corporation for any taxable year shall be allowed as a deduction from gross income of the shareholders.

Section 1374(c) of the Code provides, as a limitation, that a shareholder's portion of the net operating loss of an electing small business corporation for any taxable year shall not exceed the sum of—

(a) the adjusted basis of the shareholder's stock in the electing small business corporation, determined as of the close of the taxable year of the corporation, and

(b) the adjusted basis of any indebtedness of the corporation to the shareholder, determined as of the close of the taxable year of the corporation.

Section 174(a) of the Code provides that a taxpayer may treat research or experimental expenditures that are paid or incurred by him during the taxable year in connection with his trade or business as a deductible expense.

The substance, rather than the form, of a transaction in which a taxpayer is involved governs the tax consequences of the transaction. See, for example, *Commissioner v. Court Holding Company,* 324 U.S. 331 (1945), 1945 C.B. 58; *Helvering v.*

Clifford, 309 U.S. 331 (1940), 1940-1 C.B. 105; *Gregory v. Helvering,* 293 U.S. 465, XIV-1 C.B. 193 (1935).

In this case, the financing agreement, the research and development contract, and Z's agreement inducing Y to provide the financing were all executed and entered into at the same time as part of one transaction. The arrangement cannot reasonably be said to have purpose, substance, or utility apart from its anticipated tax consequences. *See Kapel Goldstein v. Commissioner,* 364 F.2d 734 (2nd Cir. 1966), *aff'g* 44 T.C. 284 (1965), *cert. denied,* 385 U.S. 1005 (1967) and *Knetsch v. United States,* 348 F.2d 932 (Ct. Cl. 1965). In form, Y purported to provide financing to the individuals, but as a result of the interdependent simultaneous agreements the funds remained with Y as security for Z's obligation to purchase the notes from Y. In substance there was no commercial reality to the financing agreement because no one had beneficial use of the financing proceeds, and therefore the maximum amount of research and development expenditures that X could have actually incurred is limited to $50,000.

HOLDING

The proceeds from the financing agreement are not included in the basis of stock of a shareholder of an electing small business corporation for purposes of computing the net operating loss allowed under section 1374(c)(2) of the Code.

For taxable years beginning after December 31, 1978, the provisions of section 465 also would apply to the arrangement to deny all deductions to the extent of the amount of the nonrecourse note.

Further, the holdings do not preclude the imposition of penalties under any provision of the Code.

Section 1375.—Special Rules Applicable to Distributions of Electing Small Business Corporations

26 CFR 1.1375-1: Special rules applicable to capital gains.

Treatment of pre-November 1, 1978 gain and post-October 31, 1978, gain. See Rev. Rul. 80-178, page 236.

Chapter 2.—Tax on Self-Employment Income

Section 1401.—Rate of Tax

26 CFR 1.1401-1: Tax on self-employment income.

Procedure for exemption from social security taxes under totalization agreements. See Rev. Proc. 80-56, page 851.

Section 1402.—Definitions

26 CFR 1.1402(a)-4: Rentals from real estate.

Circumstances in which the owner or tenant of land must include farm rentals in self-employment income, which is subject to social security tax. See T.D. 7710, page 254.

26 CFR 1.1402(c)-3: Employees. (Also Sections 3121, 3401, 6050A, 6652; 1.6050A-1, 31.3121(b)(20)-1, 31.3401(a)(17)-1, 301.6652-1.)

T.D. 7716

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; SUBCHAPTER C, PART 31. — EMPLOYMENT TAXES; APPLICABLE ON AND AFTER JANUARY 1, 1955; SUBCHAPTER F, PART 301.—PROCEDURE AND ADMINISTRATION

Withholding on certain crewmen engaged in fishing

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final Regulations.

SUMMARY: This document provides final regulations relating to the treatment of certain crewmen on boats engaged in catching fish as self-employed rather than as employees. Changes to the applicable tax law were made by the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1] and the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1]. These regulations provide operators and crewmen of fishing boats with guidance necessary for compliance with the Acts.

DATES: The amendments to the regulations relating to income tax withholding and self-employment taxes are effective for taxable years ending after December 31, 1954. The amendments to the regulations relating to social security taxes are effective with respect to services performed after December 31, 1954, except for services performed after December 31, 1954, but before October 4, 1976, in cases in which the owner or operator of a boat treated a share of the boat's catch as being subject to such taxes. The amendments to the regulations relating to reporting requirements are effective for calendar years beginning after October 4, 1976.

FOR FURTHER INFORMATION CONTACT: Claudine Ausness of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:LR:T) (202-566-3459).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On April 9, 1980, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1), the Employment Tax Regulations (26 CFR Part 31), and the Regulations on Procedure and Administration (26 CFR Part 301) under sections 1402, 3121, 3401, and 6050A of the Internal Revenue Code of 1954. These amendments

were proposed to conform the regulations to section 1207(e) and (f)(4) of the Tax Reform Act of 1976 (90 Stat. 1706) [*supra*, at 182, 184], as amended by section 701(z) of the Revenue Act of 1978 (92 Stat. 2921) [*supra*, at 155]. No public hearing was requested. After consideration of comments regarding the proposed amendments, those amendments are adopted by this Treasury decision as proposed.

EXPLANATION OF PROVISIONS

Under the Tax Reform Act of 1976, as amended, if certain conditions are met, after 1954 crewmen on boats engaged in catching fish and other aquatic animals are generally considered self-employed, rather than employees, for purposes of income tax withholding, self-employment tax, and the social security laws.

In order for a crewman to be considered self-employed, all of the following conditions must be met:

(1) The crew member must receive in payment for his services a fixed share of the boat's catch or of the proceeds from the sale of the catch and he must be entitled to no other cash or property independent of the size of the catch;

(2) The amount of the crew member's share must depend solely on the amount of the boat's catch, and therefore the amount of the share cannot be fixed at any minimum (in dollars or weight); and

(3) The crew of the boat on which the individual performed these services must normally be made up of fewer than 10 individuals.

Even if the criteria under the new provision are satisfied, for purposes of the social security tax a crewman is nevertheless deemed an employee, with regard to any services performed after December 31, 1954, but before October 4, 1976, if the boat operator treated a share of the boat's catch received by the crewman as subject to social security taxes.

If the new criteria are satisfied, the boat operator must file an information return on Form 1099-F (Copy A) by February 28 of the calendar year following the year in which service is performed, and, if the crewman has made his address known, the operator must furnish Copy B of the same form to the crewman. The operator must report on Form 1099-F the identity of each individual performing services, the individual's percentage share of the catch, and the amount of the proceeds received or the type and weight of the catch each crewman received as compensation for his services.

The regulation explicitly states that a crewman's share is not dependent solely on the amount of the boat's catch if the crewman is entitled under any individual or collective agreement to any fee, hourly wage, minimum for services, or any other amount unrelated to the size of the catch. Further, the operating crew includes the captain for purposes of determining the number of persons who normally make up the crew of the boat.

Two comments made with respect to the proposed rules expressed some confusion as to whether the same individual could be considered self-employed for one voyage and an employee for the next voyage as a result of how remuneration for the crewman was calculated. The regulation clearly provides that services performed by a crewman on one voyage may be excepted from employment but may not be so excepted on a subsequent voyage on the same or on a different boat, and that services of some crewman on a voyage may be excepted from employment while services of other crewmen on the same voyage may not be so excepted. For example, a crewman on a 5-man crab fishing boat, if paid solely on a share basis, might be considered self-employed for that trip, but the same crewman on a subsequent salmon tendering trip, if compensated on a per-diem basis, would be considered an employee.

The regulation specifies certain events which result in a boat operator's "treating" a share of the boat's catch as subject to social security taxes for purposes of the exception to the 1955 effective date in the case of such taxes. For example, the operator is generally deemed to have treated the share of the catch as subject to social security taxes (1) if the operator voluntarily filed Form 941, (2) if he made full or partial payment of FICA tax (unless he made such payment only in order to file a court claim for a refund), or (3) if the operator withheld FICA tax from the crewman's share (regardless of whether the tax was paid over to the Service).

The regulation makes clear that, if a share of the catch has been "treated" as subject to social security taxes, in the case of services performed after December 31, 1954, but before October 4, 1976, even though the crewman otherwise satisfied the criteria necessary for being considered self-employed, he is not required to pay tax on self-employment income with respect to such services, but is required to pay income tax on income received for such services. The fact that a boat operator has treated a share of the catch as being subject to the social security tax does not mean that the operator is required to withhold income tax with respect to that share. However, in such cases the boat operator is required to pay over both the employee and employer portions of FICA tax.

The final regulations adopted by this Treasury decision impose no significant new reporting or recordkeeping requirements. The principal effect of the final regulations is to conform existing regulations to statutory changes. Evaluation of the effectiveness of these regulations after issuance will be based upon comments received from offices within Treasury and the Internal Revenue Service, other governmental agencies, and the public.

DRAFTING INFORMATION

The principal author of these regulations is Claudine Ausness of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, the following amendments to 26 CFR Parts 1, 31, and 301 are hereby adopted:

INCOME TAX REGULATIONS
(26 CFR Part 1)

Paragraph 1. Section 1.1402(c)-3 is amended by revising the second sentence of paragraph (a) and by adding a new paragraph (g) to read as follows:

§ 1.1402(c)-3 Employees.

(a) *General rule.* * * * However, in six cases set forth in paragraphs (b) to (g), inclusive, of this section, the performance of service by an individual is considered to constitute a trade or business within the meaning of section 1402(c) and § 1.1402(c)-1. * * *

* * * * *

(g) *Individuals engaged in fishing.* For taxable years ending after December 31, 1954, service performed by an individual on a boat engaged in catching fish or other forms of aquatic animal life (hereinafter "fish") constitutes a trade or business within the meaning of section 1402(c) and § 1.1402(c)-1 if the service is excepted from the definition of employment by section 3121(b)(20) and § 31.3121(b)(20)-1(a). However, the preceding sentence does not apply to services performed after December 31, 1954, and before October 4, 1976, on a boat engaged in catching fish if the owner or operator of the boat treated the individual as an employee in the manner described in § 31.3121(b)(20)-1(b).

Par. 2. Section 1.6050A-1 is added immediately after § 1.6050-1, to read as follows:

§ 1.6050A-1 Reporting requirements of certain fishing boat operators.

(a) *Requirement of reporting.* The operator of a boat on which one or more individuals during a calendar year performed services described in § 31.3121(b)(20)-1(a) shall make an information return on Form 1099-F for that calendar year. The return shall include the following information:

(1) The name and taxpayer identification number of each individual performing the services;

(2) The percentage of each individual's share of the catch of fish or other forms of aquatic life (hereinafter "fish");

(3) The percentage of the operator's share of the catch of fish;

(4) If the individual receives all or part of his share of the catch in kind, the type and weight of the share and, if it can be ascertained, the fair market value of his share;

(5) If the individual receives a share of the proceeds of the catch, the dollar amount received; and

(6) Any other information that is required by the form.

For purposes of this section, the term "boat operator" means an employer (as defined in § 31.3121(d)-(2)) of an employee whose services are excepted from employment by section 3121(b)(20) and § 31.3121(b)(20)-1. The boat operator may make separate returns on Form 1099-F for each crew member for each voyage, or he may aggregate the information required by this paragraph for an individual for all or any part of a return period in which the type of catch (if required) and the percentage due the crew member remain the same.

(b) *Time and place for filing.* Returns required to be made under this section on Form 1099-F shall be filed with the Internal Revenue Service Center, designated in the instructions for Form 1099-F, on or before February 28 of the year following the year in which the relevant services were performed.

(c) *Requirement of and time for furnishing statement*—(1) *Requirement of furnishing statement.* Every person filing a Form 1099-F under this section shall furnish to the individual whose identifying number is (or should be) shown on the form a written statement showing the information required by paragraph (a) of this section. The requirement of the preceding sentence may be met by furnishing to the individual copy B of Form 1099-F or a reasonable facsimile of Form 1099-F that was filed pursuant to this section.

(2) *Time for furnishing statement.* Each statement required by this paragraph to be furnished to any individual for a calendar year shall be furnished on or before January 31 of the year following the calendar year for which the return was made.

EMPLOYMENT TAX REGULATIONS

(26 CFR Part 31)

Par. 3. Section 31.3121(b)(20)-1 is added immediately after § 31.3121(b)(19)-1, to read as follows:

§ 31.3121(b)(20)-1 Service performed on a boat engaged in catching fish.

(a) *In general.* (1) Service performed on or after December 31, 1954, by an individual on a boat engaged in catching fish or other forms of aquatic animal life (hereinafter "fish") are excepted from employment if—

(i) The individual receives a share of the boat's (or boats' for a fishing operation involving more than one boat) catch of fish or a share of the proceeds from the sale of the catch,

(ii) The amount of the individual's

share depends solely on the amount of the boat's (or boats' for a fishing operation involving more than one boat) catch of fish,

(iii) The individual does not receive, and is not entitled to receive, any cash remuneration, other than remuneration that is described in subdivision (i) of this subparagraph, and

(iv) The crew of the boat (or of each boat from which the individual receives a share of the catch) normally is made up of fewer than 10 individuals.

(2) The requirement of subdivision (ii) of subparagraph (1) is not satisfied if there exists an agreement with the boat's (or boats') owner or operator by which the individual's remuneration is determined partially or fully by a factor not dependent on the size of the catch. For example, if a boat is operated under a remuneration arrangement, *e.g.*, a collective agreement which specifies that crew members, in addition to receiving a share of the catch, are entitled to an hourly wage for repairing nets, regardless of whether this wage is actually paid, then all the crew members covered by the arrangement are entitled to receive cash remuneration other than a share of the catch and their services are not excepted from employment by section 3121(b)(20).

(3) The operating crew of a boat includes all persons on the boat (including the captain) who receive any form of remuneration in exchange for services rendered while on a boat engaged in catching fish. See § 1.6050A-1 for reporting requirements for the operator of a boat engaged in catching fish with respect to individuals performing services described in this section.

(4) During the same return period, service performed by a crew member may be excepted from employment by section 3121(b)(20) and this section for one voyage and not so excepted on a subsequent voyage on the same or on a different boat.

(5) During the same voyage, service performed by one crew member may be excepted from employment by section 3121(b)(20) and this section but service performed by another crew member may not be so excepted.

(b) *Special rule.* Services performed after December 31, 1954, and before October 4, 1976, on a boat by an individual engaged in catching fish are not excepted from employment for any voyage (for purposes of section 3121(b) and the corresponding regulations), even though the individual satisfies the requirements of subdivisions (i) through (iv) of paragraph (a)(1) of this section, if the owner or operator of the boat engaged in catching fish treated the individual as an employee. For purposes of this subparagraph, the individual was treated as an employee if—

(1) Form 941 was voluntarily filed by the boat operator or owner, regardless of whether the tax imposed by chapter 21 was withheld. For purposes of this subdivision, the filing of Form 941 is not voluntary if the filing was the result of action taken by the Service pursuant to section 6651(a) (relating to addition to the tax for failure to file tax return or to pay tax);

(2) The boat owner or operator withheld from the individual's share the tax imposed by chapter 21, regardless of whether the tax was paid over to the Service; or

(3) The boat owner or operator made full or partial payment of the tax imposed by chapter 21, unless the payment was made pursuant to section 7422(a) (relating to no civil actions for refund prior to filing claim for refund).

However, for purposes of this paragraph, crew members whose services, but for subdivisions (i) through (iii), would have been excepted from employment by section 3121(b)(20) are not required to pay self-employment tax on income earned in performing those services. See § 1.1402(c)-3(g). Moreover, in such cases the employer is not entitled to a refund of the employer's share of any tax imposed by chapter 21 that was paid.

Par. 4. Section 31.3401(a)(17)-1 is added after § 31.3401(a)(16)-1, to read as follows:

§ 31.3401(a)(17)-1 Remuneration for services performed on a boat engaged in catching fish.

(a) Remuneration for services performed on or after December 31, 1954, by an individual on a boat engaged in catching fish or other forms of aquatic animal life (hereinafter "fish") is excepted from wages and hence is not subject to withholding if—

(1) The individual receives a share of the boat's (or boats' for a fishing operation involving more than one boat) catch of fish or a share of the proceeds from the sale of the catch,

(2) The amount of the individual's share depends solely on the amount of the boat's (or boats' for a fishing operation involving more than one boat) catch of fish,

(3) The individual does not receive, and is not entitled to receive, any cash remuneration, other than remuneration that is described in subparagraph (1) of this paragraph, and

(4) The crew of the boat (or of each boat from which the individual receives a share of the catch) normally is made up of fewer than 10 individuals.

(b) The requirement of subparagraph (2) of paragraph (a) is not satisfied if there exists an agreement with the boat's (or boats') owner or operator by which the individual's remuneration is determined partially or fully by a factor not dependent on the size of the catch. For example, if a boat is operated under a remuneration arrangement, *e.g.*, a union contract, which specifies that crew members, in addition to receiving a share of the catch, are entitled to an hourly wage for repairing nets, regardless of whether this wage is actually paid,

then all the crew members covered by the arrangement are entitled to receive cash remuneration other than as a share of the catch and are not excepted from employment by section 3121(b)(20).

(c) The operating crew of a boat includes all persons on the boat (including the captain) who receive any form of remuneration in exchange for services rendered while on a boat engaged in catching fish. See § 1.6050A-1 for reporting requirements for the operator of a boat engaged in catching fish with respect to individuals performing services described in this section.

(d) During the same return period, service performed by a crew member may be excepted from employment by section 3121(b)(20) and this section for one voyage and not so excepted on a subsequent voyage on the same or on a different boat.

REGULATIONS ON PROCEDURE AND ADMINISTRATION

(26 CFR Part 301)

Par. 5. Section 301.6050A-1 is added immediately after § 301.6050-1, to read as follows:

§ 301.6050A-1 Information returns regarding services performed by certain crewmen on fishing boats.

For provisions relating to the requirement of returns of information regarding services performed by certain crewmen on fishing boats, see § 1.6050A-1 of this chapter (Income Tax Regulations) and § 301.6652-1 of this chapter (Regulations on Procedure and Administration).

Par. 6. Section 301.6652-1(a)(2) is amended to read as follows:

§ 301.6652-1 Failure to file certain information returns.

(a) *Returns with respect to payments made in calendar years after 1962.* * * *

(2) *Other payments; statements with respect to tips.* In the case of each failure—

(i) To file a statement of a payment made to another person required under authority of section 6041, relating to information returns with respect to certain information at source, or section 6051(d), relating to information returns with respect to payments of wages as defined in section 3401(a), or section 6050A(a), relating to information returns with respect to remuneration of certain crew members defined in section 3121(b)(20), or

(ii) To furnish a statement required under authority of section 6053(b), relating to statements furnished by employers with respect to tips, or section 6050A(b), relating to statements furnished by fishing boat operators with respect to remuneration of certain crew members, within the time prescribed by regulations under those sections for filing such statements (determined with regard to any extension of time for filing),

there shall be paid by the person failing to so file the statement $1 for each such statement not so filed. However, the total amount imposed on the delinquent person for all such failures during any calendar year shall not exceed $1,000.

* * * * *

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved: August 18, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 26, 1980, 8:45 a.m., and published in the issue of the Federal Register for August 27, 1980, 45 F.R. 57122)

Chapter 3.—Withholding of Tax on Nonresident Aliens and Foreign Corporations and Tax-free Covenant Bonds
Subchapter A.—Nonresident Aliens and Foreign Corporations

Section 1441.—Withholding Of Tax On Nonresident Aliens

26 CFR 1.1441-1: Requirement for withholding of tax on nonresident aliens, foreign partnerships, and foreign corporations.

Whether a Netherlands corporation that relicenses a patent for use in the United States and pays royalties to the licensor of the patent, an individual who is a citizen and resident of a country other than the United States or the Netherlands, is required under section 1441(a) of the Code to withhold from the royalties a tax equal to 30 percent of such royalties. See Rev. Rul. 80-362, page 208.

26 CFR 1.1441-2: Income subject to withholding.

Whether insurance premiums received by foreign corporations, which are not engaged in the conduct of a trade or business in the United States, on policies of reinsurance of United States risks, which were initially assumed by other insurance companies, that are subject to the excise tax imposed by section 4371(3) of the Code are subject to the income tax imposed by section 881 and to the withholding provisions of section 1442. See Rev. Rul. 80-222, page 211.

Section 1442.—Withholding of Tax on Foreign Corporations

26 CFR 1.1442-1: Withholding of tax on foreign corporations.

Whether insurance premiums received by foreign corporations, which are not engaged in the conduct of a trade or business in the United States, on policies of reinsurance of United States risk, which were initially assumed by other insurance companies, that are subject to the excise tax imposed by section 4371(3) of the Code are subject to the income tax imposed by section 881 and to the withholding provisions of section 1442. See Rev. Rul. 80-222, page 211.

Chapter 5.—Tax On Transfers to Avoid Income Tax

Section 1491.—Imposition of Tax

26 CFR 1.1491-1: Imposition of tax.

Tax on transfer to foreign trust; Virgin Islands resident. Section 1491 of the Code does not apply to the transfer of appreciated property

to a Virgin Islands trust by a U.S. citizen who is a permanent resident of the Virgin Islands.

Rev. Rul. 80-318

ISSUE

Does section 1491 of the Internal Revenue Code apply to a transfer of appreciated property, by a United States citizen who is a permanent resident of the United States Virgin Islands, to a revocable United States Virgin Islands trust?

FACTS

A is a United States citizen who is a permanent resident of the United States Virgin Islands. *A* has created a revocable United States Virgin Islands trust. *A* proposes to transfer appreciated real estate that is located in the Virgin Islands and stocks and securities in domestic corporations to the trust in 1980. *A* files an income tax return with, and pays the tax into, the treasury of the United States Virgin Islands. The trust is a foreign trust for purposes of section 7701(a)(31) of the Code.

LAW AND ANALYSIS

Section 1491 of the Code provides that an excise tax will be imposed on the transfer of property by a citizen or resident of the United States, or by a domestic corporation or partnership, or by an estate or trust which is not.a foreign estate or trust, to a foreign corporation as paid-in surplus or as a contribution to capital, or to a foreign estate or trust, or to a foreign partnership. The excise tax imposed is equal to 35 percent of the excess of (1) the fair market value of the property transferred over (2) the sum of (A) the adjusted basis (for determining gain) of such property in the hands of the transferor, plus (B) the amount of the gain recognized to the transferor at the time of the transfer. Section 1491 is part of Chapter 5 of Subtitle A of the Code, which relates to income taxes.

The Naval Appropriations Act of 1921, 48 U.S.C.A. section 1397 (1976), provides that the income tax laws in force in the United States of America, and those which may hereafter be enacted, shall be held to be likewise in force in the Virgin Islands of the United States, except that the proceeds of such taxes shall be paid into the treasuries of said islands.

Section 28(a) of the Revised Organic Act of the Virgin Islands, 48 U.S.C.A. section 1642 (Supp. 1979), Pub. L. 517, 1954-2 C.B. 595, provides that the proceeds of customs duties, the proceeds of the United States income tax, the proceeds of any taxes levied by the Congress on the inhabitants of the Virgin Islands, and the proceeds of all quarantine, passport, immigration, and naturalization fees collected in the Virgin Islands, less the cost of collecting all of said duties, taxes, and fees, shall be covered into the treasury of the Virgin Islands, and shall be available for expenditure as the Legislature of the Virgin Islands may provide. The Revised Organic Act further provides that the term "inhabitants of the Virgin Islands" as used in this section shall include all persons whose permanent residence is in the Virgin Islands, and such persons shall satisfy their income tax obligations under applicable taxing statutes of the United States by paying their tax on income derived from all sources, both within and outside the Virgin Islands, into the treasury of the Virgin Islands.

The income tax laws in force in the Virgin Islands are the same as the United States income tax laws although the United States and the Virgin Islands are separate and distinct taxing jurisdictions. This duplication or "mirror" tax scheme was established for the Virgin Islands by the Naval Appropriations Act of 1921. In construing the Internal Revenue Code, as in effect in the Virgin Islands, it is necessary in some sections of the law to substitute the words "Virgin Islands" for the words "United States" in order to give the law the proper effect. Rev. Rul. 73-315, 1973-2 C.B. 225, and Rev. Rul. 80-40, 1980-1 C.B. 175.

United States citizens domiciled in the Virgin Islands, who qualify as inhabitants of the Virgin Islands, as defined in section 28(a) of the Revised Organic Act of the Virgin Islands (for example, a permanent resident), are required to satisfy their income tax obligations to the United States by filing their returns with, and paying tax on income derived from all sources, both within and without the Virgin Islands, into the treasury of the Virgin Islands. Rev. Rul. 60-291, 1960-2 C.B. 407.

While section 1491 of the Code may impose an excise tax on the transfer of appreciated property by a United States citizen to a foreign trust, it is part of the income tax laws of the United States within the meaning of the Naval Appropriations Act of 1921, since it is part of Chapter 5 of Subtitle A of the Code, which is entitled "Income Taxes," and it was specifically enacted as a tax on transfers to avoid income tax. See H. Rep. No. 708, 72nd Cong., 1st Sess. 51 (1932); S. Rep. No. 665, 72nd Cong., 1st Sess. 56 (1932). Thus, it is part of the Virgin Islands tax code. A transfer of appreciated property by a United States citizen, who is a permanent resident of the Virgin Islands, to a Virgin Islands trust is a domestic transaction that is not subject to section 1491 of the Virgin Islands code.

HOLDING

Section 1491 of the Code is part of the "income tax laws" of the United States within the meaning of the Naval Appropriations Act of 1921, and thus part of the Virgin Islands tax code. *A* satisfies all United States income tax obligations by filing a return with, and paying the taxes due into, the treasury of the Virgin Islands, in accordance with the Revised Organic Act of the Virgin Islands. Therefore, section 1491 of the Code does not apply to *A*'s transfer of appreciated Virgin Islands real estate and stocks and securities in

domestic corporations to *A*'s revocable Virgin Islands trust. Further, section 1491 of the Virgin Islands code does not apply to *A*'s transfer since it is a domestic transaction for Virgin Islands purposes.

Chapter 6.—Consolidated Returns
Subchapter A.—Returns and Payment of Tax

Section 1502.—Regulations

26 CFR 1.1502-44: Percentage depletion for independent producers and royalty owners.

T.D. 7725

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Limitation on percentage depletion for independent producers and royalty owners that join in filing consolidated returns

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to consolidated returns for percentage depletion for independent producers and royalty owners. Changes to the applicable tax law were made by the Tax Reduction Act of 1975 [Pub. L. 94-12, 1975-1 C.B. 545]. The regulations would provide the public with guidance needed to comply with that Act and would affect certain corporations that file consolidated returns.

DATES: The regulations are effective for taxable years for which the due date (without extensions) for filing returns is after September 30, 1980.

FOR FURTHER INFORMATION CONTACT: Lawrence M. Axelrod of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC 20224, Attention: CC:LR:T (202-566-3458, not a toll-free call).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On April 9, 1980, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 1502 of the Internal Revenue Code of 1954 (45 FR 24203). The amendments were proposed to conform to the consolidated return regulations to section 501(a) of the Tax Reduction Act of 1975 (89 Stat. 47) [*supra* at 558]. No comments were received with respect to the proposed amendments, and no public hearing was requested or held. The proposed amendments are adopted by this Treasury decision without change.

PERCENTAGE DEPLETION FOR INDEPENDENT PRODUCERS AND ROYALTY OWNERS

Section 613 provides general rules permitting a taxpayer that extracts minerals to deduct a reasonable allowance for depletion, computed as a percentage of the gross income from the property. The allowance may not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In the case of oil and gas wells, however, section 613A, as added by section 501(a) of the Tax Reduction Act of 1975, restricts the percentage depletion allowance to certain domestic gas wells and independent producers and royalty owners. Section 613A(d) further limits the allowance in the case of independent producers and royalty owners to "65 percent of the taxpayer's taxable income" for the taxable year.

These regulations provide rules for computing the limitation under section 613A(d) on percentage depletion with respect to oil and gas wells if the corporation operating the wells is a member of an affiliated group that files a consolidated return. The regulations adopt the group's consolidated taxable income as the base for computing the 65-percent limitation. For a discussion of the reasons that alternative approaches were rejected, see the preamble to the notice of proposed rulemaking (45 FR 24203).

DRAFTING INFORMATION

The principal author of this regulation is Lawrence M. Axelrod of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, the following amendments to 26 CFR Part 1 are hereby adopted:

Paragraph 1. Section 1.1502-12 is amended as follows:

1. The material preceding paragraph (a) is revised.
2. The word "and" at the end of paragraph (n) is deleted.
3. Paragraph (o) is revised.
4. A new paragraph (p) is added.

The new and revised provisions read as follows:

§ 1.1502-12 Separate taxable income.

The separate taxable income of a member (including a case in which deductions exceed gross income) is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations, subject to the following modifications:

* * * * *

(o) Basis shall be determined under §§ 1.1502-31 and 1.1502-32, and earnings and profits shall be determined under § 1.1502-33; and

(p) The limitation on deductions provided in section 613A shall be taken into account for each member's oil and gas properties as provided in § 1.1502-44.

Par. 2. A new § 1.1502-44 is added to read as follows:

§ 1.1502-44 Percentage depletion for independent producers and royalty owners.

(a) *In general.* The sum of the percentage depletion deductions for the taxable year for all oil or gas property owned by all members, plus any carryovers under section 613A(d)(1) or paragraph (d) of this section from a prior taxable year, may not exceed 65 percent of the group's adjusted consolidated taxable income (under paragraph (b) of this section) for the consolidated return year.

(b) *Adjusted consolidated taxable income.* For purposes of this section, adjusted consolidated taxable income is an amount (not less than zero) equal to the group's consolidated taxable income determined without—

(1) Any depletion with respect to an oil or gas property (other than a gas property with respect to which the depletion allowance for all production is determined pursuant to section 613A (b)) for which percentage depletion would exceed cost depletion in the absence of the depletable quantity limitations contained in section 613A (c)(1) and (6) and the consolidated taxable income limitation contained in paragraph (a) of this section,

(2) Any consolidated net operating loss carryback to the consolidated return year under § 1.1502-21, and

(3) Any consolidated net capital loss carryback to the consolidated return year under § 1.1502-22.

(c) *Allocation to oil and gas properties.* The maximum amount allowable as a deduction under section 613A (c), after the application of paragraph (a) of this section, is allocated to properties held by members in accordance with the regulations under section 613A(d). Those regulations provide for an initial allocation and possible reallocation of the maximum allowable percentage depletion deduction among oil and gas properties. Thus, if, after the initial allocation, cost depletion exceeds the percentage depletion that would be allowable for a particular oil or gas property, cost depletion must be used for that property and the maximum amount of percentage depletion allowable as a deduction for the group is reallocated among only the remaining properties held by all members.

(d) *Carryover for disallowed amounts.* (1) If any amount is disallowed as a deduction for the taxable year by reason of section 613A(d)(1) or paragraph (a) of this section, the disallowed amount for each oil or gas property is treated as an amount allowed as a deduction under section 613A(c), for the following taxable year for the member that owned the property, in accordance with the regulations under section 613A and paragraphs (a) and (d)(2) of this section.

(2) Any amount that was disallowed as a deduction in a separate return limitation year of a member may be carried to a consolidated return year only to the extent that 65 percent of the excess determined under paragraph (d)(3) of this section exceeds the sum of the otherwise allowable percentage depletion deductions for the member's oil and gas properties for the year.

(3) The excess determined in this subparagraph (3) for a member is the excess, if any, of adjusted consolidated taxable income for the year under paragraph (b) of this section over that income recomputed by excluding the items of income and deductions of the member.

(e) *Effective date.* This section applies to taxable years for which the due date (without extensions) for filing returns is after September 30, 1980.

This Treasury decision is issued under the authority contained in sections 1502 and 7805 of the Internal Revenue Code of 1954 (68A Stat. 367 and 917; 26 U.S. 1502 and 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved September 26, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 30, 1980, 4:15 p.m., and published in the issue of the Federal Register for October 3, 1980, 45 F.R. 65560)

Subtitle B.—Estate and Gift Taxes
Chapter 11.—Estate Tax
Subchapter A.—Estate of Citizens or Residents
Part I.—Tax Imposed

Section 2001.—Imposition and Rate of Tax

26 CFR 20.0-1: Introduction.
(Also Section 2101; 20.2101-1.)

Domicile; illegal alien. An illegal alien who lived in the U.S. for 19 years with the alien's family, purchased a residence, and established strong community ties was domiciled in the U.S. at the date of death and the taxable estate is subject to the tax imposed by section 2001 of the Code.

Rev. Rul. 80-209

ISSUE

For purposes of the federal estate tax imposed by section 2001 of the Internal Revenue Code, was a person who entered the United States illegally and who continued to live in the United States until death a resident of the United States at the date of death?

FACTS

The decedent entered the United States illegally in 1959. Two years later, the decedent's spouse also entered the United States illegally. Up to the date of death in 1978, the decedent continued to remain in the United States. The decedent never secured a visa from the Government,

nor did the decedent ever apply for and receive official permission to reside in the United States. Therefore, the decedent was at all times after entering the United States subject to the laws regarding deportation of aliens.

In 1963, the decedent purchased a home in the United States and resided there until death. The decedent was, during the fifteen years prior to death, a member of several local clubs and an active participant in community affairs.

In 1964 and in 1972, the decedent purchased real property in the decedent's native country through the services of an agent. After the purchases, the properties were leased to a succession of tenants.

The representatives of the decedent's estate have argued that the decedent was not a resident of the United States and that the real property located in the decedent's native country is not includible in the federal gross estate.

LAW AND ANALYSIS

Section 2001(a) of the Code imposes a tax on the transfer of the taxable estate of "every decedent who is a citizen or resident of the United States." The tax imposed by section 2001(a) applies, in general, to property owned by a resident of the United States regardless of where the property is located.

Section 2101 of the Code imposes a separate tax on the transfer of the taxable estate of "every decedent nonresident not a citizen of the United States." Under section 2103, the gross estate of a nonresident who is not a United States citizen includes, for purposes of the tax imposed by section 2101, only property situated in the United States.

Section 20.0-1(b)(1) of the Estate Tax Regulations defines the term "resident" as follows:

> A "resident" decedent is a decedent who, at the time of his death, had his domicile in the United States. . . . A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.

The question of whether the taxable estate of a decedent who is not a United States citizen is subject to the federal estate tax under section 2001 of the Code depends upon where the decedent was domiciled at the date of death.

The requirements for acquiring a domicile are (1) legal capacity to do so; (2) physical presence; and (3) a current intention to make a home in the place. Restatement (Second) of Conflict of Laws § 15, Comment a (1971).

Legal capacity to acquire a domicile of choice has been found to exist even when people are subject to transfer to another domicile at the direction of others. *See, e.g., Stifel v. Hopkins*, 477 F.2d 1116, 1120 (6th Cir. 1973). Therefore, the fact that the decedent was subject to deportation does not render the decedent legally incapable of acquiring a domicile.

Because the decedent was physically present in this country at the date of death, the decedent would have been domiciled in the United States if the decedent had a current intention to make the United States a home. However, once a person has established a domicile in one place, it is presumed to continue in that place until it is shown to have been changed. *Mitchell v. United States*, 88 U.S. (21 Wall.) 350 (1874). The presumption can be rebutted upon facts showing an intention to remain in the United States for an indefinite period or on a permanent basis. See generally, Restatement (Second) of Conflict of Laws § 18, comment d (1971). Some of the factors used in determining such requisite intention are home ownership, local community ties and living with one's family in the claimed domicile. *See Farmer's Loan & Trust Co. v. United States*, 60 F.2d 618 (S.D.N.Y. 1932).

In the present case, the fact that the decedent lived in the United States for a long time with the decedent's family and that the decedent established strong community ties indicates an absence of any fixed intention of returning to the native country.

The purchase of property located in a person's native country is not sufficient to conclude that the decedent was not domiciled in the United States, especially since the location of an investment is not indicative of domicile. *See Rodiek v. Commissioner*, 33 B.T.A. 1020, 1034 (1936), affirmed, 87 F.2d 328 (2nd Cir. 1937), Ct. D. 1229, 1937-1 C.B. 290. The facts in the present case thus indicate that the decedent intended to remain in the United States indefinitely.

HOLDING

The decedent was domiciled in the United States at the date of death. Therefore, the taxable estate of the decedent is subject to the federal estate tax imposed by section 2001 of the Code. Further, the same conclusion would result, under the facts presented, if the decedent had entered the United States legally in 1959 as a nonimmigrant holding a visa and had remained in the United States after the visa expired. Even though such a decedent, at the time of entry, may not have had the intent to remain in the United States, nevertheless, that decedent may subsequently form the intent to remain in the United States indefinitely and establish domicile in the United States.

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26 CFR 20.2001-1: Rate of tax.

Domicile; employee of international organization. An employee of an international organization who entered the U.S. on a G-4 visa and intended to remain in the U.S. indefinitely, which intent persisted until death, was a resident of the U.S.; Rev. Rul. 74-364 revoked.

Rev. Rul. 80-363

ISSUE

For purposes of the federal estate tax imposed by Section 2001 of the Internal Revenue Code, was a person who entered the United States as a non-immigrant alien on a "G-4" visa a resident of the United States when that person intended to remain in the United States indefinitely at the date of death?

FACTS

The decedent, *D*, a citizen of a foreign country, was an employee of an international organization until death. In 1965, *D* entered and remained in the United States with a "G-4" visa. A "G-4" visa is a non-immigrant visa granted to employees of international organizations. After arrival, *D* formed the intent to remain in the United States indefinitely and the intent persisted until death in 1978.

LAW AND ANALYSIS

Section 2001(a) of the Code imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2101(a) of the Code sets out a table of graduated rates of tax to be applied to the taxable estate of a decedent who was a nonresident not a citizen of the United States at the time of death. The taxable estate of a decedent who was a citizen or resident of the United States is subject to the tax in accordance with the table set out in section 2001.

Section 20.0-1(b)(1) of the regulations provides that a resident decedent is one who, at the time of death, was domiciled in the United States. A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later moving. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile.

The Supreme Court of the United States, in *Elkins v. Moreno,* 435 U.S. 647 (1978), held that, under federal law, a nonimmigrant alien holding a "G-4" visa has the legal capacity to establish domicile within the United States. The Court concluded that when federal law, such as the statute that governs the granting of "G-4" visas, did not impose restrictions on intent or duration of stay, Congress intended that, while permanent immigration would normally occur through immigrant channels, nonrestricted nonimmigrant aliens could adopt the United States as their domicile under certain circumstances.

The question of domicile depends on whether the decedent had formed the intent to remain in the United States indefinitely. In the present situation, *D* was a resident decedent since, at the time of death, domicile had been established in the United States. *D* had formed the intent and did, in fact, reside in the United States with no definite, present intention of leaving. This is true notwithstanding that *D* had entered and remained in the United States with a "G-4" visa.

HOLDING

At the date of death, *D* was a resident of the United States. Therefore, the transfer of *D*'s taxable estate is subject to the federal estate tax imposed by section 2001 of the Code.

EFFECT ON OTHER REVENUE RULINGS

In Rev. Rul. 74-364, 1974-2 C.B. 321, the Service concluded that a French citizen, who was the holder of a "G-4" visa that was valid at date of death, was under a legal disability and could not form the necessary intent to remain indefinitely in the United States. Rev. Rul. 74-364 is hereby revoked.

Pursuant to the authority contained in Section 7805(b) of the Code, this revenue ruling will not be applied with respect to decedents dying prior to December 29, 1980, the date of publication of this revenue ruling in the Internal Revenue Bulletin.

Part II.—Credits Against Tax

Section 2012.—Credit for Gift Tax

26 CFR 20.2012-1: Credit for gift tax. (Also Section 2056; 20.2056(a)-1.)

Gift tax credit; "second limitation"; donee other than spouse. For the purpose of computing the "second limitation" of the credit for gift tax, the value of the gift made to a donee other than the decedent's spouse is not reduced under section 2012(b)(2) of the Code by the additional marital deduction that results from inclusion of the gift in the gross estate.

Rev. Rul. 80-185

ISSUE

In computing the "second limitation" of the credit for gift tax under section 2012 of the Internal Revenue Code, what is the value of the gift made to a donee other than the spouse, if the inclusion in the gross estate has the effect of increasing the marital deduction?

FACTS

The decedent, *D*, made gifts of future interests in property of 100*x* dollars to each of *D*'s two children on December 7, 1976. A federal gift tax return was filed and a gift tax was paid.

D died on January 27, 1977. On the federal estate tax return filed for *D*'s estate, the executor included the gifts in the gross estate pursuant to section 2035 of the Code. The inclusion of the transfers under section 2035 resulted in an increase in the adjusted gross estate and a corresponding increase in the maximum marital deduction, the computation of which was based on the adjusted gross estate.

The executor claimed a credit against the federal estate tax liability

for the gift tax paid with respect to the included gifts. The credit was based upon the "second limitation" under section 2012.

LAW AND ANALYSIS

Under section 2012 of the Code, a credit is allowed against the federal estate tax for federal gift tax paid with respect to the transfer of property by gift if the gift is subsequently included in the donor-decedent's gross estate. Section 2012(e), as added by the Tax Reform Act of 1976, Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1, provides that the credit is allowed only as to gifts made before January 1, 1977.

The credit is limited to the lesser of two "limitations." Section 20.2012-1 (b) of the Estate Tax Regulations. The "first limitation" is the amount of the gift tax attributable to the included gift. The "second limitation" is the amount of estate tax attributable to the inclusion of the gift in the gross estate. The "second limitation" is expressed as:

$$\frac{\text{the value of the gift (at the time of the gift or at time of death, whichever is lower)}}{\text{the value of the gross estate, less all marital and charitable deductions allowable}} \times \text{gross estate tax, less credit for state death taxes}$$

Section 2012(b)(2) of the Code provides that the value of the gift in the ratio shall be reduced if a deduction *with respect to such gift* is allowed under section 2056(a) (relating to marital deduction).

Section 20.2012-1(d)(2)(ii) of the regulations provides, in part, that the value of the gift is reduced if any portion of the value of property is allowed as a marital deduction under section 2056 of the Code.

Section 2056 of the Code, as amended by the Tax Reform Act of 1976, provides that the value of the taxable estate shall be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to the surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate. The maximum allowable marital deduction is limited to the greater of $250,000 or fifty percent of the adjusted gross estate.

The inclusion of the gift property in the decedent's gross estate resulted in an increase in the adjusted gross estate and in the allowable marital deduction. However, the gift property itself could not qualify for the marital deduction since the property did not pass to the surviving spouse. Thus, no marital deduction was allowed with respect to such gift. However, compare the example in section 20.2012-1 (d)(3) where the value of the gift was reduced because the gift was to the spouse and qualified for the estate tax marital deduction.

HOLDING

For purposes of computing the "second limitation" of the credit for gift tax, the value of the gift made to a donee other than the spouse is not reduced by the amount of the additional marital deduction resulting from the inclusion of the gift in the gross estate. Therefore, the value of the gift in the subject case is $100x$ dollars for each gift.

Section 2013.—Credit for Tax on Prior Transfers

26 CFR 20.2013-3: "Second limitation." (Also Section 2056; 20.2056(c)-1.)

Credits against tax; prior transfers; marital deduction. In determining the credit for tax on prior transfers under the "second limitation" of section 2013(c)(1) of the Code, for purposes of computing the tax on the reduced adjusted gross estate of a decedent who died after 1976, the applicable marital deduction is the value of the property actually passing to the surviving spouse, but not to exceed the greater of $250,000 or one-half of the reduced adjusted gross estate; Rev. Rul. 60-161 amplified.

Rev. Rul. 80-210

ISSUE

In determining the "second limitation" on the credit for tax on prior transfers under section 2013(c)(1) of the Internal Revenue Code, what is the applicable marital deduction used in computing the estate tax on the reduced gross estate, under the circumstances described below?

FACTS

D died in May 1979, leaving a surviving spouse, *S*. *D* had made no gifts after December 31, 1976. The value of the gross estate included on the federal estate tax return was $600,000, and debts and expenses in the amount of $40,000 were claimed as deductions. *D* bequeathed to *S* an amount equal to one-half of the federal adjusted gross estate. Thus, *S* received $280,000 ($\frac{1}{2} \times \$560{,}000$), and a marital deduction was claimed for that amount. A tax on prior transfer credit was claimed under section 2013 of the Code based on a transfer of $100,000 that *D* received from the estate of *D*'s parent, who died in November 1977.

LAW AND ANALYSIS

Section 2013 of the Code provides, in general, that a transferee's estate is allowed a credit for the estate tax paid on property transferred to the transferee from a transferor who died within ten years before, or within two years after, the transferee's death. The amount of the credit is the lesser of two limitations.

The "second limitation", as prescribed in section 2013(c)(1) of the Code and section 20.2013-3 of the Estate Tax Regulations, provides that the amount of the credit shall not exceed the amount by which (A) the

transferee's estate tax, computed after the allowance of all credits except the credit for tax on prior transfers, exceeds (B) such tax computed by excluding from the transferee's gross estate the value of the transferred property.

Section 2056 of the Code provides, with certain limitations, a deduction from the value of the gross estate for the value of the property that passes from the decedent to the surviving spouse. For estates of decedents dying before January 1, 1977, section 2056 (c) provided that the amount of the marital deduction was limited to one-half of the value of the adjusted gross estate. The Tax Reform Act of 1976, Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1, amended section 2056(c) for estates of decedents dying after December 31, 1976, to provide generally that the marital deduction shall not exceed the greater of $250,000 or one-half of the adjusted gross estate.

Rev. Rul. 60-161, 1960-1 C.B. 367, provides that if a marital deduction under section 2056 of the Code is allowable in the transferee's estate, then, in computing the estate tax on the reduced gross estate (the gross estate less the value of the transferred property) under section 2013(c)(1)(B), the applicable marital deduction is the value of the property passing to the surviving spouse, but not to exceed one-half of the reduced adjusted gross estate (the adjusted gross estate less the value of the transferred property).

In computing the estate tax on the reduced gross estate in accordance with section 2013(c)(1)(B) of the Code, for estates of transferees dying after December 31, 1976, the applicable marital deduction is the value of the property passing to the surviving spouse, but not to exceed, generally, the greater of $250,000 or one-half of the reduced adjusted gross estate.

In this case the value of the property passing to the surviving spouse is $280,000 and the reduced adjusted gross estate equals $460,000 ($600,000 gross estate less $100,000 transferred property less $40,000 debts and expenses). The maximum marital deduction allowable in computing the estate tax on the reduced estate is therefore $250,000; the value of the property passing to the surviving spouse ($280,000), but not to exceed the greater of $250,000 or one-half of the reduced adjusted gross estate ($230,000).

HOLDING

In determining the "second limitation" on the credit for tax on prior transfers under section 2013(c)(1) of the Code, the applicable marital deduction in this case is $250,000.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 60-161 is amplified.

Part III.—Gross Estate

Section 2031.—Definition of Gross Estate

26 CFR 20.2031-1: Definition of gross estate; valuation of property.
(Also Section 2053; 20.2053-4.)

Buyer's "points" assumed by seller-decedent. An individual entered into an arm's length agreement to sell a personal residence and to pay mortgage "points" for the buyer that were to be deducted from the sale proceeds, but died before consummating the sale. The amount includible in the individual's gross estate is the sales price of the property less the "points" assumed by the seller, and the "points" are not deductible under section 2053(a)(3) or (a)(4) of the Code.

Rev. Rul. 80-319

ISSUE

Under section 2031(a) of the Internal Revenue Code, should the contract sales price of a decedent's residence be reduced by the points that the decedent agreed to pay a mortgage lender under a contract of sale executed prior to the decedent's death?

FACTS

On June 1, 1977, the decedent, *D*, entered into an arm's length written sales agreement with *A*. Pursuant to the agreement, *D*'s residence was to be conveyed to *A* within 90 days for $80x$ dollars. *A* was to pay $20x$ dollars as a down payment. In addition, *A* was to obtain a home mortgage loan of $60x$ dollars.

With respect to the fee payable in connection with the acquisition of the mortgage (normally measured as a percentage of the face amount of the mortgage, each one percent being referred to as a "point"), the contract stated that *A* was to pay one point. Any additional amount, not exceeding five points, was to be borne by *D*. *D* and *A* agreed that the points assumed by *D* would be deducted from the proceeds that would be paid to *D*. *A* secured a loan commitment providing for the payment of six points.

D died on June 20, 1977. After *D*'s death, the executor completed the sale to *A* according to the terms of the agreement. The cost of the points assumed by *D* was $3x$ dollars. Consequently, the amount received by the executor upon the sale of the property was $77x$ dollars.

Under applicable local law, ownership of real property is regarded as vested in the seller at the time of death if the seller died after executing a contract of sale but before actual conveyance of the property. Local law also provides that, unless and until the contract of sale is consummated, the seller is not obliged to pay the points. When the contract is consummated, the points are merely an offset to the consideration. Therefore, the seller is never personally obligated to pay the points.

LAW AND ANALYSIS

Section 2031(a) of the Code provides generally that the value of a de-

cedent's gross estate shall be determined by including the value, at the time of death, of all property, real or personal, tangible or intangible, wherever situated. In computing the value of the taxable estate, section 2053 (a)(3) and (a)(4) allows as deductions from the value of the decedent's gross estate amounts for claims against the estate and mortgages and indebtednesses in respect of property, subject to certain limitations.

The value of property includible in the gross estate is the fair market value at the time of the decedent's death. Generally, the fair market value of the decedent's property can be established by a sale of the property around the date of the decedent's death if the consideration for the property was arrived at by arm's length negotiations. See, for example, *Estate of Ballas v. Commissioner*, T.C. Memo. 1975-103.

In the present situation, the interest includible in *D*'s gross estate is the real property because *D* was regarded as the owner of the property under local law. Inasmuch as *D* and *A* negotiated the sale of the residence in an arm's length transaction immediately before the date of *D*'s death, the value agreed upon by *D* and *A* is regarded as the fair market value of the property.

For purposes of the federal income tax, points paid by a seller of a residence as a condition to the acquisition of a mortgage loan by the buyer of the residence reduce the amount realized by the seller. See Rev. Rul. 68-650, 1968-2 C.B. 78. This principle is applicable in determining the fair market value of a decedent's residence for purposes of section 2031(a) of the Code. Consequently, if a contract of sale negotiated by the decedent is regarded as establishing the value of the residence and the decedent, as seller, agreed or local law provides that the points assumed by the decedent would be an offset to the sale price, the fair market value of the residence is computed by reducing the sale price by the cost of the points.

Because the points offset the amount actually received in exchange for the property pursuant to a contract entered into by the decedent prior to the decedent's death and neither the decedent nor the property would be liable for the payment of such points, the amount of these points is not deductible under section 2053(a)(3) or (a)(4) of the Code.

HOLDING

The amount includible under section 2031(a) of the Code with regard to *D*'s residence is $77x$ dollars, and no deduction is allowable under section 2053 (a)(3) or (a)(4) with regard to the points.

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26 CFR 20.2031-1: Definition of gross estate; valuation of property.

The valuation of closely held business. See Rev. Rul. 80-202, page 363.

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26 CFR 20.2031-3: Valuation of interests in businesses.

Whether the value of a closely held business is the value of its assets or the net amount a willing purchaser would pay to a willing seller for the business. See Rev. Rul. 80-202, page 363.

Section 2032A.—Valuation of Certain Farm, Etc., Real Property

Special use value; farms; interest rates. The interest rates to be used under section 2032A(e)(7)(A)(ii) of the Code in computing the special use value of farm real property for which an election is made under section 2032A are listed for estates of decedents dying in the period 1977-1980; Rev. Rul. 79-189 superseded.

Rev. Rul. 80-179

ISSUE

This revenue ruling contains a cumulative list of the average annual effective interest rates on new Federal Land Bank loans to be utilized under section 2032A(e)(7)(A)(ii) of the Internal Revenue Code in computing the special use value of real property used as a farm for which an election is made under the provisions of section 2032A. The interest rates listed are those applicable for the estates of decedents dying in 1977, 1978, 1979, and 1980. The rates applicable in the case of decedents dying in 1977, 1978 and 1979 were previously listed in Rev. Rul. 79-189, 1979-1 C.B. 293.

This revenue ruling also contains a list of the states within each land bank district.

Average annual effective interest rate to be utilized under section 2032A (e)(7)(A)(ii):

Federal Land Bank District in which property is located	Year of Death			
	1977	1978	1979	1980
Baltimore	8.65%	8.86%	9.04%	9.24%
Columbia	8.58%	8.79%	8.96%	9.17%
Houston	8.29%	8.48%	8.60%	8.76%
Louisville	8.64%	8.80%	8.88%	9.21%
New Orleans	8.26%	8.48%	8.72%	8.96%
Omaha	8.70%	8.92%	9.05%	9.25%
Sacramento	8.67%	8.82%	9.04%	9.35%
St. Louis	8.50%	8.71%	8.93%	9.20%
St. Paul	8.21%	8.47%	8.69%	8.95%
Spokane	8.63%	8.88%	9.10%	9.31%
Springfield	8.42%	8.55%	8.65%	8.81%
Wichita	8.52%	8.72%	8.88%	9.08%

Federal Land Bank Districts:

District	*States*
Baltimore	Delaware, District of Columbia, Maryland, Pennsylvania, Virginia, West Virginia.
Columbia	Florida, Georgia, North Carolina, South Carolina.
Houston	Texas.
Louisville	Indiana, Kentucky, Ohio, Tennessee.
New Orleans	Alabama, Louisiana, Mississippi.
Omaha	Iowa, Nebraska, South Dakota, Wyoming.
Sacramento	Arizona, California, Hawaii, Nevada, Utah.
St. Louis	Arkansas, Illinois, Missouri.
St. Paul	Michigan, Minnesota, North Dakota, Wisconsin.
Spokane	Alaska, Idaho, Montana, Oregon, Washington.
Springfield	Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, Vermont.
Wichita	Colorado, Kansas, New Mexico, Oklahoma.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 79-189 is superseded.

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26 CFR 20.2032A-3: Material participation requirements for valuaiton of certain farm and closely-held business real property.
(Also Sections 1402, 6166, 6324A; 1.1402 (a)-4, 20.6166-1, 301.6324A-1.)

T.D. 7710

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART I.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; SUBCHAPTER B, PART 20.—ESTATE TAX; SUBCHAPTER F, PART 301.—PROCEDURE AND ADMINISTRATION

Definition of Net Earnings From Self-Employment for Certain Owners and Tenants of Farms

Material Participation Requirements for Valuation of Certain Farm and Closely Held Business Real Property and Method of Valuing Farm Real Property According to Actual Use

Procedure For Various Estate Tax Elections under the Tax Reform Act of 1976

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to material participation requirements for and the method of valuing certain farm real property according to actual use. The document also contains final regulations on the procedure for electing the use valuation, for electing to extend payment of estate tax attributable to interests in closely held businesses, and for electing a special lien in lieu of personal liability for certain deferred amounts of estate tax as well as final regulations on material participation rules for certain tenants and owners of farms for self-employment income tax purposes. Changes to the applicable tax law were made by the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1] and the Act of August 7, 1974 (Pub. L. 93-368, [1974-2 C.B. 418], 88 Stat. 422). The regulations provide the public with the guidance needed to comply with those Acts. They affect farm owners and tenants, and estates comprised largely of farm and other closely-held business interests.

DATES: The regulations are effective as follows:

(1) For taxable years beginning after December 31, 1973, in the case of the provisions defining net earnings from self-employment; and

(2) For estates of decedents dying after December 31, 1976, in the case of the provisions on valuation of farm and closely held business real property, on extension of time to pay estate tax and on the special lien in lieu of personal liability for certain amounts of estate tax.

FOR FURTHER INFORMATION CONTACT: H. B. Hartley of the Leislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:LR:T, 202-566-3287 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On July 13, 1978, the Federal Register published proposed amendments to the Estate Tax Regulations (26 CFR Part 20) relating to procedures for making the elections provided under sections 2032A, 6166, and 6324A of the Internal Revenue Code of 1954 ("Code") (43 FR 30070). On December 21, 1978, amendments to these July 13, 1978, proposed regulations were published in the Federal Register (43 FR 59517). On July 19, 1978, the Federal Register published proper amendments to the Income Tax Regulations (26 CFR Part 1) under section 1402 (a) of the Code and to the Estate Tax Regulations (26 CFR Part 20) under section 2032A of the Code (43 FR 31039). On September 10, 1979, a portion, proposed § 20.2032A-4(b), of the July 19, 1978, proposed regula-

tions was withdrawn by notice published in the Federal Register (43 FR 52698). Also on September 10, 1979, the Federal Register published new proposed regulations under section 2032A replacing the withdrawn proposal (44 FR 52696). All of these regulations were proposed to conform the regulations to section 10(b) of the Act of August 7, 1974 (Pub. L. 93-368 [1974-2 C.B. 418], 88 Stat. 422) and to sections 2003(a) and 2004(a) and (d) of the Tax Reform Act of 1976 (Pub. L. 94-455 [1976-3 C.B. (Vol. 1) 1], 90 Stat. 1856, 1868).

A public hearing on the July 13, July 19, and December 21, 1978, proposed regulations was held on April 3, 1979. A public hearing was held on the September 10, 1979, proposed regulations on January 16, 1980. After consideration of all written and oral comments regarding the proposed amendments, final regulations are adopted by this Treasury decision.

PROVISIONS OF THE REGULATIONS

Net Earnings from Self-Employment

Section 1402(a)(1) of the Code, as amended in 1974, defines more narrowly the circumstances in which the owner or tenant of land must include farm rentals in self-employment income, which is subject to social security tax. Farm rentals are considered self-employment income when three requirements are met. First, the owner or tenant must arrange for another individual to farm the land. Second, that arrangement must contemplate material participation by the owner or tenant in the operation of the farm. Third, the owner or tenant must in fact participate materially in the operation of the farm.

Consistent with the various court decisions rendered prior to the enactment of Public Law 93-368, the existing regulations provide that the actions of an employee or agent will be attributed to the owner or tenant in determining whether the three requirements for material participation have been met. Thus, owners or tenants of land who arranged with agents (such as professional farm management companies) to manage and supervise the farming of their land had to include the rentals they received in their self-employment income. This was so even though they did not personally participate in the farming operation at all. As a result of this rule, many persons who thought they were merely receiving investment income found themselves liable for social security taxes.

The amendment changed the rule as to agents and employees for years beginning after 1973. Thus, activities of agents and employees are no longer taken into account in determining under section 1402 whether an owner or tenant has materially participated in the farming operation.

Material Participation and Estate Tax Valuation

Code section 2032A allows an executor to elect to value qualified real property used in farming or other closely-held business activity based upon its qualified use rather than its fair market value determined under otherwise applicable estate tax rules. That section requires, however, that the owner or a member of the owner's family materially participate in the operation of the farm or other business for specified periods both before and after the decedent's death.

Along with property owned individually by the decedent, real property owned by a qualified closely-held corporation or partnership or by a trust is permitted to be specially valued for determining the value of the decedent's interest in that business. The regulations provide that where the property is owned in this manner, the participating owner or family member may be an employee rather than be self-employed. Even though the participants are not self-employed, material participation is tested by viewing their activities as if they were self-employed.

Participation is judged in light of actual personal involvement by the decedent and family members. If the involvement occurs on less than a full-time basis, it must be pursuant to an arrangement entered into by the participant (or a member of the participant's family) calling for the activities that occur. Acts of an agent or an employee are not considered in determining whether material participation occurs unless the agent or employee is also a family member.

Material participation, if other than by full-time employment, means a regular process of consultation and inspection with active involvement in making management decisions. Advancing funds or assuming financial responsibility for the business operation are also required. Maintaining one's principal place of residence on the premises in the case of a farm or hotel is a factor in determining the degree of participation.

With corporations and partnerships, activities in the management and operation of the real estate component of the business as a whole are central. Merely holding corporate offices or being a partner in name and financial risk only is not sufficient participation. This is true even where an inactive partner returns his or her distributive share as earnings from self-employment and pays social security taxes on it. Finally, activities which are not contemplated by the required arrangement are not considered in determining whether material participation occurs.

Method of Valuing Farm Real Property under Section 2032A(e)(7)

Section 2032A(e)(7) provides a special method for valuing qualified real property used for farming purposes. This method requires the executor to locate tracts of comparable real property which are rented solely for cash. A 5-year average of gross cash rentals

from comparable real property, minus State and local real estate taxes, is then capitalized by the average annual effective interest rate charged by Federal land banks on new agricultural loans to farmers and ranchers. These regulations provide the definitions and other information necessary for valuing property according to this method.

If the section 2032A(e)(7) formula valuation method is used, the executor must document to the Internal Revenue Service the actual comparable property and cash rentals upon which the executor relies. If no such rentals are found, the executor may still value the farm real property based upon its current use under the provisions of section 2032A(e)(8).

The rules for valuing real property under section 2032A(e)(7) provided in these regulations apply only to estates where the specially valued real property is directly owned by the decedent. Regulations will be published at a later date detailing the applicability of this valuation method to property owned indirectly through a trust, a partnership, or a corporation.

Election of Use Valuation

The executor must elect special use valuation by attaching a notice of election to a timely filed estate tax return. Normally, this election is irrevocable; however, elections which are timely made on or before August 30, 1980, may be revoked during the 6-month period following that date (or any lesser period remaining before expiration of the statute of limitations). A revocation is to be accompanied by payment of any additional estate tax found due, plus interest.

An agreement signed by all parties with an interest in the property subject to the special use valuation election is also required under section 2032A. This agreement must accompany the notice of election.

Section 20.2032A-8 defines a person with an interest in the property to include all persons in being as of the date of death of the decedent who receive any vested or contingent interest in the property, who receive a power of appointment over the property, who are beneficiaries of a gift over in default of exercise of any such power, or who, under applicable state law, have any legal right which could affect the ultimate disposion of the property.

Alternate Extension of Time for Payment of Estate Tax

Section 6166 allows an executor to elect to defer payment of a percentage of the total estate tax, including the amount of certain deficiencies. The maximum percentage of tax which may be deferred corresponds to the percentage of the adjusted gross estate which is comprised of a closely held business interest (as defined in section 6166(b)(1)).

Normally, the election is made at the time the estate tax return is filed; however, an election may subsequently be made to pay certain deficiencies in installments. Additionally, where the executor is uncertain as to whether the estate needs to defer payment of tax, a protective election may be made when the estate tax return is filed. If a protective election is made, the final election is to be made within 60 days after final values causing the estate to qualify are determined (or agreed to following examination of a return).

Special Lien for Deferred Amount of Estate Tax

Section 6324A allows the executor of a decedent's estate to elect a lien in favor of the United States in lieu of bond or personal liability if an election under section 6166 or section 6166A is made. The election under section 6324A will not be effective unless all parties having an interest in the property subject to the lien sign an agreement in which they consent to the creation of the lien. The agreement must be filed with the notice of election of the lien. The election may be filed at any time prior to payment of the full amount of the estate tax.

ADDITIONAL CONSIDERATIONS

These regulations are needed in order to provide guidance to the public as well as to government employees responsible for implementation of sections 1402(a), 2032A, 6166, and 6324A of the Code. Considering both the direct and indirect effects of these regulations, it is believed that they satisfactorily implement section 10(b) of the Act of August 7, 1974 (Pub. L. 93-368 [1974-2 C.B. 418]), and sections 2003(a) and 2004(a) and (d) of the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1, 332, 338]. Evaluation of the effectiveness of the regulations after issuance will be based upon comments received from offices within the Internal Revenue Service and the Treasury Department, from other government agencies and from members of the public.

PUBLIC COMMENTS

Seventy-three comments were received in response to the four notices of proposed rulemaking. Two comments urged attributing activities of employees, but not agents, to owners for purposes of meeting both the social security and use valuation material participation requirements. This suggestion was rejected because employees are agents of their employer.

Several comments urged an express statement that use valuation under section 2032A is available even if farming is the only potential use for the real property. Sections 20.2032A-3(a) and 20.2032A-8(a) were changed to reflect this position once the Treasury learned that section 2032A(e)(7) produces land values below even a true current use value and that inequities would result between suburban and strictly rural farms if the limitation were retained. Section 20.2032A-3(b) was changed to clarify that directly owned real

property which is passively leased to the decedent's active closely held business (under section 6166(b)(1)) can be qualified property despite the passive lease. A new paragraph (b)(2) was added to § 20.2032A-3 to clarify the treatment of farm buildings as specially valued property under section 2032A.

Section 20.2032A-3(c) was changed in response to the comments to clarify that material participation must occur during periods totalling at least 5 calendar years before and after death and to provide rules under section 2032A(c) for property in which the heirs receive undivided or successive interests. In response to a commentor's question, § 20.2032A-3(c) now also states that simultaneous activities of multiple family members cannot be aggregated to find material participation. Rather, the activities of at least one family member, viewed alone, must constitute material participation at any given time. A statement was also added to clarify that no exception to the material participation requirements is made for periods when real property is owned by the decedent's estate. A new paragraph (d) was added to § 20.2032A-3 to answer questions raised by commentors about property acquired less than 5 years before death and real property, ownership of which is changed from direct to indirect in a nontaxable transfer under section 351 or 721 of the Code during that 5-year period. Proposed § 20.2032A-3(d) on activities required for material participation was renumbered § 20.2032A-3(e) and was modified to state that furnishing of farm equipment by a lessor is not a requirement. The same section now contains an expanded discussion of the relationship of material participation under sections 2032A and 1402(a)(1). Briefly stated, the rule is that payment of self-employment taxes alone is not conclusive as to the presence of material participation. However, when self-employment taxes have not been paid, material participation is presumed not to have occurred unless the executor supplies proof that such participation did in fact occur and demonstrates to the Internal Revenue Service why no such taxes were paid. In addition, any such taxes (plus interest and penalties) determined to be due must be paid.

A new sentence was added to paragraph (e) to reiterate that retention of a farm manager will not automatically disqualify a farm from special use valuation. Clarifying language was also added to that paragraph concernin activities necessary for material participation during nonproducing seasons.

Timber growers requested an explanation of the application of section 2032A to timber farms. A new example (7) has been added to § 20.2032A-3(g) in response to these comments. The example applies the material participation rules to a timber farm.

On September 10, 1979, the definition of gross cash rental contained in the originally published § 20.2032A-4(b) was withdrawn and reproposed. The reproposed section requires executors to rely on actual tracts of comparable property rented solely for cash in valuing farm real property under section 2032A(e)(7). That proposal also specified that state-wide averages of rentals and appraisals cannot be used to value property under section 2032A(e)(7). After consideration of all oral and written comments, the Treasury believes that there is no statutory basis for changing the rule as proposed in the Federal Register for September 10, 1979 (44 FR 52696).

Therefore, the final regulations adopt the position proposed on September 10, 1979. If comparable property rented solely for cash is not demonstrated by the executor for all specially valued property, all such property must be valued under section 2032A(e)(8).

Proposed § 20.2032A-8(a) required special use valuation elections to be made on a timely filed estate tax return. Several comments suggested accepting elections first made upon examination of a return. The requested suggestion was not adopted because of statutory restrictions. Several commentors asked that the final regulations include a rule on elections to specially value less than all qualified real property. A new § 20.2032A-8(a)(2) is added to the regulations permitting such partial elections, provided property sufficient to satisfy the statutory thresholds of section 2032A(b)(1)(B) and (C) is specially valued. Paragraph (a)(2) was also modified in response to the public comments to require a statement that specially valued property was owned at least 5 years before the date of the decedent's death rather than the date of acquisition. Further, the request for identification of periods of no material participation and use for farming purposes was restricted to the 8 years preceding the death.

Section 20.2032A-8(b) was changed in response to the comments to make clear that protective elections can be made even if tax is initially due and the estate qualifies based upon returned values.

A witness at the public hearing asked that final regulations include a statement on the duties of the agent designated in the areement to the section 2032A election. Section 20.2032A-8(c) was amended to specify that the agent must have satisfactory evidence of authority to act for the parties to the agreement required under section 2032A(a)(1)(B) and (d)(2) and to indicate the agent's duties. The requirement that certain creditors sign the agreement, contained in proposed § 20.2032A-8(c)(2), was deleted.

Proposed § 20.6166-1(d) was amended to delete any implied limitations on the circumstances in which a protective election can be made. The new rule is consistent with that for protective elections under section 2032A.

Proposed § 20.6324A-1 was rewritten as a cross-reference to new § 301.6324A-1 with the substantive rules contained in proposed § 20.6324A-1 being adopted as §301.6324A-1. This change was made to achieve consistency with other regulations on liens for taxes.

DRAFTING INFORMATION

The principal author of these regulations is H. B. Hartley of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, amendments to the regulations (26 CFR Parts 1, 20, and 301), are hereby adopted as set forth below:

Paragraph 1. Section 1.1402(a) is deleted.

Par. 2. Section 1.1402(a)-4 is amended by revising paragraph (b)(5) and by revising examples (5) and (6) in paragraph (b)(6) to read as follows:

§ 1.1402(a)-4 Rentals from real estate.

* * * * *

(b) *Special rule for "includible farm rental income"*— * * *

(5) *Employees or agents.* An agreement entered into by an employee or agent of an owner or tenant and another person is considered to be an arrangement entered into by the owner or tenant for purposes of satisfying the requirement set forth in paragraph (b)(2) that the income must be derived under an arrangement between the owner or tenant and another person. For purposes of determining whether the arrangement satisfies the requirement set forth in paragraph (b)(3) that the parties contemplate that the owner or tenant will materially participate in the production or management of production of a commodity, services which will be performed by an employee or agent of the owner or tenant are not considered to be services which the arrangement contemplates will be performed by the owner or tenant. Services actually performed by such employee or agent are not considered services performed by the owner or tenant in determining the extent to which the owner or tenant has participated in the production or management of production of a commodity. For taxable years beginning before January 1, 1974, contemplated or actual services of an agent or an employee of the owner or tenant are deemed to be contemplated or actual services of the owner or tenant under paragraphs (b)(3) and (b)(4) of this section.

(6) *Examples.* * * *

Example (5). I owned a farm several miles from the town in which he lived. He rented the farm to J under an arrangement which contemplated I's material participation in the management of production of wheat. I furnished one-half of the seed and fertilizer and all the farm equipment and livestock. He employed K to perform all the services in advising, consulting, and inspecting contemplated by the arrangement. I is not materially participating in the management of production of wheat by J. The work done by I's employee, K, is not attributable to I in determining the extent of I's participation. I's rental income from the arrangement is, therefore, not to be included in computing his net earnings from self-employment. For taxable years beginning before January 1, 1974, however, I's rental income would be includible in those earnings.

Example (6). L, a calendar-year taxpayer, appointed M as his agent to rent his fully equipped farm for 1974. M entered into a rental arrangement with N under which M was to direct the planting of crops, inspect them weekly during the growing season, and consult with N on any problems that might arise in connection with irrigation, etc., while N furnished all the labor needed to grow and harvest the crops. M did in fact fulfill its responsibilities under the arrangement. Although the arrangement entered into by M and N is considered to have been made by L, M's services are not attributable to L, and L's furnishing of a fully equipped farm is insufficient by itself to constitute material participation in the production of the crops. Accordingly, L's rental income from the arrangement is not included in his net earnings from self-employment for that year. For taxable years beginning before January 1, 1974, however, L's rental income would be includible in those earnings.

* * * * *

Par. 3. The following new sections are added following § 20.2032-1:

§ 20.2032A-3 Material participation requirements for valuation of certain farm and closely-held business real property.

(a) *In general.* Under section 2032A, an executor may, for estate tax purposes, make a special election concerning valuation of qualified real property (as defined in section 2032A (b)) used as a farm for farming purposes or in another trade or business. If this election is made, the property will be valued on the basis of its value for its qualified use in farming or the other trade or business, rather than its fair market value determined on the basis of highest and best use (irrespective of whether its highest and best use is the use in farming or other business). For the special valuation rules of section 2032A to apply, the deceased owner and/or a member of the owner's family (as defined in section 2032A(e)(2)) must materially participate in the operation of the farm or other business. Whether the required material participation occurs is a factual determination, and the types of activities and financial risks which will support such a finding will vary with the mode of ownership of both the property itself and of any business in which it is used. Passively collecting rents, salaries, draws, dividends, or other income from the farm or other business is not sufficient for material participation, nor is merely advancing capital and reviewing a crop plan or other business proposal and financial reports each season or business year.

(b) *Types of qualified property*— (1) *In general.* Real property valued under section 2032A must pass from

the decedent to a qualified heir or be acquired from the decedent by a qualified heir. The real property may be owned directly or may be owned indirectly through ownership of an interest in a corporation, a partnership, or a trust. However, real property is considered to be qualified real property only if a qualified heir receives or acquires a present interest in the property (determined under section 2503) from the decedent. Where the ownership is indirect, however, the decedent's interest in the business must, in addition to meeting the tests for qualification under section 2032A, qualify under the tests of section 6166(b)(1) as an interest in a closely-held business on the date of the decedent's death and for sufficient other time (combined with periods of direct ownership) to equal at least 5 years of the 8 year period preceding the death. All specially valued property must be used in a trade or business. Directly owned real property that is leased by a decedent to a separate closely held business is considered to be qualified real property, but only if the separate business qualifies as a closely held business under section 6166(b)(1) with respect to the decedent on the date of his or her death and for sufficient other time (combined with periods during which the property was operated as a proprietorship) to equal at least 5 years of the 8 year period preceding the death. For example, real property owned by the decedent and leased to a farming corporation or partnership owned and operated entirely by the decedent and fewer than 15 members of the decedent's family is eligible for special use valuation. Under section 2032A, the term trade or business applies only to an active business such as a manufacturing, mercantile, or service enterprise, or to the raising of agricultural or horticultural commodities, as distinguished from passive investment activities. The mere passive rental of property will not qualify. The decedent must own an equity interest in the farm operation. A trade or business is not necessarily present even though an office and regular hours are maintained for management of income producing assets, as the term "business" is not as broad under section 2032A as under section 162. Additionally, no trade or business is present in the case of activities not engaged in for profit. *See* section 183.

(2) *Structures and other real property improvements.* Qualified real property includes residential buildings and other structures and real property improvements occupied or used on a regular basis by the owner or lessee of real property (or by employees of the owner or lessee) for the purpose of operating the farm or other closely held business, A farm residence occupied by the decedent owner of the specially valued property is considered to be occupied for the purpose of operating the farm even though a family member (not the decedent) was the person materially participating in the operation of the farm as required under section 2032A(b)(1)(C).

(c) *Period material participation must last.* The required participation must last—

(1) For periods totalling 5 years or more during the 8 years immediately preceding the date of the decedent's death; and

(2) For periods totalling 5 years or more during any 8 year period ending after the date of the decedent's death (up to a maximum of 15 years after decedent's death, when the additional estate tax provisions of section 2032A (c) cease to apply).

In determining whether the material participation requirement is satisfied, no exception is made for periods during which real property is held by the decedent's estate. Additionally, contemporaneous material participation by 2 or more family members during a period totalling a year will not result in that year being counted as 2 or more years for purposes of satisfying the requirements of this paragraph (c). Death of a qualified heir (as defined in section 2032A(e)(1)) before the requisite time has passed ends any material participation requirement for that heir's portion of the property as to the original decedent's estate if the heir received a separate, joint or other undivided property interest from the decedent. If qualified heirs receive successive interests in specially valued property (e.g. life estate and remainder interests) from the decedent, the material participation requirement does not end with respect to any part of the property until the death of the last qualified heir (or, if earlier, the expiration of 15 years from the date of the decedent's death). The requirements of section 2032A will fully apply to an heir's estate if an election under this section is made for the same property by the heir's executor. In general, to determine whether the required participation has occurred, brief periods (*e.g.*, periods of 30 days or less) during which there was no material participation may be disregarded. This is so only if these periods were both preceded and followed by substantial periods (*e.g.*, periods of more than 120 days) in which there was uninterrupted material participation. *See* paragraph (e)(1) of this section which provides a special rule for periods when little or no activity is necessary to manage fully a farm.

(d) *Period property must be owned by decedent and family members.* Only real property which is actually owned by any combination of the decedent, members of the decedent's family, and qualified closely held businesses for periods totalling at least 5 of the 8 years preceding the date of decedent's death may be valued under section 2032A. For example, replacement property acquired in a like-kind exchange under section 1031 is considered to be owned only from the date on which the replacement property is actually acquired. On the other hand, replacement property acquired as a result of an involuntary conversion in a transfer that would meet the requirements of section 2032A(h) if it oc-

curred after the date of the decedent's death is considered to have been owned from the date in which the involuntarily converted property was acquired. Property transferred from a proprietorship to a corporation or a partnership during the 8-year period ending on the date of the decedent's death is considered to be continuously owned to the extent of the decedent's equity interest in the corporation or partnership if, (1) the transfer meets the requirements of section 351 or 721, respectively, and (2) the decedent's interest in the corporation or partnership meets the requirements for indirectly held property contained in paragraph (b)(1) of this section. Likewise, property transferred to a trust is considered to be continuously owned if the beneficial ownership of the trust property is such that the requirements of section 6166(b)(1)(C) would be so satisfied if the property were owned by a corporation and all beneficiaries having vested interests in the trust were shareholders in the corporation. Any periods following the transfer during which the interest in the corporation, partnership, or trust does not meet the requirements of section 6166(b)(1) may not be counted for purposes of satisfying the ownership requirement of this paragraph (d).

(e) *Required activities*—(1) *In general.* Actual employment of the decedent (or of a member of the decedent's family) on a substantially full-time basis (35 hours a week or more) or to any lesser extent necessary personally to manage fully the farm or business in which the real property to be valued under section 2032A is used constitutes material participation. For example, many farming operations require only seasonal activity. Material participation is present as long as all necessary functions are performed even though little or no actual activity occurs during nonproducing seasons. In the absence of this direct involvement in the farm or other business, the activities of either the decedent or family members must meet the standards prescribed in this paragraph and those prescribed in the regulations issued under section 1402(a)(1). Therefore, if the participant (or participants) is self-employed with respect to the farm or other trade or business, his or her income from the farm or other business must be earned income for purposes of the tax on self-employment income before the participant is considered to be materially participating under section 2032A. Payment of the self-employment tax is not conclusive as to the presence of material participation. If no self-employment taxes have been paid, however, material participation is presumed not to have occurred unless the executor demonstrates to the satisfaction of the Internal Revenue Service that material participation did in fact occur and informs the Service of the reason no such tax was paid. In addition, all such taxes (including interest and penalties) determined to be due must be paid. In determining whether the material participation requirement is satisfied, the activities of each participant are viewed separately from the activities of all other participants, and at any given time, the activities of at least one participant must be material. If the involvement is less than full-time, it must be pursuant to an arrangement providing for actual participation in the production or management of production where the land is used by any nonfamily member, or any trust or business entity, in farming or another business. The arrangement may be oral or written, but must be formalized in some manner capable of proof. Activities not contemplated by the arrangement will not support a finding of material participation under section 2032A, and activities of any agent or employee other than a family member may not be considered in determining the presence of material participation. Activities of family members are considered only if the family relationship existed at the time the activities occurred.

(2) *Factors considered.* No single factor is determinative of the presence of material participation, but physical work and participation in management decisions are the principal factors to be considered. As a minimum, the decedent and/or a family member must regularly advise or consult with the other managing party on the operation of the business. While they need not make all final management decisions alone, the decedent and/or family members must participate in making a substantial number of these decisions. Additionally, production activities on the land should be inspected regularly by the family participant, and funds should be advanced and financial responsibility assumed for a substantial portion of the expense involved in the operation of the farm or other business in which the real property is used. In the case of a farm, the furnishing by the owner or other family members of a substantial portion of the machinery, implements, and livestock used in the production activities is an important factor to consider in finding material participation. With farms, hotels, or apartment buildings, the operation of which qualifies as a trade or business, the participating decedent or heir's maintaining his or her principal place of residence on the premises is a factor to consider in determining whether the overall participation is material. Retention of a professional farm manager will not by itself prevent satisfaction of the material participation requirement by the decedent and family members. However, the decedent and/or a family member must personally materially participate under the terms of arrangement with the professional farm manager to satisfy this requirement.

(f) *Special rules for corporations, partnerships, and trusts*—(1) *Required arrangement.* With indirectly owned property as with property that is directly owned, there must be an arrangement calling for material participation in the business by the decedent

owner or a family member. Where the real property is indirectly owned, however, even full-time involvement must be pursuant to an arrangement between the entity and the decedent or family member specifying the services to be performed. Holding an office in which certain material functions are inherent may constitute the necessary arrangement for material participation. Where property is owned by a trust, the arrangement will generally be found in one or more of four situations. First, the arrangement may result from appointment as a trustee. Second, the arrangement may result from an employer-employee relationship in which the participant is employed by a qualified closely held business owned by the trust in a position requiring his or her material participation in its activities. Third, the participants may enter into a contract with the trustees to manage, or take part in managing, the real property for the trust. Fourth, where the trust agreement expressly grants the management rights to the beneficial owner, that grant is sufficient to constitute the arrangement required under this section.

(2) *Required activities.* The same participation standards apply under section 2032A where property is owned by a qualified closely held business as where the property is directly owned. In the case of a corporation, a partnership, or a trust where the participating decedent and/or family members are employees and thereby not subject to self-employment income taxes, they are to be viewed as if they were self-employed, and their activities must be activities that would subject them to self-employment income taxes were they so. Where property is owned by a corporation, a partnership or a trust, participation in the management and operation of the real property itself as a component of the closely held business is the determinative factor. Nominally holding positions as a corporate officer or director and receiving a salary therefrom or merely being listed as a partner and sharing in profits and losses will not alone support a finding of material participation. This is so even though, as partners, the participants pay self-employment income taxes on their distributive shares of partnership earnings under § 1.1402(a)-2. Further, it is especially true for corporate directors in states where the board of directors need not be an actively functioning entity or need only act informally. Corporate offices held by an owner are, however, factors to be considered with all other relevant facts in judging the degree of participation. When real property is directly owned and is leased to a corporation or partnership in which the decedent owns an interest which qualifies as an interest in a trade or business within the meaning of section 6166 (b)(1), the presence of material participation is determined by looking at the activities of the participant with regard to the property in whatever capacity rendered. During any periods when qualified real property is held by an estate, material participation is to be determined in the same manner as if the property were owned by a trust.

(g) *Examples.* The rules for determining material participation may be illustrated by the following examples. Additional illustrations may be found in examples (1) through (6) in § 1.1402(a)-4.

Example (1). A, the decedent, actively operated his 100-acre farm on a full-time basis for 20 years. He then leased it to B for the 10 years immediately preceding his death. By the terms of the lease, A was to consult with B on where crops were to be planted, to supervise marketing of the crop, and to share equally with B in expenses and earnings. A was present on the farm each spring for consultation; however, once planting was completed, he left for his retirement cottage where he remained until late summer, at which time he returned to the farm to supervise the marketing operation. A at all times maintained the farm home in which he had lived for the time he had owned the farm and lived there when at the farm. In light of his activities, assumption of risks, and valuable knowledge of proper techniques for the particular land gained over 20 years of full-time farming on the land involved, A is deemed to have materially participated in the farming business.

Example (2). D is the 70-year-old widow of farmer C. She lives on a farm for which special valuation has been elected and has lived there for 20 years. D leases the land to E under an arrangement calling for her participation in the operation of the farm. D annually raises a vegetable garden, chickens, and hogs. She also inspects the tobacco fields (which produce approximately 50 percent of the farm income) weekly and informs E if she finds any work that needs to be done. D and E share expenses and income equally. Other decisions such as what fields to plant and when to plant and harvest crops are left to E, but D does occasionally make suggestions. During the harvest season, D prepares and serves meals for all temporary farm help. D is deemed to participate materially in the farm operation based on her farm residence and her involvement with the main money crop.

Example (3). Assume that D in example (2) moved to a nursing home 1 year after her husband's death. E completely operated the farm for her for 6 years following her move. If E is not a member of D's family, material participation ceases when D moves; however, if E is a member of D's family, E's material participation will prevent disqualification even if D owns the property. Further, upon D's death, the section 2032A valuation could be elected for her estate if E were a member of her family and the other requirements of section 2032A were satisfied.

Example (4). F, a qualified heir, owned a specially valued farm. He contracted with G to manage the farm for him as F, a lawyer, lived and worked 15 miles away in a nearby town. F supplied all machinery and equipment and assumed financial responsibility for the expenses of the farm operation. The contract specified that G was to submit a crop plan and a list of expenses and earnings for F's approval. It also called for F to inspect the farm regularly and to approve all expenditures over $100. In practice, F visited the farm weekly during the growing season to inspect and discuss operations. He actively participated in making important management decisions such as what fields to plant or pasture and how to utilize the subsidy program. F is deemed to have materially participated in the farm operation as his personal involvement amounted to more than managing an investment. Had F not regularly inspected the farm and participated in management decisions, however, he would not be considered to be materially participating. This would be true even though F did assume financial responsibility for the operation and did review annual crop plans.

Example (5). Decedent I owned 90 percent of all outstanding stock of X Corporation, a qualified closely-held business which owns real property to be specially valued. I held no formal position in the corporation and there was no arrangement for him to participate in daily business operations. I

regularly spent several hours each day at the corporate offices and made decisions on many routine matters. I is not deemed to have materially participated in the X Corporation despite his activity because there was no arrangement requiring him to act in the manner in which he did.

Example (6). Decedent J was a senior partner in the law firm of X, Y, and Z, which is a qualified closely held business owning the building in which its offices are located. J ceased to practice law actively 5 years before his death in 1977; however, he remained a full partner and annually received a share of firm profits. J is not deemed to have materially participated under section 2032A even though he still may have reported his distributive share of partnership income for self-employment income tax purposes if the payments were not made pursuant to any retirement agreement. This is so because J does not meet the requirements of actual personal material participation.

Example (7). K, the decedent, owned a tree farm. He contracted with L, a professional forester, to manage the property for him as K, a doctor, lived and worked in a town 50 miles away. The activities of L are not considered in determining whether K materially participated in the tree farm operation. During the 5 years preceding K's death, there was no need for frequent inspections of the property or consultation concerning it, inasmuch as most of the land had been reforested and the trees were in the beginning stages of their growing cycle. However, once every year, L submitted for K's approval a proposed plan for the management of the property over the next year. K actively participated in making important management decisions, such as where and whether a pre-commercial thinning should be conducted, whether the timber was adequately protected from fire and disease, whether fire lines needed to be plowed around the new trees, and whether boundary lines were properly maintained around the property. K inspected the property at least twice every year and assumed financial responsibility for the expenses of the tree farm. K also reported his income from the tree farm as earned income for purposes of the tax on self-employment income. Over a period of several years, K had harvested and marketed timber from certain tracts of the tree farm and had supervised replanting of the areas where trees were removed. K's history of harvesting, marketing, and replanting of trees showed him to be in the business of tree farming rather than merely passively investing in timber land. If the history of K's tree farm did not show such an active business operation, however, the tree farm would not qualify for special use valuation. In light of all these facts, K is deemed to have materially participated in the farm as his personal involvement amounted to more than managing an investment.

Example (8). Decedent M died on January 1, 1978, owning a farm for which special use valuation under section 2032A has been elected. M owned the farm real property for 15 years before his death. During the 4 years preceding M's death (January 1, 1974 through December 31, 1977), the farm was rented to N, a nonfamily member, and neither M nor any member of his family materially participated in the farming operation. From January 1, 1970, until December 31, 1973, both M and his daughter, O, materially participated in the farming operation. The material participation requirement of section 2032A(b)(1)(C)(ii) is not satisfied because material participation did not occur for periods aggregating at least 5 different years of the 8 years preceding M's death.

§ 20.2032A-4 Method of valuing farm real property.

(a) *In general.* Unless the executor of the decedent's estate elects otherwise under section 2032A(e)(7)(B)(ii) or fails to document comparable rented farm property meeting the requirements of this section, the value of the property which is used for farming purposes and which is subject to an election under section 2032A is determined by—

(1) Subtracting the average annual state and local real estate taxes on actual tracts of comparable real property in the same locality from the average annual gross cash rental for that same comparable property, and

(2) Dividing the result so obtained by the average annual effective interest rate charged on new Federal land bank loans.

The computation of each average annual amount is to be based on the 5 most recent calendar years ending before the date of the decedent's death.

(b) *Gross cash rental—(1) Generally.* Gross cash rental is the total amount of cash received for the use of actual tracts of comparable farm real property in the same locality as the property being specially valued during the period of one calendar year. This amount is not diminished by the amount of any expenses or liabilities associated with the farm operation or the lease. *See*, paragraph (d) of this section for a definition of comparable property and rules for property on which buildings or other improvements are located and farms including multiple property types. Only rentals from tracts of comparable farm property which are rented solely for an amount of cash which is not contingent upon production are acceptable for use in valuing real property under section 2032A(e)(7). The rentals considered must result from an arm's-length transaction as defined in this section. Additionally, rentals received under leases which provide for payment solely in cash are not acceptable as accurate measures of cash rental value if involvement by the lessor (or a member of the lessor's family who is other than a lessee) in the management or operation of the farm to an extent which amounts to material participation under the rules of section 2032A is contemplated or actually occurs. In general, therefore, rentals for any property which qualifies for special use valuation cannot be used to compute gross cash rentals under this section because the total amount received by the lessor does not reflect the true cash rental value of the real property.

(2) *Special rules—(i) Documentation required of executor.* The executor must identify to the Internal Revenue Service actual comparable property for all specially valued property and cash rentals from that property if the decedent's real property is valued under section 2032A(e)(7). If the executor does not identify such property and cash rentals, all specially valued real property must be valued under the rules of section 2032A(e)(8) if special use valuation has been elected. *See*, however, § 20.2032A-8(d) for a special rule for estates electing section 2032A treatment on or before August 30, 1980.

(ii) *Arm's-length transaction required.* Only those cash rentals which result from a lease entered into in an arm's-length transaction are acceptable under section 2032A(e)(7). For these purposes, lands leased from the Federal government, or any state or local government, which are leased for

less than the amount that would be demanded by a private individual leasing for profit are not leased in an arm's-length transaction. Additionally, leases between family members (as defined in section 2032A(e)(2)) which do not provide a return on the property commensurate with that received under leases between unrelated parties in the locality are not acceptable under this section.

(iii) *In-kind rents, statements of appraised rental value, and area averages.* Rents which are paid wholly or partly in kind (*e.g.*, crop shares) may not be used to determine the value of real property under section 2032A(e)(7). Likewise, appraisals or other statements regarding rental value as well as area-wide averages of rentals (*i.e.*, those compiled by the United States Department of Agriculture) may not be used under section 2032A(e)(7) because they are not true measures of the actual cash rental value of comparable property in the same locality as the specially valued property.

(iv) *Period for which comparable real property must have been rented solely for cash.* Comparable real property rented solely for cash must be identified for each of the five calendar years preceding the year of the decedent's death if section 2032A(e)(7) is used to value the decedent's real property. Rentals from the same tract of comparable property need not be used for each of these 5 years, however, provided an actual tract of property meeting the requirements of this section is identified for each year.

(v) *Leases under which rental of personal property is included.* No adjustment to the rents actually received by the lessor is made for the use of any farm equipment or other personal property the use of which is included under a lease for comparable real property unless the lease specifies the amount of the total rental attributable to the personal property and that amount is reasonable under the circumstances.

(c) *State and local real estate taxes.* For purposes of the farm valuation formula under section 2032A(e)(7) state and local taxes are taxes which are assessed by a state or local government and which are allowable deductions under section 164. However, only those taxes on the comparable real property from which cash rentals are determined may be used in the formula valuation.

(d) *Comparable real property defined.* Comparable real property must be situated in the same locality as the specially valued property. This requirement is not to be viewed in terms of mileage or political divisions alone, but rather is to be judged according to generally accepted real property valuation rules. The determination of properties which are comparable is a factual one and must be based on numerous factors, no one of which is determinative. It will, therefore, frequently be necessary to value farm property in segments where there are different uses or land characteristics included in the specially valued farm. For example, if section 2032A(e)(7) is used, rented property on which comparable buildings or improvements are located must be identified for specially valued property on which buildings or other real property improvements are located. In cases involving multiple areas or land characteristics, actual comparable property for each segment must be used, and the rentals and taxes from all such properties combined (using generally accepted real property valuation rules) for use in the valuation formula given in this section. However, any premium or discount resulting from the presence of multiple uses or other characteristics in one farm is also to be reflected. All factors generally considered in real estate valuation are to be considered in determining comparability under section 2032A. While not intended as an exclusive list, the following factors are among those to be considered in determining comparability—

(1) Similarity of soil as determined by any objective means, including an official soil survey reflected in a soil productivity index;

(2) Whether the crops grown are such as would deplete the soil in a similar manner;

(3) The types of soil conservation techniques that have been practiced on the two properties;

(4) Whether the two properties are subject to flooding;

(5) The slope of the land;

(6) In the case of livestock operations, the carrying capacity of the land;

(7) Where the land is timbered, whether the timber is comparable to that on the subject property;

(8) Whether the property as a whole is unified or whether it is segmented, and where segmented, the availability of the means necessary for movement among the different segments;

(9) The number, types, and conditions of all buildings and other fixed improvements located on the properties and their location as it affects efficient management and use of property and value per se; and

(10) Availability of, and type of, transportation facilities in terms of costs and of proximity of the properties to local markets.

(e) *Effective interest rate defined—* (1) *Generally.* The annual effective interest rate on new Federal land bank loans is the average billing rate charged on new agricultural loans to farmers and ranchers in the farm credit district in which the real property to be valued under section 2032A is located, adjusted as provided in paragraph (e)(2) of this section. This rate is to be a single rate for each district covering the period of one calendar year and is to be computed to the nearest one-hundredth of one percent. In the event that the district billing rates of interest on such new agricultural loans change during a year, the

rate for that year is to be weighted to reflect the portion of the year during which each such rate was charged. If a district's billing rate on such new agricultural loans varies according to the amount of the loan, the rate applicable to a loan in an amount resulting from dividing the total dollar amount of such loans closed during the year by the total number of the loans closed is to be used under section 2032A. Applicable rates may be obtained from the district director of internal revenue.

(2) *Adjustment to billing rate of interest.* The billing rate of interest determined under this paragraph is to be adjusted to reflect the increased cost of borrowing resulting from the required purchase of land bank association stock. For section 2032A purposes, the rate of required stock investment is the average of the percentages of the face amount of new agricultural loans to farmers and ranchers required to be invested in such stock by the applicable district bank during the year. If this percentage changes during a year, the average is to be adjusted to reflect the period when each percentage requirement was effective. The percentage is viewed as a reduction in the loan proceeds actually received from the amount upon which interest is charged.

(3) *Example.* The determination of the effective interest rate for any year may be illustrated as follows:

Example. District X of the Federal land bank system charged an 8 percent billed interest rate on new agricultural loans for 8 months of the year, 1976, and an 8.75 percent rate for 4 months of the year. The average billing rate was, therefore, 8.25 percent [(1.08 × 8/12) + (1.0875 × 4/12) = 1.0825]. The district required stock equal to 5 percent of the face amount of the loan to be purchased as a precondition to receiving a loan. Thus, the borrower only received 95 percent of the funds upon which he paid interest. The applicable annual interest rate for 1976 of 8.68 percent is computed as follows: 8.25 percent × 1.00 (total loan amount) = 8.25 percent (billed interest rate) divided by 0.95 (percent of loan proceeds received by borrower) = 8.68 percent (effective interest rate for 1976).

§ 20.2032A-8 Election and agreement to have certain property valued under section 2032A for estate tax purposes.

(a) *Election of special use valuation*—(1) *In general.* An election under section 2032A is made as prescribed in paragraph (a)(3) of this section and on Form 706, United States Estate Tax Return. Once made, this election is irrevocable; however, see paragraph (d) of this section for a special rule for estates for which elections are made on or before August 30, 1980. Under section 2032A(a)(2), special use valuation may not reduce the value of the decedent's estate by more than $500,000. This election is available only if, at the time of death, the decedent was a citizen or resident of the United States.

(2) *Elections to specially value less than all qualified real property included in an estate.* An election under section 2032A need not include all real property included in an estate which is eligible for special use valuation, but sufficient property to satisfy the threshold requirements of section 2032A (b)(1)(B) must be specially valued under the election. If joint or undivided interests (e.g. interests as joint tenants or tenants in common) in the same property are received from a decedent by qualified heirs, an election with respect to one heir's joint or undivided interest need not include any other heir's interest in the same property if the electing heir's interest plus other property to be specially valued satisfy the requirements of section 2032A(b)(1)(B). If successive interests (e.g. life estates and remainder interests) are created by a decedent in otherwise qualified property, an election under section 2032A is available only with respect to that property (or portion thereof) in which qualified heirs of the decedent receive all of the successive interests, and such an election must include the interests of all of those heirs. For example, if a surviving spouse receives a life estate in otherwise qualified property and the spouse's brother receives a remainder interest in fee, no part of the property may be valued pursuant to an election under section 2032A. Where successive interests in specially valued property are created, remainder interests are treated as being received by qualified heirs only if (i) a qualified heir receives a present interest in that real property, (ii) all preceding interests in the property are vested absolutely in qualified heirs, and (iii) such remainder interests are not contingent upon surviving an alternate taker who is not a member of the decedent's family or are not vested subjected to divestment in favor of a nonfamily member. For the definition of present interest, *see* section 2503 and the regulations thereunder.

(3) *Time and manner of making election.* An election under this section is made by attaching to a timely filed estate tax return the agreement described in paragraph (c)(1) of this section and a notice of election which contains the following information:

(i) The decedent's name and taxpayer identification number as they appear on the estate tax return;

(ii) The relevant qualified use;

(iii) The items of real property shown on the estate tax return to be specially valued pursuant to the election (identified by schedule and item number);

(iv) The fair market value of the real property to be specially valued under section 2032A and its value based on its qualified use (both values determined without regard to the adjustments provided by section 2032A (b)(3)(B));

(v) The adjusted value (as defined in section 2032A(b)(3)(B) of all real property which is used in a qualified use and which passes from the decedent to a qualified heir and the adjusted value of all real property to be specially valued;

(vi) The items of personal property shown on the estate tax return that pass from the decedent to a qualified

heir and are used in a qualified use under section 2032A (identified by schedule and item number) and the total value of such personal property adjusted as provided under section 2032A(b)(3)(B);

(vii) The adjusted value of the gross estate, as defined in section 2032A(b)(3)(A);

(viii) The method used in determining the special value based on use;

(ix) Copies of written appraisals of the fair market value of the real property;

(x) A statement that the decedent and/or a member of his or her family has owned all specially valued real property for at least 5 years of the 8 years immediately preceding the date of the decedent's death;

(xi) Any periods during the 8-year period preceding the date of the decedent's death during which the decedent or a member of his or her family did not own the property, use it in a qualified use, or materially participate in the operation of the farm or other business within the meaning of section 2032A(e)(6);

(xii) The name, address, taxpayer identification number, and relationship to the decedent of each person taking an interest in each item of specially valued property, and the value of the property interests passing to each such person based on both fair market value and qualified use;

(xiii) Affidavits describing the activities constituting material participation and the identity of the material participant or participants; and

(xiv) A legal description of the specially valued property.

If neither an election nor a protective election is timely made, special use valuation is not available to the estate. *See* section 2032A(d)(1), 6075(a), and 6081(a).

(b) *Protective election.* A protective election may be made to specially value qualified real property. The availability of special use valuation pursuant to this election is contingent upon values as finally determined (or agreed to following examination of a return) meeting the requirements of section 2032A. A protective election does not, however, extend the time for payment of any amount of tax. Rules for such extensions are contained in sections 6161, 6163, 6166, and 6166A. The protective election is to be made by a notice of election filed with a timely estate tax return stating that a protective election under section 2032A is being made pending final determination of values. This notice is to include the following information:

(1) The decedent's name and taxpayer identification number as they appear on the estate tax return;

(2) The relevant qualified use; and

(3) The items of real and personal property shown on the estate tax return which are used in a qualified use, and which pass to qualified heirs (identified by schedule and item number).

If it is found that the estate qualifies for special use valuation based upon values as finally determined (or agreed to following examination of a return), an additional notice of election must be filed within 60 days after the date of such determination. This notice must set forth the information required under paragraph (a)(3) of this section and is to be attached, together with the agreement described in paragraph (c)(1) of this section, to an amended estate tax return. The new return is to be filed with the Internal Revenue Service office where the original return was filed.

(c) *Agreement to special valuation by persons with an interest in property*—(1) *In general.* The agreement required under section 2032A(a)(1)(B) and (d)(2) must be executed by all parties who have any interest in the property being valued based on its qualified use as of the date of the decedent's death. In the case of a qualified heir, the agreement must express consent to personal liability under section 2032A(c) in the event of certain early dispositions of the property or early cessation of the qualified use. *See* section 2032A(c)(6). In the case of parties (other than qualified heirs) with interests in the property, the agreement must express consent to collection of any additional estate tax imposed under section 2032A(c) from the qualified property. The agreement is to be in a form that is binding on all parties having an interest in the property. It must designate an agent with satisfactory evidence of authority to act for the parties to the agreement in all dealings with the Internal Revenue Service on matters arising under section 2032A and must indicate the address of that agent.

(2) *Persons having an interest in designated property.* An interest in property is an interest which, as of the date of the decedent's death, can be asserted under applicable local law so as to affect the disposition of the specially valued property by the estate. Any person in being at the death of the decedent who has any such interest in the property, whether present or future, or vested or contingent, must enter into the agreement. Included among such persons are owners of remainder and executory interests, the holders of general or special powers of appointment, beneficiaries of a gift over in default of exercise of any such power, co-tenants, joint tenants and holders of other undivided interests when the decedent held only a joint or undivided interest in the property or when only an undivided interest is specially valued, and trustees of trusts holding any interest in the property. An heir who has the power under local law to caveat (challenge) a will and thereby affect disposition of the property is not, however, considered to be a person with an interest in property under section 2032A solely by reason of that right. Likewise, creditors of an estate are not such persons solely by reason of their status as creditors.

(3) *Consent on behalf of interested*

party. If any person required to enter into the agreement provided for by paragraph (c)(1) either desires that an agent act for him or her or cannot legally bind himself or herself due to infancy or other incompetency, or to death before the election under section 2032A is timely exercised, a representative authorized under local law to bind such person in an agreement of this nature is permitted to sign the agreement on his or her behalf.

(4) *Duties of agent designated in agreement.* The Internal Revenue Service will contact the agent designated in the agreement under paragraph (c)(1) on all matters relating to continued qualification under section 2032A of the specially valued real property and on all matters relating to the special lien arising under section 6324B. It is the duty of the agent as attorney-in-fact for the parties with interests in the specially valued property to furnish the Service with any requested information and to notify the Service of any disposition or cessation of qualified use of any part of the property.

(d) *Special rule for estates for which elections under section 2032A are made on or before August 30, 1980.* An election to specially value real property under section 2032A that is made on or before August 30, 1980, may be revoked. To revoke an election, the executor must file a notice of revocation with the Internal Revenue Service office where the original estate tax return was filed on or before January 1, 1981 (or if earlier, the date on which the period of limitation for assessment expires). This notice of revocation must contain the decedent's name, date of death, and taxpayer identification number, and is to be accompanied by remittance of any additional amount of estate tax and interest determined to be due as a result of valuation of the qualified property based upon its fair market value. Elections that are made on or before August 30, 1980, that do not comply with this section as proposed on July 13, 1978 (43 FR 30070), and amended on December 21, 1978 (43 FR 59517), must be conformed to this final regulation by means of an amended return before the original estate tax return can be finally accepted by the Internal Revenue Service.

Par. 4. The third sentence of paragraph (c) of § 20.6081-1 is amended by striking out the first word and inserting in lieu thereof "Except as provided in § 20.2032A-8(d) and § 20.6166-1(h), the".

Par. 5. Section 20.6166 is deleted.

Par. 6. Sections 20.6166-1, 20.6166-2, 20.6166-3, and 20.6166-4 are redesignated §§ 20.6166A-1, 20.6166A-2, 20.6166A-3, and 20.6166A-4 respectively.

Par 7. The following new section is added following § 20.6165-1:

§ 20.6166-1 Election of alternate extension of time for payment of estate tax where estate consists largely of interest in closely held business.

(a) *In general.* Section 6166 allows an executor to elect to extend payment of part or all of the portion of the estate tax which is attributable to a closely held business interest (as defined in section 6166(b)(1)). If it is made at the time the estate tax return is filed, the election is applicable both to the tax originally determined to be due and to certain deficiencies. If no election is made when the estate tax return is filed, up to the full amount of certain later deficiencies (but not any tax originally determined to be due) may be paid in installments.

(b) *Time and manner of election.* The election provided under section 6166(a) is made by attaching to a timely filed estate tax return a notice of election containing the following information:

(1) The decedent's name and taxpayer identification number as they appear on the estate tax return;

(2) The amount of tax which is to be paid in installments;

(3) The date selected for payment of the first installment;

(4) The number of annual installments, including the first installment, in which the tax is to be paid;

(5) The properties shown on the estate tax return which constitute the closely held business interest (identified by schedule and item number); and

(6) The facts which formed the basis for the executor's conclusion that the estate qualifies for payment of the estate tax in installments.

In the absence of a statement in the notice of election as to the amount of tax to be paid in installments, the date selected for payment of the first installment, or the number of installments, the election is presumed to be for the maximum amount so payable and for payment thereof in 10 equal installments, the first of which is due on the date which is 5 years after the date prescribed in section 6151(a) for payment of estate tax.

(c) *Treatment of certain deficiencies*—(1) *No election before assessment of deficiency.* Where a deficiency is assessed and no election, including a protective election, has been made under section 6166(a) to pay any tax in installments, the executor may elect under section 6166(h) to pay the portion of the deficiency attributable to the closely held business interest in installments. However, this is true only if the estate qualifies under section 6166 based upon values as finally determined (or agreed to following examination of a return). Such an election is exercised by filing a notice of election with the Internal Revenue Service office where the estate tax return was filed. The notice of election must be filed within 60 days after issuance of notice and demand for payment of the deficiency, and it must contain the same information as is required under paragraph (b) of this section. The notice of election is to be accompanied by payment of the amount of tax and interest, the date for payment

of which has arrived as determined under paragraphs (e) and (f) of this section, plus any amount of unpaid tax and interest which is not attributable to the closely held business interest and which is not eligible for further extension (or currently extended) under another section (other than section 6166A).

(2) *Election made with estate tax return.* If the executor makes an election under section 6166(a) (other than a protective election) at the time the estate tax return is filed and a deficiency is later assessed, the portion of the deficiency which is attributable to the closely held business interest (but not any accrued interest thereon) will be prorated to the installments payable pursuant to the original section 6166(a) election. Any part of the deficiency prorated to an installment, the date for payment of which has arrived, is due upon notice and demand. Interest for any such period, including the deferral period, is payable upon notice and demand.

(3) *Portion of deficiency attributable to closely held business interest.* Only that portion of any deficiency which is attributable to a closely held business interest may be paid in installments under section 6166. The amount of any deficiency which is so attributable is the difference between the amount of tax which the executor has previously elected to pay in installments under section 6166 and the maximum amount of tax which the executor could have elected to pay in installments on the basis of a return which reflects the adjustments that resulted in the deficiency.

(d) *Protective election.* A protective election may be made to defer payment of any portion of tax remaining unpaid at the time values are finally determined (or agreed to following examination of a return) and any deficiencies attributable to the closely held business interest (within the meaning of paragraph (c)(3) of this section). Extension of tax payments pursuant to this election is contingent upon final values meeting the requirements of section 6166. A protective election does not, however, extend the time for payment of any amount of tax. Rules for such extensions are contained in sections 6161, 6163, and 6166A. A protective election is made by filing a notice of election with a timely filed estate tax return stating that the election is being made. Within 60 days after values are finally determined (or agreed to following examination of a return), a final notice of election which sets forth the information required under paragraph (b) of this section must be filed with the Internal Revenue Service office where the original estate tax return was filed. That notice of final election is to be accompanied by payment of any amount of previously unpaid tax and interest, the date for payment of which has arrived as determined under paragraphs (e) and (f) of this section, plus any amount of unpaid tax and interest which is not attributable to the closely held business interest and which is not eligible for further extension (or currently extended) under another section (other than section 6166A).

(e) *Special rules*—(1) *Effect of deficiencies and protective elections upon payment.* Upon election to extend the time for payment of a deficiency or upon final determination of values following a protective election, the executor must prorate the tax or deficiency attributable to the closely held business interest among all installments. All amounts attributed to installments which would have been due had the election been made at the time the tax was due to be paid under section 6151(a) and all accrued interest must be paid at the time the election is made.

(2) *Determination of date for payment of first installment.* The executor may defer payment of tax (but not interest) for any period up to 5 years from the date determined under section 6151(a) for payment of the estate tax. The date chosen for payment of the first installment of tax is not required to be on an annual anniversary of the original due date of the tax; however, it must be the date within any month which corresponds to the day of the month determined under section 6151(a).

(f) *Rule for computing interest.* Section 6601(j) provides a special 4 percent interest rate for the amount of tax (including deficiencies) which is to be paid in installments under section 6166. This special interest rate applies only to that amount of tax which is to be paid in installments and which does not exceed the limitation of section 6601(j)(2). Where payment of a greater amount of tax than is subject to section 6601(j)(2) is extended under section 6166, each installment is deemed to be comprised of both tax subject to the 4 percent interest rate and tax subject to the rate otherwise prescribed by section 6621. The percentage of any installment subject to the special 4 percent rate is equal to the percentage of the total tax payable in installments which is subject to the 4 percent rate. Where an election is made under the provisions of paragraphs (b) or (c)(1) of this section, the 4 percent rate applies from the date on which the estate tax was originally due to be paid. If only a protective election is made, section 6601(j) applies to the amount which is to be paid in installments, limited to the amount of any deficiency, from the due date for payment of estate tax. After the date upon which the section 6166 election is made final, section 6601(j) applies to the entire amount to be paid in installments.

(g) *Relation of sections 6166 and 6166A.* No election may be made under section 6166 if an election under section 6166A applies with respect to an estate. For example, no election can be made under section 6166(h) where an executor has made an election under section 6166A. If an election is timely

made under either section 6166 or section 6166A, however, a protective election can be made under the other section at the same time. If the executor then files a timely notice of final election under the section protectively elected and pays any amounts determined to be due currently following final determination of (or agreement as to) estate tax values, the original election under the other provision will be deemed never to have applied to the estate.

(h) *Special rule for estates for which elections under section 6166 are made on or before August 30, 1980.* An election to extend payment of estate tax under section 6166 that is made on or before August 30, 1980 may be revoked. To revoke an election, the executor must file a notice of revocation with the Internal Revenue Service office where the original estate tax return was filed on or before January 1, 1981 (or if earlier, the date on which the period of limitation on assessment expires). This notice of revocation must contain the decedent's name, date of death, and taxpayer identification number, and is to be accompanied by remittance of any additional amount of estate tax and interest determined to be due.

(i) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1)—(i). Based upon values shown on decedent A's timely filed estate tax return, 60 percent of the value of A's adjusted gross estate consisted of a farm which was a closely held business within the meaning of section 6166. A's executor, B, made a protective election under section 6166 when he filed A's estate tax return. B also applied for an extension of time under section 6161 to pay $15,000 of the $30,000 of estate tax shown due on the return. The requested extension was granted and was renewed at the end of 1 year. Eighteen months after the return was filed and after examination of A's estate tax return, the value of the farm was found to constitute 67 percent of the adjusted gross estate. B entered into an agreement consenting to the values as established on examination and to a deficiency of $5,000. B then filed a final notice of election under section 6166, choosing a 5-year deferral followed by 10 annual installment payments and thereby terminated his extension under section 6161 because that amount of tax was then included under the section 6166 election. B could have extended payment of 67 percent of the total estate tax, or $23,450. $23,450 is eligible for installment payments under section 6166 and the section 6166 election is considered to be for that amount. B is considered to have prepaid $3,450 of tax since only $20,000 of tax remained unpaid. The $3,450 is attributed to the first installment of $2,345 and to $1,105 of the second installment which would have been payable under the section 6166 election.

(ii) Had B been granted an extension of time under section 6161 to pay $20,000 of tax, $25,000 would remain unpaid when the final section 6166 election is made. Payment of the full $23,450 (67 percent) of tax which is attributable to the closely held business interest is included under the section 6166 election. The balance of unpaid tax ($1,550) is due upon expiration of the estate's section 6161 extension.

(iii) Assume the facts under example (1)(i). B must pay all unpaid accrued interest with his notice of final election. Since only 18 months have passed, no installments of tax are due. Interest on the $5,000 deficiency is computed at 4 percent per annum for the entire 18 months, and interest for 12 months of that period is currently due to be paid. Interest for the remaining 6 months is due at the next succeeding date for payment of interest. Interest on the $15,000 of tax extended under section 6161 is computed at the rate determined under section 6621 until the date of the final section 6166 election and is due upon termination of the section 6161 extension. After that date, the interest on the $15,000 will also accrue at 4 percent per annum.

Example (2). Assume the facts as in example (1), except B initially made an election under section 6166A and made no protective election under section 6166. Following final determination of values, B is not permitted to make any election under section 6166; however, had B protectively elected section 6166 at the time he made the section 6166A election, he could have terminated the section 6166A election and finally elected under section 6166. In such a case, the full $23,450 of tax attributable to the farm would have been eligible for extension under section 6166. The 4 percent interest rate would apply to the $5,000 deficiency from the original due date of the tax, and, as with the extension under section 6161, it would apply to the amounts extended under section 6166A only from the date on which the election under section 6166 was finalized.

Example (3). *C* died in 1977. His estate owes Federal estate taxes of $750,000, $500,000 of which is attributable to a closely held business interest. Payment of the $500,000 was extended under section 6166. A 5-year deferral followed by 10 annual installment payments was chosen by C's executor. Under paragraph (f) of this section, only 63.16 percent of each installment will be subject to the special 4 percent interest rate and the remainder will be subject to the rate determined under section 6621. The same rule applies in computing interest for the 5 years during which payment of tax is deferred. .(This is so because the 4 percent interest rate applies only to a maximum of $345,800 of tax less the $30,000 of credit allowable under section 2010(a) rather than to the entire $500,000 extended amount.)

Par 8. The following new section is added following § 20.6324-1:

§ 20.6324A-1. Election of and agreement to special lien for estate tax deferred under section 6166 or 6166A.

For regulations concerning the election of and agreement to the special lien for estate tax deferred under section 6166 or 6166A, *see* § 301.6324A-1 of this Chapter (Regulations on Procedure and Administration).

Par. 9. The following new section is added following § 301.6324-1:

§ 301.6324A-1 Election of and agreement to special lien for estate tax deferred under section 6166 or 6166A.

(a) *Election of lien.* If payment of a portion of the estate tax is deferred under section 6166 or 6166A, an executor of a decedent's estate who seeks to be discharged from personal liability may elect a lien in favor of the United States in lieu of the bonds required by sections 2204 and 2165. This election is made by applying to the Internal Revenue Service office where the estate tax return is filed at any time prior to payment of the full amount of estate tax and interest due. The application is to be a notice of election requesting the special lien provided by section 6324A and is to be accompanied by the agreement described in paragraph (b)(1) of this section.

(b) *Agreement to lien*—(1) *In general.* A lien under this section will not arise unless all parties having any interest in all property designated in the notice of election as property to which the lien is to attach sign an agreement in which they consent to the creation

of the lien. (Property so designated need not be property included in the decedent's estate.) The agreement is to be attached to the notice in which the lien under section 6324A is elected. It must be in a form that is binding on all parties having any interest on the property and must contain the following:

(i) The decedent's name and taxpayer identification number as they appear on the estate tax return;

(ii) The amount of the lien;

(iii) The fair market value of the property to be subject to the lien as of the date of the decedent's death and the date of the election under this section;

(iv) The amount, as of the date of the decedent's death and the date of the election, of all encumbrances on the property, including mortgages and any lien under section 6324B;

(v) A clear description of the property which is to be subject to the lien, and in the case of property other than land, a statement of its estimated remaining useful life; and

(vi) Designation of an agent (including the agent's address) for the beneficiaries of the estate and the consenting parties to the lien for all dealings with the Internal Revenue Service on matters arising under section 6166 or 6166A, or under section 6324A.

(2) *Persons having an interest in designated property.* An interest in property is any interest which as of the date of the election can be asserted under applicable local law so as to affect the disposition of any property designated in the agreement required under this section. Any person in being at the date of the election who has any such interest in the property, whether present or future, or vested or contingent, must enter into the agreement. Included among such persons are owners of remainder and executory interests, the holders of general or special powers of appointment, beneficiaries of a gift over in default of exercise of any such power, co-tenants, joint tenants, and holders of other undivided interests when the decedent held a joint or undivided interest in the property, and trustees of trusts holding any interest in the property. An heir who has the power under local law to caveat (challenge) a will and thereby affect disposition of the property is not, however, considered to be a person with an interest in property under section 6324A solely by reason of that right. Likewise, creditors of an estate are not such persons solely by reason of their status as creditors.

(3) *Consent on behalf of interested party.* If any person required to enter into the agreement provided for by this paragraph either desires that an agent act for him or her or cannot legally bind himself or herself due to infancy or other incompetency, a representative authorized under local law to bind the interested party in an agreement of this nature is permitted to sign the agreement on his or her behalf.

(4) *Duties of agent designated in agreement.* The Internal Revenue Service will contact the agent designated in the agreement under paragraph (b)(1) on all matters relating to continued qualification of the estate under section 6166 or 6166A and on all matters relating to the special lien arising under section 6324A. It is the duty of the agent as attorney-in-fact for the parties with interests in the property subject to the lien under section 6324A to furnish the Service with any requested information and to notify the Service of any event giving rise to acceleration of the deferred amount of tax.

(c) *Partial substitution of bond for lien.* If the amount of unpaid estate tax plus interest exceeds the value (determined for purposes of section 6324A(b)(2)) of property listed in the agreement under paragraph (b) of this section, the Internal Revenue Service may condition the release from personal liability upon the executor's submitting an agreement listing additional property or furnishing an acceptable bond in the amount of such excess.

(d) *Relation of sections 6324A and 2204.* The lien under section 6324A is deemed to be a bond under section 2204 for purposes of determining an executor's release from personal liability. If an election has been made under section 6324A, the executor may not substitute a bond pursuant to section 2204 in lieu of that lien. If a bond has been supplied under section 2204, however, the executor may, by filing a proper notice of election and agreement, substitute a lien under section 6324A for any part or all of such bond.

(e) *Relation of sections 6324A and 6324.* If there is a lien under this section on any property with respect to an estate, that lien is in lieu of the lien provided by section 6324 on such property with respect to the same estate.

(f) *Section 6324A lien to be in lieu of bond under section 6165.* The lien under section 6324A is in lieu of any bond otherwise required under section 6165 with respect to tax to be paid in installments under section 6166 or section 6166A.

(g) *Special rule for estates for which elections under section 6324A are made on or before August 30, 1980.* If a lien is elected under section 6324A on or before August 30, 1980, the original election may be revoked. To revoke an election, the executor must file a notice of revocation containing the decedent's name, date of death, and taxpayer identification number with the Internal Revenue Service office where the original estate tax return for the decedent was filed. The notice must be filed on or before January 31, 1981 (or if earlier, the date on which the period of limitation for assessment expires).

This Treasury decision is issued under the authority contained in sections 2032A and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1856, 68A Stat. 917, 26 U.S.C. 2032A, 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved July 18, 1980.

EMIL M. SUNLEY,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 28, 1980, 3:16 p.m., and published in the issue of the Federal Register for July 31, 1980, 45 F.R. 50736)

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26 CFR 20.2032A-8: Election and agreement to have certain property valued under section 2032A for estate tax purposes.

Procedures for electing to value less than all qualified real property in a decedent's gross estate under section 2032A of the Code where an election to value all the qualified real property under section 2032A was previously made on or before August 30, 1980. See Rev. Proc. 80-49, page 816.

Section 2033.—Property in Which the Decedent Had an Interest

26 CFR 20.2033-1: Property in which the decedent had an interest.

Whether property, held by the decedent and decedent's spouse as tenants by the entirety, which is converted to a tenancy in common upon divorce, is includible in decedent's gross estate under section 2033 of the Code. See Rev. Rul. 80-241, page 273.

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26 CFR 20.2033-1: Property in which the decedent had an interest.

Treatment of proceeds from life insurance policy purchased by a Texas decedent before marriage and supported after marriage by premium payments from community property funds. See Rev. Rul. 80-242, page 276.

Section 2035.—Adjustments for Gifts Made Within 3 Years of Decedent's Death

Transfer within 3 years of death; life insurance; time of transfer. An employee who was insured under a group term life insurance policy, the premiums for which were paid by the employer, assigned all rights under the policy to the insured's spouse in 1971 under an agreement assigning the spouse the rights under any arrangement of the employer for life insurance coverage. The employer terminated its insurance arrangement and obtained a similar arrangement with a different insurer in 1977, less than three years before the insured's death, and the insured assigned the new policy to the spouse. The value of the policy proceeds is not includible in the insured's gross estate. Rev. Rul. 79-231 revoked.

Rev. Rul. 80-289 [1]

The decedent, *D* was an active employee of the *X* corporation until the date of death on November 16, 1977.

In 1970, *X* corporation entered into a group term life insurance arrangement with the *Y* insurance company. Under the plan, a master insurance policy was issued to the *X* corporation and individual insurance certificates were issued to the *X* corporation employees. All premiums were paid by the *X* corporation. The *Y* insurance company master policy provides, among other things, that an insured employee may assign all rights in the insurance policy to any person with such an assignment to be effective upon written notification to, and acceptance by, the *Y* insurance company.

In 1971, *D* assigned all rights under the insurance policy issued by the *Y* insurance company to *D*'s spouse. The employer was duly notified of the assignment, and the *Y* insurance company received and accepted the assignment. Before making the assignment, *D* executed a written agreement with *D*'s spouse stating that the assignment would vest in the assignee-spouse not only *D*'s rights under the current policy issued by the *Y* insurance company, but also *D*'s rights under any arrangement for life insurance coverage of the employees of *X* corporation.

On January 17, 1977, less than 3 years before *D*'s death, the *X* corporation terminated the insurance arrangement with the *Y* insurance company and obtained a new master contract from the *Z* insurance company. Notice of the termination of coverage under the master policy of the *Y* insurance company was properly given to the employees and their assignees. Upon termination, the new master policy of the *Z* insurance company came into effect. The terms of the new master policy and the individual employees' certificates of insurance were, in all relevant aspects, identical to the terms of the previous arrangement with the *Y* insurance company. Two weeks after the *Z* insurance company coverage came into effect, the decedent executed an assignment of all rights under the new policy to the decedent's spouse.

Rev. Rul. 79-231, 1979-2 C.B. 323, concluded under identical facts that the anticipatory assignment in 1971 was not effective as a present transfer of the decedent's rights in the group term life insurance policy issued by the *Z* insurance company and that the time of transfer for purposes of section 2035 was in 1977. The Internal Revenue Service maintains the view that the anticipatory assignment was not technically effective as a present transfer of the decedent's rights in the policy issued by *Z*. Nevertheless, the Service believes that the assignment in 1977 to *D*'s spouse, the object of the anticipatory assignment in 1971, should not cause the value of the proceeds to be includible in the gross estate of the decedent under section 2035 where the assignment was necessitated by the change of the employer's master insurance plan carrier and the new arrangement is identical in all relevant aspects to the previous arrangement with *Y*.

HOLDING

The value of the proceeds from the group term life insurance policy is not includible in the gross estate of the decedent under section 2035 of the Code.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 79-231 is revoked.

[1] Also released as News Release IR-80-103, dated October 7, 1980.

26 CFR 20.2035-1: Transactions in contemplation of death.

Transfers within 3 years of death; stock dividend declared during transferee's ownership. Prior to death a decedent gratuitously transferred 500 shares of stock in a publicly traded corporation to an individual. After the transfer, the corporation declared a stock dividend of one share for every two shares owned, giving the individual 750 shares. The decedent died during the next year. The fair market value of the 750 shares of stock is includible in the decedent's gross estate.

Rev. Rul. 80-336

ISSUE

For purposes of section 2035 of the Internal Revenue Code, what is includible in the gross estate if, within three years of death, the decedent transferred shares of stock upon which a stock dividend was declared during the transferee's ownership?

FACTS

In January 1979, *D*, the decedent, gratuitously transferred 500 shares of stock of *X* Corporation to *A*. The stock of *X* Corporation is publicly traded.

In December 1979, *X* Corporation declared a stock dividend of one share of stock for every two shares owned.

At *D*'s death in 1980 *A* owned 750 shares of *X* Corporation stock. However, on the federal estate tax return, the executor included only 500 shares. The executor stated that the 250 shares acquired from the stock dividend were not part of the original transfer.

LAW AND ANALYSIS

Section 2035 of the Code provides, in part, that the value of all property that the decedent gratuitously transferred during the three-year period ending on the date of the decedent's death is includible in the decedent's gross estate.

The value of property includible in the gross estate under section 2035 is the fair market value as of the decedent's death. Neither income received subsequent to the transfer nor property purchased with such income is considered in determining the value of the property. Section 20.2035-1(e) of the regulations. Rather, only the value of the property originally transferred by the decedent is includible in the gross estate under section 2035. See Rev. Rul. 72-282, 1972-1 C.B. 306.

A stock dividend, in which common stock is proportionately distributed according to the number of common shares held, does not alter the fractional interests of the stockholders. In *Eisner v. Macomber*, 252 U.S. 189, 202 (1920), 1920-3 C.B. 25, 27, a case involving the federal income tax, the Court quoted from a previous case in describing the nature of a stock dividend as follows:

> "A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. . . . The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original share together representing the same proportional interest that the original shares represented before the issue of the new ones. . . . In short, the corporation is no poorer and the stockholder is no richer than they were before."

Similarly, for estate tax purposes, the stock acquired through such a pro rata common stock dividend is regarded as part of the interest held in the corporation prior to the dividend. *See Estate of Schlosser v. Commissioner*, 277 F. 2d 268 (3rd Cir. 1960), *cert. denied*, 364 U.S. 819 (1960), considering the treatment of a common stock dividend for alternate valuation purposes and Rev. Rul. 80-142, 1980-1 C.B. 197, holding that, for purposes of section 2040 of the Code, a common stock dividend declared on jointly owned stock is considered the contribution of the tenant who originally created the tenancy. *Compare McGehee v. Commissioner*, 260 F. 2d 818 (5th Cir. 1958). In *McGehee*, the parties stipulated that the stock dividend was generated by profits that were earned after the transfer. In view of the analysis discussed above, the analysis of *McGehee* would not be followed even if the stock dividend could be attributed to post-transfer income.

In the present situation, since the common stock dividend was distributed to common shareholders on a pro rata basis, the *X* Corporation shares held by *A* at *D*'s death represent the same fractional interest in the corporation transferred by *D*. Thus, the 250 shares are not distinguishable from the 500 original shares, for purposes of section 2035.

HOLDING

The fair market value of the 750 shares of *X* Corporation is includible in *D*'s gross estate as property transferred by *D* within three years of death.

Section 2036.—Transfers With Retained Life Estate

(Also Section 318; 1.318-1.)

Stock transferred in trust; indirect retention of voting rights. An individual owned 19 shares of a closely held corporation's stock, and the individual's children owned the other 81 shares. On June 30, 1976, the individual transferred the 19 shares to a trust. The trust instrument gave the trustee sole authority to vote the shares, but at the time of the transfer, the trustee agreed to consult the transferor with respect to voting and to vote only with the transferor's consent. The transferor indirectly retained the right to vote the transferred shares, and their value is includible in the transferor's gross estate.

Rev. Rul. 80-346

ISSUE

Are shares of stock of a closely held corporation includible in a decedent's gross estate under section 2036 of the Internal Revenue Code if the decedent transferred the shares and the voting rights, under the circumstances described below?

FACTS

The decedent, *D*, owned 19 shares of stock of *X* Corporation, a closely held corporation. *D*'s children owned the remaining 81 shares of *X* Corporation stock.

On June 30, 1976, *D* transferred the 19 shares to a trust for the benefit of *D*'s adult children. *A* was designated as trustee. The trust instrument provided that *A* would have sole authority to vote the shares. However, it was agreed, at the time of the transfer, that *A* would consult *D* with respect to voting the stock and would vote only with *D*'s consent. Thereafter, *A* exercised the voting rights only after obtaining *D*'s approval.

D died on July 12, 1979. The transferred shares were not included in *D*'s gross estate on the federal estate tax return filed.

LAW AND ANALYSIS

Section 2036(a) of the Code provides, in part, that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has made a transfer under which the decedent retained, for any period which does not in fact end before death, the enjoyment of the property.

Section 2036(b) of the Code provides, in part, that the retention of the right to vote, directly or indirectly, shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property. A corporation shall be treated as a controlled corporation if, at any time after the transfer of the property and during the three year period ending on the date of death, the decedent owned, with the application of section 318, or had the right to vote stock possessing at least 20 percent of the total combined voting power of all classes of stock.

Section 20.2036-1(a) of the regulations provides that an interest or right will be treated as having been retained or reserved if at the time of the transfer, there was an express or implied understanding that the interest or right would later be conferred.

Section 318(a) of the Code provides, in part, that an individual shall be considered as the owner of the stock owned, directly or indirectly, by the individual's children. Unless otherwise provided, as in section 2036(b), the provisions in section 318(a) apply only to the sections enumerated in section 318(b).

Section 2036(b) of the Code was enacted because Congress believed that voting rights are so significant with respect to corporate stock that the retention of voting rights by a donor should be treated as the retention of the enjoyment of the stock for estate tax purposes. H.R. Rep. No. 94-1380, 94th Cong., 2d Sess. 65 (1976), 1976-3 C.B. (Vol. 3) 735, 799. However, only shares of a controlled corporation are affected by the statute. Section 2036(b) applies only in the case of a controlled corporation.

In the present situation, under section 318, *D* is deemed to have been the owner of at least 20 percent of the total combined voting power of all of *X* Corporation stock. Therefore, *X* Corporation is a controlled corporation within the meaning of section 2036(b).

The constructive ownership rules of section 318 apply solely for the purpose of determining whether a corporation is a controlled corporation, and are not applicable in determining if the decedent possessed ownership or voting control over transferred stock. S. Rep. No. 95-745, 95th Cong., 2d Sess. 90 (1978).

Under section 2036(b), however, the transferor's retention of voting rights need not be direct to cause inclusion of the stock in the transferor's gross estate. The retention may be indirect, such as an agreement or arrangement with a trustee to vote the stock in accordance with directions of the decedent. S. Rep. No. 95-745, *supra.*, at 90.

Under the facts presented, *D*, at the time of the transfer, indirectly retained the voting rights under an oral agreement with the trustee notwithstanding that the trust instrument made no such provision. *Cf. Estate of Beckwith v. Commissioner,* 55 T.C. 242 (1970), acq., 1971-2 C.B. 1.

HOLDING

Since *D* indirectly retained the right to vote the 19 shares of the controlled corporation, the value of the shares is includible in *D*'s gross estate under section 2036 of the Code.

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26 CFR 20.2036-1: Transfers with retained life estate.
(Also Section 2038; 20.2038-1.)

Trust; retained interest; after-born and after-adopted children. The provision in a trust instrument for the inclusion of all the settlor's after-born and after-adopted children as additional beneficiaries is not the retention of a power to change the beneficial interests of the trust within the meaning of sections 2036(a)(2) and 2038(a)(1) of the Code.

Rev. Rul. 80-255

ISSUE

For purposes of sections 2036(a)(2) and 2038(a)(1) of the Internal Revenue Code, did a decedent-settlor retain a power to change the beneficial interests of a trust, requiring inclusion of the trust property in the settlor's gross estate, if under the trust instru-

ment all of the decedent-settlor's after-born and after-adopted children were to become trust beneficiaries?

FACTS

In 1975, the decedent, *D*, created an irrevocable trust. The trust instrument provided that income was to be paid in equal shares to *D*'s children. Principal was to be distributed twenty-one years after the creation of the trust in equal shares to each child (or the child's heirs). The trust instrument also provided that the children of *D*, born or adopted after the creation of the trust, were to be additional beneficiaries. When the trust was created, *D* had two children, *A* and *B*. In 1978, *D*'s third child, *C*, was born.

D died in 1980. At that time, *A*, *B*, and *C* were beneficiaries of the trust.

LAW AND ANALYSIS

Section 2036(a)(2) of the Code provides that the value of the gross estate shall include the value of any interest in property transferred by a decedent if the decedent has retained for life the right, alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 2038(a)(1) of the Code provides that the value of the gross estate shall include the value of all property transferred by the decedent if the enjoyment of the property was subject to change at his death through the exercise of a power by the decedent, alone or in conjunction with any person, to alter, amend, revoke, or terminate.

Rev. Rul. 72-307, 1972-1 C.B. 307, provided that the power to cancel a group-term life insurance policy solely terminating employment is not an incident of ownership, under section 20.2042-1(c) of the Estate Tax Regulations, in the policy. The revenue ruling at 308, stated:

> An insured's power to cancel his insurance coverage by terminating his employment is a collateral consequence of the power that every employee has to terminate his employment. The examples in section 20.2042-1(c) of the regulations, on the other hand, concern powers that directly affect the insurance policy or the payment of its proceeds without potentially costly related consequences. Where the power to cancel an insurance policy is exercisable only by terminating employment, it is not deemed to be an incident of ownership in the policy.

Accordingly, the revenue ruling held that the value of the proceeds of the group insurance was not includible in the decedent's gross estate under section 2042 of the Code. In *Estate of Whitworth*, T.C.M. 1963-41, the Tax Court concluded that Congress did not intend to include the ability to terminate one's employment, thereby revoking a spouse's rights to pension benefits, as a power to revoke within the meaning of section 2038.

In *Estate of Tully v. United States*, 528 F. 2d 1401 (Ct. Cl. 1976), the decedent-employee entered into an employment contract whereby the employer promised to pay death benefits to the decedent's widow. The court held that the decedent did not have a power to revoke under section 2038(a)(1) of the Code, even though the decedent could have divorced the spouse, thereby eliminating the spouse's possible status as widow. The court said: "In reality, a man might divorce his wife, but to assume that he would fight through an entire divorce process merely to alter employee death benefits approaches the absurd."

Likewise, the act of bearing or adopting children is an act of independent significance, the incidental and collateral consequence of which is to add the child as beneficiary to the trust. Although *D*'s act of bearing or adopting children will automatically result in adding the child as beneficiary to the trust, such result is merely a collateral consequence of the bearing or adopting children. Cf. Rev. Rul. 75-415, 1975-2 C.B. 374.

Thus, a trust provision automatically including the settlor's after-born and after-adopted children as beneficiaries is not equivalent to the settlor's retention of a power to designate or change beneficial interests within the meaning of sections 2036(a) and 2038 of the Code.

For the same reason, at the time of creation of the trust, *D* is not treated as having reserved a power to change beneficial interests under section 25.2511-2(c) of the Gift Tax Regulations as a result of providing in the trust instrument that *D*'s after-born or after-adopted children are to be trust beneficiaries. *Cf.* Rev. Rul. 55-678, 1955-2 C.B. 389. Therefore, *D*'s establishment of the trust was a completed gift, because *D* did not retain dominion and control over the transferred property.

HOLDING

D did not retain a power to change the beneficial interests of the trust, for purposes of sections 2036(a)(2) and 2038(a)(1) of the Code, notwithstanding that all of *D*'s after-born and after-adopted children were to become beneficiaries. Therefore, the trust property is not includible in *D*'s gross estate.

Section 2038.—Revocable Transfers

26 CFR 20.2038-1: Revocable transfers.

Whether a decedent-settlor retains a power to change the beneficial interests of a trust if under the trust instrument all of the decedent-settlor's after-born and after-adopted children are to become trust beneficiaries. See Rev. Rul. 80-255, page 272.

Section 2040.—Joint Interests

26 CFR 20.2040-1: Joint interests. (Also Sections 2033, 2515; 20.2033-1, 25.2515-1.)

Jointly held property; divorce. A spouse purchased real property with separate funds and took title in the names of both spouses either as tenants by the entirety or as joint tenants with right of survivorship. In a state where a subsequent divorce converts a tenancy by the entirety or a joint tenancy

into a tenancy in common, such a divorce would result in a gift of one-half the value of the property. In a state where a joint tenancy is not terminated by divorce, no gift results. Upon the contributor's death more than three years after the divorce the portion of the property that was not considered a gift is includible in the contributor's gross estate.

Rev. Rul. 80-241

ISSUE

What is the proper application of section 2040(a) and section 2515 of the Internal Revenue Code if property was held by the decedent and decedent's spouse as tenants by the entirety, or in the alternative, as joint tenants with right of survivorship and the decedent is divorced prior to death.

FACTS

Situation 1

In 1970, *A* purchased real property for 100*x* dollars and took title in the names of *A* and *B*, as tenants by the entirety. The property was located in State *X*, the jurisdiction where *A* and *B* resided. *A* provided the entire consideration for the property, and *A* did not elect under section 2515(c) of the Code to treat the creation of the tenancy by the entirety as a gift to *B*. Under the laws of State *X*, a tenancy by the entirety, unlike a joint tenancy, cannot be unilaterally severed.

In 1972 *A* and *B* were divorced. Prior to divorce, *A* and *B* did not execute a written agreement relative to their marital and property rights. The divorce decree did not contain any provision regarding the partition and disposition of the real property. However, it did provide for periodic support payments to *B*. *A* died in 1976.

The laws of State *X* provide that upon the dissolution of a marriage by divorce, a tenancy by the entirety is converted by operation of law into a tenancy in common. Each party then own an undivided one-half interest in the property. See for example, *Hendel v. Hendel*, 44 App. Div. 2d 532, 353 N.Y.S. 2d 454 (1974); *McIntyre v. McIntyre*, 377 S.W. 2d 421 (Mo. 1964); *Bernatavicius v. Bernatavicius*, 259 Mass. 486, 156 N.E. 685 (1927).

Situation 2

The facts are the same as in *Situation 1* except that title to the property was originally taken in the names of *A* and *B*, as joint tenants with right of survivorship. *Situation 2* will consider two possible dispositions of the property under state law, as follows:

1. The laws of State *X* provide that if property is held by a husband and wife as joint tenants, the joint tenancy is not affected if the parties are divorced. If the divorce decree or separation agreement does not provide for the disposition of the joint property, the property continues to be held by the parties as joint tenants after the divorce. See, *Bradley v. Mann*, 34 Colo. App. 135, 525 P. 2d 492 (1974), *aff'd* 535 P. d 213 (1975); *Summerlin v. Bowden*, 286 Ala. 391, 240 So. 2d 356 (1970); *Nichols v. Nichols*, 43 Wisc. 2d 346, 168 N.W. 2d 876 (1996); *Witzel v. Witzel*, 386 P. 2d 103 (Wyo. 1963).

2. The laws of State *X* provide that if the divorce decree or separation agreement does not provide for the disposition of the joint property, then the joint tenancy is converted by operation of law into a tenancy in common. *See for example, Ramirez v. Ramirez*, 309 So. 2d 25 (Fla. 1975); *Smith v. Smith*, 169 N.E. 2d 130 (Ind. 1960).

LAW AND ANALYSIS

Section 2033 of the Code includes in the gross estate the value of all property to the extent of the decedent's interest in the property.

Section 2040(a) of the Code provides the general rule that the decedent's gross estate shall include the entire value of property held by the decedent as a joint tenant with right of survivorship, or as a tenant by the entirety, except to the extent that the value of the property is attributable to consideration in money or money's worth furnished by the other joint tenant. *See*, section 2040(b) of the Code, which was added by the Tax Reform Act of 1976, Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1, 331, for an exception to the general rule of section 2040(a) in a situation in which the creation of tenancy by the entirety or joint tenancy in real property was treated as a gift under section 2515.

The creation of a joint tenancy or tenancy by the entirety in real property is generally considered a gift, for gift tax purposes. However, section 2515(a) provides that the creation of a tenancy by the entirety, or a joint tenancy, in real property by one spouse is not considered a transfer for purposes of the gift tax unless the donor elects to have the transfer treated as a gift. If the donor does not elect to treat the creation of the tenancy as a gift, then pursuant to section 2515(b), the termination of the tenancy other than by reason of the death of a spouse is a gift, ". . . to the extent that the proportion of the total consideration furnished by such spouses multiplied by the proceeds of such termination (whether in form of cash, property, or interests in property) exceeds the value of such proceeds of termination received by such spouse."

Section 25.2515-1(d)(2) of the Gift Tax Regulations defines the term "termination" as follows:

> . . . [A] termination of a tenancy is effected when all or a portion of the property so held by the spouses is sold, exchanged, or otherwise disposed of, by gift or in any other manner, or when the spouses, through any form of conveyance or agreement become tenants in common of the property or otherwise alter the nature of their respective interests in the property. . . .

In *Situation 1*, above, upon the issuance of the final court decree the tenancy by the entirety was terminated by operation of law. This termination

would be subject to the gift tax. At the time of *A*'s death, the property is not subject to the provisions of section 2040, because the property is not held as a tenancy by the entirety, or a joint tenancy. Only the value of *A*'s undivided one-half interest as a tenant in common is includible in *A*'s gross estate under section 2033 of the Code.

In *Situation 2*, the property was initially purchased in the names of *A* and *B* as joint tenants with right of survivorship. If, under applicable state law the property continues to be held by the parties as joint tenants after the divorce, then upon *A*'s death, section 2040 would be applicable in determining the estate taxation of the property. Since in the situation presented, the entire value of the property is attributable to consideration in money or money's worth furnished by *A*, the entire value of the property on the date of *A*'s death is includible in *A*'s gross estate pursuant to section 2040 of the Code. Further, since the property ownership remained in joint tenancy form there would be no termination for purposes of section 2515, even though the joint tenants are no longer married.

If, on the other hand, state law provided that upon divorce the joint tenancy was converted to a tenancy in common, then only the value of *A*'s interest in the property after the divorce, that is, an undivided one-half interest as a tenant in common, is includible in A's gross estate under section 2033 of the Code. The provisions of section 2040 would not apply to the property interest. Also, the conversion of the joint tenancy into a tenancy in common would be considered a termination subject to the gift tax, under section 2515(b) of the Code.

HOLDINGS

1. *Situation 1*, when, upon divorce, the tenancy by the entirety is converted into a tenancy in common one-half of the value of the property is subject to the gift tax under section 2515. Upon *A*'s death, only the value of an undivided one-half interest as a tenant in common in the property is includible in *A*'s gross estate under section 2033 of the Code.

2. In *Situation 2*, if the joint tenancy remains a joint tenancy after the divorce, then pursuant to section 2040, the entire value of the property on the date of *A*'s death is includible in *A*'s gross estate. If, in *Situation 2*, the property was converted to a tenancy in common upon divorce, then one-half the value of the property is subject to the gift tax at the time, and only the value of an undivided one-half interest as a tenant in common in the property is includible in *A*'s gross estate under section 2033.

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26 CFR 23.1: Election and eligibility to treat interests in property held jointly on December 31, 1976, as qualified joint interests.

T.D. 7731

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER B, PART 23.—TEMPORARY ESTATE TAX REGULATIONS UNDER THE ACT OF 1978

Procedure for correction of an incomplete election to treat an interest in certain joint tenancies as a qualified joint interest

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document provides temporary regulations for taxpayers who elected to treat their interest in certain jointly held property as a "qualified joint interest" under section 2040(d) of the Internal Revenue Code of 1954 (Code) but failed to comply with the requirements of section 23.1 of the Temporary Estate Tax Regulations.

DATE: The regulations apply to elections for certain property held jointly on December 31, 1976.

FOR FURTHER INFORMATION CONTACT: Stephen J. Small of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:LR:T, 202-566-3287 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On March 20, 1980, section 23.1 of the Temporary Estate Tax Regulations was published in the Federal Register (45 FR 17983) concerning the procedure for the election to treat an interest in certain joint tenancies as a qualified joint interest for estate tax purposes. The election is available under sec. 2040(d) of the Code.

Those regulations provided, generally, that the spouse who furnished more than one-half the initial consideration for the property must make the election by including the amount of the gift in a timely filed gift tax return and must pay any tax due. The regulations provided a formula for computing the amount of the gift. Under sec. 6075(b) of the Code, the due date for the gift tax return was April 15, 1980, unless the taxpayer received an extension under sec. 6081.

Sec. 23.1(a)(3) of the regulations required that a statement of consent be attached to the gift tax return, signed by the donee spouse and indicating that the donee spouse consents to the election. It has come to the attention of the Treasury Department that in many cases prior to the issuance of the regulations, taxpayers attempted to make the election by timely filing a gift tax return but failed to include a statement of consent.

PROVISIONS OF THE REGULATIONS

This amendment to the regulations provides that in the case of a timely

filed election that did not comply with sec. 23.1 of the Temporary Estate Tax Regulations under the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1], treatment of the interest as a qualified joint interest from the date of the original filing will be permitted only if a corrected gift tax return is filed that is in compliance with sec. 23.1. The regulations require that the corrected gift tax return must be filed by April 15, 1981.

WAIVER OF CERTAIN PROCEDURAL REQUIREMENTS OF TREASURY DIRECTIVE

A determination has been made by Jerome Kurtz, Commissioner of Internal Revenue, that there is an immediate need for these regulations under section 2040(d) to provide guidance to taxpayers. Compliance with the procedural requirements of paragraphs 8 through 14 of the Treasury directive relating to improved regulations (43 FR 52120) would therefore be impractical and, accordingly, the requirements have been waived.

DRAFTING INFORMATION

The principal author of this regulation was Stephen J. Small of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both in matters of substance and style.

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 23 is amended as follows:

Paragraph 1. Section 23.1 is amended as follows:

1. Paragraph (f) is redesignated as paragraph (g).

2. A new paragraph (f) is inserted to read as set forth below.

§ 23.1 Election and eligibility to treat interests in property held jointly on December 31, 1976, as qualified joint interests.

* * * * *

(f) *Incomplete election*—(1) *Corrected return required.* Where an otherwise valid election, on a timely filed gift tax return for any calendar quarter ending in 1977, 1978, or 1979, failed to satisfy the procedural requirements of this section, the election will be considered effective from the date of the original filing upon the filing of a corrected gift tax return, with the statement of consent attached, at the Internal Revenue Service Office where the original return was filed.

(2) *Due Date.* The corrected gift tax return must be filed by April 15, 1981. The executor or administrator of a spouse who dies (or the guardian or committee of a spouse who becomes legally incompetent) before the corrected gift tax return is filed may file the return or may sign the consent as the case may be.

This Treasury decision adds temporary regulations to enable taxpayers to comply with the new law on the election to treat an interest in property as a qualified joint interest. Because this regulation is necessary to provide immediate guidance to taxpayers, it is impractical to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of title 5 of the United States Code or subject to the effective date limitation of subsection (d) of this section.

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 26 U.S.C. 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved October 17, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on November 4, 1980, 8:45 a.m., and published in the issue of the Federal Register for November 5, 1980, 45 F.R. 73467)

Section 2042.—Proceeds of Life Insurance

26 CFR 20.2042-1: Proceeds of life insurance.
(Also Section 2033; 20.2033-1.)

Life insurance proceeds; community property; Texas. An individual who was a resident of Texas obtained an insurance policy on the individual's life prior to marriage, paid a portion of the premiums from separate funds and a portion from community funds, and designated the spouse as beneficiary. The amount includible in the individual's gross estate with respect to the insurance policy is reduced by one-half the amount of premiums paid with community funds.

Rev. Rul. 80-242

ISSUE

What amount is includible in *D*'s gross estate with respect to insurance on *D*'s life, under the circumstances described below?

FACTS

D, a resident of Texas, obtained, when unmarried, a whole life policy of insurance on *D*'s life, in the face amount of $100,000. *D* paid $3,000 in premiums before marriage. After marriage, $12,000 in premiums were paid with funds that were, under the law of Texas, community property. *D* held the incidents of ownership in the policy until death. The surviving spouse, *S*, was the designated beneficiary of the policy.

LAW AND ANALYSIS

Section 2033 of the Internal Revenue Code provides that a decedent's gross estate shall include the value of all property to the extent of the decedent's interest therein at the time of death.

Section 2042(2) includes in the gross estate the proceeds of insurance on the decedent's life if the decedent possessed incidents of ownership in the policy.

Under Texas law the proceeds of an insurance policy belong to the insured's separate estate, if the policy was initially the separate property of the insured when acquired. However, if after the policy is acquired premiums are paid with community funds, then the proceeds are subject to the community estate's right of reimbursement for the return of community funds used to pay the premiums. *Parson v. U.S.*, 46 F. 2d 228 (5th Cir. 1972); *Wildenthal v. Commissioner*, T.C.M. 1970-119; *Gray v. Bush*, 430 S.W. 2d 258 (Tex. Civ. App., 1968); *McCurdy v. McCurdy*, 372 S.W. 2d 381 (Tex. Civ. App. 1963).

In the present case, the policy was the separate property of *D* when acquired and therefore the proceeds belong to *D*'s separate estate. However, since $12,000 in insurance premiums was paid with community funds, the insurance proceeds are subject to the community claim for reimbursement of premiums paid. Therefore, the amount includible in *D*'s gross estate under section 2042(2) of the Code is the face amount of policy proceeds less the amount of premiums paid with community funds, or $88,000. In addition, one-half of the reimbursed premiums ($6,000) is separately includible in *D*'s gross estate under section 2033 of the Code as the value of *D*'s interest, at death, in community property. *See Wildenthal v. Commissioner*, cited above.

The above conclusions regarding the amount includible with respect to the decedent's insurance policy proceeds are in direct conflict with Rev. Rul. 54-272, 1954-2 C.B. 298, which applies a discussion of Louisiana law contained in Paragraph (E) of Rev. Rul. 232, 1953-2 C.B. 268, to similar situations arising under Texas law. Applying Rev. Rul. 54-272, to the facts in the present situation, $100,000 would be includible under section 2042 of the Code. The Service will no longer follow the position stated in Rev. Rul. 54-272 that in cases when the surviving spouse is the beneficiary the full value of the insurance proceeds, purchased in part with community funds, is includible in the gross estate under section 2042. However, in such cases the Service will continue to disallow a deduction under section 2053 for the community's claim for reimbursement, since under Texas law the community's claim for reimbursement of the insurance premiums paid from community funds is a claim on the insurance proceeds rather than a claim on the decedent's estate. *See* sections 20.2053-4 and 20.2053-7 of the Estate Tax Regulations. For the same reason, when the decedent's estate, or someone other than the surviving spouse is the beneficiary, the Service will not allow a deduction under section 2053 with regard to the community's reimbursement claim. However, the community's reimbursement claim will be reflected as a reduction in the amount includible in the gross estate under section 2042.

HOLDING

The amounts includible in *D*'s gross estate are $88,000 as insurance proceeds under section 2042 of the Code and $6,000 as community property under section 2033.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 54-272 is modified with respect to its conclusions that the full value of insurance proceeds purchased in part with community funds is includible in the gross estate, and that a claim by the community for reimbursement for premiums paid with community funds may be allowed as a deduction from the insured's gross estate in cases when either the insured's estate or someone other than the surviving spouse is the named beneficiary.

Part IV.—Taxable Estate

Section 2053.—Expenses, Indebtedness, and Taxes

26 CFR 20.2053-1: Deduction for expenses, indebtedness and taxes; in general.

Administration expenses; claims against estate; rate of exchange. In computing the amount deductible under section 2053 of the Code, the rate of exchange to be used in determining the U.S. dollar value of administration expenses incurred in a foreign country is the rate in effect on the date the payment is made. The rate to be used in determining the value of foreign claims against the estate is the rate in effect on the date of death (or alternate valuation date), provided the claim is properly valued at that date. If postdeath events must be considered in valuing the claim, the rate on the date of payment is used in determining the value of the claim.

Rev. Rul. 80-260

ISSUE

What is the proper foreign exchange rate to be used in determining the United States dollar value of administration expenses and claims incurred in a foreign country, for purposes of computing the amount deductible under section 2053 of the Internal Revenue Code?

FACTS

The decedent *D*, a United States citizen, died on September 27, 1979. In administering *D*'s estate, the executor incurred expenses in *X* country in connection with property *D* owned in *X* that was includible in *D*'s gross estate. In addition, *D* had incurred debts in *X* that were payable by *D*'s estate. The administration expenses and the debts were allowable deductions under section 2053(a)(2) and (a)(3) of the Code.

LAW AND ANALYSIS

Section 2053(a)(2) and (a)(3) of the Code provide deductions for administration expenses and claims against the estate.

With regard to administration expenses, section 20.2053-3(a) of the Estate Tax Regulations provides that only expenses actually incurred in the administration of the estate are deductible. See also sections 20.2053-3(b) and (c) of the regulations which provide the general rule that executor's commissions and attorney's fees are deductible as administration expenses in such amount ". . . as has *actually been paid*, ..." (Emphasis added.) Thus, the amount of the deduction allowable for administration expenses is based on the amount actually paid by the estate rather than on a date of death valuation of anticipated expenses.

Accordingly, the foreign exchange rate in effect at the time of payment should be used in determining the United States dollar amount of the expense and, therefore, the amount deductible under section 2053(a)(2) of the Code. See Rev. Rul. 75-439, 1975-2 C.B. 359, which holds that in computing the section 2014 credit for foreign death tax the rate of exchange in effect at the time each payment of foreign death tax is made is used to convert the foreign death taxes paid into United States dollars.

If an administration expense has not yet been paid at the time the return is filed, then an estimated United States dollar amount may be deducted provided the expense is ascertainable with reasonable certainty and will be paid. See section 20.2053-1(b)(3) of the regulations.

Generally, a claim against the estate that otherwise satisfies the requirements of section 2053(a)(3) of the Code is valued, for deduction purposes, as of the date of death. However, under appropriate circumstances, postdeath events are taken into consideration in valuing a claim otherwise deductible under section 2053(a)(3). See *Commissioner v. Estate of Shively*, 276 F.2d 372 (2d Cir. 1960), and *Chesterton v. United States*, 551 F.2d 278 (Ct. Cl. cert. denied, 434 U.S. 835 (1977)), both holding that the decedent's former spouse's claim for periodic support payments until death or remarriage was to be valued for purposes of section 2053(a)(3) based on the actual amounts paid, since the former spouse remarried shortly after the decedent's death.

Therefore, if the claim would properly be valued as of the date of death (or alternate valuation date), then the foreign exchange rate on that date must be used in determining the United States dollar value of the claim and, thus, the amount deductible under section 2053(a)(3) of the Code. However, if postdate events must be considered in valuing the claim for section 2053(a)(3) deduction purposes, then the exchange rate in effect on the date of the payment (or dates of payment in situations involving a series of payments) is used in determining the value of the claim.

HOLDING

1. The foreign exchange rate in effect on the date the payment is made is used, for purposes of section 2053(a)(2) of the Code, in determining the United States dollar value of foreign administration expenses.

2. The foreign exchange rate in effect on the date of death (or alternate valuation date), is used for purposes of section 2053(a)(3) of the Code, in determining the United States dollar value of foreign claims against the estate, provided the claim is properly valued on that date for purposes of section 2053(a)(3). The foreign exchange rate on the date of payment is used in determining the United States dollar value of the claim, if postdeath events must be considered in valuing the claim.

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26 CFR 20.2053-3: Deductions for expenses of administering estate.

(Also Sections 6161, 6163, 6166, 6166A; 20.6161-1, 20.6163-1, 20.6166-1, 20.6166A-1.)

Administration expenses; interest on federal estate tax; when deductible. Interest expense charged on the extended payment of federal estate tax is deductible when the interest accrues. No deduction is allowable on the estate tax return for an estimate of interest expense to be incurred in the future.

Rev. Rul. 80-250

ISSUE

When does interest expense charged pursuant to the executor's election to extend payment of the estate tax liability become deductible under section 2053(a)(2) of the Code?

FACTS

The decedent, *D*, died in 1978. The executor of *D*'s estate elected to pay a portion of the estate tax liability in installments in accordance with the provisions of section 6166A of the Code. In preparing the federal estate tax return for *D*'s estate, the executor estimated the total amount of interest expense that would be incurred by the estate in the future with respect to the section 6166A election. The exector claimed a deduction for this estimated amount of future expense as an expense of administration under section 2053(a)(2) of the Code.

LAW AND ANALYSIS

Section 2053(a)(2) of the Code and section 20.2053-3(a) of the Estate Tax Regulations provide an estate tax deduction for administration expenses that are actually and necessarily incurred in the administration of the decedent's estate and are allowable by the laws of the jurisdiction under which the estate is being administered.

Sections 20.2053-1(b)(3) and 20.2053-3(a) of the regulations provide that if the amount of an expense otherwise deductible under section 2053 of the Code is not actually in-

curred (i.e. accrued) at the time of the final audit of the estate tax return, then no deduction will be allowed for the expense at that time, unless the expense is ascertainable with reasonable certainty. No deduction can be taken based on a vague or uncertain estimate.

Interest expense payable incident to the extension of the time for payment of tax under section 6166A is deductible as an expense of administration under section 2053(a)(2) of the Code, if the expense is allowable under the laws of the jurisdiction in which the estate is being administered. *Estate of Bahr v. Commissioner,* 68 T.C. 74 (1977), *acq.* 1978-1 C.B. 1. See also, Rev. Rul. 78-125, 1978-1 C.B. 292.

In situations where the executor elects to extend the time for the payment of the estate tax under section 6166A the executor has the option to accelerate payment, and in certain circumstances must accelerate payment. See section 6166A(h) of the Code. The possibility that payment may be accelerated renders any estimate of future interest charges vague and uncertain, within the meaning of section 20.2053-1(b)(3) of the regulations.

Accordingly, interest expense incurred under section 6166A is deductible when the interest accrues. When the interest becomes deductible and the estate claims the deduction under section 2053(a)(2), the estate tax is recomputed. The recomputation will result in a reduction of the estate tax and previously accrued interest. Installments due will be recomputed accordingly. However, no refund will be made until the entire tax liability has been paid. Interest accrues daily. However, for purposes of administrative convenience taxpayers should claim the deduction at the time of the annual dates prescribed for payment under section 6166A. If the entire tax balance and accrued interest is prepaid at one time, the accrued interest is deductible at that time.

HOLDING

Interest expense charged pursuant to the executor's election to extend payment of the estate tax liability is deductible when the interest accrues. Therefore, no deduction is allowable on *D*'s estate tax return for the estimate of interest expense to be incurred in the future.

The conclusion of this revenue ruling applies as well to interest on estate tax, the payment of which is extended under sections 6161, 6163 or 6166 of the Code.

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26 CFR 20.2053-4: Deduction for claims against the estate; in general.

Whether buyer's points assumed by the seller-decedent prior to death are deductible by the estate. See Rev. Rul. 80-319, page 252.

Section 2055.—Transfers for Public, Charitable, and Religious Uses

26 CFR 20.2055-1: Deduction for transfers for public, charitable, and religious uses; in general.

Whether interest is due on an estate tax deficiency where the estate claimed on its return a charitable deduction for which it did not qualify at the time the return was filed, but which was later allowed when the deduction qualified. See Rev. Rul. 80-291, page 373.

Section 2056.—Bequests, Etc., to Surviving Spouse

26 CFR 20.2056(a)-1: Marital deduction; in general.

Whether in computing in the "second limitation" of the credit for gift tax under section 2012 of the Code, the value of the gift made to a donee other than the spouse is reduced where the inclusion in the gross estate has the effect of increasing the marital deduction. See Rev. Rul. 80-185, page 250.

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26 CFR 20.2056(c)-1: Marital deduction; limitation on aggregate of deductions; in general.

Determination of marital deduction for purpose of computing tax on the reduced gross estate of a decedent dying after 1976. See Rev. Rul. 80-210, page 251.

Subchapter B.—Estates of Nonresidents Not Citizens

Section 2101.—Tax Imposed

26 CFR 20.2101-1: Estates of nonresidents not citizens; tax imposed.

Whether an alien who entered the U.S. illegally and continued to live in the U.S. until death was domiciled in the U.S. at the date of death. See Rev. Rul. 80-209, page 248.

Chapter 12.—Gift Tax
Subchapter A.—Determination of Tax Liability

Section 2503.—Taxable Gifts

26 CFR 25.2503-3(a): Future interests in property.

Present v. future interest; right to share in trust corpus; exclusion. A gift of a right to demand and receive at least a pro rata portion of trust corpus conveyed to several donees is a gift of a present interest to the extent of each donee's pro rata portion, and the annual exclusion under section 2503 of the Code is allowable.

Rev. Rul. 80-261

ISSUE

Is a donor entitled to the annual exclusion, under section 2503(b) of the Internal Revenue Code, for a gift of a portion of trust corpus to a donee if an interest in the corpus was also conveyed by the donor, at the time of the gift, to other persons, under the circumstances described below?

FACTS

In 1976, *G,* the settlor, established a trust and transferred $13,000 to the trustee. Under the provisions of the trust instrument, *A, B, C, D,* and *E* each had the right to receive a total sum of $4,000 of trust corpus by submitting a written demand to the trustee. However, if there was insufficient corpus to satisfy all of the demands, then the corpus was to be distributed on a pro rata basis among those donees demanding corpus. If any donee re-

ceived an amount greater than the pro rata share of the trust corpus, the donee would be required to immediately reimburse the trustee for the excess amount in the event the trust corpus was insufficient to satisfy demands made by other donees.

LAW AND ANALYSIS

Section 2503(b) of the Code provides an exclusion of the first $3,000 of gifts made to any person by the donor during the calendar year. This exclusion applies to all gifts other than gifts of future interests. The fact that the donee must first make a demand for the corpus does not make the donee's interest a future interest. If a donee is assured of receiving some minimum amount of trust corpus, then the section 2503(b) exclusion for a gift of a present interest is allowable for the amount that the donee will receive with certainty notwithstanding that the donee must first make a demand for the corpus.

In the present situation, since each donee's demand for corpus is assured of being satisfied on a pro rata basis to the extent of $2,600, each gift of corpus is a gift of a present interest in the amount of $2,600.

HOLDING

G is entitled to an annual exclusion for each donee in the amount of $2,600.

Subchapter B.—Transfers

Section 2511.—Transfers in General

26 CFR 25.2511-1: Transfers in general.

The gift tax consequences of transfers of stock of a corporation to employees of the corporation by controlling shareholders. See Rev. Rul. 80-196, page 32.

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26 CFR 25.2511-2: Cessation of donor's dominion and control.

Option transferred; nominal consideration; related party. A transfer to a related party for nominal consideration of an option to purchase real property, for a specified period at a price below fair market value, is a completed gift on the date the option is transferred if under state law the option is binding and enforceable on the date of transfer.

Rev. Rul. 80-186

ISSUE

Is the transfer, to a related party for nominal consideration, of an option to purchase real property for a specified period a completed gift under section 2511 of the Internal Revenue Code on the date the option is transferred or on the date the option is exercised?

FACTS

On January 2, 1978, *A* transferred to *B*, A's child, an option to purchase real property located in State *X* and owned by *A*. *B* paid *A* $10 upon receipt of the option. Under the option, *B* had the right to purchase the property at any time during a two-year period for $475,000. The option could be sold or assigned by *B*. The transfer was not made in the ordinary course of business. The fair market value of the property on the date of the transfer was $500,000.

On January 1, 1980, *B* exercised the option by delivering to *A* $475,000. Upon receipt of the option price, *A* delivered to *B* a deed transferring the property to *B*.

Under the law of State *X*, an option is defined as a contract by which a person acquires from the owner of property, for consideration, the right or privilege to buy property at a fixed price within a specified time, without imposing any obligation on the optionee to do so. While an option to purchase land is property and the optionee gets valuable property rights, the option does not, before exercise, vest in the optionee any interest, estate or title in the land.

State *X* law further provides that an option supported by consideration may not be withdrawn during the time stipulated, and therefore is binding upon the parties. The fact that only nominal consideration is given for the option does not make it unenforceable. Adequacy of consideration, as measured by the general market, is not a prerequisite to enforcement.

LAW AND ANALYSIS

Section 2501 of the Code imposes a tax on the transfer of property by gift by any individual. The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee at the time of the transfer. The tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches at the time the property passes, regardless of the fact that the identity of the donee may not then be known or ascertainable. Section 25.2511-2(a) of the Gift Tax Regulations.

The gift tax is aimed at every kind of transfer by way of gift, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. Section 25.2511-1 (a) of the regulations. The term property is used in its broadest and most comprehensive sense and reaches "every species of right or interest protected by law and having an exchangeable value." H.R. Rep. No. 708, 72d Cong., 1st Sess. 27 (1932); S. Rep. No. 665, 72d Cong., 1st Sess. 39 (1932); both reprinted in 1939-1 C.B. (Part 2) at 476, 524.

Generally, a gift is complete and subject to the gift tax when the donor has so parted with dominion and control over the property transferred as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another. Section 25.2511-2(b) of the regulations.

Under section 2512(b) of the Code,

if property is transferred for less than adequate and full consideration in money or money's worth, the excess of the value of the transferred property over the value of any consideration received is a gift for federal gift tax purposes. Consideration not reducible to a value in money or money's worth, such as love and affection, is to be wholly disregarded for federal gift tax purposes. Section 25.2512-8 of the regulations.

On January 2, 1978, *B* received an enforceable right to acquire land owned by *A* provided *B* exercised the option within two years. *A*'s promise was binding and could not be withdrawn because it was supported by consideration. Although *B* received no interest or title in the land, the option itself was valuable property that was protected by law, could be transferred, and had an exchangeable value.

The gift was complete and subject to the gift tax on January 2, 1978, the date *A* transferred the option to *B*. The amount of the gift is the difference between the fair market value of the option on the date it was given to *B* and the consideration in money or money's worth paid by *B* ($10). *See Hoffman v. Commissioner,* 2 T.C. 1160 (1943), *aff'd on other issue,* 148 F. 2d 285 (9th Cir.), *cert denied,* 326 U.S. 730 (1945).

The value of the option is a factual question for determination by the district director on audit of the gift tax return. However, factors to be considered in determining the option's fair market value include the fair market value of the land on the date the option was given, the option price, any potential for appreciation or depreciation during the period, and the time period of the option.

HOLDING

The transfer, to a related party for nominal consideration, of an option to purchase real property for a specified period is a completed gift under section 2511 of the Code on the date the option is transferred if under state law the option is binding and enforceable on the date of transfer.

Section 2512.—Valuation of Gifts

26 CFR 25.2512-8: Transfers for insufficient consideration.

The gift tax consequences of transfers of stock of a corporation to employees of the corporation by controlling shareholders. See Rev. Rul. 80-196, page 32.

Section 2513.—Gift by Husband or Wife to Third Party

26 CFR 25.2513-2: Manner and time of signifying consent.

Split gifts; consent of spouse after due date of return. Spouses may not elect under section 2513 of the Code to split gifts made by one spouse after the donor spouse has filed a gift tax return reporting the gifts and the due date for filing the return has passed.

Rev. Rul. 80-224

ISSUE

Under section 2513 of the Internal Revenue Code, can spouses elect to split gifts made by one spouse, after the donor spouse has filed a gift tax return reporting the gifts and the due date for filing the return has passed?

FACTS

A gift tax return reporting gifts made by *G* during the fourth quarter of 1978 was filed on February 15, 1979, the due date for such a return. There was no indication on the return that *G*'s spouse, *S*, consented to have *G*'s gifts to third parties considered as made one-half by each spouse. In May 1979 *S* filed a gift tax return and *G* filed an amended gift tax return. Both returns were for the fourth quarter of 1978 and indicated the consent of both spouses to split the gifts that were made by *G* and that were reported on the previously filed return.

LAW AND ANALYSIS

Section 2513(a) of the Code provides that a gift made by a donor to any person other than a spouse shall be considered as made one-half by the donor and one-half by the donor's spouse, if both spouses have signified their consent to split all such gifts made during the calendar quarter, as provided in section 2513(b).

Section 2513(b)(2) of the Code provides that such consent may be signified at any time after the close of the calendar quarter in which the gift was made, subject to certain limitations. One of those limitations is that the consent may not be signified after the due date of the gift tax return unless before the due date of the return neither spouse has filed a return for that calendar quarter. If, by the due date, neither spouse has filed a gift tax return for the calendar quarter, the consent may not be signified after a return for such quarter has been filed by either spouse.

The consent to split gifts may not be made after one spouse has filed a return with respect to the gifts and the due date for filing the return has passed. A failure to comply with a statutory condition for making an election in the first return filed precludes the taxpayer from subsequently attempting to make such election, even through the failure may be due to an oversight, an error in judgment or a lack of knowledge of the law. See *McLean v. United States,* Civil No. 78-1186 (N.D. Cal., March 28, 1979), *Thorrez v. Commissioner,* 31 T.C. 655 (1958), *aff'd per curiam,* 272 F.2d 945 (6th Cir. 1959).

HOLDING

Spouses may not elect to have gifts considered as made one-half by each spouse under section 2513 of the Code after one spouse has filed a gift tax return reporting the gifts and the due date for filing the return has passed.

Section 2515.—Tenancies by the Entirety in Real Property

26 CFR 25.2515-1: Tenancies by the entirety; in general.

Whether property, held by the decedent and decedent's spouse as tenants by the entirety, which is converted to a tenancy in common upon divorce, is subject to the gift tax under section 2515 of the Code. See Rev. Rul. 80-241, page 273.

Subchapter C.—Deductions

Section 2522.—Charitable and Similar Gifts

26 CFR 25.2522(a)-1: Charitable and similar gifts; citizens or residents.

Annuity purchased from charitable organization; deduction. A taxpayer purchased from a charitable organization an annuity that is payable for the taxpayer's life from the general funds of the charity. A gift tax charitable deduction is allowable for the amount paid to the charity that exceeds the present value of the annuity.

Rev. Rul. 80-281

ISSUE

Is a gift tax charitable deduction allowable under section 2522 of the Internal Revenue Code, where a donor purchases an annuity from a charitable organization under the circumstances described below?

FACTS

On January 1, 1980, *A* purchased an annuity from *N*, a charitable organization described in sections 170(c) and 2522(a) of the Internal Revenue Code. Under the agreement *A* paid 100*x* dollars in return for an annuity of 5*x* dollars, payable in equal quarterly installments for *A*'s life. The annuity is payable out of the general funds of *N* charity. The value of the annuity received was less than 100*x* dollars.

LAW AND ANALYSIS

Section 2511 of the Internal Revenue Code provides that the gift tax applies whether the transfer is in trust or otherwise, and whether the gift is direct or indirect.

Section 2512(b) of the Code provides that where property is transferred for less than adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration received shall be deemed a gift.

Section 2522 of the Code provides a gift tax charitable deduction for the value of property transferred to charities described in section 2522(a).

Section 2522(c)(2) of the Code provides that where a donor transfers a remainder interest in property to a charitable organization and has retained an interest in the *same* property, no deduction is allowed for the interest passing to charity unless it is in a qualified form (charitable remainder annuity trust, charitable remainder unitrust or a pooled income fund).

In the instant case, *A* has made a gift to *N* charity, to the extent that the value of the property transferred by *A* exceeds the present value of the annuity received. The annuity rates to be used in determining the present value of *A*'s annuity are set forth in Rev. Rul. 72-438, 1972-2 C.B. 38.

Here, the annuity is payable out of the general funds of *N* charity, rather than the specific 100*x* dollars transferred by *A*. Thus, *A* has not retained any interest in the 100*x* dollars transferred to *N*. Therefore, the provisions of section 2522(c) are not applicable, and a deduction is allowable under section 2522(a) of the Code. See also section 1.170A-1(d) of the Income Tax Regulations.

HOLDING

Under section 2522(a) of the Code, a gift tax charitable deduction is allowable. The deduction is equal to the amount by which the value of the property transferred by *A* (100*x* dollars) exceeds the present value of the annuity received by *A*.

26 CFR 25.2522(c)-2: Disallowance of charitable, etc., deductions in the case of gifts made after December 31, 1969.

Charitable deduction; transfer in trust; trustee's power to borrow from trust. A settlor's transfer of money to a charitable trust that is a private foundation described in section 509(a) of the Code does not qualify for a gift tax charitable deduction if the trustee, an adult child of the settlor, may borrow money from the trust.

Rev. Rul. 80-271

ISSUE

Under the circumstances described below, does the settlor's transfer to a charitable trust qualify for the gift tax charitable deduction under section 2522(a) of the Code if the trustee, a member of the settlor's family, may borrow funds from the trust?

FACTS

On December 1, 1978, *G*, the settlor, transferred 10*x* dollars to be held in trust by *G*'s adult child, *A*, as trustee.

The trust is a private foundation within the meaning of section 509(a).

The trust instrument provides that income is to be paid anually to *X* Charity for 25 years. At the end of the 25 year period, the principal is to be distributed to *X* Charity. During the trust term, *A* may borrow a maximum of 2*x* dollars from the trust. The borrowed money is to be repaid, along with interest at the prevailing rate, upon the termination of the trust, if not previously repaid.

Under applicable local law the right of an individual to borrow money from a trust is not regarded as a beneficial interest in the trust since the borrowed funds must be repaid to the trust. In addition, the trustee is not prevented from exercising a power to borrow trust money.

LAW AND ANALYSIS

Section 2511(a) of the Code provides that the gift tax applies whether

the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2522(a) of the Code allows a federal gift tax deduction for transfers to or for the use of a charitable organization. Section 2522(c), however, provides that certain charitable transfers will not qualify for a deduction under section 2522(a).

Under section 2522(c)(1), no deduction is allowed for a gift to an organization or trust described in section 508(d). Section 508(d) describes, among other things, a private foundation that fails to meet the requirements of section 508(e). Under section 508(e), a private foundation is not exempt from taxation unless its governing instrument prohibits the foundation from engaging in, among others, any act of self-dealing, which includes the lending of money or other extension of credit by a trust to a trustee or to a member of the family of a substantial contributor to the trust. See sections 4941(d)(1)(B) and 4946(a)(1). Consequently, under section 2522(c)(1), a transfer to a trust from which a trustee or a member of the settlor's family may borrow money will not qualify for a federal gift tax deduction allowed by section 2522(a), notwithstanding that all of the interests are transferred for the benefit of a charity.

In the present situation, since the trust instrument authorizes an act of self-dealing, the trust fails to meet the requirements of section 508(e). Therefore, it is a trust described in section 508(d).

HOLDING

Since *A* can borrow funds from the trust, the trust is described in section 508(d) and, therefore, does not satisfy the requirements of section 2522(c)(1). Consequently, *G*'s transfer does not qualify for a gift tax charitable deduction under section 2522(a).

Chapter 13.—Tax on Certain Generation-Skipping Transfers
Subchapter A.—Tax Imposed

Section 2601.—Tax Imposed

26 CFR 26.2601-1: Effective date.

T.D. 7713

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER B, PART 26.—GENERATION-SKIPPING TRANSFER TAX REGULATIONS

Effective date provisions for generation-skipping transfer tax.

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations implementing the effective date provisions of the new tax on generation-skipping transfers that was added by the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1]. The regulations reflect changes made to the effective date provisions by the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol 1) 1], and affect all persons creating, or increasing the amount of, a generation-skipping transfer after June 11, 1976.

DATES: The regulations are effective for certain generation-skipping transfers (as defined in section 2611(e)) made after June 11, 1976.

FOR FURTHER INFORMATION CONTACT: Fred E. Grundeman of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. Attention CC:LR:T 202-566-3287, not a toll-free number.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On December 21, 1978, the Federal Register published proposed regulations implementing the new generation-skipping transfer tax (26 CFR Part 26) under Chapter 13 of the Internal Revenue Code of 1954 (43 FR 59849). A public hearing was held on April 10, 1979. After consideration of all written and oral comments regarding the proposed regulations, final regulations are adopted by this Treasury decision.

PROVISIONS OF THIS REGULATION

Under Chapter 13, a tax is imposed on every generation-skipping transfer occurring after June 11, 1976. However, section 2006(c) of the Tax Reform Act of 1976 (P.L. 94-455, 90 Stat. 1879) [*supra* at 365] provides that certain trusts in existence on that date (or created under wills in existence on that date) are excluded by effective date and transition rules from the application of the generation-skipping transfer tax provisions. The Code further provides that a trust, which is otherwise excluded from the new tax, may become subject to the tax if additions to corpus are made after June 11, 1976.

The regulations provide guidelines for determining which trusts in existence on June 11, 1976, are excluded from Chapter 13 under the effective date rule; which trusts in existence on June 11, 1976, are excluded from Chapter 13 by the transition rule; and what effect additions or amendments to trusts occurring after June 11, 1976, will have.

ADDITIONAL CONSIDERATIONS

These regulations are needed in order to provide guidance to the public as well as to government employees responsible for the implementation of Chapter 13 of the Code. Considering both the direct and indirect effects of these regulations, it is believed that they satisfactorily implement section 2006(c) of the Tax Reform Act of 1976 [*supra* at 365], as amended by section 702(n)(1) of the Revenue Act

of 1978 [*supra* at 169]. Evaluation of the effectiveness of the regulations after issuance will be based upon comments received from offices within the Internal Revenue Service and the Treasury Department, other government agencies, and the public.

PUBLIC COMMENTS

Fifty-four comments were received in response to the proposed regulations. The comments focused principally on three areas of the proposal: the definition of the term "revocable", the characterization of accumulated income as an addition to the corpus of a trust, and the characterization of a codicil as an amendment to a will at the time of execution even though ambulatory until death. The Treasury Department agrees that in these areas, as well as others, modification of the proposed regulations is appropriate.

The regulation has been revised to follow the structure of the statute more closely. It now provides an effective date rule applicable to irrevocable trusts and a transition rule applicable to wills and revocable trusts where the testator/creator dies before January 1, 1982. Under the regulation a trust will be treated as a revocable trust only if the trust would have been included in a decedent's estate under section 2038 (without regard to powers relinquished during the prior 3-year period) if the decedent had died on June 11, 1976. Furthermore, the regulation provides that accumulated income will not be an addition to the corpus of a trust. Finally, a post June 11, 1976, codicil will not be considered a disqualifying amendment to a will if it does not ultimately result in a change to the will which creates or increases the amount of a generation-skipping transfer.

Five comments were received on the transition rule treatment of mental incompetence. The Department agrees that the proposal provided results not contemplated by the statute. Accordingly, it has been revised to provide that the transition rule will apply to individuals who were mentally incompetent on June 11, 1976, for a minimum of two years after competency has been regained.

The Department believes Congress intended transitional relief be denied where individuals, after consideration of the generation-skipping aspects of their existing estate plans, alter those plans in a manner that creates or increases the amount of a generation-skipping transfer. Several commentors stated, however, that the proposed transition rule treatment of amendments to wills and revocable trusts left a number of questions unanswered and did not grant sufficient relief. In response to these comments, the proposal has been clarified in several respects. First, the regulation makes it clear that amendments to any instrument falling within the transition rule (including trust equivalents) will result in loss of "grandfathering" for all generation-skipping transfers under that instrument. Second, the word "technical" has been deleted from subsection (e)(1)(ii) because it was confusing and redundant. Third, several examples have been added. Fourth, the "independent effect" concept (under which each amendment would be tested against the facts as they exist on the date of death) has been replaced by a "cumulative effect" rule. The regulation now provides that in testing whether an amendment results in the creation or increase in the amount of a generation-skipping transfer, the instruments that exist on the date of death (or any prior taxable distribution or termination) will be compared to the instruments that existed on June 11, 1976.

Several commentors felt that a republication of a will that was in existence on June 11, 1976, should be treated as a will in existence on that date, arguing that the "revival" concept recognized in the proposal is a technicality. After reconsideration, the Department believes it would be unwise to modify the proposed rule. The apparent intent of Congress was to provide transitional relief for those wills that would be effective were the testator to die on June 11, 1976. The rule as proposed requires that any instrument "in place" on that date, be probated, and, therefore, open to challenge. Treating a republication as the original instrument, would place the Internal Revenue Service in the impractical position of "proving" that the instrument being republished not only was a valid will but that it was the instrument that would have controlled the devolution of the testator's property had the testator died on June 11, 1976.

The proposed regulation provided that post June 11, 1976, additions to both irrevocable and revocable trusts would subject a proportionate amount of transfers from the trust to Chapter 13. Upon reconsideration the Treasury Department believes that the statute distinguishes between additions to trusts subject to the effective date rule and those subject to the transition rule. Thus, under the final regulation, an addition to the corpus of an irrevocable trust will result in a proportionate part of future distributions being subject to tax, while an addition to a revocable trust will result in future distributions being fully subject to tax. However, to alleviate potentially harsh results, the regulation provides that if all post June 11, 1976, additions to a revocable trust are set aside as a separate fund prior to January 1, 1982, only the separate fund will be subject to Chapter 13.

Other comments suggested that either tracing or segregation of assets should be allowed as an alternative to the proposed rule that generation-skipping transfers occurring subsequent to an addition to corpus of an irrevocable trust are proportionately "tainted"; *i.e.*, subject to tax under Chapter 13, to the same extent that the value of the corpus represented added assets immediately after the additions. The Treasury Department continues to believe that a single approach provides the more equitable

result in terms of both trust and tax administration.

A number of commentors stated that "additions" to the corpus of a trust should only occur where property is conveyed to the trust from an outside source. They argued that the "constructive addition" concept adopted in the proposal was not intended by Congress. After reconsideration, the Department feels the legislative history does not support the position of the commentors. The structure of the statute (including both an effective date rule and a transition rule) and the language in the Conference Committee Report (expressly providing that "grandfather" protection will not in all cases be applicable to an irrevocable trust subject to a "limited" power of appointment) clearly indicate a congressional intent to provide relief from the provisions of Chapter 13 only in those cases where the generation-skipping transfer could not be avoided. Thus, subject to the application of the transition rule, it is appropriate to subject property to the generation-skipping tax where an individual is, for gift and estate tax purposes, treated as owning the property. This result is accomplished by the "constructive addition" concept.

As a number of commentors noted, the generation-skipping tax is essentially complementary to the estate and gift taxes and burdensome legal and administrative questions may arise if traditional transfer tax concepts are not followed. The Department recognizes the validity of these concerns and has revised the regulation to provide that a constructive addition will be deemed to occur in those cases where the exercise, release or relapse of a power of appointment is subject to either the Federal estate or gift tax, with the further provision that if a nongeneral power is exercised in a manner that may result in an extension of the term of the trust more than 21 years beyond a life or lives in being at the original creation of the trust, there will be a constructive addition to the corpus of the trust. However, principally for purposes of administrative convenience, where a constructive addition occurs by reason of the exercise, release or lapse of a power which is in any part taxable under Chapter 11 or Chapter 12 the amount of the addition will be equal to the entire portion of the trust subject to the power. Rules to determine the grantor of such construction additions will be set forth in definitional regulations to be published shortly in proposed form.

Six commentors felt that the "pour-over" exception to the addition to corpus rule should be expanded beyond a "grandfathered" will or revocable trust. The regulation now provides that any "pour-over" involving two "grandfathered" instruments will not result in loss of relief under either the effective date or the transition rule.

The regulation also contains an example stating that the transition rule is inapplicable where the holder of a general power of appointment dies before January 1, 1982, but had no will in existence on June 11, 1976. The Department believes this rule is necessary to relieve the Internal Revenue Service from having to inquire whether a will was destroyed after June 11, 1976, to avoid adverse generation-skipping tax consequences.

Finally, several grammatical changes suggested by commentors were adopted.

DRAFTING INFORMATION

The principal author of these regulations is Fred E. Grundeman of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and the Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of regulations

Accordingly, a new Part 26, Generation-Skipping Transfer Tax Regulations, is added to Title 26 of the Code of Federal Regulations, and the first regulations adopted thereunder are as follows:

Sec. 26.2601-1 Effective Date.

Authority. Sections 2622 and 7805, Internal Revenue Code of 1954 (90 Stat. 1887, 68A Stat. 917, 26 USC; 2622, 7805).

§ 26.2601-1 Effective Date.

(a) *In general.* Except as provided in paragraphs (b)(1) and (b)(2) of this section, the provisions of Chapter 13 of the Code apply to any generation-skipping transfer, as defined in section 2611(a), made after June 11, 1976. For purposes of this section, any reference to a trust includes a "trust equivalent" within the meaning of section 2611(d).

(b) *Exceptions*—(1) *General rule.* The provisions of Chapter 13 of the Code will not apply to any generation-skipping transfer—

(i) under a trust which was irrevocable on June 11, 1976, but only to the extent that the transfer is not made out of corpus added to the trust after that date (the effective date rule); or

(ii) under any other trust created before June 12, 1976, or established under a will executed before June 12, 1976, which becomes irrevocable by reason of the death of a decedent before January 1, 1982, provided that the document in existence on June 11, 1976, was not amended at any time after June 11, 1976, in any respect which results in the creation of, or an increase in the amount of, a generation-skipping transfer (the transition rule).

(2) *Mental disability.* If an individual on June 11, 1976, was under a mental disability to change the disposition of his or her property, the date in the transition rule of this section (and in every reference to the transition rule) by which a document must become irrevocable shall be the later of January 1, 1982, or the date which is two years after the date on which the individual first regains his or her com-

petence to dispose of his or her property. For purposes of this provision, the term "mental disability" means mental incompetence, in fact, to execute the instrument governing the disposition of his property, whether or not there was an adjudication of incompetence.

(3) *Examples.* The provisions of paragraphs (b)(1) and (b)(2) may be illustrated by the following examples:

Example (1). *A,* a resident of State X, had executed an irrevocable generation-skipping trust, but had not funded the trust as of June 11, 1976. On that date the trust was named irrevocable beneficiary of certain paid up life insurance policies on the life of *A.* Under the law of State *X* a trust is not considered a separate entity until it is funded. However, under the law of State *X* the combination of documents in existence on June 11, 1976, is considered as irrevocably disposing of the insurance proceeds, and is, therefore, an irrevocable trust equivalent for purposes of Chapter 13. Assuming that the trust is not funded (and that no further arrangements are made to add corpus to the trust or enhance the benefit payable under the policies) future generation-skipping transfers pursuant to the trust will not be subject to Chapter 13 by reason of the effective date rule.

Example (2). Assume the same facts as in example (1) except that under the law of State *X* the documents did not irrevocably determine the disposition of the insurance proceeds. Under these circumstances the combination of documents in existence on June 11, 1976, is a revocable trust equivalent. Assume further that after executing the documents but before June 12, 1976, *A* became mentally disabled and was incompetent to dispose of his property by will until his death on August 15, 1985, at which time the trust was funded with the insurance proceeds. Since the revocable trust equivalent was in existence on June 11, 1976, and the decedent was at that time mentally disabled, no generation-skipping transfers pursuant to the trust will be subject to tax under Chapter 13.

Example (3). Assume the same facts as in example (2) except that the decedent became mentally disabled after June 11, 1976. In this case, since *A* became mentally disabled after June 11, 1976, and survived beyond December 31, 1981, the transition rule is not applicable and all generation-skipping transfers pursuant to the trust will be subject to the provisions of Chapter 13.

(c) *Irrevocable trusts*—(1) *In general.* For purposes of this section, any trust in existence on June 11, 1976, will be considered an irrevocable trust except to the extent that on that date it was subject to a power that would have caused the value of the trust to be included in a decedent's gross estate for Federal estate tax purposes by reason of section 2038 (without regard to those powers relinquished during the prior 3-year period) if the decedent had died on that date. Thus, a trust will be considered subject to a power on June 11, 1976, even though the exercise of the power was subject to the precedent giving of notice, or even though the exercise could take effect only on the expiration of a stated period, whether or not on or before June 11, 1976, notice had been given or the power had been exercised. Moreover, a trust will not be considered subject to a power if the power is, by its terms, exercisable only on the occurrence of an event or contingency not subject to the possessor's control (other than the death of the possessor) and if the event or contingency had not in fact taken place on June 11, 1976.

(2) *Examples.* The provisions of paragraph (c)(1) of this section may be illustrated by the following examples:

Example (1). On June 11, 1976, *Y,* the settlor of a trust that was otherwise irrevocable on June 11, 1976, had a testamentary power to add new beneficiaries to the trust. The testamentary power held by *Y* would have caused the trust to be included in *Y's* gross estate under section 2038 if *Y* had died on June 11, 1976. Therefore the trust is not an irrevocable trust for purposes of this section.

Example (2). On June 11, 1976, *A,* the wife of the settlor of a trust in existence on that date, had the right to withdraw 15% of the corpus in each calendar year. The trust had a value of $100,000 on June 11, 1976, and was otherwise irrevocable on that date. Because the power was not held by the settlor of the trust it is not a power described in section 2038 of the Code and the trust is considered irrevocable on June 11, 1976.

Example (3). In 1972, *A* created a trust retaining the right to expand the class of remaindermen to include any of *A's* afterborn grandchildren. On June 11, 1976, there were no grandchildren who were not named remaindermen of the trust. Since *A's* power on June 11, 1976, was dependent on afterborn grandchildren being in existence, a contingency that had not occurred, the trust is not considered subject to the power on June 11, 1976, and is an irrevocable trust for purposes of this section.

(d) *Amendments to wills or revocable trusts.*—(1) *In general.* For purposes of this section, an amendment to a will or revocable trust in existence on June 11, 1976, will not be considered to result in the creation of, or an increase in the amount of, a generation-skipping transfer, where the amendment is—

(i) Basically administrative or clarifying in nature and only incidentally increases the amount transferred, or

(ii) Designed to ensure that an existing bequest or transfer qualifies for the applicable marital, charitable or minor child (orphans) deduction for estate, gift, or generating-skipping tax purposes and only incidentally increases the amount transferred.

For purposes of determining whether a particular amendment to a will (or revocable trust) creates, or increases the amount of, a generation-skipping transfer, the effect of the instrument(s) in existence on June 11, 1976, will be measured against the effect of the instrument(s) in existence on the date of death of the decedent or on the date of any prior generation-skipping transfer. If the effect of an amendment cannot be immediately determined, it will be deemed to create, or increase the amount of, a generation-skipping transfer until a determination can be made.

(2) *Wills and trusts in existence on June 11, 1976.* For purposes of this section, a will or revocable trust will be considered in existence on June 11, 1976, if (i) the will or revocable trust was in existence on June 11, 1976, (ii) the will or revocable trust was revoked in its entirety by a new will or revocable trust and (iii) prior to the death of the testator or creator the new will or revocable trust is revoked in such a manner that, under local law, the document(s) in existence on June 11, 1976, (or a conformed copy thereof)

again controls the passing of property at death.

(3) *Examples.* The provisions of paragraph (d)(1) and (2) of this section may be illustrated by the following examples:

Example (1). An amendment changes the trustees of a revocable trust in existence on June 11, 1976. Although the amendment may have the effect of lowering administrative costs and thus increasing the corpus of the trust, it will be considered administrative in nature. Therefore, assuming that the generations to which the new trustees belong do not result in the creation of, or an increase in the amount of, a generation-skipping transfer, the amendment will not prevent transfers pursuant to the trust from qualifying under the transition rule.

Example (2). On September 1, 1976, *A* executes a codicil to a will in existence on June 11, 1976, removing one of the coexecutors named in the will. Although the codicil may have the effect of lowering administrative costs and thus increasing the corpus of a residuary trust, it will be considered administrative in nature and will not prevent generation-skipping transfers under the will from qualifying under the transition rule.

Example (3). A will, in existence on June 11, 1976, containing a formula marital deduction provision coming within the transition rule of section 2002(d)(1) of the Tax Reform Act of 1976, is amended to allow the estate to continue to obtain the maximum allowable estate tax marital deduction. Such an amendment does not prevent transfers under the will from qualifying under the transition rule even if the amendment incidentally produces an estate tax savings that increases the amount passing to a residuary generation-skipping trust.

Example (4). On September 1, 1976, *A* executes a codicil to his will that was in existence on June 11, 1976, revoking a bequest of $10,000 to *B* and causing that amount to be added to a residuary trust containing generation-skipping provisions. Such an amendment will be deemed to increase a generation-skipping transfer and will prevent transfers under the will from qualifying under the transition rule. If, however, *B* dies before *A* and the bequest would have lapsed under local law, the codicil will not be considered an amendment that increases a generation-skipping transfer.

Example (5). On June 11, 1976, a will provided that an amount equal to the maximum allowable marital deduction would pass to the testator's spouse. After June 11, 1976, the will is amended by codicil to provide that the amount passing to the surviving spouse will not exceed one-half of the adjusted gross estate, even though a larger deduction may be allowable by reason of certain generation-skipping transfers or the application of section 2056(c)(1)(A)(i). As the amendment merely removes a potential ambiguity created by changes in the law subsequent to execution of the will (and does not change the original distribution of the estate), it will be considered clarifying in nature and will not prevent transfers under the will from qualifying under the transition rule.

Example (6). On June 11, 1976, *D's* will provided that an amount equal to the maximum allowable marital deduction would pass to *D's* spouse with the residue of the estate passing to a testamentary generation-skipping trust. After June 11, 1976, the will is amended to provide that the marital share passing to *D's* spouse shall be the lesser of the maximum allowable marital deduction or that amount which will result in no estate tax liability for *D's* estate. The amendment is not considered clarifying in nature and may, therefore, prevent any generation-skipping transfers under the will from qualifying under the transition rule.

Example (7). On June 11, 1976, *C's* will provided for the creation of two generation-skipping trusts. On September 1, 1976, *C* executed a codicil to the will specifically increasing the amount to be used to fund one of the trusts. Since the codicil is an amendment to a will in existence on June 11, 1976, which, if effective, will increase the amount of a generation-skipping transfer, all transfers made pursuant to the will or either of the trusts created thereunder are precluded from qualifying under the transition rule.

Example (8). Assume that *C* in example (7) executed a second codicil deleting the increase to the fund. Because the provision increasing a generation-skipping transfer did not become effective it will not be considered an amendment to a will in existence on June 11, 1976.

Example (9). On June 11, 1976, *C's* revocable trust provided for certain generation-skipping transfers. Prior to his death on August 7, 1980, *C* amended his trust to provide that an amount, previously payable to *C*'s child, be paid instead to charity under *C*'s death. *C's* trust provided that any estate tax attributable to the trust should be paid by the trust. The effect of the charitable amendment was to decrease the estate tax attributable to the trust thereby increasing the corpus for subsequent generation-skipping transfers. Because the amendment does more than perfect an existing deductible transfer, the amendment is considered as increasing the amount of a generation-skipping transfer, and all transfers made pursuant to the trust are precluded from qualifying under the transition rule.

Example (10). Prior to June 11, 1976, *S* created a revocable trust providing that upon the death of *S* the income was to be paid to *S's* nephews *A*, *B* and *C* in equal shares for life, with one-third of the corpus to be distributed per stripes to each nephew's surviving issue upon the death of the nephew. *A* becomes disabled and *S* modifies the trust in 1978 to increase *A's* share of the income. Since the amendment cannot result in the creation of, or increase in the amount of, a generation-skipping transfer, transfers pursuant to the trust will not be subject to taxation under Chapter 13.

Example (11). Assume the same facts as in example (10) except that the amendment adds a fourth nephew, *D*, as an income beneficiary. Since the amendment does not create or increase the amount of, a generation-skipping transfer, transfers pursuant to the trust will not be subject to Chapter 13.

Example (12). Assume the same facts as in example (11) except that *D's* issue are to take a one-fourth share of the corpus per stirpes upon *D's* death. Because the distribution to be made upon *D's* death may involve a younger generation than would be involved if one-third shares were distributed under the original trust, the amendment will be considered an amendment that creates or increases a generation-skipping transfer until a determination can be made. Accordingly, any generation-skipping distribution of the trust corpus will be considered a taxable generation-skipping transfer until it is apparent that a younger generation has not been added to the trust. At that time a claim for refund may be filed with respect to any generation-skipping transfer tax that was paid within the period set out in section 6511.

Example (13). On June 15, 1976, *C* executed a new will revoking entirely a will in existence on June 11, 1976. The second will is considered a new will which was not in existence on June 11, 1976, and will not qualify under the transition rule even though each generation-skipping transfer under the new will is no greater than the transfer that would have occurred under the will in existence on June 11, 1976. If prior to *C's* death, *C* revokes the new will in such a manner that the document in existence on June 11, 1976, becomes subject to probate, the intervening instrument will not disqualify the original instrument for purposes of the transition rule. If *C* revokes the new will by a later will republishing the original will in its entirety the republication would not qualify transfers under the will under the transition rule unless local law would require the proof of the original document as *C's* will.

(e) *Additions to corpus*—(1) *Irrevocable trusts.* An addition made after June 11, 1976, to the corpus of a trust that was irrevocable on June 11, 1976, will subject a proportionate amount of the transfers from such a trust to the provisions of Chapter 13 of the Code. In such a case, the portion subject to Chapter 13 is a fraction of the trust's

total value. The numerator of this fraction is the amount of the addition (valued as of the date the addition was made) and the denominator is the total value of the trust immediately after the addition. Where there is more than one addition to corpus after June 11, 1976, the portion of the trust attributable to all such additions will be a similar fraction. The numerator of this fraction is the sum of:

(i) The total value of the trust immediately before the latest addition, which, because of the prior addition, is subject to Chapter 13, and

(ii) The amount of the latest addition. The denominator of the fraction is the total value of the trust immediately after the latest addition.

(2) *Revocable trusts.* Except as provided in paragraph (e)(4) of this section, an addition made after June 11, 1976, but before the death of the settlor, to the corpus of a trust described in the transition rule will subject all subsequent generation-skipping transfers involving the trust to the provisions of Chapter 13 of the Code unless the corpus of the trust as it existed on June 11, 1976, is severed from the additions thereto. The corpus will be considered severed if, before January 1, 1982, the assets transferred to the trust after June 11, 1976 (together with all income and capital gains derived therefrom and after all losses, expenses, and distributions chargeable thereto) are permanently set aside as a separate fund so that the trust will be treated as two separate trusts under local law. Under these circumstances, all distributions from the separate fund will be subject to the provisions of Chapter 13. Additions made to the corpus of a trust described in the transition rule after it becomes irrevocable by reason of the death of the settlor will be treated as additions to an irrevocable trust.

(3) *Constructive addition.* Where any portion of the corpus of an irrevocable trust remains in the trust after the post June 11, 1976, release, exercise or lapse of a power of appointment over that portion of the corpus and the release, exercise or lapse is treated to any extent as a taxable transfer under either Chapter 11 (estate tax) or Chapter 12 (gift tax) of the Code, the value of the entire portion of the corpus involved in the release, exercise or lapse of the power (and not merely the taxable portion) will be treated as an addition to the trust for purposes of this chapter. Further, where any portion of the corpus of a trust is subject to a power of appointment, that portion will be considered an addition to the corpus of the trust, if, and to the extent that, after June 11, 1976, the power is exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years. If a power is exercised by creating another power it will be deemed to be exercised to whatever extent the second power may be exercised. In the case of a decedent dying before January 1, 1982, the provisions of this paragraph (e)(3) will not be applicable to the exercise of a power pursuant to an instrument described in the transition rule.

(4) *Exceptions.* Any addition to a trust made pursuant to a trust meeting the requirements of the effective date rule or, in the case of a decedent dying before January 1, 1982, pursuant to an instrument described in the transition rule, will not be treated as an addition to corpus for purposes of this section. Where a decedent fails to exercise a general power of appointment in a will described in the transition rule, the corpus passing in default of the exercise will be considered as passing pursuant to the will. In addition, in the case of a decedent dying before January 1, 1982, any property transferred inter vivos to a trust will not be treated as an addition to corpus if the same property or money would have been added to the trust pursuant to a will or trust described in the transition rule, or passed in the same way, but for the inter vivos transfer. However, in any case where it cannot be determined at the time of an addition to corpus if the transition rule will apply, the property transferred will be deemed to be an addition to corpus until such time as a determination can be made.

(5) *Appreciation and income.* Except to the extent that the provisions of paragraph (e)(1) of this section allocate subsequent appreciation and accumulated income between original corpus and additions thereto, appreciation in the value of the corpus of a trust and undistributed income added thereto will not be considered an addition to the corpus of a trust.

(6) *Relation to other sections.* No provision of this section is to be construed as in any way modifying the rules to be applied in determining the identity of the grantor of a generation-skipping trust. For example, an addition to corpus occurring by reason of an exercise of a power of appointment will not cause the individual exercising the power to be considered a grantor of the trust unless the exercise is treated as a taxable transfer under Chapter 11 or Chapter 12 of the Code.

(7) *Examples.* The provisions of paragraphs (e)(1), (e)(2), (e)(3), and (e)(4) of this section may be illustrated by the following examples:

Example (1). *A*, the settlor of a generation-skipping trust that was irrevocable on June 11, 1976, added $100,000 to the trust corpus on July 30, 1976. Immediately before the addition, the corpus of the trust had a value of $900,000. Transfers pursuant to the trust after the addition on July 30, 1976, will be subject to the generation-skipping transfer provisions to the extent of 10 percent (that is, $100,000/($900,000 + $100,000)).

Example (2). Assume the same facts as in example (1) except that on August 30, 1977, when the value of the trust corpus was $2,000,000, a constructive addition of one-half the corpus is made. Since 10% of the corpus is subject to Chapter 13 by reason of the first addition, then 10% of the constructive addition is attributable to corpus already subject to Chapter 13. Therefore, the new portion of the trust subject to Chapter 13 is 55%. The numerator of the fraction set out in paragraph

(e)(1) of this section is $200,000 (10% of $2,000,000) plus $900,000 (90% of ½ of $2,000,000) or $1,100,000. The denominator is $2,000,000.

Example (3). Assume the same facts as in example (1) except that the trust was revocable rather than irrevocable on June 11, 1976, and the $100,000 addition would not have passed to the trust but for the inter vivos transfer. Transfers pursuant to the trust after the addition to corpus on June 30, 1976, will be fully subject to the generation-skipping transfer provisions unless, before January 1, 1982, the additional assets (together with all increments and after all distributions) are permanently set aside in such a manner that under local law the fund traceable to the "grandfathered" corpus will be treated as a separate trust.

Example (4). Assume the same facts as in example (1) except that *A* was also the settlor of a revocable trust in existence on June 11, 1976, and that *A* died on September 30, 1979, without amending, or adding corpus to, the revocable trust. Upon the death of *A*, the trustee of the revocable trust was directed to terminate the trust, distributing the assets to the trustee of the irrevocable trust. At the time of the "pour-over" on September 30, 1979, the corpus of each trust equaled $1,500,000. To determine the percentage of each generation-skipping transfer after September 30, 1979, that is subject to tax under Chapter 13, $150,000 (10% of $1,500,000, the value of the corpus of the irrevocable trust immediately before the "pour-over") is the numerator of the fraction described in paragraph (e)(1) of this section. No other amount is treated as an addition on that date under the transition rule. Therefore, assuming no other corpus is added to the trust, 5% (that is $150,000/($1,500,000 + $1,500,000) of any generation-skipping transfer pursuant to the trust after September 30, 1979, will be subject to Chapter 13.

Example (5). Assume the same facts as in example (4) except that the $1,500,000 added to the irrevocable trust did not come within the transition rule. In that case, to determine the percentage of subsequent distributions subject to tax, $1,650,000 (10% of the $1,500,000 corpus plus the $1,500,000 addition) is the numerator of the fraction described in paragraph (e)(1) of this section. Thereafter, assuming no other corpus is added to the trust, 55% (that is $1,650,000/($1,500,000 + $1,500,000)) of future generation-skipping transfers will be subject to Chapter 13.

Example (6). On June 11, 1976, *B*, the surviving child of the settlor of a trust that was irrevocable on that date, possessed a general power of appointment over the corpus. Under the terms of the trust (created in 1970) *B's* power lapsed upon attaining age 21, an event that occurred on September 23, 1979. Under section 2514, ninety-five percent (100%—5%) of the value of the corpus was treated as a gift by *B* for federal gift tax purposes. However, because the entire trust was subject to the power of appointment, 100% (that portion of the trust subject to the power) of all generation-skipping transfers pursuant to the trust occurring after September 23, 1979, will be subject to Chapter 13.

Example (7). *H* is the grantor of an irrevocable generation-skipping trust which was in existence on June 11, 1976. *H's* will, which was executed before June 11, 1976, and not amended thereafter, provides that upon his death the entire estate will pour-over into his trust. In 1980, *H* transfers $10,000 to the trust. If *H* dies after 1981, the transfer will be treated as an addition to corpus for purposes of any distribution made after the transfer to the trust in 1980. If *H* dies before 1982, the entire trust (as well as any distribution made by the trust prior to his death) will be excluded under paragraphs (b)(1)(i) and (e)(2) of this section from the generation-skipping transfer tax provisions, because the $10,000 would have been added to the trust under a will which would have qualified under paragraph (b)(1)(ii) of this section. In either case, for any generation-skipping transfers made after the transfer to the trust in 1980 but before *H's* death the $10,000 will be treated as an addition to corpus and a proportionate amount of such transfer will be subject to the generation-skipping transfer tax provisions. If *H* dies before January 1, 1982, the person liable for any previously paid generation-skipping transfer tax may file a claim for refund of such tax within the time limit set out in section 6511.

Example (8). *A* is the settlor of a generation-skipping trust which was in existence on June 11, 1976. Under the terms of the trust, *A*, on June 11, 1976, possessed the power to withdraw one-half of the corpus for *A's* personal use. The trust was irrevocable in all other respects. If *A* dies before January 1, 1982, the entire trust will be excluded from the generation-skipping transfer tax provisions. If *A* dies after December 31, 1981, one-half of all generation-skipping transfers pursuant to the trust will be subject to Chapter 13.

Example (9). Assume the same facts as in example (8) except that on July 30, 1980, while *A* is alive, a generation-skipping distribution is made from the trust. Because, on that date, it can not be determined whether the transition rule will be applicable, the revocable portion of the trust must be treated as a constructive addition to the irrevocable portion of the trust occurring on June 11, 1976. If *A* dies before January 1, 1982, the person liable for any previously paid generation-skipping transfer tax may file a claim for refund of such tax within the time limit set out in section 6511.

Example (10). *H* and *W* are the settlors of separate revocable generation-skipping trusts which were in existence on June 11, 1976, and not amended after that date. *W* dies in 1980 and under the provisions of her trust the corpus pours over into *H's* trust. If *H* dies before January 1, 1982, the entire trust is excluded under paragraph (b)(1) of this section from the operation of Chapter 13. If *H* dies after 1981, the entire trust is subject to the generation-skipping transfer tax provisions because *H's* trust did not qualify under the transition rule. The fact that *W* died before 1982 is irrelevant, because the corpus of her trust was added to a trust that never qualified under the transition rule.

Example (11). Assume the same facts as in example (10) except that upon the death of *W* in 1980 her trust continues as an irrevocable trust and that the corpus of *H's* trust is to be paid over upon his death to *W's* trust should he survive her. Again, if *H* dies before 1982, the entire trust falls within the provisions of paragraph (b)(1) of this section. However, if *H* dies after 1981, the "pour-over" is considered an addition to the corpus of a trust which falls within the transition rule, and a proportionate part of subsequent distributions and terminations will be subject to tax under Chapter 13.

Example (12). *A*, the spouse of the settlor of an irrevocable trust that was created in 1973, had, on June 11, 1976, a general power of appointment over the trust assets. The trust provides that should *A* fail to exercise the power the trustee is to continue the trust as a generation-skipping trust. On June 11, 1976, *A* had a will in existence under which *A* failed to exercise the power of appointment. If *A* dies before January 1, 1982, without having exercised the power in a manner which results in the creation of, or increase in the amount of, a generation-skipping transfer (or amended the will in a manner that results in the creation of, or increase in the amount of, a generation-skipping transfer) transfers pursuant to the trust will not be subject to Chapter 13 because the trust qualifies under the effective date rule, the will qualifies under the transition rule, and there is no constructive addition by reason of paragraph (e)(4) of this section.

Example (13). Assume the same facts as in example (12) except that on June 11, 1976, *A* did not have a will. Upon *A's* death, or upon the prior exercise or release of the power, the value of the entire trust will be treated as a constructive addition to the corpus and all subsequent distributions or terminations pursuant to the trust will be subject to Chapter 13. It is immaterial whether *A's* death occurs before January 1, 1982, since the transition rule is only applicable where a will was in existence on June 11, 1976.

This Treasury decision is issued under the authority contained in sections 2621 and 7805 of the Internal

Revenue Code of 1954 (90 Stat. 1887, 68A Stat. 917, 26 U.S.C. 2621, 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved July 31, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 8, 1980, 8:45 a.m., and published in the issue of the Federal Register for August 11, 1980, 45 F.R. 53123.)

Subchapter C.—Administration

Section 2621.—Administration

26 CFR 26a.2621-1: Generation-skipping transfer tax return requirements.

T.D. 7711

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER B,—PART 26a.—TEMPORARY GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1976

Return requirements

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document provides a temporary regulation relating to the filing of returns for the tax on generation-skipping transfers. That tax was introduced by the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1]. The temporary regulation identifies the person required to make the return of tax and prescribes the time and manner of filing, and the form used to make the return. It affects trustees and beneficiaries of generation-skipping trusts. In addition, the rules contained in the temporary regulation in this document also serve as a notice of proposed rulemaking by which the rules are proposed to be prescribed as final regualtions.

DATE: The regulation applies generally to any generation-skipping transfer made after June 11, 1976.

FOR FURTHER INFORMATION CONTACT: Robert H. Waltuch of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:LR:T, 202-566-3287, not a toll free call.

SUPPLEMENTARY INFORMATION

BACKGROUND

This document provides a temporary generation-skipping transfer tax regulation under Chapter 13 of the Internal Revenue Code of 1954 (Code), as added by section 2006(a) of the Tax Reform Act of 1976 (Public Law 94-455; 90 Stat. 1879) [1976-3 C.B. (Vol. 1) 1, 355] to provide rules for making the necessary return of tax. The temporary regulation provided by this document will remain in effect until superseded by final regulations on this subject. By a separate document appearing elsewhere in this issue of the Federal Register, the regulation promulgated in this document is also proposed to be prescribed as final Generation-Skipping Transfer Tax Regulations (26 CFR Part 26) under section 2621 of the Code.

PROVISIONS OF THE REGULATION

The generation-skipping transfer tax return consists of a statement filed with the Internal Revenue Service within the time specified in the regulation. The due date depends upon the type of event which gives rise to liability for the tax.

With a taxable distribution, generally it is the distributee of the money or property who must make the return. To enable the distributee to file the return, the distributee must first obtain information from the trustee and in many cases from the Service. Therefore, the regulation requires the trustee to file an information return with the Service and to send a statement to the distributee identifying the portion of a distribution that is taxable. If the distributee needs any additional information to compute the tax imposed on the taxable distribution, the distributee may obtain this information by filing a written request with the Service. After the Service has supplied the requested information, the distributee is then able to compute the tax and file the return. In the case of a taxable termination, the trustee must make the return and if the trustee is in need of additional information the trustee may also file a written request with the Service. Furthermore, the regulation provides guidelines for situations when there is no trustee (as in the case of a trust equivalent) or when the distributee is unable to act for him or herself.

Under the temporary regulations, generally section 643(b) income is computed on an annual basis in determining whether distributions from the trust are taxable distributions. If during the taxable year of the trust there are distributions and a termination, then section 643(b) income is computed for two short periods. This rule will curtail the possible abuse that could arise when the trustee anticipates that a taxable termination will occur during the taxable year of the trust and therefore distributes money or property to a younger generation beneficiary equal in value to what the anticipated section 643(b) income will be for the year. But for this rule, a trustee could distribute unearned but anticipated income prior to a taxable termination and it would not be taxable because of the current income exclusion, nor would it be on hand to be included in the trust on the date of the taxable termination.

DRAFTING INFORMATION

The principal author of this regulation is Robert H. Waltuch of the Legislation and Regulations Division of the

Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

Waiver of Procedural Requirements of Treasury Directive

There is need for expeditous adoption of the provisions contained in this document because of the need for immediate guidance to persons required to file a return of tax. For this reason, Jerome Kurtz, Commissioner of Internal Revenue, has determined that the provisions of paragraphs 8 through 14 of the Treasury Department directive implementing Executive Order 12044 must be waived.

Adoption of regulations

A new part 26a, Temporary Generation-Skipping Transfer Tax Regulations under the Tax Reform Act of 1976, is hereby added to Title 26 of the Code of Federal Regulations, and the following temporary regulation is hereby adopted:

Sec.

26a.2621-1 Generation-skipping transfer tax return requirements.

Authority. Sections 2622 and 7805, Internal Revenue Code of 1954 (90 Stat. 1887, 68A Stat. 917, 26 USC 2621, 7805).

§ 26a.2621-1 Generation - skipping transfer tax return requirements.

(a) *In general.* Chapter 13 of the Code imposes a tax on generation-skipping transfers, as defined in section 2611. The tax applies to both taxable distributions and terminations of either interests in property or powers over property. For purposes of this part, the term "distributee" means a younger generation beneficiary who actually receives money or property (or has money or property applied for his benefit) from a generation-skipping trust or trust equivalent. This section contains rules for making the required tax return.

(b) *Person required to make return*—(1) *In general.* Except as otherwise provided in this section, the following person must make the required tax return, Form 706-B, Generation-Skipping Transfer Tax Return,—

(i) The distributee in a taxable distribution, as defined in section 2613 (a),

(ii) The trustee in the case of a taxable termination, as defined in section 2613(b), or

(iii) The distributee in the case of a generation-skipping transfer involving a generation-skipping trust equivalent.

(2) *Entity.* If a trust, estate, corporation or partnership is the recipient of money or property in a taxable distribution, then those persons who are assigned to a generation under section 2611(c)(7) shall be treated as distributees to the extent of their interest in the entity and are responsible for filing the return and paying the tax.

(3) *Exceptions*—(i) *Minors.* If a distributee is otherwise required to make a return, but the distributee is a minor, a return must be made by the minor or must be made for the minor by the minor's guardian or other person charged with the care of the minor's person or property.

(ii) *Returns made by agents.* The return of tax may be made by an agent if, by reason of disease, injury, illness or absence from the country, the person liable for making the return is unable to make it. Mere convenience is not sufficient reason for authorizing an agent to make the return. If the return is made by an agent, the return must be ratified by the principal within a reasonable time after such person becomes able to do so. If not ratified, it will not be the return required by the statute. The ratification must be in the form of a statement executed under penalties of perjury by the principal and filed with the Internal Revenue Service office with which the return was filed. It must state specifically that the return made by the agent has been carefully examined and that the principal ratifies the return. If a return is signed by an agent, a statement fully explaining the inability of the principal must accompany the return.

(iii) *Returns filed by fiduciary or executor on behalf of distributee.* A fiduciary acting as the guardian or committee of an insane person must make the required return. If a distributee who would be required to make the return for a transfer dies after the transfer occurs but before the return is filed, the executor or other person in possession of the decedent's assets is required to make the return.

(4) *Special rules*—(i) *Joint and undivided interests with distributees making return.* If paragraph (b)(1) of this section requires the distributee to make the tax return and if more than one distributee of a deemed transferor receives an interest in or power over property jointly, or simultaneously receives other undivided interests in property, all of the distributees must jointly make the return. Should any distributee fail to join in making the return, the remaining distributees must make a return for the entire transfer. This return must identify the distributee not joining in it and the property interests passing to that distributee. The tax is to be computed on the entire transfer and is to be paid in full by the distributees making the return, unless their liability under paragraph (h)(1) of this section is less than that amount, in which case an amount equal to their full liability must be remitted. This payment does not, however, relieve the non-filing distributee of any liability under state law to the person who filed the return for tax attributable to property received by the non-filing distributee.

(ii) *Multiple trustees.* In the case of a taxable termination, if there is more than one trustee of a generation-skipping trust, the return may be made by any one of them. The return must

identify the trustees not joining in it. Payment of the entire amount of tax is due with the return.

(c) *Time and manner of filing return*—(1) *In general.* Form 706-B must be filed with the Internal Revenue Service office with which an estate or gift tax return of the deemed transferor must be filed. It must be filed—

(i) Except as provided in paragraph (c)(1)(ii) of this section, in the case of a taxable distribution or termination that occurs before the death of the deemed transferor, on or before the expiration of 6 months after the close of the taxable year of the trust (or in the case of a trust equivalent, the close of the deemed transferor's taxable year in which the transfer occurred).

(ii) In the case of a taxable distribution or termination that occurs within the same taxable year as the death of the deemed transferor, or any time after the death of the deemed transferor, on or before the later of the expiration of 6 month after the last day allowed for filing the estate tax return (including extensions), or 6 months after the close of the taxable year of the trust (or in the case of a trust equivalent, the close of the distributee's taxable year in which the transfer occurred).

When, under section 2613(b), any transfer is deemed to occur later than it actually does, the time for filing the return is to be measured from the date on which the transfer is deemed to occur (see also paragraph (k) of this section for initial filing date).

(2) *Transfers within 3 years of death of deemed transferor.* If a deemed transferor dies within 3 years after a generation-skipping transfer has occurred, an amended return must be filed for the transfer. The due date for the return is determined as if the prior transfer occurred at the same time as the deemed transferor's death and the tax must be recomputed as if the transfer had occurred immediately after the deemed transferor's death. Only one amended return need be filed by each distributee who filed previously. It must include all transfers that occurred within 3 years prior to the deemed transferor's death and any increase in tax must be paid by that distributee. If the rules under § 26a.2621-1(g)(2) (relating to a distribution and a termination occurring during the same taxable year) apply, then those persons required to file a return under § 26a.2621-1(b) because of a distribution in a short period (described in paragraph (g)(2) of this section) and an amended return for transfers within 3 years of death are required to file only one return which includes all the transfers that occurred during the 3-year period.

(d) *Form of return.* Form 706-B must be filed in accordance with its instructions.

(e) *Requirement of return where no tax is due.* A return of tax for every generation-skipping transfer, as defined in section 2611(a), and every transfer that would be a generation-skipping transfer but for the application of section 2613(a)(4)(A) or (b)(5)(A), must be made as provided in this section. This is so even if no tax liability arises from a given transfer.

(f) *Information return*—(1) *General rule.* In the case of a generation-skipping transfer, the trustee must complete and file Form 706-B(1), *Information Return by Trustee for a Taxable Distribution or Termination From a Generation-Skipping Trust,* with the same Internal Revenue Service Center with which the distributee must file Form 706-B. Only one Form 706-B is required to be filed for younger generation beneficiaries having the same deemed transferor. In addition, the trustee must complete and send Form 706-B(2), *Beneficiary's Share of a Taxable Distribution From a Generation-Skipping Trust,* to each distributee required to file Form 706-B within the time the trustee is required to file Form 706-B(1).

(2) *Time for filing.* If the due date of the 706-B is determined under § 26a.2621-1(c)(1)(i), then Form 706-B(1) must be filed on or before the fifteenth day of the third month following the close of the taxable year of the trust. If the due date of Form 706-B is determined under §26a.2621-1(c)(1)(ii), then Form 706-B(1) must be filed on or before the later of the fifteenth day of the third month following the close of the taxable year of the trust, or the fifteenth day of the third month following the last day allowed for filing the estate tax return.

(g) *Taxable distributions*—(1) *Annual return.* The return required by this section must include all taxable distributions received by the distributee from a trust that occurred during the taxable year of the trust. For the sole purpose of determining the rate at which a taxable distribution is taxed, all taxable distributions that relate to the same deemed transferor and that are from the same or different trusts which have the same taxable year are treated as occurring simultaneously during the taxable year (or short period) and the rules under section 2602 apply in computing the tax on each.

(2) *Exception.* If, in addition to taxable distributions occurring during the taxable year of the trust, there is also a taxable termination which is not the result of the death of the deemed transferor, then for the purpose of determining whether distributions exceed the amount of section 643(b) income, section 643(b) income is computed separately for each of two periods. The first period begins on the first day of the taxable year of the trust and ends on the day immediately preceding the day on which the taxable termination occurs (or is deemed to occur). The second begins the day the taxable termination occurs (or is deemed to occur) and ends on the last day of the taxable year. If the termination is the result of the death of a deemed transferor, the first period ends immediately before the termination occurs (or is deemed to occur) and the second period begins immediately after the termi-

nation occurs(or is deemed to occur). The amount of section 643(b) income for each period is then determined as if each short period were a short taxable year. If after computing section 643(b) income for each period, distributions during a period exceed section 643(b) income for that period, then the return must be filed for the year if the distribution of the money or property meets the definition of a taxable distribution. If after computing section 643(b) income for the first short period the income exceeds the amount distributed, then the excess is treated as earned during the second short period.

(3) *Examples.* This paragraph may be illustrated by the following examples.

Example (1). Assume A creates a generation-skipping trust with the income and/or corpus payable to his child B and his grandchildren C and D (the children of B) for their joint lives and the life of the survivor, and upon the death of the last survivor to the grandchildren of B per stirpes. Assume that the grandchild exclusion has been utilized and that all section 643(b) income has been distributed previously. During the year 1990 C received $40,000 from the trust and D received $110,000. B has made no gifts during his lifetime and there have been no other generation-skipping transfers. Since C and D both have the same deemed transferor, the transfers are treated as occurring simultaneously and the tax is computed in the following manner:

(1) Fair market value of property transferred to C & D	$150,000
(2) Prior generation-skipping transfers	0
(3) Adjusted taxable gifts	0
(4) Taxable estate	0
(5) Total	$150,000
(6) Tax on amount on line 5	$ 38,800
(7) Tax due from C $\frac{(40,000}{(150,000} \times 38,800)$	$ 10,347
(8) Tax due from D $\frac{(110,000}{(150,000} \times 38,800)$	$ 28,453

Example (2). Assume A creates a generation-skipping trust with the income and/or corpus payable in the sole discretion of the trustee to his child B, grandchild C, and great grandchild D for their joint lives and for the lives of the survivors. Upon the death of the last survivor the trust corpus is to be distributed to A's great great grandchlidren per stirpes. The trust is a calendar year taxpayer. On January 1, 1990, the trustee distributes $20,000 to C. On June 1, 1990, B dies. Section 643(b) income for the full year is $30,000, one-half ($15,000) of which was earned between Jan. 1, 1990, and June 1, 1990. Thus, under paragraph (c) $5,000 ($20,000 minus $15,000) of the $20,000 distribution is a taxable distribution.

(h) *Liability for tax*—(1) *Distributee.* If the tax imposed is not paid when due, each distributee (whether or not required to file a return) that receives property from the trust at the same time as or any time after a generation-skipping transfer is personally liable for the tax under section 2603 (a)(1)(B) as a distributee to the extent of an amount equal to the fair market value of the property received determined as of the date of the distribution.

(2) *Trustees.* In the case of a taxable termination, if a trustee is required to make the return, the trustee is personally liable for the tax imposed on the transfer if the tax is not paid when due. This liability applies whether or not a trustee joins in making the tax return in situations involving multiple trustees or makes the return when it is the sole trustee. If a trustee pays the tax determined to be due based on written data furnished by the Service, the trustee is not personally liable for any tax exceeding the amount determined to be due based on that data. This limit on a trustee's personal liability applies only if all the required information that was furnished to the Service by the trustee (or trustees) was accurate and complete. An increase in tax based on a higher property valuation than that claimed by the trustee is, for example, the result of inaccurate information and therefore the trustee will be liable for any increase in tax.

(3) *Lien on property.* The tax imposed by section 2601 is a lien on all property transferred in a generation-skipping transfer until the tax is fully paid or becomes unenforceable by reason of lapse of time. The lien attaches at the time of the generation-skipping transfer and is in addition to the lien for taxes under section 6321. Thus, for example, if property passes to more than one person in a simultaneous transfer as described in section 2602 (b), the property passing to each person is liable for the full amount of tax caused by the total transfer.

(i) This designation is not used.

(j) *Request to Internal Revenue Service for information*—(1) *In general.* A trustee or distributee may, before making a generation-skipping transfer tax return, request in writing that the Internal Revenue Service supply it with a statement showing—

(i) The amount of the deemed transferor's adjusted taxable gifts within the meaning of section 201(b) as modified by section 201(e),

(ii) The amount of the deemed transferor's taxable estate and the estate tax thereon before allowance of any credits,

(iii) The amount of prior generation-skipping transfers with respect to the deemed transferor,

(iv) The amount of prior generation-skipping transfers that occurred within three years prior to the deemed transferor's death and the amount of the generation-skipping transfer tax paid with respect to these transfers,

(v) The amount of generation-skipping transfer tax imposed before the allowance of any credits with respect to prior generation-skipping transfers,

(vi) The amount of State death tax credit allowed on the deemed transferor's estate tax return and the amount of State death tax credit allowed on prior generation-skipping transfer tax returns,

(vii) The amounts necessary to complete Schedule F, Credit for Tax on Prior Transfers,

(viii) The amount of the grandchild exclusion that has been used for transfers to a grandchild of the grantor,

(ix) The amount of any taxable distributions or taxable terminations that occurred during the same taxable year and that were made from other trusts

having the same deemed transferor, and

(x) Any other data that may be needed to complete Form 706-B, *Generation-Skipping Transfers Tax Return.*

(2) *Filing of request.* The request for the information specified in paragraph (j)(1) of this section must be in writing and signed by any person required to file the return. It must be addressed to the Internal Revenue Service office with which an estate or gift tax return of the deemed transferor would be filed. It should be filed not less than 90 days before the due date of the generation-skipping tax return for the transfer involved. If the request is filed less than 90 days before the due date of the return, the failure to obtain the information will not be considered reasonable cause for failing to file a timely return or to pay the tax under section 6651. The written request should include the following information:

(i) The name and taxpayer identification number of the deemed transferor and of the grantor;

(i) A statement of the specific information requested from the Service;

(iii) In the case of a trustee or other agent, a certified copy of its appointment.

(k) *Initial filing date.* Notwithstanding any other provision of these regulations, the time for filing the Form 706-B shall be the date determined under paragraph (c) of this section or February 5, 1981, whichever is later.

There is a need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue it with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

This Treasury decision is issued under the authority contained in section 2622 and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1887, 68A Stat. 917, 26 U.S.C. 2622, 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved July 18, 1980.

EMIL M. SUNLEY,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 4, 1980, 8:45 a.m., and published in the issue of the Federal Register for August 5, 1980, 45 F.R. 51771)

Subtitle C.—Employment Taxes
Chapter 21.—Federal Insurance Contributions Act
Subchapter A.—Tax on Employees

Section 3101.—Rate of Tax

26 CFR 31.3101-1: Measure of employee tax.

Procedure for exemption from social security taxes under totalization agreements. See Rev. Proc. 80-56, page 851.

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26 CFR 31.3101-1: Measure of employee tax.

Whether payments to a trust to which the taxpayer's lifetime services have been assigned, by a corporation for which the taxpayer performs such services, are wages for purposes of federal income tax withholding and FICA taxes. See Rev. Rul. 80-321, page 33.

Section 3102.—Deduction of Tax from Wages

26 CFR 31.3102-1: Collection of and liability for, employee tax; in general.

Modified procedures relating to the employment tax status of independent contractors. See Rev. Proc. 80-35, page 769.

Subchapter B.—Tax on Employers

Section 3111.—Rate of Tax

26 CFR 31.3111-1: Measure of employer tax.

Procedure for exemption from social security taxes under totalization agreements. See Rev. Proc. 80-56, page 851.

26 CFR 31.3111-1: Measure of employer tax.

Whether payments to a trust to which the taxpayer's lifetime services have been assigned, by a corporation for which the taxpayer performs such services, are wages for purposes of federal income tax withholding and FICA taxes. See Rev. Rul. 80-321, page 33.

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26 CFR 31.3111-4: Liability for employer tax.

Modified procedures relating to the employment tax status of independent contractors. See Rev. Proc. 80-35, page 769.

Subchapter C.—General Provisions

Section 3121.—Definitions

26 CFR 31.3121(a)-1: Wages.
(Also Sections 61, 162, 3306, 3401; 1.61-1, 1.162-1, 31.3306(b)-1, 31.3401(a)-1.)

Legal fees and interest awarded with back pay. Examples illustrate the income tax and employment tax consequences of interest and attorneys' fees being awarded by a court in connection with claims for back pay.

Rev. Rul. 80-364

ISSUE

Whether interest and an attorney's fee awarded by a court in connection with a claim for back pay are wages for federal employment tax purposes.

FACTS

Situation 1. After termination of employment by a company, an individual filed a complaint against the company for back pay owed to the individual. The court awarded the individual $8x$ dollars as back pay, and also awarded interest of $1x$ dollars and an attorney's fee of $1x$ dollars.

Situation 2. An individual sued the individual's employer for $15x$ dollars for back pay. Pursuant to a court order the employer made a payment to the employee of $10x$ dollars. The court order did not indicate that a portion of the award was attorney's fees or interest. The employee paid $1x$ dollars

for an attorney's fee which was paid out of the award.

Situation 3. Due to a breach of a collective bargaining agreement a union filed claims on behalf of its members against a company. Subsequently, the union and the company entered into a settlement agreement, later approved by a federal district court, that provided that the company would pay the union 40*x* dollars in full settlement of all claims. The union paid 6*x* dollars of the settlement for atorney's fees and returned 34*x* dollars to the employees for back pay owed to them. The back pay was distributed among the employees in proportion to their claims.

LAW AND ANALYSIS

Section 61(a) of the Internal Revenue Code provides that gross income means all income from whatever source derived, including compensation for services.

Section 3121(a) of the Code relating to the Federal Insurance Contributions Act and section 3306(b) relating to the Federal Unemployment Tax Act provide that the term "wages" means all remuneration for employment. Section 3401(a), relating to income tax withholding, contains a similar definition.

Rev. Rul. 72-268, 1972-1 C.B. 313, holds that payments by employers for previously unpaid minimum wages and overtime compensation under the Fair Labor Standards Act of 1938 are wages for federal employment tax purposes. However, payments of liquidated damages to employees under the Act are not remuneration for employment and are not wages.

HOLDINGS

In *Situation 1,* while the full amount of the award is income to the employee and must be included in the employee's gross income, only the back pay award of 8*x* dollars is wages for federal employment tax purposes. The payments for interest and the attorney's fee are not wages, because they are not remuneration for employment.

In *Situation 2,* the full amount of the award is income to the employee and it is also wages for federal employment tax purposes, notwithstanding that a portion of it was spent on attorney's fees.

In *Situation 3,* the amount of the settlement paid by the union for attorney's fees is not remuneration to the individual employees and, therefore, is not wages for purposes of the federal employment taxes. The attorney's fees portion of the settlement is a reimbursement for expenses incurred by the union to enforce the collective bargaining agreement. The amount allocated to attorney's fees is not includible in the gross income of the individual employees and the individual employees may not deduct the attorney's fees as a business expense. Compare Rev. Rul. 58-301, 1958-1 C.B. 23.

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26 CFR 31.3121(a)-1: Wages.

Whether employees of the American Institute in Taiwan are subject to FICA. See Rev. Rul. 80-208, page 212.

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26 CFR 31.3121(a)-1: Wages.

Whether reimbursement payments made by a union to its members are wages. See Rev. Rul. 80-348, page 31.

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26 CFR 31.3121(a)(2)-1: Payments under employers' plans on account of retirement, sickness or accident disability, medical or hospitalization expenses, or death.
(Also Section 3306; 31.3306(b)(2)-1.)

Unwritten sick pay plan. Payments that are made under an employer's unwritten sick pay plan that is open to all full-time employees and in which the employees have, for a number of years, been made aware by the customary practice of the employer are excepted from wages under sections 3121(a)(2) and 3306(b)(2) of the Code.

Rev. Rul. 80-303

ISSUE

Are payments made by an employer under an unwritten sick pay plan excluded from "wages" under sections 3121(a)(2) and 3306(b)(2) of the Internal Revenue Code?

FACTS

The employer's plan is open to all full-time employees after 6 months of service. Employees with the company for at least six months are entitled to a minimum of one day's regular wage for one day sick per year. For periods in excess of one day supervisors decide whether to authorize sick pay and the duration of the payments to employees.

The employer initiated the plan voluntarily and has, for a number of years, made payments pursuant to the plan to all employees generally. Although the plan is not in writing, the employees are made aware of it by custom and usage and by discussions among the employees.

LAW AND ANALYSIS

Sections 3121(a)(2) and 3306(b)(2) of the Code except from wages payments made to employees under sick pay plans or systems established by their employer.

For sick pay payments to employees to come within the exclusion from wages, the employer must have a definite plan or system applicable to all employees generally, or to a class or classes of employees, as distinguished from merely a good intention to aid employees in time of need.

Generally, a plan or system exists if any one of the following conditions exists: (A) the plan or system is in writing or is otherwise made known to the employees (for example, through the medium of a bulletin board announcement or the long and established practice of the employer); (B) there is a reference to the plan or system in the contract of employment;

(C) employees contribute to the plan or system; (D) there is a special fund for these payments, separate and apart from the salary account; or (E) the employer is required to make the payments.

The payments in this case are made to employees when absent from work because of illness, and are paid under a definite sick pay plan or system that is made known to the employees. The plan was in effect for a number of years, the employees were aware of it and sick pay payments were made pursuant to the plan.

HOLDING

The payments made by the employer under the plan are excepted from wages under sections 3121(a)(2) and 3306(b)(2) of the Code.

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26 CFR 31.3121(b)(8)-1: Services performed by a minister of a church or a member of a religious order.

Whether Rev. Rul. 77-290, 1977-2 C.B. 26, is applicable to members of an organization described in section 501(d) of the Code. See Rev. Rul. 80-332, page 34.

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26 CFR 31.3121(b)(8)-2: Services in employ of religious, charitable, educational, or certain other organizations exempt from income tax.

Whether an exempt organization is deemed to have filed a waiver certificate under section 3121(k)(4) of the Code when it files a Form 941 covering three previous quarters and pays the taxes with respect to such periods. See Rev. Rul. 80-337, this page.

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26 CFR 31.3121(b)(20)-1: Service performed on a boat engaged in catching fish.

Treatment of certain crewmen on boats engaged in catching fish as self-employed rather than as employees. See T.D. 7716, page 241.

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26 CFR 31.3121(d)-1: Who are employees.

Whether babysitters engaged by a sitter agency are employees. See Rev. Rul. 80-365, page 300.

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26 CFR 31.3121(k)-1: Waiver of exemption from taxes.
(Also 31.3121(b)(8)-2.)

Exempt organization; waiver certificate; constructive filing. An exempt organization that began withholding FICA taxes from its employees at the beginning of the year and filed Forms 941 and paid the tax for the first three quarters during the fourth quarter is deemed to have filed a waiver certificate under section 3121(k)(4) of the Code.

Rev. Rul. 80-337

ISSUE

Is an exempt organization deemed to have filed a waiver certificate under section 3121(k)(4) of the Internal Revenue Code when it files a Form 941 covering three previous quarters and pays the taxes with respect to such periods?

FACTS

In January 1979 an organization exempt from income tax under section 501(c)(3) of the Code began withholding the taxes imposed under the Federal Insurance Contributions Act from the wages of its employees. The organization never filed a Form 941, Employer's Federal Quarterly Tax Return. In November of 1979 a new treasurer of the organization filed Forms 941 for the first three quarters and made a lump-sum payment of the withheld taxes and the employer taxes for those quarters. The organization had never filed a Form SS-15, Certificate Waiving Exemption from Taxes under the Federal Insurance Contributions Act.

LAW AND ANALYSIS

Services performed by an employee for an organization described in section 501(c)(3) of the Code are excepted from the definition of employment under section 3121(b)(8)(B) of the Code and remuneration for such services is not subject to the taxes imposed by the FICA. However, pursuant to section 3121(k), section 31.3121(k)-1 of the Employment Tax Regulations states that the organization may elect social security coverage by filing a Form SS-15.

Section 3121(k)(4) of the Code provides that if an exempt organization has not filed a certificate it will be deemed for purposes of section 3121(b)(8)(B) to have constructively filed a certificate covering employees for whom the payments were made if it paid the taxes during any period of not less than three consecutive calendar quarters. Although one payment was made in this case, that payment represents FICA taxes on wages for three consecutive quarters.

HOLDING

The organization is deemed to have filed a waiver certificate under section 3121(k)(4) of the Code.

Chapter 22.—Railroad Retirement Tax Act
Subchapter C.—Tax on Employers

Section 3221.—Rate of Tax

RAILROAD RETIREMENT BOARD

Determination of Quarterly Rate of Excise Tax for Railroad Retirement Supplemental Annuity Program

In accordance with directions in section 3221(c) of the Railroad Retirement Tax Act (26 U.S.C. § 3221(c)), the Railroad Retirement Board has determined that the excise tax imposed by such section 3221(c) on every employer, with respect to having individuals in his employ, for each work-hour for which compensation is paid by such employer for services rendered to him during the quarter beginning October 1, 1980, shall be at the rate of twelve and one-half cents.

In accordance with directions in section 15(a) of the Railroad Retirement Act of 1974, the Railroad Retirement Board has determined that for the quarter beginning October 1, 1980, 21.3 percent of the taxes collected under sections 3211(b) and 3221(c) of

the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Account and 78.7 percent of the taxes collected under section 3211(b) and 3221(c) plus one hundred percent of the taxes collected under section 3221 (d) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Supplemental Account.

By Authority of the Board.

Dated: August 19, 1980.

R. F. BUTLER,
Secretary of the Board.

(Filed by the Office of the Federal Register on August 27, 1980, 8:45 a.m., and published in the issue of the Federal Register for August 28, 1980, 45 F.R. 57619)

RAILROAD RETIREMENT BOARD

Determination of Quarterly Rate of Excise Tax for Railroad Retirement Supplemental Annuity Program

In accordance with directions in Section 3221(c) of the Railroad Retirement Tax Act (26 U.S.C. 3221 (c)), the Railroad Retirement Board has determined that the excise tax imposed by such Section 3221(c) on every employer, with respect to having individuals in his employ, for each work-hour for which compensation is paid by such employer for services rendered to him during the quarter beginning January 1, 1981, shall be at the rate of fourteen and one-half cents.

In accordance with directions in Section 15(a) of the Railroad Retirement Act of 1974, the Railroad Retirement Board has determined that for the quarter beginning January 1, 1981, 20.7 percent of the taxes collected under Sections 3211(b) and 3221(c) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Account and 79.3 percent of the taxes collected under such Sections 3211(b) and 3221(c) plus one hundred percent of the taxes collected under Section 3221(d) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Supplemental Account.

By Authority of the Board.
Dated: November 4, 1980.

R. R. BUTLER,
Secretary of the Board.

(Filed by the Office of the Federal Register on November 10, 1980, 8:45 a.m., and published in the issue of the Federal Register for November 12, 1980, 45 F.R. 74798.)

Chapter 23.—Federal Unemployment Tax Act

Section 3301.—Rate of Tax

26 CFR 31.3301-1: Persons liable for tax.

Modified procedures relating to the employment tax status of independent contractors. See Rev. Proc. 80-35, page 769.

Section 3302.—Credits Against Tax

26 CFR 31.3302(c)-1: Limit on total credits.

Reductions in credit applicable to employers for whom services are performed in 1980 in various states, the District of Columbia, Puerto Rico, and the Virgin Islands. See Rev. Proc. 80-60, page 856.

Section 3306.—Definitions

26 CFR 31.3306(b)-1: Wages.

Whether reimbursement payments made by a union to its members are wages. See Rev. Rul. 80-348, page 31.

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26 CFR 31.3306(b)-1: Wages.

Whether a court awarded payment of interest and attorney's fee along with a payment of back pay, is wages for federal employment tax purposes. See. Rev. Rul. 80-364, page 294.

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26 CFR 31.3306(b)(2)-1: Payments under employers' plans on account of retirement, sickness or accident disability, medical or hospitalization expenses, or death.

Whether payments made by an employer under an unwritten sick pay plan are excepted from wages. See Rev. Rul. 80-303, page 295.

26 CFR 31.3306(i)-1: Who are employees.

Whether babysitters engaged by a sitter agency are employees. See Rev. Rul. 80-365, page 300.

Chapter 24.—Collection of Income Tax at Source on Wages

Section 3401.—Definitions

26 CFR 31.3401(a)-1: Wages.

Whether fringe benefits are wages. See Rev. Proc. 80-53, page 848.

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26 CFR 31.3401(a)-1: Wages.

Whether a taxpayer who participates in a training program of the taxpayer's employer is considered "away from home" and accordingly may exclude per diem amounts from gross income. See Rev. Rul. 80-212, page 58.

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26 CFR 31.3401(a)-1: Wages.

Whether payments to a trust to which the taxpayer's lifetime services have been assigned, by a corporation for which the taxpayer performs such services, are wages for purposes of federal income tax withholding and FICA taxes. See Rev. Rul. 80-321, page 33.

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26 CFR 31.3401(a)-1: Wages.

Whether reimbursement payments made by a union to its members are wages. See Rev. Rul. 80-348, page 31.

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26 CFR 31.3401(a)-1: Wages.

Whether a court awarded payment of interest and attorney's fee along with a payment of back pay, is wages for federal employment tax purposes. See Rev. Rul. 80-364, page 294.

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26 CFR 31.3401(a)(9)-1: Remuneration for services performed by a minister of a church or a member of a religious order.

Whether Rev. Rul. 77-290, 1977-2 C.B. 26, is applicable to members of an organization described in section 501(d) of the Code. See Rev. Rul. 80-332, page 34.

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26 CFR 31.3401(a)(12)-1: Payments from or to certain tax-exempt trusts, or under or to certain annuity plans or bond purchase plans, or to individual retirement plans. (Also Section 6693; 301.6693-1.)

T.D. 7730 [1]

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER C, PART 31.—EMPLOYMENT TAXES; APPLICABLE ON AND AFTER JANUARY 1, 1955; SUBCHAPTER F, PART 301.—PROCEDURE AND ADMINISTRATION

Information return penalties and withholding tax rules concerning individual retirement plans

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations prescribing withholding tax rules for individual retirement plans and penalties for failure to furnish information in connection with such plans. Changes to the applicable tax law were made by the Employee Retirement Income Security Act of 1974 [Pub. L. 93-406, 1974-3 C.B. 1] and the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1]. These regulations would provide the public with additional guidance needed to comply with those Acts and would affect the parties responsible for furnishing or filing certain documents concerning individual retirement plans and employers contributing to such plans.

DATE: The regulations have varying effective dates as indicated. The provisions imposing a penalty tax for the failure to furnish or file documents concerning individual retirement plans are effective January 1, 1975.

FOR FURTHER INFORMATION CONTACT: Kirk F. Maldonado of the Employee Plans and Exempt Organizations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:LR:T), 202-566-3430 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On August 20, 1979, the Federal Register published proposed amendments to the Procedure and Administration Tax Regulations (26 CFR Part 301) under section 6693 of the Internal Revenue Code of 1954 and to the Employment Tax Regulations (26 CFR Part 31) under section 3401 of the Code (44 FR 48719). The amendments were proposed to conform the Regulations to section 2002(f) and (g)(7) of the Employee Retirement Income Security Act of 1974 (88 Stat. 967, 970) [*supra* at 136 and 139] and section 1501(b)(7) of the Tax Reform Act of 1976 (90 Stat. 1736) [*supra* at 212]. A public hearing was neither requested nor held on these regulations. After consideration of all the comments regarding the proposed amendments, those amendments are adopted, as revised by this Treasury decision.

EXCLUSION FROM "WAGES" OF PAYMENTS TO INDIVIDUAL RETIREMENT PLANS

Section 3401 defines the term "wages" for purposes of chapter 24 of the Code (relating to withholding taxes). Section 3401(a)(12)(D) excludes from the definition of "wages" payments to individual retirement plans described in section 219(a) or section 220(a) if, at the time of such payment, it is reasonable for the employer to believe the employee will be entitled to a deduction under section 219 or 220 for the payment. In general, the effect of the exclusion from wages is that the employer does not have to withhold any income taxes for the employee for these payments.

The final regulations make it clear that this exclusion is also available for payments to a simplified employee pension arrangement described in section 408(k).

PENALTIES FOR FAILURE TO FURNISH INFORMATION CONCERNING INDIVIDUAL RETIREMENT PLANS

Section 6693 of the Code imposes a $10 penalty for each failure to furnish or file a report or statement required by the regulations under section 408(i) regarding each individual retirement account or individual retirement annuity. This penalty is assessed against the person required by section 408(i) to furnish or file the report or statement. A penalty shall not be assessed, however, if it is established that there was reasonable cause for the failure.

DRAFTING INFORMATION

The principal author of these regulations is Kirk F. Maldonado of the Employee Plans and Exempt Organizations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and the Treasury Department participated in developing these regulations, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, the following amendments to 26 CFR Parts 31 and 301 are hereby adopted.

EMPLOYMENT TAX REGULATIONS [26 CFR Part 31]

Paragraph 1. The title of section 31.3401(a)(12)-1 is amended and a new paragraph (d) is added to read as follows:

§ 31.3401(a)(12)-1 Payment from or to certain tax-exempt trusts, or under or to certain annuity plans

[1] This publication of the Treasury decision contains the full text of the regulations. The individual instructions for modifying the notice of proposed rulemaking have been omitted.

or bond purchase plans, or to individual retirement plans.

* * * * *

(d) *Payment to individual retirement plans.* (1) The term "wages" does not include any payment to an individual retirement plan described in section 7701(a)(37) by an employer after December 31, 1974, on behalf of an employee, if, at the time of such payment, it is reasonable for the employer to believe that the employee will be entitled to a deduction for such payment under section 219(a).

(2) The term "wages" does not include any payment to an individual retirement plan described in section 7701(a)(37) by an employer after December 31, 1976, on behalf of an employee, if, at the time of such payment, it is reasonable for the employer to believe that the employee on whose behalf the payment is made will be entitled to a deduction for such payment under section 220(a).

(3) The term "wages" does not include any payment to a simplified employee pension arrangement described in section 408(k) by an employer after December 31, 1978, on behalf of an employee, if, at the time of such payment, it is reasonable for the employer to believe that the employee on whose behalf the payment is made will be entitled to a deduction for such payment under section 219(a).

PROCEDURE AND ADMINISTRATION TAX REGULATIONS

26 CFR Part 301

Par. 2. Section 301.6693-1 is added at the appropriate place to read as follows:

§ 301.6693-1 Penalty for failure to provide reports and documents concerning individual retirement accounts or annuities.

(a) *In general*—(1) *Annual reports, etc.* The trustee of an individual retirement account described in section 408(a), or the issuer of an individual retirement annuity described in section 408(b), who fails to furnish or file a report or any other document required under section 408(i) and § 1.408-5 within the time and in the manner prescribed for furnishing or filing such item shall pay a penalty of $10 for each failure unless it is shown that such failure is due to reasonable cause.

(2) *Disclosure statements.* The trustee of an individual retirement account described in section 408(a), or the issuer of an individual retirement annuity described in section 408(b), who fails to furnish or file a disclosure statement, a governing instrument, an amendment to either, or any other document required under section 408(i) and § 1.408-6, within the time and in the manner prescribed for furnishing or filing such item, shall pay a penalty of $10 for each failure unless it is shown that such failure is due to reasonable cause.

(b) *Showing of reasonable cause.* The penalty imposed by section 6693 shall not apply to any person with respect to a failure to furnish or file a report, statement, or other document within the time and in the manner prescribed if it is established to the satisfaction of the district director that such failure was due to reasonable cause. An affirmative showing of reasonable cause must be made in the form of a written statement, containing a declaration by such person that it is made under the penalties of perjury and setting forth all the facts alleged to constitute reasonable cause.

(c) *Deficiency procedures not to apply.* The penalty imposed by section 6693 may be assessed and collected without regard to the deficiency procedures provided by subchapter B of chapter 63 of the Code.

(d) *Other penalties.* The penalties of section 6693 and this section are in lieu of any penalty imposed by section 6652(f) for violation of section 6047(d), with respect to any failure to furnish or file described in this section.

(e) *Effective date.* This section shall take effect on January 1, 1975.

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved October 7, 1980.

EMIL M. SUNLEY,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 31, 1980, 8:45 a.m., and published in the issue of the Federal Register for November 3, 1980, 45 F.R. 72651)

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26 CFR 31.3401(a)(17)-1: Remuneration for services performed on a boat engaged in catching fish.

Treatment of certain crewmen on boats engaged in catching fish as self-employed rather than as employees. See T.D. 7716, page 241.

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26 CFR 31.3401(c)-1: Employee.

Whether babysitters engaged by a sitter agency are employees. See Rev. Rul. 80-365, page 300.

Section 3402.—Income Tax Collected at Source

26 CFR 31.3402(a)-1: Requirement of withholding.

Whether payments to a trust to which the taxpayer's lifetime services have been assigned, by a corporation for which the taxpayer performs such services, are wages for purposes of federal income tax withholding and FICA taxes. See Rev. Rul. 80-321, page 33.

Section 3403.—Liability for Tax

26 CFR 31.3403-1: Liability for tax.

Modified procedures relating to the employment tax status of independent contractors. See Rev. Proc. 80-35, page 769.

Chapter 25.—General Provisions Relating to Employment Taxes

Section 3506.—Individuals Providing Companion Sitting Placement Services

26 CFR 31.3506-1: Companion sitting placement services.
(Also Sections 3121, 3306, 3401; 31.3121(d)-1, 31.3306(i)-1, 31.3401(c)-1.)

Babysitters. Individuals engaged to perform sitting services for the clients of a babysitting agency that receives a fixed percentage of the fee collected by the sitters are not employees of the agency with respect to remuneration received after 1974. The general rule for determining employee status set forth in Rev. Rul. 56-502 only applies to sitting services if the agency pays the sitters directly. Rev. Rul. 74-414 revoked; Rev. Rul. 56-502 modified.

Rev. Rul. 80-365

ISSUE

Are individuals engaged by a babysitting agency to perform sitting services for the clients of the babysitting agency employees of the agency under sections 3121(d), 3306(i) and 3401 (c) of the Internal Revenue Code?

FACTS

As a result of section 10 of Pub. L. No. 95-171, 1978-1 C.B. 457, 458, which added section 3506 to the Code, the Internal Revenue Service has given further consideration to Rev. Rul. 56-502, 1956-2 C.B. 688 and Rev. Rul. 74-414, 1974-2 C.B. 334.

Rev. Rul. 56-502 holds that individuals engaged by an agency that is not licensed or registered under state or municipal law as an employment agency to perform domestic service for its clients are employees of the agency for federal employment tax purposes. In that revenue ruling, the agency holds itself out as being engaged in the business of furnishing domestic help and determines the individuals' remuneration. The clients pay the agency for the individual's services, and the agency deducts a stipulated commission from the amount and turns the balance over to the individuals.

Rev. Rul. 56-502 sets forth a general rule to be applied in situations concerning the federal employment tax status of individuals engaged by a company to perform domestic services for its clients. The individuals are considered to be employees of such agency for federal employment tax purposes where the facts show that (1) the agency is engaged in the business of furnishing such services and so holds itself out to the general public, (2) the agency furnishes the employment of the individuals and fixes their remuneration, (3) the parents, homeowners, or others for whom the services are performed look to the agency for duly qualified and trained individuals, (4) the services are necessary to the conduct of the agency's business and promote or advance its business interests, and (5) the total business income of the agency is derived through a percentage of the remuneration received by the individuals for the performance of their services. Rev. Rul. 56-502 states that the above rule is considered applicable whether the agency pays the individuals directly or the individuals are paid directly by the agency's clients.

However, Rev. Rul. 56-502 holds that the foregoing general rule does not apply in those instances where the agency furnishing the services is licensed or registered under state or municipal law as an employment agency that has the function of furnishing applicants for employment to prospective employers and is subject to the applicable laws and regulations respecting the charging of fees, the maintenance of its employment register, etc.

Rev. Rul. 74-414 holds that individuals performing babysitting services for customers of a babysitting agency licensed as an employment agency in accordance with city and state requirements are employees of the agency for federal employment tax purposes, since the agency has retained the primary right to direct and control them. That agency furnishes instructions regarding conduct, requires semimonthly reports, prohibits the individuals from engaging assistants or substitutes or securing work with a client other than through the agency, and determines the fee to be charged. The babysitters collect the total fee for the services from the clients and pay a fixed percentage to the agency.

In addition to its holding, Rev. Rul. 74-414 clarifies Rev. Rul. 56-202 to provide that a state or municipal licensing requirement is not exclusively determinative of the existence of an employer-employee relationship, if, in fact, the agency has the right to control and direct the individual under the common law rules. The clarification is effective with respect to the remuneration received by individuals engaged by a company to perform domestic services for its clients for calendar quarters beginning after August 26, 1974.

LAW AND ANALYSIS

Effective with respect to remuneration received after December 31, 1974, section 3506(a) of the Code provides that, for federal employment tax purposes, a person engaged in the trade or business of putting sitters in touch with individuals who wish to employ them shall not be treated as the employer of such sitters (and such sitters shall not be treated as employees of such person) if such person does not pay or receive the salary or wages of the sitters and such person is compensated by the sitters or the persons who employ them on a fee basis.

Section 3506(b) provides that the term "sitters" means individuals who furnish personal attendance, companionship, or household care services

to children or to individuals who are elderly or disabled.

Section 31.3506-1(c) of the Employment Tax Regulations provides that sitters not treated as employees by reason of section 3506 of the Code, shall be deemed to be self-employed for purposes of the tax on self-employment income imposed by section 1401.

HOLDING

The babysitters engaged by the agency in Rev. Rul. 74-414 to perform sitting services for its clients are not treated as employees of the agency for federal employment tax purposes with respect to remuneration received by them after December 31, 1974. However, they are self-employed for purposes of the tax on self-employment income imposed by section 1401 of the Code with respect to remuneration received after that date.

Since the agency in Rev. Rul. 56-502 receives the entire amount of the charges for the domestic services performed by the individuals, retains a percentage, and pays the difference to the individuals, individuals performing sitting services remain the employees of the agency under the facts of that revenue ruling and are not affected by the provisions of section 3506 of the Code.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 74-414 is revoked, effective with respect to remuneration received by the sitters after December 31, 1974.

Rev. Rul. 56-502 is modified to state that the general rule set forth in that ruling only applies to sitting services if the agency pays the sitters directly.

The clarification of Rev. Rul. 56-502, effective with respect to remuneration for calendar quarters beginning after August 26, 1974, remains in effect.

Subtitle D.—Miscellaneous Excise Taxes
Chapter 31.—Special Fuels

Section 4042.—Tax on Fuel Used in Commercial Transportation on Inland Waterways

26 CFR 48.4042-1: Tax on fuel used in commercial waterway transportation.

T.D. 7727

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER D, PART 48.—MANUFACTURERS AND RETAILERS EXCISE TAXES

Excise tax on fuel used in commercial waterway transportation

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final rulemaking.

SUMMARY: This document provides final regulations relating to the new excise tax on the use of fuel in commercial waterway transportation. Changes to the applicable tax law were made by section 202 of the Inland Waterways Revenue Act of 1978 [Pub. L. 95-502, 1978-2 C.B. 393]. The regulations affect all operators of commercial vessels used on certain inland and intracoastal waterways.

EFFECTIVE DATE: These regulations apply to fuel consumed after September 30, 1980.

FOR FURTHER INFORMATION CONTACT: John R. Harman of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:LR:T, LR-175-78, 202-566-4351, not a toll-free call.

SUPPLEMENTARY INFORMATION:

BACKGROUND

Section 202 of the Inland Waterways Revenue Act of 1978 (the "Act"), Pub. L. 95-502, 92 Stat. 1996, imposes an excise tax on the use of liquid fuel in commercial waterway transportation. It taxes only fuel used by certain types of commercial vessels along particular inland and intracoastal waterways.

On June 9, 1980, the Federal Register published a proposed amendment to the Excise Tax Regulations (26 CFR 48) under section 4042 of the Internal Revenue Code of 1954 (Code) (45 FR 38411). The amendment was proposed to conform the regulations to the amendment of the Code made by the Act. A correction to the initially published proposal was published on July 29, 1980 (45 FR 50368). A public hearing on the proposed regulations was held on September 25, 1980. After consideration of all comments regarding the proposed amendment, final regulations are adopted by this Treasury decision.

These regulations meet the Treasury criteria for significant regulations.

SUMMARY OF COMMENTS AND SUBSTANTIVE REVISIONS

Twenty-two organizations submitted comments in response to the invitation in the notice. Several organizations objected to implementation of the Act on constitutional grounds, claiming the Act conflicts with the tax uniformity clause, the ports preference clause, and the due process clause. *See generally* U.S. CONST. art. 1, § 8, cl. 1; U.S. CONST. art. 1, § 9, cl. 6; U.S. CONST. amend. V.

Several commentators expressed concern that the statement regarding the general purpose of the fuel tax, contained in the supplementary information to the proposal, might be misapplied. They were concerned that the statement could be construed to impose a restriction on the ultimate uses of the tax collected, a result which was not intended. The statement was not substantive. As a result of the comments, it has been deleted from the

supplementary information to these final regulations.

The tax only applies to vessels used in commercial transportation. Several commentators requested clarification of whether commercial transportation vessels will be subject to the tax while fleeting barges into a single tow and while used to dislodge a tow grounded on a sandbar. The final regulations clarify that they are. *See* § 48.4042-1 (f)(1). Congress intended to tax fuel consumed in vessels used for commercial waterway transportation, but not to limit the tax to fuel consumed by vessels while actually transporting property. Vessel operators seeking a ruling as to whether other uses of vessels constitute commercial waterway transportation, within the meaning of § 48.4042-1(f)(1), should consult Rev. Proc. 80-20, 1980-1 C.B. 633.

Only fuel used on waterways specified in section 206 of the Act [Pub. L. 95-502, 1978-2 C.B. 393, 394] is taxable. Several comments pointed out ambiguities in the descriptions of three of the specified waterways; namely, the Atlantic Intracoastal Waterway, the Gulf Intracoastal Waterway, and the Illinois Waterway. Those descriptions are clarified by the final regulations to better apprise operators of where fuel consumption is taxable. *See* § 48.4042-1(g)(6), (g)(11), and (g)(12).

By imposing a tax on the use of liquid fuel, Congress intended to impose a tax similar to a preexisting tax on liquid fuel used in motor vehicles (Code section 4041), which had been interpreted to apply only to propulsion fuels. Accordingly, § 48.4042-2(a)(1), as proposed, provided that only fuel used in the propulsion system of the vessel is taxed. That section has been modified in response to several requests to define what constitutes a propulsion system. The final regulations clarify that a propulsion system means any engine generating movement of a vessel, including bow thrusters used for steering.

Several commentators expressed concern that § 48.4042-2(b) might be interpreted to require vessel operators to install fuel gauges and that § 48.4042-2(c) might be interpreted to require operators to maintain a second set of records duplicating records already contained in vessel logs and invoices of fuel purchases. Such expenditures are not required by the regulations.

Many comments pointed out situations where, because of an operator's circumstances, maintaining certain records listed in § 48.4042-2(c)(1) would serve little or no purpose—such as (1) requiring fuel refining firms operating barges to maintain records of fuel acquired for all purposes and (2) requiring records of arrival and departure times for a vessel used exclusively in taxable waterways. Section 48.4042-2(c)(1) has been changed to clarify that a vessel operator is only required to maintain records sufficient to establish to the satisfaction of the district director the amount of fuel used for taxable purposes.

Several comments pointed out the fact that many vessels do not have identification numbers, but rather are assigned names. Section 48.4042-2(c)(1) has been changed to allow operators to maintain records for each vessel under either a vessel name or identification number.

Several commentators requested clarification of whether interim deposits will be required and whether filing can be delayed until a later date when the operator is allowed until that later date to report another tax with the Form 720—such as the windfall profits tax. The final rules, §§ 48.4042-2(d) and 48.6302(c)-1(f), clarify that interim deposits are not required. *See* Rev. Proc. 80-23, 1980-1 C.B. 657, for the extension currently allowed taxpayers using Form 720 to report taxes subject to different reporting deadlines.

Many changes were requested which would be contrary to Congress' intent or the language of the statute itself and for that reason have not been made. Those requests include: collecting the tax from persons selling fuel; making lessees and charterers pay the tax regardless of who operates the vessel; excluding fuel used in the propulsion engine to create energy for nonpropulsion purposes; excluding fuel used by private operators transporting property destined for a State or local government's use; excluding fuel used by tugs to move LASH and SEABEE barges regardless of whether the tow is comprised exclusively of such barges.

DRAFTING INFORMATION

The principal author of these regulations is John R. Harman of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly 26 CFR Part 48 is amended as follows:

Paragraph 1. There are added immediately after § 48.4041-14 the following new sections:

§ 48.4042-1 Tax on fuel used in commercial waterway transportation.

(a) *In general.* Section 4042(a) imposes an excise tax on the use of liquid fuel in the propulsion system of commercial transportation vessels while traveling on certain inland and intracoastal waterways (*see* § 48.4042-1(f)). The tax applies generally to all types of vessels, including ships, barges, and tugboats. It is in addition to all other taxes imposed on the sale or use of fuel.

(b) *Amount of tax.* The tax imposed by section 4042(a) shall be determined from the following table:

If the use occurs—	The tax is—
After Sept. 30, 1980 and before Oct. 1, 1981	4 cents a gallon
After Sept. 30, 1981 and before Oct. 1, 1983	6 cents a gallon
After Sept. 30, 1983 and before Oct. 1, 1985	8 cents a gallon
After Sept. 30, 1985	10 cents a gallon

(c) *Person liable for tax.* The person operating the vessel in which the propulsion fuel is consumed is the user of liquid fuel for purposes of section 4042(a). Thus, a person who operates (or whose employees operate) a vessel is responsible for filing returns and paying the tax. If a vessel owner (or lessee) contracts with an independent contractor to operate the vessel, the independent contractor is the user of liquid fuel for purposes of section 4042(a), regardless of who purchases the fuel.

(d) *Time of use.* Fuel is not taxed by section 4042(a) when put into a vessel's tanks. For purposes of section 4042(a), fuel is used when it is actually consumed by a vessel's engine.

(e) *Liquid fuels.* For purposes of section 4042(a), liquid fuel includes any liquid fuel, including—

(1) Diesel fuel, or

(2) Bunker C residual fuel oil, or

(3) Special motor fuel as defined in paragraph (f) of § 48.4041-7, or

(4) Gasoline as defined in paragraph (b) of § 48.4082-1.

(f) *Commercial waterway transportation*—(1) *In general.* For purposes of section 4042(a) and § 48.4042-2(c)(1), the term "commercial waterway transportation" means the use of a vessel on the waterways specified in paragraphs (g)(1) through (26) of this section if—

(i) Use of the vessel is in the business of transporting property for compensation or hire, or

(ii) Use of the vessel is in transporting property in the business of the owner, lessee, or operator of the vessel (whether or not a fee is charged).

Except for the operation of certain fishing vessels, the operation of all vessels satisfying the requirements of paragraphs (f)(1)(i) or (1)(ii) of this section will be deemed "commercial waterway transportation," regardless of whether the vessel is actually engaged in the transportation of property on a particular voyage. Thus, "commercial waterway transportation" includes the operation of vessels while moving empty of cargo, while awaiting passage through locks, while dislodging vessels grounded on a sandbar, while moving to or from a repair facility, while maneuvering around loading and unloading docks, and while fleeting barges into a single tow.

(2) *Fishing vessels exception.* A vessel does not transport property in the business of the owner, lessee, or operator, for purposes of paragraph (f)(1)(ii) of this section, by merely transporting fish or other aquatic animal life caught on the voyage. The tax imposed by section 4042(a) does not apply to fuel used by a fishing vessel while traveling to a fishing site, while engaged in fishing, or while returning from the fishing site with its catch. However, the tax applies to fuel used by a commercial vessel along the taxable waterways while traveling to pick up aquatic animal life caught by another vessel and while transporting the catch of such other vessel.

(g) *Specified waterways.* Only fuel used on those waterways specified in section 206 of the Inland Waterways Revenue Act of 1978 (specified waterways) is taxable. The specified waterways are as follows:

(1) Alabama-Coosa Rivers: From junction with the Tombigbee River at river mile (hereinafter referred to as RM) 0 to junction with the Coosa River at RM 314.

(2) Allegheny River: From confluence with the Monongahela River to form the Ohio River at RM 0 to the head of the existing project at East Brady, Pennsylvania, RM 72.

(3) Apalachicola-Chattahoochee and Flint Rivers: Apalachicola River from mouth at Apalachicola Bay (intersection with the Gulf Intracoastal Waterway) RM 0 to junction with Chattahoochee and Flint Rivers at RM 107.8. Chattahoochee River from junction with Apalachicola and Flint Rivers at RM 0 to Columbus, Georgia, at RM 155 and Flint River, from junction with Apalachicola and Chattahoochee Rivers at RM 0 to Bainbridge, Georgia, at RM 28.

(4) Arkansas River (McClellan-Kerr Arkansas River Navigation System): From junction with Mississippi River at RM 0 to port of Catoosa, Oklahoma, at RM 448.2.

(5) Atchafalaya River: From RM 0 at its intersection with the Gulf Intracoastal Waterway at Morgan City, Louisiana, upstream to junction with Red River at RM 116.8.

(6) Atlantic Intracoastal Waterway (A.I.W.W.): Two inland water routes approximately paralleling the Atlantic coast between Norfolk, Virginia, and Miami, Florida, for 1,192 miles via both the Albermarle and Chesapeake Canal and Great Dismal Swamp Canal routes. For vessels traveling along the A.I.W.W. no matter how short the distance, the A.I.W.W. includes the main channel, all alternate channels, and all adjoining bays and sounds, regardless of depth. However, vessels merely crossing the A.I.W.W. on route either to a coastal port or to a nonspecified waterway will not be treated as traveling on the A.I.W.W.

(7) Black Warrior-Tombigbee-Mobile Rivers: Black Warrior River System from RM 2.9, Mobile River (at Chickasaw Creek) to confluence with Tombigbee River at RM 45. Tombigbee River (to Demopolis at RM 215.4) to port of Birmingham, RM's 374—411 and upstream to head of navigation on Mulberry Fork (RM 429.6), Locust Fork (RM 407.8), and Sipsey Fork (RM 430.4).

(8) Columbia River (Columbia-Snake Rivers Inland Waterways): From The Dalles at RM 191.5 to Pasco, Washington (McNary Pool), at RM 330, Snake River from RM 0

at the mouth to RM 231.5 at Johnson Bar Landing, Idaho.

(9) Cumberland River: Junction with Ohio River at RM 0 to head of navigation, upstream to Carthage, Tennessee, at RM 313.5.

(10) Green and Barren Rivers: Green River from junction with the Ohio River at RM 0 to head of navigation at RM 149.1.

(11) Gulf Intracoastal Waterway (G.I.W.W): From the mouth of St. Mark's River, Florida, to Brownsville, Texas, 1,134.5 miles. For vessels traveling along the G.I.W.W. no matter how short the distance, the G.I.W.W. includes the main channel, all alternate channels, and all adjoining bays and sounds, regardless of depth. However, vessels merely crossing the G.I.WW. on route either to a coastal port or to a nonspecified waterway will not be treated as traveling on the G.I.W.W.

(12) Illinois Waterway: Illinois River from junction with the Mississippi River at RM 0 to the Des Plaines River and along the Des Plaines River to Lockport Lock and Dam at RM 291. Chicago Sanitary and Ship Canal from Lockport Lock and Dam at RM 291 to the South Branch Chicago River and along the South Branch Chicago River to Lake Street, Chicago at RM 325.5 near Chicago Harbor. Calumet-Sag Channel from junction with the Chicago Sanitary and Ship Canal to the Little Calumet River and along the Little Calumet and Calumet Rivers to turning basin 5, near the entrance to Lake Calumet, an additional 23.8 RMS. Total waterway distance approximately 350 RMs.

(13) Kanawha River: From junction with Ohio River at RM 0 to RM 90.6 at Deepwater, West Virginia.

(14) Kaskaskia River: From junction with the Mississippi River at RM 0 to RM 36.2 at Fayettville, Illinois.

(15) Kentucky River: From junction with Ohio River at RM 0 to confluence of Middle and North Forks at RM 258.6.

(16) Lower Mississippi River: From Baton Rouge, Louisiana, RM 233.9 to Cairo, Illinois, RM 953.8.

(17) Upper Mississippi River: From Cairo, Illinois, RM 953.8 to Minneapolis, Minnesota, RM 1,811.4.

(18) Missouri River: From junction with Mississippi River at RM 0 to Sioux City, Iowa, at RM 734.8.

(19) Monongahela River: From junction with Allegheny River to form the Ohio River at RM 0 to junction of the Tygart and West Fork Rivers, Fairmont, West Virginia, at RM 128.7.

(20) Ohio River: From junction with the Mississippi River at RM 0 to junction of the Allegheny and Monongahela Rivers at Pittsburgh, Pennsylvania, at RM 981.

(21) Ouachita-Black Rivers: From the mouth of the Black River at its junction with the Red River at RM 0 to RM 351 at Camden, Arkansas.

(22) Pearl River: From junction of West Pearl River with the Rigolets at RM 0 to Bogalusa, Louisiana, RM 58.

(23) Red River: From RM 0 to the mouth of Cypress Bayou at RM 236.

(24) Tennessee River: From junction with Ohio River at RM 0 to confluence with Holstein and French Rivers at RM 652.

(25) White River: From RM 9.8 to RM 255 at Newport, Arkansas.

(26) Willamette River: From RM 21 upstream of Portland, Oregon, to Harrisburg, Oregon, at RM 194.

§ 48.4042-2 Special rules.

(a) *Dual use of liquid fuels*—(1) *Dual use by the propulsion engine.* The tax imposed by section 4042(a) applies to all taxable liquid used as a fuel in the propulsion system of the vessel, regardless of whether the engine (or other propulsion system) is used for a purpose other than propulsion of the vessel. For purposes of this section, any engines generating movement of a vessel (including bow thrusters used for steering) are part of the propulsion system. The tax does not apply to fuel consumed in engines which are not used to generate movement of a vessel. When the propulsion engine operates special equipment by means of a power take-off or power transfer, the tax applies to all liquid fuel consumed by that engine. For example, the tax applies to all fuel used in the engine operating an alternator, a generator, or pumps, if that engine is used to generate movement of a vessel.

(2) *Common tank.* If the liquid fuel consumed by a nonpropulsion engine is drawn from the same tank as fuel consumed by a propulsion engine, a reasonable determination of the quantity of fuel used in such a separate engine will be acceptable for purposes of excluding from taxation a portion of the fuel consumed by the vessel. The determination of the amount of fuel consumed by the nonpropulsion engine may be based primarily on the operating experience of the person using the fuel; however, in order to exclude fuel from taxation under the rule set out in this paragraph (a)(2), the taxpayer must maintain records which will support the allocation used.

(b) *Voyages crossing boundaries of the specified waterways.* Fuel consumed by a vessel traveling along the specified waterways is taxable only to the extent of fuel consumed for propulsion while on the specified waterways. Generally, the operator may calculate the amount of fuel consumed while on the specified waterways during a particular voyage by multiplying total fuel consumed in the propulsion engine by a fraction. The numerator of the fraction is the time spent operating on the specified waterways; the denominator is the total time spent operating on the specified and nonspecified waterways during the voyage. This calculation may not be used when it is unreasonable. It may be determined to be unreasonable by:

(1) Better evidence of fuel con-

sumed (*e.g.*, readings from an accurate fuel gauge or records from similar voyages); or

(2) The existence of factors causing a substantial discrepancy between the rate of fuel consumption on the specified and nonspecified waterways.

(c) *Records required.* (1) All operators of vessels used in commercial waterway transportation must maintain records sufficient to establish to the satisfaction of the district director the amount of fuel used for taxable purposes. Those records may include, when relevant to establish liability:

(i) Quantity of fuel and date of acquisition of all liquid fuels acquired for both taxable and nontaxable purposes, whether delivered to storage tanks or tanks on a vessel;

(ii) Date and quantity of fuel pumped into tanks on each vessel;

(iii) Identification number or name of each vessel using fuel; and

(iv) Departure time, departure point, route traveled, destination, and arrival time for each vessel.

(2) Vessel operators seeking a tax exemption provided by section 4042 (c) must maintain records which will support any exemption claimed. Where applicable, the records shall contain:

(i) The draft of the vessel on each voyage (for exemption under section 4042(c)(1));

(ii) The type of vessel in which fuel is consumed and the type of vessel in which cargo is transported (for exemption under section 4042(c)(1), (2) or (4)); and

(iii) The ultimate use of cargo transported (for exemption under section 4042(c)(3)).

(d) *Date for filing return.* In general, the return (Form 720, Quarterly Federal Excise Tax Return) must be filed and the tax paid by the last day of the first month following the quarter in which tax liability has accrued. Thus, for the first taxable quarter (October through December 1980) the return is due and the tax must be paid by January 31, 1981. Notwithstanding any provisions in this part to the contrary, the tax imposed by section 4042 (a) need not be deposited with a government depository.

§ 48.4042-3 Certain types of commercial waterway transportation excluded.

(a) *Deep draft ocean-going vessels*—(1) *In general.* Under section 4042 (c)(1), there is no tax imposed by section 4042(a) if:

(i) The vessel was designed primarily for use on the high seas; and

(ii) The vessel has a draft of more than 12 feet on the voyage for which the fuel tax exclusion is sought (*e.g.* 12 feet 1 inch).

(2) *Meaning of "designated primarily for use on the high seas."* Section 4042(c)(1) requires a determination of the primary of the design features rendering the vessel useful for service on the high seas, as opposed to the features which render the vessel useful for service on all less turbulent waters. Thus, whether a ship is "designed primarily for use on the high seas" must be determined from all the facts, including structural features and equipment. If the predominant use of a vessel is on the high seas, it shall be presumed to be "designed primarily for use on the high seas." If the predominant use of a vessel is on waters other than the high seas, it shall be presumed not to be "designed primarily for use on the high seas."

(3) *Meaning of "high seas."* For purposes of this section, "high seas" shall mean waters other than the territorial waters of the United States or any other country. Thus, the high seas shall not include the internal waters of any country, the Great Lakes, harbors, or narrow coastal indentations.

(4) *Twelve-foot draft*—(i) *Definition.* For purposes of section 4042(c)(1), "draft" shall mean the maximum vertical distance between the mean water line and the bottom of the keel. In cases where a vessel has a skeg or other appendage extending locally below the line of the keel, the draft shall be measured from the deepest appendage. A separate determination of draft must be made for each voyage when the vessel has its greatest load of cargo and fuel. For purposes of this determination, the term "voyage" means a round trip voyage. Therefore, if a vessel travels into the specified waterway system to pick up cargo and has a draft sufficient to qualify for the exclusion when loaded, then for purposes of section 4042(c)(1) the vessel satisfies the 12 foot draft requirement for the entire voyage. Similarly, if a vessel loaded with cargo travels into the specified waterway system with a draft sufficient to qualify for the exclusion provided by section 4042(c)(1), then the fuel consumed on the entire voyage may be excluded, regardless of the vessel's draft after the cargo is unloaded.

(ii) *Example.* The following example illustrates the application of paragraph (a)(4)(i) of this section:

Example. A ship with a design draft of 20 feet (maximum certified draft when fully loaded) travels into a taxable waterway with only a partial load, such that the draft is 12 feet. The ship unloads and departs the waterway empty. The portion of the fuel consumed for propulsion of the vessel on the specified waterway is taxable because only vessels with a draft greater than 12 feet are eligible for the section 4042(c)(1) exemption from tax.

(b) *Commercial passenger vessels.* Under section 4042(c)(2), the tax imposed by section 4042(a) does not apply to fuel consumed by vessels used primarily for the transportation of persons. Thus, commercial passenger vessels while being operated as passenger vessels are not subject to tax, even if such vessels in fact transport property in addition to transporting passengers. Similarly, ferry boats carrying passengers are not subject to tax, even if such vessels carry the passengers' automobiles.

(c) *Exemption for State or local governments*—(1) *In general.* Under section 4042(c)(3), there is no tax imposed by section 4042(a) if:

(i) The vessel is being used by a State or local government; and

(ii) The vessel is being used in transporting property in the State or local government's business.

(2) *State or local government.* For purposes of paragraph (c)(1)(i) of this section a "vessel is being used by a State or local government" if it is operated by any State, the District of Columbia, or any political subdivision of a State. If a private party is contracted to haul for a State or local government, the vessel is not "being used by a State or local government." Similarly, if a person other than a State or local government is contracted to supply vessel operators, the fuel consumed by the vessel is not used "by a State or local government," regardless of ownership of the vessel. However, when a local government leases barges and employees of the local government operate the barges, the vessel is being used by the local government.

(3) *Government business.* The test for whether a vessel is being used "in transporting in a State or local government's business," within the meaning of paragraph (c)(1)(ii) of this section, is whether the ultimate use of the cargo is for a function which is ordinarily carried out by governmental units. For example, when the cargo transported is salt to be spread on icy roads, the vessel is being used "in transporting in a State or local business" because the use to which the cargo will be put (road maintenance) is a function ordinarily performed by governmental units. Fuel consumed in a vessel transporting property for compensation or in furtherance of a business not ordinarily carried out by a governmental unit is not exempt from taxation by section 4042(c)(3).

(d) *Ocean-going barges.* Under section 4042(c)(4), the tax imposed by section 4042(a) does not apply to fuel consumed by tugs moving exclusively barges released by ocean-going carriers solely to pick up or deliver international cargoes. The tax exemption provided by section 4042(c)(4) applies to LASH barges, SEABEE barges, and all other ocean-going barges carried aboard ocean-going vessels. There is no exemption under section 4042(c)(4) while:

(1) One or more of the barges in the tow is not a LASH barge, SEABEE barge, or other ocean-going barge carried aboard an ocean-going vessel; or

(2) One or more of the barges in the tow is not on an international voyage; or

(3) Part of the cargo in the tow is not being transported internationally.

Par. 2. Section 48.6302(c)-1 is amended by adding a new paragraph (f) as set forth below.

§ 48.6302(c)-1 Use of Government depositaries.

* * * * *

(f) *Special rule for the tax imposed by section 4042(a).* For purposes of the computations provided by this section, the tax imposed by section 4042(a) shall be disregarded.

(This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).)

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved October 16, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 22, 1980, 11:39 a.m, and published in the issue of the Federal Register for October 27, 1980, 45 F.R. 70860)

Chapter 32.—Manufacturers Excise Taxes
Subchapter A.—Automotive and Related Items
Part I.—Motor Vehicles

Section 4061.—Imposition of Tax

26 CFR 48.4061(a)-1: Imposition of tax; exclusion for light-duty trucks, etc.

Paint striping equipment. Sales, by the manufacturer, of certain paint striping equipment units that are mounted on tax-paid truck chassis are subject to the tax imposed by section 4061(a)(1) of the Code, but amounts charged for equipment that does not contribute to the highway transportation function are not part of the taxable sales price; Rev. Rul. 58-214, dealing with self-propelled line marking machines, is obsoleted.

Rev. Rul. 80-237

ISSUE

Whether sales, by the manufacturer, of certain paint striping equipment as described below that is installed on tax-paid truck chassis are subject to the manufacturers excise tax imposed by section 4061(a)(1) of the Internal Revenue Code.

FACTS

Unit (1). A paint striping unit that is mounted on a tax-paid truck chassis. The unit consists of a platform; paint tank and pump to fill it; bead tank to add glass beads into the wet paint immediately after it has been sprayed onto the highway; solvent tank to permit cleaning portions of the equipment, including the paint tank; piping for tanks and the pump; heating system to minimize the time it takes to dry paint on the highway; jacketed paint hoses; manifolds; gun carriages and spray guns; and an air compressor and power take-off that primarily operate equipment associated with spraying paint at the job-site.

In operation, paint is drawn from the tank through lines by an intervening hydraulic pump driven by the

power take-off and some paint is returned to the tank through return lines to provide agitation. The paint not returned passes into the heating system to the paint hoses which lead to manifolds, and from there to the spray guns. The spray equipment is controlled by operators from a control panel mounted on the platform.

Additional equipment may include an intercom system to permit the operators to communicate with the driver during painting operations; flashing warning lights that stand above the platform and floodlights to permit night painting operations; a mechanical pointer; footage counter; dusting system; a cab console control for circuit breakers, switches and lights to control flashing lights and switches for the spraying system; intermittent line mechanism; control panel seats; flashing signboard; speed meter to provide audio-visual alarms to the driver in operations; and an optical pointer. This equipment is used only at the job site in connection with paint application operations.

Unit (2). A pressure-type paint striping unit that is mounted on a tax-paid truck chassis. The unit has the same basic equipment as *Unit* (*1*). This unit transfers paint from the tank to the heating apparatus by air pressure. Instead of return lines to provide agitation, that function is performed by air-operated motors and agitators located on top of the paint tanks. In addition, the power take-off primarily operates the paint fill pumps and the air compressor primarily powers the agitator and pressurizes the tanks.

LAW AND ANALYSIS

Under section 4061(a)(1) of the Code, a tax is imposed on sales of automobile truck bodies and chassis by the manufacturer. Section 4061(a)(2), as added by the Revenue Act of 1971, section 401(a), 1972-1 C.B. 443, 463, applicable to sales on and after December 11, 1971, excludes from the tax imposed by section 4061(a)(1), sales by the manufacturer of truck chassis and bodies suitable for use with a vehicle having a gross vehicle weight of 10,000 pounds or less.

Under sections 48.4061(a)-1(a)(2) and (e)(1) of the Manufacturers and Retailers Excise Tax Regulations, a truck body or chassis is taxable if it is, in any sense, reasonably suitable for use as a component part of a highway vehicle (as defined in section 48.4061(a)-1(d)(1)).

Section 48.4061(a)-1(d)(1) of the regulations provides that the term "highway vehicle" means any self-propelled vehicle, or any trailer or semitrailer, designed to perform a function of transporting a load over public highways, whether or not also designed to perform other functions.

Section 48.4061(a)-1(a)(3)(i) of the regulations includes as part of a taxable truck chassis or body equipment that is installed on a taxable chassis or body and that contributes to the highway transportation function of the chassis or body. This section of the regulations says that loading and unloading equipment is an example of equipment that contributes to the highway transportation function of a chassis or body.

Section 48.4061(a)-1(a)(3)(ii) of the regulations provides that amounts charged for equipment installed on a taxable chassis or body are not part of the taxable sale price if (A) such equipment does not contribute toward the highway transportation function of the chassis or body and (B) the reasonableness of the charge is supported by adequate records.

Rev. Rul. 58-214, 1958-1 C.B. 399, holds that a self-propelled line marking machine designed for use in painting guide lines on highways, streets, parking lots, airports, playgrounds, etc., is not a taxable motor vehicle. This machine consists primarily of an engine for driving a compressor and propelling the machine, a paint tank, spray guns, and controls. It has a steel platform on which a person may stand to steer the vehicle and operate the paint equipment, 4.00 x 8 pneumatic tires having an overall diameter of sixteen inches, a normal painting speed of three to six miles per hour, but does not have head lights or tail lights.

Rev. Rul. 74-47, 1974-1 C.B. 307, holds that power takeoff systems and components thereof that are designed to operate both taxable and nontaxable equipment are not taxable under section 4061(b) of the Code if primarily designed to operate nontaxable equipment. This test is equally appropriate under section 4061(a)(1) for power take-offs and air compressors.

Rev. Rul. 58-214 limits its conclusion to the line marking machine described in that ruling and thus is not applicable to *Units* (*1*) and (*2*) described above.

Moreover, although not expressly stated in Rev. Rul. 58-214, the line marking machine described therein has a gross vehicle weight of less than 10,000 pounds. Thus, effective for sales of the vehicle by the manufacturer on or after December 11, 1971, the vehicle comes within the scope of the exclusion provided by section 4061(a)(2) of the Code.

Units (*1*) and (*2*) described above are component parts of vehicles designed to transport a load over the public highway to a job site. The platform, paint tank and fill pump, bead tank, solvent tank, intervening pump, and the piping and lines used to unload the tanks contribute to the highway transportation of paint to the jobsite. Thus, these articles constitute a truck body of a highway vehicle.

The agitator equipment on *Unit* (2) and the power take-off and air compressor on that unit load and unload the unit and thereby are part of the body. The heating system, which is used on both units, is not required to preserve the paint or further liquefy it for unloading and, therefore, it is primarily designed to apply the paint rather than for transportation. Likewise, with respect to both units, the jacketed hoses, manifolds, gun car-

riages and spray guns, and the above-listed additional equipment are primarily designed for such purpose.

HOLDING

Sales by the manufacturer of *Units (1)* and *(2)* are subject to the tax imposed by section 4061(a)(1) of the Code. Amounts charged for the air compressor and power take-off on *Unit (2)* are part of the taxable sale price but amounts charged for such articles on *Unit (1)* are not part of the taxable sale price provided the reasonableness of the charges is supported by adequate records. In addition, amounts charged with respect to both Units for the heating system, jacketed hoses, manifold, gun carriages, spray guns, intercom system, flashing warning lights and floodlights, mechanical pointer, footage counter, dusting system, cab console control, intermittent line mechanism, control panel seats, flashing signboard, speed meter, and optical pointer are not part of the taxable sale price, provided the charges are properly supported.

EFFECT ON OTHER REVENUE RULING

Rev. Rul. 58-214 is obsolete.

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26 CFR 48.4061(a)-1: Imposition of tax; exclusion for light-duty trucks, etc.
(Also Sections 4216, 4217, 4221; 48.4216(b)-2, 48.4217-2, 48.4221-6.)

Truck sold after exempt lease. The tax imposed by section 4061(a) of the Code applies to a manufacturer's retail sale of a truck that when new had first been leased under an exempt lease. For such sales after 1978, the tax base is 90 percent of the actual selling price after taking into account the adjustments provided by section 4216(a). For pre-1979 sales, the tax base is the higher of 75 percent of the actual selling price or the manufacturer's cost of production adjusted by straight line depreciation and limited to actual sales price. Rev. Rul. 74-577 obsoleted.

Rev. Rul. 80-256

ISSUE

Does the manufacturers excise tax imposed by section 4061(a) of the Internal Revenue Code apply under the circumstances described below?

FACTS

A truck manufacturer, regularly engaged in selling its trucks at retail in arm's length transactions, leased a new truck to a school for six months to meet the school's temporary needs. The lease agreement contained no option to renew and no option to purchase. The lease payments to the manufacturer by the school were not subject to the manufacturers excise tax imposed by section 4061(a) of the Code by reason of the exemption provided by section 4221(a)(5). At the end of the six-month period the manufacturer sold the truck at retail and at arm's length.

LAW AND ANALYSIS

Section 4061(a) of the Code imposes a tax on the sale by the manufacturer, producer, or importer of certain enumerated articles, including automobile truck chassis and bodies, unless such articles are suitable for use with a vehicle having a gross vehicle weight of 10,000 pounds or less.

Section 4217(a) of the Code provides that, for purposes of the manufacturers excise taxes imposed under Chapter 32 (which includes section 4061), the lease of an article (including any renewal or any extension of a lease or any subsequent lease of such article) by the manufacturer, producer, or importer is considered to be a sale of such article. Section 4217(d)(2) provides rules for determining the amount of tax payable upon the sale of an article by the manufacturer where the manufacturer has previously leased such article under a taxable lease.

In this case the manufacturer leased the truck under an exempt lease and then sold it to a nonexempt purchaser. The fact that the exempt lease occurred prior to the sale does not remove the sale from the scope of section 4061(a)(1) of the Code. The language of section 4217(d) indicates that Congress did not intend that a lease of an article insulate a later sale of such article from manufacturers excise tax because that section provides rules for determining the amount of tax due upon a sale of an article following a taxable lease of such article. Thus, the manufacturer's sale in this case is subject to tax under section 4061(a)(1).

However, the amount of tax due on the sale of the article is not governed by section 4217(d)(2) of the Code because the rules stated therein apply only in the case of a sale following a taxable lease. Accordingly, the tax base is determinable under the general rule of section 4061(a). Since the sale is at retail, the constructive sale price provisions of section 4216(b)(1)(A), as amended by Pub. L. No. 95-458, section 1, 1978-2 C.B. 367, 368, are applicable.

Under section 4216(b)(1)(A) of the Code, as amended, where a manufacturer, producer, or importer of taxable truck bodies and chassis sells such articles at retail, the tax is to be computed on a constructive sale price that is a percentage of the actual selling price. This percentage is to be based on the highest price for which such articles are sold by manufacturers and producers in the ordinary course of trade, as determined by the Service. The manufacturer's cost is not a factor. This section, as amended, is effective with respect to sales on or after January 1, 1979.

Rev. Rul. 79-33, 1979-1 C.B. 356, effective with respect to sales on or after January 1, 1979, provides that where a manufacturer, producer, or importer of a taxable truck chassis or body, or truck-tractor, sells such articles at retail, the basis for computing manufacturers excise tax is 90 percent of the actual selling price after taking into account the adjustments provided by section 4216(a) of the Code.

Rev. Rul. 74-577, 1974-2 C.B. 349, provides that the manufacturers excise tax applies to a manufacturer's retail sale of a bus that when new had been leased to an organization under an exempt lease, and the tax base is the higher of 75 percent of the actual selling price or the manufacturer's cost of producing the new vehicle adjusted by straight line depreciation and limited to the actual sales price. However, under section 4063(a)(6) of the Code, as amended by Pub. L. No. 95-618, section 231(a), 1978-3 C.B. (Vol. 2) 1, 13, the manufacturers excise tax does not apply with respect to buses sold after November 9, 1978.

HOLDING

The tax imposed by section 4061 (a)(1) of the Code applies to a manufacturer's retail sale of a truck that when new had first been leased to an organization under an exempt lease. With respect to sales on or after January 1, 1979, the tax base is 90 percent of the actual selling price after taking into account the adjustments provided by section 4216(a). No further adjustment under section 4216 is allowable. With respect to sales prior to January 1, 1979, the tax base is the higher of 75 percent of the actual selling price or the manufacturer's cost of producing the new vehicle adjusted by straight line depreciation and limited to actual sales price.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 74-577 is hereby declared obsolete.

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26 CFR 48.4061(a)-1: Imposition of tax; exclusion for light-duty trucks, etc. (Also Section 4063.)

Trucks used in servicing oil wells. Descriptions are provided of two types of truck chassis used in servicing oil wells that are subject to the tax imposed by section 4061 (a)(1) of the Code and two types that are not subject to the tax; Rev. Rul. 66-61 superseded.

Rev. Rul. 80-353

ISSUE

Are sales of certain truck chassis used in servicing oil wells subject to manufacturers excise tax under section 4061(a)(1) of the Internal Revenue Code?

FACTS

The truck chassis have specially designed subframes with oil field machinery mounted thereon. They have heavy duty, high tensile steel frames that have been reinforced by the addition of fishplating and cross members positioned to support the heavier machinery components, standard running gear, and special drive trains. The chassis are used on and off the highway, are capable of traveling at 52 miles per hour, and are of the following types:

(1) Three or four-axled truck chassis on which are mounted engines, pumps, and other equipment to pump various materials, such as chemicals, sand, or sand and chemical mixtures, into oil and gas wells. The modification of the chassis by the addition of the fishplating, cross members, and subframes results in a framework with an asymmetric configuration designed to accommodate the equipment and the chassis. The chassis, as modified, are substantially different structurally from chassis that would ordinarily be used for hauling some other load.

(2) A three-axled truck chassis on which three tanks or compartments are mounted that are designed for and used in transporting cement and water, mixing the cement at the job site, and pumping it into wells.

(3) A three-axled truck chassis on which a diesel engine, a transmission, pumps, a tank, and air, mixing, lubrication, and electrical systems are mounted that are used for mixing cement with fluids and pumping the mixture into wells. This equipment has no storage capacity and therefore cannot be used for transporting cement or fluids. The modification of the chassis by the addition of the fishplating, cross members, and subframes results in a symmetrical grid frame on the chassis. As modified, the chassis is not substantially different structurally from a chassis that would ordinarily be used for hauling some other load.

(4) A three or four-axled truck chassis on which an acid storage tank and a pump with an engine or a power take-off are mounted for use in pumping acid into a well. It does not transport acid but is supplied by a nurse tank. The cooling system is mounted behind the cab on the machinery for use with both the chassis engine and equipment engine. The modification of the chassis by the addition of the fishplating, cross members, and subframes results in an asymmetrical configuration designed to accommodate the equipment. The chassis, as modified, are substantially structurally different from chassis that would ordinarily be used for hauling some other load.

LAW AND ANALYSIS

Section 4061 of the Internal Revenue Code imposes a manufacturers excise tax on certain truck chassis and trucktractors. Section 4063(a)(5) exempts from that tax articles designed (1) to be mounted on truck chassis and (2) to be used to process or prepare concrete.

Sections 48.4061(a)-1(a)(2) and (e)(2)(i) of the Manufacturers and Retailers Excise Tax Regulations provide that a truck chassis which is sold as part of a completed vehicle is taxable uder section 4061(a)(1) only if the vehicle is a highway vehicle.

Section 48.4061(a)-1(d)(1) of the regulations defines the term "highway vehicle" as meaning any self-propelled vehicle designed to perform a function of transporting a load over public highways.

Section 48.4061(a)-1(d)(2)(i) of the regulations provides that a vehicle is not a highway vehicle if it (A) consists of a chassis to which there has been permanently mounted machinery

or equipment to perform a construction, manufacturing, processing, farming, mining, drilling, timbering, or operation similar to any of the foregoing, if the operation of the machinery or equipment is unrelated to transportation on or off the public highways; (B) the chassis has been specially designed to serve only as a mobile carriage and mount for such machinery or equipment; and (C) by reason of such special design, such chassis could not, without substantial structural modification, be used as a component of a vehicle designed to haul a load other than that particular machinery or equipment.

Section 48.4061(a)-1(a)(3)(ii) of the regulations provides that amounts charged for machinery or equipment installed on a taxable chassis are not part of the taxable sale price of the chassis if (A) the machinery or equipment does not contribute to the highway transportation function of the vehicle and (B) the reasonableness of the charge for the machinery or equipment is supportable by adequate records.

Rev. Rul. 66-61, 1966-1 C.B. 250, held under prior regulations that truck chassis designed to be equipped with high pressure pumping equipment for use at oil well sites for cementing, fracturing, acidizing, etc., are subject to manufacturers excise tax. The chassis resemble conventional truck chassis but have features that distinguish them from such chassis including a reinforced frame with specially located cross members to accommodate the pumping equipment, an oversized diesel truck engine for operating pump equipment, a heavy-duty power transmission or torque converter with a specially designed hydraulic power takeoff system, a cooling system that cools engine oil and water and also the hydraulic system of the transmission or converter, and a fireproof exhaust system.

Rev. Rul. 79-423, 1979-2 C.B. 386, states that the focus of the three part test of section 48.4061(a)-1(d)(2)(i) of the regulations is the character of the vehicle chassis and that the test applies to a chassis as modified for use as a component of the completed vehicle. The ruling also concludes that a chassis meets the part C requirement of the regulation if it has been specially designed to hold particular machinery or equipment and if it is substantially structurally different from a chassis that would ordinarily be used for hauling a load other than that particular machinery or equipment or similar machinery or equipment requiring such a specially designed chassis.

The types 1, 3, and 4 chassis have machinery mounted on them to perform a construction, drilling, or similar operation, and the operation of the machinery is unrelated to transportation. Therefore, these chassis satisfy the part A requirement of section 48.4061(a)-1(d)(2)(i) of the regulations. The type 2 chassis, however, does not satisfy this requirement. The machinery mounted on this chassis is used to transport cement and water to the job site, and, therefore, its operation is not unrelated to transportation.

The types 1, 3, and 4 chassis also satisfy the part B requirement of section 48.4061(a)-1(d)(2)(i) of the regulations. Because the structural additions are designed to adapt the chassis to the weight distribution and operating characteristics of the particular machinery, the chassis are specially designed to serve only as a mobile carriage and mount for that machinery.

The types 1 and 4 chassis also satisfy the part C requirement of section 48.4061(a)-1(d)(2)(i) of the regulations. As modified, they are substantially structurally different from a chassis that would ordinarily be used for hauling some other load.

The type 3 chassis does not satisfy the part C requirement. As modified, it is not substantially structurally different from a chassis that would ordinarily be used for hauling some other load.

The subframes mounted on the four types of chassis are part of the chassis. This is because they are mounted on the chassis to help support machinery or equipment on the chassis.

HOLDING

The types 2 and 3 chassis are highway vehicles and their sale by the manufacturer is subject to the manufacturers excise tax imposed by section 4061(a)(1) of the Code. However, the types 1 and 4 chassis are not highway vehicles and their sale by the manufacturer is not subject to the tax. Under the provisions of section 48.4061(a)-1(a)(3)(ii) of the regulations, the machinery and equipment installed on the type 3 chassis are not taxable under section 4061(a)(1) if the reasonableness of the charge allocated to the machinery and equipment is supportable by adequate records. The tanks or compartments on the type 2 chassis are exempt from tax under section 4063(a)(5).

EFFECT ON OTHER REVENUE RULING

Rev. Rul. 66-61 is superseded.

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26 CFR 48.4061(a)-1: Imposition of tax; exclusion for light-duty trucks, etc.

Whether certain discounts and allowances may be taken into account in determining the lowest price at which the distributor, a member of the same affiliated group of corporations as the manufacturer, regularly sells truck trailers to independent retailers. See Rev. Rul. 80-232, page 316.

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26 CFR 48.4061(b)-1: Imposition of tax. (Also Sections 4063, 4218, 6416; 48.4218-1, 146.1-1.)

Manufacturers; spring leaves; assembly, replacement, or renovation. Examples illustrate the manufacturers excise tax liability of a company in the business of repairing and replacing automotive springs on customer-owned highway trucks.

Rev. Rul. 80-290

ISSUE

Does the fabrication or repair of

truck springs, as described below, result in manufacturers excise tax liability?

FACTS

A company performs three types of operations on springs of customer-owned highway trucks:

Operation (1). It assembles a spring from parts in inventory such as main and wrap leaves, bushings, clips, center bolts, and U-bolts to replace a damaged spring.

Operation (2). It restores one or more leaves in a damaged spring by heating them and reshaping the arches to original specification. This operation is not performed if more than 40 percent of the leaves need restoration; instead, a new spring is needed.

Operation (3). It replaces one or more of the leaves in a damaged spring. This operation is not performed if more than 40 percent of the leaves need replacement; instead a new spring is needed.

In Operations (1) and (3) the company will ordinarily use a leaf it has purchased but will, when necessary, manufacture its own leaves.

LAW AND ANALYSIS

Section 4061(b)(1) of the Internal Revenue Code imposes a tax upon parts or accessories (other than tires and inner tubes) for any article enumerated in section 4061(a)(1) when sold by the manufacturer, producer, or importer. Among the articles enumerated in section 4061(a)(1) are chassis and bodies for trucks.

Section 4063(c) of the Code excludes rebuilt parts or accessories from the tax.

Section 48.4061(b)-2(a) of the Manufacturers and Retailers Excise Tax Regulations provides that, in general, the term "parts or accessories" includes (1) any article the primary use of which is to improve, repair, replace, or serve as a component part of an automobile truck or bus chassis or body, or taxable tractor, (2) any article designed to be attached to or used in connection with such chassis, body, or tractor, to add to its utility or ornamentation, and (3) any article the primary use of which is in connection with such chassis, body, or tractor, whether or not essential to its operation or use.

Section 48.0-2(a)(4)(i) of the regulations defines a "manufacturer" as including any person who produces a taxable article from scrap, salvage or junk material, or from new or raw material by processing, manipulating, or changing the form of an article or by combining or assembling two or more articles.

Section 146.1-1 of the temporary regulations provides that the rebuilder of a part or accessory shall not be treated as the manufacturer of that part or accessory. However, the section further provides that the rebuilder must pay tax under section 4218(b) of the Code on all new parts or accessories it manufactures and that are used in the rebuilding of the parts or accessories.

The assembly of a replacement spring from various parts is an act of manufacture whether the spring is from scrap, salvage or junk material, or from new or raw material. A new spring has therefore been produced for manufacturers excise tax purposes.

The company's reshaping of up to 40 percent of the leaves of a damaged spring by heating and retempering does not constitute the manufacture of a new spring.

The company's replacement of up to 40 percent of the broken leaves in a damaged spring does not constitute the manufacture of a new spring.

HOLDING

In Operation (1) the assembly by the company of a replacement spring from various parts is the manufacture of a taxable part or accessory within the meaning of section 4061(b)(1) of the Code. The company is liable for the tax imposed by that section on its sale of the spring. The company is entitled to a credit under section 6416(b)(3) for any parts, such as leaves, it purchased tax paid and used in assembling the spring.

In Operation (2) the restoration of the damaged spring leaves by reshaping them does not result in manufacturers excise tax liability.

In Operation (3) the replacement of the broken leaves does not result in manufacturers excise tax liability. However, the company is liable for tax under section 4218 for any leaves it manufactures and uses in this operation.

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26 CFR 48.4061(b)-1: Imposition of tax.

Constructive sale price for automotive parts or accessories sold at retail. See Rev. Rul. 80-273, page 315.

Section 4063.—Exemptions

Applicability of exemption under section 4063(a)(5) to tanks or compartments on truck chassis used in servicing oil wells. See Rev. Rul. 80-353, page 309.

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26 CFR 146.1-1: Tax-exempt sales of rebuilt automotive parts or accessories.

Whether a company in the business of repairing automotive springs incurs manufacturers excise tax liability in three described operations. See Rev. Rul. 80-290, page 310.

Part II.—Tires and Tubes

Section 4071.—Imposition of Tax

26 CFR 48.4071-1: Imposition and rates of tax.

Whether a credit or refund of the manufacturers excise tax on tread rubber is available where a retreader uses tax-paid tread rubber to recap or retread tires used by its customers on intercity, local, or school buses. See Rev. Rul. 80-192, page 368.

Part III.—Petroleum Products
Subpart A.—Gasoline

Section 4081.—Imposition of Tax

26 CFR 48.4081-2: Gasoline mixed with alcohol.

Gasoline; exemption; sale by parent to gasohol producer subsidiary. A subsidiary that 1) regularly

buys gasoline from its parent, 2) mixes the gasoline with alcohol in its transport trucks to produce a 10 percent alcohol mixture, and 3) transports and unloads the mixture into its underground storage tanks at its service stations is a producer of gasohol for resale under section 48.4081-2(b) of the regulations. The sale of gasoline by the parent to the subsidiary qualifies for exemption from tax under section 4081(c) of the Code.

Rev. Rul. 80-354

ISSUE

For purposes of the manufacturers excise tax exemption provided by section 4081(c)(1) of the Internal Revenue Code, is *S* a producer under the circumstances described below?

FACTS

P, the parent company of *S*, is the sole supplier of gasoline to *S*. *S* operates a chain of retail service stations. To make gasohol, *S* purchases gasoline from *P* and alcohol from an independent alcohol supplier. The alcohol *S* purchases is not made from petroleum, natural gas, or coal. The gasoline and alcohol are mixed when loaded into *S*'s transport trucks. The mixture is then transported to and unloaded into its underground storage tanks at *S*'s service stations. The mixture contains 10 percent alcohol.

LAW AND ANALYSIS

Section 4081(a) of the Code imposes on gasoline sold by the producer or importer a tax of 4 cents a gallon. Section 4081(c) provides that no tax shall be imposed by section 4081(a) on the sale of gasoline (A) in a mixture with alcohol, if at least 10 percent of the mixture is alcohol, or (B) for use in producing a mixture at least 10 percent of which is alcohol.

Section 48.4081-2(a) of the Manufacturers and Retailers Excise Tax Regulations provides that under section 4081(c) of the Code the tax imposed by section 4081 on the sale of gasoline does not apply to the sale of qualifying gasohol or to the sale of gasoline for the purpose of producing gasohol if the requirements of this section are met. Qualifying gasohol is referred to in this section as gasohol. Gasohol is a blend of gasoline and alcohol (whether domestic or imported alcohol) in a mixture at least 10 percent of which is alcohol made from any product other than petroleum, natural gas, or coal.

Section 48.4081-2(b) of the regulations provides that under section 4081(c) of the Code sales of gasoline for the purpose of producing gasohol are not exempt unless the sale is in bulk quantities for delivery into a bulk storage tank of a producer who meets the requirements of this section. For purposes of section 4081(c) the term "producer" means any person who in the ordinary course of its trade or business regularly buys gasoline and alcohol in bulk quantities for blending for use in its trade or business or for resale. Thus, the mere purchase of gasoline for blending into gasohol does not qualify a person as a producer. A person is not a producer for purposes of section 4082 (which defines a producer for purposes of the tax imposed on gasoline by section 4081) merely because such a person is a producer of gasohol for purposes of section 4081(c). Thus, the provisions of section 4083 (relating to certain exempt sales to producers) do not necessarily apply.

S regularly buys gasoline and alcohol in bulk quantities for blending, storage in the bulk tanks at its service stations, and for resale. Although the regulations require only that a mixture of gasoline and alcohol yield a product that is at least 10 percent alcohol and the alcohol may not be from certain sources, neither the Code nor the regulations indicate that a special process is required in the production of gasohol. The mixing of the gasoline and alcohol on the transport trucks constitutes the blending of gasohol.

HOLDING

S meets the requirements of section 48.4081-2(b) of the regulations and is a producer of gasohol for resale. The sale of gasoline by *P* to *S* qualifies for the exemption from manufacturers excise tax provided by section 4081(c) of the Code.

Subchapter B.—Coal

Section 4121.—Imposition of Tax

26 CFR 48.4121-1: Imposition and rate of tax on coal.

T.D. 7726 [1]

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER D, PART 48.—MANUFACTURERS AND RETAILERS EXCISE TAXES

Excise tax on coal

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to the excise tax on coal. Changes to the applicable law were made by the Black Lung Benefits Revenue Act of 1977 [Pub. L. 95-227, 1978-1 C.B. 494]. The regulations provide the public with the guidance needed to comply with the Act and affect all producers who mine or reclaim coal in the United States.

DATE: The regulations are effective for coal sold or used by the producer in other than a mining process after March 31, 1978.

FOR FURTHER INFORMATION CONTACT: Robert H. Waltuch of the Legislation and Regulations Divi-

[1] This publication of the Treasury Decision contains the complete text of the amendments to the regulations. The instruction for modifying the notice of proposed rulemaking have been omitted.

sion, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:LR:T, 202-566-3287, not a toll-free call.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On August 27, 1979, the Federal Register published proposed amendments to the Excise Tax Regulations (26 CFR Part 48) under section 4121 of the Internal Revenue Code of 1954 (44 FR 50065). The amendments were proposed to conform the regulations to section 2 of the Black Lung Benefits Revenue Act of 1977 (Pub. L. 95-227; 92 Stat. 11) [*supra*]. A public hearing was held on January 10, 1980. After consideration of all comments regarding the proposed amendments, those amendments are adopted as revised by this Treasury decision.

SUMMARY OF FINAL REGULATIONS

Under section 4121 of the Code, an excise tax is imposed on the sale or use of coal by the producer. The proposed regulation defined the term "producer" as the person who owns the coal immediately after extraction from the mine. One commentator disagreed with this approach and requested that the Treasury adopt a rule apportioning the excise tax between the royalty owner and the operator of the mine. The requested change has not been made regarding the definition of the term "producer" because the tax imposed under section 4121 is on the first sale of coal by the producer. However, the definition of the term "producer" has been expanded to include any person who extracts coal from coal waste refuse piles. Several examples have been added to illustrate the application of the definition of the term "producer."

Several comments were received criticizing the method used in determining the existence of lignite. The proposed regulation defined lignite in accordance with the standard specification for the classification of coals by rank of the American Society for Testing and Materials (Annual Book of ASTM Standards, Part 26, D 388). The criticism was based on the high cost involved and the inaccurate results that may be obtained. Despite these criticisms the legislative history is clear that the ASTM classification is to be used. Therefore, the regulation has not been revised as it relates to the definition of lignite.

Paragraph (c) of § 48.4121-1 of the proposed regulations has been revised to clarify two other issues raised at both the public hearing and in the written comments. The first issue clarified is that silt waste is not subject to the excise tax on coal. The second issue is that in determining whether all or a portion of a particular mine contains lignite, all the facts and circumstances will be considered. For example, the Service will examine the contract price, contract specifications and will also determine whether lignite is commonly found in the area. Furthermore, to claim the exemption, the producer must maintain records which clearly identify the portion of the mineral from the mine that is lignite.

The final issue raised at the hearing and in the comments was the inequity that arises when the small mining company sells raw coal to a cleaning plant and must pay the tax based upon the uncleaned weight. After carefully considering this problem, the proposed regulation has not been revised because under section 4121, the tax is imposed on the first sale of coal, not upon the first sale after the coal has been cleaned.

DRAFTING INFORMATION

The principal author of this regulation is Robert H. Waltuch of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, 26 CFR Parts 48 and 139 are amended as follows:

Paragraph 1. § 48.4121-1 is added to read as set forth below.

§ 48.4121-1 Imposition and rate of tax on coal.

(a) *Imposition of tax.*—(1) *In general.* Section 4121(a) imposes a tax on coal mined at any time in this country if the coal is sold or used by the producer after March 31, 1978 (see section 4218 and the regulations under that section for rules relating to the use of coal being treated as a sale of coal). For purposes of this section, the term "producer" means the person in whom is vested ownership of the coal under state law immediately after the coal is severed from the ground, without regard to the existence of any contractual arrangement for the sale or other disposition of the coal or the payment of any royalties between the producer and third parties. The term includes any person who extracts coal from coal waste refuse piles or from the silt waste product which results from the wet washing (or similar processing) of coal. However, the excise tax does not apply to a producer who sells the silt waste product without extracting the coal from it, or to the producer who uses the silt waste product without extracting the coal from it. Furthermore, the excise tax does not apply to the sale or use of the silt waste product after any coal has been extracted from it.

(2) *Examples.* Paragraph (a)(1) of this section may be illustrated by the following examples:

Example (1). A, a limited partnership, is the owner of land on which a coal mine is located. A contracts with XYZ Company to extract the coal for a set price per ton. XYZ Company is an independent contractor and has no ownership interest in the coal mined. Under state law, A is the owner of

the coal immediately after severance. After XYZ extracts the coal from the mine, A sells the coal. A is the producer of the coal and is responsible for the payment of the excise tax.

Example (2). A, a limited partnership, is the owner of land on which a coal mine is located. A leases the land to XYZ Company, and XYZ Company extracts coal from the mine and sells it. Under state law, XYZ is the owner of the coal immediately after the coal is severed from the ground. XYZ Company is the producer and must pay the excise tax. This is true even though the lease agreement requires XYZ to pay a royalty to A.

Example (3). XYZ Company purchases a coal waste refuse pile from B and extracts the coal from the waste refuse pile and sells the coal. XYZ is the producer and must pay the excise tax.

Example (4). XYZ Company is a producer of coal and operates its own cleaning plant. After wet washing the coal, it sells the coal and the silt waste product. The sale of the coal is subject to the excise tax whereas the sale of the silt is not.

Example (5). Assume the same facts as in example (4) except that before selling the silt waste product XYZ Company extracts a small quantity of finely sized coal from the silt waste product and then sells both the finely sized coal and the silt waste product. The sale of the finely sized coal is subject to the excise tax whereas the sale of the silt is not.

(b) *Rate of tax.*—(1) *Underground mines; surface mines.* The rate of tax imposed on coal from underground mines located in the United States is the lower of 50 cents per ton (2,000 pounds), or 2 percent of the sale price. The rate of tax imposed on coal from surface mines located in the United States is the lower of 25 cents per ton (2,000 pounds) or 2 percent of the sale price. If a sale or use includes a portion of a ton, the tax is applied proportionately. Thus, if 1,200 pounds of coal from an underground mine are sold for $35.00, the tax is 30 cents.

(2) *Combination.* If a single mine yields coal from both surface and underground mining, the producer must determine the rate (50 cents or 25 cents per ton) for each ton of coal mined. It is presumed that coal is mined from underground mines (50 cents per ton) unless the producer keeps sufficient records to establish to the satisfaction of the Secretary that the coal was mined from a surface mine.

(c) *Exemptions.*—(1) *Lignite or imported coal.* The excise tax on coal does not apply to lignite or imported coal. Lignite is defined in accordance with the standard specification for classification of coals by rank of the American Society for Testing and Materials (Annual Book of ASTM Standards, Part 26, D 388). The procedures specified in D 388 must be followed. If a producer extracts both taxable coal and lignite, then the producer must maintain adequate records to establish the portion of the mineral mined that is exempt from the tax. In determining whether all or a portion of the mineral extracted is lignite, the Service will consider all the facts and circumstances. For example, if a producer sells lignite and coal, the Service will examine all the facts and circumstances, including the contract price, contract specifications, and the amount of lignite extracted as it compares to the amount of lignite sold.

(2) *Other exemptions not applicable.* There are no exemptions for sales for further manufacture, for export, for use as supplies for vessels or aircraft, for the use of a State or local government, or for the use of a nonprofit educational organization. Furthermore, the Secretary does not have discretion to exempt sales of coal for use of the United States from the tax. There is also no exemption from the coal excise tax when the coal is used in further manufacture of another article that is subject to manufacturers excise tax. For example, if a producer of coal converts coal into gasoline which the producer then sells, the producer is liable for the coal excise tax when the coal is converted into gasoline and also liable for the manufacturers excise tax on gasoline when the gasoline is sold.

(d) *Definitions and special rules.*—(1) *Coal produced from surface mine.* Coal is treated as produced from a surface mine if all of the geological matter (e.g. trees, earth, rock) above the coal is removed before the coal is mined. In addition, both coal mined by auger and coal that is reclaimed from coal waste refuse piles are treated as produced from a surface mine.

(2) *Coal produced from underground mine.* Coal is treated as produced from an underground mine if it is not produced from a surface mine.

(3) *Coal used by the producer.* For purposes of this section, the term "coal used by the producer" means use by the producer in other than a mining process. A mining process is determined the same way it is determined for percentage depletion purposes. For example, a producer who mines coal does not "use" the coal and thereby becomes liable for the tax merely because, before selling the coal, the producer breaks it, cleans it, sizes it, or applies one of the other processes listed in section 613(c)(4)(A) of the Code. In such a case, the producer will be liable for the tax only when he sells the coal. On the other hand, a producer who mines coal does become liable for the tax when he uses the coal as fuel, as an ingredient in making coke, or in another process not treated as "mining" under section 613(c).

(4) *Tonnage sold and sales price.* For purposes of determining both the amount of coal sold by a producer and the sales price of the coal, the point of sale is f.o.b. mine, or f.o.b. cleaning point if the producer cleans the coal before selling it. This is true even if the producer sells the coal on the basis of a delivered price. Accordingly, f.o.b. mine or cleaning point is the point at which the number of tons sold is to be determined for purposes of applying the applicable tonnage rate, and the point at which the sales price is to be determined for purposes of the tax under the 2 percent rate.

(5) *Constructive sale price.* If a producer uses coal mined by the producer in other than a mining process, a constructive sale price must be used in determining the tax under the 2 percent rate. This constructive price is determined under sections 613(c) and 4218(e) of the Code, and is based on sales of like kind and grade of coal by the producer or other producers made

f.o.b. mine (if the coal is used without first being cleaned) or f.o.b. cleaning plant (if the coal is cleaned before it is used). Normally, this constructive price will be the same as the constructive price used in determining the producer's percentage depletion deduction.

(e) *Due date of tax returns; payment of tax, and tax deposits.* For information relating to the due date of tax returns and the time and place for the payment of the tax see § 48.6011 (a)-1, § 48.6151-1 and § 48.6071(a)-1 of the Manufacturers and Retailers Excise Tax Regulations. The return form is Form 720, Quarterly Federal Excise Tax Return. For information relating to tax deposits, see § 48.6302 (c)-1 of the Manufacturers and Retailers Excise Tax Regulations and Form 720 (Quarterly Federal Excise Tax Return) and the accompanying instructions.

Par. 2. Section 139.4121-1 is revoked.

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved September 22, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 6, 1980, 8:45 a.m., and published in the issue of the Federal Register for October 7, 1980, 45 F.R. 66452)

Subchapter D.—Recreational Equipment
Part I.—Sporting Goods

Section 4161.—Imposition of Tax

26 CFR 48.4161(a)-1: Imposition and rate of tax; fishing equipment.

Constructive sale price for fishing equipment sold at retail. See Rev. Rul. 80-273, this page.

26 CFR 48.4161(b)-1: Imposition and rates of tax; bows and arrows.

Constructive sale price for bows and arrows sold at retail. See Rev. Rul. 80-273, this page.

Part III.—Firearms

Section 4181.—Imposition of Tax

26 CFR 48.4181-1: Imposition and rates of tax.

Constructive sale price for firearms sold at retail. See Rev. Rul. 80-273, below.

Subchapter F.—Special Provisions Applicable to Manufacturers Tax

Section 4216.—Definition of Price

26 CFR 48.4216(b)-2: Constructive sale price; basic rules.
(Also Sections 4061, 4161, 4181, 7805; 48.4061(b)-1, 48.4161(a)-1, 48.4161(b)-1, 48.4181-1, 301.7805-1.)

Constructive sale price; retail sales; no sales to wholesalers. The constructive sale price for computing the taxes imposed by sections 4061(b)(1), 4161(a), 4161(b), and 4181 of the Code on articles sold at retail by manufacturers, producers, or importers who do not sell like articles to wholesale distributors is 75 percent of the actual selling price after the adjustments provided by section 4216(a), unless it can be shown on an industry-wide basis that a lower percentage should apply; Rev. Rul. 87 modified.

Rev. Rul. 80-273

FACTS

The Internal Revenue Service has established a new basis for computing the manufacturers excise tax on the sale at retail of automotive parts or accessories, fishing equipment, bows and arrows, and firearms in situations where the manufacturers, producers, or importers do not sell like articles to wholesale distributors.

LAW AND ANALYSIS

Sections 4061(b)(1), 4161(a), 4161 (b), and 4181 of the Internal Revenue Code impose manufacturers excise taxes on the sale of automotive parts or accessories, fishing equipment, bows and arrows, and firearms, respectively.

Section 4216(a) of the Code relates to the allowance of certain adjustments to the sale price for purposes of computing manufacturers excise tax liability.

Section 4216(b)(1)(A) of the Code provides that if an article is sold at retail, the manufacturers excise tax shall (if based on the price for which the article is sold) be computed on whichever of the following prices is the lower: (i) the price for which such article is sold, or (ii) the highest price for which such articles are sold to wholesale distributors, in the ordinary course of trade, by manufacturers or producers thereof, as determined by the Secretary.

Section 48.4216(b)-2(b) of the Manufacturers and Retailers Excise Tax Regulations provides that in determining the highest price for which articles are sold by manufacturers to wholesale distributors (the constructive sale price) there must be taken into consideration the normal industry practices with respect to section 4216 (a) inclusions and exclusions. However, once a constructive sale price has been determined by the Secretary, no further adjustment of such price shall be made.

Rev. Ruls. 79-32 and 79-33, 1979-1 C.B. 355 and 356, provide that the basis for computing manufacturers excise tax where truck trailer and semitrailer chassis and bodies, and truck chassis and bodies and truck-tractors, respectively, are sold at retail is 90 percent of the actual selling price after taking into account the adjustments provided by section 4216 (a) of the Code unless it can be shown that a lower percentage should apply to a particular segment of the industry. Under section 4216(b)(1)(A), the manufacturer's cost is no longer a factor with respect to articles taxable under section 4061(a).

HOLDING

The constructive sale price for computing the taxes imposed by sections 4061(b)(1), 4161(a), 4161(b), and 4181 of the Code, where the articles are sold at retail by manufacturers, producers, or importers who do not sell like articles to wholesale distributors, is 75 percent of the actual selling price after taking into account the adjustments provided by section 4216 (a) unless it can be shown on an industry-wide basis that a lower percentage should apply. No further adjustments under section 4216 are allowable. The manufacturer's cost is not to be a factor in determining the constructive sale price.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 87, 1953-1 C.B. 464, which holds that certain custom-made racks for delivery trucks are taxable automotive parts or accessories, is modified to indicate that the constructive sale price for such articles sold only at retail is 75 percent of the actual selling price after taking into account the allowable adjustments.

PROSPECTIVE APPLICATION

Under the authority granted by section 7805(b) of the Code, this revenue ruling is effective with respect to sales of the aforementioned articles by manufacturers, producers, and importers on and after January 1, 1981.

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26 CFR 48.4216(b)-2: Constructive sale price; basic rules.

Basis for tax on a manufacturer's retail sale of a truck that when new had first been leased to an organization under an exempt lease. See Rev. Rul. 80-256, page 308.

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26 CFR 48.4216(b)-4: Constructive sale price; affiliated corporations.
(Also Section 4061; 48.4061(a)-1.)

Truck trailers; sales price; discounts. In determining the lowest price at which a distributor, a member of the same affiliated group of corporations as the manufacturer, sells truck trailers to independent dealers, certain discounts and allowances may be taken into account, but only if regularly given and not merely offered.

Rev. Rul. 80-232

ISSUE

For purposes of computing the manufacturers excise tax on sales of truck trailers, can certain discounts and allowances be taken into account in determining the lowest price at which a distributor, a member of the same affiliated group of corporations as the manufacturer, regularly sells trailers to independent retailers?

FACTS

The manufacturer sells all its truck trailers to the distributor. The distributor offers and regularly allows the following discounts to its customers: (1) a 1 percent discount from the list price for payment within 15 days; (2) a 2 percent discount on all sales to an authorized stocking dealer; and (3) a 1 to 4 percent discount based on the cumulative volume of purchases by an authorized stocking dealer during the year.

To be a stocking dealer, rather than a non-stocking dealer, a dealer must (1) have adequate facilities and personnel to properly displace and service trailers, (2) be in compliance with state regulations governing the sale and registration of trailers and furnish information satisfactory to the distributor for use in establishing credit, (3) not be a stocking dealer for any other line of trailer considered by the manufacturer to be competitive, and (4) stock the manufacturer's trailers at a quantity satisfactory to the manufacturer.

LAW AND ANALYSIS

Section 4061(a)(1) of the Internal Revenue Code imposes a manufacturers excise tax on truck trailers.

Section 4216(b)(5) of the Code provides that if the manufacturer of a trailer regularly sells such article to a distributor that is a member of the same affiliated group (as defined in section 1504(a)) as the manufacturer, and such distributor regularly sells such article to one or more independent retailers, the constructive sale price of such article shall be 98½ percent of the lowest price for which such distributor regularly sells such article in arm's length transactions to independent retailers.

Section 48.4216(b)-4(f)(1)(i) of the Manufacturers and Retailers Excise Tax Regulations provides that a lowest price shall be determined without requiring that a given percentage of sales be made at that price (provided that the volume of sales made at that price is great enough to indicate that those sales have not been engaged in primarily to establish a lower tax base).

Discounts of the type given in this case, when regularly given by a distributor to a dealer, are properly to be considered in determining the "lowest price" under section 4216(b)(5) of the Code. The fact that a particular discount is offered, in and of itself, is not sufficient.

HOLDING

The discounts and allowances may be taken into account in determining the lowest price at which the distributor regularly sells truck trailers to independent retailers. The maximum percentage volume discount that can be used in the computation is the maximum volume discount at which sales are regularly made. If, for example, the distributor regularly allows the 1 percent early payment discount, the 2 percent authorized stocking dealer discount, and a 3 percent volume discount, but only occasionally makes a sale large enough to qualify for the 4 percent volume discount, the "lowest price" is list price minus the sum of the 1 percent early payment discount, the 2 percent authorized

stocking dealer discount and the 3 percent volume discount, that is, list price minus 6 percent.

Section 4217.—Leases

26 CFR 48.4217.2: Limitation on amount of tax applicable to certain leases.

Basis for tax on a manufacturer's retail sale of a truck that when new had first been leased to an organization under an exempt lease. See Rev. Rul. 80-256, page 308.

Section 4218.—Use by Manufacturer or Importer Considered Sale

26 CFR 48.4218-1: Tax on use by manufacturer, producer, or importer.

Whether a company in the business of repairing automotive springs incurs manufacturers excise tax liability for leaves it manufactures and uses to replace broken leaves. See Rev. Rul. 80-290, page 310.

Subchapter G.—Exemptions, Registrations, etc.

Section 4221.—Certain Tax-Free Sales

Whether a credit or refund of the manufacturers excise tax on tread rubber is available where a retreader purchases tread rubber tax paid, rather than tax free, and uses it in recapping or retreading tires that are used by its customers on intercity, local, or school buses. See Rev. Rul. 80-192, page 368.

26 CFR 48.4221-3: Tax-free sale of articles for export, or for resale by the purchaser to a second purchaser for export.

T.D. 7729

TITLE 26.—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER D, PART 48.—MANUFACTURERS AND RETAILERS EXCISE TAXES

Excise tax treatment of articles sold tax free for exportation upon their subsequent importation into the United States

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final Manufacturers and Retailers Excise Tax Regulations relating to the excise tax treatment of articles previously sold tax free for exportation under section 4221(a)(2) of the Internal Revenue Code of 1954 upon their subsequent return to the United States. These regulations provide necessary guidance to importers of previously exported articles that are returned to the United States in an unused condition.

DATE: The regulations are effective December 1, 1980.

FOR FURTHER INFORMATION CONTACT: Kyllikki Kusma of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:LR:T:LR-13-80, 202-566-3287, not a toll-free-call.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On June 9, 1980, the Federal Register published proposed amendments to the Manufacturers and Retailers Excise Tax Regulations (26 CFR Part 48) under section 4221(a)(2) of the Code. No written comments were received, and a public hearing was neither requested nor held. After further consideration, those amendments are adopted as revised by this Treasury decision.

EXPLANATION OF THE REGULATIONS

Section 48.4221-3 of the regulations is currently silent with respect to the excise tax treatment of articles that previously were sold tax free for exportation but which subsequently are imported to the United States in an unused and undamaged condition. These regulations provide that the importer of these articles is subject to the excise tax imposed by Chapter 32 of the Code on the subsequent sale or use of the imported article in the United States.

A change has been made in these regulations as proposed. The reference to a bus in example (2) at § 48.4221-3(a)(2) is inappropriate as bus chassis and bodies are now exempt from manufacturers excise taxes by reason of section 4063(a)(6) of the Code. Consequently, this example is amended by changing the subject of the example from a bus to a truck.

DRAFTING INFORMATION

The principal author of this regulation is Kyllikki Kusma of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, the following amendments to the regulations (26 CFR Part 48) are hereby adopted:

Paragraph 1. Section 48.4221-3(a) is redesignated as § 48.4221-3(a)(1) and a new § 48.4221-3(a)(2) is added to read as follows:

§ 48.4221-3 Tax-free sales of articles for export, or for resale by the purchaser to a second purchaser for export.

(a) *In general*—(1) * * *

(2) If an article, otherwise taxable under chapter 32 of the Code—

(i) Is sold tax free by the manufacturer pursuant to section 4221(a)(2) and this section, and

(ii) Is returned subsequently to the United States in an unused and undamaged condition,

then the importer is liable for the tax imposed by chapter 32 on the subsequent sale or use of the article in the United States. The provisions of this

paragraph (a)(2) may be illustrated by the following examples:

Example (1). Q, a U.S. motor vehicle manufacturer, previously sold a truck chassis to R, a company in Canada. The sale was tax free under section 4221(a)(2). R mounted a truck body on the truck chassis and sold the completed vehicle to S. Thereafter S sold the completed new vehicle to T who imported the vehicle into the United States and sold it. The sale of the completed truck subjects T to an excise tax liability under section 4061(a)(1) with respect to both the body and the chassis.

Example (2). X, a U.S. manufacturer of trucks, sold a trash collection truck to Y, a company in France. The sale was tax free under section 4221(a)(2). The truck was sold by Y to the City of Nice, France. After initial use, the city determined that the truck was not suited for its needs and resold the truck to X. X returned the truck to the United States where it was resold. The resale of the truck by X does not subject X to an excise tax liability under section 4061(a)(1).

* * * * *

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved October 23, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 31, 1980, 8:45 a.m., and published in the issue of the Federal Register for November 3, 1980, 45 F.R. 72653)

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26 CFR 48.4221-6: Tax-free sales of articles to nonprofit educational organizations.

Basis for tax on a manufacturer's retail sale of a truck that when new had first been leased to an organization under an exempt lease. See Rev. Rul. 80-256, page 308.

Chapter 34.—Policies Issued By Foreign Insurers

Section 4371.—Imposition of Tax

26 CFR 46.4371-2: Imposition of tax on policies issued by foreign insurers; scope of tax.

Whether insurance premiums received by foreign corporations, which are not engaged in the conduct of a trade or business in the United States, on policies of reinsurance of United States risks, which were initially assumed by other insurance companies, that are subject to the excise tax imposed by section 4371(3) of the Code not subject to the income tax imposed by section 881 and to the withholding provisions of section 1442. See Rev. Rul. 80-222, page 211.

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26 CFR 46.4371-3: Rate and computation of tax.
(Also Sections 842, 864, 4373; 1.864-2.)

Foreign insurance company; U.S. agent; surplus lines insurance. A foreign insurance company, which is not licensed in a particular state, conducts a surplus lines insurance business in that state through a licensed broker that acts as the company's agent, regularly signs and countersigns policies, and settles losses arising from such policies. The excise tax imposed by section 4371 of the Code does not apply to premiums paid to the foreign insurance company on such policies.

Rev. Rul. 80-225

ISSUE

Does the federal excise tax imposed by section 4371 of the Internal Revenue Code on foreign insurance policies apply to insurance premiums paid to a foreign insurance company under the facts described below?

FACTS

Company *X* is a foreign casualty insurance company, conducting a surplus lines insurance business. Surplus lines insurance involves insuring risks which licensed insurers (those licensed to conduct an insurance business in the state) are unwilling to accept.

X has not obtained a license to conduct any insurance business under the laws of State *A*. However, in determining that no licensed market for a risk exists, a person licensed by State *A* as a surplus lines broker is permitted by the laws of State *A* to place the risk with an eligible surplus lines insurer, such as *X*, that is not licensed to conduct insurance business in State *A*. Thus, the laws of State *A* allow *X* to conduct a surplus lines insurance business in State *A* to the extent of signing or countersigning surplus lines insurance policies in the state covering the above risks and settling claims arising thereunder.

Company *Y* is licensed by State *A* as a surplus lines broker. *Y* regularly signs and countersigns surplus lines insurance policies in State *A* as agent for *X* with respect to surplus insurance risks, wholly or partly, within the State *A* and settles losses arising thereunder in *X*'s name.

LAW AND ANALYSIS

Section 4371 of the Code imposes a tax on each policy of insurance or reinsurance issued by any foreign insurer or reinsurer.

Under section 4373 of the Code, the tax does not apply to any policy signed or countersigned by an officer or agent of the insurer in a state, or in the District of Columbia, within which such insurer is authorized to do business.

Congress adopted section 4371 because it did not believe that any United States income tax (including withholding tax) was applicable to insurance premiums paid to foreign insurance companies not engaged in trade or business in the United States. See generally Rev. Rul. 80-222, page 211, this Bulletin.

As a result of *Y*'s regularly signing and countersigning policies in State *A* as agent for *X*, *X* is engaged in a trade or business in the United States under sections 842 and 864 of the Code and is thus subject to income tax under section 831 on its underwriting income derived from the premiums received on the policies described above. *See, e.g., Amodio v. Commissioner,* 34 T.C. 894, 906 (1960), holding a nonresident alien taxpayer to be engaged in a trade or business in the United States as a result of activities performed on its

behalf by an independent agent of the taxpayer in the United States.

Although *X* is not licensed to conduct an insurance business in State *A*, the laws of State *A* permit *X* to engage in certain surplus lines insurance activities in State *A* (the signing or countersigning of policies) without obtaining a license, and as a result of regularly performing these activities, *X* is engaged in a trade or business in the United States. Thus, with respect to the policies described above, *X* is authorized to do a surplus lines insurance business in State *A* within the meaning of section 4373(1) of the Code.

HOLDING

The excise tax imposed by section 4371 of the Code does not apply to the premiums on those policies paid to *X*, provided *X* is engaged in a U.S. trade or business with respect to the underwriting income derived by *X* from those premiums.

Compare Rev. Rul. 80-222, which relates to a situation where a foreign insurer is not engaged in business in the United States and is not subject to U.S. income tax, but is subject to the excise tax imposed by sections 4371 of the Code.

Section 4373.—Exemptions

Whether the excise tax on foreign insurance policies applies to premiums paid to a foreign insurance company that is also subject to United States income tax. See Rev. Rul. 80-225, page 318.

Chapter 42.—Private Foundations; Black Lung Benefit Trusts
Subchapter A.—Private Foundations

Section 4941.—Taxes on Self-Dealing

26 CFR 53.4941(d)-1: Definition of self-dealing.

Private foundations; self-dealing; incidental benefit to disqualified person. A private foundation made a grant to an exempt university to establish an educational program providing instruction in manufacturing engineering. A corporation that is a disqualified person with respect to the private foundation intends to hire graduates of the new program and encourage its employees to enroll in the program, but will not receive preferential treatment in recruiting graduates or enrolling its employees. The grant is not an act of self-dealing within the meaning of section 4941 of the Code.

Rev. Rul. 80-310

ISSUE

In the situation described below, does a grant by a private foundation to a university to establish an educational program constitute an act of self-dealing within the meaning of section 4941 of the Internal Revenue Code because the program benefits a corporation that is a disqualified person?

FACTS

P is exempt from federal income tax under section 501(c)(3) of the Code, and is a private foundation within the meaning of section 509(a). *P* has made a grant to *U*, a university that is exempt under section 501(c)(3), and is not a private foundation because it is described in sections 170(b)(1)(A)(ii) and 509(a)(1). By its terms, the grant must be used by *U* to establish a new educational department providing instruction in manufacturing engineering. Students enrolled in the program will acquire skills useful in a wide range of manufacturing businesses.

W corporation has its headquarters and principal manufacturing plant located in the same city as *P* and *U*. *W* is a disqualified person with respect to *P* within the meaning of section 4946 of the Code. *W* intends to seek to employ graduates of the new program at *U*, and will encourage its employees to enroll in the program. However, *W* will not receive preferential treatment in its attempts to recruit graduates, and its employees will compete for admission to the program on an equal nondiscriminatory basis with other members of the general public. It is expected that a number of other manufacturers, including competitors of *W*, will seek to recruit graduates of the program and to enroll their employees in the program.

LAW AND ANALYSIS

Section 4941 of the Code imposes a tax on each act of self-dealing between a disqualified person and a private foundation. Section 4941(d)(1)(E) provides that the term "self-dealing" includes any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or the assets of a private foundation.

Section 53.4941(d)-2(f)(2) of the Foundation Excise Tax Regulations provides that the fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing. For example, a grant by a private foundation to a section 509(a)(1), (2), or (3) organization will not be an act of self-dealing merely because such organization is located in the same area as a corporation that is a substantial contributor and thus a disqualified person with respect to the foundation. This is illustrated by *Example* (1) of section 53.4941(d)-2(f)(4), which considers a grant by a private foundation to the governing body of a city for the purpose of alleviating the slum conditions that exist in a particular neighborhood of the city. A corporation that is a substantial contributor to the foundation, and thus a disqualified person with respect to the foundation, is located in the same area in which the grant is to be used. Although the general improvement of the area may constitute an incidental and tenuous benefit to the corporation, such benefit by itself will not constitute an act of self-dealing under section 4941 of the Code.

An incidental or tenuous benefit occurs when the general reputation or

prestige of a disqualified person is enhanced by public acknowledgement of some specific donation by such person, when a disqualified person receives some other relatively minor benefit of an indirect nature, or when such person merely participates to a wholly incidental degree in the fruits of some charitable program that is of broad public interest in the community. See Rev. Rul. 77-331, 1977-2 C.B. 388.

In this case, as in the slum clearance program described in *Example* (1) of section 53.4941(d)-2(f)(4) of the regulations, the educational program is of broad public interest to the community. The corporation will benefit from the program only in an incidental manner as one of many manufacturing businesses that can benefit from the skills acquired by the students in the program. *W* will not receive preferential treatment in recruiting graduates of the program, and *W*'s employees must compete for admission to the program on an equal basis with the general public, including employees of other manufacturing businesses. Under the circumstances, *W* will receive only an incidental or tenuous benefit from the grant by *P* to *U*.

HOLDING

Since any benefit to the corporation, a disqualified person, is incidental, the grant by the private foundation to the university to establish an educational program in manufacturing engineering does not constitute an act of self-dealing within the meaning of section 4941 of the Code.

Section 4942.—Taxes on Failure to Distribute Income

26 CFR 53.4942(a)-2: Computation of undistributed income.

T.D. 7715[1]

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER D, PART 53.—FOUNDATION EXCISE TAXES; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1975

Reduction in value for blockage or similar factors.

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to the use of blockage or similar factors in determining the value of private foundations' noncharitable assets consisting of listed securities issues for purposes of determining the amount foundations must distribute annually for charitable purposes. Changes to the applicable tax law were made by the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1]. The regulations provide foundation managers with the guidance needed to comply with that Act and affect all foundations that hold listed securities issues for which reductions in value due to blockage or related factors are appropriate.

EFFECTIVE DATE: Taxable years beginning after December 31, 1975.

FOR FURTHER INFORMATION CONTACT: David E. Dickinson of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:LR:T) (202-566-3218).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On March 12, 1980, the Federal Register published proposed amendments to the Foundation Excise Tax Regulations (26 CFR Part 53) under section 4942(e)(2)(B) of the Internal Revenue Code of 1954 (45 FR 15945). These amendments were proposed to conform the regulations to section 1303(a) of the Tax Reform Act of 1976 (90 Stat. 1715) [*supra* at 191]. No public hearing was requested or held. After consideration of the two comments received in response to the notice of proposed rulemaking, those amendments are adopted by this Treasury decision with the change described below.

EXPLANATION OF PROVISIONS

OLD LAW

Under section 4942(e)(2) as it existed prior to the Tax Reform Act of 1976 and § 53.4942(a)-2(c)(4)(i)(*b*) of the regulations, estate tax valuation methods were to be used to value noncharitable assets of private foundations consisting of listed securities issues.

NEW LAW

Section 4942(e)(2)(B) established certain new, more explicit rules for valuing a private foundation's noncharitable assets consisting of listed securities issues. In determining the value of such securities for minimum charitable expenditures purposes, their fair market value (determined without regard to any reduction in value) is not to be reduced unless, and only to the extent that, a private foundation establishes that as a result of a certain factor or combination of factors enumerated in the statutory provision, the securities could not be liquidated within a reasonable period of time except at a price less than such fair market value. Any reduction in value is to be made only for one or more of these reasons and must not in the aggregate exceed 10 percent of the fair market value of the securities.

FINAL REGULATIONS

These amendments to the regulations explain that the new law applies only to assets that are securities issues described in § 53.4942(a)-2(c)(4)(i)(*a*) (generally, securities issues for which quotations are readily available, referred to in this preamble as "listed

[1] This publication of the Treasury Decision contains the complete text of the amendments to the regulations. The instructions for modifying the notice of proposed rulemaking have been omitted.

securities issues"). See § 53.4942(a)-2 (c)(4)(i)(*c*).

They give as an example of a "forced or distressed sale" under section 4942(e)(2)(B)(iii) of the Code the situation where securities cannot be sold on the open market without first being registered under the Securities Act of 1933. See § 53.4942(a)-2 (c)(4)(i)(*c*)(*3*).

One public comment received objects to this rule, which requires unregistered shares of a listed securities issue to be valued first by reference to market quotations for the listed issue and then discounted under section 4942(e)(2)(B), if applicable, to reflect the fact that the shares are unregistered. Instead, as the comment is understood, the lack of registration should first be taken into account in determining the "fair market value" of the shares before applying factors, such as blockage, listed in section 4942 (e)(2)(B)(i), (ii), and (iii).

It is clear that enactment of section 4942(e)(2)(B) responded to congressional concerns that excessive discounts were being claimed in making valuations of listed securities issues. It is believed that the valuation mechanism contemplated in section 4942(e)(2)(B) must begin with undiscounted market quotations for the listed issue and then allows reductions in this beginning value to the extent, but only to the extent, permitted by section 4942(e)(2)(B)(i), (ii), or (iii) and subject to the overall discount limitation of 10 percent. Adoption of this commentator's suggestion would only continue opportunities for excessive discounts which Congress sought to prevent in enacting section 4942(e)(2)(B).

Further, the commentator's suggested formula would necessarily involve an initial calculation based solely upon lack of registration and completely ignore the size of the block of unregistered stock, the size of the block being a factor to take into account only later under section 4942(e)(2)(B)(i). It is seriously doubted that such a calculation reasonably could be made.

The regulations, as proposed, effectively provide that if a private foundation owns unlisted securities of a corporation (issuer) that owns assets comprising listed securities issues, those underlying listed securities issues are to be valued using market quotations or in accordance with the new rules, if applicable. The second commentator objected to this rule as contrary to the statute, which on its face applies to listed securities issues owned by the private foundation as opposed to an intermediate holding company. The commentator did, however, correctly suggest that the reason for this rule was to prevent a private foundation's avoiding section 4942(e)(2)(B) simply by incorporating its investment portfolio as a holding company. While the commentator had no objection to a regulatory rule which addressed this potential avoidance situation, it objected to application of the rule to cases where the private foundation held only a small minority interest in the unlisted holding company.

In response to this comment, the final regulations amending § 53.4942 (a)-2(c)(iv)(*a*) provide that if a private foundation owns voting stock of an unlisted issuer and has, or together with disqualified persons or another private foundation has, effective control of the unlisted issuer within the meaning of § 53.4943-3(b)(3)(ii), then to the extent that the issuer's assets consist of listed securities issues, such assets are to be valued monthly on the basis of market quotations or in accordance with section 4942(e)(2)(B), if applicable, in determining the net worth of the issuer.

Finally, the final regulations revoke the obsolete version of section 4942 from the CFR and set forth the effective date of the new and old rules. See § 53.4942(a)-2(c)(4)(i)(*b*), new last two sentences.

DRAFTING INFORMATION

The principal author of these proposed regulations was David E. Dickinson of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, the following amendments to the regulations are hereby adopted:

Paragraph 1. Section 53.4942 is revoked.

Par. 2. Two sentences are added to the end of § 53.4942(a)-2(c)(4)(i)(*b*) to read as follows:

§ 53.4942(a)-2 Computation of undistributed income.

* * * * *

(c) *Minimum investment return.* * * *

(4) *Valuation of assets*—(i) *Certain securities.* * * *

(*b*) * * * This paragraph (c)(4)(i)(*b*) applies only for taxable years beginning before January 1, 1976. See section 4942(e)(2)(B) and paragraph (c)(4)(i)(*c*) of this section for special valuation rules that apply for subsequent taxable years.

* * * * *

Par. 3. Sections 53.4942(a)-2(c)(4)(i)(*c*) and 53.4942(a)-2(c)(4)(i)(*d*) are redesignated as §§ 53.4942(a)-2(c)(4)(i)(*d*) and 53.4942(a)-2(c)(4)(i)(*e*), respectively, and a new § 53.4942(a)-2(c)(4)(i)(*c*) is added to read as follows:

§ 53.4942(a)-2 Computation of undistributed income.

* * * * *

(c) *Minimum investment return.* * * *

(4) *Valuation of assets*—(i) *Certain securities.* * * *

(*c*) For purposes of this subdivision (i) and with respect to taxable years beginning after December 31, 1975, if the private foundation can show that the value of securities determined on the basis of market quotations as provided by subdivision (i)(*a*) does not reflect the fair market value thereof because—

(*1*) The securities constitute a block of securities so large in relation to the volume of actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market,

(*2*) The securities are securities in a closely held corporation and sales are few or of a sporadic nature, and/or

(*3*) The sale of the securities would result in a forced or distress sale because the securities could not be offered to the public for sale without first being registered under the Securities Act of 1933 or because of other factors,

then the price at which the securities could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations. On the other hand, if the securities to be valued represent a controlling interest, either actual or effective, in a going business, the price at which other lots change hands may have little relation to the true value of the securities. No decrease in the fair market value of any given class of securities determined on the basis of market quotations as provided by subdivision (i)(*a*) shall be allowed except as authorized by this subdivision, and no such decrease shall in the aggregate exceed 10 percent of the fair market value of such class of securities so determined on the basis of market quotations and without regard to this subdivision.

* * * * *

Par. 4. Two sentences are inserted between the second and third sentences of § 53.4942(a)-2(c)(4)(iv)(*a*), as follows:

§ 53.4942(a)-2 Computation of undistributed income.

* * * * *

(c) *Minimum investment return.* * * *

(4) *Valuation of assets*—* * *

(iv) *Other assets.* * * *

(*a*) * * * If, however, a private foundation owns voting stock of an issuer of unlisted securities and has, or together with disqualified persons or another private foundation has, effective control of the issuer (within the meaning of § 53.4943-3(b)(3)(ii)), then to the extent that the issuer's assets consist of shares of listed securities issues, such assets shall be valued monthly on the basis of market quotations or in accordance with section 4942(e)(2)(B), if applicable. Thus, for example, if a private foundation and a disqualified person together own all of the unlisted voting stock of a holding company which in turn holds a portfolio of securities of issues which are listed on the New York Stock Exchange, in determining the net worth of the holding company, the underlying portfolio securities are to be valued monthly by reference to market quotations for their issues unless a decrease in such value is authorized in accordance with section 4942(e)(2)(B). * * *

* * * * *

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 26 U.S.C. 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved August 8, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 25, 1980, 8:45 a.m., and published in the issue of the Federal Register for August 26, 1980, 45 F.R. 56802)

26 CFR 53.4942(b)-1: Operating foundations.

T.D. 7718

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953, SUBCHAPTER D, PART 53.—FOUNDATION AND SIMILAR EXCISE TAXES, SUBCHAPTER F, PART 301.—PROCEDURE AND ADMINISTRATION

Treatment of certain elderly care facilities

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the treatment of private foundations that maintain certain elderly care facilities. Changes to the applicable tax law were made by the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1]. The regulations provide private foundations with the guidance needed to comply with that Act and affect private foundations that provide long-term care facilities for disabled persons, elderly persons, needy widows, and children.

DATES: The regulations are effective for taxable years beginning after December 31, 1969.

FOR FURTHER INFORMATION CONTACT: Charles Kerby of the Employee Plans and Exempt Organizations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:EE-2-79 (202-566-3422) (not a toll-free number).

SUPPLEMENTARY INFORMATION:

On March 24, 1980, the Federal Register published proposed amend-

ments to the Regulations on Foundation and Similar Excise Taxes (26 CFR Part 53) under section 4942 (j)(6) of the Internal Revenue Code of 1954 (45 F.R. 18973). The amendments were proposed to conform existing regulations to section 522 of the Revenue Act of 1978 (92 Stat. 2885) [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1, 119]. In the same document deletions were proposed to the Income Tax Regulations (26 CFR Part 1) and the Regulations on Procedure and Administration (26 CFR Part 301) to reflect the repeal of section 6050 of the Code by section 5 of the Act of December 29, 1979 (Pub. L. No. 96-167; 93 Stat. 1275) [1980-1 C.B. 483]. The only comment received from the public on the proposed regulations supported the issuance of the regulations in final form.

DRAFTING INFORMATION

The principal author of this regulation is Charles Kerby of the Employee Plans and Exempt Organizations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, the following amendments to the regulations are hereby adopted under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 26 U.S.C. 7805):

Paragraph 1. Section 1.6050-1 is deleted.

Par. 2. Section 53.4942(b)-1(a) is revised to read as follows:

§ 53.4942(b)-1 Operating foundations.

(a) *Operating foundation defined*—(1) *In general.* For purposes of section 4942 and the regulations thereunder, the term "operating foundation" means any private foundation which makes qualifying distributions (within the meaning of § 53.4942(a)-3(a)(2)) directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose equal in value to substantially all of its adjusted net income (as defined in § 53.4942(a)-2(d)) and which, in addition, satisfies the assets test, the endowment test or the support test set forth in § 53.4942(b)-2 (a), (b) and (c).

(2) *Certain elderly care facilities described in section 4942(j)(6)*—(i) *In general.* For purposes of the distribution requirements of section 4942 (but no other provision of the Internal Revenue Code) and for taxable years beginning after December 31, 1969, the term "operating foundation" includes a private foundation which—

(A) On or before May 26, 1969, and continuously thereafter to the close of the taxable year, operates and maintains, as its principal functional purpose, residential facilities for the long-term care, comfort, maintenance, or education of permanently and totally disabled persons, elderly persons, needy widows, or children, and

(B) Satisfies the endowment test set forth in § 53.4942(b)-2(b).

(ii) *Principal functional purpose.* For purposes of section 4942(j)(6) and this subparagraph (2), an organization's "principal functional purpose" is operating and maintaining residential facilities for the long-term care, comfort, maintenance, or education of permanently and totally disabled persons, elderly persons, needy widows, or children, if it is organized for the principal purpose of operating and maintaining such residential facilities and is primarily engaged directly in the operation and maintenance of those facilities. An organization will be treated as being primarily engaged directly in the operation and maintenance of the described residential facilities if at least 50% of the qualifying distributions (as defined in § 53.4942(a)-3(a)(2)) normally made by the organization are expended for the operation and maintenance of the facilities.

* * * * *

Par. 3. Section 301.6050-1 is deleted.

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved August 25, 1980.

EMIL M. SUNLEY,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 3, 1980, 8:45 a.m., and published in the issue of the Federal Register for September 4, 1980, 45 F.R. 58520)

Section 4945.—Taxes on Taxable Expenditures

26 CFR 53.4945-4: Grants to individuals.

Whether educational loans made by a private foundation under an employer-related loan program are taxable expenditures under section 4945 of the Code. See Rev. Proc. 80-39, page 772.

Chapter 43.—Qualified Pensions, etc., Plans

Section 4974.—Excise Tax on Certain Accumulations in Individual Retirement Accounts or Annuities

26 CFR 54.4974-1: Excise tax on accumulations in individual retirement accounts or annuities.

Regulations relating to individual retirement arrangements. See T.D. 7714, page 83.

Section 4975.—Tax on Prohibited Transactions

Prohibited Transaction Exemption 80-26

Pension and Welfare Benefit Programs

Class Exemption for Certain Interest Free Loans to Employee Benefit Plans

AGENCY: Department of Labor.

ACTION: Grant of class exemption.

SUMMARY: This class exemption permits parties in interest with respect to employee benefit plans to make interest free loans to such plans. Such loans would be prohibited by the Employee Retirement Income Security Act of 1974 [Pub. L. 93-406, 1974-3 C.B. 1] (the Act) and the Internal Revenue Code of 1954 (the Code). The exemption affects all employee benefit plans, their participants and beneficiaries, and parties in interest with respect to those plans.

EFFECTIVE DATE: January 1, 1975.

FOR FURTHER INFORMATION CONTACT: Jane M. Kheel: Plan Benefits Security Division, Office of the Solicitor, U.S. Department of Labor (202) 523-9141. (This is not a toll-free number.)

SUPPLEMENTARY INFORMATION: On February 8, 1980, notice was published in the Federal Register (45 FR 8761) of the pendency before the Department of Labor (the Department) of a proposed class exemption from the restrictions of section 406(a)(1)(B) and (D) and section 406(b)(2) of the Act and from the taxes imposed by section 4975(a) and (b) of the Code by reason of section 4975(c)(1)(B) and (D) of the Code[1] in connection with certain interest free loans to employee benefit plans. The class exemption was proposed in response to an application filed by the National Coordinating Committee for Multiemployer Plans. The notice set forth a summary of facts and representations contained in the application, and referred interested persons to the application for a complete statement of the facts and representations. The application has been available for public inspection at the Department in Washington, D.C. The notice invited interested parties to submit written comments or requests for a hearing on the proposed exemption to the Department. The exemption was proposed and comments received in accordance with the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975). No requests for a public hearing were received by the Department.

Discussion of Comments

All of the comments received by the Department in response to the notice favor the proposed exemption.

One comment concerns the second condition of the proposed exemption, which requires that the proceeds of a covered loan or other extension of credit be used only for ordinary operating expenses of the plan. The commentator requests that the exemption be expanded to cover certain transactions that might constitute interest free loans but which might not be considered to be made for the purpose of paying ordinary operating expenses.

The commentator gives two examples of such transactions. One involves temporary overdrafts incurred by a plan trustee to pay for securities purchased for the plan. It explains that cash to cover the purchase might be invested in Treasury bills or commercial paper that could not be liquidated until the following day. Under ordinary circumstances, the commentator asserts, the bank trustee would simply advance the purchase price and obtain reimbursement in a day or two when cash becomes available.

The other example of such transaction involves the crediting, by a bank trustee, of dividends or interest to a plan on the due date, even though the dividend or interest has not in fact been received by the bank.

The Department agrees that such extensions of credit, although incidental to the operation of a plan and beneficial to a plan, may not be covered by the exemption as proposed. Therefore, the second condition has been modified in order to cover the transactions discussed above and similar incidental extensions of credit.

Another commentator suggested that the proposed exemption may cause confusion concerning the permissibility of maintaining unallocated suspense accounts in defined contribution plans. He noted that, under certain circumstances, the maintenance of an unallocated suspense account in a defined contribution plan is prohibited by the Internal Revenue Service.[2] According to the commentator, some plan sponsors may be misled into thinking that the proposed exemption permits such unallocated suspense accounts. The Department notes that the exemption has no effect on any such prohibitions.

Two commentators suggested that the second condition of the proposed exemption, which requires that the proceeds of the loan or extension of credit be used only for the payment of ordinary operating expenses, including the payment of benefits and periodic premiums under an insurance or annuity contract, be expanded to permit the proceeds of the loan to be used by an employee stock ownership plan (ESOP) to purchase employer securities from beneficiaries of the ESOP who have received the securities as plan distributions. One of the commentators stated that, although the employer sponsoring an ESOP is required to repurchase the securities from a distributee, in actual operation, many ESOPs repurchase the securities. The Department notes, however, that the requirement that an employer repurchase employer securities distributed by an ESOP relates only to certain securities that are purchased by an ESOP with the proceeds of a loan from a party in interest or a loan that is guaranteed by a party in inter-

[1] The authority of the Secretary of Labor to issue exemptions under section 4975(c)(2) of the Code is set forth in section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), effective December 31, 1978.

[2] *See* Revenue Ruling 70-125, 1970-1 C.B. 87.

est. Such a loan is permitted by sections 408(b)(3) of the Act and 4975(d)(3) of the Code if the conditions of those sections and the regulations issued thereunder are met.[3] Since those sections permit a party in interest to make a loan to an ESOP for the purpose of purchasing employer securities from any person (including participants and beneficiaries of the ESOP), the Department does not believe that the requested expansion of the proposed exemption is either necessary or appropriate.

Another commentator suggested that the proposed exemption be broadened to include arrangements under which employee benefit plans could receive valuable services or facilities, at no cost, from parties in interest. The Department has considered this comment and has decided that such arrangements, if prohibited at all, are not within the scope of the application for exemption and are not properly included within this exemption. In this regard, the Department notes that section 408(b)(2) of the Act and section 4975(d)(2) of the Code, and regulations thereunder, provide statutory exemptions from the prohibitions of sections 406(a) of the Act and 4975(c)(1)(A) through (D) of the Code, respectively, for contracting or making reasonable arrangements with a partiy in interest (or disqualified person) for the leasing of office space to a plan, or the provision of legal, accounting, or other services necessary for the establishment or operation of a plan, and for the provision of goods incidental to such services, if no more than reasonable compensation is paid therefor.[4]

One commentator also requested that the exemption make it clear that an interest free loan to a plan covered by the exemption would not give rise to an indirect contribution to the plan for tax purposes.[5] The Department notes that this issue is outside the scope of the exemption.

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of the Act and section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person from certain other provisions of the Act and the Code. These provisions include any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act, which, among other things, require a fiduciary to discharge his duties respecting the plan solely in the interests of participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act; nor does it affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of employees of employers maintaining the plan and their beneficiaries.

(2) This exemption does not extend to transactions prohibited under section 406(b)(1) and (3) of the Act or section 4975(c)(1)(E) and (F) of the Code.

(3) This exemption is supplemental to, and not in derogation of, any other provisions of the Act and the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

(4) This class exemption is applicable to a particular transaction only if the transaction satisfies the conditions specified in the class exemption.

Exemption

In accordance with section 408(a) of the Act and section 4975(c)(2) of the Code, and based upon the entire record including the written comments submitted in response to the notice of February 8, 1980, the Department makes the following determinations:

(a) The class exemption set forth herein is administratively feasible;

(b) It is in the interests of plans and of their participants and beneficiaries; and

(c) It is protective of the rights of participants and beneficiaries of plans.

Accordingly, the following exemption is hereby granted under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code and in accordance with the procedures set forth in ERISA Procedure 75-1.

Effective January 1, 1975, the restrictions of section 406(a)(1)(B) and (D) and section 406(b)(2) of the Act, and the taxes imposed by section 4975(a) and (b) of the Code by reason of section 4975(c)(1)(B) and (D) of the Code, shall not apply to the lending of money or other extension of credit from party in interest or disqualified person to an employee benefit plan, nor to the repayment of such loan or other extension of credit in accordance with its terms or written modifications thereof, if:

(a) No interest or other fee is charged to the plan, and no discount for payment in cash is relinquished by the plan, in connection with the loan or extension of credit;

(b) The proceeds of the loan or extension of credit are used only:

(1) For the payment of ordinary operating expenses of the plan, including the payment of benefits in accordance with the terms of the plan and periodic premiums under an insurance or annuity contract; or

(2) For a period of no more than three days, for a purpose incidental to the ordinary operation of the plan;

[3] *See* 29 CFR § 2550.408b-3 and 26 CFR § 54.4975-7(b).

[4] See, as to the leasing of office space and the provision of services, 29 CFR § 2550.408b-2 and 26 CFR § 54.4975-6(a); See, as to the meaning of "reasonable compensation", 29 CFR § 2550.408c-2 and 26 CFR § 54.4975-6(e).

[5] Such an extension of credit might constitute an excess contribution under section 415 of the Code.

(c) The loan or extension of credit is unsecured; and

(d) The loan or extension of credit is not directly or indirectly made by an employee benefit plan.

Chapter 45.—Windfall Profit Tax on Domestic Crude Oil
Subchapter A.—Imposition and Amount of Tax

Section 4986.—Imposition of Tax

Whether a state privilege tax imposed on the removal of oil, and a related income tax credit, when taken together, qualify for the severance tax adjustment allowed in computing liability for the crude oil windfall profit tax. See Rev. Rul. 80-217, page 338.

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26 CFR 150.4986-1: Imposition of tax.

Whether certain price adjustments are taken into account in determining base prices under section 4989(d)(2) of the Code. See Rev. Rul. 80-320, this page.

Section 4988.—Windfall Profit; Removal Price

26 CFR 150.4988-1: Windfall profit; removal price.

Whether a state privilege tax imposed on the removal of oil, and a related income tax credit, when taken together qualify for the severance tax adjustment allowed in computing liability for the crude oil windfall profit tax. See Rev. Rul. 80-217, page 338.

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26 CFR 150.4988-1: Windfall profits; removal price.

Whether certain price adjustments are taken into account in determining base prices under section 4989(d)(2) of the Code. See Rev. Rul. 80-320, below.

Section 4989.—Adjusted Base Price

26 CFR 150.4989-1: Adjusted base price. (Also Sections 4986, 4988, 4991; 150.4986-1, 150.4988-1, 150.4991-1.)

Windfall profit tax; base price; adjustments to posted price. The effect on the determination of base price under the interim rule is described in situations in which a purchaser of crude oil adjusts the posted price.

Rev. Rul. 80-320 [1]

ISSUE

In the situations described below what price adjustments, if any, are taken into account in determining base prices under section 4989(d)(2) of the Internal Revenue Code?

FACTS

Situation 1

On December 1, 1979, *P*, a purchaser of crude oil, circulated publicly among sellers and buyers of crude oil in a certain geographical area a written offer to purchase newly discovered oil of a particular grade and quality at a specific price, effective for all purchases in the geographical area on and after November 1, 1979. On January 1, 1980, *P* publicly circulated a written adjustment to the above price, effective for all purchases on and after December 1, 1979.

Situation 2

The facts are the same as in *Situation 1* except that the written adjustment of January 1, 1980, was effective with respect to only two of the fields in the geographical area and was circulated publicly only among buyers and sellers of crude oil in those fields.

Situation 3

The facts are the same as in *Situation 1* except that the adjustment of January 1, 1980, was made orally and written confirmation of the adjustment was not circulated until January 16, 1980.

LAW AND ANALYSIS

Section 4986(a) of the Code imposes an excise tax on the windfall profit from taxable crude oil removed from the premises during each taxable period. Section 4986(b) provides that the tax imposed by this section shall be paid by the producer of the crude oil.

Section 4988(a) of the Code defines the term "windfall profit" as the excess of the removal price of the barrel of crude oil over the sum of the adjusted base price of the barrel and the amount of the severance tax adjustment.

Section 4989(a) of the Code defines the term "adjusted base price" as the base price for the barrel of crude oil plus an amount equal to the base price multiplied by the inflation adjustment for the calendar quarter in which the crude oil is removed from the premises, such amount to be rounded to the nearest cent.

Section 4989(d)(2) of the Code provides that for months beginning before October 1980 (or such earlier date as may be provided in the regulations) the base prices for tier 2 and tier 3 oil shall be the product of—

(A)(i) the highest posted price for December 31, 1979, for uncontrolled crude oil of the same grade, quality, and field, or

(ii) if there is no posted price described in clause (i), the highest posted price for such date for uncontrolled crude oil at the nearest domestic field for which prices for oil of the same grade and quality were posted for such date, multiplied by

(B) a fraction the denominator of which is $35, and the numerator of which is—

(i) $15.20 for purposes of determining base prices for tier 2 oil, and

(ii) $16.55 for purposes of determining base prices for tier 3 oil.

For purposes of the preceding sentence, no price which was posted after January 14, 1980, shall be taken into account.

Section 4991(d) of the Code provides that tier 2 oil is any oil from a stripper well property within the meaning of the June 1979 energy regulations, and any oil from an economic interest in a National Petroleum Reserve held by the United States. Section 4991(e) defines tier 3 oil as (a) newly discovered oil, (b) heavy oil and (c) incremental tertiary oil.

Section 150.4989-1(c)(2) of the

[1] Also released in News Release IR-80-116, dated November 3, 1980.

Temporary Excise Tax Regulations under the Crude Oil Windfall Profit Tax Act of 1980, as amended by T.D. 7720, page 327, this Bulletin, 45 F.R. 63263, provides that for purposes of determining the highest posted price for December 31, 1979, "posted price" means a written statement of crude oil prices constituting an offer to purchase oil at that price circulated publicly among sellers and buyers of crude oil in a particular field in accordance with historic practices. Although the formality of a printed price bulletin such as is published by major purchasers is not necessary for a price to be a valid posted price, the formality of a publicly circulated written offer is necessary. The requirement that the offer be in writing and publicly circulated eliminates oral offers and offers made only to specified producers.

That section further provides that in determining the "highest posted price," a producer should first determine which offers qualify as posted prices for December 31, 1979. An offer does not constitute a posted price for December 31, 1979, unless the offer was initially made on or before December 31, 1979, and was in effect for oil purchased on that date. However, in determining the highest posted price for December 31, 1979, a valid posted price that was adjusted on or before January 14, 1980, shall be considered to be an offer made at the price as adjusted so long as the adjusted price applies to all oil purchased pursuant to the initial offer.

An offer made on or before December 31, 1979, to purchase crude oil at a specific price that is adjusted after December 31, 1979, constitutes a posted price for December 31, 1979, at the price as adjusted, provided that 1) the initial offer meets all the requirements for a valid posted price, 2) the adjustment is in effect for December 31, 1979, 3) the adjustment meets all the requirements for a valid posted price for the field or area to which it applies on or before January 14, 1980, and 4) the adjustment applies to all oil in the applicable field or area purchased during the effective period of the adjustment.

HOLDING

Situation 1

P's adjusted price of January 1, 1980, constitutes a "posted price for December 31, 1979," for the named geographical area for purposes of determining base price under section 4989(d)(2) of the Code.

Situation 2

P's adjusted price of January 1, 1980, constitutes a "posted price for December 31, 1979," for purposes of determining base price in the two fields subject to the adjustment. *P*'s initial offer price of December 1, 1979, constitutes a "posted price for December 31, 1979," for purposes of determining base price in the remainder of the geographic area.

Situation 3

Since *P*'s adjusted price was made orally and was not reduced to writing until after January 14, 1980, the adjusted price does not constitute a "posted price for December 31, 1979." Rather, *P*'s price circulated on December 1, 1979, is a "posted price for December 31, 1979," in the geographic area for purposes of determining base price.

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26 CFR 150.4989-1: Adjusted base price.

T.D. 7720

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER D, PART 150.—TEMPORARY EXCISE TAX REGULATIONS UNDER THE CRUDE OIL WINDFALL PROFIT TAX ACT OF 1980

Interim rule for determining base prices for tier 2 and tier 3 oil

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document provides temporary excise tax regulations relating to the windfall profit tax on domestic crude oil imposed by title I of the Crude Oil Windfall Profit Tax Act of 1980 [Pub. L. 96-223, 1980-3 C.B. 2]. The temporary regulations provide rules to be followed by producers and purchasers of domestic crude oil. In addition, the text contained in the temporary regulations set forth in this document serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in the Proposed Rules section of the issue of the Federal Register for September 24, 1980, 45 F.R. 63297.

DATES: These temporary regulations are effective with respect to oil removed after February 29, 1980.

FOR FURTHER INFORMATION CONTACT: David B. Cubeta of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:LR:T) (202-566-3297).

SUPPLEMENTARY INFORMATION

BACKGROUND

On April 4, 1980, the Federal Register published temporary regulations (45 F.R. 23384) under sections 4986, 4987, 4988, 4989, 4991, 4992, 4993, 4994, 4995, 4996, 4997, 6050C, 6076, and 6402 of the Internal Revenue Code of 1954. The temporary regulations were required to implement various sections of the Crude Oil Windfall Profit Tax Act of 1980. This document contains an amendment to § 150.4989-1(c)(2) of those temporary regulations (relating to the interim rule for determining tier 2 and tier 3 base prices).

The regulations promulgated in this document are also proposed to be prescribed as final Excise Tax Regulations (26 CFR Part 51).

EXPLANATION OF PROVISIONS

Numerous commentators on the proposed windfall profit tax regulations published on April 4, 1980 requested that further guidance be provided as to what constitutes a valid posted price for purposes of the interim base price rule for tier 2 and tier 3 oil. Several commentators suggested that the concepts contained in FEA Ruling 1977-1, which sets forth the criteria for a valid posted price in determining ceiling prices, be adopted for the purpose of determining which prices should be used in computing the interim base prices for tier 2 and tier 3 oil. That suggestion has been accepted, and these regulations adopt the principles contained in FEA Ruling 1977-1 with the modifications necessary to conform those rules to the windfall profit tax.

Because these regulations are effective with respect to oil removed after February 29, 1980, purchasers will be required to make withholding adjustments if it is determined that an improper base price has been used in computing windfall profit tax withholding.

WAIVER OF PROCEDURAL REQUIREMENTS OF TREASURY DIRECTIVE

The expeditious adoption of the provisions contained in this document is necessary because of the need for immediate guidance to taxpayers liable for the windfall profit tax on domestic crude oil and to other persons required to withhold and deposit tax, file returns, provide information, etc. For this reason, Jerome Kurtz, Commissioner of Internal Revenue, has determined that the provisions of paragraphs 8 through 14 of the Treasury Department directive implementing Executive Order 12044 must be waived.

DRAFTING INFORMATION

The principal author of these regulations is David B. Cubeta of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, Part 150, Temporary Excise Tax Regulations under the Crude Oil Windfall Profit Tax Act of 1980, is amended as follows:

Paragraph 1. Paragraph (c) of § 150.4989-1 is amended by revising the flush language following subparagraph (2)(ii)(B). Amended paragraph (c) reads as follows:

§ 150.4989-1 Adjusted base price.

* * * * *

(c) *Base prices for tier 2 and tier 3 oil*—(1) *General rule.* [Reserved]

(2) *Interim rule.* This subparagraph and subparagraph (3) apply to oil removed during a month beginning before October 1980 (or such earlier date as may be provided in regulations taking effect before such earlier date). Except as provided in subparagraph (3), the base prices for tier 2 oil and tier 3 oil, respectively, shall be the product of—

(i)(A) The highest posted price for December 31, 1979, for uncontrolled crude oil of the same grade, quality, and field, or

(B) If there is no posted price described in inferior subdivision (A), the highest posted price for such date for uncontrolled crude oil at the nearest domestic field for which prices for oil of the same grade and quality were posted for such date, multiplied by

(ii) A fraction the denominator of which is $35, and the numerator of which is—

(A) $15.20 for purposes of determining base prices of tier 2 oil, and

(B) $16.55 for purposes of determining base prices of tier 3 oil.

In determining the base price for tier 2 or tier 3 oil, the grade and quality of the oil produced in December 1979 shall be used. For purposes of determining the highest posted price for December 31, 1979, "posted price" means a written statement of crude oil prices constituting an offer to purchase oil at that price circulated publicly among sellers and buyers of crude oil in a particular field in accordance with historic practices. Although the formality of a printed price bulletin such as is published by major purchasers is not necessary for a price to be a valid posted price, the formality of a publicly circulated written offer is necessary. The requirement that the offer be in writing and publicly circulated eliminates oral offers and offers made only to specified producers. Accordingly, other than the published price bulletins of the type traditionally issued by major oil companies, written offers to purchase constitute a "posted price" only if they are bona fide public offers of general applicability to crude oil producers in the field. For example, a letter from a purchaser to all crude oil producers in a field or in an area would constitute a posted price if the letter was a bona fide offer to purchase from all producers in that field or area. A written contract, of course, would not qualify as a posted price because it represents an agreement between a buyer and specific producer, not a bona fide offer to purchase from all producers. Accordingly, in determining the "highest posted price," a producer should first determine which offers qualify as posted prices for December 31, 1979. Because a posted price must constitute an offer to purchase, an offer does not constitute a posted price for December 31, 1979, unless the offer was initially made on or before December 31, 1979,

and was in effect for oil purchased on that date. However, in determining the highest posted price for December 31, 1979, a valid posted price that was adjusted in a subsequent posted price circulated on or before January 14, 1980, shall be considered to be an offer made at the price as adjusted so long as the adjusted price applies to all oil purchased pursuant to the initial offer. In determining which posted prices were applicable to a particular field on December 31, 1979, the term "field" means a general area underlain by one or more reservoirs. Historical field designations commonly used by regulatory agencies and the oil industry will generally be used in the determination of a given field. Price bulletins which specify only a geographical area and crude oil grade (*e.g.*, "West Texas Sour") are presumed to be applicable to every field within the named area, unless a particular field is specifically excluded. However, the existence of a price bulletin stating a higher price for specifically named fields within the same area supersedes the area-wide price bulletin for the named field only. Finally, posted prices do not include either offers to buy at a price not specified in a sum certain (*e.g.*, a price "determined by the purchaser to be competitive") or premiums above posted prices which may have been paid for crude oil purchased on December 31, 1979.

(3) *Minimum interim base price.* The base price determined under paragraph (c)(2) of this section for tier 2 oil or tier 3 oil shall not be less than the sum of—

(i) The ceiling price which would have applied to such oil under the March 1979 energy regulations if it had been produced and sold in May 1979 as upper tier oil, plus

(ii)(A) $1 in the case of tier 2 oil, or

(B) $2 in the case of tier 3 oil.

For purposes of this determination, the grade and quality of the oil produced from the property in May 1979 shall be used.

* * * * *

There is need for the immediate guidance provided by the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

This Treasury decision is issued under the authority contained in sections 4997 and 7805 of title 26 of the United States Code.

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved September 17, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 19, 1980, 4:34 p.m., and published in the issue of the Federal Register for September 24, 1980, 45 F.R. 63263)

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26 CFR 150.4989-1: Adjusted base price. (Also Section 4995; 150.4995-1.)

T.D. 7721

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER D, PART 150.—TEMPORARY EXCISE TAX REGULATIONS UNDER THE CRUDE OIL WINDFALL PROFIT TAX ACT OF 1980

Base prices of tier 2 and tier 3 oil

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document provides temporary excise tax regulations relating to base prices of tier 2 and tier 3 oil for purposes of the windfall profit tax on oil imposed by title I of the Crude Oil Windfall Profit Tax Act of 1980 [Pub. L. 96-223, 1980-3 C.B. 2]. These base prices are generally determined under a formula calculated by reference to the actual removal price of oil rather than posted prices, which are used only for oil removed before October 1, 1980. The prices are those for oil removed during the base period, December 1979. The regulations also establish minimum base prices calculated by multiplying a property's May 1979 upper tier ceiling price by 1.1 (for tier 2 oil) or 1.2 (for tier 3 oil).

This document also amends the rules relating to withholding of the windfall profit tax in the absence of current data on an effective operator's certificate.

In addition, the text of the temporary regulations set forth in this document serves as the text of proposed regulations cross-referenced in the Proposed Rules section of the issue of the Federal Register for September 30, 1980, FR 64603.

DATES: The temporary regulations relating to base prices are effective with respect to liability for windfall profit tax upon crude oil removed from the premises after September 30, 1980. However, persons required to withhold or deposit the windfall profit tax may, at their option, continue to withhold or deposit under the old base price rules through November 30, 1980. Similarly, the amendment to the rules relating to operators' certificates is effective on the latter date unless the purchaser chooses an earlier date.

FOR FURTHER INFORMATION CONTACT: Eileen Murphy of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:LR:T) (202-566-3297).

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains temporary

regulations under section 4989(d) of the Internal Revenue Code of 1954, relating to base prices for tier 2 and tier 3 oil. On April 4, 1980, temporary and proposed regulations under the Crude Oil Windfall Profit Tax Act of 1980 were published in the Federal Register (45 FR 23384). The original temporary regulations (Treasury Decision 7690 [1980-1 C.B. 259, 264]), in paragraph (c)(2) of § 150.4989-1, provided an interim rule for determining those base prices. That interim rule was amended in Treasury Decision 7720 (published in the Federal Register for September 24, 1980) [page 327, this Bulletin] to clarify what constitutes a valid posted price. The interim rule expires on October 1, 1980 (or on an earlier date if a permanent rule is provided by regulations effective before that date). The new temporary regulations in this document provide a permanent rule for determining base prices, effective with respect to tax liability for crude oil removed from the premises after September 30, 1980. However, persons required to withhold or deposit the tax may, at their option, use the interim rule through November 30, 1980. Adjustments to withholding for prior inaccuracies in withholding, taking into account the new rules in the case of oil removed after September 30, 1980, shall be made pursuant to paragraph (c) of § 150.4995-1.

The temporary regulations prescribed in this document are also proposed to be prescribed as final excise tax regulations (26 CFR Part 51) under sections 4989(d) and 4995 of the Internal Revenue Code of 1954.

BASE PRICES

These temporary regulations provide new excise tax regulations under Code section 4989(d), relating to base prices of tier 2 and tier 3 crude oil for purposes of the windfall profit tax. The windfall profit tax is imposed upon the windfall profit, defined as the difference between the removal price of the barrel of crude oil and the sum of the adjusted base price of the barrel of oil plus a severance tax adjustment. The adjusted base price is the base price adjusted by an inflation adjustment formula provided in section 4989(b).

Under section 4989(d)(1), the permanent base prices for tier 2 and tier 3 oil are prices determined pursuant to the method prescribed by regulations. The method prescribed by the regulations must be designed so as to yield, with respect to oil of any grade, quality, and field, a base price approximating the price at which such oil would have sold in December 1979 if it is assumed that all domestic crude oil was uncontrolled and the average removal price for all domestic crude oil (excluding Sadlerochit oil) was $15.20 a barrel (for tier 2 oil) and $16.55 a barrel (for tier 3 oil). The regulations provide a formula for determining base prices for tier 2 and tier 3 crude oil. The formula assumes that the same grade, quality, and location factors that caused a certain uncontrolled domestic crude oil to sell for more or less than the actual average uncontrolled price of all domestic crude oil (excluding Sadlerochit oil) in the base period would cause similar crude oil to sell for proportionately more or less than the applicable statutory average uncontrolled price of $15.20 or $16.55. For purposes of the formula, the temporary regulations establish that the actual average removal price for uncontrolled domestic crude oil during the base period was $35.80.

BASE PERIOD UNCONTROLLED SALES

The temporary regulations, in § 150.4989-1(c)(4), provide rules relating to uncontrolled base period sales, which produce the variable price factor to be used in the formula for determining base prices for tier 2 and tier 3 oil. The term "base period" is defined as December 1979, pursuant to the statutory mandate in section 4989(d)(1).

CONSTRUCTIVE UNCONTROLLED BASE PERIOD BASE

The temporary regulations, in § 150.4989-1(c)(3), provide rules for determining the base price for tier 2 and tier 3 oil produced from a reservoir that did not produce oil sold by or for the taxpayer in uncontrolled base period sales. In the case of a transfer of a property after November 30, 1979, the taxpayer takes the base price of the taxpayer's transferor. The taxpayer must obtain a statement of such base price from the transferor, the operator, or the first purchaser. In a case where no such transfer took place, the taxpayer's constructive uncontrolled base period sales price is determined by reference to the following prices (stated in the order of priority): The representative market or field price of oil of similar grade and quality produced from the same reservoir during the base period; or base period prices of oil of similar grade and quality purchased or sold by the taxpayer from the nearest reservoir that produced such oil during the base period; or the representative market or field price of such oil from the nearest reservoir (from which no oil was purchased or sold by the taxpayer in uncontrolled base period sales). If none of these rules apply, the tax shall be computed on the basis of the minimum base price under § 150.4989-1(c)(6) of the temporary regulations. Similarly, if under the taxpayer's particular facts and circumstances the taxpayer is required to make a determination under one of these rules and fails to do so, the tax shall be computed on the basis of the minimum base price and not under any other rule.

MINIMUM BASE PRICES

The temporary regulations, in § 150.4989-1(c)(6), provide a rule under which minimum base prices are established. This rule is similar to the minimum base price rule under the interim rule in section 4989(d)(3).

However, multipliers rather than dollar amounts are used in computing the minimum. The minimum base price rule is prescribed because the Treasury Department has determined that the actual selling price of certain oil during the base period did not reflect its value relative to other oil. The minimum base price rule is prescribed in response to a clear Congressional intention reflected in the legislative history of the windfall profit tax. The Conference Report (*H.R. Rep. No. 96-817*, 96th Cong., 2d Sess. 97 (March 7, 1980) [1980-3 C.B. 245, 257]) states: "[T]he interim rule may lead to inequities in the case of oil produced in California and certain other areas because its December 1979 price was much lower, relative to the national average, than it had been in prior years and is likely to be in the future." The conferees noted that they had given "the Secretary enough flexibility to devise a permanent solution to this problem."

ABSENCE OF COMPLETE AND CURRENT OPERATOR'S CERTIFICATE

The temporary regulations also amend the withholding rules under § 150.4995-1(b)(2) that apply when the purchaser has not received the operator's certification under section 6050C or when the purchaser has reason to believe that certain information provided by the operator is not correct. The new rules provide that the purchaser may continue to rely on the portion of the certified information that there is no reason to believe is not correct. The rules also set forth assumptions that are to be substituted for the item of information that is missing or that the purchaser has reason to believe is not correct. These rules would apply, for example, when the effective date for the new rules for withholding on the permanent base price rule has passed and the purchaser has not yet received a revised base price certification.

WAIVER OF PROCEDURAL REQUIREMENTS OF TREASURY DIRECTIVE

There is need for expeditious adoption of the provisions contained in this document because of the need to provide a permanent base price rule before the expiration of the interim base price rules on September 30, 1980, and because of the necessity of allowing sufficient time for those who must compute or withhold the windfall profit tax to ascertain the applicable base price. For this reason, Jerome Kurtz, Commissioner of Internal Revenue, has determined that the provisions of paragraphs 8 through 14 of the Treasury Department directive implementing Executive Order 12044 must be waived.

DRAFTING INFORMATION

The principal author of these regulations was Eileen Murphy of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing these regulations, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, Part 150, Temporary Excise Tax Regulations under the Crude Oil Windfall Profit Tax Act of 1980, is amended as follows:

Paragraph 1. Paragraph (c) of § 150.4989-1 is revised to read as follows:

§ 150.4989-1 Adjusted base price.

* * * * *

(c) *Base prices for tier 2 and tier 3 oil*—(1) *In general.* Except as otherwise provided in the minimum base price and interim rules set forth in paragraph (c)(6) and (8) of this section, the base prices for tier 2 oil and tier 3 oil shall be determined under paragraph (c)(2) or (3). Paragraph (c)(2) and (3) provides rules designed to approximate the price at which oil would have sold in December 1979, taking into account quality, grade, and field, if it is assumed that all domestic crude oil was uncontrolled and the average removal price of all domestic crude oil (other than Sadlerochit oil was $15.20 a barrel for tier 2 oil and $16.55 a barrel for tier 3 oil. The rules of paragraph (c)(2) apply to oil produced from a reservoir that produced oil sold by or for the taxpayer in uncontrolled base period sales. The rules of paragraph (c)(3) generally apply to all other tier 2 or tier 3 oil. For definitions relating to uncontrolled base period sales, see paragraph (c)(4). For effective date provisions, see paragraph (c)(7).

(2) *Oil produced from a reservoir that produced oil sold by or for the taxpayer in uncontrolled base period sales.* The base price for tier 2 or tier 3 oil produced from a reservoir that produced oil sold by or for the taxpayer in uncontrolled base period sales (see paragraph (c)(4)) is determined by multiplying the uncontrolled base period price per barrel by the tier 2 multiplier in the case of tier 2 oil or by the tier 3 multiplier in the case of tier 3 oil. See paragraph (c)(5) for the definitions of the tier 2 multiplier and the tier 3 multiplier. The uncontrolled base period price per barrel of oil from a reservoir is the weighted average removal price per barrel of oil from the reservoir sold by or for the taxpayer in uncontrolled sales during the base period, determined without regard to any price adjustments made after February 29, 1980. The weighted average is obtained by multiplying the number of barrels sold at each price by the price at which the barrels were sold, adding the products, and dividing by the total number of barrels sold in such sales.

(3) *Oil produced from a reservoir that did not produce oil sold by or for the taxpayer in uncontrolled base period sales*—(i) *In general.* The base price for tier 2 or tier 3 oil produced

from a reservoir that did not produce oil sold by or for the taxpayer in uncontrolled base period sales is determined by multiplying the constructive uncontrolled base period price by the tier 2 multiplier in the case of tier 2 oil or by the tier 3 multiplier in the case of tier 3 oil. However, in the case of a transfer of a property to the taxpayer after November 30, 1979, if the taxpayer's transferor sold production from the reservoir from which the taxpayer's oil is produced in uncontrolled base period sales, the taxpayer's base price shall be—

(A) If the taxpayer obtains a written statement under the penalties of perjury from the transferor, or the transferor's operator or first purchaser, setting forth the transferor's base price for tier 2 or tier 3 oil and all facts bearing on the correctness of that base price, the base price of the taxpayer's transferor; and

(B) If the taxpayer does not obtain such a statement, the minimum base price provided in paragraph (c)(6) of this section.

(ii) *Constructive uncontrolled base period price.* For purposes of paragraph (c)(3)(i), the constructive uncontrolled base period price is the price that would have been obtained for the oil if it had been sold in uncontrolled sales by or for the taxpayer during the base period. In making this determination of constructive uncontrolled base period price:

(A) If oil of similar grade and quality was produced from the same reservoir and sold in uncontrolled sales during the base period, then the taxpayer's constructive uncontrolled base period price is the representative market or field price of such oil.

(B) If paragraph (c)(3)(ii)(A) does not apply and oil of similar grade and quality (*1*) was sold or purchased by or for the taxpayer in uncontrolled sales or purchases during the base period, and (*2*) was produced from the nearest reservoir from which oil of similar grade and quality was sold by or for any producer in uncontrolled sales during the base period, then the taxpayer's constructive uncontrolled base period price is the weighted average removal price per barrel of such oil.

(C) If paragraph (c)(3)(ii)(A) and (B) does not apply, then the taxpayer's constructive uncontrolled base period price is the representative market or field price of oil of similar grade and quality from the nearest reservoir from which such oil was produced and sold (by or for a producer other than the taxpayer) in uncontrolled sales during the base period.

If the taxpayer does not make the determination required by paragraph (c)(3)(ii)(A), (B), or (C) of this section (whichever is applicable under the circumstances of the taxpayer) the tax shall be computed on the basis of a base price that is the minimum base price determined under paragraph (c)(6) of this section. For purposes of this subdivision, the term "representative market or field price" has the same meaning as the meaning with which that term is used in the regulations under section 613. Also, prices shall be determined without regard to any price adjustment made after February 29, 1980.

(4) *Uncontrolled base period sales.* For purposes of paragraph (c)(1), (2), and (3) of this section, the term "uncontrolled sales" means sales in arms-length transactions at prices not subject to price controls imposed by the energy regulations. The term "base period" means December 1979.

(5) *Tier 2 multiplier and tier 3 multiplier.* For purposes of this section—

(i) The tier 2 multiplier is 0.42458 (the number representing the ratio of $15.20, the statutory average removal price for uncontrolled domestic crude oil to be used in the case of tier 2 oil, to $35.80, the actual average removal price for all uncontrolled domestic crude oil (except Sadlerochit oil) sold during the base period), and

(ii) The tier 3 multiplier is 0.46229 (the number representing the ratio of $16.55 to $35.80).

(6) *Minimum base prices for tier 2 and tier 3 oil.* The base price determined under paragraph (c)(1) through (5) of this section for tier 2 or tier 3 crude oil shall not be less than the product of—

(i) The ceiling price which would have applied to such oil under the March 1979 energy regulations if it had been produced and sold in May 1979 as upper tier oil, multiplied by

(ii)(A) 1.1 in the case of tier 2 oil, or

(B) 1.2 in the case of tier 3 oil.

For purposes of this determination, the grade and quality of the oil produced from the property in May 1979 shall be used.

(7) *Effective dates.* The rules of paragraph (c)(1) through (6) of this section are effective with respect to tax liability for crude oil removed from the premises after September 30, 1980. However, persons required by § 150.4995-1 to withhold windfall profit tax or by § 150.4995-3 to deposit payments of that tax may, at their option, continue to use through November 30, 1980, the interim rule set forth in paragraph (c)(8) of this section for purposes of determining the amount to be withheld or deposited. After November 30, 1980, withholding and depositing under the new rules are mandatory and adjustments to withholding for prior inaccuracies in withholding, taking account of the new rules in the case of oil removed after September 30, 1980, shall be made pursuant to paragraph (c) of § 150.4995-1.

(8) *Interim rule.* (i) This subparagraph applies to oil removed during a month before October 1980. Except as provided in paragraph (c)(8)(ii) of this section, the base prices for tier 2 oil and tier 3 oil, respectively, shall be the product of—

(A) The highest posted price for December 31, 1979, for uncontrolled crude oil of the same grade, quality, and field, or, if there is no such posted

price, the highest posted price for such date for uncontrolled crude oil at the nearest domestic field for which prices for oil of the same grade and quality were posted for such date, multiplied by

(B) A fraction the denominator of which is $35, and the numerator of which is $15.20 for purposes of determining base prices of tier 2 oil and $16.55 for purposes of determining base prices of tier 3 oil.

In determining the base price for tier 2 or tier 3 oil, the grade and quality of the oil produced in December 1979 shall be used. For purpose of determining the highest posted price for December 31, 1979, "posted price" means a written statement of crude oil prices constituting an offer to purchase oil at that price circulated publicly among sellers and buyers of crude oil in a particular field in accordance with historic practices. Although the formality of a printed price bulletin such as is published by major purchasers is not necessary for a price to be a valid posted price, the formality of a publicly circulated written offer is necessary. The requirement that the offer be in writing and publicly circulated eliminates oral offers and offers made only to specified producers. Accordingly, other than the published price bulletins of the type traditionally issued by major oil companies, written offers to purchase constitute a "posted price" only if they are bona fide public offers of general applicability to crude oil producers in the field. For example, a letter from a purchaser to all crude oil producers in a field or in an area would constitute a posted price if the letter was a bona fide offer to purchase from all producers in that field or area. A written contract, of course, would not qualify as a posted price because it represents an agreement between a buyer and specific producer, not a bona fide offer to purchase from all producers. Accordingly, in determining the "highest posted price," a producer should first determine which offers qualify as posted prices for December 31, 1979. Because a posted price must constitute an offer to purchase, an offer does not constitute a posted price for December 31, 1979, unless the offer was initially made on or before December 31, 1979, and was in effect for oil purchased on that date. However, in determining the highest posted price for December 31, 1979, a valid posted price that was adjusted in a subsequent posted price circulated on or before January 14, 1980, shall be considered to be an offer made at the price as adjusted so long as the adjusted price applies to all oil purchased pursuant to the initial offer. In determining which posted prices were applicable to a particular field on December 31, 1979, the term "field" means a general area underlain by one or more reservoirs. Historical field designations commonly used by regulatory agencies and the oil industry will generally be used in the determination of a given field. Price bulletins which specify only a geographical area and crude oil grade (*e.g.*, "West Texas Sour") are presumed to be applicable to every field within the named area, unless a particular field is specifically excluded. However, the existence of a price bulletin stating a higher price for specifically named fields within the same area supersedes the area-wide price bulletin for the named field only. Finally, posted prices do not include either offers to buy at a price not specified in a sum certain (*e.g.*, a price "determined by the purchaser to be competitive") or premiums above posted prices which may have been paid for crude oil purchased on December 31, 1979.

(ii) *Minimum interim base price.* The base price determined under paragraph (c)(8)(i) of this section for tier 2 oil or tier 3 oil shall not be less than the sum of—

(A) The ceiling price which would have applied to such oil under the March 1979 energy regulations if it had been produced and sold in May 1979 as upper tier oil, plus

(B) $1 in the case of tier 2 oil or $2 in the case of tier 3 oil.

For purposes of this determination, the grade and quality of the oil produced from the property in May 1979 shall be used.

* * * * *

Par. 2. Paragraph (b)(2) of § 150.4995-1 is revised to read as follows:

§ 150.4995-1 Requirement of withholding.

* * * * *

(b) *Amount to be deducted and withheld.* * * *

(2) *Absence of completed and current operator's certification.* (i) *In general.* This subparagraph applies if the purchaser has not received the certification required to be furnished by the operator pursuant to section 6050C and § 150.6050C-1, or if the certification does not contain all the information necessary for the purchaser to compute the amount to be withheld under paragraph (b)(1) of this section, or if the purchaser has reason to believe that any information contained in that certification that affects the tax computation is not correct (including information that was correct when provided but that has become incorrect, such as a base price that was correct under the interim rule of § 150.4989-1(c)(8) after that rule ceases to apply). In such a case, the amount of tax to be deducted and withheld under paragraph (a) of this section is the amount of tax imposed by section 4986 (without regard to the net income limitation provided in section 4988(b)) based on the information, if any, provided in the operator's certification that the purchaser has no reason to believe is not correct, and on the substitution of the following assumptions for any item of information that is absent from the certification or

that the purchaser has reason to believe is not correct:

(A) If the item that is absent or that the purchaser has reason to believe is not correct is the tax tier of the oil, the oil shall be assumed to be in tier 1 subject to the 70 percent rate of tax;

(B) If the item is the adjusted base price, the adjusted base price shall be assumed to be—

(*1*) In the case of tier 1 oil, $11.01 plus the amount equal to $11.01 multiplied by the inflation adjustment provided under section 4989(b)(1) for the calendar quarter in which the oil was removed,

(*2*) In the case of tier 2 oil, $12.11 (the amount equal to $11.01 multiplied by 1.1, the amount specified in § 150.4989-1(c)(6)(ii)(A)) plus the amount equal to $12.11 multiplied by the inflation adjustment provided under section 4989(b)(1) for the calendar quarter in which the oil was removed, and

(*3*) In the case of tier 3 oil, $13.21 (the amount equal to $11.01 multiplied by 1.2, the amount specified in § 150.4989-1(c)(6)(ii)(B)) plus the amount equal to $13.21 multiplied by the inflation adjustment provided under section 4989(b)(2) for the calendar quarter in which the oil was removed;

(C) If the item is the severance tax adjustment provided by section 4996(c), the severance tax adjustment shall be assumed to be inapplicable unless the amount of that adjustment is known by the purchaser.

(ii) *Effective date.* Notwithstanding paragraph (f) of this section, this subparagraph is effective with respect to payments made after November 30, 1980, for oil removed on or after March 1, 1980, unless the purchaser chooses to apply this subparagraph at an earlier date. However, prior to the effective date of this subparagraph as provided in the preceding sentence, this subparagraph as originally promulgated in Treasury Decision 7690 (see 45 FR 23384) is effective as provided in paragraph (f) of this section.

* * * * *

There is need for the immediate guidance provided by the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

This Treasury decision is issued under the authority contained in sections 4989(d)(1), 4995, 4997(b), and 7805 of title 26 of the United States Code and section 101 of the Crude Oil Windfall Profit Tax Act of 1980 [Pub. L. 96-223, 1980-3 C.B. 2].

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved September 24, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 29, 1980, 8:45 a.m., and published in the issue of the Federal Register for September 30, 1980, 45 F.R. 64574)

Subchapter B.—Categories of Oil

Section 4991.—Taxable Crude Oil; Categories of Oil

26 CFR 150.4991-1: Taxable crude oil; tiers of oil.

Whether certain price adjustments are taken into account in determining base prices under section 4989(d)(2) of the Code. See Rev. Rul. 80-320, page 326.

Subchapter C.—Miscellaneous Provisions

Section 4995.—Withholding; Depositary Requirements

26 CFR 150.4995-1: Requirement of withholding.

Temporary excise tax regulations relating to withholding the windfall profit tax in the absence of an effective operator's certificate. See T.D. 7721, page 329.

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26 CFR 150.4995-3: Depositary requirements.
(Also Sections 4997, 6402; 150.4997-1, 150.6402-1.)

T.D. 7732

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER D, PART 150.—TEMPORARY EXCISE TAX REGULATIONS UNDER THE CRUDE OIL WINDFALL PROFIT TAX ACT OF 1980

Tax deposits and refunds based on the net income limitation

AGENCY: Internal Revenue Service, Treasury.

ACTION: Amendment of temporary regulations.

SUMMARY: This document amends temporary excise tax regulations relating to the windfall profit tax on domestic crude oil imposed by title I of the Crude Oil Windfall Profit Tax Act of 1980 [Pub.L. 96-223, 1980-3 C.B. 2]. The new temporary regulations provide rules to be followed by producers of domestic crude oil. In addition, the text contained in the temporary regulations set forth in this document serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in the Proposed Rules section of the issue of the Federal Register for November 5, 1980, 45 F.R. 73467.

DATES: These temporary regulations are effective with respect to oil removed after February 29, 1980.

FOR FURTHER INFORMATION CONTACT: David B. Cubeta of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC 20224 (Attention: CC:LR:T) (202-566-3297).

SUPPLEMENTARY INFORMATION

BACKGROUND

On April 4, 1980, the Federal Register published temporary regulations (45 FR 23384) under sections 4986, 4987, 4988, 4989, 4991, 4992, 4993, 4994, 4995, 4996, 4997, 6050C, 6076, and 6402 of the Internal Revenue Code of 1954. The temporary regulations were required to implement various sections of the Crude Oil Windfall Profit Tax Act of 1980. Certain amendments to the temporary regulations were published on April 25, 1980 (45 FR 27929). This document contains amendments to §§ 150.4995-3, 150.4997-1, and 150.6402-1 of those temporary regulations (relating to windfall profit tax deposits, returns, and refunds).

EXPLANATION OF PROVISIONS

Numerous commentators on the proposed windfall profit tax regulations published on April 4, 1980 expressed concern over the operation of the tax deposit and refund rules in situations involving the application of the net income limitation on windfall profit provided in section 4988(b). Several commentators suggested that in order to avoid overpayments of tax, the deposit rules should be amended to clarify that producers may take the net income limitation into account in depositing their own tax under § 150.4995-3(a) or (f) when the first purchaser is not required to withhold. This suggestion has been adopted, and § 150.4995-3(a) and (f) is amended to specifically provide that the net income limitation may be taken into account by producers depositing their own tax liability. The amendment is effective with respect to oil removed after February 29, 1980. Therefore, producers may reduce future deposits if more than the tax imposed by section 4986, computed with regard to the net income limitation, has been deposited for past periods. However, refund claims may not be filed until after the end of the producer's taxable year (for Federal income tax purposes).

Most of the commentators recognized that section 4995(a)(2)(B) precludes the first purchaser from taking the net income limitation into account in determining the amount to be withheld from producers. However, it was requested that the regulations be amended to expedite refunds to producers from whom tax has been overwithheld due to the net income limitation.

These regulations amend § 150.6402-1 to permit refund claims to be filed as soon as the statute permits and the amount of the overpayment can be determined. Producers whose taxable year (for Federal income tax purposes) is the calendar year may file a claim for credit or refund any time after the last day of February following the year of removal (the date that section 4995(a)(4)(B) deems the tax to have been paid). Producers whose taxable year is not the calendar year may file two claims for credit or refund each year. First, after the last day of February following the calendar year of removal, the producer may file a claim for credit or refund of overpayments attributable to the portion of the calendar year that is within the taxable year that ended during that calendar year. Second, after the end of the following taxable year, the producer may file a claim for credit or refund of overpayments attributable to the remainder of the calendar year.

WAIVER OF PROCEDURAL REQUIREMENTS OF TREASURY DIRECTIVE

The expeditious adoption of the provisions contained in this document is necessary because of the need for immediate guidance to taxpayers liable for the windfall profit tax on domestic crude oil. For this reason, Jerome Kurtz, Commissioner of Internal Revenue, has determined that the provisions of paragraphs 8 through 14 of the Treasury Department directive implementing Executive Order 12044 must be waived.

DRAFTING INFORMATION

The principal author of these regulations is David B. Cubeta of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, part 150, Temporary Excise Tax Regulations under the Crude Oil Windfall Profit Tax Act of 1980, is amended as follows:

Paragraph 1. Section 150.4995-3 is amended by revising so much of paragraph (a)(1) as precedes subdivision (i), by revising so much of paragraph (f)(1) as precedes subdivision (i), and by redesignating paragraphs (g) and (h) as (h) and (i) and inserting new paragraph (g) immediately after paragraph (f). These revised, redesignated, and added provisions read as follows:

§ 150.4995-3 Depositary requirements.

(a) *Deposits by integrated oil companies other than independent refiners*—(1) *In general.* Every integrated oil company (as defined in § 150.4996-1(g)) other than an independent refiner (as defined in § 150.4996-1(h)) that is either liable as a producer for the tax imposed by section 4986 (unless such tax is required by § 150.4995-1 to be deducted and withheld by the purchaser) or is required as a purchaser to deduct and withhold tax pursuant to § 150.4995-1 shall make deposits with respect to

semimonthly periods (as defined in subparagraph (3)(i) of this paragraph). The amount to be deposited for each semimonthly period is the amount of tax imposed by section 4986 (computed with regard to the net income limitation provided in section 4988(b), if applicable) that is not required to be withheld under § 150.4995-1 on oil removed from the premises during that semimonthly period for which the company is liable as a producer, plus the amount required to be withheld by the company as a purchaser pursuant to § 150.4995-1 from payments that have been or will be made for oil removed from the premises during that semimonthly period. The deposits shall be made on or before the depositary date (as defined in subparagraph (3)(ii) of this paragraph) for the semimonthly period in which the oil is removed. These depositary requirements will be considered to have been met for a semimonthly period with respect to estimated deposits, including deposits based upon the producer's estimate of the effect of the net income limitation provided in section 4988(b), only if—

* * * * *

(f) *Deposits by producers of tax due on oil not subject to withholding*—(1) *In general.* Except as provided in paragraph (a) (relating to certain integrated oil companies), every producer shall deposit for each calendar month the tax imposed by section 4986 (computed with regard to the net income limitation provided in section 4988(b), if applicable) on the removal in that month of oil that is not subject to withholding under § 150.4995-1. The deposits shall be made not later than 45 days after the close of the month in which the oil was removed (or deemed removed under section 4988(c)(4)) from the premises. These deposit requirements will be considered to have been met for a month with respect to estimated deposits, including deposits based upon the producer's estimate of the effect of the net income limitation provided in section 4988(b), only if—

* * * * *

(g) *Special rules applicable if the net income limitation is taken into account in depositing tax*—(1) *Reporting requirements.* For the requirement that the producer file quarterly and annual statements if windfall profit tax deposits have been based on an application of the net income limitation provided in section 4988(b), see § 150.4997-1.

(2) *Treatment of deposits by a producer in excess of liability due to the net income limitation*—(i) *In general.* Under §150.6402-1, a producer who deposits for a taxable period an amount that exceeds the tax imposed by section 4986 but does not exceed the tax imposed by section 4986 computed without regard to the net income limitation provided by section 4988(b) may not claim a credit or refund of the excess until the end of the producer's taxable year (for Federal income tax purposes) with respect to which the limitation is computed. However, the excess (if any) of a producer's deposits for a semimonthly period (calendar month in the case of producers depositing under paragraph (f) of this section) over the tax imposed by section 4986 (computed with regard to the net income limitation) for that period (or month) shall be applied in order of time to each of the producer's succeeding semimonthly periods (or months), to the extent that the amount by which the taxes for that period (or month) exceed the deposit for such subsequent period (or month), until such excess is exhausted. The preceding sentence shall not apply to any amount for which the producer files a claim for credit or refund pursuant to § 150.6402-1. Furthermore, no amount shall be applied to a deposit for a subsequent semimonthly period (or month) that occurs in a taxable period beginning in a different taxable year (for Federal income tax purposes).

(ii) *Examples.* The rules of this paragraph and their relationship to the rules of § 150.6402-1 may be illustrated by the following examples:

Example (1). A, whose taxable year (for Federal income tax purposes) ends September 30, is the producer of oil from property X. For each taxable period (calendar quarter) within his taxable year ending September 30, 1981, A's windfall profit tax liability, determined without taking the net income limitation into account, is $1,000. The purchaser of A's oil is not required to withhold any windfall profit tax, and for the last taxable period of 1980 A has deposited $1,000. At the beginning of the first taxable period of 1981, A determines that the net income limitation will reduce the windfall profit tax with respect to the oil removed from property X during the taxable year ending September 30, 1981, by approximately 10 percent. Therefore, A concludes that the tax paid for the preceding taxable period (calendar quarter) exceeds his liability for tax for that period, although the exact amount of the excess cannot be determined until the taxable year ends. Under § 150.6402-1, A may not claim a refund for the amount of any such excess until the taxable year ends on September 30, 1981. However, paragraphs (a) and (f) of § 150.4995-3 do not require deposit of more than the tax imposed by section 4986. Therefore, A may estimate the effect of the net income limitation in determining the amount of windfall profit tax to be deposited for each taxable period. Furthermore, the amount by which the tax deposited by A for a preceding deposit period exceeds the actual liability for that period is treated as deposited for the next period. Accordingly, A deposits a total of $800 for the first taxable period of 1981 and $900 for each of the next two taxable periods. Thus, at the end of the four taxable periods ending within A's taxable year, A has made the following deposits:

Oct.-Dec. 1980	*Jan.-Mar. 1981*	*Apr.-June 1981*	*July-Sept. 1981*
$1,000	$800	$900	$900

After September 30, 1981, A computes his net income limitation for property X and determines that his actual tax liability was $850 for each taxable period. A has satisfied the deposit requirements and is entitled to file a claim for credit or refund of $200.

Example (2). Assume the same facts as in example (1), except that A overestimates the effect of the net income limitation and deposits a total of $600 for the first taxable period of 1981 and $800 for each of the next two taxable periods. After September 30, 1981, A's deposits are as follows:

Oct.-Dec. 1980	*Jan.-Mar. 1981*	*Apr.-June 1981*	*July-Sept. 1981*
$1,000	$600	$800	$800

$150 of the deposits for October, November, and December 1980 is treated as carried over to and deposited in the next taxable period, bringing the total deposit required for Jan.-Mar. 1981 to $700 (the amount equal to the $850 actual liability less $150 carried from the preceding period). However, due to the overestimation of the effect of the net income limitation, A has not deposited the total liability for that period or the next two taxable periods. Therefore, A is liable for $200 in undeposited tax (the amount equal to $3,400 total liability less $3,200 total deposits) plus interest and penalties (unless A's error was due to reasonable cause).

(h) *Government depositories.* * * *

(i) *Depositary forms.* * * *

Par. 2. Section 150.4997-1 is amended by revising the portion of paragraph (a) that follows subparagraph (2) to read as follows:

§ 150.4997-1 Returns and recordkeeping.

(a) *Returns.* * * *

Every producer taking the net income limitation provided by section 4988 (b) into account in making windfall profit tax deposits shall file quarterly and annual statements in accordance with forms and instructions provided for that purpose. See § 150.6076-1 for the rules relating to the time for filing the returns required by this section.

* * * * *

Par 3. Section 150.6402-1 is amended by revising paragraphs (b) and (c) and by adding new paragraphs (e) and (f) immediately after paragraph (d). These added and revised paragraphs read as follows:

§ 150.6402-1 Credit or refund of overpayment of windfall profit tax.

* * * * *

(b) *Overpayments not attributable to amounts deducted and withheld*—(1) *In general.* If, for any taxable period, a producer has paid more than the amount of tax imposed by section 4986 (computed without regard to the net income limitation on windfall profit provided in section 4988 (b)) that is attributable solely to tax paid on crude oil not subject to withholding, the producer may file a claim for refund of that overpayment on or after the date for filing the return of such tax for such taxable period under section 6076 or may claim credit for such overpayment against any liability for a tax imposed by Chapter 1 or 45 in accordance with the forms and instructions provided for that purpose.

(2) *Net income limitation.* Except as provided in paragraph (b)(1), if, for any taxable period, a producer has paid more than the amount of tax imposed by section 4986 (computed with regard to the net income limitation provided in section 4988(b)) that is attributable solely to tax paid on crude oil not subject to withholding, the producer may file a claim for credit or refund of that overpayment only after the end of the producer's taxable year (for Federal income tax purposes) with respect to which the limitation is computed. At that time, the producer may claim a credit or refund of the overpayment as provided in paragraph (b)(1) of this section.

(c) *Overpayments attributable to amounts deducted and withheld*—(1) *In general.* Under section 4995(a)(4), the producer of oil is treated as having paid any amount withheld on the last day of the first February after the calendar year in which the oil was removed from the premises. Therefore, if the sum of the producer's liability for the tax imposed by section 4986 (computed without regard to the net income limitation provided in section 4988(b)) on oil subject to withholding under § 150.4995-1 for all taxable periods of a calendar year is less than the amount deducted and withheld from the producer under § 150.4995-1 with respect to oil removed during the calendar year, an overpayment of tax exists after such last day of February. The producer may file a claim for refund of the overpayment or may claim credit for the overpayment against any liability for a tax imposed by chapter 1 or 45 in accordance with the forms and instructions provided for that purpose. The producer shall attach to the claim a copy of all Forms 6248 furnished to the producer pursuant to § 150.4997-2.

(2) *Net income limitation.* Except as provided in paragraph (c)(1), if the sum of the producer's liability for the tax imposed by section 4986 (computed with regard to the net income limitation provided in section 4988 (b)) on oil subject to withholding under § 150.4995-1 for any taxable period is less than the sum of the amounts deducted and withheld from the producer under § 150.4995-1 with respect to oil removed in that taxable period, the excess may be claimed as a credit or refund only after the later of—

(A) The last day of the first February after the end of the taxable period, or

(B) The last day of the producer's taxable year (for Federal income tax purposes) with respect to which the limitation is computed.

Thereafter, the producer may file a claim for credit or refund of the overpayment as provided in paragraph (c)(1) of this section.

* * * * *

(e) *Examples.* The rules of this section may be illustrated by the following examples:

Example (1). Under § 150.4995-1, the purchaser of oil from producer A is not required to deduct and withhold any tax from payments made to A. Consequently, A deposited a total of $1,100 for a certain taxable period. After the end of the taxable period, it is determined that the tax imposed by section 4986, computed without regard to the net income limitation, is $1,000. A estimates that, due to the net income limitation, the actual liability is only $900. Under paragraph (b)(1) of this section, A may file a claim for credit or refund of $100 (the amount by which

the $1,100 deposit exceeds the $1,000 tax imposed by section 4986, computed without regard to the net income limitation). Under paragraph (b)(2) of this section, A may claim credit or refund of any overpayment due to the application of the net income limitation only after A's taxable year (for Federal income tax purposes) has ended. However, see § 150.4995-3(g)(2) for rules relating to estimated tax deposits.

Example (2). Producer B's taxable year for income tax purposes is the calendar year. Due to the application of the net income limitation, the amount of windfall profit tax withheld from B exceeds B's liability for each of the four taxable periods of the calendar year. B may file a claim for credit or refund of the overwithheld tax after the last day of February following the end of the calendar year.

Example (3). Producer C's taxable year for income tax purposes ends on June 30. Due to the application of the net income limitation, C's windfall profit tax has been overwithheld for each of the four taxable periods within C's taxable year ending June 30, 1981. C may claim credit or refund after June 30, 1981, for the overpayment attributable to oil removed during the last two taxable periods of calendar year 1980 (July-September and October-December 1980), because by that time C has been deemed, under section 4995(a)(4), to have paid the tax with respect to those taxable periods, and the taxable year in which the oil was removed has ended. However, C must wait until after February 28, 1982, to claim credit or refund for the overpayment attributable to oil removed during the first two taxable periods of calendar year 1981 (January-March and April-June 1981).

Example (4). Assume the same facts as in example (3), except that the purchaser of C's oil made an error and overwithheld tax during the last taxable period of calendar year 1980. The error remained unadjusted when the purchaser furnished C the annual information statement under § 150.4997-2. After February 28, 1981, C may file a claim for credit or refund of the amount overwithheld due to the withholding error. However, C may not claim a credit or refund for the overpayment due to the application of the net income limitation until the dates specified in example (3).

Example (5). Assume the same facts as in example (3), except that C's taxable year ends on August 31, and the overpayment due to the net income limitation relates to C's taxable year ending August 31, 1981. C may claim a credit or refund after August 31, 1981, for the overpayment attributable to oil removed during the last two taxable periods of calendar year 1980. After February 28, 1982, C may claim credit or refund for the overpayment attributable to oil removed during the first three taxable periods of calendar year 1981. However, that claim may only reflect overpayments due to the application of the net income limitation for oil removed through August 1981 because the last month of the third taxable period of 1981 (September 1981) is in C's next income tax year.

(f) *Cross-reference.* For examples illustrating the interrelationship of § 150.4995-3 (relating to depositary requirements) and this section, see § 150.4995-3(g)(2)(ii).

There is need for the immediate guidance provided by the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

This Treasury decision is issued under the authority contained in sections 4997 and 7805 of title 26 of the United States Code (94 Stat. 249 and 68A Stat. 917; 26 U.S.C. 4997 and 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved October 31, 1980.

ROBERT CARSWELL,
Deputy Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 31, 1980, 11:59 a.m., and published in the issue of the Federal Register for November 5, 1980, 45 F.R. 73467)

Section 4996.—Other Definitions and Special Rules

26 CFR 150.4996-2: Severance tax adjustment.
(Also Sections 4986, 4988; 150.4986-1, 150.4988-1.)

Windfall profit tax; severance tax adjustment. A state privilege tax imposed on the removal of oil, when taken together with the related income tax credit or refund, that is not determined on the basis of the gross value of the extracted oil but is determined by reference to the windfall profit portion of such value does not meet the requirements for the severance tax adjustment that may be taken into account in determining the windfall profit.

Rev. Rul. 80-217

ISSUE

Whether a state tax imposed on the removal of oil, and a related income tax credit, when taken together, constitute a severance tax for purposes of the crude oil windfall profit tax adjustment allowed by section 4988(a)(2) of the Internal Revenue Code.

FACTS

State *X* imposes a privilege tax on the removal of oil from the ground at the rate of 15 percent of the gross value of the oil at the wellhead. In addition the state's imposing statute provides the taxpayer with a state income tax credit in an amount equal to the total amount of the privilege tax imposed less the difference between (1) the federal windfall profit tax computed with a state severance tax adjustment (were the state tax in question to qualify for the severance tax adjustment), and (2) the federal windfall profit tax computed without the same state severance tax adjustment. Under the state statute, if the amount of such tax credit exceeds the taxpayer's state income tax liability for the taxable year, the excess amount is refundable to the taxpayer.

LAW AND ANALYSIS

Section 4986 of the Code imposes a tax on the windfall profit from taxable crude oil removed from the premises during each taxable period. The tax is to be paid by the producer of the crude oil.

Under section 4988 of the Code the term "windfall profit" means the excess of the removal price of the barrel of crude oil over the sum of (1) the adjusted base price of such barrel, and (2) the amount of the severance tax

adjustment with respect to such barrel provided by section 4996(c).

Section 4996(c) of the Code provides that the severance tax adjustment with respect to any barrel of crude oil shall be the amount by which (A) any severance tax imposed with respect to such barrel, exceeds (B) the severance tax that would have been imposed if the barrel had been valued at its adjusted base price. For purposes of the severance tax adjustment, the term "severance tax" is defined as a tax (A) imposed by a state with respect to the extraction of oil, and (B) determined on the basis of the gross value of the extracted oil. Under section 4996(c)(3), a severance tax is not taken into account to the extent that the rate thereof exceeds 15 percent.

Section 150.4996-2(b) of the Temporary Excise Tax Regulations Under the Crude Oil Windfall Profit Tax Act of 1980 provides that the term "severance tax" does not include a tax levied on the value of reserves in the ground or a tax levied on the basis of net proceeds from production. That section further provides that a tax on the removal of crude oil from the ground levied at a fixed fee per barrel is not a severance tax because the amount of that tax is not determined by reference to the gross value of the extracted oil.

In this case, although the privilege tax imposed by state *X* is ostensibly on the gross value of the oil, only a portion of the amount of tax paid by the taxpayer is retained by the state. The following example illustrates the above:

A, located in state *X*, extracts oil from the ground that has a removal value of $40.00 per barrel. The adjusted base price of the oil is $16.00 per barrel. The oil is of the type that is subject to the federal windfall profit tax at the 50 percent rate. The computations are as follows:

State *X* Privilege Tax Imposed ($40.00 × 15 percent)		$ 6.00
Less: Privilege Tax on Adjusted Base Price ($16.00 × 15 percent)		$ 2.40
Severance Tax Adjustment (if allowed)		$ 3.60
Federal Windfall Profit Tax (WPT) Computation:		
Removal value of oil		$40.00
Less: Adjusted base price		$16.00
Windfall profit before severance tax adjustment		$24.00
Less: Severance Tax Adjustment		3.60
Windfall profit with severance tax adjustment		$20.40
WPT with severance tax adjustment ($20.40 × 50 percent)		$10.20
WPT without severance tax adjustment ($24.00 × 50 percent)		$12.00
State *X* Income Tax Credit:		
Privilege Tax Paid by *A*		$ 6.00
WPT without severance tax adjustment	$12.00	
WPT with severance tax adjustment	$10.20	
Difference		$ 1.80
Amount of privilege tax refunded to *A*		$ 4.20
Amount of privilege tax retained by state *X*		$ 1.80

The example indicates that although the state *X* tax (15 percent) is ostensibly determined on the basis of the gross value of the oil, and *A* initially pays $6.00 tax to the state, *A* receives a credit or refund of $4.20 from the state resulting in a net tax paid of $1.80. This net tax ($1.80) equals the rate of state *X*'s tax (15 percent) multiplied by the amount of *A*'s federal windfall profit tax liability computed without a severance tax adjustment ($12.00).

Thus, the state privilege tax, when taken together with the related income tax credit or refund, is not determined on the basis of the gross value of the extracted oil but is determined by reference to the windfall profit portion of such value.

HOLDING

The privilege tax imposed by state *X* does not meet the requirements for the severance tax adjustment and thus may not be taken into account in determining the windfall profit for purposes of computing the crude oil windfall profit tax imposed by section 4986 of the Code.

Section 4997.—Records and Information; Regulations

26 CFR 150.4997-1: Returns and recordkeeping.

Windfall profit tax; recordkeeping requirements; ADP users. Punched cards, magnetic tapes, disks, and other machine-sensible data media used for recordkeeping in a taxpayer's automatic data processing system are records within the meaning of section 4997 of the Code and must be retained so long as the contents may become material in the administration of any internal revenue law. However, punched cards used merely as a means of input to the system need not be retained if the input information is duplicated on other records.

Rev. Rul. 80-272 [1]

ISSUE

Do punched cards, magnetic tapes, disks, and other machine-sensible data media used in the automatic data processing of accounting transactions

[1] Also released in News Release IR-80-96 dated September 23, 1980.

constitute records within the meaning of section 4997 of the Internal Revenue Code?

FACTS

In the typical situation the taxpayer maintains records within his automatic data processing (ADP) system. Daily transactions are recorded on punched cards and processed by the taxpayer's computer, which prints daily listings and accumulates the individual transaction records for a month's business on magnetic tapes. At the month's end the tapes are used to print out monthly journals, registers, and subsidiary ledgers and to prepare account summary totals entered on punch cards. The summary data from these cards is posted to the general ledger, and a monthly printout is generated to reflect opening balances, summary total postings, and closing balances. At the year's end several closing ledger runs are made to record adjusting entries. In other situations taxpayers use punched cards, disks, or other machine-sensible data media to store accounting information.

LAW AND ANALYSIS

Section 4986(a) of the Code imposes an excise tax on the windfall profit from taxable crude oil removed from the premises during each taxable period. Section 4986(b) provides that this tax shall be paid by the producer of the crude oil.

Section 4997 of the Code provides that each taxpayer liable for tax under section 4986, each partnership, trust, or estate producing domestic crude oil, each purchaser of domestic crude oil, and each operator of a well from which domestic crude oil was produced, shall keep such records, make such returns and furnish such information with respect to such oil as the Secretary may by regulations prescribe.

Under section 150.4997-1(b) of the Temporary Excise Tax Regulations under the Crude Oil Windfall Profit Tax Act of 1980, each of the parties described in section 4997 of the Code shall keep records of all documents, material, and information necessary to the determination of the windfall profit tax or that affect his or her administrative obligations under the Act or regulations, including material furnished to other persons, as well as information received from other persons. The records shall be kept at all times available for inspection by authorized internal revenue officers or employees and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

HOLDING

Punched cards, magnetic tapes, disks, and other machine-sensible data media used for recording, consolidating, and summarizing accounting transactions and records within a taxpayer's automatic data processing system are records within the meaning of section 4997 of the Code and section 150.4997-1(b) of the regulations and are required to be retained so long as the contents may become material in the administration of any internal revenue law. However, where punched cards are used merely as a means of input to the system and the information is duplicated on magnetic tapes, disks, or other machine-sensible records, such punched cards need not be retained.

It is recognized that ADP accounting systems will vary from taxpayer to taxpayer and, usually, will be designed to fit the specific needs of the taxpayer. Accordingly, taxpayers who are in doubt as to which records are to be retained or who desire further information should contact their district director for assistance.

See Rev. Proc. 80-42, page 776, this Bulletin, which sets forth guidelines for keeping records with an ADP system.

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26 CFR 150.4997-1: Returns and recordkeeping.

Basic recordkeeping requirements essential in meeting the requirements set forth by the Crude Oil Windfall Profit Tax Act of 1980, for a taxpayer using an automatic data processing system. See Rev. Proc. 80-42, page 776.

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26 CFR 150.4997-1: Returns and recordkeeping.

Statements required by producers taking the net income limitation provided by section 4988(b) of the Code. See T.D. 7732, page 334.

Subtitle F.—Procedure and Administration
Chapter 61.—Information and Returns
Subchapter A.—Returns and Records
Part I.—Records, Statements, and Special Returns

Section 6001.—Notice or Regulations Requiring Records, Statements, and Special Returns

26 CFR 1.6001-1: Records.
(Also Section 165; 1.165-1(b).)

Evidence of loss; confirmation statements from foreign broker. The Service is not required to assume the existence of a loss from a futures transaction in U.S. Government interest-bearing certificates carried out on a foreign exchange that is evidenced by an investment prospectus, cancelled checks, and confirmation statements from a foreign investment firm whose records are not available for examination by the Service.

Rev. Rul. 80-324 [1]

ISSUE

Are an investment prospectus, cancelled checks, and confirmation statements sufficient to substantiate a loss deduction claimed by the taxpayer under the circumstances described below?

FACTS

A taxpayer, responding to an investment prospectus, invested money with a foreign investment firm (a foreign corporation) located in a foreign country. The money was to be used to engage in certain transactions involving

[1] Also released as News Release IR-80-114, dated October 30, 1980.

futures contracts in United States Government interest-bearing certificates. These futures transactions were carried out on a foreign exchange not subject to regulatory supervision similar to that existing in the United States. During the taxable year, a foreign broker, on behalf of the taxpayer, purportedly covered a "short position" on some of these certificates, which resulted in a loss to the taxpayer. To discharge the resulting liability to the broker, the taxpayer allegedly borrowed money from the foreign corporation and purportedly assumed personal liability to repay this debt.

On the federal income tax return for the year in question, the taxpayer claimed a 100,000*x* dollar loss deduction on account of this transaction. Upon audit of the taxpayer's return, the taxpayer, to substantiate this loss, presented (1) the investment prospectus of the foreign corporation, (2) a cancelled check in the amount of 12,500*x* dollars made payable to the foreign corporation (and with which the taxpayer claimed to have opened the trading account), and (3) confirmation certificates prepared by the foreign corporation evidencing the claimed loss. The foreign investment corporation's records of the taxpayer's transactions are not available for examination by the Internal Revenue Service because the foreign country's secrecy laws preclude such examination.

LAW AND ANALYSIS

Section 165(a) of the Internal Revenue Code provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 1.165-1(b) of the Income Tax Regulations provides, in part, that to be allowable as a deduction under section 165(a) of the Code, a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. This provision further provides that only a bona fide loss is allowable.

Section 6001 of the Code provides that every person liable for any tax imposed by the Code, or for the collection thereof, shall keep records as the Secretary of the Treasury or the Secretary's delegate may from time to time prescribe.

Section 1.6001-1(a) of the regulations provides that any person subject to income tax shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.

Thus, on audit, a taxpayer can be required to supply sufficient information to permit the Service to determine the bona fides of any claimed deduction or credit. A taxpayer is not relieved of his obligation to establish the bona fides of any claimed deduction or credit because the transaction giving rise to the deduction or credit is carried out through a foreign investment vehicle (foreign partnership, corporation, or trust, for instance) that operates in a foreign jurisdiction whose laws or practices prohibit or restrict disclosure to the Service.

HOLDING

Because the foreign futures transactions are not subject to regulatory supervision equal to that provided in the United States, the Service is not required to assume the existence of these transactions merely because the taxpayer produces some documentation (e.g., investment prospectus, cancelled checks, and confirmation statements) purporting to evidence such transactions.

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26 CFR 1.6001-1: Records.

Requirements for the reproduction and private design and printing of substitute federal tax return forms. See Rev. Proc. 80-47, page 782.

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26 CFR 1.6001-1: Records.

Conditions for the acceptance of computer-prepared tax forms and computer-generated tax forms and schedules. See Rev. Proc. 80-48, page 792.

Part II.—Tax Returns or Statements
Subpart A.—General Requirement

Section 6011.—General Requirement of Return, Statement, or List

26 CFR 1.6011-1: General requirement of return, statement, or list.

Requirements for the reproduction and private design and printing of substitute federal tax return forms. See Rev. Proc. 80-47, page 782.

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26 CFR 1.6011-1: General requirement of return, statement, or list.

Conditions for the acceptance of computer-prepared tax forms and computer-generated tax forms and schedules. See Rev. Proc. 80-48, page 792.

Subpart B.—Income Tax Returns

Section 6012.—Persons Required to Make Returns of Income

26 CFR 1.6012-1: Individuals required to make returns of income.

Conditions under which a Presidential appointee who has an interest in a blind trust that meets the requirements of section 202(f)(4)(B) of the ethics in Government Act of 1978, will be granted permission to have a trustee file the appointee's income tax return and to state the procedure that the trustee must follow in filing the appointee's income tax return. See Rev. Proc. 80-59, page 855.

Section 6013.—Joint Returns of Income Tax by Husband and Wife

26 CFR 1.6013-2: Joint return after filing separate return.

Whether the addition to the tax for underpayment of estimated tax is based on the tax shown on the joint return filed after the due date or on the separate returns filed by the due date. See Rev. Rul. 80-355, page 374.

Subpart C.—Estate and Gift Tax Returns

Section 6018.—Estate Tax Returns

26 CFR 20.6018-1: Returns.
(Also Section 6075; 20.6075-1.)

Returns of missing persons. An estate tax return must be filed within 9 months following the period of time state law sets for declaring a missing person dead; Rev. Rul. 66-286 clarified and modified.

Rev. Rul. 80-347

ISSUE

Whether a federal estate tax return must be filed with respect to a missing person's estate within the prescribed period following 7 years from the disappearance or 14 years therefrom when under the law of the state in which the person resided there can be no court adjudication of death until the elapse of 14 years from the disappearance.

FACTS

The taxpayer has been missing for 7 years and has not been seen or heard from since. Under the state law, in the absence of evidence of death, a missing person is presumed to be alive until 14 years have elapsed. Since there is no such evidence with respect to the taxpayer, a state court will not issue a death decree before the end of the 14-year period. Receivers for the taxpayer's property have been appointed by the probate court.

LAW AND ANALYSIS

Section 6018 of the Internal Revenue Code provides that the executor shall make a return with respect to the federal estate tax. Under section 6075(a), as amended by the Excise, Estate, and Gift Tax Adjustment Act of 1970, section 101(b), 1971-1 C.B. 533, estate tax returns must be filed within 9 months after the date of the decedent's death.

Rev. Rul. 66-286, 1966-2 C.B. 485, sets forth requirements for filing an estate tax return for the estate of a missing person depending upon when the title to the person's property is transferred as if the person was deceased. This may occur by a state court proceeding, the application of a state statute, or the person's property being treated by others as if it were theirs. As Rev. Rul. 66-286 indicates, where the gross estate exceeds the exemption, a return must generally be filed within 15 months following 7 years of continuous and unexplained absence raising the common law presumption of death. The 7-year presumption of death rule referred to in Rev. Rul. 66-286 is a rule that has been adopted by many states, either by statute or court decision. However, where a state statute provides for a different time period, that period will determine when the return is due.

In this case, under state law the taxpayer is presumed to be alive and the taxpayer's property has merely been put into receivership. There is no transfer of title or assets as in Rev. Rul. 66-286. However, if there is a transfer pursuant to a state court decision, the date of death would be indicated thereby. Thus, giving proper regard to the state statutes and court proceedings would allow a period longer than the general rule, and the 7-year requirement of Rev. Rul. 66-286 is not applicable.

HOLDING

The estate tax return is required to be filed within 9 months following the 14-year period specified in the state statute, unless death is established earlier.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 66-286 is clarified, and is modified to indicate the 9-month period for filing a return under section 6075(a) of the Code, as amended.

Part III.—Information Returns
Subpart A.—Information Concerning Persons Subject to Special Provisions

Section 6033.—Returns by Exempt Organizations

26 CFR 1.6033-2: Returns by exempt organizations; taxable years beginning after December 31, 1969.

Exempt organizations that are not required to file Form 990. See Rev. Proc. 80-44, page 777.

Subpart B.—Information Concerning Transactions with Other Persons

Section 6041.—Information at Source

26 CFR 1.6041-1: Return of information as to payments of $600 or more.

Magnetic tape reporting requirements. See Rev. Proc. 80-52, page 828.

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26 CFR 1.6041-2: Return of information as to payments to employees.

Whether fringe benefits that are not wages must be reported on Forms W-2. See Rev. Proc. 80-53, page 848.

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26 CFR 1.6041-4: Returns of information as to foreign items.

Magnetic tape reporting requirements. See Rev. Proc. 80-52, page 828.

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26 CFR 1.6041-5: Information as to actual owner.

Magnetic tape reporting requirements. See Rev. Proc. 80-52, page 828.

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26 CFR 1.6041-7: Permission to submit information required by Form 1099 or W-2 on magnetic tape.

Magnetic tape reporting requirements. See Rev. Proc. 80-52, page 828.

Section 6042.—Returns Regarding Payments of Dividends and Corporate Earnings and Profits

26 CFR 1.6042-2: Returns of information as to dividends paid in calendar years after 1962.

Magnetic tape reporting requirements. See Rev. Proc. 80-52, page 828.

26 CFR 1.6042-3: Dividends subject to reporting.

Magnetic tape reporting requirements. See Rev. Proc. 80-52, page 828.

Section 6043.—Return Regarding Liquidation, Dissolution, Termination, or Contraction

26 CFR 1.6043-2: Return of information regarding distributions in liquidation.

Magnetic tape reporting requirements. See Rev. Proc. 80-52, page 828.

Section 6047.—Information Relating to Certain Trusts and Annuity and Bond Purchase Plans

26 CFR 1.6047-1: Information to be furnished with regard to employee retirement plan covering an owner-employee.

Magnetic tape reporting requirements. See Rev. Proc. 80-52, page 828.

26 CFR 301.6047-1: Information relating to certain trusts and annuity and bond purchase plans.

Magnetic tape reporting requirements. See Rev. Proc. 80-52, page 828.

Section 6049.—Returns Regarding Payments of Interest

26 CFR 1.6049-1: Returns of information as to interest paid in calendar years after 1962 and original issue discount for calendar years after 1970.

Magnetic tape reporting requirements. See Rev. Proc. 80-52, page 828.

Section 6050A.—Reporting Requirements of Certain Fishing Boat Operators

26 CFR 1.6050A-1: Reporting requirements of certain fishing boat operators.

Treatment of certain crewmen on boats engaged in catching fish as self-employed rather than as employees. See T.D. 7716, page 241.

Section 6050B.—Returns Relating to Unemployment Compensation

26 CFR 1.6050B-1: Information returns by person making unemployment compensation payments.

Requirement for persons making unemployment compensation payments to file information returns. See T.D. 7705, page 37.

Part V.—Time for Filing Returns and Other Documents

Section 6073.—Time for Filing Declarations of Estimated Income Tax by Individuals

26 CFR 1.6073-1: Time and place for filing declarations of esimated income tax by individuals.

Estimated tax; beneficiary of farming trust. Income to a beneficiary who receives more than two-thirds of the beneficiary's yearly gross income from a trust that is engaged solely in the business of farming is considered to be gross income from farming for estimated tax purposes; Rev. Rul. 63-26 modified.

Rev. Rul. 80-366

ISSUE

Is income to a beneficiary from a trust that is engaged in the business of farming considered to be gross income from farming to the beneficiary for estimated tax purposes?

FACTS

A is the beneficiary of a trust described in section 651 of the Internal Revenue Code that is engaged solely in the business of farming. *A* does not participate in the operation or management of the farm. For 1978, more than two-thirds of *A*'s gross income was attributable to payments from the trust. *A* is a calendar year taxpayer.

LAW AND ANALYSIS

Section 652(a) of the Code provides that beneficiaries of trusts must include in income the amount required to be distributed to them whether or not distributed.

Section 652(b) of the Code provides that the amounts distributed to the beneficiary shall have the same character in the hands of the beneficiary as in the hands of the trust.

Section 6015(f)(1) of the Code and the regulations thereunder provide that if an individual referred to in section 6073(b) files a return for the taxable year for which the declaration is required on or before March 1 of the succeeding taxable year, and pays in full at the time of filing the amount computed on the return as payable, such return shall be considered a declaration of estimated tax.

Section 6073(b) of the Code concerns individuals whose estimated gross income from farming or fishing for the taxable year is at least two-thirds of their estimated gross income from all sources for the taxable year.

Section 1.6073-1(b) of the Income Tax Regulations provides that estimated gross income from farming is the estimated income from oyster farming, the cultivation of the soil, the raising or harvesting of any agricultural or horticultural commodities and the raising of livestock, bees, or poultry. The regulation also provides that the requisite gross income from farming must be derived from the operations of a stock, dairy, poultry, fruit, or truck farm, or plantation, ranch, nursery, range, orchard, or oyster bed. If an individual receives for the use of the land income in the form of a share of the crops produced thereon, such income is from farming.

The legilsative history of section 60(a) of the Internal Revenue Code of 1939, the predecessor of section 6073(b) of the 1954 Code, indicates that it was created in recognition of the difficulty of accurately estimating early in the tax year the amount of income derived from farm operations since unexpected crop failures and market prices may have a drastic bearing on the result of farming operations. See H. Rep. No. 78-401, 78th Cong., 1st Sess. 36 (1943) 1943 C.B. 1283, 1310. The income of a beneficiary of a trust described in section 651 that is engaged in farming is as variable and as

difficult to estimate as that of a person actively involved in farming operations.

Under Section 652(b) of the Code, income from farming to a trust described in section 651 is considered income from farming to the trust's beneficiary.

Rev. Rul. 63-26, 1963-1 C.B. 295, concerns whether gains from the sale of livestock held for draft, breeding, or dairy purposes, and gains from the sale of farm land and depreciable farm equipment constitute gross income from farming for purposes of section 6073(b) of the Code. In resolving these questions the ruling appropriately referred to the definition contained in section 1.175-5(a)(2) of the Income Tax Regulations. However, since section 175 and section 6073(b) have different objectives, the definition of gross income from farming for purposes of section 175 will not, in all instances, apply for purposes of section 6073(b). Accordingly, Rev. Rul. 63-26 is modified to remove the implication that the same meaning is attributable to that term in interpreting both section 175 and section 6073(b).

HOLDING

Income to a beneficiary from a trust that is engaged in the business of farming is considered to be gross income from farming to the beneficiary for estimated tax purposes.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 63-26 is modified.

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26 CFR 1.6073-1: Time and place for filing declarations of estimated income tax by individuals.

T.D. 7719

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Time for filing declarations of estimated income tax by farmers, fishermen, and certain nonresident aliens

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to the time for filing estimated income tax by farmers, fishermen, and certain nonresident aliens. Changes to the applicable tax law were made by the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1] and the Act of November 10, 1978 [Pub. L. 95-628, 1978-2 C.B. 435]. These amendments to the regulations specify the dates for filing declarations of tax in a timely manner and thereby provide the public with needed guidance to comply with the Acts.

DATES: The amendment relating to the time for farmers and fishermen to file declarations of estimated tax is effective for taxable years beginning after November 10, 1978. The amendment relating to the time for nonresident aliens to file declarations of estimated tax is effective for taxable years beginning after December 31, 1976.

FOR FURTHER INFORMATION CONTACT: Claudine Ausness of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:LR:T) (202-566-3459).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On May 21, 1980, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 6073 of the Internal Revenue Code of 1954. These amendments were proposed to conform the regulations to section 1012(c) of the Tax Reform Act of 1976 (90 Stat. 1614) [*supra* at 90] and section 7 of the Act of November 10, 1978 (Pub. L. 95-628, 92 Stat. 3630) [*supra* at 437]. The one written comment received raised an issue unrelated to the proposed regulation changes and no public hearing was requested or held. The proposed amendment is adopted by this Treasury decision without change.

EXPLANATION OF PROVISIONS

The amendment made by the Tax Reform Act provides that, in the case of nonresident aliens who are not subject to wage withholding, the due date for filing a declaration of estimated tax for the current taxable year is not earlier than the due date for filing an income tax return for the preceding taxable year. The amendment made by the Act of November 10, 1978, provides an additional exception for farmers and fishermen to the quarterly requirements relating to declarations of estimated tax. The regulations adopted by this Treasury decision reflect these statutory changes.

The regulations adopted by this Treasury decision impose no new reporting burdens or recordkeeping requirements. Evaluation of the effectiveness of these regulations will be based upon comments received from members of Congress, offices within Treasury and the Internal Revenue Service, other governmental services, and the public.

DRAFTING INFORMATION

The principal author of this regulation is Claudine Ausness of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, the following amend-

ments to 26 CFR Part 1 are hereby adopted:

Paragraph 1. Section 1.6073-1 is amended by revising subparagraph (1) of paragraph (b), by redesignating paragraphs (c) and (d) as paragraphs (d) and (e), respectively, and by adding a new paragraph (c). These revised and added provisions read as follows:

§ 1.6073-1 Time and place for filing declarations of estimated [income] tax by individuals.

* * * * *

(b) *Farmers or fishermen*—(1) *In general.* In the case of an individual on a calendar year basis—

(i) If at least two-thirds of the individual's total estimated gross income from all sources for the calendar year is from farming or fishing (including oyster farming), or

(ii) If at least two-thirds of the individual's total gross income from all sources shown on the return for the preceding taxable year was from farming or fishing (including oyster farming) (with respect to declarations of estimated tax for taxable years beginning after November 10, 1978),

he may file a declaration of estimated tax on or before the 15th day of January of the succeeding calendar year in lieu of the time prescribed in paragraph (a) of this section. For the filing of a return in lieu of a declaration, see paragraph (a) of § 1.6015-1.

* * * * *

(c) *Nonresident aliens.* Notwithstanding the provisions of paragraph (a) of this section, for taxable years beginning after December 31, 1976, in the case of a nonresident alien described in section 6072(c) (relating to returns of nonresident aliens whose wages are not subject to withholding) whose estimated gross income for the calendar year meets the requirements of section 6015(a), a declaration of estimated tax for the calendar year need not be made before June 15th of such calendar year.

* * * * *

Par. 2. Section 1.6073-2 is amended by revising paragraphs (b) and (c) to read as follows:

§ 1.6073-2 Fiscal years.

* * * * *

(b) *Farmers or fishermen.* In the case of an individual on a fiscal year basis—

(1) If at least two-thirds of the individual's total estimated gross income from all sources for the fiscal year is from farming or fishing (including oyster farming), or

(2) If at least two-thirds of the individual's total gross income from all sources shown on the return for the preceding taxable year was from farming or fishing (including oyster farming) (with respect to declarations of estimated tax for taxable years beginning after November 10, 1978),

he may file a declaration on or before the 15th day of the month immediately following the close of his taxable year, in lieu of the time prescribed in paragraph (a) of this section.

(c) *Nonresident aliens.* Notwithstanding the provisions of paragraph (a) of this section, in the case of a nonresident alien described in section 6072(c) (relating to returns of nonresident aliens whose wages are not subject to withholding) whose anticipated income for the fiscal year meets the requirements of section 6015(a), § 1.6015(a)-1, and § 1.6015(i)-1, the declaration of estimated tax for the fiscal year need not be filed before the 15th day of the 6th month of such fiscal year.

Par. 3. Section 1.6073-3 is amended by revising paragraphs (b) and (c) to read as follows:

§ 1.6073-3 Short taxable years.

* * * * *

(b) *Farmers or fishermen.* In the case of an individual—

(1) Whose current taxable year is a short taxable year and whose estimated gross income from farming or fishing (including oyster farming) is at least two-thirds of his total estimated gross income from all sources for such current taxable year, or

(2) Whose taxable year preceding the current taxable year was a short taxable year and whose gross income from farming or fishing (including oyster farming) was at least two-thirds of the total gross income from all sources shown on the return for such preceding short taxable year (with respect to declarations of estimated tax for taxable years beginning after November 10, 1978),

he may file a declaration of estimated tax on or before the 15th day of the month immediately following the close of the current taxable year, in lieu of the time prescribed in paragraph (a) of this section.

(c) *Nonresident aliens.* Notwithstanding the provisions of paragraph (a) of this section, in the case of a short taxable year, a nonresident alien described in section 6072(c) (relating to returns of nonresident aliens whose wages are not subject to withholding) whose anticipated income for the short taxable year meets the requirements of section 6015(a), § 1.6015(a)-1, § 1.6015(g)-1, and § 1.6015(i)-1 on or before the 1st day of the 6th month following the beginning of such year need not file a declaration of estimated tax before the 15th day of the 6th month following the beginning of such year.

This Treasury decision is issued under the authority contained in section 6073(d) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 750, 917; 26 U.S.C. 6073(d) and 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved August 27, 1980.

EMIL M. SUNLEY,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 12, 1980, 8:45 a.m., and published in the issue of the Federal Register for September 15, 1980, 45 F.R. 60902)

Section 6075.—Time for Filing Estate and Gift Tax Returns

26 CFR 20.6075-1: Returns; time for filing estate tax return.

Filing of an estate tax return for the estate of a missing person when there can be no court adjudication of death until the elapse of 14 years from the disappearance. See Rev. Rul. 80-347, page 342.

Subchapter B.—Miscellaneous Provisions

Section 6103.—Confidentiality and Disclosure of Returns and Return Information

26 CFR 301.6103(a)-1: Disclosures after December 31, 1976 by officers and employees of Federal agencies of returns and return information (including taxpayer return information) disclosed to such officers and employees by the Internal Revenue Service before January 1, 1977 for a purpose not involving tax administration.

T.D. 7723 [1]

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER B, PART 301.—REGULATIONS ON PROCEDURE AND ADMINISTRATION; PART 404.—TEMPORARY REGULATIONS UNDER THE TAX REFORM ACT OF 1976; PART 420.—TEMPORARY REGULATIONS UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

Disclosures of returns and return information

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to disclosures of returns and return information under certain circumstances. These regulations affect disclosures of such returns and return information for such purposes as are described herein.

DATES: The regulations apply to disclosures of returns and return information made after October 3, 1980.

FOR FURTHER INFORMATION CONTACT: David E. Dickinson of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. Attention: CC:LR:T, 202-566-3218, not a toll-free call.

SUPPLEMENTARY INFORMATION

BACKGROUND

On March 24, 1980, the Federal Register published proposed regulations on section 6103 of the Internal Revenue Code of 1954, relating to disclosures of returns and return information (45 FR 18986). Three comments on these proposed regulations were received, but no public hearing was requested or held.

This Treasury decision adopts the regulations as proposed with changes to §§ 301.6103(l)(2)-3 and 301.6103(n)-1 described below.

PROVISIONS OF THE REGULATIONS

Sections 301.6103(a)-1 and 301.6103(a)-2

Prior to its amendment by section 1202 of the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1, 143], effective as of January 1, 1977, section 6103(a) of the Code authorized the disclosure of Federal tax data by the Internal Revenue Service to other Federal agencies for nontax related purposes as provided by orders of the President and implementing rules and regulations approved by the President. Section 301.6103(a)-1 provides that returns and return information so disclosed by the Service to another Federal agency before January 1, 1977 pursuant to the authority of prior law (and orders of the President and implementing rules and regulations) may, with one restriction, be disclosed after December 31, 1976 by such agency for any purpose authorized by such prior law (and orders, rules, and regulations). The restriction on such further disclosure is use of such returns or return information after December 31, 1976, by, or on behalf of, the Federal agency in an administrative or judicial proceeding. Such use is restricted to an administrative or judicial proceeding described in section 6103(i)(4) and then only if the requirements of section 6103(i)(4) are first met.

Prior to amendment by the Tax Reform Act of 1976, the Code authorized disclosures of tax returns and tax return information to Justice Department attorneys and Internal Revenue Service Chief Counsel personnel for Federal tax administration purposes as provided by Presidentially approved regulations. A substantial volume of tax returns and tax return information furnished to these attorneys and personnel for tax administration purposes under prior law and regulations was in their possession on January 1, 1977, the effective date of the new statutory disclosure rules of the Act.

Section 301.6103(a)-2 provides that, as a general rule, tax returns and tax return information furnished to these persons under prior law for Federal tax administration purposes may be used by them after December 31, 1976 for tax administration purposes authorized by prior law. However, if any such tax returns or tax return information is to be introduced into evidence in tax litigation after that date, the

[1] This publication of the Treasury Decision contains the complete text of the amendments to the regulations. The instructions for modifying the notice of proposed rulemaking have been omitted.

statutory relevancy tests prescribed by the new law must first be met.

Section 301.6103(c)-1

The Tax Reform Act of 1976 amended section 6103(c) of the Code to permit disclosures of tax returns and tax return information to a person designated by the taxpayer in a written request or consent. Paragraph (a) of § 301.6103(c)-1 prescribes rules governing the necessary form and content of these written requests or consents. Paragraph (b) of § 301.6103(c)-1 prescribes rules for disclosures to a person who has been requested by the taxpayer to obtain information or provide assistance concerning a contact between the taxpayer and the Service.

Section 301.6103(h)(2)-1

This Treasury decision amends § 301.6103(h)(2)-1 of existing regulations to conform them to certain amendments made to section 6103(h)(2) of the Code by section 503 of the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1, 113]. First, the section is amended to make the requirements of section 6103(h)(2), rather than those of section 6103(h)(4), applicable to the use of returns and return information in Federal grand jury proceedings involving tax administration. Second, the section is amended to authorize Service disclosures of returns and return information to "officers and employees" of the Department of Justice as opposed to the more limited category of "attorneys" as provided by prior law.

Section 301.6103(i)-1

This section of the regulations describes the circumstances and conditions under which returns and return information may be disclosed to and by officers and employees of the Department of Justice and other Federal agencies in connection with preparation for, or investigations which may result in, proceedings pertaining to the enforcement of specifically designated Federal criminal statutes (not involving tax administration) to which the United States or a Federal agency is or may be a party. This section also makes it clear that use of returns and return information by the Department of Justice in Federal grand jury proceedings is governed by the requirements of section 6103(i)(1) or (2) of the Code rather than those of section 6103(i)(4).

Section 301.6103(j)(2)-1

This section of the regulations provides rules governing disclosures of return information to certain officers and employees of the Federal Trade Commission for statistical purposes and related activities authorized by section 6103(j)(2) of the Code.

The regulations describe in detail the particular return information which the Service will disclose to officers and employees of the Division of Financial Statistics of the Bureau of Economics of the Federal Trade Commission for use in statistical programs and related activities authorized by law. The regulations also prescribe the procedures to be followed with respect to requested disclosures of return information and the limited extent to which such return can be redisclosed and provide that the confidentiality of return information disclosed as provided by the regulations must be protected to the satisfaction of the Service.

Section 301.6103(k)(6)-1

This section of the regulations provides rules governing disclosures of return information by officers and employees of the Service and Office of the Chief Counsel thereof for investigative purposes authorized by section 6103(k)(6) of the Code.

The regulations describe the circumstances and conditions under which such officers or employees are authorized to disclose return information to a person other than the taxpayer to whom such return information relates (or such taxpayer's representative) in connection with official duties relating to an examination, collection activity, civil or criminal investigation, enforcement activity, or other offense under the internal revenue laws or relating to certain personnel or claimant representative matters under such laws or 31 U.S.C. 1026.

Sections 301.6103(l)(2)-1, 301.6103(l)(2)-2 and 301.6103(l)(2)-3

These sections of the regulations under section 6103(l)(2) of the Code provide rules regarding disclosures of returns and return information to and by officers and employees of the Department of Labor, the Pension Benefit Guaranty Corporation, and the Department of Justice for purposes of administering titles I and IV of the Employee Retirement Income Security Act of 1974 [Pub. L. 93-406, 1974-3 C.B. 1, 172]. The section also makes it clear that returns and return information may be used by the Department of Justice in Federal grand jury proceedings where necessary to enforce the Act.

In response to a comment received, § 301.6103(l)(2)-3(a)(9), (21), and (22), as proposed, is revised, three additional categories of return information subject to automatic disclosure by the Service are added to § 301.6103(l)(2)-3(a), and § 301.6103(l)(2)-3(b)(3) is revised to require that requests for disclosures of additional returns and return information to officers and employees of the Department of Labor and Pension Benefit Guaranty Corporation identify such officers and employees only by title rather than by name and title. These changes are designed to further enhance compliance programs under titles I and IV of the Act.

Section 301.6103(n)-1

These regulations describe the circumstances and conditions under which an officer or employee of the Treasury Department (including the

Internal Revenue Service), a State tax agency described in section 6103 (d), or the Social Security Administration is authorized under section 6103(n) of the Code to disclose returns and return information to a person for the purpose of procuring property and services necessary to Federal or State tax administration. The regulations provide general rules regarding the requirement of necessity for the disclosure and limiting the extent to which such disclosures are authorized. The regulations also provide that the person to whom disclosures are made for these purposes may in turn disclose the tax data only for purposes specified by section 6103 (n) and must maintain, to the satisfaction of the Service, safeguards to protect the confidentiality of the returns and return information and ensure against unauthorized disclosures.

As proposed, § 301.6103(n)-1(d) failed to specify that the terms of a contract between the Social Security Administration and its contractor provide, or be amended to provide, that the contractor is to comply with the safeguard requirements described in that paragraph. As adopted, § 301.6103(n)-1(d) makes this clear.

Section 301.6103(p)(2)(B)-1

Under section 6103 of the Code, a substantial volume of tax returns and tax return information is disclosable by the Service to other Federal agencies for purposes authorized or required by section 6103. It is likely that much of this tax information otherwise disclosable directly by the Service to yet other agencies as authorized or required by section 6103 may be more readily available from the intermediate Federal agency than the Service. For this reason, § 301.6103(p)(2)(B)-1 permits the Service to authorize disclosures of tax returns and tax return information by the intermediate Federal agency to other agencies to whom section 6103 otherwise authorizes or requires disclosures directly by the Service. Under this regulation, however, the Service retains the authority to impose, by regulation or otherwise, such restrictions on these disclosures as the Service may deem appropriate to properly protect the confidentiality of the information to be disclosed consistent with the requirements of section 6103. Further, this regulation imposes upon the head of the disclosing Federal agency the duty to maintain records of disclosures made under this regulation in order to meet the reporting requirements of section 6103(p)(3)(B) and (C).

DRAFTING INFORMATION

The principal author of these regulations was David E. Dickinson of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, the following amendments to 26 CFR Parts 301, 404, and 420 are hereby adopted:

REGULATIONS ON PROCEDURE AND ADMINISTRATION

(26 CFR Part 301)

Paragraph 1. The following new sections are added immediately after § 301.6102-1:

§ 301.6103(a)-1 Disclosures after December 31, 1976 by officers and employees of Federal agencies of returns and return information (including taxpayer return information) disclosed to such officers and employees by the Internal Revenue Service before January 1, 1977 for a purpose not involving tax administration.

(a) *General rule.* Except as provided by paragraph (b) of this section, a return or return information (including taxpayer return information), as defined in section 6103(b)(1), (2), and (3) of the Internal Revenue Code, disclosed by the Internal Revenue Service before January 1, 1977, to an officer or employee of a Federal agency (as defined in section 6103(b)(9)) for a purpose not involving tax administration (as defined in section 6103(b)(4)) pursuant to the authority of section 6103 (or any order of the President under section 6103 or rules and regulations thereunder prescribed by the Secretary or his delegate and approved by the President) before amendment of such section by section 1202 of the Tax Reform Act of 1976 (Pub. L. 94-455, 90 Stat. 1667) [1976-3 C.B. (Vol. 1) 1, 143] may be disclosed by, or on behalf of, such officer, employee, or agency after December 31, 1976, for any purpose authorized by such section (or such order or rules and regulations) before such amendment.

(b) *Exception.* Notwithstanding the provisions of paragraph (a) of this section, a return or return information (including taxpayer return information) disclosed before January 1, 1977, by the Service to an officer or employee of a Federal agency for a purpose unrelated to tax administration as described in paragraph (a) may, after December 31, 1976, be disclosed by, or on behalf of, such agency, officer, or employee in an administrative or judicial proceeding only if such proceeding is one described in section 6103(i)(4) of the Code and if the requirements of section 6103(i)(4) have first been met.

§ 301.6103(a)-2 Disclosures after December 31, 1976 by attorneys of the Department of Justice and officers and employees of the Office of the Chief Counsel for the Internal Revenue Service of returns and return information (including taxpayer return information) disclosed to such attorneys, officers, and employees by

the Service before January 1, 1977 for a purpose involving tax administration.

(a) *General rule.* Except as provided by paragraph (b) of this section and subject to the requirements of this paragraph, a return or return information (including taxpayer return information), as defined in section 6103(b)(1), (2), and (3), of the Internal Revenue Code disclosed by the Internal Revenue Service before January 1, 1977, to an attorney of the Department of Justice (including a United States attorney) or to an officer or employee of the Office of the Chief Counsel for the Service for a purpose involving tax administration (as defined in section 6103(b)(4)) pursuant to the authority of section 6103 (or any order of the President under section 6103 or rules and regulations thereunder prescribed by the Secretary or his delegate and approved by the President) before amendment of such section by section 1202 of the Tax Reform Act of 1976 (Pub. L. 94-455, 90 Stat. 1667 [1976-3 C.B. (Vol. 1) 1, 143]) may be disclosed by, or on behalf of, such attorney, officer, or employee after December 31, 1976, for any purpose authorized by such section (or such order or rules and regulations) before such amendment.

(b) *Exception.* Notwithstanding the provisions of paragraph (a) of this section, a return or return information (including taxpayer return information) disclosed before January 1, 1977, by the Service to an attorney of the Department of Justice or to an officer or employee of the Office of the Chief Counsel for the Service for a purpose related to tax administration as described in paragraph (a) may, after December 31, 1976, be disclosed by, or on behalf of, such attorney, officer, or employee in an administrative or judicial proceeding only if such proceeding is one described in section 6103(h)(4) of the Code and if the requirements of section 6103(h)(4) have first been met.

§ 301.6103(c)-1 Disclosure of returns and return information (including taxpayer return information) to designee of taxpayer.

(a) *Disclosure of returns and return information (including taxpayer return information) to person or persons designated in a written request or consent.* Section 6103(c) of the Internal Revenue Code applies to disclosures of a return or return information (including taxpayer return information) to a person designated in a written request for or consent to disclosure. A request for or consent to disclosure must be in the form of a written document pertaining solely to the authorized disclosure. The written document must be signed and dated by the taxpayer who filed the return or to whom the return information relates. The taxpayer must also indicate in the written document—

(1) The taxpayer's taxpayer identity information described in section 6103(b)(6);

(2) The identity of the person to whom disclosure is to be made;

(3) The type of return (or specified portion of the return) or return information (and the particular data) that is to be disclosed; and

(4) The taxable year covered by the return or return information.

Thus, for example, a provision included in a taxpayer's application for a loan or other benefit authorizing the Internal Revenue Service to disclose to the grantor of the loan or other benefit such returns or return information as the grantor may request for purposes of verifying information supplied on the application does not meet the requirements of this paragraph. The disclosure of a return or return information authorized by a request for or consent to the disclosure shall not be made unless the request or consent is received by the Service within 60 days following the date upon which the request or consent was signed and dated by the taxpayer.

(b) *Disclosure of returns and return information (including taxpayer return information) to designee of taxpayer to comply with request for information or assistance.* Section 6103(c) of the Code applies to requests made by the taxpayer to other persons (for example, members of Congress, friends or relatives of the taxpayer, and, when not acting as a taxpayer's representative, income tax return preparers) for information or assistance relating to the taxpayer's return or a transaction or other contact between the taxpayer and the Service.

The taxpayer's request for information or assistance must be in the form of a letter or other written document signed and dated by the taxpayer. The taxpayer must also indicate in the written request—

(1) The taxpayer's taxpayer identity information described in section 6103(b)(6);

(2) The identity of the person to whom disclosure is to be made; and

(3) Sufficient facts underlying the request for information or assistance to enable the Service to determine the nature and extent of the information or assistance requested and the returns or return information to be disclosed in order to comply with the taxpayer's request.

A return or return information will be disclosed to the taxpayer's designee as provided by this paragraph only to the extent considered necessary by the Service to comply with the taxpayer's request for information or assistance. This paragraph does not apply to disclosures to a taxpayer's representative in connection with practice before the Service (as defined in Treasury Department Circular No. 230). For disclosures in these cases, see § 601.502(c) of this chapter.

(c) *Exceptions.* A disclosure of return information shall not be made under this section if the Service determines that the disclosure would seri-

ously impair Federal tax administration (as defined in section 6103(b)(4) of the Code).

Par. 2. Section 301.6103(h)(2)-1 is amended to read as follows:

§ 301.6103(h)(2)-1 Disclosure of returns and return information (including taxpayer return information) to and by officers and employees of the Department of Justice for use in Federal grand jury proceeding, or in preparation for proceeding or investigation, involving tax administration.

(a) *Disclosure of returns and return information (including taxpayer return information) to and by officers and employees of the Department of Justice.* (1) Returns and return information (including taxpayer return information), as defined in section 6103(b)(1), (2), and (3) of the Internal Revenue Code, shall, to the extent provided by section 6103(h)(2)(A), (B), and (C) and subject to the requirements of section 6103(h)(3), be open to inspection by or disclosure to officers and employees of the Department of Justice (including United States attorneys) personally and directly engaged in, and for their necessary use in, any Federal grand jury proceeding, or preparation for any proceeding (or for their necessary use in an investigation which may result in such a proceeding) before a Federal grand jury or any Federal or State court, in a matter involving tax administration (as defined in section 6103(b)(4)), including any such proceeding (or any such investigation) also involving the enforcement of a related Federal criminal statute which has been referred by the Secretary to the Department of Justice.

(2) Returns and return information (including taxpayer return information) inspected by or disclosed to officers and employees of the Department of Justice as provided in paragraph (a)(1) of this section may also be used by such officers and employees or disclosed by them to other officers and employees (including United States attorneys and supervisory personnel, such as Section Chiefs, Deputy Assistant Attorneys General, Assistant Attorneys General, the Deputy Attorney General, and the Attorney General), of the Department of Justice where necessary—

(i) In connection with any Federal grand jury proceeding, or preparation for any proceeding (or with an investigation which may result in such a proceeding), described in paragraph (a)(1), or

(ii) In connection with any Federal grand jury proceeding, or preparation for any proceeding (or with an investigation which may result in such a proceeding), described in paragraph (a)(1) which also involves enforcement of a specific Federal criminal statute other than one described in paragraph (a)(1) to which the United States is or may be a party, provided such matter involves or arises out of the particular facts and circumstances giving rise to the proceeding (or investigation) described in paragraph (a)(1) and further provided the tax portion of such proceeding (or investigation) has been duly authorized by or on behalf of the Assistant Attorney General for the Tax Division of the Department of Justice, pursuant to the request of the Secretary, as a proceeding (or investigation) described in paragraph (a)(1).

If, in the course of a Federal grand jury proceeding, or preparation for a proceeding (or the conduct of an investigation which may result in such a proceeding), described in subdivision (ii) of this subparagraph, the tax administration portion thereof is terminated for any reason, any further use or disclosure of such returns or taxpayer return information in such Federal grand jury proceeding, or preparation or investigation, with respect to the remaining portion may be made only pursuant to, and upon the grant of, a court order as provided by section 6103(i)(1)(A), provided, however, that the returns and taxpayer return information may in any event be used for purposes of obtaining the necessary court order.

(b) *Disclosure of returns and return information (including taxpayer return information) by officers and employees of the Department of Justice.* (1) Returns and return information (including taxpayer return information), as defined in section 6103(b)(1), (2), and (3) of the Code, inspected by or disclosed to officers and employees of the Department of Justice as provided by paragraph (a) of this section may be disclosed by such officers and employees to other persons, including, but not limited to, persons described in paragraph (b)(2), but only to the extent necessary in connection with a Federal grand jury proceeding, or the proper preparation for a proceeding (or in connection with an investigation which may result in such a proceeding), described in paragraph (a). Such disclosures may include, but are not limited to, disclosures—

(i) To properly accomplish any purpose or activity of the nature described in section 6103(k)(6) and the regulations thereunder which is essential to such Federal grand jury proceeding, or to such proper preparation (or to such investigation);

(ii) To properly interview, consult, depose, or interrogate or otherwise obtain relevant information from, the taxpayer to whom such return or return information relates (or such taxpayer's legal representative) or from any witness who may be called to give evidence in the proceeding; or

(iii) To properly conduct negotiations concerning, or obtain authorization for, settlement or disposition of the proceeding, in whole or in part, or stipulations of fact in connection with the proceeding.

Disclosure of a return or return information to a person other than the taxpayer to whom such return or return

information relates or such taxpayer's legal representative to properly accomplish any purpose or activity described in this paragraph should be made, however, only if such purpose or activity cannot otherwise properly be accomplished without making such disclosure.

(2) Among those persons to whom returns and return information may be disclosed by officers and employees of the Department of Justice as provided by paragraph (a)(1) of this section are—

(i) Other officers and employees of the Department of Justice, such as personnel of an office, board, division, or bureau of such department (for example, the Federal Bureau of Investigation or the Drug Enforcement Administration), clerical personnel (for example, secretaries, stenographers, docket and file room clerks, and mail room employees) and supervisory personnel (such as supervisory personnel of the Federal Bureau of Investigation or the Drug Enforcement Administration);

(ii) Officers and employees of another Federal agency (as defined in section 6103(b)(9)) working under the direction and control of any such officers and employees of the Department of Justice; and

(iii) Court reporters.

Par. 3. The following new sections are added immediately after § 301.-6103(h)(2)-1:

§ 301.6103(i)-1 Disclosure of returns and return information (including taxpayer return information) to and by officers and employees of the Department of Justice or another Federal agency for use in Federal grand jury proceeding, or preparation for proceeding or investigation, involving enforcement of Federal criminal statute not involving tax administration.

(a) *Disclosure of returns and return information (including taxpayer return information) to officers and employees of the Department of Justice or another Federal agency.* Returns and return information (including taxpayer return information), as defined in section 6103(b)(1), (2), and (3) of the Internal Revenue Code, shall, to the extent provided by section 6103(i)(1), (2), and (3) and subject to the requirements of section 6103(i)(1) and (2), be open to inspection by or disclosure to officers and employees of the Department of Justice (including United States attorneys) or of another Federal agency (as defined in section 6103(b)(9)) personally and directly engaged in, and for their necessary use in, any Federal grand jury proceeding, or preparation for any administration or judicial proceeding (or their necessary use in an investigation which may result in such a proceeding), pertaining to enforcement of a specifically designated Federal criminal statute not involving or related to tax administration to which the United States or such agency is or may be a party.

(b) *Disclosure of returns and return information (including taxpayer return information) by officers and employees of the Department of Justice or another Federal agency.* (1) Returns and return information (including taxpayer return information), as defined in section 6103(b)(1), (2), and (3) of the Code, disclosed to officers and employees of the Department of Justice or other Federal agency (as defined in section 6103(b)(9)) as provided by paragraph (a) of this section may be disclosed by such officers and employees to other persons, including, but not limited to, persons described in subparagraph (2) of this paragraph, but only to the extent necessary in connection with a Federal grand jury proceeding, or the proper preparation for a proceeding (or in connection with an investigation which may result in such a proceeding), described in paragraph (a). Such disclosures may include, but are not limited to, disclosures where necessary—

(i) To properly obtain the services of persons having special knowledge or technical skills (such as, but not limited to, handwriting analysis, photographic development, sound recording enhancement, or voice identification);

(ii) To properly interview, consult, depose, or interrogate or otherwise obtain relevant information from, the taxpayer to whom such return or return information relates (or such taxpayer's legal representative) or any witness who may be called to give evidence in the proceeding; or

(iii) To properly conduct negotiations concerning, or obtain authorization for, disposition of the proceeding, in whole or in part, or stipulations of fact in connection with the proceeding.

Disclosure of a return or return information to a person other than the taxpayer to whom such return or return information relates or such taxpayer's legal representative to properly accomplish any purpose or activity described in this subparagraph should be made, however, only if such purpose or activity cannot otherwise properly be accomplished without making such disclosures.

(2) Among those persons to whom returns and return information may be disclosed by officers and employees of the Department of Justice or other Federal agency as provided by subparagraph (1) of this paragraph are—

(i) Other officers and employees of the Department of Justice (including an office, board, division, or bureau of such department, such as the Federal Bureau of Investigation or the Drug Enforcement Administration) or other Federal agency described in subparagraph (1), such as clerical personnel (for example, secretaries, stenographers, docket and file room clerks, and mail room employees) and supervisory personnel (for example, in the case of the Department of Justice, Section Chiefs, Deputy Assistant Attorneys General, Assistant Attorneys General, the Deputy Attorney General, the Attorney General, and supervisory per-

sonnel of the Federal Bureau of Investigation or the Drug Enforcement Administration);

(ii) Officers and employees of another Federal agency (as defined in section 6103(b)(9)) working under the direction and control of such officers and employees of the Department of Justice or other Federal agency described in subparagraph (1); and

(iii) Court reporters.

§ 301.6103(j)(2)-1 Disclosure of return information to officers and employees of the Federal Trade Commission for certain statistical purposes and related activities.

(a) *General rule.* (1) Pursuant to the provisions of section 6103(j)(2) of the Internal Revenue Code and subject to the requirements of paragraph (b) of this section, officers or employees of the Internal Revenue Service will disclose the following return information (as defined by section 6103(b)(2) but not including return information described in section 6103(o)(2)) reflected on the return of a corporation with respect to the tax imposed by chapter 1 to officers and employees of the Division of Financial Statistics of the Bureau of Economics of the Federal Trade Commission for purposes of, but only to the extent necessary in, developing and preparing, as authorized by law, the Quarterly Financial Report —

(i) From the business master files of the Service—

(A) Taxpayer identity information (as defined in section 6103(b)(6)),

(B) Consolidated return and final return indicators,

(C) Principal industrial activity code,

(D) Partial year indicator,

(E) Annual accounting period,

(F) Gross receipts less returns and allowances,

(G) Net income or loss,

(H) Total assets; and

(ii) From Form SS-4—

(A) Month and year in which such form was executed,

(B) Taxpayer identity information; and

(C) Principal industrial activity, geographic, firm size, and reason for application codes.

(2) Subject to the requirements of paragraph (b) of this section and § 301.6103(p)(2)(B)-1, officers or employees of the Social Security Administration to whom the following return information reflected on Form SS-4 with respect to a corporation has been disclosed as provided by section 6103(l)(1)(A) may disclose such return information to officers and employees of the Division of Financial Statistics of the Bureau of Economics of the Federal Trade Commission for a purpose described in subparagraph (1) of this paragraph—

(i) Month and year in which such form was executed;

(ii) Taxpayer identity information; and

(iii) Principal industrial activity, geographic, firm size, and reason for application codes.

(b) *Procedures and restrictions.* Disclosure of return information by officers or employees of the Service or the Social Security Administration as provided by paragraph (a) of this section will be made only upon written request to the Commissioner of Internal Revenue by the Chairman of the Federal Trade Commission describing the particular return information to be disclosed and the taxable period or date to which such return information relates and designating by name and title the officers and employees of the Division of Financial Statistics of the Bureau of Economics to whom such disclosure is authorized. No such officer or employee to whom return information is disclosed pursuant to the provisions of paragraph (a) shall disclose such return information to any person, other than the taxpayer to whom such return information relates or other officers or employees of such division whose duties or responsibilities require such disclosure for a purpose described in paragraph (a), except in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer. If the Service determines that the division, or any officer or employee thereof, has failed to, or does not, satisfy the requirements of section 6103(p)(4) of the Code or regulations or published procedures thereunder, the Service may take such actions as are deemed necessary to ensure that such requirements are or will be satisfied, including suspension of disclosures of return information otherwise authorized by section 6103(j)(2) and paragraph (a) of this section until the Service determines that such requirements have been or will be satisfied.

§ 301.6103(k)(6)-1 Disclosure of return information by internal revenue officers and employees for investigative purposes.

(a) *Disclosure of taxpayer identity information and fact of investigation in connection with official duties relating to examination, collection activity, civil or criminal investigation, enforcement activity, or other offense under the internal revenue laws.* In connection with the performance of official duties relating to any examination, collection activity, civil or criminal investigation, enforcement activity, or other offense under the internal revenue laws, or in connection with preparation for any proceeding (or investigation which may result in such a proceeding) described in section 6103(h)(2) of the Internal Revenue Code, an officer or employee of the Internal Revenue Service or Office of the Chief Counsel therefor is authorized to disclose taxpayer identity information (as defined in section 6103(b)(6)), the fact that the inquiry pertains to the performance of official duties, and the nature of the official duties in order to obtain necessary information relating to performance of such official duties or where necessary in order to properly accomplish any activity described in subparagraph (6) of paragraph (b) of this section. Disclosure

of taxpayer identity information to a person other than the taxpayer to whom such taxpayer identity information relates or such taxpayer's legal representative for the purpose of obtaining such necessary information or otherwise properly accomplishing such activities as authorized by this paragraph should be made, however, only if the necessary information cannot, under the facts and circumstances of the particular case, otherwise reasonably be obtained in accurate and sufficiently probative form, or in a timely manner, and without impairing the proper performance of the official duties, or if such activities cannot otherwise properly be accomplished without making such disclosure.

(b) *Disclosure of return information in connection with official duties relating to examination, collection activity, civil or criminal investigation, enforcement activity, or other offense under the internal revenue laws.* In connection with the performance of official duties relating to any examination, collection activity, civil or criminal investigation, enforcement activity, or other offense under the internal revenue laws, an officer or employee of the Service or Office of the Chief Counsel therefor is authorized to disclose return information (as defined in section 6103(b)(2)) in order to obtain necessary information relating to the following—

(1) To establish or verify the correctness or completeness of any return (as defined in section 6103(b)(1) of the Code) or return information;

(2) To determine the responsibility for filing a return, for making a return where none has been made, or for performing such acts as may be required by law concerning such matters;

(3) To establish or verify the liability (or possible liability) of any person, or the liability (or possible liability) at law or in equity of any transferee or fiduciary of any person, for any tax, penalty, interest, fine, forfeiture, or other imposition or offense under the internal revenue laws or the amount thereof to be collected;

(4) To establish or verify misconduct (or possible misconduct) or other activity proscribed by the internal revenue laws;

(5) To obtain the services of persons having special knowledge or technical skills (such as, but not limited to, knowledge of particular facts and circumstances relevant to a correct determination of a liability described in subparagraph (3) of this paragraph or skills relating to handwriting analysis, photographic development, sound recording enhancement, or voice identification) or having recognized expertise in matters involving the valuation of property where relevant to proper performance of a duty or responsibility described in this paragraph;

(6) To establish or verify the financial status or condition and location of the taxpayer against whom collection activity is or may be directed, to locate assets in which the taxpayer has an interest, to ascertain the amount of any liability described in subparagraph (3) of this paragraph to be collected, or otherwise to apply the provisions of the Code relating to establishment of liens against such assets, or levy on, or seizure, or sale of, the assets to satisfy any such liability; or

(7) To prepare for any proceeding described in section 6103(h)(2) or conduct an investigation which may result in such a proceeding,

or where necessary in order to accomplish any activity described in subparagraph (6) of this paragraph. Disclosure of return information to a person other than the taxpayer to whom such return information relates or such taxpayer's legal representative for the purpose of obtaining information necessary to properly carry out the foregoing duties and responsibilities as authorized by this paragraph or for the purpose of otherwise properly accomplishing any activity described in subparagraph (6) of this paragraph should be made, however, only if such necessary information cannot, under the facts and circumstances of the particular case, otherwise reasonably be obtained in accurate and sufficiently probative form, or in a timely manner, and without impairing the proper performance of such duties and responsibilities, or if the activities described in subparagraph (6) of this paragraph cannot otherwise properly be accomplished without making such disclosure.

(c) *Disclosure of return information in connection with certain personnel or claimant representative matters.* In connection with the performance of official duties relating to any investigation concerned with the enforcement of any provision of the Code, including enforcement of any rules, directives, or manual issuances prescribed by the Secretary or his delegate under section 7803 or any other provision of the Code, which affects or may affect the personnel or employment rights or status, or civil or criminal liability, of any employee or former or prospective employee of the Treasury Department or the rights of any person who is or may be a party to an administrative action or proceeding pursuant to 31 U.S.C. 1026, an officer or employee of the Service or Office of the Chief Counsel therefor is authorized to disclose return information (as defined in section 6103(b)(2)) for the purpose of obtaining, verifying, or establishing other information which is or may be relevant and material to such investigation. Disclosure of return information to a person other than the taxpayer to whom such return information relates or such taxpayer's legal representative for the purpose of obtaining information necessary to properly carry out the foregoing duties and responsibilities as authorized by this paragraph should be made, however, only if such necessary information cannot, under the facts and circumstances of the particular case, otherwise reasonably be

obtained in accurate and sufficiently probative form, or in a timely manner, and without impairing the proper performance of such duties and responsibilities.

§ 301.6103(l)(2)-1 Disclosure of returns and return information to Pension Benefit Guaranty Corporation for purposes of research and studies.

(a) *General rule.* Pursuant to the provisions of section 6103(l)(2) of the Internal Revenue Code and subject to the requirements of paragraph (b) of this section, officers and employees of the Internal Revenue Service may disclose returns and return information (as defined by section 6103(b)) to officers and employees of the Pension Benefit Guaranty Corporation for purposes of, but only to the extent necessary in, conducting research and studies authorized by title IV of the Employee Retirement Income Security Act of 1974.

(b) *Procedures and restrictions.* Disclosure of returns or return information by officers or employees of the Service as provided by paragraph (a) of this section will be made only upon written request to the Commissioner of Internal Revenue by the Executive Director of the Pension Benefit Guaranty Corporation describing the returns or return information to be disclosed, the taxable period or date to which such returns or return information relates, and the purpose for which the returns or return information is needed in the administration of title IV of the Employee Retirement Income Security Act of 1974, and designating by title the officers and employees of such corporation to whom such disclosure is authorized. No such officer or employee to whom returns or return information is disclosed pursuant to the provisions of paragraph (a) shall disclose such returns or return information to any person, other than the taxpayer by whom the return was made or to whom the return information relates or other officers or employees of such corporation whose duties or responsibilities require such disclosure for a purpose described in paragraph (a), except in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer.

§ 301.6103(l)(2)-2 Disclosure of returns and return information to Department of Labor for purposes of research and studies.

(a) *General rule.* Pursuant to the provisions of section 6103(l)(2) of the Internal Revenue Code and subject to the requirements of paragraph (b) of this section, officers or employees of the Internal Revenue Service may disclose returns and return information (as defined by section 6103(b)) to officers and employees of the Department of Labor for purposes of, but only to the extent necessary in, conducting research and studies authorized by section 513 of the Employee Retirement Income Security Act of 1974.

(b) *Procedures and restrictions.* Disclosure of returns or return information by officers or employees of the Service as provided by paragraph (a) of this section will be made only upon written request to the Commissioner of Internal Revenue by the Administrator of the Pension and Welfare Benefit Programs of the Department of Labor describing the returns or return information to be disclosed, the taxable period or date to which such returns or return information relates, and the purpose for which the returns or return information is needed in the administration of title I of the Employee Retirement Income Security Act of 1974, and designating by title the officers and employees of such department to whom such disclosure is authorized. No such officer or employee to whom returns or return information is disclosed pursuant to the provisions of paragraph (a) shall disclose such returns or return information to any person, other than the taxpayer by whom the return was made or to whom the return information relates or other officers or employees of such department whose duties or responsibilities require such disclosure for a purpose described in paragraph (a), except in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer.

§ 301.6103(l)(2)-3 Disclosure of Department of Labor and Pension Benefit Guaranty Corporation of certain returns and return information.

(a) *Disclosure following general requests.* Pursuant to the provisions of section 6103(l)(2) of the Internal Revenue Code and subject to the requirements of this paragraph, officers or employees of the Internal Revenue Service may disclose the following returns and return information (as defined by section 6103(b)) to officers and employees of the Department of Labor or the Pension Benefit Guaranty Corporation for purposes of, but only to the extent necessary in, the administration of title I or IV of the Employee Retirement Income Security Act of 1974 (hereinafter referred to in this section as the Act)—

(1) Notification of receipt by the Service of an application by a particular taxpayer for a determination of whether a pension, profit-sharing, or stock bonus plan, a trust which is a part of such a plan, or an annuity or bond purchase plan meets the applicable requirements of part I of subchapter D of chapter 1 of the Code;

(2) Notification that a particular application described in subparagraph (1) of this paragraph alleges that certain employees may be excluded from participation by reason of section 410(b)(2)(A) and (B) for the purpose of obtaining the finding necessary for the application of such section;

(3) An application by a particular taxpayer for a determination of

whether a pension, profit-sharing, or stock bonus plan, or an annuity or bond purchase plan, meets the applicable requirements of part I of subchapter D of chapter 1 of the Code with respect to a termination or proposed termination of the plan or to a partial termination or proposed partial termination of the plan, and any statement filed as provided by section 6058(b);

(4) Notification that the Service has determined that a plan or trust described in subparagraph (1) or (3) of this paragraph meets or does not meet the applicable requirements of part I of subchapter D of chapter 1 of the Code and has issued a determination letter to such effect to a particular taxpayer or that an application for such a determination has been withdrawn by the taxpayer;

(5) If the Department of Labor or the Pension Benefit Guaranty Corporation has commented on an application upon which a determination letter described in subparagraph (4) of this paragraph has been issued, a copy of the letter or document issued to the applicant;

(6) Notification to a particular taxpayer that the Service intends to disqualify a pension, profit-sharing, or stock bonus plan, a trust which is a part of such plan, or an annuity or bond purchase plan because such plan or trust does not meet the requirements of section 410(a) or 411 as of the date that such notification is issued;

(7) Notification required by section 3002(a) of the Act of the commencement of any proceeding to determine whether a particular pension, profit-sharing, or stock bonus plan, a trust which is a part of such plan, or an annuity or bond purchase plan meets the requirements of section 410(a) or 411;

(8) Prior to issuance of a notice of deficiency to a particular taxpayer under section 6212, notification that the Service has determined that a deficiency exists under section 6211 with respect to the tax imposed by section 4971(a) or (b) on such taxpayer, except that if the Service determines that the collection of such tax is in jeopardy within the meaning of section 6861(a), such notification may be disclosed after issuance of the notice of deficiency or jeopardy assessment;

(9) Notification of receipt by the Service of, and action taken with respect to, an application by or on behalf of a particular taxpayer for a waiver of the tax imposed by section 4971(b);

(10) Prior to issuance of a notice of deficiency to a particular taxpayer under section 6212, notification that a deficiency exists under section 6211 with respect to the tax imposed by section 4975(a) or (b) on such taxpayer, except that if the Service determines that the collection of such tax is in jeopardy within the meaning of section 6861(a), such notification may be disclosed after issuance of the notice of deficiency or jeopardy assessment;

(11) Notification that the Service has waived the tax imposed by section 4975(b) on a particular taxpayer;

(12) Notification of applicability of section 4975 to a particular pension, profit-sharing, or stock bonus plan, a trust which is a part of such plan, or an annuity or stock purchase plan engaged in prohibited transactions within the meaning of section 4975(c);

(13) Notification to a plan administrator that the Service has determined that a pension, profit-sharing, stock bonus, annuity, or stock purchase plan no longer meets the requirements of section 401(a) or 404(a)(2);

(14) Notification that the Service has determined that there has been a termination or partial termination of a particular pension, profit-sharing, stock bonus, annuity, or stock purchase plan within the meaning of section 411(d)(3);

(15) Notification of the occurrence of an event (other than an event described in subparagraph (13), (14), or (18) of this paragraph) which the Service has determined to indicate that a particular pension, profit-sharing, stock bonus, annuity, or stock purchase plan may not be sound under section 4043(c)(2) of the Act;

(16) Notification that the Service has received and responded to a request on behalf of a particular pension, profit-sharing, or stock bonus plan, a trust which is a part of such plan, or an annuity or stock purchase plan for an extension of time for filing an annual return by such plan or trust;

(17) Notification that the Service has received and responded to a request on behalf of a particular pension, profit-sharing, or stock bonus plan, a trust which is a part of such plan, or an annuity or stock purchase plan to change the annual accounting period of such plan or trust;

(18) Notification that the Service has determined that a particular plan does not meet the requirements of section 412 without regard to whether such plan is one described in section 4021(a)(2) of the Act;

(19) Notification of the results of an investigation by the Service requested by the Department of Labor or the Pension Benefit Guaranty Corporation, or both, with respect to whether the tax described in section 4971 should be imposed on any employer named in such request or whether the tax imposed by section 4975 should be paid by any person named in the request;

(20) Notification of receipt by the Service of an application by a particular taxpayer for exemption under section 4975(c)(2) or of initiation by the Service of an administrative proceeding for such exemption;

(21) Notification of receipt by the Service of, and action taken with respect to, an application by or on behalf of a particular taxpayer for a waiver or variance of the minimum funding standard under section 303 of the Act or section 412(d);

(22) Notification that the Service intends to undertake, is undertaking,

or has completed, an examination to determine whether—

(i) A particular pension, profit-sharing, or stock bonus plan, a trust which is a part of such plan, or an annuity or stock purchase plan meets the applicable requirements of part 1 of subchapter D of chapter 1 of the Code;

(ii) Any particular person is or may be liable for any tax imposed by section 4971 or 4975; or

(iii) A particular employee welfare benefit plan, as defined in section 3(1) of the Act, meets the applicable requirements of section 501(c) or 120,

together with any completed Department of Labor or Pension Benefit Guaranty Corporation form (and supplemental schedules) relating to such examination;

(23) Copies of initial pleadings indicating that the Service intends to intervene in a civil action under section 502(h) of the Act.

Return information disclosed under this paragraph includes the taxpayer identity information (as defined in section 6103(b)(6)) of the plan or trust, the name and address of the sponsor and administrator of the plan or trustee of the trust, and the name and address of the person authorized to represent the plan or trust before the Service; and

(24) Notification of receipt by the Service of a request for technical advice as to whether a particular pension, profit-sharing, or stock bonus plan, a trust which is a part of such plan, or an annuity or bond purchase plan should be disqualified because of fiduciary actions subject to part 4 of subtitle B of title I of the Act which may violate the exclusive benefit rule of section 401(a);

(25) Notification of receipt by the National Office of the Service of a request by or on behalf of a particular taxpayer for a ruling, opinion, variance, or waiver under any provision of title I of the Act and a copy of any such ruling, opinion, variance or waiver;

(26) Notification that the Service proposes to take substantive action which would significantly impact on or substantially affect collectively bargained plans and a description of such proposed substantive action; and

(27) Notification of receipt by the Service of, and action taken with respect to, a request by a particular taxpayer for a ruling under section 412(c)(8), 412(e), or 412(f).

Disclosure of returns or return information as provided by this paragraph will be made only following receipt by the Commissioner of Internal Revenue of an annual written request for such disclosure by the Administrator of Pension and Benefit Welfare Programs of the Department of Labor or the Executive Director of the Pension Benefit Guaranty Corporation describing the categories of returns or return information to be disclosed by the Service and the particular purpose for which the returns or return information is needed in the administration of title I or IV of the Act, and designating by title the officers and employees of the Department of Labor or such corporation to whom such disclosure is authorized.

(b) *Additional returns and return information subject to disclosure*—(1) *Returns and return information relating to automatic notification.* Subject to the requirements of subparagraph (3) of this paragraph, officers or employees of the Service may disclose to officers and employees of the Department of Labor or the Pension Benefit Guaranty Corporation for purposes of, but only to the extent necessary in, the administration of title I or IV of the Act additional returns and return information relating to any item described in paragraph (a) of this section.

(2) *Other returns and return information.* Subject to the requirements of subparagraph (3) of this paragraph, officers or employees of the Service may disclose to officers and employees of the Department of Labor or the Pension Benefit Guaranty Corporation returns and return information (other than returns and return information disclosed as provided by paragraph (a) of this section or § 301.6103(l)(2)-1 or § 301.6103(l)(2)-2 for purposes of, but only to the extent necessary in, administration of title I or IV of the Act.

(3) *Procedures.* Disclosure of returns or return information by officers or employees of the Service as provided by this paragraph will be made only upon written request to the Commissioner of Internal Revenue or his delegate by the Secretary of Labor or his delegate or the Executive Director of the Pension Benefit Guaranty Corporation or his delegate identifying the particular taxpayer by whom such return was made or to whom such return information relates, describing the particular returns or return information to be disclosed, stating the purpose for which the returns or return information is needed in the administration of title I or IV of the Act, and designating by title the officers and employees of such department or corporation to whom such disclosure is authorized.

(c) *Disclosure and use of returns and return information by officers and employees of Department of Labor, Pension Benefit Guaranty Corporation, and Department of Justice*—(1) *Use by officers and employees of Department of Labor and Pension Benefit Guaranty Corporation.* Returns and return information disclosed to officers and employees of the Department of Labor and the Pension Benefit Guaranty Corporation as provided by this section may be used by such officers and employees for purposes of, but only to the extent necessary in, administration of any provision of title I or IV of the Act, including any preparation for any administrative or judicial proceeding (or investigation which may result in such a proceeding) authorized by, or described in, title I or IV of the Act.

(2) *Disclosure by officers and employees of Department of Labor and Pension Benefit Guaranty Corporation to, and use by, other persons, including officers and employees of the Department of Justice.* (i) Returns and return information disclosed to officers and employees of the Department of Labor or the Pension Benefit Guaranty Corporation as provided by this section may be disclosed by such officers and employees to officers and employees of the Department of Justice (including United States attorneys) personally and directly engaged in, and for their necessary use in, any Federal grand jury proceeding, or preparation for any civil or criminal judicial proceeding (or for their necessary use in an investigation which may result in such a proceeding), authorized by, or described in, title I or IV of the Act.

(ii) Returns and return information disclosed to officers and employees of the Department of Labor, the Pension Benefit Guaranty Corporation, and the Department of Justice as provided by this section may be disclosed by such officers and employees to other persons, including, but not limited to, persons described in subparagraph (2)(iii) of this paragraph, but only to the extent necessary in connection with administration of the provisions of title I or IV of the Act, including a Federal grand jury proceeding, and proper preparation for a proceeding (or investigation), described in subparagraph (1) or (2)(i). Such disclosures may include, but are not limited to, disclosures where necessary—

(A) To properly obtain the services of persons having special knowledge or technical skills;

(B) To properly interview, consult, depose, or interrogate or otherwise obtain relevant information from the taxpayer to whom such return or return information relates (or the legal representative of such taxpayer) or any witness who may be called to give evidence in the proceeding; or

(C) To properly conduct negotiations concerning, or obtain authorization for, settlement or disposition of the proceeding, in whole or in part, or stipulations of fact in connection with the proceeding.

Disclosure of a return or return information to a person other than the taxpayer to whom such return or return information relates (or the legal representative of such taxpayer) to properly accomplish any purpose or activity described in this subparagraph should be made, however, only if such purpose or activity cannot otherwise properly be accomplished without making such disclosure.

(iii) Among those persons to whom returns and return information may be disclosed by officers and employees of the Department of Labor, the Pension Benefit Guaranty Corporation, and the Department of Justice as provided by subparagraph (2)(ii) of this paragraph are:

(A) Other officers and employees of the Department of Labor, the Pension Benefit Guaranty Corporation, and the Department of Justice;

(B) Officers and employees of another Federal agency (as defined in section 6103(b)(9)) working under the direction and control of such officers and employees of the Department of Labor, the Pension Benefit Guaranty Corporation, or the Department of Justice; and

(C) Court reporters.

Disclosure of returns or return information to other persons by officers and employees of the Department of Labor or the Pension Benefit Guaranty Corporation as provided by subparagraph (2)(ii) of this paragraph for purposes of conducting research, surveys, studies, and publications referred to in section 513(a), or authorized by title IV, of the Act shall be restricted, however, to disclosure to other officers and employees of such department or corporation to whom such disclosure is necessary in connection with such conduct or to the taxpayer by whom such return was made or to whom such return information relates if the return or return information can be associated with, or otherwise identify, directly or indirectly, a particular taxpayer.

(3) *Disclosure in judicial proceedings.* A return or return information disclosed to officers and employees of the Department of Labor, the Pension Benefit Guaranty Corporation, or the Department of Justice as provided by this section may be entered into evidence by such officers or employees in a civil or criminal judicial proceeding authorized by, or described in, title I or IV of the Act, provided that, in the case of a judicial proceeding described in section 6103(i)(4), the requirements of section 6103(i)(4) have first been met.

(d) *Disclosure of returns and return information in connection with certain consultations between Departments of the Treasury and Labor.* Upon general written request to the Commissioner of Internal Revenue by the Secretary of Labor, officers and employees of the Service may disclose to officers and employees of the Department of Labor such returns and return information as may be necessary to properly carry out any consultation required by section 3002, 3003, or 3004 of the Act.

(e) *Return information open to public inspection under section 6104.* Nothing in these regulations shall be construed to deny officers and employees of the Department of Labor and the Pension Benefit Guaranty Corporation the right to inspect return information available to the public under section 6104 of the Code.

§ 301.6103(n)-1 Disclosure of returns and return information in connection with procurement of property and services for tax administration purposes.

(a) *General rule.* Pursuant to the provisions of section 6103(n) of the

Internal Revenue Code and subject to the requirements of paragraphs (b), (c), and (d) of this section, officers or employees of the Treasury Department, a State tax agency, or the Social Security Administration are authorized to disclose returns and return information (as defined in section 6103 (b)) to any person (including, in the case of the Treasury Department, any person described in section 7513(a)), or to an officer or employee of such person, to the extent necessary in connection with contractual procurement of—

(1) Equipment or other property, or

(2) Services relating to the processing, storage, transmission, or reproduction of such returns or return information, or to the programming, maintenance, repair, or testing of equipment or other property, for purposes of tax administration (as defined in section 6103(b)(4)).

No person, or officer or employee of such person, to whom a return or return information is disclosed by an officer or employee of the Treasury Department, the State tax agency, or the Social Security Administration under the authority of this paragraph shall in turn disclose such return or return information for any purpose other than as described in this paragraph, and no such further disclosure for any such described purpose shall be made by such person, officer, or employee to anyone, other than another officer or employee of such person whose duties or responsibilities require such disclosure for a purpose described in this paragraph, without written approval by the Internal Revenue Service.

(b) *Limitation.* For purposes of paragraph (a) of this section, disclosure of returns or return information in connection with contractual procurement of property or services described in such paragraph will be treated as necessary only if such procurement or the performance of such services cannot otherwise be reasonably, properly, or economically carried out or performed without such disclosures. Thus, for example, disclosures of returns or return information to employees of a contractor for purposes of programming, maintaining, repairing, or testing computer equipment used by the Internal Revenue Service or a State tax agency should be made only if such services cannot be reasonably, properly, or economically performed by use of information or other data in a form which does not identify a particular taxpayer. If, however, disclosure of returns or return information is in fact necessary in order for such employees to reasonably, properly, or economically perform the computer related services, such disclosures should be restricted to returns or return information selected or appearing at random. Further, for purposes of paragraph (a), disclosure of returns or return information in connection with the contractual procurement of property or services described in such paragraph should be made only to the extent necessary to reasonably, properly, or economically conduct such procurement activity.

Thus, for example, if an activity described in paragraph (a) can be reasonably, properly, and economically conducted by disclosure of only parts or portions of a return or if deletion of taxpayer identity information (as defined in section 6103(b)(6) of the Code) reflected on a return would not seriously impair the ability of the contractor or his officers or employees to conduct the activity, then only such parts or portions of the return, or only the return with taxpayer identity information deleted, should be disclosed.

(c) *Notification requirements.* Each officer or employee of any person to whom returns or return information is or may be disclosed as authorized by paragraph (a) of this section shall be notified in writing by such person that returns or return information disclosed to such officer or employee can be used only for a purpose and to the extent authorized by paragraph (a) of this section and that further disclosure of any such returns or return information for a purpose or to an extent unauthorized by such paragraph constitutes a felony, punishable upon conviction by a fine of as much as $5,000, or imprisonment for as long as 5 years, or both, together with the costs of prosecution. Such person shall also so notify each such officer and employee that any such unauthorized further disclosure of returns or return information may also result in an award of civil damages against the officer or employee in an amount not less than $1,000 with respect to each instance of unauthorized disclosure.

(d) *Safeguards.* Any person to whom a return or return information is disclosed as authorized by paragraph (a) of this section shall comply with all applicable conditions and requirements which may be prescribed by the Internal Revenue Service for the purposes of protecting the confidentiality of returns and return information and preventing disclosures of returns or return information in a manner unauthorized by paragraph (a). The terms of any contract between the Treasury Department, a State tax agency, or the Social Security Administration and a person pursuant to which a return or return information is or may be disclosed for a purpose described in paragraph (a) shall provide, or shall be amended to provide, that such person, and officers and employees of the person, shall comply with all such applicable conditions and restrictions as may be prescribed by the Service by regulation, published rules or procedures, or written communication to such person. If the Service determines that any person, or an officer or employee of any such person, to whom returns or return information has been disclosed as provided in paragraph (a) has failed to, or does not, satisfy such prescribed conditions or requirements, the Service may take such actions as

are deemed necessary to ensure that such conditions or requirements are or will be satisfied, including—

(1) Suspension or termination of any duty or obligation arising under a contract with the Treasury Department referred to in this paragraph or suspension of disclosures by the Treasury Department otherwise authorized by paragraph (a) of this section, or

(2) Suspension of further disclosures of returns or return information by the Service to the State tax agency, until the Service determines that such conditions and requirements have been or will be satisfied.

(e) *Definitions.* For purposes of this section—

(1) The term "Treasury Department" includes the Internal Revenue Service and the Office of the Chief Counsel for the Internal Revenue Service, and

(2) The term "State tax agency" means an agency, body, or commission described in section 6103(d) of the Code.

§ 301.6103(p)(2)(B)-1 Disclosure of certain returns and return information by other Federal agencies.

(a) *General rule.* Subject to the requirements of this section, returns and return information disclosed by the Internal Revenue Service to officers and employees of another Federal agency (as defined in section 6103(b)(9) of the Internal Revenue Code) as provided by section 6103 may, if the Commissioner of Internal Revenue determines that such returns or return information is more readily available from such Federal agency, be disclosed by such officers and employees to officers and employees of another Federal agency, the General Accounting Office, an agency, body, or commission described in section 6103(d) or (l)(6), or a person described in section 6103(e) for a purpose or use authorized or required by, but subject to any requirements imposed by, any other provision of section 6103 and the regulations thereunder. Any such disclosure may be made only as, to the extent, and to such persons as may be authorized in writing by the Commissioner pursuant to a written request for such disclosure by such person, and containing such information, as may be designated or provided by the applicable provision of section 6103 and the regulations thereunder pursuant to which the disclosure is sought. Such disclosure authorization by the Commissioner shall be directed to the head of the Federal agency from which disclosure is sought and may contain such conditions or restrictions as the Commissioner may prescribe.

(b) *Records and reports of disclosure.* The Federal agency making a disclosure authorized by paragraph (a) of this section shall maintain to the satisfaction of the Service a permanent system of standardized records with respect to any disclosure authorization by the Commissioner described in paragraph (a) and any disclosure of returns or return information made pursuant to such authorization. In order to enable the Service to make a timely submission of the public report on disclosures to the Joint Committee on Taxation as required by section 6103(p)(3)(C) of the Code, the Federal agency shall, within 30 days after the close of each calendar year, furnish to the Commissioner a report with respect to such records which provides the number of—

(1) Disclosure authorizations by the Commissioner,

(2) Instances in which returns or return information was disclosed pursuant to such disclosure authorizations and to disclosure authorizations executed in prior calendar years, and

(3) Taxpayers whose returns or return information with respect to whom was disclosed pursuant to the disclosure authorization described in subparagraph (2).

In addition, in order to enable the Service to make a timely submission of the report to the Joint Committee on Taxation required by section 6103(p)(3)(B), the Federal agency shall furnish to the Commissioner a report with respect to, or summary of, the records at such time or times, in such form, and containing such information as the Commissioner may prescribe in a written request directed to the head of such Federal agency. The requirements of this paragraph do not apply to disclosures of taxpayer identity information described in section 6103(m) or to disclosures of returns and return information as provided by paragraph (a) which, had such disclosures been made directly by the Service, would not have been subject to the recordkeeping requirements imposed by section 6103(p)(3)(A).

TEMPORARY REGULATIONS ON PROCEDURE AND ADMINISTRATION UNDER THE TAX REFORM ACT OF 1976

(26 CFR Part 404)

Par. 4. Sections 404.6103(a)-1, 404.6103(a)-2, 404.6103(c)-1, 404.6103(i)-1, 404.6103(j)(2)-1, 404.6103(k)(6)-1, and 404.6103(n)-1 are deleted.

TEMPORARY REGULATIONS ON PROCEDURE AND ADMINISTRATION UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

(26 CFR Part 420)

Par. 5. Sections 420.6103(1)(2)-1, 420.6103(l)(2)-2, and 420.6103(l)(2)-3 are deleted.

This Treasury decision is issued under the authority contained in sections 6103 and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1667, 68A Stat. 917; 26 U.S.C. 6103 and 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved September 10, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 30, 1980, 5:01 p.m., and published in the issue of the Federal Register for October 3, 1980, 45 F.R. 65564)

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26 CFR 301.6103(c)-1: Disclosure of returns and return information (including taxpayer return information) to designee of taxpayer.

Procedures by which business entities may submit letters authorizing the Service to disclose confidential tax information to certain employees. See Rev. Proc. 80-46, page 779.

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26 CFR 301.6103(j)(1)-1: Disclosures of return information to officers and employees of the Department of Commerce for certain statistical purposes and related activities.

T.D. 7724 [1]

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER B, PART 301.—REGULATIONS ON PROCEDURE AND ADMINISTRATION; PART 404.—TEMPORARY REGULATIONS ON PROCEDURE AND ADMINISTRATION UNDER THE TAX REFORM ACT OF 1976

Disclosure of return information to and by officers and employees of the Department of Commerce for certain statistical purposes and related activities

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the disclosure of certain return information to and by officers and employees of the Department of Commerce for certain statistical purposes and related activities. They affect all disclosures to and by the Bureaus of the Census and Economic Analysis.

DATE: The regulations apply to disclosures of return information after December 31, 1976.

FOR FURTHER INFORMATION CONTACT: David E. Dickinson of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:LR:T, 202-566-3218.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On March 24, 1980, the Federal Register published proposed regulations relating to disclosure of return information to and by the Bureaus of the Census and Economic Analysis of the Department of Commerce for certain statistical purposes under section 6103(j)(1) of the Internal Revenue Code of 1954. A public hearing was requested, but the request was withdrawn. After considering the two comments received, those proposed regulations are adopted as revised by this Treasury decision.

These regulations provide rules governing disclosures of return information to certain officers and employees of the Department of Commerce for statistical purposes and related activities authorized by section 6103(j)(1) of the Code.

The regulations describe in detail the particular return information which the Service will disclose to officers and employees of the Bureaus of the Census and Economic Analysis for use in statistical programs and related activities authorized by law. The regulations also prescribe the procedures to be followed with respect to requested disclosures of return information and the limited extent to which such return information can be redisclosed and provide that the confidentiality of return information disclosed as provided by the regulations must be protected to the satisfaction of the Service.

Two comments were received with respect to the proposed regulations. One objected on principle to the disclosure of any return information to the Bureaus of the Census and Economic Analysis. This objection fails to recognize that section 6103(j)(1) of the Code specifically authorizes such disclosures.

The second comment came from the Bureau of the Census and relates to a technical flaw in the proposed regulations. Prior to February 21, 1980, the temporary disclosure regulations authorized the disclosure of return information to the Bureau for purposes of conducting statistical programs "authorized by law." This authority permitted Bureau access to return information for both mandated statistical programs described in chapter 5 of Title 13, United States Code, and discretionary statistical programs conducted by the Bureau at the request of other agencies and persons under the authority of chapter 1 of Title 13. On February 21, 1980, however, the temporary regulations were amended to restrict Bureau use of return information to mandated statistical programs under chapter 5. At the time of this amendment, the fact was overlooked that the Bureau was in the process of conducting an important chapter 1 study requested by another Federal agency and was using employment tax data for this purpose. The effect of the amendment was to deny the Bureau further access to employment tax data to complete the study.

Because the Bureau undertook this chapter 1 study in reliance on regulatory authority in existence at the time, these final regulations effectively permit the Bureau to continue using employment tax data in order to complete its chapter 1 study. See § 301.6103(j)(1)-1(b)(5).

Finally, these final regulations make minor technical amendments to § 301.6103(j)(1)-1(b)(3)(ii) and

[1] This publication of the Treasury Decision contains the complete text of the amendments to the regulations. The instructions for modifying the notice of proposed rulemaking have been omitted.

(iii), as proposed, to authorize disclosure of a consolidated return indicator and to conform the description of return information to be disclosed to business related information readily available from Form 1040, Schedule F.

DRAFTING INFORMATION

The principal author of these regulations was David E. Dickinson of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of the regulations

Accordingly, the following amendments to the regulations are hereby adopted:

REGULATIONS ON PROCEDURE AND ADMINISTRATION (26 CFR PART 301)

Paragraph 1. The following new section is added immediately after § 301.6103(i)-1:

§ 301.6103(j)(1)-1 Disclosures of return information to officers and employees of the Department of Commerce for certain statistical purposes and related activities.

(a) *General rule.* Pursuant to the provisions of section 6103(j)(1) of the Internal Revenue Code and subject to the requirements of paragraph (d) of this section, officers or employees of the Internal Revenue Service will disclose return information (as defined by section 6103(b)(2) but not including return information described in section 6103(o)(2)) to officers and employees of the Department of Commerce to the extent, and for such purposes as may be, provided by paragraphs (b) and (c) of this section. Further, in the case of any disclosure of return information so provided by paragraphs (b) and (c), the tax period or accounting period to which such return information relates will also be disclosed.

(b) *Disclosure of return information to officers and employees of the Bureau of the Census.* (1) Officers or employees of the Service will disclose the following return information reflected on returns of an individual taxpayer to officers and employees of the Bureau of the Census for purposes of, but only to the extent necessary in, conducting and preparing, as authorized by chapter 5 of Title 13, United States Code, intercensal estimates of population and per capita income for all geographic areas included in the general revenue sharing program and demographic statistics programs, censuses and related program evaluation—

(i) Taxpayer identity information (as defined in section 6103(b)(6) of the Code), validity code with respect to the taxpayer identifying number (as described in section 6109), and taxpayer identifying number of spouse, if reported;

(ii) District office and service center codes;

(iii) Marital status;

(iv) Number and classifications of reported exemptions;

(v) Adjusted gross income;

(vi) Wage and salary income;

(vii) Dividend income;

(viii) Interest income;

(ix) Gross rent and royalty income;

(x) Entity code;

(xi) Residence information from the revenue sharing question;

(xii) Code indicators for Form 1040; Schedules C, D, E, F, and SE;

(xiii) Julian date relative to filing; and

(xiv)(A) Earned income credit, and

(B) Advance earned income credit payments received.

(2) Officers or employees of the Service will disclose to officers and employees of the Bureau of the Census for purposes of, but only to the extent necessary in, conducting, as authorized by chapter 5 of Title 13, United States Code, demographic, economic, and agricultural statistics programs and censuses and related program evaluation—

(i) From the business master files of the Service, the taxpayer name directory and entity records consisting of taxpayer identity information (as defined in section 6103(b)(6)) with respect to taxpayers engaged in a trade or business, the principal industrial activity code, and monthly corrections of, and additions to, such entity records.

(ii) From Form SS-4, all return information reflected on such return;

(iii) From an employment tax return—

(A) Taxpayer identifying number (as described in section 6109) of the employer and any employee identified on such return,

(B) Total compensation reported,

(C) Total number of employees reflected on such return,

(D) Master file tax account number,

(E) Taxable period covered by such return,

(F) Employment code,

(G) Final return indicator,

(H) Document locator number,

(I) Record code,

(J) Total number of individuals employed in the taxable period covered by the return,

(K) Taxable wages paid for purposes of chapter 21 to each such employee,

(L) Taxable tip income for purposes of chapter 21 reported on the return with respect to each such employee,

(M) Total taxable wages paid for purposes of chapter 21, and

(N) Total taxable tip income reported for purposes of chapter 21; and

(iv) From Form 1040, Schedule SE—

(A) Taxpayer identifying number of self-employed individual,

(B) Business activities subject to the tax imposed by chapter 21,

(C) Net earnings from farming,

(D) Net earnings from nonfarming activities,

(E) Total net earnings from self-employment, and

(F) Taxable self-employment income for purposes of chapter 2.

(3) Officers or employees of the Service will disclose the following business related return information reflected on the return of a taxpayer to officers and employees of the Bureau of the Census for purposes of, but only to the extent necessary in, conducting and preparing, as authorized by chapter 5 of Title 13, United States Code, demographic, economic, and agricultural statistics programs and censuses—

(i) From Form 1040, Schedule C, taxpayer identity information (as defined in section 6103(b)(6)), the principal industrial activity code, reported gross receipts, returns and allowances, cost of labor, and salaries and wages;

(ii) From Form 1120F, Section II, and Forms 1065, 1120, 1120S, 990C, and 990T, the taxpayer identifying number (as described in section 6109), the principal industrial activity code, the consolidated return indicator (if any), and reported gross receipts less returns and allowances;

(iii) From Form 1040, Schedule F, taxpayer identity information, reported gross profits, and labor hired;

(iv) From Form 1040, Schedule C, and Forms 1065, 1120, and 1120S, answers to the business activity questions;

(v) From Form 1040, Schedule C, business address and answer to the question relating to Form 941;

(vi) From Form 990PF, the taxpayer identifying number, the principal industrial activity code, and reported total receipts;

(vii) From Form 1065, the names and taxpayer identifying numbers of no more than 10 members of the partnership; and

(viii) From Form 1120S, the names and taxpayer identifying numbers of, and the number of shares of stock owned by, no more than 10 shareholders of the corporation.

(4) Officers or employees of the Service will disclose return information relating to a taxpayer contained in the exempt organization master files of the Service to officers and employees of the Bureau of the Census for purposes of, but only to the extent necessary in, conducting and preparing, as authorized by chapter 5 of Title 13, United States Code, economic censuses. This return information consists of taxpayer identity information (as defined in section 6103(b)(6)), activity codes, and filing requirement code, and monthly corrections of, and additions to, such return information.

(5) Subject to the requirements of paragraph (d) of this section and § 301.6103(p)(2)(B)-1, officers or employees of the Social Security Administration to whom the following return information has been disclosed as provided by section 6103(l)(1)(A) or (5) may disclose such return information to officers and employees of the Bureau of the Census for necessary purposes described in subparagraph (2) or (3) of this paragraph (or for purposes of conducting, as authorized by chapter 1 of Title 13, United States Code, a demographic or economic statistics program or census and related program evaluation in progress as of February 21, 1980)—

(i) From Form SS-4, all return information reflected on such return;

(ii) From an employment tax return—

(A) Taxpayer identifying number (as described in section 6109) of the employer and any employee identified on such return,

(B) Total number of employees reflected on the return,

(C) Total number of individuals employed in the taxable period covered by the return,

(D) Total compensation reported,

(E) Taxable wages paid for purposes of chapter 21 to each such employee,

(F) Taxable tip income for purposes of chapter 21 reported on the return with respect to each such employee,

(G) Total taxable wages paid for purposes of chapter 21, and

(H) Total taxable tip income reported for purposes of chapter 21,

(I) Employment code; and

(iii) From Form 1040, Schedule SE—

(A) Taxpayer identifying number of self-employed individual,

(B) Business activities subject to the tax imposed by chapter 21,

(C) Net earnings from farming,

(D) Net earnings from nonfarming activities,

(E) Total net earnings from self-employment, and

(F) Taxable self-employment income for purposes of chapter 2.

(c) *Disclosure of return information to officers and employees of the Bureau of Economic Analysis.* Officers or employees of the Service will disclose to officers and employees of the Bureau of Economic Analysis for purposes of, but only to the extent necessary in, conducting and preparing, as authorized by law, statistical analyses return information consisting of Statistics of Income transcript—edit sheets containing return information reflected on returns of designated classes or categories of corporations with respect to the tax imposed by chapter 1 and microfilmed records of return information reflected on such returns where needed for further use in connection with such conduct or preparation.

(d) *Procedures and restrictions.* Disclosure of return information by officers or employees of the Service or the Social Security Administration as provided by paragraphs (b) and (c) of this section will be made only upon written request to the Commissioner of Internal Revenue by the Secretary of Commerce describing—

(1) The particular return information to be disclosed,

(2) The taxable period or date to which such return information relates, and

(3) The particular purpose for which the return information is to be used,

and designating by name and title the officers and employees of the Bureau of the Census or the Bureau of Economic Analysis to whom such disclosure is authorized. No such officer or employee to whom return information is disclosed pursuant to the provisions of paragraph (b) or (c) shall disclose such return information to any person, other than the taxpayer to whom such return information relates or other officers or employees of such bureau whose duties or responsibilities require such disclosure for a purpose described in paragraph (b) or (c), except in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer. If the Service determines that the Bureau of the Census or the Bureau of Economic Analysis, or any officer or employee thereof, has failed to, or does not, satisfy the requirements of section 6103(p)(4) of the Code or regulations or published procedures thereunder, the Service may take such actions as are deemed necessary to ensure that such requirements are or will be satisfied, including suspension of disclosures of return information otherwise authorized by section 6103(j)(1) and paragraph (b) or (c) of this section, until the Service determines that such requirements have been or will be satisfied.

TEMPORARY REGULATIONS ON PROCEDURE AND ADMINISTRATION UNDER THE TAX REFORM ACT OF 1976 (26 CFR PART 404)

Par. 2. Section 404.6103(j)(1)-1 is deleted.

This Treasury decision is issued under the authority contained in sections 6103(j)(1) and (q) and 7805 of the Interval Revenue Code of 1954 (90 Stat. 1678 and 1685, 68A Stat. 7805; 26 U.S.C. 6103(j)(1) and (q), 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved September 19, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 2, 1980, 8:45 a.m., and published in the issue of the Federal Register for October 3, 1980, 45 F.R. 65561)

Section 6109.—Identifying Numbers

26 CFR 1.6109-1: Identifying numbers.

Magnetic tape reporting requirements. See Rev. Proc. 80-52, page 828.

Chapter 62.—Time and Place for Paying Tax
Subchapter B.—Extensions of Time for Payment

Section 6161.—Extension Of Time for Paying Tax

26 CFR 20.6161-1: Extension of time for paying tax shown on return.

When interest expense charged pursuant to the executor's election in accordance with the provisions of section 6161 of the Code to extend payment of the estate tax liability becomes deductible under section 2053(a)(2) of the Code. See Rev. Rul. 80-250, page 278.

Section 6163.—Extension of Time for Payment of Estate Tax on Value of Reversionary or Remainder Interest in Property

26 CFR 20.6163-1: Extension of time for payment of estate on value of reversionary or remainder interest in property.

When interest expense charged pursuant to the executor's election in accordance with the provisions of section 6163 of the Code to extend payment of the part of the estate tax liability attributable to the value of a reversionary or remainder interest in property included in the value of the decedent's gross estate becomes deductible under section 2053(a)(2) of the Code. See Rev. Rul. 80-250, page 278.

Section 6166.—Alternate Extension of Time for Payment of Estate Tax Where Estate Consists Largely of Interest in Closely Held Business

The value of a decedent's interest as a proprietor in a trade or business carried on as a proprietorship. See Rev. Rul. 80-202, this page.

26 CFR 20.6166-1: Election of alternate extension of time for payment of estate tax where estate consists largely of interest in closely held business.

When interest expense charged pursuant to the executor's election in accordance with the provisions of section 6166 of the Code to pay a portion of the estate tax liability in installments becomes deductible under section 2053(a)(2) of the Code. See Rev. Rul. 80-250, page 278.

26 CFR 20.6166-1: Election of alternate extension of time for payment of estate tax where estate consists largely of interest in closely held business.

Election by an executor to extend payment of part or all of the portion of the estate tax which is attributable to a closely held business interest. See T.D. 7710, page 254.

Section 6166A.—Extension of Time for Payment of Estate Tax Where Estate Consists Largely of Interest in Closely Held Business

26 CFR 20.6166A-1: Extension of time for payment of estate tax where estate consists largely of interest in closely held business. (Also Sections 2031, 6166; 20.2031-1, 20.2031-3.)

Installment payments; closely held business; valuation. In computing the limitation on the amount of estate tax that may be paid in installments under section 6166A of the Code, the value of a decedent's interest as a proprietor in a trade or business carried on as a proprietorship is the net amount a willing purchaser would pay for the interest to a willing seller.

Rev. Rul. 80-202

ISSUE

How should the value of a decedent's interest as a proprietor in a trade or business carried on as a proprietorship be computed for purposes of determining the limitation on the amount of estate tax that may be paid in installments under section 6166A of the Internal Revenue Code?

LAW AND ANALYSIS

Section 6166A(a) of the Code provides for the payment of estate tax in installments if the value of an interest in a closely held business that is included in determining the gross estate exceeds either (1) 35 percent of the value of the gross estate, or (2) 50 percent of the taxable estate. This provision specifies that value for purposes of applying section 6166A shall be value determined for federal estate tax purposes.

Section 6166A(b) of the Code provides that the amount of tax that may be paid in installments shall be an amount that bears the same ratio to the estate tax imposed by section 2001 (reduced by credits against such tax) as the value of the interest in a closely held business that qualifies for the election to pay the tax in installments bears to the value of the gross estate.

Section 6166A(c)(1) of the Code provides that the term "interest in a closely held business" includes an interest as a proprietor in a trade or business carried on as a proprietorship.

Section 20.2031-1(b) of the Estate Tax Regulations provides that the value of every item of property includible in a decedent's gross estate is its fair market value at the time of the decedent's death.

Section 20.2031-3 of the regulations provides that the fair market value of any interest of a decedent in a proprietorship is the net amount a willing purchaser would pay for the interest to a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.

For estate tax purposes, the fair market value of a decedent's interest as a proprietor in a trade or business carried on as a proprietorship is the net amount a purchaser would pay for the interest to a seller. The value of the gross estate includes only such net amount and not the total value of the assets of the proprietorship.

HOLDING

In computing the limitation on the amount of estate tax that may be paid in installments under section 6166A of the Code, the value of a decedent's interest as a proprietor in a trade or business carried on as a proprietorship is the net amount a willing purchaser would pay for the interest to a willing seller.

The above conclusion also applies to section 6166 of the Code.

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26 CFR 20.6166A-1: Extension of time for payment of estate tax where estate consists largely of interest in closely held business.

When interest expense charged pursuant to the executor's election in accordance with the provisions of section 6166A of the Code to pay a portion of the estate tax liability in installments becomes deductible under section 2053(a)(2) of the Code. See Rev. Rul. 80-250, page 278.

Chapter 64.—Collection
Subchapter A.—General Provisions

Section 6302.—Mode or Time of Collection

26 CFR 31.6302(c)-1: Use of government depositaries in connection with taxes under Federal Insurance Contributions Act and income tax withheld.

T.D. 7701 [1]

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER C, PART 31.—EMPLOYMENT TAXES; APPLICABLE ON AND AFTER JANUARY 1, 1955

Changes in the deposit requirements for social security and withheld income taxes

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the requirements with regard to depositing social security and withheld income taxes. The regulations affect certain employers with undeposited amounts of those taxes, and provide necessary guidance to such employers.

DATES: The regulations are generally effective with respect to wages paid after December 31, 1980. However, the "safe haven" provision for large employers will be effective with respect to wages paid after December 31, 1981.

FOR FURTHER INFORMATION CONTACT: John A. Tolleris of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:LR:T) (202-566-3294).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On February 8, 1980, the Federal Register published proposed amendments to the Employment Tax Regulations (26 CFR Part 31) under section 6302 of the Internal Revenue Code of 1954 (45 FR 8666). The amendments were proposed to balance the administrative burden of the deposit requirements for social security and withheld income taxes against the benefits of more rapid deposits of those taxes. In addition, the amendments were proposed to reduce the administrative burdens for small- and medium-sized employers. After consideration of all comments received in response to the notice of proposed rulemaking and at the public hearing on the proposed amendments which was held on April 16, 1980, those amendments are adopted as modified by this Treasury decision.

EXPLANATION OF PROVISIONS

Section 6302(c) of the Internal

[1] This publication of the Treasury Decision contains the complete text of the amendments to the regulations. The instructions for modifying the notice of proposed rulemaking have been omitted.

Revenue Code of 1954 authorizes the Secretary to prescribe the manner, times, and other conditions with which employers must comply in depositing social security and withheld income taxes in authorized depositaries. These amendments establish new deposit requirements pursuant to that authorization.

Among the modifications made to the proposed rules after consideration of the public comments received is the reduction to $500 (from the $1,000 level proposed in the notice) in the end-of-month level of accumulated employment taxes which subjects an employee to the monthly deposit requirement. This amendment was made as a result of the concern expressed at the public hearing that the proposal allowing small employers to defer payment of up to $1,000 of accumulated employment taxes until the end of a calendar quarter could cause compliance difficulties for these employers. The rule adopted represents a relaxation of the currently applicable $200 threshold for the monthly deposit requirement. Employers with aggregate taxes of under $500 during a calendar quarter may remit them with their quarterly returns, effective on January 1, 1981.

After review of the comments regarding the difficulties medium-sized employers would face in making monthly deposits of at least 95 percent of the taxes within 7 days after the end of the month, this Treasury decision revises the proposed rule to provide that such employers must deposit the full amount of the undeposited taxes within 15 days after the end of the month. This is generally the same as the presently applicable rule, except that the deposit with respect to the final month of a return period will also be due on the 15th day of the following month rather than, as under current rules, on the last day of the following month.

In view of the generally unfavorable comments on the proposal to permit employers with under $13,000 of employment taxes in each of the 4 preceding calendar quarters to make monthly deposits of such taxes during the current calendar quarter, this provision is not adopted by the Treasury decision. Instead, the Treasury decision eases the deposit requirement for a number of medium-sized employers by providing that those employers with less than $3,000 (instead of the present $2,000) of aggregate taxes with respect to wages paid at the end of a month will, effective on January 1, 1981, be permitted to make a monthly deposit. In lieu of the $13,000 "safe haven", the Treasury decision also provides that most employers who can establish to the Commissioner's satisfaction that they had not been required to make any quarter-monthly or eighth-monthly deposit during the previous 4 calendar quarters or during earlier months of the current quarter may make a monthly deposit for the first month in which they have accumulated $3,000 or more by the end of the month. Such employers thus would not be penalized for failure to make a 3-banking-day deposit for the first month in which they otherwise would be required to comply with the eighth-monthly deposit provision.

After consideration of the adverse comments regarding administrative burdens caused by the acceleration from the present quarterly-monthly deposit schedule to the proposed eighth-monthly deposit schedule, it was determined that the eighth-monthly rule should be adopted but revised to provide that an employer will be required to make a deposit with respect to an eighth-monthly period only when the aggregate undeposited taxes with respect to the period (and any prior eighth-monthly period with respect to which no deposit was made) reaches or exceeds $3,000, thus relaxing the proposed $1,000 rule as well as the currently applicable $2,000 threshold for 3-banking-day deposits. This change will substantially reduce (as compared with the proposed rule) the number of employers who will be required to make more than 4 deposits a month.

In addition, the Treasury decision does not adopt the proposed rule which would have required aggregating any undeposited "safe haven" amount for purposes of determining when the first eighth-monthly deposit after the 15th day of the following month must be made.

A number of commentators criticized the proposal to reduce the "safe haven" for deposits by large employers from 90 percent to 95 percent; this change, they argued, would make even more difficult those employers' task in correctly estimating the amount of deposit required without risking a penalty for an underdeposit. Upon consideration of these comments, it was determined that a 5 percent margin is sufficient for purposes of estimating deposit amounts. Therefore, the Treasury decision adopts the proposed requirement that, effective on January 1, 1982, employers deposit at least 95 percent of the taxes with respect to wages paid during an eighth-monthly period.

A number of commentators expressed confusion regarding whether large employers would be required to make 8 deposits per month, even if they paid their employees less frequently, such as on a weekly or semi-monthly schedule. As is the case under the current quarter-monthly deposit requirements, an eighth-monthly deposit will only be required when aggregate taxes with respect to wages actually paid during the eighth-monthly period (and earlier periods with respect to which no deposit was made) equal or exceed the threshold amount. Taxes with respect to wages earned by but not yet paid to employees are not aggregated for purposes of determining the frequency or amount of deposits.

Following is a table which summarizes the rules provided by this decision:

Payment Schedule for Withheld Income Tax and FICA Tax Liabilities
(Effective January 1, 1981)

If the accumulated unpaid liability is:	Then the payment requirement is:
$3,000 or more at end of any eighth-monthly period (eighth-monthly periods end on the 3rd, 7th, 11th, 15th, 19th, 22nd, 25th, and the last day of each month)	Employer must deposit accumulated liability within 3 banking days after close of eighth-monthly period. No penalty imposed provided employer deposits at least 95 percent (90 percent in 1981) of liability within 3 banking days, with remainder paid by specified dates. Exception provided for most first-time 3-banking-day depositors.
$500 or more at the end of any month (unless an eighth-monthly deposit was required during the month pursuant to above rule)	Employer must deposit the accumulated liability by the 15th of the following month.
Less than $500 at the end of the calendar quarter.	Employer must pay the accumulated liability by the end of the following month (the due date of the quarterly return). Liability may be paid with the return or deposited.

Office of the Secretary of the Treasury; Office of Tax Analysis

May 29, 1980

Evaluation of the effectiveness of these regulations will be based on comments received from offices within the Treasury and the Internal Revenue Service, other governmental agencies, the Congress, State and local governments, and the public. Although these regulations will impose no new reporting requirement, they may impose additional recordkeeping and administrative burdens for certain large employers due to the acceleration of deposits provided by this Treasury decision.

DRAFTING INFORMATION

The principal author of these proposed regulations is John A. Tolleris of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department developed the substance of the regulations.

Adoption of amendments to the regulations

Accordingly, the following amendments to the regulations are hereby adopted:

Subparagraph (1) (i), (ii), and (iv) of § 31.6302(c)-1(a) is amended to read as follows:

§ 31.6302(c)-1 Use of Government depositaries in connection with taxes under Federal Insurance Contributions Act and income tax withheld.

(a) *Requirement*—(1) *In general.* (i) In the case of a calendar month which begins after December 31, 1980—

(*a*) Except as provided in paragraph (b) of this section and hereinafter in this subdivision (i), if at the close of any calendar month the aggregate amount of undeposited taxes (as defined in subdivision (iii) of this subparagraph) is $500 or more, the employer shall deposit the undeposited taxes in a Federal Reserve bank or authorized financial institution within 15 calendar days after the close of such calendar month. However, this (*a*) of subdivision (i) shall not apply if the employer was required to make a deposit of taxes pursuant to (*b*) of this subdivision (i) with respect to an eighth-monthly period which occurred during the calendar month.

(*b*) Except as provided in paragraph (b) of this section and except in the case of first-time 3-banking-day depositors, if at the close of any eighth-monthly period the aggregate amount of undeposited taxes is $3,000 or more, the employer shall deposit the undeposited taxes in a Federal Reserve bank or authorized financial institution within 3 banking days after the close of such eighth-monthly period. For purposes of determining the amount of undeposited taxes at the close of an eighth-monthly period, undeposited taxes with respect to wages paid during a prior eighth-monthly period shall not be taken into account if the employer has made a deposit with respect to such prior eighth-monthly period. An employer will be considered to have complied with the requirements of this subdivision (i) (*b*) for a deposit with respect to the close of an eighth-monthly period if—

(*1*) His deposit is not less than 95 percent (90 percent before January 1, 1982) of the aggregate amount of the taxes with respect to wages paid during the period for which the deposit is made, and

(*2*) If such eighth-monthly period occurs in a month other than the last month of a period for which a return is required to be filed (hereinafter in this subparagraph referred to as a return period), he deposits any underpayment with his first deposit which is otherwise required by this subdivision (i) (*b*) to be made after the 15th day of the following month.

For purposes of this subdivision (i) (*b*),

a "first-time 3-banking-day depositor" is an employer who establishes to the satisfaction of the Commissioner that he was not required (but for this exception) to make a deposit pursuant to this subdivision (i) (*b*) (or pursuant to subdivision (ii) (*b*) of this subparagraph) with respect to each period in any preceding month of the current calendar quarter and with respect to each period in the 4 calendar quarters preceding the current calendar quarter. An employer may in no event qualify as a "first-time 3-banking-day depositor" with respect to any eighth-monthly period if the undeposited taxes at the close of that period are $10,000 or more. The excess (if any) of a deposit over the actual taxes for a deposit period shall be applied in order of time to each of the employer's succeeding deposits with respect to the same return period, until exhausted, to the extent that the amount by which the taxes for a subsequent deposit period exceed the deposit for such subsequent deposit period. For purposes of this subdivision (i), "eighth-monthly period" means the first 3 days of a calendar month, the 4th day through the 7th day of a calendar month, the 8th day through the 11th day of a calendar month, the 12th day through the 15th day of a calendar month, the 16th day through the 19th day of a calendar month, the 20th day through the 22nd day of a calendar month, the 23rd day through the 25th day of a calendar month, or the portion of a calendar month following the 25th day of such month.

(ii) In the case of a calendar month which begins after January 31, 1971, and before January 1, 1981—

(*a*) Except as provided in paragraph (b) of this section and hereinafter in this subdivision (ii), if at the close of any calendar month other than the last month of a period for which a return is required to be filed, the aggregate amount of taxes (as defined in subdivision (iii) of this subparagraph) is $200 or more, the employer shall deposit the undeposited taxes in a Federal Reserve bank or authorized financial institution within 15 days after the close of such calendar month. However, the preceding sentence shall not apply if the employer has made a deposit of taxes pursuant to (*b*) of this subdivision (ii) with respect to a quarter-monthly period which occurred during such month; or

(*b*) If at the close of any quarter-monthly period the aggregate amount of undeposited taxes is $2,000 or more, the employer shall deposit the undeposited taxes in a Federal Reserve bank or authorized commercial bank within 3 banking days after the close of such quarter-monthly period. For purposes of determining the amount of undeposited taxes at the close of a quarter-monthly period, undeposited taxes with respect to wages paid during a prior quarter-monthly period shall not be taken into account if the employer has made a deposit with respect to such prior quarter-monthly period. An employer will be considered to have complied with the requirements of this subdivision (ii) (*b*) for a deposit with respect to the close of a quarter-monthly period if—

(*1*) His deposit is not less than 90 percent of the aggregate amount of the taxes with respect to wages paid during the period for which the deposit is made, and

(*2*) If such quarter-monthly period occurs in a month other than the last month of a return period, he deposits any underpayment with his first deposit which is otherwise required by this subdivision (ii) to be made after the 15th day of the following month.

The excess (if any) of a deposit over the actual taxes for a deposit period shall be applied in order of time to each of the employer's succeeding deposits with respect to the same return period, until exhausted, to the extent that the amount by which the taxes for a subsequent deposit period exceed the deposit for such subsequent deposit period. For purposes of this subdivision (ii), "quarter-monthly period" means the first 7 days of a calendar month, the 8th day through the 15th day of a calendar month, the 16th day through the 22nd day of a calendar month, or the portion of a calendar month following the 22nd day of such month.

* * * * *

(iv) If the aggregate amount of taxes reportable on a return (other than a return on Form 942) for a return period exceeds the total amount deposited by the employer pursuant to subdivision (i) or (ii) of this subparagraph for such return period (*a*) by $500 or more in the case of a return period which ends after December 31, 1980, or (*b*) by more than $200 in the case of a return period which ends after December 31, 1970, and before January 1, 1981, the employer shall, on or before the last day of the first calendar month following the return period, deposit with a Federal Reserve bank or authorized financial institution an amount equal to the amount by which the taxes reportable on the return exceed the total deposits (if any) made pursuant to subdivision (i) or (ii) of this subparagraph for such period. As used in this subdivision, the term "taxes" shall have the meaning assigned to such term in subdivision (iii) of this subparagraph, except that the term shall include the taxes referred to in (*a*), (*b*), and (*c*) of such subdivision (iii) of this subparagraph with respect to any wages for domestic service in a private home of the employer which the employer elects to report on a quarterly return other than a quarterly return made on Form 942.

This Treasury decision is issued under the authority contained in sections 6302 and 7805 of the Internal Revenue Code of 1954 (68A Stat. 775, 917; 26 U.S.C. §§ 6302, 7805).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved June 6, 1980.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 9, 1980, 8:45 a.m., and published in the issue of the Federal Register for June 11, 1980, 45 F.R. 39499)

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26 CFR 31.6302(c)-1: Use of government depositaries in connection with taxes under Federal Insurance Contributions Act and income tax withheld.

Procedures under which qualifying agents may request permission to prepare federal tax deposit cards instead of using the prepunched cards provided by the Treasury Department. See Rev. Rul. 80-31, page 760.

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26 CFR 31.6302(c)-3: Use of government depositaries in connection with tax under the Federal Unemployment Tax Act.

Procedures under which qualifying agents may request permission to prepare federal tax deposit cards instead of using the prepunched cards provided by the Treasury Department. See Rev. Rul. 80-31, page 760.

Subchapter C.—Lien for Taxes

Section 6324A.—Special Lien for Estate Tax Deferred Under Section 6166

26 CFR 301.6324A-1: Election of and agreement to special lien for estate tax deferred under section 6166 or 6166A.

Election of a lien in favor of the U.S. by executor of a decedent's estate who seeks to be discharged from personal liability. See T.D. 7710, page 254.

Chapter 65.—Abatements, Credits, and Refunds
Subchapter A.—Procedure in General

Section 6402.—Authority to Make Credits or Refunds

26 CFR 150.6402-1: Credit or refund of overpayment of windfall profit tax.

Time for filing of refund or credit claims for overpayments. See T.D. 7732, page 334.

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26 CFR 301.6402-3: Special rules applicable to income tax.

Claims for refund based on changes of effective rates for depreciation as a result of revising the effective dates of Rev. Proc. 79-26, 1979-1 C.B. 566, and Rev. Proc. 79-35, 1979-2 C.B. 498, both of which prescribed certain changes to Rev. Proc. 77-10, 1977-1 C.B. 548, regarding the Class Life Asset Depreciation Range system. See Rev. Proc. 80-33, page 768.

Subchapter B.—Rules of Special Applications

Section 6416.—Certain Taxes on Sales and Services

Whether a company in the business of repairing automotive springs is entitled to a credit for parts purchased tax paid and used in assembling a spring. See Rev. Rul. 80-290, page 310.

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26 CFR 48.6416(a)-1: Refund or credit of tax under chapter 31 or 32.
(Also Sections 4071, 4221; 48.4071-1.)

Tread rubber; credit or refund; intercity, local, or school buses. The credit or refund provided by section 6416(b)(2)(M) of the Code is available to a tread rubber manufacturer who sells tread rubber tax-paid to its franchised retail dealers for use in retreading or recapping tires that are used by their customers on intercity, local, or school buses.

Rev. Rul. 80-192

ISSUE

Is a credit or refund of the manufacturers excise tax on tread rubber available under the circumstances described below?

FACTS

A manufacturer of tread rubber sells tread rubber tax-paid to its franchised retail dealers. The dealers use the tread rubber in retreading or recapping tires they intend to sell and also in retreading or recapping customer-owned tires. In either instance many of the retreaded tires are used by the dealers' customers on intercity, local, or school buses as defined in section 4221(d)(7) of the Internal Revenue Code.

LAW AND ANALYSIS

Section 4071(a)(4) of the Code imposes a tax on tread rubber sold by the manufacturer, producer or importer. Under section 4221(e)(5)(B), as amended by the Energy Tax Act of 1978, Pub. L. 95-618, section 233, 1978-3 C.B. (Vol. 2) 1, 16, the tax on tread rubber does not apply where it is sold for use by the purchaser in the recapping or retreading of any tire to be used by the purchaser on or in connection with a qualified bus as defined in section 4221(d)(7).

Under section 6416(b)(2)(M) of the Code, as amended by the Energy Tax Act, a credit or refund is available in the case of tax-paid tread rubber used in the recapping or retreading of a tire sold to any person for use on or in connection with a qualified bus. This credit or refund is available provided the conditions to allowance set forth in section 6416 (a) have been satisfied.

It was the intention of Congress to remove the excise tax from tread rubber and other taxable articles that are used in private intercity, local, and school bus operations. See Senate Report No. 95-529, 95th Cong., 1st Sess. (1978), 1978-3 C.B. (Vol. 2) 199, 247, accompanying the Energy Tax Act. By enacting the credit or refund provision as well as the tax-free sale provision, Congress ensured tax relief wherever the ultimate use of tread rubber is in the recapping or retreading of a tire that is used on any intercity, local, or school bus. The fact that there may be an intervening party between the tread rubber manufacturer and the bus operator who uses the retreaded tires does not preclude the availability of the credit or refund. However, the credit or refund must be claimed by the tread rubber manufacturer, who paid the tax, rather than by the retreader or bus operator.

HOLDING

The credit or refund provided by section 6416(b)(2)(M) of the Code is available to the tread rubber manufacturer under the above circumstances, provided the conditions to allowances set forth in 6416(a) have been satisfied.

Section 6420.—Gasoline Used on Farms

26 CFR 48.6420(a)-1: Payments to user and ultimate purchaser of gasoline used on a farm for farming purposes.
(Also Section 6427; 48.6427-1.)

T.D. 7709

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER D, PARTS 48 AND 140.—MISCELLANEOUS EXCISE TAXES

Payments to be made to aerial applicators in certain cases

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations governing claims by aerial applicators for payment of an amount equal to the tax imposed on gasoline and special fuels used on farms for farming purposes. Changes to the applicable tax law were made by section 3 of the Act of October 14, 1978 (Public Law 95-458) [1978-2 C.B. 367, 368]. These regulations affect all aerial applicators and all owners, tenants, and operators of farms who employ the services of aerial applicators. The regulations provide the guidance needed to comply with the law.

EFFECTIVE DATE: The regulations apply to payments for gasoline and special fuels used after March 31, 1979, on farms for farming purposes by aerial applicators.

FOR FURTHER INFORMATION CONTACT: H. B. Hartley of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC 20224, Attention: CC:LR:T, 202-566-3287, not a toll-free call.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On December 27, 1979 [44 FR 76563], the Federal Register published proposed amendments to the Miscellaneous Excise Tax Regulations (26 CFR Part 48), and temporary excise tax regulations under section 3 of the Act of October 14, 1978 (Public Law 95-458; 26 CFR Part 140), both relating to claims by aerial applicators for payment of an amount equal to the taxes imposed under sections 4081 and 4041 of the Internal Revenue Code of 1954 ("Code") on gasoline and special fuels used on farms for farming purposes. Sections 6420 and 6427 of the Code authorize the payments to the user and ultimate purchaser of these fuels. The law was amended by section 3 of the Act of October 14, 1978 (Pub. L. 95-458, 92 Stat. 1257) to permit aerial applicators to receive payments as users and ultimate purchasers of fuels they use on farms for farming purposes.

No public comments were received in response to the invitation contained in the proposed amendments to the regulations, and no public hearing on the proposal was held. This document revokes the temporary regulations (26 CFR Part 140) and adopts final regulations (26 CFR Part 48).

PROVISIONS OF THE REGULATIONS

Sections 6420 and 6427 provide, respectively, for payment to the user and ultimate purchaser of an amount equal to the tax imposed under section 4081 on gasoline and under section 4041 on special fuels, if the gasoline or special fuel is used on a farm for farming purposes. For fuel used before April 1, 1979, only the owner, tenant, or operator of a farm is entitled to claim a payment as user and ultimate purchaser. Section 3 of the Act of October 14, 1978, amended sections 6420 and 6427 to entitle aerial applicators to receive these payments for fuels used by them after March 31, 1979. Before an aerial applicator may receive a payment, however, the owner, tenant, or operator of the farm served by the aerial applicator must waive his or her right to receive the payment in a written statement retained by the aerial applicator. The statement waiving the right of the owner, tenant, or operator to be treated as the user and ultimate purchaser of the gasoline or special fuels may be in any form that substantially meets the requirements of the regulations.

ADDITIONAL CONSIDERATIONS

These regulations are needed in order to provide guidance to the public as well as to government employees responsible for implementation of sections 6420 and 6427 of the Code. Considering both the direct and indirect effects of these regulations, it is believed that they satisfactorily implement section 3 of the Act of October 14, 1978 (Public Law 95-458). Evaluation of the effectiveness of the regulations after issuance will be based upon comments received from offices within the Internal Revenue Service and the Treasury Department, and from members of the public.

DRAFTING INFORMATION

The principal author of these regulations is H. B. Hartley of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of amendments to the regulations

The following amendments to the regulations (26 CFR Part 48) are hereby adopted:

PART 48—MANUFACTURERS AND RETAILERS EXCISE TAXES

Paragraph 1. Section 48.6420(a)-1

is retitled and paragraphs (a)(1) and (b) thereof are amended to read as follows:

§ 48.6420(a)-1. Payments to user and ultimate purchaser of gasoline used on a farm for farming purposes.

(a) *In general.* (1) Section 6420 provides a payment (without interest) to the user and ultimate purchaser of gasoline used on a farm for farming purposes. The amount of the payment is determined by multiplying (i) the number of gallons of gasoline used on the farm for farming purposes by (ii) the rate of tax on gasoline under section 4081 which applied on the date the gasoline was purchased by the user and ultimate purchaser. No payment shall be made for gasoline purchased by a user and ultimate purchaser before January 1, 1956, irrespective of the use of gasoline. For gasoline purchased after December 31, 1955, and used on a farm for farming purposes, payment is made only if the user and ultimate purchaser files a claim at the time and in the manner indicated in these regulations. For rates of tax on gasoline under section 4081, see that section and § 48.4081-1. For the meaning of the terms "used on a farm for farming purposes", "farm", "farming purposes", and "gasoline", see § 48.6420(c)-1. For the meaning of "user and ultimate purchaser" see paragraph (b) of this section.

* * * * *

(b) *User and ultimate purchaser defined.* Except as otherwise provided in section 6420, the term "user and ultimate purchaser" means only an owner, tenant, or operator of a farm. In general, an owner, tenant, or operator of a farm is considered to be the user and ultimate purchaser of gasoline only if the gasoline is (1) purchased by him or her and (2) used for farming purposes on a farm of which he or she is the owner, tenant, or operator. If, however, the cost of gasoline supplied by a particular person (e.g., an owner of a farm) is by agreement borne by the tenant or operator of the farm, the tenant or operator who bore the cost of the gasoline is the user and ultimate purchaser. See paragraph (c) of this section for rules on gasoline used on farms by persons other than the owner, tenant, or operator of the farm.

* * * * *

Par. 2. The second sentence of § 48.6420(a)-1(c)(1) is amended, a new third sentence is inserted therein, and a new example (3) is added to the end of § 48.6420(a)-1(c)(2), all to read as follows:

§ 48.6420(a)-1. Payments to user and ultimate purchaser of gasoline used on a farm for farming purposes.

* * * * *

(c) *Exception with respect to use by custom operator, etc.*—(1) * * * In such a case, the owner, tenant, or operator of the farm on which the gasoline is used is considered to be the user and ultimate purchaser of the gasoline. See, however, section 6420(c)(4) which provides for waivers by owners, tenants, and operators of their right to be so treated when gasoline is used on the farm by an aerial applicator. * * *

(2) The application of paragraph (c)(1) of this section may be illustrated by the following examples.

* * * * *

Example (3). Assume the facts of example (2) except Farmer A executes a timely waiver (as provided in § 48.6420(c)-2) of his right to be treated as user and ultimate purchaser of the fuel used by XYZ Company in dusting his crops. XYZ Company is entitled to receive the payment for the 600 gallons of gasoline actually used by it in the crop dusting operation.

Par. 3. Paragraphs (d) and (e) of § 48.6420(b)-1 are deleted and paragraphs (a), (b), and (c) of that section are amended to read as follows:

(a) *In general.* A claim in respect of gasoline used on a farm for farming purposes must cover one full taxable year. A person's taxable year means his or her taxable year for purposes of subtitle A of the Internal Revenue Code. In the case of persons included under section 6420(g), the calendar year is considered to be the person's taxable year. Gasoline on hand at the end of one taxable year (e.g., fuel in supply tanks of farm machinery or in storage tanks and drums) must be excluded from a claim filed for that year. On the other hand, gasoline used during a taxable year may be covered by a claim for the year even though the gasoline has not been paid for at the time the claim is filed. A claim for any taxable year is not allowable unless filed on or before the last date prescribed by law for filing a claim for credit or refund of overpayment of income tax for the taxable year concerned.

(b) *Limit of one claim during any one taxable year.* Not more than one claim can be filed under section 6420 by any person for gasoline used during any one taxable year.

(c) *Form and content of claim.* All persons except those identified in section 6420(g), must claim any payment allowed them under section 6420 as a credit against tax on their income tax return (or a timely amended return) for the taxable year in which the gasoline was used. For persons identified in section 6420(g), a claim for payment for gasoline used on a farm for farming purposes is made on Form 843 in accordance with the instructions prescribed for the preparation of that form. A claim for a partnership must be shown on the partnership's return.

Par. 4. Paragraph (c)(2)(i) of § 48.6420(c)-1 is amended by deleting the last sentence thereof, and paragraph (c)(5) of that section is amended by deleting the first four

words of the third sentence and inserting in lieu thereof, "Since the gasoline must generally".

Par. 5. A new § 48.6420(c)-2 is inserted immediately following § 48.6420(c)-1 to read as follows:

§ 48.6420(c)-2. Payment under section 6420 to be made to aerial applicators in certain cases.

(a) *Effective date.* This regulation is effective for payments for gasoline used after March 31, 1979, by aerial applicators on farms for farming purposes.

(b) *General rule.* Section 6420 provides a payment to the user and ultimate purchaser of gasoline used on a farm for farming purposes of an amount equal to the tax imposed on gasoline under section 4081. The general rule of section 6420(c)(3)(A) is that only the owner, tenant, or operator of a farm is entitled to be treated as a user and ultimate purchaser. Section 6420(c)(4) provides that under section 6420(c)(3)(A), an aerial applicator is entitled to be treated as the user and ultimate purchaser of gasoline used by it on a farm for farming purposes, but only if the owner, tenant, or operator who is otherwise entitled to treatment as the user and ultimate purchaser waives his or her right to the payment.

(c) *Form and manner of waiver.* To waive the right to be treated as user and ultimate purchaser of gasoline which is used on a farm by an aerial applicator, the owner, tenant, or operator of a farm who is otherwise entitled to treatment as user and ultimate purchaser must execute an irrevocable written agreement no later than the date on which the aerial applicator claiming the credit files its return for the taxable year in which the gasoline is used. The agreement must identify the period during which the owner, tenant, or operator waives his or her right to payment. The effective period of the waiver cannot extend beyond the last day of the taxable year of the owner, tenant, or operator of the farm on which the gasoline was used. If the owner, tenant, or operator's taxable year extends beyond the taxable year of the applicator, the applicator can only claim payment for periods included in the applicator's taxable year. Periods after the last day of the applicator's taxable year which are included under the agreement must be claimed on the applicator's return for the next succeeding taxable year. The waiver may be in the form shown under paragraph (g) of this section or in any other form that meets the requirements of these regulations, but must clearly evidence that the owner, tenant, or operator of the farm knowingly gives up the right to receive a payment.

(d) *Agreement included on aerial applicator's invoice.* The agreement waiving a right to receive a payment under section 6420 may be a separate document or may appear on the face or the reverse side of an invoice for aerial application services or other unrelated document from the aerial applicator to the owner, tenant, or operator of the farm. If the waiver agreement appears on an invoice or other unrelated document, however, it must be printed in a section of the invoice or other document clearly set off from all other material contained in the invoice or other document, and it must be printed in type sufficiently large to put the owner, tenant, or operator of the farm on notice that he or she has waived his or her right to receive a payment under section 6420. Additionally, if the waiver agreement appears as part of any invoice or other unrelated document, it must be executed separately from any other item included in the invoice or other document which requires the owner, tenant, or operator's signature.

(e) *Copies of agreement waiving right to payment.* No copies of any agreement waiving a right to payments under section 6420 are to be submitted to the Internal Revenue Service unless a request is made by the Service to the taxpayer for the waivers. Aerial applicators must, however, retain copies of all waivers, and a copy of each waiver must be supplied by the aerial applicator to the owner, tenant, or operator of the farm who waives his or her right to receive a payment. See regulations § 48.6420(f)-1 for general requirements for records to be kept.

(f) *Waiver on behalf of owner, tenant, or operator of farm.* If any owner, tenant, or operator of a farm desires that an agent (e.g., a cooperative) act for him or her or cannot legally bind himself or herself due to infancy or other incompetency, a representative expressly authorized under local law to bind the owner, tenant, or operator in a waiver of his or her rights to payment under section 6420 may sign the waiver on his or her behalf.

(g) *Sample form of agreement.* While no specific form is required for an effective waiver, an acceptable form waiving the right to receive a payment under section 6420 follows:

I hereby waive my right as owner/tenant/operator of a farm located at (address) _____ to receive payment or credit from the United States for gasoline used by (aerial applicator) _____ on the farm in connection with cultivating the soil, or the raising or harvesting of any agricultural or horticultural commodity. This waiver applies to gasoline used during the period _____, both dates inclusive.

I understand that by signing this waiver I give up my right to claim any credit or payment for gasoline used by the aerial applicator during the period indicated, and I acknowledge that I have not previously claimed any credit or payment for that gasoline.

_____
(Signature of Owner/Tenant/Operator)

Taxpayer Identification No: _____

Par. 6. A new § 48.6427-1 is inserted following § 48.6421(g)-1 to read as follows:

§ 48.6427-1 Payment under section 6427 to be made to aerial applicators in certain cases.

(a) *Effective date.* This regulation is effective for payments for special fuels used after March 31, 1979, by aerial applicators on farms for farming purposes.

(b) *In general.* Section 6427 provides for payment to the user and ultimate purchaser of certain fuels used on a farm for farming purposes of an amount equal to the amount of tax imposed on these fuels under section 4041. The general rule is that only an owner, tenant, or operator of a farm is entitled to be treated as a user and ultimate purchaser. Section 6427(c) provides that an aerial applicator is entitled to be treated as the user and ultimate purchaser of fuels which it uses on a farm for farming purposes, but only if the owner, tenant, or operator who is otherwise entitled to treatment as the user and ultimate purchaser waives his or her right to the payment.

(c) *Form and manner of waiver.* To waive the right to be treated as user and ultimate purchaser of special fuels which are used on a farm by an aerial applicator, the owner, tenant, or operator of a farm who is otherwise entitled to treatment as user and ultimate purchaser must execute an irrevocable written agreement no later than the date on which the aerial applicator claiming the credit files its return for the taxable year in which the special fuels are used. The agreement must identify the period during which the owner, tenant, or operator waives his or her right to payment. The effective period of the waiver cannot extend beyond the last day of the taxable year of the owner, tenant, or operator of the farm on which the special fuels were used. If the owner, tenant, or operator's taxable year extends beyond the taxable year of the applicator, the applicator can only claim payment for periods included in the applicator's taxable year. Periods after the last day of the applicator's taxable year which are included under the agreement must be claimed on the applicator's return for the next succeeding taxable year. The waiver may be in the form shown under paragraph (g) of this section or in any other form that meets the requirements of these regulations, but must clearly evidence that the owner, tenant, or operator of the farm knowingly gives up the right to receive a payment.

(d) *Agreement included on aerial applicator's invoice.* The agreement waiving a right to receive a payment under section 6427 may be a separate document or may appear on the face or the reverse side of an invoice for aerial application services or other unrelated document from the aerial applicator to the owner, tenant, or operator of the farm. If the waiver agreement appears on an invoice or other unrelated document, however, it must be printed in a section of the invoice or other document clearly set off from all other material contained in the invoice or other document, and it must be printed in type sufficiently large to put the owner, tenant, or operator of the farm on notice that he or she has waived his or her right to receive a payment under section 6427. Additionally, if the waiver agreement appears as part of any invoice or other unrelated document, it must be executed separately from any other item included in the invoice or other document which requires the owner, tenant, or operator's signature.

(e) *Copies of agreement waiving right to payment.* No copies of any agreement waiving a right to payments under section 6427 are to be submitted to the Internal Revenue Service unless a request is made by the Service to the taxpayer for the waivers. Aerial applicators must, however, retain copies of all waivers, and a copy of each waiver must be supplied by the aerial applicator to the owner, tenant, or operator of the farm who waives his or her right to receive a payment. See regulations § 48.6420(f)-1 for general requirements for records to be kept.

(f) *Waiver on behalf of owner, tenant, or operator of farm.* If any owner, tenant, or operator of a farm desires that an agent (*e.g.*, a cooperative) act for him or her or cannot legally bind himself or herself due to infancy or other incompetency, a representative expressly authorized under local law to bind the owner, tenant, or operator in a waiver of his or her rights to a payment under section 6427 may sign the waiver on his or her behalf.

(g) *Sample form of agreement.* While no specific form is required for an effective waiver, an acceptable form waiving the right to receive a payment under section 6427 follows:

I hereby waive my right as owner/tenant/operator of a farm located at (address) _____ to receive payment or credit from the United States for special fuels used by (aerial applicator) _____ on the farm in connection with cultivating the soil, or the raising or harvesting of any agricultural or horticultural commodity. This waiver applies to special fuels used during the period _____, both dates inclusive.

I understand that by signing this waiver I give up my right to claim any credit or payment for special fuels used by the aerial applicator during the period indicated, and I acknowledge that I have not previously claimed any credit or payment for that special fuel.

_____

(Signature of Owner/Tenant/Operator)

Taxpayer Identification No: _____

TEMPORARY EXCISE TAX REGULATIONS UNDER SECTION 3 OF THE ACT OF OCTOBER 14, 1978 (PUBLIC LAW 95-458)

Par. 7. 26 CFR Part 140 is revoked.

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805) and in section 3 of the Act of October 14, 1978 (Pub. L. 95-458, 92 Stat. 1257).

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved July 9, 1980

DONALD S. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 24, 1980, 8:45 a.m., and published in the issue of the Federal Register for July 25, 1980, 45 F.R. 49544)

Section 6427.—Fuels Not Used for Taxable Purposes

26 CFR 48.6427-1: Payments under section 6427 to be made to aerial applicators in certain cases.

Final regulations relating to claims by aerial applicators for payments equal to the tax on gasoline and certain other fuels that are used on farms for farming purposes. See T.D. 7709, page 369.

Chapter 67.—Interest
Subchapter A.—Interest on Underpayments

Section 6601.—Interest on Underpayment, Nonpayment, or Extensions of Time for Payment of Tax

26 CFR 301.6601-1: Interest on underpayments.
(Also Section 2055; 20.2055-1.)

Interest on deficiency; deduction subsequently allowed. A charitable deduction claimed on an estate tax return was disallowed because the deduction did not satisfy the requirements of section 2055(e) of the Code, but was subsequently allowed when the gift was made to qualify. Interest is due on the deficiency from the due date of the return to the end of a 180-day period following the filing of a claim for credit or refund.

Rev. Rul. 80-291

ISSUE

For what period is interest due when a charitable deduction claimed on an estate tax return was disallowed because the deduction did not satisfy the requirements of section 2055 of the Internal Revenue Code at the time the return was filed, but which was later allowed when the gift qualified?

FACTS

The decedent died on April 12, 1977. The estate tax return was timely filed on the due date, January 12, 1978. A charitable deduction was claimed on the return for a bequest that did not satisfy the requirements of section 2055(e) of the Code. Upon examination of the estate tax return the deduction was disallowed by the Internal Revenue Service. On December 19, 1978, the estate petitioned the state court for a reformation of the testamentary trust created by the decedent's will and for relief from certain provisions of the state law so that the remainder devised to charity would qualify for the deduction under section 2055. On February 27, 1979, while the examination of the estate was still pending, the state court entered a judgment granting the relief that the estate requested. On February 28, 1979, the estate filed a claim for credit or refund based on the fact that the testamentary trust had been amended in order to satisfy the requirements of section 2055(e). The examiner secured two waivers, one agreeing to a deficiency based on the disallowed original deduction and the other agreeing to an overassessment based on the subsequently filed claim.

LAW AND ANALYSIS

Section 2055(e)(3) of the Code provides that if the amendment of the governing instrument is made after the due date for filing of the estate tax return, the deduction shall be allowed upon the filing of a timely claim for credit or refund (as provided for in section 6511) of an overpayment resulting from the application of this paragraph. In the case of a credit or refund resulting from an amendment made pursuant to section 2055(e), no interest is allowable for the period before the expiration of the 180th day after the date on which the claim for credit or refund is filed.

Section 6601(a) of the Code provides that if any amount of tax imposed by the Code is not paid on or before the last date prescribed for payment, interest shall be paid on such amount for the period from such last date to the date paid.

Section 2.01 of Rev. Proc. 60-17, 1960-2 C.B. 942, provides that interest generally is paid on a tax overpayment for the time the government has the use of the taxpayer's money. Similarly, interest is collected for the time the taxpayer has the use of the government's money. Section 3.02(5)d of Rev. Proc. 60-17 states that the date of overpayment in a restricted interest case is the date from which interest is allowable on the overpayment, and that this same date is the terminating date for charging interest on a deficiency satisfied by credit of an overpayment.

In *Manning v. Seeley Tube and Box Co.*, 338 U.S. 561 (1950), Ct. D. 1729, 1950-1 C.B. 113, the Supreme Court held that a net operating loss carryback that eliminates a deficiency does not abate the interest previously assessed on that deficiency.

Since the estate is not entitled to the use of the money resulting from taking this deduction from the due date of the return to the end of the 180-day period beginning after the date on

which the estate filed the claim for refund, interest is due for this period.

HOLDING

Interest is due on the estate tax deficiency from January 12, 1978, the due date of the estate tax return, to August 27, 1979, the end of the 180-day period.

Chapter 68.—Additions to the Tax, Additional Amounts, and Assessable Penalties
Subchapter A.—Additions to the Tax and Additional Amounts

Section 6651.—Failure to File Tax Return or to Pay Tax

26 CFR 301.6651-1: Failure to file tax return or to pay tax.

An extension of the time in which contractors or subcontractors with contracts subject to the Vinson-Trammell Act must file Form 949 and 949-A. See Rev. Proc. 80-45, page 778.

Section 6652.—Failure to File Certain Information Returns, Registration Statements, Etc.

26 CFR 301.6652-1: Failure to file certain information returns.

Treatment of certain crewmen on boats engaged in catching fish as self-employed rather than as employees. See T.D. 7716, page 241.

Section 6654.—Failure by Individual to Pay Estimated Income Tax

26 CFR 1.6654-1: Addition to the tax in the case of an individual.
(Also Section 6013; 1.6013-2.)

Penalty; estimated tax underpayment; joint return following separate returns. The tax shown on a joint return filed after due date, to replace separate returns filed before the due date, is the basis for computing the addition to tax for underpayment of estimated tax.

Rev. Rul. 80-355

ISSUE

Is the addition to the tax for underpayment of estimated tax based on the tax shown on the separate returns of the taxpayers or the tax shown on a joint return filed after the due date prescribed by law for the filing of the return?

FACTS

The taxpayers filed separate income tax returns for a taxable year by the due date, although they were eligible to file a joint return. Both were assessed the addition to the tax for underpayment of estimated tax since both taxpayers' estimated tax payments throughout the taxable year were less than 80 percent of the tax shown on each separate return. After the due date they filed a joint return, which resulted in less tax shown on the return than the total tax that had been shown on the two individual returns. Their estimated tax payments throughout the taxable year were more than 80 percent of the tax shown on the joint return.

LAW AND ANALYSIS

Section 6654(a) of the Internal Revenue Code provides that in the case of underpayments of estimated tax by an individual there shall be added to the tax an amount determined at an annual rate established under section 6621 upon the amount of the underpayment for the period of the underpayment.

Section 6654(b) of the Code provides that the underpayment shall be the difference between the amount paid on or before the last date prescribed for such payment and the amount that would be required to be paid if the estimated tax were equal to 80 percent of the tax shown on the return for the taxable year.

Section 6013(b) of the Code provides that if an individual has filed a separate return for a taxable year for which a joint return could have been made and the time prescribed by law for filing the return for such taxable year has expired, a joint return may be filed before expiration of the statute of limitations. The joint return shall be the return of the spouses for such taxable year. It also provides that for purposes of assessment and collection, where both spouses have filed separate returns, the joint return is deemed filed on the date the later separate return was filed (but not earlier than the last date prescribed by law for filing the return of either spouse).

The intent in allowing taxpayers to change their elections and file joint returns at any time within the period of the statute of limitations was to enable married taxpayers to minimize their tax liability. See S. Rep. No. 781, 82nd Cong., 1st Sess. 48 (1951), 1951-2 C.B. 458, 492.

Thus, in the case of a joint return following separate returns, any addition to the tax is based upon the joint return. Compare the case of amended returns where for purposes of determining the underpayment of estimated tax under section 6654(b) of the Code, the return for the taxable year is the original return of the taxpayer rather than any amended return filed after the due date and extensions thereof.

HOLDING

The addition to the tax for underpayment of estimated tax is based on the tax shown on the joint return of the taxpayers filed after the due date prescribed by law for the filing of the return when the joint return replaces the previously filed separate returns of the taxpayers.

Section 6655.—Failure by Corporation to Pay Estimated Income Tax

26 CFR 1.6655-2: Exceptions to imposition of the addition to the tax in the case of corporations.
(Also Section 995; 1.995-2.)

Estimated tax; corporation; year-end dividend from DISC. A corporation using the same accounting

period and method as its wholly owned DISC may compute estimated tax under section 6655(d)(3)(A)(iv) of the Code without taking into account the constructive dividend deemed to be received from the DISC on the last day of the corporation's taxable year.

Rev. Rul. 80-343

ISSUE

May a corporation compute the estimated tax under section 6655(d)(3)(A)(iv) of the Internal Revenue Code by placing its taxable income on an annualized basis for the appropriate period of months without taking into account any part of a constructive distribution deemed to be received on the last day of its taxable year?

FACTS

X, a corporation, owns all the stock of *Y*, a Domestic International Sales Corporation (DISC). *X* and *Y* keep their books and file their tax returns using the accrual method of accounting and a fiscal year ending on October 31. Pursuant to section 995(b)(1) of the Code, *X* includes in its income an amount deemed received from *Y* on the last day of its taxable year. Prior to October 31 it is not possible to determine the amount of the deemed distribution.

LAW AND ANALYSIS

Section 995(b)(1) of the Code provides that a shareholder of a DISC shall be treated as having received a distribution taxable as a dividend with respect to its stock in an amount that is equal to its pro rata share of the sum of certain enumerated items, or if smaller, the earnings and profits of the DISC. Section 1.995-1(b)(2) and 1.995-2(a) of the Income Tax Regulations specify that such distribution shall be deemed to be received on the last day of the taxable year of the DISC in which the income was derived.

Section 6655(a) of the Code provides for an addition to the tax in the case of any underpayment of estimated tax by a corporation. Section 6655(d)(3)(A)(iv) provides that such addition shall not be imposed if the total amount of all payments of estimated tax made on or before the last date prescribed for the payment of such installment equals or exceeds the amount that would have been required to be paid on or before such date if the estimated tax were an amount equal to 80 percent of the tax for the taxable year computed by placing on an annualized basis the taxable income for the first 9 months or for the first 11 months of the taxable year in the case of the installment required to be paid in the 12th month of the taxable year.

X is not deemed to have received the distribution from *Y* until the last day of *Y*'s taxable year, October 31. That is also the last day of *X*'s taxable year and *X* does not receive income from *Y* until that date. Under section 6655(d)(3)(A)(iv) of the Code, taxable income for the 12th month is not included in the taxable income to be annualized.

HOLDING

X may compute the estimated tax under section 6655(d)(3)(A)(iv) of the Code without taking into account any part of the section 995(b)(1) distribution from *Y*.

Subchapter B.—Assessable Penalties

Section 6693.—Failure to Provide Reports on Individual Retirement Accounts or Annuities

26 CFR 301.6693-1: Penalty for failure to provide reports and documents concerning individual retirement accounts or annuities.

Penalties for failure to furnish information in connection with individual retirement plans. See T.D. 7730, page 297.

Section 6694.—Understatement of Taxpayer's Liability by Income Tax Return Preparer

26 CFR 1.6694-1: Understatement of taxpayer's liability by income tax return preparer.

Return preparer; mathematical or clerical error. An inadvertent error made by a return preparer in either listing or totaling on Schedule B, Form 1040, the separate amounts shown on Forms 1099-INT furnished by a taxpayer that does not result in substantial understatement of tax and is the only error on the return does not subject the preparer to the negligence penalty under section 6694(a) of the Code.

Rev. Rul. 80-262 [1]

ISSUE

Does the penalty for negligent disregard of rules and regulations under section 6694(a) of the Internal Revenue Code apply to a preparer in the following situations?

FACTS

Situation 1

The taxpayer furnished the income tax return preparer with all of the Forms 1099-INT, Statement for Recipients of Interest Income, that the taxpayer had received. The preparer failed to list the amount shown on one of the Forms 1099-INT on schedule B of Form 1040, U.S. Individual Income Tax Return. Upon examination of the return by the Service, it was determined that the omission resulted in an understatement of tax liability. However, the amount of the understatement was not substantial and the omission was the only error on the return.

The preparer stated that the reason for the failure to report the omitted amount was that the Form 1099-INT

[1] Also released as New Release IR-80-94 dated Sept. 15, 1980.

showing the omitted amount was overlooked.

Situation 2

The taxpayer furnished the income tax return preparer with all of the Forms 1099-INT that the taxpayer had received. The preparer correctly listed all of the amounts shown on the Forms 1099-INT on schedule B of Form 1040 but made an error in totalling the separate amounts. Upon examination of the return by the Service, it was determined that the error resulted in an understatement of tax liability. However, the amount of the understatement was not substantial and the omission was the only error on the return.

LAW AND ANALYSIS

Rev. Proc. 80-40, page 774, this Bulletin, sets forth guidelines for the application of the penalty under section 6694(a) of the Code for the negligent disregard of rules and regulations by an income tax return preparer. The revenue procedure indicates that the Service will consider the nature of the error causing the understatement, the frequency of the errors and the materiality of the errors. Rev. Proc. 80-40 specifically provides that an isolated mathematical or clerical error ordinarily reflects no more than mere inadvertence and thus will not result in the assertion of the penalty unless the error is of such magnitude or so conspicuous that it should have been discovered after its commission.

Under the facts as stated the error in situation 1 was clerical in nature and the error in situation 2 was mathematical in nature. Furthermore, in each situation, the error was the only error on the return and the amount of the understatement was not substantial.

HOLDING

The penalty for negligent disregard of rules and regulations does not apply to the preparers in either situation 1 or 2.

26 CFR 1.6694-1: Understatement of taxpayer's liability by income tax return preparer.

Return preparer, normal office practice; pattern of errors. A return peparer failed to list all income shown on a taxpayer's Forms 1099, incorrectly totaled itemized deductions, and used the wrong tax table. Even though the preparer's normal office practice was to review the taxpayer-provided information, check the return for completeness, and check the tax computation, there was a pattern of errors on the return, and the penalty under section 6694(a) of the Code applies.

Rev. Rul. 80-263 [1]

ISSUE

Does the penalty for negligent disregard of rules and regulations under section 6694(a) of the Internal Revenue Code apply in the following situation?

FACTS

The taxpayer furnished the income tax return preparer with all of the Forms 1099-INT, Statement for Recipients of Interest Income, and Forms 1099-DIV, Statement for Recipients of Dividends and Distributions, that the taxpayer had received. The preparer failed to list the amount shown on one of the Forms 1099-INT and on one of the Forms 1099-DIV on Schedule B, Interest and Dividend Income, of Form 1040, U.S. Individual Income Tax Return. Also, the preparer made an error in totalling the amounts of itemized deductions on Schedule A, Itemized Deductions, and used the wrong tax table in determining the tax. Upon examination of the return the Internal Revenue Service determined that these errors resulted in an understatement of liability. None of these understatements was substantial in amount.

The preparer stated that these errors were merely oversights and demonstrated that the preparer's normal practice was to review the information provided by the taxpayer, review the return to check for completeness, and check the computation of the tax.

LAW AND ANALYSIS

Section 6694(a) of the Code provides that if any part of any understatement of liability with respect to any return is due to the negligent or intentional disregard of rules and regulations by any person who is an income tax return preparer with respect to such return, such person shall pay a penalty of $100 with respect to such return.

Rev. Proc. 80-40, page , this Bulletin, sets forth guidelines for the application of the penalty under section 6694(a) of the Code for the negligent disregard of rules and regulations by an income tax return preparer. The revenue procedure indicates that the Service will consider the nature of the error causing the understatement, the frequency of the errors and the materiality of the errors. The revenue procedure also provides that where all the relevant facts and circumstances suggest that the return was negligently prepared, the penalty will not be asserted if (1) the preparer's normal office practice, when considered together with other facts and circumstances, indicated that the error in question would rarely occur and (2) the normal office practice was followed in preparing the return in question.

Although each error, if the sole error on the return, would not result in the imposition of the penalty, all of the errors taken together suggest that the return was negligently prepared. In addition, although the preparer alleged that the preparer's normal office practice, considered with other facts and circumstances, indicated that the errors in question would rarely occur, in this situation the normal office practice of the preparer will not re-

[1] Also released as New Release IR-80-94 dated Sept. 15, 1980.

lieve the preparer from the penalty because there is a pattern of errors on the return.

HOLDING

The penalty for negligent disregard of rules or regulations applies.

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26 CFR 1.6694-1: Understatement of taxpayer's liability by income tax return preparer.

Return preparer; normal office practice; failure to report minimum tax liability. A return preparer who failed to report a minimum tax liability showed that normal office practice, when taken together with other factors, indicated that the minimum tax error would rarely occur and that normal office practice was followed in preparing the return. The preparer was not liable for the negligence penalty under section 6694(a) of the Code. Rev. Rul. 80-28 distingiushed.

Rev. Rul. 80-264 [1]

ISSUE

Does the penalty for the negligent disregard of rules and regulations under section 6694(a) of the Internal Revenue Code apply to a preparer in the following situation?

FACTS

An income tax return preparer failed to report a substantial minimum tax liability resulting from a net capital gain deduction shown on the individual taxpayer's 1978 return. This was the only error on the return. The preparer agreed that there was an understatement on the return and explained that the failure to report the minimum tax was due to an oversight. To show that the preparer's normal office practice was to correctly apply the minimum tax provisions, the preparer presented a checklist that showed when the minimum tax must be considered. The workpapers of the preparer for the return in question indicated that the checklist had been reviewed. Consideration of the knowledge of the preparer, the internal procedures for review, and other facts and circumstances indicated that this error would rarely occur.

LAW AND ANALYSIS

Section 56(a) of the Code provides for the imposition of an income tax on certain items of tax preference. Section 57(a)(9)(A) treats as a tax preference item an amount equal to the net capital gain deduction for the taxable year determined under section 1202. For taxable years ending prior to January 1, 1979, such item was taxed under section 56(a). For years beginning after December 31, 1978, such item is taxed under section 55 (relating to the alternative minimum tax).

Section 6694(a) of the Code provides that if any part of any understatement of liability with respect to any return is due to the negligent or intentional disregard of rules and regulations by any person who is an income tax return preparer with respect to such return, such person shall pay a penalty of $100 with respect to such return.

Rev. Rul. 80-28, 1980-1 C.B. 304, holds that an income tax return preparer who failed to report a minimum tax liability on an individual taxpayer's income tax return because of an oversight was required to pay a penalty for negligent or intentional disregard of rules and regulations.

Rev. Proc. 80-40, page 22, this Bulletin, sets forth guidelines for the application of the penalty under section 6694(a) of the Code for the negligent disregard of rules and regulations by an income tax preparer. This revenue procedure indicates that the Service will consider the nature of the error causing the understatement, the frequency of the errors and the materiality of the errors. The revenue procedure also provides that where the facts and circumstances suggest that the return was negligently prepared, the penalty will not be asserted if (1) the preparer's normal office practice, when considered together with other facts and circumstances, indicates that the error in question would rarely occur and (2) the normal office practice was followed in preparing the return in question.

The facts and circumstances suggested that the return was negligently prepared by the preparer. Although the failure to report the minimum tax was the only error on the return, the amount of the understatement was substantial and the error could have been discovered by reviewing the return. However, the preparer showed that the preparer's normal office practice, when taken together with other facts and circumstances, indicates that the error in question would rarely occur and that the normal office practice was followed in preparing the return in question. Furthermore, the error is not a flagrant one.

HOLDING

The preparer is not liable for a penalty for the negligent disregard of rules and regulations.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 80-28 is distinguished.

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26 CFR 1.6694-1: Understatement of taxpayer's liability by income tax return preparer.

Return preparer; failure to report income deducted on related return. A return preparer who prepared both an individual's return and the return of the individual's wholly owned corporation deducted interest paid by the corporation to the individual on the corporate return, but did not report the interest as income on the individual's return. The negligence penalty does not apply to the preparer if the information provided by the corporation

[1] Also released as New Release IR-80-94 dated Sept. 15, 1980.

did not indicate who received the interest and the information provided by the individual did not indicate receipt of such payment. However, the penalty would apply if the information provided by the corporation indicated that the individual received the interest payment.

Rev. Rul. 80-265 [1]

ISSUE

Does the penalty for negligent disregard of rules and regulations under section 6694(a) of the Internal Reve- Code apply in the following situations?

FACTS

Situation 1

An income tax return preparer prepared both *A*'s individual federal income tax return for calendar year 1978 and the corporate income tax return of *X*, *A*'s wholly-owned corporation for its taxable year ended December 31, 1978. The preparer was not the auditor of *X* and had no knowledge whatsoever of any loans by *A* to *X*. The preparer deducted interest paid by *X* to *A* on the corporation's return filed March 15, 1979. However, the preparer did not report the interest as income on *A*'s individual return filed April 15, 1979. The information provided by *X* to the preparer did not indicate who received the interest payment and the information provided by *A* to the preparer did not indicate receipt of such payment. Upon examination the Internal Revenue Service determined that the failure to report the interest income resulted in an understatement of tax liability on *A*'s individual return.

Situation 2

The facts are the same as in situation 1 except that the information provided by *X* indicated *A* received the interest payment from *X*.

[1] Also released as New Release IR-80-94 dated Sept. 15, 1980.

LAW AND ANALYSIS

Section 6694(a) of the Code provides that if any part of any understatement of liability with respect to any return is due to the negligent or intentional disregard of rules and regulations by any person who is an income tax return preparer with respect to such return, such person shall pay a penalty of $100 with respect to such return.

Under section 61 of the Code interest received on loans are includable in gross income.

Rev. Proc. 80-40, page 774, this Bulletin, sets forth guidelines for the application of the penalty under section 6694(a) of the Code for the negligent disregard of rules and regulations by an income tax return preparer. The revenue procedure indicates that the penalty generally will not apply where a preparer in good faith relies without verification upon information furnished by the taxpayer, but the preparer may not ignore the implications of information furnished to the preparer or actually known to the preparer.

In situation 1, the preparer could rely upon the information furnished by *A* in connection with *A*'s individual return. The preparer was not required to examine or review *A*'s books and records and had no reason to believe that the information as furnished might be incorrect or incomplete.

In situation 2, the preparer, based on the information furnished by *X*, in connection with *X*'s corporate return, had reason to believe that the information furnished by *A* might be incorrect or incomplete. The preparer should have made inquiries to reconcile the information furnished by *X* with the omission by *A* of the interest income.

HOLDING

The penalty for negligent disregard of rules and regulations under section 6694(a) of the Code does not apply to the preparer in situation 1. The penalty does apply to the preparer in situation 2.

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26 CFR 1.6694-1: Understatement of taxpayer's liability by income tax return preparer.

Return preparer; reliance on taxpayer's assurances; entertainment expenses. A return preparer who asks a taxpayer if entertainment expense substantiation that satisfies the requirements of section 274(d) of the Code exists and receives assurances that it does will not be subject to the negligence penalty under section 6694(a) as a result of the taxpayer's failure to substantiate the expenses in an audit. A return preparer who does not ask for such assurances will be subject to the penaltv, as will the first preparer in a subsequent year if the same assurances are received and the preparer is aware of the prior audit results.

Rev. Rul. 80-266 [1]

ISSUE

Does the penalty for negligent disregard of rules and regulations under section 6694(a) of the Internal Revenue Code apply to an income tax return preparer where the preparer relied upon incorrect information provided by the taxpayer?

FACTS

Situation 1

A preparer was engaged to prepare a tax return of a taxpayer who claimed to have incurred deductible entertainment expenses. The preparer inquired whether the taxpayer had records showing the amount, the time, the place and the business purpose of the expenses and the business relationship to the taxpayer of the persons entertained in accordance with the requirements of section 274(d) of the

[1] Also released as New Release IR-80-94 dated Sept. 15, 1980.

Code. The taxpayer represented to the preparer that it had such records. The preparer then prepared the return claiming a reduction for entertainment expenses in the amount indicated by the taxpayer.

Upon examination, the Service disallowed a portion of the claimed deductions because the taxpayer could not substantiate with respect to certain expenses either the business purpose or the business relationship of some of the persons entertained. This determination resulted in an understatement of tax liability as defined in section 6694(e) of the Code.

Situation 2

The facts are the same as in situation 1 except that the preparer did not inquire whether the taxpayer had adequate records, and the taxpayer did not make any representations that it had such records. The preparer did not adequately demonstrate that the preparer's normal office practice should prevent the assertion of the penalty.

Situation 3

The preparer in situation 1 completed the return of the same taxpayer for the year following the examination. The taxpayer again claimed to have incurred deductible entertainment expenses. The preparer inquired whether the taxpayer had records showing the amount, the time, the place, and the business purpose of the expenses, and the business relationship to the taxpayer of the persons entertained. The taxpayer again represented that it had such records. The preparer did not make a further inquiry although the preparer was aware that the taxpayer could not substantiate certain entertainment deductions during the examination in the prior year.

Upon examination the Service again disallowed a portion of the deductions claimed by the taxpayer for entertainment because the taxpayer could not substantiate with respect to certain expenses either the business purpose or the business relationship of some of the persons entertained. This determination resulted in an understatement of tax liability.

LAW AND ANALYSIS

Section 6694(a) of the Code provides that if any part of any underpayment of liability with respect to any return is due to the negligent or intentional disregard of rules and regulations by any person who is an income tax return preparer with respect to such return, such person shall pay a penalty of $100 with respect to such return.

Section 274(d) of the Code provides that no deduction will be allowed for travel and entertainment unless the taxpayer substantiates it with adequate records.

Rev. Proc. 80-40, page 774, this Bulletin, sets forth guidelines for the application of the penalty under section 6694(a) of the Code for the negligent disregard of rules and regulations by an income tax return preparer, including factors that will be taken into consideration in determining whether the penalty will be applied. The revenue procedure provides that a preparer must make appropriate inquiries to determine the existence of facts and circumstances required by a Code section or regulations as a condition to claiming a deduction.

In situation 1 the preparer made appropriate inquiries as to whether the taxpayer had records adequate to meet the requirements of section 274(d) and the regulations thereunder. Because the taxpayer represented that it had such records, it was proper for the preparer to claim the deduction.

In situation 2 the preparer failed to inquire whether the taxpayer had records adequate to meet the requirements of section 274(d) of the Code and the regulations thereunder.

In situation 3 the preparer was aware that the taxpayer could not substantiate some of the entertainment deductions in the examination during the prior year and thus had reason to believe that the taxpayer might not have adequate records for the current year. Therefore, although the inquiry made by the preparer was sufficient in situation 1, it was not sufficient in situation 3. The preparer should have made further inquiries to reconcile the inadequacy of the records in the recent examination of an earlier year with the taxpayer's representation in order to reasonably conclude that the taxpayer now has adequate records.

HOLDINGS

The penalty for negligent disregard of rules and regulations under section 6694(a) of the Code does not apply to the preparer in situation 1. The penalty does apply to the preparer in situations 2 and 3.

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26 CFR 1.6694-1: Understatement of taxpayer's liability by income tax return preparer.

Guidelines for the application of the penalty under section 6694(a) of the Code for the negligent disregard of rules and regulations by an income tax return preparer. See Rev. Proc. 80-40, page 774.

Chapter 75.—Crimes, Other Offenses, and Forfeitures
Subchapter A.—Crimes
Part I.—General Provisions

Section 7214.—Offenses by Officers and Employees of the United States

Ct. D. 2000

SUPREME COURT
OF THE
UNITED STATES
No. 79-383

F. W. Standefer, Petitioner,
v. United States

[447 U.S. 10]

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

[June 9, 1980]

Syllabus

No. 79-383. Argued April 14, 1980—Decided June 9, 1980

Petitioner was indicted for, *inter alia,* aiding and abetting a named Internal Revenue Service agent in accepting unlawful compensation, in violation of 26 U.S.C. § 7214(a)(2) and 18 U.S.C. § 2, which provides that whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal. Prior to the indictment, the IRS agent was acquitted of certain of the § 7214(a)(2) violations which petitioner was accused of aiding and abetting. Petitioner moved to dismiss his indictment as to aiding and abetting these violations on the ground that since the agent had been acquitted of such violations, petitioner could not be convicted of aiding and abetting them. The District Court denied the motion, and after trial petitioner was convicted. The Court of Appeals affirmed.

Held: A defendant accused of aiding and abetting in the commission of a federal offense may properly be convicted despite the prior acquittal of the alleged actual perpetrator of the offense.

(a) Read against its common-law background, 18 U.S.C. § 2 evinces a clear congressional intent to permit such a conviction. The section gives general effect to what had always been a common-law rule for second-degree principals (principals who were actually or constructively present at the scene of the crime and aided and abetted its commission) and for all misdemeanants. The legislative history of § 2 confirms this understanding. With the enactment of § 2, all participants in conduct violating a federal criminal statute are "principals," and as such they are punishable for their criminal conduct, the fate of other participants being irrelevant.

(b) The Government is not barred, under the doctrine of nonmutual collateral estoppel, from relitigating the issue of whether the IRS agent accepted unlawful compensation. Application of that doctrine is not appropriate here. In a criminal case, the Government is often without the kind of "full and fair opportunity to litigate" that is a prerequisite of estoppel. The application of collateral estoppel in criminal cases is also complicated by rules of evidence and exclusion unique to criminal law. Finally, in this case the important federal interest in the enforcement of the criminal law outweighs the economy concerns undergirding the collateral estoppel doctrine.

610 F. 2d 1076, affirmed.

BURGER, C. J., delivered the opinion for a unanimous Court.

MR. CHIEF JUSTICE BURGER delivered the opinion of the Court.

We granted certiorari in this case to decide whether a defendant accused of aiding and abetting in the commission of a federal offense may be convicted after the named principal has been acquitted of that offense.

I

In June 1977, petitioner Standefer was indicted on four counts of making gifts to a public official, in violation of 18 U.S.C. § 201(f), and on five counts of aiding and abetting a revenue official in accepting compensation in addition to that authorized by law, in violation of 26 U.S.C. § 7214(a)(2) and 18 U.S.C. § (2).[1] The indictment charged that petitioner, as head of Gulf Oil Company's tax department, had authorized payments for five vacation trips to Cyril Niederberger, who then was the Internal Revenue Service agent in charge of the audits of Gulf's federal income tax returns.[2] Specifically, the indictment alleged that Gulf, on petitioner's authorization, had paid for vacations for Niederberger in Pompano Beach (July 1971), Miami (January 1973), Absecon (August-September 1973), Pebble Beach (April 1974), and Las Vegas (June 1974). The four counts under 18 U.S.C. § 201(f) related to the Miami, Absecon, Pebble Beach, and Las Vegas vacations; the five counts under 26 U.S.C. § 7214(a)(2) and 18 U.S.C. § 2 were one for each vacation.[3]

Prior to the filing of this indictment, Niederberger was separately charged in a 10-count indictment—two counts for each of the five vacations—with violating 18 U.S.C. § 201(g) and 26 U.S.C. § 7214(a)(2).[4] In February 1977, Niederberger was tried on these charges. He was convicted on four counts of violating § 201(g) in connection with the vacations in Miami, Absecon, Pebble Beach, and Las Vegas and of two counts of violating § 7215(a)(2) for the Pebble Beach and Las Vegas trips. He was acquitted on the § 201(g) count involving the Pompano Beach trip and on the three counts under § 7214(a)(2) charging him with accepting payments from Gulf for trips to Pompano Beach, Miami, and Absecon.[5]

In July 1977, following Niederberger's trial and before the trial in his own case commenced, petitioner moved to dismiss the counts under § 7214(a)(2) and 18 U.S.C. § (2) which charged him with aiding and abetting Niederberger in connection with the Pompano Beach, Miami, and Absecon vacations. Petitioner argued that because Niederberger, the only named principal, had been acquitted of accepting unlawful compensation as to those va-

[1] 18 U.S.C. § 201(f) provides, in relevant part, as follows:

"Whoever, otherwise than as provided by law for the proper discharge of official duty, directly or indirectly gives, offers, or promises anything of value to any public official . . . for or because of any official act performed or to be performed by such public official . . . [is guilty of an offense]."

26 U.S. § 7214(a)(2) punishes:

"Any officer or employee of the United States acting in connection with any revenue law of the United States . . . who knowingly demands other or greater sums than are authorized by law, or receives any fee, compensation, or reward, except as by law prescribed, for the performance of any duty."

18 U.S.C. § 2 provides in relevant part:

"Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal."

[2] The indictment also named Gulf Oil Corporation and Joseph Fitzgerald, a manager in Gulf's tax department, as defendants. Gulf pleaded guilty and Fitzgerald *nolo contendere* to all nine counts.

[3] It appears that the statute of limitations had run on any violation of 18 U.S.C. § 201(f) in connection with the Pompano Beach vacation.

[4] 18 U.S.C. § 201(g) punishes:

"Whoever, being a public official . . . , otherwise than as provided by law for the proper discharge of official duty, directly or indirectly asks, demands, exacts, solicits, seeks, accepts, receives, or agrees to receive anything of value for himself for or because of any official act performed or to be performed by him."

[5] Niederberger was sentenced to six months' imprisonment followed by a five-year period of probation, and he was fined $5,000. His convictions were affirmed by the Court of Appeals. *United States* v. *Niederberger,* 580 F.2d 63 (CA3 1978).

cations, he could not be convicted of aiding and abetting in the commission of those offenses. The District Court denied the motion.

Petitioner's case then proceeded to trial on all nine counts. At trial, petitioner admitted authorizing payment for all five vacation trips, but testified that the trips were purely social and not designed to influence Niederberger in the performance of his official duties. The jury returned guilty verdicts on all nine counts.[6] Petitioner was sentenced to concurrent terms of six months' imprisonment followed by two years' probation; he was fined a total of $18,000—$2,000 on each count.

Petitioner appealed his convictions to the Court of Appeals for the Third Circuit claiming, *inter alia*, that he could not be convicted of aiding and abetting a principal, Niederberger, when that principal had been acquitted of the charged offense. By a divided vote, the Court of Appeals, sitting en banc, rejected that contention. 610 F.2d 1076 (1979). It concluded that "the outcome of Niederberger's prosecution has no effect on [petitioner's] convictions." *Id.*, at 1078.

Because the question presented is one of importance to the administration of criminal justice on which the Courts of Appeals are in conflict, we granted certiorari.[7] We affirm.

[6] The jury was instructed that in order to render a guilty verdict on the § 7214(a) counts it must determine (1) that Niederberger knowingly "received a fee, compensation or reward except as prescribed by law . . . for the performance . . . of any duty" and (2) that petitioner "willfully aided and abetted [him]." App. 52a-56a.

[7] The Courts of Appeals for the Fifth Circuit, the Ninth Circuit, and the District of Columbia have reached the same conclusion as the Third Circuit. See *United States* v. *Musgrave*, 483 F.2d 327, 331-332 (CA5 1973); *United States* v. *Azadian*, 436 F.2d 81 (CA9 1971); *Perkins* v. *United States*, 315 F.2d 120, 122 (CA9 1963); *Gray* v. *United States*, 104 U.S. App. D.C. 153, 260 F.2d 483 (1958). The Court of Appeals for the Fourth Circuit has taken the contrary view that "where the only potential principal has been acquitted, no crime has been established and the conviction of an aider and abettor cannot be sustained." *United States* v. *Shuford*, 454 F.2d 772, 779 (1971). Accord, *United States* v. *Prince*, 430 F.2d 1325 (CA4 1970). See also n. 11, *infra*.

[8] Petitioner also challenges the instructions to the jury on criminal intent. We agree with the Court of Appeals that the instructions were correct.

II

Petitioner makes two main arguments: first, that Congress in enacting 18 U.S.C. § 2 did not intend to authorize prosecution of an aider and abettor after the principal has been acquitted of the offense charged; second, that, even if § 2 permits such a prosecution, the government should be barred from relitigating the issue of whether Niederberger accepted unlawful compensation in connection with the Pompano Beach, Miami, and Absecon vacations.[8] The first contention relies largely on the common law as it prevailed before the enactment of 18 U.S.C. § 2. The second rests on the contemporary doctrine of nonmutual collateral estoppel.

A

At common law, the subject of principals and accessories was riddled with "intricate" distinctions. 2 J. Stephen, History of the Criminal Law of England 231 (1883). In felony cases, parties to a crime were divided into four distinct categories: (1) principals in the first degree who actually perpetrated the offense; (2) principals in the second degree who were actually or constructively present at the scene of the crime and aided or abetted its commission; (3) accessories before the fact who aided or abetted the crime, but were not present at its commission; and (4) accessories after the fact who rendered assistance after the crime was complete. See W. LaFave & A. Scott, Criminal Law § 63 (1972); 4 W. Blackstone, Commentaries on the Laws of England, 33 (1765); Perkins, Parties to Crime, 89 U. Pa. L. Rev. 581 (1941). By contrast, misdemeanor cases "d[id] not admit of accessaries [*sic*] either before or after the fact," *United States* v. *Hartwell*, 26 F. Cas. 196, 199 (1869); instead, all parties to a misdemeanor, whatever their roles, were principals. *United States* v. *Dotterweich*, 320 U.S. 277, 281 (1943); C. Torcia, 1 Wharton's Criminal Law, § 33 (1978).

Because at early common law all parties to a felony received the death penalty, certain procedural rules developed tending to shield accessories from punishment. See W. LaFave & A. Scott, at 499. Among them was one of special relevance to this case: the rule that an accessory could not be convicted without the prior conviction of the principal offender. See 1 M. Hale, Pleas of the Crown, 623-624 (1847). Under this rule, the principal's flight, death, or acquittal barred prosecution of the accessory. And if the principal were pardoned or his conviction reversed on appeal, the accessory's conviction could not stand. In every way, "an accessory follow[ed], like a shadow, his principal." 1 J. Bishop, Criminal Law § 666 (8th ed. 1892).

This procedural bar applied only to the prosecution of accessories in felony cases. In misdemeanor cases, where all participants were deemed principals, a prior acquittal of the actual perpetrator did not prevent the subsequent conviction of a person who rendered assistance. *R. Humphreys and Turner*, 3 All Eng. L. Rep. 689 (1965); *R.* v. *Burton*, 13 Cox, C.C. 71, 75 (1875). And in felony cases a principal in the second degree could be convicted notwithstanding the prior acquittal of the first-degree principal. *King* v. *Taylor and Shaw*, 168 Eng. Rep. 283 (1785); *R.* v. *Wallis*, 91 Eng. Rep. 294 (1703); *Brown* v. *State*, 28 Georgia 199 (1859); *State* v. *Whitt*, 113 N.C. 716, 18 S.E. 715 (1897). Not surprisingly, considerable effort was expended in defining the categories—in determining, for instance, when a person was "constructively present" so as to be a second-degree principal. 4 Blackstone Commentaries on the Laws of England 34 (1765). In the process, justice all too frequently was defeated.

To overcome these judge-made rules, statutes were enacted in England and in the United States. In 1848 the Parliament enacted a statute providing that an accessory before the fact could be "indicted, tried, convicted, and punished in all respects *as if he were a principal felon.*" 11 & 12 Vic. ch. 46. s. 1 (emphasis added). As interpreted, the statute permitted an accessory to be convicted "although the principal be acquitted." *R* v. *Hughes,* Bell's Crown Cases 242, 248 (1860). Several state legislatures followed suit.[9] In 1899, Congress joined this growing reform movement with the enactment of a general penal code for Alaska which "abrogated" the common-law distinctions and provided that "all persons concerned in the commission of a felony . . . must be indicted, tried, and punished as principals, *as in the case of a misdemeanor.*" Act of Mar. 3, 1899, ch. 429, §§ 184-187, 30 Stat. 1282 (emphasis added). In 1901 Congress enacted a similar provision for the District of Columbia.[10]

The enactment of 18 U.S.C. § 2 in 1909 was part and parcel of this same reform movement. The language of the statute, as enacted, unmistakably demonstrates the point:

"Whoever directly commits any act constituting an offense defined in any law of the United States, or aids, abets, counsels, commands, induces or procures its commission, *is a principal.*" Act of March 4, 1909, ch. 321, 35 Stat. 1152 (emphasis added).[11]

The statute "abolishe[d] the distinction between principals and accessories and [made] them all principals." *Hammer v. United States,* 271 U.S. 620, 628 (1926). Read against its common-law background, the provision evinces a clear intent to permit the conviction of accessories to federal criminal offenses despite the prior acquittal of the actual perpetrator of the offense. It gives general effect to what had always been the rule for second-degree principals and for all misdemeanants.

The legislative history of § 2 confirms this understanding. The provision was recommended by the Commission to Revise and Codify the Criminal and Penal Laws of the United States as "in accordance with the policy of recent legislation" by which "those whose relations to a crime would be that of accessories before the fact according to the common law are made principals." Final Re-

[9] By 1909, when § 2 was enacted, 13 states had enacted legislation providing that the acquittal of the actual perpetrator was not a bar to the conviction of one charged with giving him aid. See Cal. Stat. ch. 99, §§ 11-12 (1850) (see *People* v. *Bearss,* 10 Cal. 68-70 (1858)); Del. Laws (Rev. Code) §§ 2919-2921 (1852); Iowa Rev. Code § 4314 (1882) (see *State* v. *Lee,* 91 Iowa 499, 501-502, 60 N. W. 119, 120 (1894)); Kan. Gen. Stat. § 5180 (1889) (see *State* v. *Bogue,* 52 Kan. 79, 86-87, 34 P. 410, 412 (1893)); Ky. Stat. § 1128 (1903) (see *Commonwealth* v. *Hicks,* 118 Ky. 637, 642, 82 S. W. 265, 266 (1904); Miss. Code § 1026 (1906) (see *Fleming* v. *State,* 142 Miss. 872, 880-881, 108 S. 143, 144-145 (1926)); Mont. Codes Ann. (Penal Code) § 1854 (1895); N. Y. Penal Code § 29 (1895) (see *People* v. *Kief,* 126 N. Y. 661, 663-664, 27 N. E. 556, 557 (1891)); N. D. Rev. Codes § 8060 (1895); Okla. Stat. § 5523 (1890); S. D. Ann. Stat. § 8520 (1899); Utah Comp. Laws § 4752 (1907); Wash. Code of Proc. § 1189 (1891) (see *State* v. *Gifford,* 19 Wash. 464, 467-468, 53 P. 709, 710 (1898).

Since then, at least 21 other states have enacted legislation with that effect. See 1977 Ala. Laws, Act. No. 607, § 425; Ariz. Rev. Stat. Ann. § 13-304-1 (1978); Ark. Stat. Ann. § 41-304 (1977); Colo. Rev. Stat. § 18-1-605 (1973) (see *Robert* v. *People,* 103 Colo. 250, 87 P. 2d 251 (1938)); Conn. Gen. Stat. § 53a-9 (1979); Fla. Stat. § 777.011 (1976) (see *Butts* v. *State,* 286 So. 2d 28 (1973)); Ga. Code § 26-802 (1978); Ill. Rev. Stat. ch. 38 § 5-3 (1972); Ind. Code § 35-41-2-4 (1979); La. Rev. Stat. Ann. § 14.24 (West) (1974) (see *State* v. *McAllister,* 366 S. 2d 1340 (1978)); Me. Rev. Stat. Ann., Tit. 17-A § 57; Mich. Comp. Laws § 767.39 (1968) (*People* v. *Smith,* 271 Mich. 553, 260 N. W. 911 (1935)); Mo. Rev. Stat. § 562.046 (1978); Neb. Rev. Stat. § 28-206 (Cum. Supp. 1978) (*State* v. *Rice,* 188 Neb. R. 728, 199 N. W. 2d 480 (1972)); N. H. Rev. Stat. Ann. § 626.8 (1974); N. J. Stat. Ann § 2C: 2-6 (West 1979); N. M. Stat. Ann. § 30-1-13 (1978); Penn. Cons. Stat. 18 § 306 (Cum. Supp. 1979); S. C. Code § 16-1-50 (*State* v. *Massey,* 229 S. E. 2d 332 (1976)); Tex. Code Ann. § 77.03 (1973); Wis. Stat. § 39.05 (1958).

Eleven other states have enacted statutes that modify the common-law rule; these statutes have not been authoritatively construed on whether an accessory can be prosecuted after his principal's acquittal. See Haw. Rev. Stat. § 702-225 (1976); Idaho Code § 19-1431 (1979); Mass. Gen. Laws Ann. ch. 274 § 3 (1970); Minn. Stat. § 609.05 (1964); Nev. Rev. Stat. § 195.040 (1979); Ohio Rev. Code Ann. § 2923.03 (1979); Okla. Stat., Tit. 21 § 172 (1971); Ore. Rev. Stat. § 161.160 (1979); Vt. Stat. Ann., Tit. 13 § 3 (1974); Va. Code § 18.2-21 (1975); W. Va. Code § 61-11-7 (1977); Wyo. Stat. § 6-1-7114 (1977).

Only four states—Maryland, North Carolina, Rhode Island, and Tennessee—clearly retain the common-law bar. See *State* v. *Wood,* 284 Md. 189, 396 A. 2d 1041 (1978); *State* v. *Jones,* 101 N. C. 719, 8 S. E. 147 (1888) (interpreting N. C. Gen. Stat. § 14-15 (1969)); R. I. Gen. Laws § 11-1-3 (1956); *Pierce* v. *State,* 130 Tenn. 24, 168 S. W. 851 (1914).

The Model Penal Code provides that an accomplice may be convicted "though the person claimed to have committed the offense . . . has been acquitted." § 2.06 (7) and see comments Tentative Draft No. 1, May 1953, at 38-39.

[10] The provision is still in effect; it provides that all persons "aiding or abetting the principal offender, shall be charged as principals, not as accessories, the *intent of this section being that as to all accessories before the fact the law heretofore applicable in cases of misdemeanor only shall apply to all crimes. . . .*" Act of March 3, 1901, ch. 854, Section 908, 31 Stat. 1337; D. C. Code § 22-105 (1976) emphasis added).

[11] In 1951 the words "is a principal" were altered to read "is punishable as a principal." That change was designed to eliminate all doubt that in the case of offenses whose prohibition are directed at members of specified classes (*e. g.,* federal employees) a person who is not himself a member of that class may nonetheless be punished as a principal if he induces a person in that class to violate the prohibition. See S. Rep. No. 1020, 82d Cong., 1st Sess., 7-8 (1951). The change was fully consistent with congressional intent to treat accessories before the fact as principals and to abolish the common-law procedural bar. Indeed, by the time of the 1951 re-enactment, the circuit courts that had addressed the question had concluded that § 2 authorizes conviction of an aider and abettor notwithstanding the prior acquittal of the perpetrator of the offense. See *United States* v. *Klass,* 166 F.2d 373, 380 (CA3 1948); *Von Patzoll* v. *United States,* 163 F.2d 216 (CA10 (1946); *Kelly* v. *United States,* 258 F. 392, 402 (CA6 1919); *Rooney* v. *United States,* 203 F. 928, 931-932 (CA 9 1913). Congress manifested no intent to disturb this interpretation. See *Lorillard* v. *Pons,* 434 U.S. 575, 580 (1978).

port of the Commission to Revise and Codify the Laws of the United States 118-119 (1906). The Commission's recommendation was adopted without change. The House and Senate Committee reports, in identical language, stated its intended effect:

"The committee has deemed it wise to make those who are accessories before the fact at common-law principal offenders, thereby permitting their indictment and conviction for a substantive offense. At common law an accessory can not be tried without his consent before the conviction or outlawry of the principal except where the principal and accessory are tried together; if the principal could not be found or if he had been indicted and refused to plead, had been pardoned or died before conviction, the accessory could not be tried at all. This change of the existing law renders these obstacles to justice impossible." S. Rep. No. 10, 60th Cong., 1st Sess., Pt. 1, at 13 (1908); H. R. Rep. No. 2, 6th Cong., 1st Sess., at 13 (1908).[12]

And on the floor of the House of Representatives, Representative Moon, the chairman of the joint select committee, put the point simply: "[we] have abolished the existing arbitrary distinctions between felonies and misdemeanors." 42 Cong. Rec. 585 (1908).

This history plainly rebuts petitioner's contention that § 2 was not intended to authorize conviction of an aider and abettor after the principal had been acquitted of the offense charged.[13] With the enactment of that section, all participants in conduct violating a federal criminal statute are "principals." As such, they are punishable for their criminal conduct; the fate of other participants is irrelevant.[14]

B

The doctrine of nonmutual collateral estoppel was unknown to the common law and to the Congress when it enacted § 2 in 1909.[15] It emerged in a civil case in 1942, *Bernhard* v. *Bank of America Nat. Trust & Savings Assn.*, 19 Cal. 2d 807, 112 P.2d 892. This Court first applied the doctrine in *Blonder-Tongue* v. *University Foundation*, 402 U.S. 313 (1971). There, we held that a determination of patent invalidity in a prior infringement action was entitled to preclusive effect against the patentee in subsequent litigation against a different defendant. Just this past Term we again applied the doctrine—this time "offensively"—to hold that a defendant who had had a "full and fair" opportunity to litigate issues of fact in a civil proceeding initiated by the Securities and Exchange Commission could be estopped from relitigating those issues in a subsequent action brought by a private plaintiff. *Parklane Hosiery Co.* v. *Shore*, 439 U.S. 322 (1979). In both cases, application of nonmutual estoppel promoted judicial economy and conserved private resources without unfairness to the litigant against whom estoppel was invoked.

Here, petitioner urges us to apply nonmutual estoppel against the government; specifically he argues that the government should be barred from relitigating Niederberger's guilt under § 7214(a)(2) in connection with the vacation trips to Pompano Beach, Miami, and Absecon. That issue, he notes, was an element of his offense which was determined adversely to the government at Niederberger's trial.[16]

This, however, is a criminal case, presenting considerations different from those in *Blonder-Tongue* or *Parkland Hosiery*. First, in a criminal case, the government is often without the kind of "full and fair opportunity to litigate" that is a prerequisite of estoppel. Several aspects of our criminal law make this so: the prosecution's discovery rights in criminal cases are limited, both by rules of court and

[12] Petitioner emphasizes the fact that the committee report fails to mention the common-law rule that the prior acquittal of a principal barred conviction of an accessory, and argues accordingly that Congress did not view that rule as an "obstacle to justice." The Court of Appeals correctly rejected this argument, being unwilling to "apply the canon of statutory interpretation . . . *expressio unius, exclusio alterius* . . . to the language employed in a committee report." 610 F.2d, at 1084 (emphasis added). We agree. Petitioner's argument would permit an omission in the legislative history to nullify the plain meaning of a statute. The language of § 2 abolishes the common-law categories and treats all parties as principals. It is not necessary for Congress in its committee reports to identify all of the "weeds" which are being excised from the garden.

[13] It bears mention that even prior to 1909 petitioner would not have prevailed in his attempt to bar prosecution on the § 7214(a)(2) counts. As the government notes, the version of 26 U. S. C. § 7214 then in effect defined the offense to be a misdemeanor. See R. S. 3169 (1878). Hence, the prior acquittal of his principal would not have barred petitioner's prosecution. And because petitioner accompanied Niederberger on four of five trips and therefore was "present" at the scene of the crime, see Tr. 1018-1020, 1024-1027, 1034-1036, 1096, he could have been convicted at common law for those crimes even if the offense had been designated a felony.

[14] Nothing in *Shuttlesworth* v. *Birmingham*, 373 U. S. 262 (1963), relied on by petitioner, is to the contrary. There, petitioner had been convicted of aiding and abetting others to violate a city trespass ordinance which subsequently was declared constitutionally invalid. See *Gober* v. *Birmingham*, 373 U. S. 374 (1963). Shuttlesworth's case merely applied the rule that "there can be no conviction for aiding and abetting someone do an innocent act." *Id.*, at 265. Here, by contrast, the government proved in petitioner's case that Niederberger had violated § 7214(a)(2) in connection with each of the five trips. See no. 6, *supra*.

[15] In 1912 in *Bigelow* v. *Old Dominion Copper Co.*, 225 U. S. 111, 127, this Court stated that it was "a principle of general elementary law that the estoppel of a judgment must be mutual." See also *Stone* v. *Farmers Bank*, 174 U. S. 409 (1899); *Keokuk & W. R. Co. v. Missouri*, 152 U. S. 301, 317 (1894); *Litchfield* v. *Goodnow*, 123 U. S. 549, 552 (1887).

[16] Petitioner does not contend that the Constitution prevents the government from prosecuting him on the three § 7214(a)(2) counts as to which Niederberger was acquitted. Nothing in the Double Jeopardy Clause or the Due Process Clause forecloses putting petitioner on trial as an aider and abettor simply because another jury has determined that his principal was not guilty of the offenses charged. Compare *Ashe* v. *Swenson*, 397 U.S. 436 (1970).

constitutional privileges; it is prohibited from being granted a directed verdict or from obtaining a judgment notwithstanding the verdict no matter how clear the evidence in support of guilt, compare Fed. Rule Civ. Proc. 50; it can not secure a new trial on the ground that an acquittal was plainly contrary to the weight of the evidence, compare Fed. Rule Civ. Proc. 59; and it can not secure appellate review where a defendant has been acquitted. See *United States* v. *Ball*, 163 U.S. 662, 671 (1896).

The absence of these remedial procedures in criminal cases permits juries to acquit out of compassion or compromise or because of "their assumption of a power which they had no right to exercise, but which they were disposed through lenity." *Dunn* v. *United States*, 284 U.S. 390, 393 (1932). See generally H. Kalven & H. Zeisel, The American Jury 193-347 (1966).[17] It is of course true that verdicts induced by passion and prejudice are not unknown in civil suits. But in civil cases, post-trial motions and appellate review provide an aggrieved litigant a remedy; in a criminal case the government has no similar avenue to correct errors. Under contemporary principles of collateral estoppel, this factor strongly militates against giving an acquittal preclusive effect. See Restatement (Second) of Judgments § 68.1 (Ten. Draft No. 3, May 1976) (denying preclusive effect to an unreviewable judgment).[18]

The application of nonmutual estoppel in criminal cases is also complicated by the existence of rules of evidence and exclusion unique to our criminal law. It is frequently true in criminal cases that evidence inadmissible against one defendant is admissible against another. The Exclusionary Rule, for example, may bar the government from introducing evidence against one defendant because that evidence was obtained in violation of his constitutional rights. And the suppression of that evidence may result in an acquittal. The same evidence, however, may be admissible against other parties to the crime "whose rights were [not] violated." *Alderman* v. *United States*, 394 U.S. 165, 171-172 (1969). Accord, *Rakas* v. *Illinois*, 439 U.S. 128, 134 (1978). In such circumstances, where evidentiary rules prevent the Government from presenting all its proof in the first case, application of nonmutual estoppel would be plainly unwarranted.[19]

It is argued that this concern could be met on a case-by-case basis by conducting a pretrial hearing to determine whether any such evidentiary ruling had deprived the Government of an opportunity to present its case fully the first time around. That process, however, could prove protracted and burdensome. Under such a scheme, the Government presumably would be entitled to seek review of any adverse evidentiary ruling rendered in the first proceeding and of any aspect of the jury charge in that case that worked to its detriment. Nothing short of that would insure that its opportunity to litigate had been "full and fair." If so, the "pre-trial hearing" would fast become a substitute for appellate review, and the very purpose of litigation economy that estoppel is designed to promote would be frustrated.

Finally, this case involves an ingredient not present in either *Blonder-Tongue* or *Parklane Hosiery:* the important federal interest in the enforcement of the criminal law. *Blonder-Tongue* and *Parkland Hosiery* were disputes over private rights between private litigants. In such cases, no significant harm flows from enforcing a rule that affords a litigant only one full and fair opportunity to litigate an issue, and there is no sound reason for burdening the courts with repetitive litigation.

That is not so here. The Court of Appeals opinion put the point well:

"[T]he purpose of a criminal court is not to provide a forum for the ascertainment of private rights. Rather it is to vindicate the public interest in the enforcement of the criminal law while at the same time safeguarding the rights of the individual defendant. The public interest in the accuracy and justice of criminal results is greater than the concern for judicial economy professed in civil cases and we are thus inclined to reject, at least as a general matter, a rule that would spread the effect of an erroneous acquittal to all those who participated in a particular criminal transaction. To plead crowded dockets as an excuse for not trying criminal defendants is in our view neither in the best interests of the courts, nor the public." 610 F.2d, at 1093.

In short, this criminal case involves "competing policy considerations" that outweigh the economy concerns that undergird the estoppel doctrine. See Restatement (Second) of Judgments

[17] Niederberger's case demonstrates the point. As to the Absecon and Miami vacations, the jury convicted Niederberger of receiving something of value "because of any official act performed . . . by him," 18 U. S. C. § 201(g), but acquitted him of receiving "any fee, compensation, or reward . . . for the performance of any duty," 26 U. S. C. § 7214(a)(2). No explanation has been offered for these seemingly irreconcilable determinations. This inconsistency is reason, in itself, for not giving preclusive effect to the acquittals on the Absecon and Miami counts. See Restatement (Second) Judgments, § 88(4). See also 610 F.2d at 1112 (Gibbons, J., concurring in part and dissenting in part); *Harary* v. *Blumenthal*, 55 F.2d 1113, 1116-1117 (CA2 1977).

[18] This is not to suggest that the availability of appellate review is always an essential predicate of estoppel. See *Johnson Co.* v. *Wharton*, 152 U.S. 252 (1894); see generally 1B Moore's Federal Practice ¶ 0.416 [5]. The estoppel doctrine, however, is premised upon an underlying confidence that the result achieved in the initial litigation was substantially correct. In the absence of appellate review, or of similar procedures, such confidence is often unwarranted.

[19] Indeed, as the Court of Appeals observed, to give the first case preclusive effect would undermine the *Alderman* rule by affording a defendant whose rights were not violated the benefits of suppression. See 610 F.2d, at 1094, n. 51.

§ 68.1(e) and comments thereto; cf. *Commissioner* v. *Sunnen,* 333 U.S. 591 (1948) [Ct. D. 1698, 1948-1 C.B. 7].

III

In denying preclusive effect to Niederberger's acquittal, we do not deviate from the sound teaching that "justice must satisfy the appearance of justice." *Offutt* v. *United States,* 348 U.S. 11, 14 (1954). This case does no more than manifest the simple, if discomforting, reality that "different juries [may] reach different results under any criminal statute. That is one of the consequences of our jury system." *Roth* v. *United States,* 354 U.S. 476, 492 (1957). While symmetry of results may be intellectually satisfying, it is not required. See *Hamling* v. *United States,* 418 U.S. 87, 101 (1974).

Here, petitioner received a fair trial at which the Government bore the burden of proving beyond reasonable doubt that Niederberger violated 26 U.S.C. § 7214(a)(2) and that petitioner aided and abetted him in that venture. He was entitled to no less—and to no more.

The judgment of the Court of Appeals is

Affirmed.

Section 7216.—Disclosure or Use of Information by Preparers of Returns

26 CFR 301.7216-2: Disclosure or use without formal consent of the taxpayer.

T.D. 7708

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER F.—PART 301.—PROCEDURE AND ADMINISTRATION

Disclosure or use of information by preparers of tax returns

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations under section 7216 of the Internal Revenue Code of 1954, relating to disclosure of tax return information by tax return preparers. The regulations affect tax return preparers and provide them with the guidance needed to comply with the law.

DATES: The amendments are effective as of January 1, 1972.

FOR FURTHER INFORMATION CONTACT: Jacob Feldman of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:LR:T, 202-566-3289, not a toll-free call).

SUPPLEMENTARY INFORMATION

BACKGROUND

On February 21, 1980, the Federal Register published proposed amendments to the Regulations on Procedure and Administration (26 CFR Part 301) under section 7216 of the Code. No comments were received with respect to the proposed amendments, and no public hearing was requested or held. The proposed amendments are adopted by this Treasury decision without change.

EXPLANATION

Section 7216(a) provides that a tax return preparer who discloses or uses any tax return information other than for the specific purpose of preparing, or assisting in the preparation of, any tax return of the taxpayer by or for whom the information was made available to the tax return preparer, is guilty of a misdemeanor. Section 7216(b) provides exceptions to the general rule of section 7216(a).

The amendment made to § 301.7216-2(c) of the regulations exempts from the provision of section 7216(a) and § 301.7216-1 the disclosure of income tax information made pursuant to an administrative order, demand, summons, or subpoena issued in the performance of its duties by any State agency, body, or commission charged under the laws of a State or political subdivision of the State with licensing, registration or regulation of tax return preparers. The order, demand, summons, or subpoena must clearly identify the information to be disclosed. Paragraph (c) is also amended to include all Federal agency orders and not simply the orders of a Federal regulatory agency. In addition, § 301.7216-2(n) is amended to permit disclosure to local officials of tax return information relating to the commission of a crime.

DRAFTING INFORMATION

The principal author of these regulations is Jacob Feldman of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of amendments to the regulations

Accordingly, the following amendments to 26 CFR Part 301 are hereby adopted:

§ 301.7216-2 Disclosure or use without formal consent of the taxpayer.

* * * * *

(c) *Disclosure pursuant to an order of a court or of a Federal or State agency.* The provisions of section 7216(a) and § 301.7216-1 do not apply to any disclosure of tax return information if such disclosure is made pursuant to any one of the following documents:

(1) The order of any court of record, Federal, State, or local, or

(2) An administrative order, demand, summons, or subpoena which is issued in the performance of its duties by—

(i) Any Federal agency, or

(ii) A State agency, body, or commision charged under the laws of the State or a political subdivision of the State with the licensing, registration, or regulation of tax return preparers.

Information must be clearly identified in the document in order to be disclosed under this paragraph (c).

* * * * *

(n) *Disclosure to report the commission of a crime.* The provisions of section 7216(a) and § 301.7216-1 do not apply to the disclosure of any tax return information to the proper Federal, State or local official in order, and to the extent necessary, to inform the official of activities which may constitute, or may have constituted, a violation of any criminal law. In addition, such a disclosure made in the bona fide but mistaken belief that the activities constituted a violation of criminal law is not subject to section 7216(a) and § 301.7216-1.

(This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).)

JEROME KURTZ,
Commissioner of Internal Revenue.

Approved July 15, 1980.

EMIL M. SUNLEY,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 24, 1980, 8:45 a.m., and published in the issue of the Federal Register for July 25, 1980, 45 F.R. 49547)

Chapter 77.—Miscellaneous Provisions

Section 7502.—Timely Mailing Treated as Timely Filing and Paying

26 CFR 301.7502-1: Timely mailing treated as timely filing.

Timely filing of returns; taxpayer in foreign country. Tax returns mailed by taxpayers in foreign countries will be accepted as timely filed if they bear an official postmark dated on or before midnight of the last date prescribed for filing, including any extensions.

Rev. Rul. 80-218

United States federal tax returns mailed by taxpayers in foreign countries will be accepted as timely filed if they bear an official postmark dated on or before midnight of the last date prescribed for filing, including any extension of time for such filing. If the last date for filing falls on a Saturday or Sunday, returns will be considered timely if postmarked on or before midnight of the following Monday.

This revenue ruling does not extend to claims, statements, or other documents.

Chapter 79.—Definitions

Section 7701.—Definitions

26 CFR 301.7701-4: Trusts.

Specific conditions that must be present before the Service will consider issuing advance rulings concerning the classification of organizations as liquidating trusts. See Rev. Proc. 80-54, page 848.

Chapter 80.—General Rules
Subchapter A.—Application of Internal Revenue Laws

Section 7805.—Rules and Regulations

26 CFR 301.7805-1: Rules and regulations.

Obsolete rulings. Certain post-1952 rulings dealing with engineering and corporate matters, including reorganizations, are declared obsolete.

Rev. Rul. 80-367

Rev. Proc. 67-6, 1967-1 C.B. 576, anounced a program for the review of rulings published before 1953 with the immediate objective of identifying and publishing lists of those rulings that, although not specifically revoked or suspended, are not considered determinative with respect to future transactions.

Consistent with the objectives of that program, the Internal Revenue Service has undertaken a review of certain rulings that were published in the Internal Revenue Bulletin after 1952. The purpose of this revenue ruling is to publish a list of post 1952 rulings dealing with engineering and corporate matters, including reorganizations that, although not specifically revoked or suspended, are not considered determinative with respect to future transactions because (1) the applicable statutory provisions have been changed or repealed; (2) the ruling position is specifically covered by statute, regulations, or a subsequent published position; or (3) the facts set forth no longer exist or are not sufficient to permit application to the current statute.

Accordingly, the rulings listed below are declared obsolete.

Rev. Rul. No.	*C.B. Citation*
259	1953-2, 55
289	1953-2, 37
55-78	1955-1, 357
55-120	1955-1, 382
55-121	1955-1, 382
55-592	1955-2, 573
56-170	1956-1, 155
56-227	1956-1, 183
56-449	1956-2, 180
56-485	1956-2, 176
56-540	1956-2, 177
59-308	1959-2, 110
64-157	1964-1 (Part 1), 139
65-7	1965-1, 254
68-547	1968-2, 123
74-230	1974-1, 187

The purpose of this declaration of obsolescence is to make clear to all concerned that the above-listed rulings are not determinative with respect to future transactions. It is not the purpose of this revenue ruling to determine their applicability to past transactions.

Other rulings published after 1952 relating to reorganization, corporate

and engineering matters will continue to be reviewed to ascertain those that are inapplicable to future transactions. Therefore, failure to include any particular ruling in the above list should not be construed as an indication that the ruling necessarily is determinative with respect to future transactions.

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26 CFR 301.7805-1: Rules and regulations.

Whether educational loans made by a private foundation under an employer-related loan program are taxable expenditures under section 4945 of the Code. See Rev. Proc. 80-39, page 772.

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26 CFR 301.7805-1: Rules and regulations.

Whether service fees paid for assistance in participating in programs to acquire federal oil and gas leases are capital expenditures, and whether the cost of an option to sell a fractional interest in all leases acquired as part of the program is properly treated as a reduction of the amount realized from the subsequent sale of a fractional interest in any leases acquired. See Rev. Rul. 80-176, page 97.

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26 CFR 301.7805-1: Rules and regulations.

Whether the revocation of Rev. Rul. 69-442, relating to the application of sections 357(c) and 358(d) of the Code to deductible accounts payable liabilities should be applied retroactively or prospectively only. See Rev. Rul. 80-199, page 122.

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26 CFR 301.7805-1: Rules and regulations.

Nonretroactive application of a revenue ruling relating to the classification of municipal bonds as industrial development bonds. See Rev. Rul. 80-251, page 40.

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26 CFR 301.7805-1: Rules and regulations.

Prospective application of revenue ruling relating to the constructive sale price for computing manufacturers excise tax on certain articles sold at retail. See Rev. Rul. 80-273, page 315.

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26 CFR 301.7805-1: Rules and regulations.

Nonretroactive application of rulings relating to whether the holding of Rev. Rul. 70-597, 1970-2 C.B. 146 that dividends paid by a regulated investment company out of net short-term capital gains qualify for the $100 dividends received individual exclusion under section 116 and the 85 percent dividends received corporate deduction under section 243, subject to the limitations under section 854, is correct. See Rev. Rul. 80-345, page 204.

Subchapter B.—Effective Date and Related Provisions

Section 7852.—Other Applicable Rules

Whether section 1031 of the Tax Reform Act of 1976, which amended section 904 (a) of the Code to provide that the limitation on the foreign tax credit provided in section 901 shall be computed using only the overall method, supersedes the per-country limitation on the foreign tax credit provided in United States income tax treaties. See Rev. Rul. 80-201, page 221.

Whether the enactment of sections 901 (f) and 907 of the Code by section 601 of the Tax Reduction Act of 1975 supersedes inconsistent provisions of income tax treaties with foreign countries entered into prior to the enactment of these sections. See Rev. Rul. 80-223, page 217.

Miscellaneous Provisions

26 CFR 1.9100-1: Extension of time for making certain elections.

Whether an extension of time may be granted under section 1.9100-1 of the regulations for a failure to satisfy the notification requirement of section 508(a) of the Code. See Rev. Rul. 80-259, page 192.

Part II. Treaties and Tax Legislation

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Part II. Treaties and Tax Legislation

Subpart A.—Tax Conventions

United States-Republic of Austria Income Tax Convention

1957-2 C.B. 985

Austria; situs of nonprofit organization. The exemption from tax provided under Article XIII (3) of the U.S.-Austria Income Tax Convention for a recipient of a grant, allowance, or award from a nonprofit religious, charitable, scientific, literary, or educational organization shall be allowed without regard to the situs of the nonprofit organization.

Rev. Rul. 80-304

Advice has been requested whether the situs of nonprofit organizations has any effect on the application of Article XIII (3) of the United States-Republic of Austria Income Tax Convention (the Convention), 1957-2 C.B. 985.

Article XIII (3) of the Convention provides that a resident of one of the contracting States who is a recipient of a grant, allowance or award from a nonprofit religious, charitable, scientific, literary or educational organization, shall be exempt from tax by the other State on such payments from such organization (other than compensation for personal services).

Under the authority granted by Article XVII of the Convention, the Competent Authority of the United States and the Competent Authority for the Republic of Austria have agreed that the exemption provided under Article XIII (3) of the Convention shall be allowed without regard to the situs of the nonprofit organization.

United States-France Estate, Inheritance, and Gift Tax Convention [1]

Convention signed at Washington November 24, 1978;
Ratification advised by the Senate of the United States of America July 9, 1979;
Ratified by the President of the United States of America July 30, 1979;
Ratified by the French Republic July 24, 1980;
Ratifications exchanged at Paris August 7, 1980;
Proclaimed by the President of the United States of America September 9, 1980;
Entered into force October 1, 1980.

BY THE PRESIDENT OF THE UNITED STATES OF AMERICA
A PROCLAMATION

CONSIDERING THAT:

The Convention between the United States of America and the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Estates, Inheritances, and Gifts was signed at Washington on November 24, 1978, the texts of which are hereto annexed;

The Senate of the United States of America by its resolution of July 9, 1979, two-thirds of the Senators present concurring therein, gave its advice and consent to ratification of the Convention;

The Convention was ratified by the President of the United States of America on July 30, 1979, in pursuance of the advice and consent of the Senate, and was ratified on the part of the French Republic on July 24, 1980;

It is provided in Article 19 of the Convention that the Convention shall enter into force the first day of the second month following the month in which the exchange of the instruments of ratification takes place;

The instruments of ratification of the Convention were exchanged at Paris on August 7, 1980, and accordingly the Convention enters into force on October 1, 1980;

NOW, THEREFORE, I, Jimmy Carter, President of the United States of America, proclaim and make public the Convention to the end that it shall be observed and fulfilled with good faith on and after October 1, 1980, by the United States of America and by the citizens of the United States of America and all other persons subject to the jurisdiction thereof.

IN TESTIMONY WHEREOF, I have signed this proclamation and caused the Seal of the United States of America to be affixed.

DONE at the city of Washington this ninth day of September in the year of our Lord one thousand nine hundred eighty and of the Independence of the United States of America the two hundred fifth.

By the President:

JIMMY CARTER

Secretary of State:

EDMUND S. MUSKIE

CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND THE FRENCH REPUBLIC FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON ESTATES, INHERITANCES, AND GIFTS

The President of the United States of America and the President of the

[1] The text of the convention is contained in the pamphlet of the Treaties and Other International Act Series (TIAS) and is designated TIAS 9812. Pertinent excerpts from Senate Report No. 96-3, page 397; Treasury Department Technical Explanation, page 405; Senate Executive J is not published.

French Republic, desiring to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on estates, inheritances, and gifts, have appointed for that purpose as their respective plenipotentiaries:

The President of the United States of America: The Honorable George S. Vest, Assistant Secretary of State for European Affairs, the President of the French Republic: His Excellency François de Laboulaye, Ambassador of France, who having communicated to each other their full powers, found in good and due form, have agreed upon the following provisions.

Chapter I.—Scope of the Convention

Article 1.—Estates and gifts covered

(1) This Convention shall apply to estates of decedents whose domicile at death was in France and to estates of decedents which are subject to the taxing jurisdiction of the United States by reason of the decedent's domicile therein or citizenship thereof at death.

(2) This Convention shall also apply to gifts of donors whose domicile at the time of making a gift was in France, and to gifts which are subject to the taxing jurisdiction of the United States by reason of the donor's domicile therein or citizenship thereof at the time of making of a gift.

(3) A person who at the time of death or the making of a gift was a resident of a possession of the United States and who acquired United States citizenship solely by reason of (a) his being a citizen of such possession, or (b) his birth or residence within such possession, shall be considered as having been neither domiciled in nor a citizen of the United States for purposes of this Convention.

Article 2.—Taxes covered

(1) This Convention shall apply to:

(a) In the case of the United States: the Federal gift tax and the Federal estate tax, including the tax on generation-skipping transfers; and

(b) In the case of France: the duty on gifts and the duty levied on succession.

(2) This Convention shall also apply to any identical or substantially similar taxes on estates, inheritances, and gifts which are subsequently imposed by a Contracting State in addition to, or in place of, the existing taxes.

(3) The competent authorities of the Contracting States shall notify each other of any substantial changes which have been made in their respective laws relating to taxes on estates, inheritances, and gifts.

Chapter II.—Definitions

Article 3.—General definitions

(1) In this Convention:

(a) The terms "Contracting State" and "other Contracting State" mean the United States or France, as the context requires.

(b) The term "United States" means the United States of America and, when used in a geographical sense, means the states thereof and the District of Columbia. Such term also includes any area outside the States and the District of Columbia which is, in accordance with international law, an area within which the United States may exercise rights with respect to the natural resources of the seabed and sub-soil.

(c) The term "France" means the French Republic and, when used in a geographical sense, means the European and Overseas departments of the French Republic. Such term also includes any area outside those departments which is, in accordance with international law, an area within which France may exercise rights with respect to the natural resources of the seabed and sub-soil.

(d) The term "enterprise" means a commercial or industrial enterprise carried on by an individual domiciled in a Contracting State.

(e) Except where expressly stated to the contrary, the term "tax" means the tax or taxes referred to in Article 2 which are imposed by the Contracting State (or Contracting States) as indicated by the context of the term's usage.

(f) The term "competent authority" means:

(i) In the case of the United States, the Secretary of the Treasury or his delegate, and

(ii) In the case of France, the Minister of Budget or his delegate.

(2) Any term not otherwise defined in this Convention shall, unless the context otherwise requires, have the meaning which it has under the tax laws of the Contracting State whose tax is being determined. However, if the meaning of such a term under the laws of one of the Contracting States is different from the meaning of the term under the laws of the other Contracting State, the Contracting State may, in order to prevent double taxation or to further any other purposes of this Convention, establish a common meaning of the term for purposes of this Convention.

Article 4.—Fiscal domicile

(1) For the purpose of this Convention, the question whether an individual was domiciled in one of the Contracting States shall be determined according to the law of that State.

(2) Where by reason of the provisions of paragraph (1) an individual was domiciled in both Contracting States, then this case shall be determined in accordance with the following rules:

(a) He shall be deemed to have been domiciled in the Contracting State in which he maintained his permanent home;

(b) If he had a permanent home in both Contracting States or in neither of the Contracting States, his domicile shall be deemed to be in the Contracting State with which his personal relations were closest (center of vital interests);

(c) If the Contracting State in which he had his center of vital interests cannot be determined, his domicile shall be deemed to be in the Contracting State in which he had an habitual abode;

(d) If he had an habitual abode in both Contracting States or in neither of the Contracting States, his domicile shall be deemed to be in the Contracting State of which he was a citizen; or

(e) If he was a citizen of both Contracting States or of neither of them, the competent authorities of the Contracting States shall determine the Contracting State of his domicile by mutual agreement.

(3)(a) Notwithstanding the provisions of paragraph (2), an individual who at the time of his death or the making of a gift was a citizen of one of the Contracting States without being a citizen of the other Contracting State, and who would be considered under paragraph (1) as having been domiciled in both Contracting States, shall be deemed to have been domiciled only in the Contracting State of which he was a citizen, if he had a clear intention to retain his domicile in that Contracting State and if he was domiciled in the other Contracting State in the aggregate less than 5 years during the 7-year period ending with the year of his death or the making of a gift.

(b) Notwithstanding the provisions of paragraph (2) or of subparagraph (a) of this paragraph, an individual who at the time of his death or the making of a gift was a citizen of one of the Contracting States without being a citizen of the other Contracting State, and who would be considered under paragraph (1) as having been domiciled in both Contracting States, shall be deemed to have been domiciled only in the Contracting State of which he was a citizen if:

(i) He was domiciled in the other Contracting State in the aggregate less than 5 years during the 7-year period ending with the year of his death or the making of a gift, provided that he was in that other Contracting State by reason of an assignment of employment or as the spouse or other dependent (personne à charge) of a person present in that other Contracting State for such a purpose; or

(ii) He was domiciled in the other Contracting State in the aggregate less than 7 years during the 10-year period ending with the year of his death or the making of a gift, provided that he was in that other Contracting State by reason of a renewal of an assignment of employment or as the spouse or other dependent (personne à charge) of a person present in that other Contracting State for such a purpose.

Chapter III.—Taxing Rules

Article 5.—Immovable (real) property

(1) Immovable (real) property may be taxed by a Contracting State if such property is situated in that State.

(2) The term "immovable (real) property" shall be defined in accordance with the tax laws of the Contracting State in which such property is situated. Mortgages or other claims secured by immovable (real) property shall not be regarded as immovable (real) property.

(3) The provisions of paragraphs (1) and (2) shall also apply to immovable (real) property which forms part of the business property of a permanent establishment or is used for the performance of professional services or other independent activities of a similar character.

Article 6.—Business property of a permanent establishment and assets pertaining to a fixed base used for the performance of professional services

(1) Except as provided in Article 5, assets (other than ships and aircraft operated in international traffic and movable property pertaining to the operation of such ships and aircraft) used in or held for use in the conduct of the business of a permanent establishment may be taxed by a Contracting State if the permanent establishment is situated therein.

(2) For purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on. If an individual is a member of a partnership or other association that is not a corporation which is engaged in industrial or commercial activity through a fixed place of business, he shall be deemed to have been so engaged to the extent of his interest therein.

(3) The term "permanent establishment" shall include especially:

(a) A seat of management;

(b) A branch;

(c) An office;

(d) A factory;

(e) A workshop;

(f) A warehouse;

(g) A mine, quarry, or other place of extraction of natural resources; and

(h) A building site or a construction or assembly project which exists for more than 12 months.

(4) Notwithstanding the provisions of paragraphs (2) and (3), the term "permanent establishment" shall not be deemed to include:

(a) The use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;

(b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery;

(c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another person;

(d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or the collection of information, for the enterprise;

(e) The maintenance of a fixed place of business solely for the purpose of advertising, supplying information, conducting scientific research, or similar activities which have a preparatory or auxiliary character, for the enterprise; or

(f) The maintenance of a fixed place of business solely for investment purposes (and not for purposes of engaging in industrial or commercial activity) of an individual, whether by the individual or his employees or through a broker or other agent.

(5) A person who was acting in a Contracting State on behalf of an enterprise—other than agent to whom paragraph (4)(f) or (6) applies—shall be deemed to have been a permanent establishment of the enterprise in that State if such person had, and habitually exercised in that State, an authority to conclude contracts in the name of the enterprise, unless the exercise of such authority was limited to the purchase of goods or merchandise for the enterprise.

(6) An enterprise shall not be deemed to have had a permanent establishment in a Contracting State merely because the enterprise engaged in industrial or commercial activity in that State through a broker, general commission agent, or any other agent of an independent status acting in the ordinary course of his business.

(7) The fact that an enterprise controlled a corporation which engaged in industrial or commercial activity in a Contracting State (whether through a permanent establishment or otherwise) shall not be taken into account in determining whether the enterprise had a permanent establishment in that State.

(8) Except as provided in Article 5, assets pertaining to a fixed base used for the performance of professional services or other independent activities of a similar character may be taxed by a Contracting State if the fixed base is situated in that State.

ARTICLE 7.—TANGIBLE MOVABLE PROPERTY

(1) Tangible movable property other than currency may be taxed by a Contracting State if such property is situated in that State and is not taxable by the other Contracting State pursuant to Article 6. For this purpose, tangible movable property which is in transit shall be considered situated at the place of destination.

(2) Notwithstanding the provisions of paragraph (1), tangible movable property owned by an individual referred to in paragraph (3) of Article 4 and used for his normal personal use or that of his family may be taxed only by the Contracting State in which the individual was domiciled.

(3) Notwithstanding the provisions of paragraph (1), ships and aircraft operated in international traffic, and movable property pertaining to the operation of such ships and aircraft, may be taxed by a Contracting State if such ships and aircraft are registered in that Contracting State. Other ships and aircraft may be taxed by a Contracting State if the harbors and airports most frequently used by such ships and aircraft are situated in that State.

ARTICLE 8.—TAXATION OTHER THAN PURSUANT TO ARTICLES 5, 6, AND 7

Except as provided in Articles 5, 6, and 7, property, including shares or stock in a corporation, debt obligations (whether or not there is written evidence thereof), other intangible property, and currency may be taxed by a Contracting State only if the decedent or donor was a citizen of or was domiciled in that State at the time of death or the making of a gift, and if taxable by that State under its laws.

ARTICLE 9.—DEDUCTIONS OF DEBTS

(1) Debts, to the extent they would be deductible according to the internal law of a Contracting State, shall be deducted from the gross value of the property which may be taxed by that State in the proportion that such gross value bears to the gross value of the entire property wherever situated.

(2) Notwithstanding the provisions of paragraph (1), for purposes of determining the French tax:

(a) Debts pertaining to a permanent establishment or to a fixed base used for the performance of professional services or other independent activities of a similar character shall be deducted from the value of assets referred to in Article 6.

(b) Debts pertaining to ships and aircraft operated in international traffic and to movable property related to the operation of such ships and aircraft shall be deducted from the value of these assets.

ARTICLE 10.—CHARITABLE EXEMPTIONS AND DEDUCTIONS

(1) A transfer to a legal entity created or organized in a Contracting State shall be exempt from tax, or fully deductible from the gross value liable to tax, in the other Contracting State with respect to its taxes referred to in Article 2, provided the transfer would be eligible for such exemption or deduction if the legal entity had been created or organized in that other Contracting State.

(2) The provisions of paragraph (1) shall apply only if the legal entity:

(a) Has a tax-exempt status in the first Contracting State by reason of which transfers to such legal entity are exempt or fully deductible;

(b) Is organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes; and

(c) Receives a substantial part of its support from contributions from the public or governmental funds.

(3) This Article shall not apply to transfers to a Contracting State or a political or administrative subdivision thereof unless specifically limited to a purpose described in paragraph (2)(b).

ARTICLE 11.—COMMUNITY PROPERTY AND MARITAL DEDUCTION

(1) Property (other than community property) which was acquired during marriage for consideration by an individual who at the time of death or the making of a gift was domiciled in, or a citizen of, the United States and which passes to the spouse of such individual shall, for the purposes of determining the French tax, be treated as if it were community property, unless the spouses expressly elected to have a treatment other than community property treatment provided by French civil law.

(2) In the case of an individual who was domiciled in France there shall, for purpose of determining the United States tax, be allowed the same marital deduction in effect on the date of signature of this Convention, as if such

individual were domiciled in the United States, and in such a case the tax rates applicable if the decedent or donor had been domiciled in the United States shall apply. If the tax determined without regard to the preceding provision of this paragraph is lower than that computed under the preceding provision, the lower tax shall apply.

(3) In the event the laws of either Contracting State are changed substantially to reduce the tax benefits of the marital deduction or community property, the competent authorities of the Contracting States shall consult to determine whether this Article shall be modified or shall cease to have effect.

Chapter IV.—Relief From Double Taxation

Article 12.—Exemptions and Credits

(1) Except as otherwise provided in this Convention, each Contracting State shall impose its tax, and shall allow exemptions, deductions, credits, and other allowances, in accordance with its laws.

(2) Double taxation shall be avoided in the following manner:

(a) In determining the French tax where property may be taxed by the United States in accordance with Article 5, 6, or 7, such property shall be exempt from the French tax. However, French tax with respect to property which is taxable by France in accordance with this Convention shall be computed at the rate appropriate to the total of property taxable under French law.

(b) In determining the United States tax:

(i) Where both Contracting States impose tax with respect to property which is taxable by France in accordance with Article 5, 6, or 7, the United States shall allow a credit equal to the amount of the tax imposed by France with respect to such property.

(ii) Notwithstanding the provisions of subparagraph (i), the total amount of all credits allowed by the United States pursuant to this Article or pursuant to its laws or other conventions with respect to all property in respect of which a credit is allowable under subparagraph (i) shall not exceed that part of the tax of the United States which is attributable to such property.

(iii) Any credits for tax imposed by France allowable under this Article are in lieu of, and not in addition to, any such credits allowed by the laws of the United States.

(3) If the decedent or donor was a citizen of the United States at the time of death or the making of a gift and would be considered under Article 4 as having been domiciled in France at such time, the United States shall allow a credit equal to the amount of the tax imposed by France.

(4) Exemption and credits under this Article shall be tentatively allowed by the United States on the basis of statements made in the tax return as to the amount of any tax paid or payable to France. However, such exemptions and credits shall not be finally allowed until any such tax for which the exemption or credit is allowable has been paid.

(5) The provisions of this Convention shall not result in an increase in the amount of the tax imposed by either Contracting State under its domestic laws. A reduction in the credit allowed against United States tax for the tax paid to France which results from the application of this Convention shall not be considered as an increase in tax.

Chapter V.—Special Provisions

Article 13.—Time Limitations on Claims for Credit or Refund

(1) Any claim for credit or for refund of tax founded on the provisions of this Convention shall be made before the expiration of the latest of:

(a) The time for the making of a claim for refund of tax under the laws of the Contracting State to which the claim for credit or refund is made;

(b) Five years from the date of death of the decedent, or from the making of a gift with respect to which the claim is made; or

(c) One year after final determination (administrative or judicial) and payment of tax for which any credit under Article 12 is claimed, provided that the determination and payment are made within 10 years of the date of death of the decedent or of the making of a gift.

(2) Any refund based on the provisions of this Convention shall be made without payment of interest on the amount so refunded.

Article 14.—Mutual Agreement Procedure

(1) Any person who considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with this Convention may, notwithstanding the remedies provided by the laws of those States, present his case to the competent authority of either Contracting State. Such presentation must be made within the period of time prescribed for the filing of a claim for credit or refund under Article 13. Should the person's claim be considered to have merit by the competent authority of the Contracting State to which the claim is made, it shall seek agreement with the competent authority of the other Contracting State with a view to the avoidance of taxation contrary to the provisions of this Convention.

(2) The competent authorities of the Contracting States shall resolve by mutual agreement any difficulties or doubts arising as to the application of this Convention.

(3) The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of this Article. When it seems advisable for the purpose of reaching an agreement, the competent authorities may meet together for an oral exchange of opinions.

(4) When the competent authorities reach such an agreement, taxes shall be imposed, and refund or credit

of taxes shall be allowed by the Contracting States in accordance with such agreement, notwithstanding any procedural rule (including the statute of limitations) applicable under the laws of either Contracting State.

(5) The competent authority of each Contracting State may prescribe such regulations and forms as may be necessary or appropriate to give effect. to and implement the provisions of this Convention.

ARTICLE 15.—FILING OF RETURNS AND EXCHANGE OF INFORMATION

(1) (a) The provisions of Articles 5, 6, 7, or 8, which change the taxability or situs of property or the amount of tax which would have been due in the absence of this Convention, shall not change:

(i) The requirements of the respective tax laws of the Contracting States relating to information or tax returns or notices, transfer certificates or maintenance of records, and

(ii) The applicability and amount of any sanctions of such laws with respect to the requirements referred to to in subparagraph (i).

(b) As concerns the United States, notwithstanding the provisions of paragraph (a), the requirements or sanctions found to be unnecessary for the prevention of fraud or fiscal evasion with respect to taxes to which this Convention applies may be eliminated or modified (but not made more burdensome) by regulations prescribed pursuant to paragraph (5) of Article 14.

(2) The competent authority of each Contracting State shall furnish the competent authority of the other Contracting State such information as is pertinent to:

(a) Carrying out the provisions of this Convention or the laws of such other Contracting State concerning its tax insofar as the taxation thereunder is in accordance with this Convention, or

(b) Preventing fraud or fiscal evasion in relation to the taxes which are the subject of this Convention (including information with respect to property exempted from the tax of the first-mentioned Contracting State by reason of Article 8).

However, this paragraph shall not require the competent authority of a Contracting State to furnish information not in the possession of that Contracting State with respect to property exempted from its tax by reason of Article 8. Any information furnished shall be treated as secret and shall not be disclosed to any persons other than those (including a court or administrative body) concerned with assessment, collection, enforcement, or prosecution in respect of the taxes which are the subject of this Convention.

(3) In no case shall the provisions of paragraph (2) be construed so as to impose on one of the Contracting States the obligation:

(a) To carry out administrative measures at variance with the laws or the administrative practice of that or of the other Contracting State;

(b) To supply particulars which are not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

(c) To supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

(4) The furnishing of information shall be either on a routine basis or on request with reference to particular cases. The competent authorities of the Contracting States shall agree on the list of information which shall be furnished on a routine basis.

ARTICLE 16.—ASSISTANCE IN COLLECTION

(1) The two Contracting States undertake to lend assistance and support to each other in the collection of the taxes to which this Convention relates, together with interest, costs, and additions to the taxes and fines not being of a penal character according to the laws of the State requested, in cases where the taxes are definitively due according to the laws of the State making the application.

(2) In the case of an application for enforcement of taxes, revenue claims of each of the Contracting States which have been finally determined will be accepted for enforcement by the State to which application is made and collected in that State in accordance with the laws applicable to the enforcement and collection of its own taxes.

(3) The application will be accompanied by such documents as are required by the laws of the State making the application to establish that the taxes have been finally determined.

(4) If the revenue claim has not been finally determined, the State to which application is made will take such measures of conservancy (including measures with respect to transfer of property belonging to nonresident aliens) as are authorized by its laws for the enforcement of its own taxes.

(5) The assistance provided for in this Article shall not be accorded with respect to estates of citizens of the Contracting States to which application is made.

ARTICLE 17.—DIPLOMATIC AND CONSULAR OFFICIALS

(1) Nothing in this Convention shall affect the fiscal privileges of diplomatic or consular officials under the general rules of international law or under the provisions of special agreements.

(2) Insofar as such privileges prevent the imposition of tax in the receiving Contracting State, the right to tax shall be reserved to the Contracting State in whose service the persons concerned exercised their functions and, notwithstanding any other provisions of this Convention, such persons shall not be deemed to have been domiciled in the receiving Contracting State.

ARTICLE 18.—TERRITORIAL EXTENSION

(1) This Convention may be extended, either in its entirety or with

necessary modifications, to all or any of the Overseas Territories of the French Republic or the territories for whose international relations the United States is responsible, if such territories impose taxes substantially similar in character to those referred to in Article 2. Any such extension shall take effect from such date and subject to such modifications and conditions as may be specified and agreed between the Contracting States in notes to be exchanged through diplomatic channels or in any other manner in accordance with their constitutional procedure. In the case of the United States, such procedure shall be that set forth in Article II, Section 2, of the Constitution of the United States (advice and consent of the Senate).

(2) At any time after the expiration of a period of one year from the effective date of an extension made by virtue of paragraph (1) either of the Contracting States may, by a written notice of termination given to the other Contracting State through diplomatic channels, terminate the application of the provisions in respect of any territory to which this Convention has been extended, in which case the provisions of the Convention shall cease to be applicable to such territory on and after the first day of January following the date of such notice.

(3) Unless otherwise agreed by both Contracting States, the termination of the Convention by one of the Contracting States under Article 20 shall also terminate the application of the Convention to any territory to which it has been extended under this Article.

CHAPTER VI.—FINAL PROVISIONS

ARTICLE 19.—ENTRY INTO FORCE

(1) This Convention shall be ratified and the instruments of ratification shall be exchanged at Paris as soon as possible.

(2) This Convention shall enter into force the first day of the second month following the month in which the exchange of the instruments of ratification takes place. Its provisions shall apply to estates of persons dying and to gifts made on or after that date.

(3) The Convention of October 18, 1946, as modified by the Protocol of May 17, 1948, and the Convention of June 22, 1956, shall be terminated on, and shall cease to have effect from, the date on which the present Convention enters into force according to paragraph (2).

ARTICLE 20.—TERMINATION

(1) This Convention shall remain in force until terminated by one of the Contracting States. However, not earlier than the fifth year following the year in which this Convention entered into force, either Contracting State may, between the first of January and the thirtieth of June, give written notice of termination through diplomatic channels, with effect from the end of the calendar year in which such notice is given. In such an event, its provisions shall not apply to estates of persons dying or to gifts made after the end of the calendar year with respect to the end of which this Convention has been terminated.

(2) Notwithstanding the provisions of paragraph (1), if the effects of this Convention are substantially altered as a result of changes made in the tax law of either Contracting State, either Contracting State may, through diplomatic channels, give a written notice of termination with effect not earlier than 6 months after such notice is given. In such an event, its provisions shall not apply to estates of persons dying or to gifts made on or after the effective date of the termination.

In witness whereof, the plenipotentiaries of the two Contracting States have signed this Convention and affixed thereto their seals.

Done at Washington, in duplicate, in the English and French languages, each text being equally authentic, this 24th day of November 1978.

For the President of the United States of America: GEORGE S. VEST

For the President of the French Republic: FRANCOIS DE LABOULAYE

Senate Executive Report No. 96-3

[Bracketed numerals indicate official report page numbers]

ESTATE AND GIFT TAX TREATY WITH THE FRENCH REPUBLIC

JUNE 15, 1979

Mr. CHURCH, from the Committee on Foreign Relations, submitted the following report to accompany Ex. J, 96th Cong., 1st sess.

The Committee on Foreign Relations, to which was referred the Estate and Gift Tax Treaty with the French Republic ("France")[1] for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on estates, inheritances and gifts, having considered the same, reports favorably thereon without reservation and recommends that the Senate give its advice and consent to ratification thereof.

I. PURPOSE

The purpose of the proposed estate and gift tax treaty between the United States and France is to alleviate double taxation on estates and gifts of French and U.S. domiciliaries and U.S. citizens by modifying the jurisdictional rules of estate and gift taxation with respect to these individuals.

[2] II. BACKGROUND

The proposed treaty was signed by the United States and the French Republic on November 24, 1978, and has been submitted to the Senate for advice and consent to its ratification. The Tax Treaty was transmitted to the Senate on February 9, 1979.

The portion of the proposed treaty dealing with state taxation will replace the existing estate tax treaty and protocol between the United States and France, which have been in force since October 17, 1949 [1956-1 C.B. 837]. There is no existing gift tax treaty between the two countries.

[1] Page 391; Technical Explanation, page 405; Senate Executive J is not published.

III. SUMMARY OF TREATY

The proposed treaty will alleviate double taxation on gifts and estates of United States citizens and domiciliaries and French domiciliaries in some situations by allowing only one country to impose its tax and in others by allowing both countries to impose a tax but requiring one of the countries to allow a credit against its tax for the taxes paid to the other country.

In most situations, the treaty allows the country of domicile to assert primary tax jurisdiction. However, the situs country is given priority taxation in the case of real property, tangible personal property, and business assets which are located in that country.

The treaty provides that the domicile of an individual will be determined separately under the laws of each country. If only one of the two countries treats the individual as a domiciliary under its domestic laws, then that is the country of domicile for purposes of the treaty. However, if both countries treat the individual as a domiciliary under their domestic laws, then the treaty sets forth an extensive set of rules to determine the individual's domicile for purposes of establishing primary tax jurisdiction under the treaty. The approach used in this set of rules is to recognize that where an individual domiciled in both countries is a national of one of the two countries and has been resident for only a limited period of time in the other country, his ties with the country of residence are not sufficient to justify the assertion of primary tax jurisdiction by that country. However, where an individual has been domiciled in both countries for a substantial period of time, the country with which he has his closest ties (such as the place of his permanent home) has the greater claim to domicile and, thus, primary tax jurisdiction will generally be allowed to that country.

[3] IV. DATE OF ENTRY INTO FORCE AND TERMINATION

Entry into force

The proposed treaty will enter into force on the first day of the second month following the month in which the instruments of ratification are exchanged and will apply to estates of persons dying and to gifts made on or after that date. The existing treaty terminates at that time.

Termination

The proposed treaty will continue in force indefinitely but either country may terminate it as of the close of any calendar year which ends at least 5 years after the treaty enters into force. Termination is accomplished by delivering written notice between January 1st and June 30th of that same year.

The proposed treaty can also be terminated if changes in the tax laws of either country result in a substantial alteration of the effects of the treaty. Such termination will occur 6 months after the delivery of notice. A termination under this provision is not subject to the 5-year minimum period previously mentioned.

V. COMMITTEE ACTION

The Committee on Foreign Relations held public hearings on the proposed French estate and gift tax treaty and on other proposed tax treaties, on June 6, 1979. The Committee considered the proposed treaty on June 12, 1979 and ordered it favorably reported by a vote of 13 yeas, no nays, with the recommendation that the Senate give its advice and consent to ratification of the treaty.

VI. BUDGET IMPACT

The Committee estimates that the effect of the proposed treaty on budget receipts will be negligible.

In accordance with the objectives of section 403 of the Budget Act, the Committee advises that the Director of the Congressional Budget Office has examined the Committee's budget estimate and agrees that the effect on budget receipts will be negligible. In keeping with section 308(a) of the Budget Act, and after consultation with the Director of the Congressional Budget Office, the Committee states that the treaty does not provide any new budget authority or any new or increased tax expenditures.

[4] VII. EXPLANATION OF TREATY PROVISIONS

A comprehensive article-by-article explanation of the proposed estate, inheritance and gift tax treaty between the United States and France is set forth below.

Article 1. Estates and gifts covered

The proposed treaty applies to estates of decedents who were domiciled in France at the time of their death and to estates that are subject to tax in the United States because the decedent was a citizen or domiciliary of the United States at the time of his death. With respect to gifts, the treaty applies to gifts made while the donor was a domiciliary of France and to gifts which are subject to tax in the United States because the donor was a citizen or domiciliary of the United States when the gift was made. Generation-skipping transfers which are subject to tax in the United States because the transferor was a U.S. citizen or domiciliary are also covered.

The proposed treaty does not treat certain residents of U.S. possessions as U.S. citizens or domiciliaries. These are individuals who acquired U.S. citizenship solely because they were citizens of a possession or because they were born in a possession or were residents of a possession. Under U.S. law (Code sec. 2209 and sec. 2501(c)), these individuals are not taxed by the United States on their worldwide estates and gifts, so protection against double taxation is generally unnecessary. Accordingly, the proposed treaty will not apply to estates or gifts of these individuals, unless it is applicable by reason of their being domiciled in France.

Article 2. Taxes covered

The proposed treaty applies to the U.S. estate tax, gift tax, and the tax on generation-skipping transfers.

The United States imposes its estate tax on the worldwide assets of estates of persons who were citizens or domiciliaries of the United States at the time of their death, and on property belonging to non-domiciliaries of the United States which is situated in the United States at the time of their death. The U.S. gift tax is imposed on all gifts made by U.S. citizens and domiciliaries, and on gifts of property made by nondomiciliaries where the property is tangible property located in the United States at the time of the gift.

The U.S. tax on generation-skipping transfers was enacted in 1976 to prevent the transfer of the use of property among generations of the transferor's descendants without the payment of gift or estate taxes. In general, the tax on such transfers is imposed when property passes through a trust from persons of one generation to persons of another generation, and the transfer is not otherwise subject to estate or gift tax.

The proposed treaty applies to the French succession duty and the French gift duty. The succession duty is imposed on the world-wide [5] assets of persons domiciled in France at the time of their death, and on property of nondomiciliaries of France where the property is located in France at the time of their death. France imposes a gift duty on all gifts made by persons domiciled in France, and on property of nondomiciliaries that is located in France at the time of the gift.

As is generally true in the case of other U.S. estate tax treaties, the proposed treaty does not apply to death or gift taxes imposed by state or local governments. In addition, the proposed treaty provides that it will apply to any substantially similar taxes on estates, inheritances and gifts that either country may subsequently impose. The competent authorities of both countries are required to notify each other in the case of any substantial changes in their estate, inheritance or gift tax laws.

Article 3. General definitions

The standard definitions generally found in most existing U.S. estate tax treaties are contained in the proposed treaty.

The United States is defined to mean the fifty states and the District of Columbia. Thus, U.S. possessions and territories are not covered by the treaty. France is defined to mean that part of France situated in Europe and the Overseas Departments of the French Republic which include Guadaloupe, Martinique, Guyane and Reunion. The geographical definition of both countries also includes any area where either country may, under international law, exercise rights with respect to the natural resources of the seabed and subsoil.

The proposed treaty also contains the standard provision that undefined terms are to have the meaning which they have under the applicable tax laws of the country whose tax is being determined. In addition, it is further provided that where a term defined in a different manner by the two countries, the countries may establish a common meaning of the term in order to prevent double taxation or to further any other purposes of the proposed convention.

Article 4. Fiscal domicile

The concept of domicile is important under the proposed treaty because the country of domicile has, under the treaty, primary tax jurisdiction on all property other than the property subject to situs taxation. The country of domicile is initially determined by each country under its domestic laws. However, in those situations where both countries would treat an individual as a domiciliary, the treaty sets forth rules for establishing the country of domicile for purposes of the taxes covered by the treaty.

Ordinarily, the tests employed by countries to determine the domicile of an individual often are not exactly the same. Under the Internal Revenue Code an individual is considered a domiciliary of the United States for purposes of the Federal estate and gift tax if the person was residing in the United States and had the intent to remain in the United States indefinitely (or had been residing in the United States with such an intent and had subsequently left this country without an intent to remain indefinitely at his new place of residence). A person is considered domiciled in France if his main establishment is in France. In general, a person's main establishment is where he phys- [6] ically resides and intends to live permanently. In the situation where an individual resides (or has resided) in both countries, it is possible that each country, in ascertaining where the individual intended to make his permanent home, could arrive at different conclusions from the individual's actions. Thus, each country could hold that these actions clearly demonstrate the individual's intention to make that country his permanent home and, accordingly, his domicile.

To provide relief from double taxation where each country considers the individual to be a domiciliary under its domestic laws, the proposed treaty provides a series of rules designed to establish a single country of domicile for the individual for purposes of the taxes covered by the treaty. The country so selected will then have the primary tax jurisdiction with respect to the worldwide estate of the decedent or his worldwide gifts, other than with respect to real property, business assets or tangible property situated in the other country. As described below, these rules are based on the concept that primary tax jurisdiction should be exercised either by the country of nationality, if the dual domicile individual has not been resident in the other country for a substantial period of time prior to his death or the making of the gift, or by the country in which he has his most significant contacts if the nationality test is not determinative.

In determining the domicile of an individual under the proposed treaty,

each country will first determine whether the individual is considered a domiciliary under its law. If the individual is a domiciliary of only one country then that will be the individual's country of domicile for purposes of the proposed treaty. However, if both countries determine the individual to be a domiciliary, the proposed treaty provides a series of rules by which an exclusive domicile for the individual will be determined.

The first rule that is applied consists of two separate tests which apply to persons who are citizens of only one of the two countries. Under the first test, such a person will be considered domiciled in the country of which he is a citizen if he was domiciled in the other country for less than 5 years during the 7-year period which ends with the year of his death or the year the gift was made, and he was in that country because of an assignment of employment or because he was the spouse or dependent of a person who was in that country for such a purpose. Under the second test, the person will be considered a domiciliary of the country of which he is a citizen if he was domiciled in the other country for less than 7 years during the 10-year period which ends with the year of his death or the year the gift was made, and he was in that country because of a renewal of an assignment of employment or because he was the spouse or dependent of a person who was in that country for such a purpose.

A second rule, which is similar to the first in that it applies to persons who are domiciliaries of both countries and citizens of only one of the countries, applies if domicile cannot be resolved under the first rule. Under the second rule such a person will be considered a domiciliary of the country of which he is a citizen if he had a clear intention to retain his domicile in that country and he was domiciled in the other country for less than 5 years during the 7-year period which ends with the year of death or the year the gift was made.

[7] It is contemplated that these rules will resolve the great majority of dual domicile situations. However, if a dual domicile problem still remains after application of these rules, the proposed treaty provides four additional rules to determine domicile. The rules (applied in the order presented) provide that the individual will be considered domiciled in the country (1) in which he maintained his permanent home, (2) in which his personal relations were the closest (center of vital interests), (3) in which he had a habitual abode, or (4) in his country of citizenship. In cases where an individual's domicile cannot be determined under these rules, the competent authorities of the countries are to settle the question by mutual agreement.

Article 5. Immovable (real) property

Under the proposed treaty, immovable (real) property is one of the three types of property over which the situs country, rather than the country of domicile has primary tax jurisdiction. The other two are assets of a permanent establishment or fixed base (*Article 6*) and tangible movable property (*Article 7*).

The determination of whether an item of property is immovable (real) property is to be made under tax laws of the country in which the property is located. Although U.S. law does not define "immovable (real) property," that term for U.S. purposes is considered to mean real property. It is further provided that immovable (real) property does not include claims secured by real property (such as mortgages). Real property which is part of the business assets of a permanent establishment or used for the performance of professional or similar independent services is taxable under this article, rather than Article 6.

Article 6. Business property of a permanent establishment and assets pertaining to a fixed base used for the performance of professional services

Under the proposed treaty, the second type of property over which the situs country has primary tax jurisdiction is the business assets (other than ships and aircraft operated in international traffic and related personal property and other than real property) of an individual's permanent establishment which located in the situs country and the assets (other than real property) of a fixed base of an individual which is situated in the country and is used for the performance of professional services or other similar independent activities. The real property of a permanent establishment or fixed base is to be taxed by the country in which it is situated, as provided in Article 5.

The proposed treaty contains a definition of the term "permanent establishment" which is similar to the definition found in recent U.S. income tax treaties. Generally, any fixed place of business through which a person engages in a trade or business is considered a permanent establishment. For this purpose, a person is considered engaged in a trade or business regardless of whether the business is carried on as a sole proprietorship or through a partnership or as an unincorporated association which is not taxed as a corporation. In the case of a partnership or association, however, only the person's interest in the business entity will be taken into account for purposes of this provision.

A fixed place of business generally includes a branch, office, factory, workshop, warehouse, place of extraction of natural resources, and [8] any building site or construction or assembly project which exists for more than 12 months. This general rule is modified by providing that a fixed place of business which is used for certain activities specified in the treaty will not be considered a permanent establishment. These activities include, for example, the warehousing of goods for purposes of storage, display, or delivery, and the use of a fixed place of business solely for the purpose of purchasing merchandise or collecting information. An additional activity in-

cluded within this exempt category is the maintenance of a fixed place of business solely for investment purposes of an individual, whether conducted by the individual, his employees, a broker or other agent.

The proposed treaty also provides that a person will be deemed to have a permanent establishment in a country if he had an agent in that country who had and habitually exercised a general contracting authority (other than for the purchase of goods or merchandise) in that country. This agency rule does not apply, however, if the agent is a broker, general commission agent, or any other agent of an independent status, provided the agent is acting in the ordinary course of his business.

A company will not be held to have a permanent establishment in one of the countries solely because it controls a company which is a resident of that country.

Article 7. Tangible movable property

With three exceptions, tangible movable (i.e., personal) property, other than currency, is subject to tax in the country in which the property is situated. The first exception is for property which is held for use by a permanent establishment or a fixed base used for the performance of professional services which is located in the other country. This property is subject to tax by the country in which the permanent establishment or fixed base is located.

A second exception is for property owned by an individual who is considered domiciled in the country of which he is a citizen (under the special 5-of-7 or 7-of-10 year rules used in Article 4(3) to determine domicile) if the property is for the normal personal use of that person or his family. Essentially, this property can only be taxed by the country of citizenship.

Finally, ships and aircraft operated in international traffic, and personal property pertaining to the operation of such ships and aircraft, may be taxed by the country in which they are registered. Other ships and aircraft may be taxed by the country whose harbors and airports are most frequently used by the ships and aircraft.

Article 8. Taxation other than pursuant to Articles 5, 6, and 7

This article sets forth the general treaty rule that the country of domicile, as determined under the treaty, has the primary tax jurisdiction over the estates or gifts of its domiciliaries other than the property specifically reserved for situs taxation.

The proposed treaty provides that property, other than real property, assets of a permanent establishment or fixed base, and tangible personal property, may be subject to tax in either of the two countries only if the individual is a citizen or domiciliary of that country and the property is otherwise subject to tax in that country. This provision is explicitly intended to cover corporate stock, debt obligations, other intangible property and currency.

[9] Since the United States does tax based upon citizenship (France does not), there is still the possibility of double taxation if an individual is a U.S. citizen and a French domiciliary. The possibility of double taxation in that situation is, however, alleviated under the tax credit structure established in Article 12.

Article 9. Deduction of debts

The proposed treaty provides that if debts are deductible from the value of property in computing the estate or gift tax of either country, these debts are to be deducted from the gross value of the property subject to tax in that country in the same proportion that such gross value bears to the total gross value of all the property. However, in computing the French tax, debts pertaining to a permanent establishment or a fixed base are to be deducted in total from the assets (other than real property) that relate to the permanent establishment or fixed base. Similarly, debts relating to ships and aircraft, and their movable property, are to be deducted in total from the value of those assets. These debts are to be allowed as a deduction in computing the French tax under the treaty even if they would not be allowed as a deduction under French internal law.

Article 10. Charitable exemptions and deductions

Essentially, this provision allows contributions made to charitable organizations in one country to be exempt from tax in the other country or to be deductible in computing the tax in that other country. This treatment is allowed only if the transfer would be eligible for an exemption or deduction if the charitable organization had been created in the taxing country. Additionally, the charitable organization must have a tax-exempt status in its home country so that payments to it are exempt or fully deductible, it must be organized and operated exclusively for religious, charitable, scientific, literary or educational purposes, and it must receive a substantial part of its support from public or governmental funds. Thus, in computing the French tax, no deduction or exemption is allowed for contributions to a private foundation, even if the contribution would be deductible under U.S. law.

Contributions to governmental organizations will not qualify for exempt or deductible status unless the contribution is specifically limited to one of the tax-exempt purposes enumerated above.

Article 11. Community property and marital deduction

The proposed treaty allows U.S. citizens and domiciliaries to elect to treat property which is subject to the French tax as being community property. Essentially, this means that France will only tax one-half of the gifts made by a person to his spouse and it will only tax one-half of the property that passes from a decedent to his spouse. In both cases, the other one-half is deemed to already belong to the spouse under the elected community property laws.

Reciprocally, French domiciliaries may, in computing their U.S. tax, take the marital deduction that would be allowed to a U.S. domiciliary on November 24, 1978, the date the proposed treaty was signed. Currently, a nondomiciliary does not get a marital deduction, but is entitled to lower tax rates than those applicable to domiciliaries and citizens. If a French domiciliary claims the marital deduction allowed by this article, he is required to compute his tax at the rates [10] applicable to U.S. citizens and domiciliaries. A French domiciliary will be taxed at the rates applicable to nondomiciliaries without a marital deduction, if the tax computed on that basis is lower than the tax computed by allowing a marital deduction and applying the higher rates.

If the laws of either country are modified substantially to reduce the benefits of the community property rules in the case of France or the marital deduction in the case of the United States, the tax authorities of the two countries will consult on whether this provision should be modified or terminated. Actual modification or termination will require termination of the entire treaty (*Article 20*) or other action in accord with the constitutional procedures of each country.

Article 12. Exemptions and credits

Except as otherwise provided in the treaty, each country shall compute its estate or gift tax in accordance with its own laws including the allowance of exemptions, deductions, credits, and other allowances allowed under the country's internal law. In general, double taxation is avoided because France exempts property from taxation that is subject to situs taxation in the United States and because the United States allows a credit for taxes paid to France on property subject to situs taxation in France.

Specifically, real property, assets of a permanent establishment or fixed base, and tangible movable property, which are subject to situs taxation in the United States, as provided for in the proposed treaty, will be completely exempt from tax in France. However, this property will be taken into account in determining the appropriate tax rate applicable to the property which is subject to French taxation (i.e., an exemption with progression).

Correspondingly, the United States will allow a credit against its estate or gift tax for taxes paid to France on property where, under the proposed treaty, the property is subject to situs taxation in France. However, the credit will only be allowed for taxes actually paid to France and the credit is not to exceed the U.S. estate or gift tax attributable to the property. In addition, the credit is in lieu of any other such credits allowed under the laws of the United States.

The United States gives France primary tax jurisdiction over U.S. citizens determined to be French domiciliaries under the treaty. The treaty provides that the United States will give a full tax credit for taxes paid to France by a U.S. citizen who is deemed to be a French domiciliary under the treaty (i.e. the amount of the credit can exceed the amount of the U.S. tax attributable to the property, but it cannot, of course, exceed the U.S. tax on the entire estate). However, if the U.S. tax exceeds the French tax, the excess will be collected by the United States.

The proposed treaty stipulates that the treaty will not increase the amount of tax due to either country under its domestic laws. However, a reduction in the amount of the foreign tax credit allowed by the United States against its estate and gift tax will not be considered to be an increase in tax. This prevents the argument that an individual would have received a higher foreign tax credit without the treaty, because he would have paid more French taxes, and thus should be [11] allowed the higher foreign tax credit even though the treaty reduced his French tax.

Article 13. Time limitations on claims for credit or refund

Under the Internal Revenue Code, a claim for credit or refund of U.S. estate and gift taxes generally must be made within 3 years from the date the return was filed. The proposed treaty provides a period of limitation during which claims for credit or refund of taxes based on the provisions of the treaty may be made which, in some cases, may be longer than that allowed by the Internal Revenue Code. It is provided that a claim for a credit or refund of taxes based on the provisions of the treaty must be made before the expiration of the latest of (1) the period of limitations prescribed under the domestic law of the country to which the claim is made, (2) 5 years from the date of the decedent's death or the date of the gift, or (3) 1 year after final determination and payment of a tax for which a credit is claimed under the treaty (provided the determination and payment occur within 10 years from the date of the decedent's death or the date of the gift).

The proposed treaty follows the approach of other U.S. estate tax treaties and provides that any refund based on the provisions of the treaty is to be made without interest.

Articles 14 and 15. Administrative provisions

The proposed treaty contains various administrative provisions which are generally found in other U.S. tax treaties. In general, the proposed treaty provides—

(1) For consultation and negotiation between the competent authorities of the two countries to resolve differences arising in the interpretation or application of the proposed treaty and also to resolve claims by taxpayers that they are being subjected to taxation contrary to the proposed treaty;

(2) For the exchange between the countries of information pertinent to carrying out the provisions of the proposed treaty or the tax laws of one of the countries, insofar as its taxation is in accordance with the proposed treaty, or to prevent fraud or fiscal

evasion with respect to the taxes covered by the proposed treaty; and

(3) For continuing the tax return and recordkeeping requirements that exist under each country's domestic law, except with respect to U.S. provisions which the Treasury finds are not necessary for the prevention of fraud or fiscal evasion.

Article 16. Assistance in collection

The two countries agree to assist each other in collecting each other's estate and gift taxes. This assistance extends to enforcing assessments that have been finally determined under the law of the requesting country and taking measures of conservancy where the assessment has not been finally determined. The assistance each country is obligated to give is limited to the enforcement measures it can take in enforcing its own assessments.

The assistance provided by a country will not extend to enforcement of assessments against estates of its own citizens.

[12] *Article 17. Diplomatic and consular officials*

The proposed treaty provides that its provisions are not to affect the fiscal privileges which diplomatic and consular officials and officials of international organizations enjoy under the general rules of international law or the provisions of special agreements. It is further provided that the right to tax those persons will be reserved to the country for whom they perform their functions and that these officials are not to be considered domiciled in the country where they are employed. This provision is designed to prevent diplomatic and consular officials of a third country from claiming domicile in either the United States or France so as to bring themselves within the provisions of the convention.

Article 18. Territorial extension

The proposed treaty contains a method similar to that found in some of our other U.S. tax treaties by which the treaty may be extended to any of the Overseas Territories of the French Republic or to any territories for whose international relations the United States is responsible, if the territory imposes taxes substantially similar to those covered by the treaty. The treaty may be extended pursuant to this provision either in its entirety or with necessary modifications. The extension is to be effected in accordance with the constitutional procedures of the two countries. This requirement follows the U.S. Senate's reservation to the territorial extension provision of the income tax treaty between the United States and France.

Any extension of the treaty to an eligible territory of either country may be terminated after one year. Additionally, if the treaty between the two countries is terminated, the termination shall extend to any extensions made under the treaty.

Article 19. Entry into force

The proposed treaty will enter into force on the first day of the second month following the month in which the instruments of ratification are exchanged and will apply to estates of persons dying and to gifts made on or after that date. The existing treaty terminates at that time.

Article 20. Termination

The proposed treaty will continue in force indefinitely but either country may terminate it as of the close of any calendar year which ends at least 5 years after the treaty enters into force. Termination is accomplished by delivering written notice between January 1st and June 30th of that same year.

The proposed treaty can also be terminated if changes in the tax laws of either country result in a substantial alteration of the effects of the treaty. Such termination will occur 6 months after the delivery of notice. A termination under this provision is not subject to the 5-year minimum period previously mentioned.

[13] VIII. TEXT OF RESOLUTION OF RATIFICATION

* * * * *

RESOLUTION OF RATIFICATION

Resolved (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Convention Between the United States of America and the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Estates, Inheritances and Gifts, done at Washington on November 24, 1978 (Ex. J, Ninety-sixth Congress, first session).

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[58] APPENDIX C

WRITTEN RESPONSES BY TREASURY TO QUESTIONS BY THE COMMITTEE STAFF

DEPARTMENT OF THE TREASURY,
Washington, D.C., June 8, 1979.

Hon. FRANK CHURCH,
Chairman, Committee on Foreign Relations,
U.S. Senate
Washington, D.C.

DEAR MR. CHAIRMAN: To follow-up my testimony at the June 6 hearings concerning the six tax conventions or protocols involving the United Kingdom, France, Hungary and Korea, I want to assure you that Article I of the Third Protocol of the proposed US-UK Income Tax Treaty gives full effect to the Senate's reservation on Article 9(4) of that treaty. Let me also assure you that there is no similar state tax issue in any of the other five treaties which were considered by the Committee yesterday.

Again let me emphasize our view that each of these treaties is impor-

tant to the United States and that their prompt approval is desirable.

I am also enclosing answers to the written questions submitted to me by your staff at the hearings as well as copies of my answers to questions from Senator Helms and Senator Javits.

Sincerely,

DONALD C. LUBICK,
Assistant Secretary (Tax Policy).

Enclosures.

QUESTIONS FOR ASSISTANT SECRETARY FOR TAX POLICY DONALD C. LUBICK [1]

* * * * *

[60] QUESTIONS ON UNITED STATES-FRANCE ESTATE AND GIFT TAX TREATY

Question 1. The proposed Convention is an extension of the Foreign Investors Tax Act of 1966 [Pub. L. 89-809, 1966-2 C.B. 656], could you please describe the benefits, as you see them, that the U.S. has derived from the 1966 Act as well as the first convention under the Act with the Netherlands [1967-2 C.B. 472]?

Answer. The proposed Convention is not really an "extension" of the Foreign Investors Tax Act of 1966. It is a Convention which modifies the provisions of the convention currently in force between two parties in order to harmonize the treaty arrangement with the provisions of the 1966 Act.

The primary objective of the 1966 Act was to remove or reduce barriers created by the tax system to the free flow of foreign capital into the United States. The estate tax provisions of the Act lowered the tax rate imposed upon the estates of foreigners who owned U.S. property at their death. The primary achievement of the statute was [61] to lessen tax barriers to the inflow of foreign capital into the United States.

The primary achievement of the Netherlands Convention from the perspective of the United States was the agreement by the Netherlands to the special rules which deem a U.S. citizen a domiciliary of the U.S. if he is deemed domiciled in both countries at the time of his death, but if he has not lived in the Netherlands more than 7 of the 10 years ending with his death. This ensures that American citizens living in the Netherlands will not be subject to Netherlands estate tax unless they have formed an intent to stay in the Netherlands, or have lived there a long time. This is of substantial importance to U.S. companies doing business in the Netherlands, since it permits them to assign their executives to the Netherlands without the employees becoming subject, simply by virtue of living in the Netherlands for a short time, to Netherlands estate taxes.

Question 2. A major feature of the proposed convention is the use of a five year time period that will be the basis for determining the domicile of a taxpayer. Could you explain the reason the five year time period was selected?

Answer. The five-year period is relevant only in cases where each State under its own law considers an individual to be its own domiciliary at the same time. The five-year period is irrelevant to the determination of domicile under domestic law, and comes into play only after such a determination has been made in each State. It also applies only if the person is a citizen of only one of the Contracting States.

The five-year period (or the 5-of-7 rule of Article 4(3) of the Convention) was the product of bargaining between the parties. The official U.S. position, reflected in the model treaty and the U.S.-Netherlands treaty, is that a person should have to live in a country other than that of his citizenship 7 of 10 years before his death to be subject to the new country's death taxes. The French position was that only the "tie-breaker" rules of Article 4(2) should be used for any case of "double domicile," regardless of the fact that the person was a citizen of only one Contracting State. The 5-of-7 rule represents a compromise between the two positions.

The 7-of-10 year rule of the model is based upon a balancing of concerns for determining which State should have the right to tax the lifetime accumulation of an individual. In general, the U.S. believes that the momentary circumstance of residence at death should not be controlling, particularly where a citizen of one country is residing abroad, and doing so only for a short time. The U.S. believes, however, that if a person lives in a country for a substantial period of time, at some point that country acquires a legitimate claim to tax the person's lifetime accumulation, even if the person is not a citizen of the country and does not intend to remain there forever.

Question 3. Would you detail the number of individuals affected by the proposed Convention and the revenue that will be received by the Treasury as a result of the proposed Convention? In addition, would you, for the record, submit estimated cost to the Department of Treasury, IRS, or other U.S. Government entities responsible for enforcing the terms of the Convention?

[62] *Answer.* It is impossible to determine which individuals will be affected by the proposed Convention, since that depends upon the domicile of individuals at the time of their death or their gifts, and upon what property such individuals own at such times. The Treasury does not have statistics on the number of U.S. citizens living in France or French citi-

[1] General questions and answers 1-5 may be found in Senate Executive Report 96-6, 1980-1 C.B. 375. The questions and answers relating specifically to the other protocols and treaties considered at the June 6, 1979, hearings are set forth in the committee reports relating to those treaties.

zens living in the United States, who might be affected by the domicile determination rules of the Convention; nor does it have reliable data concerning the amount of U.S. situs property held by French domiciliaries, or French situs property held by U.S. domiciliaries, the taxation of which might be affected by the allocation of tax jurisdiction effected by the Convention.

The Treasury believes, however, that the Convention will not have a substantial revenue effect. This is because the Convention embodies a balance of concessions by the two sides, respective revenue effects of which are likely to cancel each other out. For instance, the Convention's domicile rules enable the U.S. to tax its citizens living in France if they have not lived there more than 5 of 7 years: to this extent, it is likely to result in a slight revenue gain to the U.S. On the other hand, the Convention also restricts the rights of the U.S. to tax certain intangible U.S. property owned by French persons at the time of death; to this extent, it probably involves some revenue cost to the U.S. To the extent the Convention as a whole eliminates barriers created by potential double taxation to the free flow of goods, persons, and capital between the two countries, it probably results in a slight revenue gain to each country.

The Convention should not involve appreciable administrative costs to the U.S. Government. The rules of the Convention apply to estates, gifts, and generation-skipping transfers which even in the absence of the Convention would be subject to U.S. statutory law, and would therefore have to be subject to return requirements, audit and collection procedures, and the like, under statutory law. The Convention only results in substitute or supplementary legal rules governing the taxation of such transfers, and as such should not result in any measurable administrative costs.

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TECHNICAL EXPLANATION [1] OF THE CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND THE FRENCH REPUBLIC FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON ESTATES, INHERITANCES, AND GIFTS, SIGNED AT WASHINGTON ON NOVEMBER 24, 1978 [2]

Introduction

The Estate and Gift Tax Convention with France is the second such Convention signed by the United States since U.S. estate and gift tax laws were substantially modified in the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1]. Modification included combining the separate estate and gift tax rates into a single rate schedule, substituting a unified credit for the former separate estate and gift tax exemptions, and imposing a tax on generation-skipping transfers. The Convention will replace the existing estate tax convention between the two countries, which has been in force since 1946 [1956-1 C.B. 837].

The Convention is similar to the United States Estate Tax Convention with the Netherlands [1976-1 C.B. 471], which entered into force in 1971, and to the United States Model Estate and Gift Tax Convention published by the Treasury Department on March 16, 1977. The Convention is also based, in part, on the provisions of the Model Estate Tax Convention (Draft Double Taxation Convention on Estates and Inheritances) of the Organization for Economic Cooperation and Development (OECD), published in 1966.

The general principle underlying the Convention is that the primary right to tax the worldwide estate, gifts, or generation-skipping transfers of a decedent, donor, or deemed transferor should lie with the country of domicile. Property situated in the other State is either exempted from tax in that State or the tax levied by that State is allowed as a credit in the State of domicile. Immovable (real) property, certain business assets, and certain categories of tangible movable (personal) property are the types of property that are taxable in the State of situs. The Convention also contemplates that the United States will impose a tax on the worldwide property of its citizens, but that it will allow a credit for taxes paid to France by any person who was a domiciliary of France at the time of death, or at the time of a gift or generation-skipping transfer.

CHAPTER I
SCOPE OF THE CONVENTION

Article 1. Estates and Gifts Covered

This article describes the transfers of estates or by gift or generation-skipping transfer that are subject to the provisions of the Convention. Paragraph (1) provides that the Convention applies to estates of decedents whose domicile at death was in France, and to estates of decedents which are subject to the taxing jurisdiction of the United States by reason of the decedent's domicile in, or citizenship of, the United States at the time of death. The Convention does not apply to transfers of estates of decedents who were citizens of France at the time of their death, if they were not domiciled in France or the United States at that time. Under paragraph (1), the Convention applies to genera-

[1] It is the practice of the Treasury Department to prepare for the use of the Senate and other interested persons a Technical Explanation of the tax conventions which are submitted to the Senate for its advice and consent to ratification.

An estate, inheritance, and gift tax convention with France was signed on November 24, 1978, and submitted by the President to the Senate on February 9, 1979. On June 6, 1979, The Senate Committee on Foreign Relations held hearings and this Technical Explanation was presented. The Senate voted its advice and consent on July 9, 1979, and instruments of ratification were exchanged on August 7, 1980.

[2] Page 391; pertinent excerpts from Senate Executive Report No. 96-3, page 397; Senate Executive J is not published.

tion-skipping transfers deemed to occur at or after the death of the deemed transferor, if the deemed transferor was a citizen or domiciliary of the United States at the time of his death.

Paragraph (2) provides that the Convention applies to gifts of donors whose domicile at the time of making the gift was in France, and to gifts subject to the taxing jurisdiction of the United States by reason of the donor's domicile in, or citizenship of, the United States at the time of the gift. The Convention does not apply to gifts made by persons who were citizens of France, but not domiciled in either France or the United States, at the time of the making of the gift. Under paragraph (2), the Convention applies to transfers deemed to occur under the U.S. generation-skipping transfer tax at a time before the death of a deemed transferor, if the deemed transferor was a domiciliary or citizen of the United States at that time.

Paragraph (3) provides that a person who is at the time of his death or the making of a gift a resident of a possession of the United States, and who acquired U.S. citizenship solely by being a citizen of such U.S. possession, or by birth or residence within such possession, is considered as being neither domiciled in, nor a citizen of, the U.S. for purposes of the Convention. Under sections 2208 and 2209 of the Internal Revenue Code, such persons are treated as nonresidents not citizens of the United States for purposes of U.S. estate, gift, and generation-skipping transfer taxes, and therefore are not subject to such taxes on their worldwide property.

Article 2. Taxes Covered

Paragraph (1) identifies the taxes covered by the Convention. In the case of the United States, the Convention applies to the Federal gift tax and the Federal estate tax, including the tax on generation-skipping transfers. In the case of France, the Convention applies to the duty on gifts and the duty levied on succession. The Convention does not apply to any state, sub-Federal, or local taxes imposed in either Contracting State.

Paragraph (2) provides that the Convention also applies to any substantially similar taxes which are subsequently enacted in addition to, or in place of, the existing taxes. Under paragraph (3), the competent authorities of the Contracting States are required to notify each other of substantial changes in their respective laws relating to the taxation of estates and gifts.

Article 3. General Definitions

Paragraph (1) defines the terms "Contracting State" and "other Contracting States," "United States," "France," "enterprise," "tax," and "competent authority." The term "United States" does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory. The term "France" includes the overseas departments of the French Republic.

Paragraph (2) provides that any term not otherwise defined in the Convention shall, unless the context otherwise requires, have the meaning which that term has under the tax laws of the Contracting State whose tax is being determined. If, however, the meaning of a term under the laws of one of the Contracting States is different from the meaning of the term under the laws of the other State, the two States may, in order to prevent double taxation or to further any other purpose of the Convention, establish a common meaning for purposes of the Convention.

Article 4. Fiscal Domicile

This Article sets forth rules for determining "domicile" for purposes of the Convention. The determination of a single fiscal domicile for Convention purposes is important, because the country of domicile has the primary right to tax the worldwide estate, gifts, or other transfers of a decedent, donor, or deemed transferor, with the exception of property covered by Articles 5 (Immovable (Real) Property), 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Professional Services), and 7 (Tangible Movable Property).

Under paragraph (1), domicile is determined in the first instance under the domestic law of the respective Contracting States. Paragraphs (2) and (3) set forth rules for resolving cases of double domicile—where each State considers a person domiciled in that State under its domestic law. Under paragraph (2) such a person is deemed domiciled in the Contracting State in which he maintained his permanent home. If he has a permanent home in both Contracting States or in neither State, he is deemed domiciled in the Contracting State with which his personal relations were closest (his center of vital interests). If his center of vital interests cannot be determined, his domicile is deemed to be in the State in which he had an habitual abode. If he had an habitual abode in both Contracting States or neither of them, his domicile is deemed to be in the State of which he was a citizen. If he was a citizen of neither Contracting State or of both, his domicile is to be determined by the competent authorities by mutual agreement.

Paragraph (3) provides special rules for cases of double domicile with respect to individuals who were citizens of only one of the Contracting States. These special rules override the general rules of paragraph (2). Paragraph (3)(a) provides that such an individual shall be deemed domiciled in the Contracting State of which he was a citizen if he had a clear intention of retaining his domicile in that State, and if he was domiciled in the other Contracting State in the aggregate less than 5 years during the 7-year period ending on the date of his death or the making of a gift. In the case of a generation-skipping transfer, the relevant 7-year period ends with the year during which the transfer is deemed made, in the case of a transfer deemed made before the death of the deemed transferor, and with the year of death, in the event a transfer is

deemed made at or after the death of the deemed transferor. Paragraph (3) (b) provides that an individual with "double domicile" but "single citizenship" shall be deemed domiciled in the Contracting State of which he was a citizen, even in the absence of a clear intention of retaining his domicile in that State, if he was domiciled in the other Contracting State in the aggregate less than 5 years during the 7-year period ending with the year of his death or the making of a gift, provided he was in the other State by reason of an assignment of employment or as the spouse or other dependent of a person present in that State for such a purpose; or if he was domiciled in the other Contracting State in the aggregate less than 7 years during the 10-year period ending with the year of his death or the making of a gift, provided he was in the other State by reason of a renewal of an assignment of employment, or as the spouse or other dependent of a person present in the other State for such a purpose. These domicile rules are reciprocal.

If the rules of paragraph (3) do not apply to an individual who would be deemed under paragraph (1) to be domiciled in both Contracting States, but who is a citizen of only one of the Contracting States, then that individual's domicile shall be determined in accordance with the rules of paragraph (2).

CHAPTER III
TAXING RULES

Article 5. Immovable (Real) Property

This Article provides that immovable property may be taxed in a Contracting State if such property is situated in that State. The term "immovable (real) property" is defined in accordance with the tax laws of the Contracting State in which such property is situated.

Under paragraph (3), the provisions of Article 5 apply to property which forms part of the business property of a permanent establishment or is used for the performance of professional services or other independent activities of a similar character. For example, real property situated in France owned by a domiciliary of France not a citizen of the U.S. which formed part of the business property of a permanent establishment in the United States would be subject to tax in France and not in the United States.

Article 6. Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Professional Services

Paragraph (1) establishes the general rule that, except as provided in Article 5 (Immovable (Real) Property), and with the exception of ships and aircraft operated in international traffic and movable property pertaining to the operation of such ships and aircraft, assets forming part of the business property of a permanent establishment of an enterprise may be taxed by a Contracting State if the permanent establishment is situated in that State.

Paragraph (2) defines the term "permanent establishment" as a fixed place of business through which the business of an enterprise is wholly or partly carried on. The definition is substantially similar to the definition of "permanent establishment" in Article 4 of the Income Tax Convention between the United States and the French Republic signed on July 28, 1967 [1968-2 C.B. 691, 693]. Illustrations in paragraph (3) of a permanent establishment include a branch; an office; a factory; a workshop; a warehouse; a mine, quarry, or other place of extraction of natural resources; and a building site or construction or installation project which lasts for more than twelve months. The twelve month period for a construction or installation project begins when work physically commences in the other Contracting State. A series of contracts or projects which are interdependent both commercially and geographically is to be treated as a single project for the purpose of applying the twelve-months test.

Paragraph (4) provides that a permanent establishment does not include: the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise; the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise; the maintenance of a fixed place of business solely for the purpose of advertising, supplying information, conducting scientific research, or similar activities which have a preparatory or auxiliary character; or the maintenance of a fixed place of business solely for investment purposes (and not for purposes of engaging in industrial or commercial activity) of an individual, whether by the individual or his employees or through a broker or other agent. These exceptions are cumulative; a fixed place of business used solely for one or more of these purposes will not be considered a permanent establishment under the Convention.

Under paragraph (5), a person, other than an agent of an independent status to whom paragraph (4)(f) or (6) applies, acting in one Contracting State on behalf of an enterprise of the other Contracting State, will be deemed to constitute a permanent establishment if such person has, and habitually exercises in this first-mentioned Contracting State, an authority to conclude contracts in the name of the enterprise, unless that person's activities are limited to the purchase of goods or merchandise for the enterprise.

On the other hand, paragraph (6) provides that an enterprise of one Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because such enterprise carries on business in the other Contracting State through a broker, general commission agent, or

any other agent of an independent status, where the broker or agent is acting in the ordinary course of his business.

Under paragraph (7), the fact that an enterprise controls a corporation which is engaged in industrial or commercial activity in a Contracting State (whether through a permanent establishment or otherwise) is not to be taken into account in determining whether the enterprise had a permanent establishment in that State.

Paragraph (8) provides that, except for assets described in Article 5 (Immovable (Real) Property), assets pertaining to a fixed base used for the performance of independent personal services may be taxed by a Contracting State if the fixed base is situated in that State.

Article 7. Tangible Movable Property

Under paragraph (1), tangible movable property other than currency may be taxed by a Contracting State if the property is situated in that State, and if the property does not form part of the business assets of a permanent establishment situated in the other Contracting State. Tangible movable property for purposes of the wealth transfer taxes imposed by the United States includes whatever property would be considered tangible property under section 2501(a)(2) of the Internal Revenue Code other than property which would be considered real property. Paragraph (1) provides that tangible movable property which is in transit is to be considered situated at the place of its destination.

Under paragraph (2), notwithstanding the provisions of paragraph (1), tangible movable property owned by an individual referred to in paragraph (3) of Article 4 and used for that person's normal personal use or that of his family may be taxed only by the Contracting State in which the individual was domiciled. Under this paragraph, personal property owned by a person who has "double domicile" but who is taxable in the state of his citizenship by virtue of Article 4(3) will be taxable only in the State of citizenship.

Under paragraph (3), notwithstanding paragraph (1), ships and aircraft operated in international traffic, and movable property pertaining to the operation of such ships and aircraft, may be taxed by a Contracting State if the ship or aircraft is registered in that Contracting State. In addition, a ship or aircraft not registered in a Contracting State may be taxed by a Contracting State if the harbors or airports most frequently used by such ship or aircraft are situated in that State.

Article 8. Taxation Other Than Pursuant to Articles 5, 6 and 7

Article 8 states that, except as provided in Articles 5, 6, and 7, property, including shares of stock in a corporation, debt obligations (whether or not there is written evidence of such obligations), other intangible property, and currency may be taxed by a Contracting State only if the decedent or donor was a citizen of, or was domiciled in, that State at the time of death or the making of the gift, and only if the transfer was taxable by that State under its law. The proviso that the transfer must be taxable under the law of the State of domicile or citizenship is intended to ensure that the Convention not be interpreted as permitting a tax not contemplated by internal law.

Article 9. Deduction of Debts

Under paragraph (1), debts, to the extent they are deductible according to the internal law of a Contracting State, are to be deducted from the gross value of property which may be taxed by that State in the proportion that that gross value bears to the gross value of the entire property wherever situated. Under U.S. law, the proration required by paragraph (1) will be made only with respect to transfers of estates of decedents and generation-skipping transfers deemed to occur at or after the death of the deemed transferor. U.S. gift tax law, which in these respects also supplies the law applicable to generation-skipping transfers deemed to occur before the death of the deemed transferor, does not provide a deduction for debts. However, if a donee of a gift, or a transferee of a deemed generation-skipping transfer, assumes a liability in connection with a gift or transfer, the value of the gift or transfer subject to tax will ordinarily be the value of the property transferred net of the liability assumed.

Paragraph (2)(a) provides that, notwithstanding paragraph (1), for purposes of determining French tax debts pertaining to a permanent establishment or to a fixed base used for the performance of independent personal services are to be deducted from the value of assets referred to in Article 6. These deductions are to be allowed, regardless of whether they would be allowed according to French internal law. Under paragraph (2)(b), again notwithstanding paragraph (1), for purposes of determining French tax debts pertaining to ships and aircraft operated in international traffic and to movable property related to the operation of such ships and aircraft are to be deducted from the value of the property to which such debts pertain. These deductions too are to be allowed regardless of whether they would be allowed according to French internal law.

Article 10. Charitable Exemptions and Deductions

Under paragraph (1), a transfer to a legal entity created or organized in a Contracting State is exempt from tax, or fully deductible from the gross value liable to tax, in the other Contracting State, with respect to taxes referred to in Article 2, if the transfer would be eligible for such exemption or deduction if the legal entity had been created or organized in the other Contracting State. Under paragraph (2), the provisions of paragraph (1) apply only if the legal entity to which property is transferred (a) has tax exempt status in the State in which it is created or organized by reason of which transfers to it are exempt or fully deductible from the taxes described in Article 2; (b) is organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes; and (c) receives a substantial part of

its support from contributions from the public or from government funds. Under paragraph (3), the provisions of Article 10 apply to transfers to a Contracting State or a political or administrative subdivision of a Contracting State only if the transfers are specifically limited to a religious, charitable, scientific, literary, or educational purpose.

The provisions of Article 10 apply to estates, gifts, and generation-skipping transfers regardless of where the property transferred is situated. In addition, Article 10 requires a Contracting State to exempt or give a full deduction for property situated in that Contracting State transferred by a person who is a domiciliary of that State, if the property is transferred to an entity of the other Contracting State which meets the conditions set forth in paragraphs (1) and (2).

Article 11. Community Property and Marital Deduction

Under paragraph (1), property (other than community property) which was acquired during marriage for consideration by an individual who at the time of death or the making of a gift was domiciled in or a citizen of the United States, and which passes to the spouse, and which under the Convention is taxable by France, whether by virtue of Article 5, 6, or 7 or by virtue of the fact that the individual was domiciled in France, is treated as if it were community property, unless the spouses have elected expressly to have the property treated other than as community property under French civil law.

Under paragraph (2), in the case of an individual domiciled in France, there must be allowed, for purposes of determining the United States tax upon property taxable by the United States under Articles 5, 6, or 7, a marital deduction computed and applied in the manner in which a marital deduction claimed by an individual who was domiciled in the United States would be computed and applied under the law in effect on November 24, 1978. If such deduction is claimed and allowed, the rate of tax imposed upon the property is to be the rate which would be imposed under the law in effect on the date of transfer to transfers by U.S. domiciliaries. If the tax determined without a marital deduction, and with the application of rates applicable under United States law to nonresidents not citizens of the U.S., is lower than the tax resulting from the application of the rule of the first sentence of paragraph (2), then the lower tax shall be the amount due.

The rationale for paragraph (2) derives from modification of internal U.S. law governing the taxation of the estates of nonresidents not citizens of the United States by the Foreign Investors Tax Act of 1966. In adopting that law, Congress was cognizant of the facts that many foreign countries had estate tax rates substantially lower than the U.S., but that the effect of these lower rates was counteracted to some extent by the fact that many of these countries did not allow a marital deduction comparable to that permitted under U.S. law. In order to create more parallel treatment between U.S. and foreign laws with respect to the estates of nonresidents who were not U.S. citizens, Congress adopted a separate rate schedule applicable to such estates, and did not provide a marital deduction for such estates. The rate schedule was substantially lower than that applicable to the estates of citizens and residents. Paragraph (2) assures to domiciliaries of France that they will receive the more favorable of the two forms of treatment—lower rates with no marital deduction, or higher rates with a marital deduction. The benefit conferred by this paragraph is matched by the benefit conferred by France on U.S. citizens and domiciliaries under paragraph (1), under which France has agreed to give community property treatment to all property acquired for consideration after marriage which passes from one spouse to another. This treatment accomplishes substantially the equivalent of a marital deduction on all after-acquired property subject to tax by France under the Convention.

Under paragraph (3), the competent authorities are required to consult to determine whether Article 11 shall be modified or cease to have effect in the event the laws of either Contracting State are changed substantially to reduce the benefits of marital deduction or community property provisions.*

* Corrected.

CHAPTER IV
RELIEF FROM DOUBLE TAXATION

Article 12. Exemptions and Credits

Under paragraph (1), each Contracting State is required, except as otherwise provided in the Convention, to impose its tax, and to allow exemptions, deductions, credits, and other allowances, in accordance with its own internal laws.

Paragraph (2) provides specific rules for relieving double taxation. Under paragraph (2)(a), property which may be taxed by the United States in accordance with Article 5, 6, or 7, is exempted from French tax. However, French tax with respect to property which is taxable by France in accordance with the Convention is to be computed at the rate appropriate to the total of property taxable under French law. Thus, the Convention provides for "exemption under progression" with respect to French tax for property that remains subject to taxation by France under the Convention.

Under paragraph (2)(b)(i), where both States impose a tax with respect to property which is taxable by France in accordance with Articles 5, 6, or 7, the United States must allow a credit equal to the amount of the tax imposed by France with respect to such property. Under paragraph (2)(b)(ii), notwithstanding the provisions of paragraph (2)(b)(i), the total amount of all credits allowed by the United States pursuant to Article 12 or pursuant to its own laws or other conventions with respect to all property in respect of which a foreign tax credit is allowable under subparagraph

(i) of paragraph (2)(b) is not to exceed that part of the United States tax which is attributable to such property. The part of the tax deemed to be so attributable is to be determined in accordance with the principles of section 2014(b)(2) of the Code and section 20.2014-3 of the Estate Tax Regulations. Under paragraph (2)(b)(iii), the credits for tax imposed by France under Article 10(2) are in lieu of, and not in addition to, any credits for such taxes allowed by the internal law of the United States.

Under paragraph (3), if a decedent, donor or deemed transferor was a citizen of the United States at the time of his death or the making of a gift, and such person is considered under Article 4 as having been domiciled in France, the United States must allow a credit equal to the amount of the tax imposed by France. There is no limitation imposed upon the credit which must be allowed under paragraph (3), except that the amount must be an amount of tax paid to France.

Under paragraph (4), exemptions and credits required by Article 12 are to be tentatively allowed by the United States on the basis of statements made in the tax return as to the amount of any tax paid or payable to France. Such exemptions and credits, however, are not finally allowed until such tax for which the exemption or credit is allowable has actually been paid. Under this provision, interest and penalties for underpayments of tax may not be assessed by the United States for any underpayments attributable to a claim for a credit or exemption required under Article 12 if at the time payment of the tax for which the credit or exemption is claimed is not due to France. Interest and penalties may be assessed, however, from such time as tax is due and payable to France, if at such time the amount of tax due and payable is less than the amount of the credit claimed.

Under paragraph (5), the provisions of the Convention may not result in an increase in the amount of the tax imposed by either Contracting State under its domestic laws. A reduction in the credit allowed against United States tax for tax paid to France, which reduction results from the application of the Convention, is not for these purposes to be construed as an increase in tax.

CHAPTER V
SPECIAL PROVISIONS

Article 13. Time Limitations on Claims for Credit or Refund

Under paragraph (1), a claim for credit or for refund of tax founded on the provisions of the Convention must be made before the latest of three dates specified in paragraph (1). The three dates are (1) the time for the making of a claim for refund of tax specified under the internal law of the Contracting State to which the claim for refund or credit is made; (2) five years from the date of death of the decedent, or from the making of a gift with respect to which the claim is made; or (3) one year after final determination (administrative or judicial) and payment of tax for which any credit under Article 12 is claimed, provided that the determination and payment are made within 10 years of the date of death of the decedent or the making of the gift. Under paragraph (2), any refund based on the provisions of the Convention is to be made without payment of interest on the amount refunded.

Article 14. Mutual Agreement

Article 14 provides for competent authority procedures to ensure taxation in accordance with the Convention, and for other purposes. Under paragraph (1), any person who considers that the actions of one or both Contracting States results or will result in taxation not in accordance with the Convention may, notwithstanding remedies provided by the internal law of the Contracting States, present his case to the competent authority of either Contracting State. Such a presentation must be made within the time period specified by Article 13(1) for filing a claim for refund. If the person's claim is considered to have merit by the competent authority to which the claim is made, that authority is required to seek agreement with the competent authority of the other Contracting State with a view to avoiding taxation contrary to the provisions of the Convention.

Under paragraph (2), the competent authorities are to resolve by mutual agreement any difficulties or doubts arising as to the application of the Convention.

Under paragraph (3), the competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement under Article 14. When it seems to them advisable, the competent authorities are empowered to meet together for an oral exchange of opinions.

Under paragraph (4), when the competent authorities reach an agreement for the purpose of avoiding taxation not in accordance with the Convention, taxes are to be imposed, and refund or credit of taxes to be allowed in accordance with the agreement, notwithstanding any procedural rule (including the statute of limitations) applicable under the laws of either Contracting State. Under this paragraph, an agreement between the competent authorities is to be implemented notwithstanding time limitations imposed by the internal law of the Contracting States, and notwithstanding the time limitations for filing a claim for refund or credit imposed by Article 13.

Under paragraph (5), the competent authorities of the Contracting States are permitted to prescribe any regulations and forms as may be necessary or appropriate to give effect to and implement the Convention.

Article 15. Filing of Returns and Exchange of Information

Paragraph (1) preserves obligations to file returns or transfer certificates or notices, or to maintain records, imposed by the internal law of each State, notwithstanding alterations of

substantive taxing jurisdiction made by the Convention. Under paragraph (1)(a), the provisions of Articles 5, 6, 7, and 8 which change the taxability or situs of property or the amount of tax which would have been due in the absence of the Convention, do not change (i) the requirements of the respective tax laws of the Contracting States relating to information or tax returns or notices, transfer certificates, or maintenance of records; or (ii) the applicability and amount of any sanctions of such laws with respect to those requirements.

Under paragraph (1)(a)(i), the executor of a French domiciliary whose estate included property which would be considered situated in the United States under United States internal law would be required to file a tax return with respect to such property, even if the property is not subject to taxation by the United States by reason of Article 8, and even though property not subject to taxation by the United States by reason of Article 8 is the only property in the estate that is situated in the United States. Under paragraph (1)(b), as concerns the United States and notwithstanding the provisions of paragraph (1)(a), requirements or sanctions found to be unnecessary for the prevention of fraud or fiscal evasion with respect to taxes to which this Convention applies may be eliminated or modified (but not made more burdensome) by regulations prescribed pursuant to paragraph (5) of Article 14. Under this paragraph, the Treasury Department will be empowered, through published regulations, to vary the requirements of U.S. statutory law with respect to filing of tax or information returns, or maintenance of records or transfer certificates, if it finds any such requirements unnecessary for the prevention of fraud or fiscal evasion with respect to taxes covered by this Convention.

Under paragraph (2), the competent authority of each Contracting State is required to exchange information with the competent authority of the other Contracting State. Two categories of information are required to be exchanged: (a) information pertinent to carrying out the provisions of the Convention or the laws of the other Contracting State concerning the taxes subject to the Convention, insofar as taxation under those laws is in accordance with the Convention; or (b) information pertinent to preventing fraud or fiscal evasion in relation to the taxes which are the subject of the Convention, including information in the possession of a Contracting State with respect to property not subject to taxation by that State by reason of Article 8. The paragraph contains a proviso to the effect that the competent authority of a Contracting State is not required to furnish information not in the possession of that State with respect to property exempted from that State's tax by reason of Article 8. Thus, a competent authority is not required to gather information from sources outside its government concerning exempt property. The competent authority is required to furnish information in its own possesion, or in the possession of other agencies of the Contracting State, concerning such property. Paragraph (2) further provides that any information furnished must be treated as secret by the recipient State. Such information may not be disclosed to persons other than those concerned with assessment, collection, enforcement, or prosecution in respect of the taxes which are the subject of the Convention. Such persons include a court or administrative body.

Under paragraph (3), the provisions of paragraph (2) are in no case to be construed so as to impose upon a Contracting State obligations (a) to carry out administrative measures at variance with its own laws or administrative practices, or those of the other Contracting State; (b) to supply particulars which are not obtainable under its laws or in the normal course of its administration, or that of the other Contracting State; or (c) to supply information which would tend to disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

Under paragraph (4), the furnishing of information may be either on a routine basis, or on request with reference to particular cases. The competent authorities are required to agree on a list of information to be subject to routine exchange.

Article 16. Assistance in Collection

Under paragraph (1), each Contracting State undertakes to lend assistance and support to the other in the collection of the taxes subject to the Convention, as well as interest, costs, and additions to the taxes and fines not of a penal character. This assistance is to be provided only in cases where the taxes are definitively due according to the laws of the applicant State.

Under paragraph (2), in the case of an application for the enforcement of taxes, revenue claims of each of the Contracting States which have been finally determined will be accepted for enforcement by the State to which application is made, and shall be collected in that State in accordance with the laws applicable to the enforcement and collection of its own taxes.

Under paragraph (3), an application under Article 16 must be accompanied by such documents as are required by the laws of the State making the application to establish that the taxes have been finally determined.

Under paragraph (4), if a revenue claim has not been finally determined, the State to which application is made is required to take such measures of conservancy, including measures applicable with respect to transfers of property belonging to nonresident aliens, as are authorized by its own laws for the enforcement of its own taxes.

Under paragraph (5), the assistance in collection available under Article 16 is not to be accorded with respect to estates of citizens of the Contracting State to which application is made.

Article 17. Diplomatic and Consular Officials

Article 17 preserves such rights as each Contracting State has to impose wealth transfer taxes upon its diplomatic and consular officials. Under paragraph (1), nothing in the Convention is to affect the fiscal privileges of diplomatic or consular officials under the general rules of international law or under the provisions of special agreements. Under paragraph (2), insofar as such privileges prevent the imposition of tax in a receiving Contracting State, the right to tax is reserved to the Contracting State in whose service the persons concerned exercised their functions and, notwithstanding any other provisions of the Convention, such persons are not to be deemed to have been domiciled in the receiving State.

Article 18. Territorial Extension

Under paragraph (1), the Convention may be extended, either in its entirety or with necessary modifications, to all or any of the Overseas Territories of the French Republic or the territories for whose international relations the United States is responsible, if the territory to which the Convention is to be extended imposes taxes substantially similar in character to those referred to in Article 2. Any such extension is permitted to take effect from such date and subject to such modifications and conditions as may be specified and agreed between the Contracting States in notes to be exchanged through diplomatic channels or in any other manner in accordance with the constitutional procedures of the Contracting States. In the case of the United States, extension of the Convention to one of its territories or to a territory of France must be accomplished in accordance with the procedure required by Article II, Section 2, of the Constitution of the United States, which requires that the President secure the advice and consent of a two-thirds vote of the Senate of the United States as a prerequisite to ratification of a treaty.

Under paragraph (2), at any time after the expiration of a period of 1 year from the effective date of an extension made by virtue of paragraph (1), either of the Contracting States is permitted, by written notice of termination given to the other Contracting State through diplomatic channels, to terminate the application of the provisions of the Convention with respect to any territory to which it has been extended. If such notice is given, the Convention shall cease to be applicable to such territory on and after the first day of January following the date of such notice.

Under paragraph (3), unless it is otherwise agreed by both Contracting States, the termination of the Convention by one of the Contracting States under Article 20 will also terminate the application of the Convention to any territory to which it has been extended under Article 18.

CHAPTER VI.
FINAL PROVISIONS

Article 19. Entry into Force

Under paragraph (1), the Convention is required to be ratified, and instruments of ratification are to be exchanged at Paris as soon as possible.

Under paragraph (2), the Convention will enter into force on the first day of the second month following the month in which the exchange of instruments of ratification takes place. The provisions of the Convention are to apply to estates of persons dying, to gifts made, and to generation-skipping transfers deemed to occur, on or after the date on which the Convention enters into force.

Under paragraph (3), the Convention of October 18, 1946, as modified by the Protocol of May 17, 1948, and the Convention of June 22, 1956, shall be terminated on, and shall cease to have effect from, the date on which this Convention enters into force according to paragraph (2).

Article 20. Termination

Under paragraph (1), the Convention is to remain in force until it is terminated by one of the Contracting States. However, not earlier than the fifth year following the year in which the Convention enters into force, either Contracting State is permitted, between January 1 and June 30 of any year, to give written notice of termination, through diplomatic channels. Such written notice will terminate the Convention, effective from the end of the calendar year in which the notice is given. In the event of termination, the provisions of the Convention are not to apply to estates of persons dying, to gifts made, or to generation-skipping transfers deemed to occur, on or after the end of the calendar year with respect to the end of which the Convention is terminated.

Under paragraph (2), notwithstanding the provisions of paragraph (1), if the effects of the Convention are substantially altered as a result of changes made in the tax law of either Contracting State, either Contracting State may, through diplomatic channels, give written notice of termination. Such a notice will have effect on a date to be specified in the notice, which date may not be earlier than 6 months following the date of the notice. In the event notice of termination is given under paragraph (2), the Convention will not apply to estates of persons dying, to gifts made, or to generation-skipping transfers deemed to occur, on or after the effective date of the termination.

The provisions of Article 11 may be terminated without termination of the entire Convention in the event of certain described changes in the tax laws of the Contracting States. See the discussion of Article 11 above. Changes in the tax laws of one or both of the Contracting States which are grounds for termination of the provisions of Article 11, if unaccompanied by other changes which would independently give grounds for termination under paragraph (2) of Article 20, may not be grounds for termination of the entire Convention under paragraph (2) of Article 20.

United States-United Kingdom Income Tax Convention

T.D. 5569, 1947-2 C.B. 100
1980-1 C.B. 394

(Also Part I, Sections 164, 882, 906; 1.164-1, 1.882-1.)

United Kingdom; permanent U.S. establishment; deduction for tax paid on U.S. income. A United Kingdom corporation that has a permanent establishment in the U.S. paid U.K. income tax on business profits attributable to its U.S. operation only because the corporation was a resident of the U.K. Section 906(b)(1)(B) of the Code is not contrary to any treaty provisions, and the corporation may not deduct the U.K. income tax paid on U.S. profits. However, the corporation may deduct the U.K. income tax paid on effectively connected income from another foreign country. Rev. Ruls. 55-532, 58-310, and 65-234 obsoleted.

Rev. Rul. 80-243

ISSUE

Is a United Kingdom corporation with a permanent establishment in the United States entitled to deduct, in computing its taxable income for United States income tax purposes, the United Kingdom income tax it paid that is attributable to operations of its United States permanent establishment?

FACTS

X, a United Kingdom corporation, has a United States branch that constitutes a permanent establishment within the meaning of:

(1) Article II(1)(1) of the United States-United Kingdom Income Tax Convention (Old Convention), T.D. 5569, 1947-2 C.B. 100, as last modified by a Supplementary Protocol, signed on March 17, 1966, and generally effective for taxable years beginning on or after January 1, 1966, 1966-2 C.B. 582 (Old Supplementary Protocol); and (2) Article 5(1) of the New United States-United Kingdom Income Tax Convention (New Convention), 1980-1 C.B. 394 as modified by three Supplementary Protocols, signed, respectively, on August 26, 1976, March 31, 1977, and March 15, 1979, all generally effective for taxable years beginning on or after January 1, 1975.

Pursuant to Article III(1) of the Old Convention and Article 7(1) of the New Convention, *X* is subject to and pays United States tax on its business profits attributable to the income from the branch operation. The branch earns income attributable to the United States trade or business from both United States and foreign sources.

On its 1974 and 1975 federal income tax returns, filed on a calendar year basis, *X* deducted United Kingdom income tax it paid on its business profits attributable to the income from the branch operation. The United Kingdom income tax paid by *X* was imposed solely because *X* was a resident of the United Kingdom.

LAW AND ANALYSIS

Under section 882(a)(1) of the Internal Revenue Code a foreign corporation engaged in a trade or business within the United States during the taxable year shall be taxable on its taxable income which is effectively connected with the conduct of a trade or business within the United States. Section 882(c)(1)(A) provides that a foreign corporation shall be allowed deductions to the extent they are connected with income which is effectively connected with the conduct of a trade or business within the United States.

Section 164(a)(3) of the Code provides that state and local, and foreign income taxes shall be allowed as a deduction for the taxable year within which paid or accrued.

Section 906(b)(1)(B) of the Code provides a rule for determining the amount of foreign tax paid or accrued in order to determine deductions allowable to a foreign corporation under section 882(c). It states that there shall not be taken into account any amount of tax to the extent the tax so paid or accrued is imposed with respect to income from sources within the United States that would not be taxed by such foreign country but for the fact that such corporation was created or organized under the law of such foreign country or is domiciled for tax purposes in such country.

Under Article III(3) of the Old Convention, as modified by the Old Supplementary Protocol, in determining the industrial and commercial profits of a United States permanent establishment, deductions are allowed for all expenses that would be deductible if the permanent establishment were an independent enterprise, if they are reasonably connected with the taxable profits, wherever the expenses are incurred. Under Article 7(3) of the New Convention, in determining the profits of a United States permanent establishment, deductions are allowed for those expenses which are incurred for the purposes of the permanent establishment, wherever those expenses are incurred. Neither Article III(3) of the Old Convention nor Article 7(3) of the New Convention elaborates on what income tax expenses are allowed as deductions.

Article II(3) of the Old Convention and Article 3(2) of the New Convention provide that, with respect to the application of the respective Conventions by one of the Contracting Parties, any term not otherwise defined shall, unless the context otherwise requires, and subject to Article 25 (Mutual Agreement Procedure), have the meaning which it has under the laws of that Contracting Party relating to the taxes which are the subject of the Convention. Since neither Article II (3) of the Old Convention nor Article 3(2) of the New Convention elaborate on what income tax expenses are allowed as deductions, the context of those Articles does not otherwise require, and there has been no mutal agreement under Article 25(3), reference is made to United States internal law in accordance with Article II(3) of the Old Convention and Article 3(2) of the New Convention to determine what tax expenses are allowed as deductions.

Under the Code in effect at the time the Old Convention was signed, and subsequently at the time the Old Supplementary Protocol was signed and became effective, a deduction was allowed by United States internal tax law for a ratable portion of the United Kingdom income taxes paid by United Kingdom corporations in computing taxable income from sources within the United States. *See* Rev. Rul. 55-532, 1955-2 C.B. 592, as clarified by Rev. Rul. 58-310, 1958-1 C.B. 262. See also Rev. Rul. 65-234, 1965-2 C.B. 238. However, section 906(b)(1)(B) of the Code, added by the Foreign Investors Tax Act of 1966, Pub. L. 89-809, 1966-2 C.B. 656 (FITA), has the effect of denying this deduction unless the application of section 906(b)(1)(B) would be contrary to an existing treaty obligation, in which case section 110 of FITA provides that section 906(b)(1)(B) shall not apply.

The Old Convention as it is currently constituted does not contain a provision requiring that an interpretation be made with reference to internal law in effect on a particular date, although such references were included elsewhere in the Old Convention in the past. See, for example, Article XIII(1) of the Old Convention, prior to amendment by Article 9 of the Old Supplementary Protocol, which provided, with respect to the foreign tax credit applicable to certain dividends and royalties, that the credit would be allowed "[s]ubject to sections 901 to 905 of the United States Internal Revenue Code as in effect on the 1st day of January 1956." Therefore, in determining what income tax expenses are deductible by *X* for 1974 in computing its United States income tax liability under the Code, section 906(b)(1)(B) must be applied even though it was not in the Code at the time the Old Convention and the Old Supplemental Protocol became effective.

Section 110 of FITA does not prevent the application of section 906(b)(1)(B) under the Old Convention. Article III(3), as previously indicated, does not elaborate on what income tax expenses are allowed as deductions and section 906(b)(1)(B) is, therefore, not contrary to the Old Convention. Similarly, the provisions of section 906(b)(1)(B) are not contrary to Article 7(3) of the New Convention, which also does not address what income tax expenses are deductible. Therefore, pursuant to Articles II(3) and 3(2) of the Old and New Conventions, respectively, section 906(b)(1)(B) applied and precludes *X* from taking a deduction on its 1974 and 1975 federal income tax returns for foreign taxes that are paid with respect to income from sources within the United States that would not be taxed by the United Kingdom but for the fact that *X* is domiciled for tax purposes in the United Kingdom.

However, section 906(b)(1)(B) does not preclude *X* from taking a deduction for foreign taxes for its 1974 and 1975 taxable years that are paid with respect to income from foreign sources subject to taxation by the United States. To the extent that foreign source income subject to United States taxation is derived from the United Kingdom, then *X* may deduct any United Kingdom tax paid on such income for purpose of computing *X*'s United States taxable income. To the extent that foreign source income subject to United States taxation is derived from a source other than the United Kingdom, the deduction for United Kingdom tax paid on such income is limited to any United Kingdom tax paid in excess of a United Kingdom tax credit allowed as a result of the payment of income tax to the foreign income source country.

HOLDINGS

A United Kingdom corporation having a permanent establishment in the United States cannot deduct, in computing its taxable income for United States purposes, United Kingdom income tax imposed solely because the corporation is a resident of the United Kingdom and paid with respect to income from sources within the United States. However, such corporation may deduct the amount of United Kingdom income tax it paid with respect to the permanent establishment's income from foreign sources attributable to its permanent establishment to the extent such tax exceeds the United Kingdom tax credit allowed as a result of payment of income tax to the foreign income source country. In this latter situation, in which the foreign income source country is not the United Kingdom, the corporation is also entitled to deduct any income taxes paid to such country subject to the limitations of section 906(b)(1)(B).

EFFECT ON OTHER REVENUE RULINGS

Rev. Ruls. 55-532, 58-310 and 65-234 involve the deductibility of the United Kingdom income tax paid by United Kingdom corporations doing business in the United States with respect to income from sources within the United States prior to the enactment of section 906(b)(1)(B) of the Code. Consequently, these revenue ruling are obsoleted.

Subpart B.—Legislation and Related Committee Reports

Public Law 96-249 96th Congress, H.R. 4303 [1] May 26, 1980

An Act to amend the Food Stamp Act of 1977 to improve food stamp program fiscal accountability through reductions in inaccurate eligibility and benefit determinations; to improve the system of deductions; to increase the specific dollar limitations on appropriations for the fiscal years 1980 and 1981 food stamp programs; and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited

[1] This publication of the law, House Report No. 96-788, page 415, and Conference Report No. 96-957, page 417, is restricted to excerpts involving tax matters. Senate Report No. 96-236 and Conference Report No. 96-704 are not published.

as the "Food Stamp Act Amendments of 1980."

TITLE I—REDUCTION IN FOOD STAMP ERROR AND FRAUD AND REVISION OF DEDUCTIONS

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DISCLOSURE PROVISIONS

SEC. 127.(a)(1) Subsection (i) of section 6103 of the Internal Revenue Code of 1954 (relating to disclosure of returns and return information for purposes other than tax administration) is amended by adding at the end thereof the following new paragraph:

"(7) DISCLOSURE OF CERTAIN RETURN INFORMATION BY SOCIAL SECURITY ADMINISTRATION TO DEPARTMENT OF AGRICULTURE AND TO STATE FOOD STAMP AGENCIES.—

"(A) IN GENERAL.—The Commissioner of Social Security may disclose return information from returns with respect to net earnings from self-employment (as defined in section 1402), wages (as defined in section 3121(a) or 3401(a)), and payments of retirement income which have been disclosed to the Social Security Administration as provided by paragraph (1) or (5) of this subsection—

"(i) upon request, to officers and employees of the Department of Agriculture, and

"(ii) upon written request, to officers and employees of a State food stamp agency.

"(B) RESTRICTION ON DISCLOSURE.—The Commissioner of Social Security shall disclose return information under subparagraph (A) only for purposes of, and to the extent necessary in, determining an individual's eligibility for benefits, or the amounts of benefits, under the food stamp program established under the Food Stamp Act of 1977.

"(C) STATE FOOD STAMP AGENCY.—For purposes of this paragraph, the term 'State food stamp agency' means any agency described in section 3(n)(1) of the Food Stamp Act of 1977 which administers the food stamp program established under such Act.".

(2)(A) Subparagraph (A) of section 6103(p)(3) of such Code (relating to records of inspection and disclosure) is amended by striking out "(l)(1) or (4)(B) or (5)" and inserting in lieu thereof "(l)(1), (4)(B), (5), or (7)".

(B) Paragraph (4) of section 6103(p) of such Code (relating to safeguards) is amended by striking out "(l)(3) or (6)" in so much of such paragraph as precedes subparagraph (A) thereof and inserting in lieu thereof "(l)(3), (6), or (7)".

(C) Clause (i) of section 6103(p)(4)(F) of such Code is amended by striking out "(l)(6)" and inserting in lieu thereof "(l)(6) or (7)".

(D) The first sentence of paragraph (2) of section 7213(a) of such Code is amended—

(i) by striking out "or any educational institution" and inserting in lieu thereof "any educational institution, or any State food stamp agency (as defined in section 6103(l)(7)(C))", and

(ii) by striking out "subsection (d), (l)(6), or (m)(4)(B)" and inserting in lieu thereof "subsection (d), (l)(6) or (7), or (m)(4)(B)".

(3) The amendments made by this subsection shall take effect on the date of the enactment of this Act.

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Approved May 26, 1980.

House Report No. 96-788 2d Session

[Bracketed numerals indicate official report page numbers]

FOOD STAMP ACT AMENDMENTS OF 1980

FEBRUARY 27, 1980

Mr. FOLEY, from the Committee on Agriculture, submitted the following report together with supplemental views, dissenting views, additional, dissenting views, and separate views to accompany S. 1309.[1]

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[1] Public Law 96-249, page 414.

[24] III. BACKGROUND, PURPOSE, AND NEED FOR THE LEGISLATION

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[68] B. CONTROL OF ERROR AND FRAUD

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[101] 7. DEDUCTION OF ERROR AND FRAUD THROUGH COMPUTER MATCHING

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[106] *d. Present legal barriers*

This Committee commenced its efforts to foster computer matching in Public Law 96-58 when it required food stamp recipients to provide social security numbers as a condition for eligibility with the intent of using those numbers in computer matching to compare the income reported by food stamp households against wage and benefit information in the files of the Social Security Administration.

Requiring the social security number was only the first step in achieving that goal. This bill removes other legal barriers to access to the Social Security Administration's files (by way of the necessary social security number) as well as State unemployment compensation files and the files of any other Federal agency with benefit data that could affect the eligibility or benefit levels of a significant part of the food stamp applicant and recipient population.

The legal barriers that need to be lowered or, in some instances, withdrawn entirely, are substantial, appropriately so in light of the privacy considerations involved and the danger of abuse of confidential information for illegitimate purposes by both Federal and State food stamp personnel. The program need for certain information is great, but it must be carefully balanced by the need to protect needy individuals from having their privacy bartered away in order to assuage their hunger. Existing protections should not be reduced without careful consideration and without the substitution of

other meaningful safeguards. The Committee's bill attempts to achieve this balanced approach to disclosure of relevant wage and benefit information.

Under present law, tax returns and return information are confidential and generally are not subject to disclosure except as provided in section 6103 of the Internal Revenue Code (hereafter "Code"). Disclosure is permitted, in certain circumstances, to the Social Security Administration, the Department of Health, Education, and Welfare, and Federal, State, and local child support enforcement agencies.

Under present law, tax returns and return information are confidential and generally are not subject to disclosure except as provided in section 6103 of the Internal Revenue Code. Disclosure is permitted, in certain circumstances, to the Social Security Administration, the Department of Health, Education, and Welfare, and Federal, State, and local child support enforcement agencies.

Upon written request, the Social Security Administration may obtain returns and return information concerning employment taxes for purposes of the administration of the Social Security Act (Code sec. 6103(l)(1)). In addition, copies of annual registration statements of employee benefit plans and related information concerning vested benefits of employees may be furnished to the Social Security Administration. The Secretary of Health, Education, and Welfare may also receive, upon written request, certain information returns for the purpose of carrying out an effective return processing program (Code sec. 6103 (l)(5)).

Federal, State, and local child support enforcement agencies may receive, upon written request, certain return information with respect to individuals for whom child support obligations are sought to be enforced or established and with respect to individuals to whom support obligations are owing (Code sec. 6103(l)(6)). This return infor-[107]mation may be disclosed only for purposes of, and to the extent necessary in, establishing and collecting child support obligations from, and locating, individuals owing such obligations.

Where disclosure or inspection of return information is permitted under the Code, it is permitted only at the times, in the manner, and at the places prescribed by the Internal Revenue Service. Present law generally requires the IRS to maintain a standardized system of permanent records on the use and disclosure of returns and return information. (Code sec. 6103 (p)(3)). This requirement applies with respect to disclosures made to Federal, State, and local child support enforcement agencies but does not apply in the case of disclosure made to the Social Security Administration or to the Department of Health, Education, and Welfare. In addition to the recordkeeping requirements imposed on the IRS, present law requires each Federal and State agency that receives tax information to maintain, pursuant to Treasury regulations, a standardized system of permanent records on the use and disclosure of that information. Maintaining these records is a prerequisite to obtaining, and continuing to receive, tax information.

Under present law, no tax information may be furnished by the IRS to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (Code sec. 6103 (p)(4)). Disclosure by the IRS of tax information to other agencies is conditioned upon the recipient maintaining a secure place for storing the information, restricting access to the information to individuals whose duties require access and to whom disclosure is permitted, providing other safeguards necessary to keeping the information confidential, and returning or destroying the information when the agency is finished with it. The IRS is required to review, on a regular basis, the safeguards established by agencies to whom disclosure is made. In the event of unauthorized disclosure by the employees of another agency, the IRS may discontinue disclosure to that agency.

Any unauthorized disclosure of a return or return information is a felony which is punishable by a fine of up to $5,000, imprisonment of up to five years, or both (Code sec. 7213).

e. Safeguards and limitations

The safeguards and limitations contained in section 6103 of the Code with respect to the disclosure of tax returns and return information ought to be applied to similar disclosure in the context of the food stamp program.

The Committee on Ways and Means of the House of Representatives in preparing H.R. 4904, the Social Welfare Reform Amendments Act of 1979, which passed the House on November 7, 1979, extended those safeguards and limitations to such disclosure for purposes of administering the AFDC program by inserting a new section in the Social Security Act containing a cross reference to section 6103 of the Code for provisions relating to the disclosure of return information to State welfare agencies and by amending another section of the Social Security Act to provide that the disclosure of returns or return information transmitted from the Internal Revenue Service to the Department of Health, Education, and Welfare would be permitted only as prescribed under section 6103 of the Code.

[108] To further cement this into law and in light of the express desire of the Internal Revenue Service, repeated in testimony to this Committee by Emil Sunley, Deputy Assistant Secretary of the Treasury for Tax Policy, on October 30, 1979, to "ensure a degree of uniformity in applying confidentiality standards to, and safeguards on, the use of tax data for nontax related purposes" by consolidating "in the tax code all of the rules relating to disclosure of tax information" rather than reverting "to the piecemeal approach to tax disclosure that existed prior to 1976" when Congress performed the consolidation, the welfare

reform bill also amended section 6103 of the Code to incorporate this new form of disclosure and thereby subject it to all of the existing uniform safeguards and limitations.

This Committee, unlike the Ways and Means Committee, lacks the jurisdictional authority to amend the Code in order to make the Code's specific provisions applicable to the disclosure of return information, but this Committee intends to make certain insofar as it legally can that the same safeguards and limitations apply. It is the Committee's understanding that the preferable way to handle the matter would be by way of direct amendment to the Code, but, lacking that authority, the Committee notes its confirmed desire to reach the safe objective indirectly, with the hope that the appropriate Committees will propose the necessary accompanying changes in section 6103 of the Code.

Accordingly, this bill would provide that the Secretary of Health, Education, and Welfare would have to disclose to officers and employees of the Department and to officers and employees of a State welfare agency (the "State agency" within the meaning of section 3(n) of the Act) information with respect to wages, net earnings from self-employment, benefits, and payments of retirement income (the latter two appear to be synonymous, but the former includes any other Federal program benefits, if any, as to which information is available) that is contained in the records of the Social Security Administration, including such information which previously was disclosed to the Social Security Administration (that is the Secretary of Health, Education, and Welfare or his officers and employees) in the form of information from returns from the Internal Revenue Service's files pursuant to law (that is, under the authority of sections 6103(l)(1) or (5) of the Code).

The safeguards and limitations that would confine this disclosure are multiple and would be made effective by way of regulations promulgated by the Secretary of Health, Education, and Welfare, whom the bill empowers to establish such safeguards as the Secretary determines to be necessary to insure that any information made available is used only for authorized purposes:

(1) The Department's officers and employees would have to make a request in order to obtain the information, which request could be oral as well as written.

(2) The Department's officers and employees, despite a request, could not obtain the information unless their duties required them to have access to such information and unless disclosure legally could be made to them.

(3) The State agency's officers and employees would have to make a written request in order to obtain the information.

[109] (4) The State agency's officers and employees would not be entitled to the requested information unless their duties required them to have access to it and unless disclosure legally could be made to them. This limitation would have to be enforced with particular ease in the case of any tribal organization of an Indian tribe that became the State agency in accordance with the provisions of section 3(n)(2), 4(b), and 11(d) of the Act.

(5) Disclosure could be made only for three purposes and only to the extent necessary to accomplish them—(a) initially determining a household's eligibility to receive food stamps (on the amount thereof) at the point of certification or recertification, (b) auditing a household's eligibility to receive food stamps (and the amount thereof) during quality control or post-certification reviews or in light of reported changes, and (c) verifying any information related to the processes referred to in (a) or (b).

(6) The recordkeeping requirements, safeguard requirements, and penalties for unauthorized disclosure contained in section 6103 of the Code would govern this expanded disclosure through the regulations promulgated by the Secretary of Health, Education, and Welfare. For example, the Social Security Administration would be required to maintain a permanent system of standardized records on the use and disclosure of tax information permitted to be disclosed under the bill, and the Department of Health, Education, and Welfare, the Department, and State agencies would be required to maintain a strict accounting with respect to return information they receive from the Social Security Administration: In addition, the Department of Health, Education, and Welfare, the Department, and State agencies would be required to establish procedures satisfactory to the Internal Revenue Service for safeguarding the return information they receive from the Social Security Administration. See 45 C.F.R. § 431.300 et. seq.

The concerns for privacy would, we believe, be more than adequately protected by these safeguards modeled on section 6103 of the Code, and in particular section 6103(p)(4), of restricting access only to people who have legitimate need for the information, of making sure that those persons are thoroughly trained in privacy issues, and of guaranteeing proper physical security with respect to the storage of such sensitive information. The Privacy Act, 5 U.S.C. § 552a, and, in particular, section 552a(b) would be satisfied by these legal limitations.

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Conference Report No. 96-957 2d Session

[Bracketed numerals indicate official report page numbers]

FOOD STAMP ACT AMENDMENTS OF 1980

MAY 14, 1980

Mr. FOLEY, from the committee of conference, submitted the following conference report to accompany S. 1309.[1]

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[1] Public Law 96-249, page 414.

[17] JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE

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[26] (25) *Disclosure provisions*

The *House* amendment required the disclosure of certain income tax information in the files of the Social Security Administration and certain wage and unemployment insurance (UI) information in the records of State UI agencies to the Department and State food stamp agencies only for the purpose of, and to the extent necessary for, determining a person's eligibility for food stamps. The *House* amendment requires that tax return information be disclosed in accordance with the procedures, conditions and safeguards specified in section 6103 of the Internal Revenue Code. The *House* amendment, effective January 1, 1983, further provides that as a condition of receipt of its Federal UI administrative grant, each State UI agency would have to make available, under procedures and safeguards to be established by the Secretary of Labor, information in its records pertaining to an individual's wages, home address, UI eligibility, and offers of employment.

The *Senate* bill contains no comparable provisions.

The *Conference* substitute adopts the *House* provisions.

Public Law 96-265 96th Congress, H.R. 3236 [1] June 9, 1980

An Act to amend the Social Security Act to provide better work incentives and improve accountability in the disability programs, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Social Security Disability Amendments of 1980".

* * * * *

ACCESS TO WAGE INFORMATION FOR PURPOSES OF CARRYING OUT STATE PLANS FOR CHILD SUPPORT

SEC. 408. (a)(1) Subsection (l) of section 6103 of the Internal Revenue Code of 1954 (relating to disclosure of returns and return information for purposes other than tax administration) is amended by adding at the end thereof the following new paragraph:

"(7) DISCLOSURE OF CERTAIN RETURN INFORMATION BY SOCIAL SECURITY ADMINISTRATION TO STATE AND LOCAL CHILD SUPPORT ENFORCEMENT AGENCIES.—

"(A) IN GENERAL.—Upon written request, the Commissioner of Social Security shall disclose directly to officers and employees of a State or local child support enforcement agency return information from returns with respect to net earnings from self-employment (as defined in section 1402), wages (as defined in section 3121(a) or 3401(a)), and payments of retirement income which have been disclosed to the Social Security Administration as provided by paragraph (1) or (5) of this subsection.

"(B) RESTRICTION ON DISCLOSURE.—The Commissioner of Social Security shall disclose return information under subparagraph (A) only for purposes of, and to the extent necessary in, establishing and collecting child support obligations from, and locating, individuals owing such obligations. For purposes of the preceding sentence, the term 'child support obligations' only includes obligations which are being enforced pursuant to a plan described in section 454 of the Social Security Act which has been approved by the Secretary of Health and Human Services under part D of title IV of such Act.

"(C) STATE OR LOCAL CHILD SUPPORT ENFORCEMENT AGENCY.—For purposes of this paragraph, the term 'State or local child support enforcement agency' means any agency of a State or political subdivision thereof operating pursuant to a plan described in subparagraph (B)."

(2)(A) Subparagraph (A) of section 6103(p)(3) of such Code (relating to records of inspection and disclosure) is amended by striking out "(l)(1) or (4)(B) or (5)" and inserting in lieu thereof "(l)(1), (4)(B), (5), or (7)".

(B) Paragraph (4) of section 6103(p) of such Code (relating to safeguards) is amended by striking out "(l)(3) or (6)" in so much of such paragraph as precedes subparagraph (A) thereof and inserting in lieu thereof "(l)(3), (6), or (7)".

(C) Clause (i) of section 6103(p)(4)(F) of such Code is amended by striking out "(l)(6)" and inserting in lieu thereof "(l)(6) or (7)".

(D) The first sentence of paragraph (2) of section 7213(a) of such Code is amended by striking out "subsection (d), (l)(6), or (m)(4)(B)" and inserting in lieu thereof "subsection (d), (l)(6) or (7), or (m)(4)(B)".

(3) The amendments made by this subsection shall take effect on the date of the enactment of this Act.

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Approved June 9, 1980.

Conference Report No. 96-944 2d Session

[Bracketed numerals indicate official report page numbers]

SOCIAL SECURITY DISABILITY AMENDMENTS OF 1980

MAY 13, 1980.

Mr. ULLMAN, from the committee of conference, submitted the following conference report to accompany H.R. 3236.[1]

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[66] Access to Wage Information for Child Support Program

(Sec. 408)

Present law.—Present law requires

[1] The publication of the law and Conference Report No. 96-444, this page, is restricted to excerpts involving tax matters. House Report No. 96-100 and Senate Report No. 96-408 are not published.

[1] Public Law 96-265, this page.

the Secretary of HHS to make available to States and political subdivisions wage information contained in the records of the Social Security Administration which is necessary to determine eligibility for AFDC. The law requires the Secretary to establish safeguards to insure that information is used only for authorized purposes. There is no similar provision for purposes of child support.

In addition, present law requires agencies that administer State unemployment compensation to make available to States and political subdivisions wage information contained in their records which is necessary to determine eligibility for AFDC, and requires the Secretary to establish safeguards to insure that information is used only for authorized purposes. There is no similar provision for purposes of child support.

Under the Internal Revenue Code, tax return information may be disclosed by IRS (1) to the Social Security Administration for purposes of administering the Social Security Act, and (2) to Federal, State and local child support agencies for establishing and enforcing child support obligations under the child support program. Agencies receiving this information must comply with specified safeguards. SSA may not transfer information it receives from IRS to State and [67] local agencies. Information must be obtained by the agencies directly from IRS.

Senate bill.—The Senate bill provided the same requirement for disclosure of wage information (other than tax return information) for purposes of the child support program as exists in present law for purposes of AFDC. It also provided the same requirement for provision of wage information by State unemployment compensation agencies for purposes of the child support program as exists in present law for purposes of AFDC.

The Senate bill required SSA to disclose tax return information obtained from IRS with respect to earnings from self-employment and wages (1) to officers and employees of HHS, and (2) to officers and employees of an appropriate State or local agency, body, or commission. Information could be disclosed for purposes of establishing, determining, and enforcing child support obligations under the child support program.

Agencies or commissions authorized to receive tax return information could disclose such information to any person to the extent necessary in connection with the processing and use of information necessary for the purpose of establishing, determining, or enforcing child support obligations.

Conference agreement.—Under the conference agreement, certain tax return information must be disclosed by the Social Security Administration to State and local child support enforcement agencies, as follows.

The conferees agreed to amend the Internal Revenue Code to provide that, upon written request, the Commissioner of Social Security shall directly disclose return information with respect to net earnings from self-employment, wages, and payments of retirement income to officers and employees of a State or local child support enforcement agency. Disclosure will be allowable only for purposes of, and to the extent necessary in, establishing and collecting child suport obligations from, and locating individuals owing child support obligations.

Any agency receiving information must comply with conditions specified in current law for safeguarding information. Under these safeguards, information may be used on a computer in uncoded form if the computer is used only by the child support enforcement agency. If this information is used on computer systems shared with agencies which are not child support agencies, it must be introduced into the system and coded so that it is available only to officers and employees of the child support enforcement agency. Generally, disclosure to individuals other than officers and employees of the child support enforcement agency would not be authorized; however, the information may be disclosed to the taxpayer to whom the information pertains. This provision is effective on enactment.

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Public Law 96-272
96th Congress, H.R. 3434 [1]
June 17, 1980

An Act to establish a program of adoption assistance, to strengthen the program of foster care assistance for needy and dependent children, to improve the child welfare, social services, and aid to families with dependent children programs, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act, with the following table of contents, may be cited as the "Adoption Assistance and Child Welfare Act of 1980".

* * * * *

PERMANENT EXTENSION OF PROVISIONS RELATING TO CHILD DAY CARE SERVICES AND WIN TAX CREDIT

SEC. 208. * * *

(b)(1) Section 50B(i) of the Internal Revenue Code of 1954 (relating to special rules with respect to employment of day care workers) is amended to read as follows:

"(i) SPECIAL RULES WITH RESPECT TO EMPLOYMENT OF DAY CARE WORKERS.—

"(1) ELIGIBLE EMPLOYEE.—An individual who would be an 'eligible employee' (as that term is defined for purposes of this section) except for the fact that such individual's employment is not on a substantially full-time basis, shall be deemed to be an eligible employee as so defined, if such employee's employment is related to the provision

[1] This publication of the law, Senate Report No. 96-336, page 420, and Conference Report No. 96-900, page 421, is restricted to excerpts involving tax matters. House Report No. 96-136 and House Report No. 96-136, Part 2, are not published.

of child day care services and is performed on either a full-time or part-time basis.

"(2) ALTERNATIVE COMPUTATION WITH RESPECT TO CHILD DAY CARE SERVICES ELIGIBLE EMPLOYEES PAID FROM FUNDS MADE AVAILABLE UNDER TITLE XX OF THE SOCIAL SECURITY ACT.—The amount of the credit allowed a taxpayer under section 40, as determined under section 50A and the preceding provisions of this section, with respect to work incentive program expenses paid or incurred by him with respect to an eligible employee whose services are performed in connection with a child day care services program conducted by the taxpayer, and with respect to whom the taxpayer is reimbursed (in whole or in part) from funds made available pursuant to section 2007 of the Social Security Act, at the option of the taxpayer shall be equal to 100 percent of the unreimbursed wages paid or incurred by the taxpayer with respect to such employee, but not more than the amount of the limitation in paragraph (4).

"(3) UNREIMBURSED WAGES.—For purposes of this subsection, the term 'unreimbursed wages' means work incentive program expenses for which the taxpayer was not reimbursed under section 2007 of the Social Security Act or under any other grant or program.

"(4) LIMITATION.—The amount of the credit, as determined under paragraph (2), with respect to any employee shall not exceed the lesser of—

"(A) an amount equal to $6,000 minus the amount of the funds reimbursed to the taxpayer with respect to such employee from funds made available pursuant to section 2007 of the Social Security Act; or

"(B) with respect to work incentive program expenses attributable to service rendered—

"(i) during the one-year period which begins on the day such employee begins work for the taxpayer, an amount equal to the lesser of—

"(I) $3,000, or

"(II) 50 percent of the sum of the amount of the unreimbursed wages of such employee and the amount reimbursed to the taxpayer with respect to such employee from funds made available pursuant to section 2007 of the Social Security Act; or

"(ii) during the one-year period which begins on the day after the last day of the one-year period described in clause (i), an amount equal to the lesser of—

"(I) $1,500, or

"(II) 25 percent of the sum of the amount of the unreimbursed wages of such employee and the amount reimbursed to the taxpayer with respect to such employee from funds made available pursuant to section 2007 of the Social Security Act."

(2) Section 50B(h)(1)(B) of such Code is amended by inserting "(except as provided in subsection (i))" after "full-time basis".

(3)(A) The amendments made by paragraphs (1) and (2) shall be effective with respect to taxable years beginning after December 31, 1979.

(B) The redesignation of subsection (i) of section 50B of the Internal Revenue Code of 1954 as subsection (j) by section 3(a)(1) of Public Law 96-178 [1980-1 C.B. 494] shall remain in effect with respect to taxable years beginning after December 31, 1979.

* * * * *

Approved June 17, 1980.

Senate Report No. 96-336 1st Session

[Bracketed numerals indicate official report page numbers]

ADOPTION ASSISTANCE AND CHILD WELFARE ACT OF 1979

OCTOBER 2 (legislative day JUNE 21), 1979.

Mr. LONG, from the Committee on Finance, submitted the following report together with additional views to accompany H.R. 3431.[1]

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General Discussion of the Bill

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[1] Public Law 96-272, page 419.

[84] CHANGES TO COORDINATE TAX CREDIT AND SOCIAL SERVICES PROVISIONS

Present law.—The amount of wages eligible to be paid for through the social services program was limited to $4,000 in the case of proprietary employers on the presumption that they would claim the 20 percent tax credit and thus receive full reimbursement for the first $5,000 of wages paid. The tax credit, however, is computed only on the net wages actually paid by the employer after deducting any reimbursement he receives from other sources. Thus, if an employer pays wages of $5,000 and receives a social services grant to meet $4,000 of that total, his tax credit would have been computed only on the remaining $1,000. Under the former tax credit provisions this would have provided a tax credit of $200 (20 percent of $1,000). H.R. 12973 as reported by the Finance Committee last year would have permitted any wages reimbursed under the social services provisions to be included in computing the tax credit. However, because the tax credit percentage has now been increased to 50 percent for the first year wages and 25 percent for the second year wages, this change could result in a total reimbursement exceeding 100 percent of costs. H.R. 12973 included an overall limit of $1,000 on the credit to avoid such situations. Even with such a limit, however, there could still be instances of more than 100 percent reimbursement.

Committee bill.—The committee amendment would permit employers who hire welfare recipients in child care jobs to include any costs reimbursed under the title XX grant program in computing their tax credit. The amount of the credit would, however, be reduced to whatever extent necessary so that the combination of title XX grant and tax credit would never exceed 100 percent of the first $6,000 of wages paid to the employee. The amendment is effective for taxable years beginning after December 31, 1978.

CREDIT MADE APPLICABLE TO PART-TIME EMPLOYMENT

Present law.—H.R. 12973, as reported last year by the Committee, also modified the tax credit as applicable to child care jobs so that the tax credit and the related reimbursement under the social services provisions could be used for part-time as well as full-time employment. The tax credit is restricted to employees who have been employed for at least 30 days on a substantially full-time basis. The purpose of this change was to make the credit and payment provisions available in cases where the child care facility might hire, for example, two welfare recipients on a half-time basis for $4,000 per year each to perform a job for which they might otherwise hire a single full-time employee at a salary of $8,000 per year.

[85] *Committee bill.*—Effective for taxable years beginning after December 31, 1978, the Committee amendment would permit the tax credit and related title XX grant provisions to be applied to part-time as well as full-time employment by welfare recipients in child care jobs.

CHANGES RELATED TO PUBLIC LAW 95-600 [1978-3 C.B. (VOL. 1) 1]

Present law.—The 1978 tax reduction act (Public Law 95-600) made several significant changes in the tax credit provisions for hiring welfare recipients. Under prior law, the tax credit for hiring welfare recipients in child care jobs was limited to 20 percent of the first $5,000 of wages and was available only through September 30, 1978. Effective January 1, 1979, the new law treats child care jobs in the same manner as other employment for purposes of the tax credit. The credit is made permanent and applies to the first $6,000 of wages (at a 50 percent rate in the first year and a 25 percent rate in the second year).

Committee bill.—The committee amendment contains several provisions related to the changes made by Public Law 95-600:

1. The title XX grant provisions would be conformed to the $6,000 maximum wages creditable for the tax provision. (That is, grants up to $5,000 per eligible employee could be made for profit-making child care facilities and up to $6,000 for public and nonprofit facilities.)

2. The former tax credit provisions for child care jobs are reinstated for the period October 1, 1978 to December 31, 1978. (After that date, the new provisions of Public Law 95-600 are effective under existing law.)

3. A number of technical amendments are made to perfect the transition provisions in Public Law 95-600 and to rectify certain clerical errors in that statute.

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Conference Report No. 96-900 2d Session

[Bracketed numerals indicate official report page numbers]

ADOPTION ASSISTANCE, CHILD WELFARE, AND SOCIAL SERVICES

APRIL 23, 1980.

Mr. ULLMAN, from the committee of conference, submitted the following conference report to accompany H.R. 3431.[1]

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Joint Explanatory Statement of the Committee of Conference

* * * * *

Permanent Extension of Provisions Relating to Child Day Care Services and WIN Tax Credit (Sec. 208)

Present law.—Employers of AFDC recipients who are placed in jobs under the WIN program, or who have received AFDC for at least 90 days, are eligible for a tax credit equal to 50% of up to $6,000 of wages per employee for the first year of employment and 25% of such wages for the second year.

House bill.—Present law.

Senate bill.—The Senate bill would permit employers who receive Title XX grants for purposes of hiring welfare recipients in child care jobs to elect to include such grants in wages eligible for the tax credit. For taxpayers who so elect, the credit amount would be limited so that the total amount of the credit plus the grant could not exceed the lesser of $6,000 or 100% of total wages paid to the employee. In addition, the bill would allow the tax credit for persons employed on a part-time basis in child care jobs and would make certain technical amendments to correct errors in the Revenue Act of 1978 [1978-3 C.B. (Vol. 1) 1].

Conference agreement.—The conference agreement maintains the current law provision which provides that the credit is not allowed for wages reimbursed by a grant. The conference agreement provides, however, for a special 100-percent credit with respect to unreimbursed wages paid to workers whose wages are reimbursed in whole or in part by funds made available under section 2007 (grants to hire welfare recipients as child care workers) of the Social Security Act. If the taxpayer elects to compute the credit using this rate, the credit with respect to any employee is limited to the least of: (1) $6,000 minus the reimbursement with respect to this employee under section 2007, (2) $3,000 (for the first year of employment) or $1,500 (for the second year of employment), or (3) 50 percent (for the first year of employment) or 25 percent (for the second year of employment) of the sum of unreimbursed wages and the reimbursement under section 2007.

The conference agreement includes the Senate provision with regard to the eligibility of part-time child care workers for the credit. Regulations should define a minimum standard for part-time employment, such as 8 hours per week for the first 4 weeks of employment, to ensure that employees are

[1] Public Law 96-272, page 419.

eligible only if they have established a regular employment relationship with the employer.

* * * * *

Public Law 96-283
96th Congress, H.R. 2759 [1]
June 28, 1980

An Act to establish an interim procedure for the orderly development of hard mineral resources in the deep seabed, pending adoption of an international regime relating thereto, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Deep Seabed Hard Mineral Resources Act".

* * * * *

SEC. 4. DEFINITIONS.

For purposes of this Act, the term—

(1) "commercial recovery" means—

(A) any activity engaged in at sea to recover any hard mineral resource at a substantial rate for the primary purpose of marketing or commercially using such resource to earn a net profit, whether or not such net profit is actually earned;

(B) if such recovered hard mineral resource will be processed at sea, such processing; and

(C) if the waste of such activity to recover any hard mineral resource, or of such processing at sea, will be disposed of at sea, such disposal;

* * * * *

(9) "permittee" means the holder of a permit issued under title I of this Act to engage in commercial recovery;

(10) "person" means any United States citizen, any individual, and any corporation, partnership, joint venture, association, or other entity organized or existing under the laws of any nation;

* * * * *

(13) "United States" means the several States, the District of Columbia, the Commonwealth of Puerto Rico, American Samoa, the United States, Virgin Islands, Guam, and any other Commonwealth, territory, or possession of the United States; and

* * * * *

TITLE IV—TAX

SEC. 401. SHORT TITLE.

This title may be cited as the "Deep Seabed Hard Mineral Removal Tax Act of 1979".

SEC. 402. IMPOSITION OF TAX ON REMOVAL OF HARD MINERAL RESOURCES FROM DEEP SEABED.

(a) GENERAL RULE.—Chapter 36 of the Internal Revenue Code of 1954 (relating to certain other excise taxes) is amended by adding at the end thereof the following new subchapter:

"Subchapter F—Tax on Removal of Hard Mineral Resources From Deep Seabed

"SEC. 4495. Imposition of tax.
"SEC. 4496. Definitions.
"SEC. 4497. Imputed value.
"SEC. 4498. Termination.

"SEC. 4495. IMPOSITION OF TAX.

"(a) GENERAL RULE.—There is hereby imposed a tax on any removal of a hard mineral resource from the deep seabed pursuant to a deep seabed permit.

"(b) AMOUNT OF TAX.—The amount of the tax imposed by subsection (a) on any removal shall be 3.75 percent of the imputed value of the resource so removed.

"(c) LIABILITY FOR TAX.—The tax imposed by subsection (a) shall be paid by the person to whom the deep seabed permit is issued.

"(d) TIME FOR PAYING TAX.—The time for paying the tax imposed by subsection (a) shall be the time prescribed by the Secretary by regulations. The time so prescribed with respect to any removal shall be not earlier than the earlier of—

"(1) the commercial use of, or the sale or disposition of, any portion of the resource so removed, or

"(2) the day which is 12 months after the date of the removal of the resource.

"SEC. 4496. DEFINITIONS.

"(a) DEEP SEABED PERMIT.—For purposes of this subchapter, the term 'deep seabed permit' means a permit issued under title I of the Deep Seabed Hard Minerals Resources Act.

"(b) HARD MINERAL RESOURCE.—For purposes of this subchapter, the term 'hard mineral resource' means any deposit or accretion on, or just below, the surface of the deep seabed of nodules which contain one or more minerals, at least one of which is manganese, nickel, cobalt, or copper.

"(c) DEEP SEABED.—For purposes of this subchapter, the term 'deep seabed' means the seabed, and the subsoil thereof to a depth of 10 meters, lying seaward of, and outside—

"(1) the Continental Shelf of any nation; and

"(2) any area of national resource jurisdiction of any foreign nation, if such area extends beyond the Continental Shelf of such nation and such jurisdiction is recognized by the United States.

"(d) CONTINENTAL SHELF.—For purposes of this subchapter, the term 'Continental Shelf' means—

"(1) the seabed and subsoil of the submarine areas adjacent to the coast but outside the area of the territorial sea, to a depth of 200 meters or, beyond that limit, to where the depth of the superjacent waters admits of the exploitation of the natural resources of such areas; and

"(2) the seabed and subsoil of similar submarine areas adjacent to the coasts of islands.

"SEC. 4497. IMPUTED VALUE.

"(a) IN GENERAL.—For purposes of

[1] This publication of the law, House Report No. 96-411, Part 3, page 423, and Senate Report No. 96-307, page 426, are restricted to excerpts involving tax matters. Senate Report Nos. 96-357 and 96-360, and House Report No. 96-411, Parts I, 2, and IV are not published.

this subchapter, the term 'imputed value' means, with respect to any hard mineral resource, 20 percent of the fair market value of the commercially recoverable metals and minerals contained in such resource. Such fair market value shall be determined—

"(1) as of the date of the removal of the hard mineral resource from the deep seabed; and

"(2) as if the metals and minerals contained in such resource were separated from such resource and were in the most basic form for which there is a readily ascertainable market price.

"(b) COMMERCIAL RECOVERABILITY.—

"(1) MANGANESE, NICKEL, COBALT, AND COPPER.—For purposes of subsection (a), manganese, nickel, cobalt, and copper shall be treated as commercially recoverable.

"(2) MINIMUM QUANTITIES AND PERCENTAGES.—The Secretary may by regulations prescribe for each metal or mineral quantities or percentages below which the metal or mineral shall be treated as not commercially recoverable.

"(c) SUSPENSION OF TAX WITH RESPECT TO CERTAIN METALS AND MINERALS HELD FOR LATER PROCESSING.—

"(1) ELECTION.—The permittee may, in such manner and at such time as may be prescribed by regulations, elect to have the application of the tax suspended with respect to one or more commercially recoverable metals or minerals in the resource which the permittee does not intend to process within one year of the date of extraction. Any metal or mineral affected by such election shall not be taken into account in determining the imputed value of the resource at the time of its removal from the deep seabed. Any suspension under this paragraph with respect to a metal or mineral shall be permanent unless there is a redetermination affecting such metal or mineral under paragraph (2).

"(2) LATER COMPUTATION OF TAX.—If the permittee processes any metal or mineral affected by the election under paragraph (1), or if he sells any portion of the resource containing such a metal or mineral, then the amount of the tax under section 4495 shall be redetermined as if there had been no suspension under paragraph (1) with respect to such metal or mineral. In any such case there shall be added to the increase in tax determined under the preceding sentence an amount equal to the interest (at rates determined under section 6621) on such increase for the period from the date prescribed for paying the tax on the resources (determined under section 4495(d)) to the date of the processing or sale.

"(d) DETERMINATIONS OF VALUE.—All determinations of value necessary for the application of this subchapter shall be made by the Secretary (after consultation with other appropriate Federal officials) on the basis of the best available information. Such determinations shall be made under procedures established by the Secretary by regulations.

"SEC. 4498. TERMINATION.

"(a) GENERAL RULE.—The tax imposed by section 4495 shall not apply to any removal from the deep seabed after the earlier of—

"(1) the date on which an international deep seabed treaty takes effect with respect to the United States, or

"(2) the date 10 years after the date of the enactment of this subchapter.

"(b) INTERNATIONAL DEEP SEABED TREATY.—For purposes of subsection (a), the term 'international deep seabed treaty means any treaty which—

"(1) is adopted by a United Nations Conference on the Law of the Sea, and

"(2) requires contributions to an international fund for the sharing of revenues from deep seabed mining".

(b) CLERICAL AMENDMENT.—The table of subchapters for chapter 36 of such Code is amended by adding at the end thereof the following new item:

"SUBCHAPTER F. Tax on removal of hard mineral resources from deep seabed."

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on January 1, 1980.

* * * * *

SEC. 404. ACT NOT TO AFFECT TAX OR CUSTOMS OR TARIFF TREATMENT OF DEEP SEABED MINING.

Except as otherwise provided in section 402, nothing in this Act shall affect the application of the Internal Revenue Code of 1954. Nothing in this Act shall affect the application of the customs or tariff laws of the United States.

Approved June 28, 1980.

House of Representatives Report No. 96-411, Part 3 1st Session

[Bracketed numerals indicate official report page numbers]

DEEP SEABED HARD MINERAL RESOURCES ACT

NOVEMBER 2, 1979

Mr. ULLMAN, from the Committee on Ways and Means, submitted the following report to accompany H.R. 2759 [1] which on March 8, 1979, was jointly referred to the Committee on Foreign Affairs, the Committee on Interior and Insular Affairs, the Committee on Merchant Marine and Fisheries, and the Committee on Ways and Means.

The Committee on Ways and Means, to whom was referred the bill (H.R. 2759) to promote the orderly development of hard mineral resources in the deep seabed, pending adoption of an international regime relating thereto, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment (stated in terms of

[1] Public Law 96-283, page 422.

page and line numbers of the introduced bill) is as follows:

Page 44, line 18, strike out "1978" and insert in lieu thereof "1979".

I. SUMMARY

Under title IV of the bill, an excise tax is imposed on the removal from the deep seabed of nodules containing manganese, nickel, cobalt or copper. The tax rate is 3.75 percent of the "imputed value" of the nodules removed. The imputed value is defined as 20 percent of the fair market value of the commercially recoverable metals or minerals contained in the nodule; thus the tax, in effect, is 0.75 percent of the fair market value of the commercially recoverable metals and minerals in the nodules. The tax will take effect on January 1, 1980, and will terminate when an international deep seabed treaty meeting specified requirements comes into force with respect to the United States, or after 10 years from the date of enactment of the Act, whichever is earlier.

The proceeds of the tax are to be paid into a Deep Seabed Revenue Sharing Trust Fund established by title IV. The amounts in the Trust Fund will be available for appropriation by Congress to make contributions under the international deep seabed treaty. If there is no [2] treaty after 10 years, Congress will determine the disposition of the amounts in the Trust Fund.

H.R. 2759 was also referred to the Committees on Interior and Insular Affairs, Merchant Marine and Fisheries, and Foreign Relations.

II. GENERAL STATEMENT

Present law

At present, the deep seabed is not being mined on a commercial basis. The provisions of H.R. 2759 other than title IV are intended to establish a framework which would permit U.S. persons to undertake deep seabed mining in an orderly manner. Under present law, no Federal excise taxes are imposed on the removal of minerals from the deep seabed.

Reasons for change

Since 1967, discussions have been under way at the United Nations on the use of ocean space. In 1970, the United Nations General Assembly adopted in Resolution 2749 a declaration of principles which stated that "the seabed and ocean floor and the subsoil thereof beyond the limits of national jurisdiction, as well as the resources of the area, are the common heritage of mankind," and that "no state or person, natural or juridical, shall claim, exercise, or acquire rights with respect to the area or its resources incompatible with the international regime to be established and the principle of this Declaration." The United States supported this declaration of principles, while simultaneously maintaining that deep seabed mining constitutes a freedom of the high seas according to the principles of the 1958 Geneva Convention on the Deep Seas. Discussions on these and other matters led the General Assembly to agree to hold a third United Nations Conference on the Law of the Sea.

The Law of the Sea Conference, which was formally opened in 1973, has not yet been able to reach agreement with respect to the creation of a proposed international seabed authority which would govern the exploration for and the mining of minerals from the area of the deep seabed which is beyond the national jurisdiction of the United States or any foreign country. In response to the apparent lack of progress in these negotiations, H.R. 2759, the Deep Seabed Hard Minerals Resources Act, would establish an interim framework governing deep seabed mining until an international treaty enters into force with respect to the United States. The committee believes that the creation of the Revenue Sharing Trust Fund and the imposition of the excise tax on the removal of hard minerals from the deep seabed, as provided by title IV of the bill, demonstrate the United States' commitment to the principle that deep seabed resources are part of the common heritage of mankind.

Explanation of provisions

Excise tax

Under title IV of the bill, an excise tax is imposed on the removal of hard mineral resources from the deep seabed. The holder of a permit (referred to in this explanation as the "mining company") issued under the Act is to be liable for the payment of the tax. The mining company will be liable regardless of whether it removes nod- [3] ules itself from the deep seabed, or authorizes another to remove the nodules on its behalf. Similarly, the mining company is to be liable for the payment of the tax where it acquiesces in the removal of nodules from its permit area by another.

For purposes of the tax, the "deep seabed" is the seabed, including its subsoil to a depth of 10 meters, lying seaward of, and outside (1) the continental shelf of any foreign country, and (2) any foreign country's national resource jurisdiction which is recognized by the United States and which extends beyond the continental shelf of that nation. For this purpose, "continental shelf" means (1) the seabed and subsoil of the submarine areas adjacent to the coast, but outside the area of the territorial sea, to a depth of 200 meters or, beyond that limit, to where the depth of the superjacent waters admits of the exploitation of the natural resources of those areas, and (2) the seabed and subsoil of similar submarine areas adjacent to the coasts of islands. A "hard mineral resource," the removal of which is subject to the tax, is any deposit or accretion on, or just below, the surface of the deep seabed of nodules which contain manganese, nickel, cobalt, or copper. These definitions are the same as those applicable under the other titles of H.R. 2759.

The excise tax is imposed at the rate of 3.75 percent of the "imputed value" of the nodules removed from the deep seabed. The "imputed value" for this purpose is 20 percent of the fair market value of the commercially recoverable metals and minerals con-

tained in the nodules. Thus, the excise tax, in effect, is imposed at the rate of 0.75 percent of the fair market value of the commercially recoverable metals and minerals. The 20-percent figure relates to the estimated proportional share of the costs of the mining process itself in relation to the total costs involved in mining, transporting, processing, and marketing the nodules. This is consistent with the United States' Law of the Sea negotiating position, as it would limit revenue sharing to the mining phase alone. The rate of tax set in the bill is not intended to serve as a guideline or precedent which would be binding for any profit sharing or royalty agreement negotiated by the United States at the Law of the Sea Conference.

The excise tax is to be imposed with respect to any commercially recoverable metals or minerals contained in the nodule, so long as the nodule contains manganese, nickel, cobalt or copper. Thus, the tax is to be imposed on the imputed value of all commercially recoverable minerals contained in the nodules removed from the deep seabed, regardless of whether or not they are one of the four previously mentioned. Commercial recoverability is to be determined with respect to the technical considerations and economic conditions prevailing at the time of removal of the nodules from the deep seabed. Moreover, the tax will be imposed on any manganese, nickel, cobalt or copper from nodules removed from the deep seabed which is processed, used, or sold by the mining company, even if that mineral was not commercially recoverable at the time of removal.

The fair market value of each commercially recoverable metal or mineral contained in a nodule is to be determined (1) as of the date of the removal of the nodule from the seabed and (2) as if it were separated from the nodule and in the most basic form for which there is a readily ascertainable market price and a substantial volume of sales. Determinations of value (including determinations as to the appropri-[4]ate basic form and commercial recoverability) for this and all other purposes under the tax are to be made by the Secretary of the Treasury, after consultation with other appropriate Federal officials, on the basis of the best available information. These determinations are to be made under procedures established by regulations.

Moreover, in order to facilitate both certainty in ascertaining tax liability and the efficient and expeditious administration and collection of the tax, the committee anticipates that the Secretary, pursuant to these procedures, may make determinations as to the value of the nodules removed based, in part, upon reasonable assumptions as to the various metals and minerals generally contained in nodules removed from any particular deep seabed area. For example, the committee anticipates that the Secretary may specify that nodules removed from an area are presumed conclusively to contain x percent of one mineral, y percent of another, and z percent of a third mineral, and that the balance of the nodule consists of minerals which are not commercially recoverable. The Secretary may also by regulations prescribe for each metal or mineral (including manganese, nickel, cobalt, and copper) *de minimis* quantities or percentages below which the metal or mineral will be treated as not commercially recoverable.

Although the excise tax is imposed on the removal of the nodule from the deep seabed, the tax is not payable until the time prescribed by regulation by the Secretary of the Treasury. This time may not be earlier than the earlier of (1) the commercial use or the sale or disposition of any metal or mineral in the nodule so removed, or (2) the day which is 12 months after the date of the removal of the nodule. The tax due at the time would be based on the value of all commercially recoverable metals and minerals in the nodule except those for which the mining company has elected to suspend the tax, as described below. For this purpose, "commercial use" means use as a mineral product and not merely as a bulk material, such as ballast. A "disposition" includes any transfer, *e.g.*, a distribution by a mining company as a dividend or in liquidation or a contribution to capital of a subsidiary, for use as a mineral product and not as bulk material. A disposition would not include abandonment or a transfer to an unrelated party which is not for value.

As an exception to the general rules, the mining company may elect, in a manner to be prescribed by regulations, to have the application of the tax suspended with respect to one or more commercially recoverable metals or minerals contained in the nodules if the mining company does not intend to process, use commercially, or sell that metal or mineral within 1 year after the date of extraction. The imputed value of the metals or minerals with respect to which the election is made is not to be taken into account in determining the tax. However, if the mining company subsequently recovers any metal or mineral with respect to which the election was made from the nodules, or if it uses commercially or sells any portion of the nodules containing a metal or mineral so reserved, the tax is to be redetermined as if the election with respect to that metal or mineral or that portion had not been made. Thus, upon a subsequent processing, commercial use, or sale of a previously reserved metal or mineral (or the resource in which it is contained), an additional tax will be due from the mining company. Furthermore, in such an event, the mining company is also to pay an [5] amount equal to interest (determined at the rates for interest on deficiencies and overpayments of tax) on the additional tax for the period from the date on which the tax would have been imposed if the election had not been made to the date of processing, commercial use, or sale. It is intended that the suspension election may be made with respect to any portion of the nodules

recovered. Moreover, redeterminations of the tax shall be made only with respect to those nodules (or the intermediate products of the nodules) which are actually processed, used commercially, or sold. Unless a mining company can identify the nodules, it will be treated as processing, commercially using, or selling them on a first in-first out basis. If the metals or minerals with respect to which an election has been made are never processed, used commercially, or sold, no tax will be payable with respect to them.

The tax is not to apply to any removal of nodules from the deep seabed after the earlier of (1) 10 years after the date of enactment of the Act, or (2) the date on which an international deep seabed treaty to which the Senate has given its advice and consent to ratification takes effect with respect to the United States. For this purpose, an "international deep seabed treaty" means any treaty adopted by the United Nations Conference on the Law of the Sea which requires contributions either by the United States or the mining company to an international fund for the sharing of revenues from deep seabed mining. Any other bilateral or multilateral treaty or agreement which the United States may enter into which relates to deep seabed mining will not terminate the tax. In case an election has been made to suspend the tax with respect to certain metals or minerals from the tax, the tax will apply to those metals or minerals when they are processed, used, or sold even if that date is subsequent to the termination date of the tax, if removal from the deep seabed occurred prior to the termination date.

Matters relating to collection and other administrative aspects of the tax are to be determined under applicable provisions of the Internal Revenue Code of 1954 and regulations promulgated by the Treasury Department.

Deep Seabed Revenue Sharing Trust Fund

The proceeds of the excise tax are held in a Deep Seabed Revenue Sharing Trust Fund established pursuant to title IV of the bill. The Trust Fund is to be administered by the Treasury Department and is to consist of the amounts appropriated or credited to it in accordance with title IV.

Title IV of the bill provides that amounts in the Trust Fund shall be available, as provided by appropriations Acts, for making contributions which may be required pursuant to an international deep seabed treaty (as described above under the heading "Excise Tax") which may become effective with respect to the United States on or before the date 10 years after the date of the enactment of H.R. 2759. The contributions for which Trust Fund amounts may be appropriated are to be for the purpose of sharing the revenue from deep seabed mining among nations of the world. Nothing in title IV is intended to authorize any program or other activity not otherwise authorized by law.

* * * * *

[6] *Effect on tax, tariff, and customs laws*

The title specifically provides that nothing in H.R. 2759, other than the tax imposed by title IV, shall affect the application of the Internal Revenue Code of 1954 or the application of the customs and tariff laws of the United States. It is anticipated that the tax, customs, and tariff consequences of deep seabed mining will be the subject of future [7] legislative proposals which may be considered by the committee. Accordingly, this provision is intended to make it clear that, pending that consideration, H.R. 2759 will not explicitly or implicitly convey any tax, customs or tariff benefits which would not be available in its absence.

Effective date

The provisions relating to the excise tax on deep seabed mining are to take effect on January 1, 1980. They are to terminate on the earlier of the date 10 years from the date of the enactment of H.R. 2759, or at the time when an international deep seabed treaty comes into effect with respect to the United States.

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Senate Report No. 96-307 1st Session

[Bracketed numerals indicate official report page numbers]

DEEP SEABED MINERAL RESOURCES ACT

AUGUST 9, 1979

Mr. JACKSON, from the Committee on Energy and Natural Resources, and on behalf of Mr. CANNON, from the Committee on Commerce, Science, and Transportation; and Mr. CHURCH, from the Committee on Foreign Relations, submitted the following report together with additional views to accompany S. 493. [1]

The Committee on Energy and Natural Resources; Commerce, Science and Transportation; and Foreign Relations, to which was jointly referred the bill (S. 493) to promote the orderly development of hard mineral resources in the deep seabed, pending adoption of an international regime relating thereto, and for other purposes, having considered the same, reports favorably thereon with amendments and recommends that the bill, as amended, do pass.

PURPOSE

The Deep Seabed Mineral Resources Act is designed to promote the conservation and orderly development of the manganese nodule resources of the deep seabed by United States citizens. It is interim legislation which expressly provides that it will be superseded by the terms of any international agreement binding on the United States. Negotiations looking toward such an agreement are currently underway at the Third United

[1] Public Law 96-283, page 422.

Nations Conference on the Law of the Sea.

* * * * *

[64] DEPARTMENT OF THE TREASURY,
OFFICE OF THE GENERAL COUNSEL,
Washington, D.C.,
April 10, 1979.

HON. HENRY M. JACKSON,
Chairman, U.S. Senate, Committee on Energy and Natural Resources, Washington, D.C.

DEAR MR. CHAIRMAN: This is in reply to your request for the views of the Department of the Treasury on S. 493, the "Deep Seabed Mineral Resources Act."

* * * * *

[65] Title V may also be cited as the "Deep Seabed Hard Mineral Removal Tax Act of 1979." The Department has no objection to the provisions contained in section 502 and strongly supports section 504.

However, the Department has two technical comments relating to section 502. First, the definitions in proposed section 4496 of the Internal Revenue Code includes a definition of the Continental Shelf. The Department notes that this definition is broader than the definition of continental shelf areas contained in section 638 of the Internal Revenue Code. Second, the Department notes that the effective date provision in subsection (c) does not require the issuance of regulations required by proposed section 4497 of the Internal Revenue Code dealing with imputed value. Although the imputed value determinations required to be done by regulation could be accomplished by the Secretary of the Treasury without regulations, the Internal Revenue [66] Service will need administrative time to develop the program and forms required by a regulatory scheme.

Amounts equivalent to the taxes imposed under section 502 would be credited to the Deep Seabed Fund established by section 503. The Department supports the establishment of this fund in this case to bolster the principle of the "common heritage of mankind." The 3.75 percent is a reasonable revenue sharing obligation under domestic seabed legislation and is high enough to demonstrate the United States commitment to this principle.

The Department, however, is reviewing the transfer, management, and expenditures provision of the fund to determine their consistency with current fiscal policy. A separate report will be submitted by the Department to Congress regarding these technical aspects of the Deep Seabed Fund.

The Office of Management and Budget has advised that there is no objection from the standpoint of the Administrations program to the submission of this report to your Committee.

Sincerely yours,

H. C. STOCKELL, JR.,
Deputy General Counsel.

* * * * *

[96] ADDITIONAL VIEWS OF THE COMMITTEE ON FOREIGN RELATIONS

S. 493 is similar to the bill (S. 2053) reported by the Committee on August 16, 1978. Therefore, in its mark-up on July 30, 1979, the Committee focused primarily upon the differences between S. 493, as reported by the Energy Committee, and the bill reported last session. The Committee also took note of certain changes proposed to the bill by the Commerce Committee in its mark-up of July 27, 1979.

Fifteen principal issues were considered by the Foreign Relations Committee:

1. DEEP SEABED FUND AND TAX PROVISIONS: TITLE V

The Committee endorsed the establishment of a deep seabed fund, represented by Title V of S. 493, as providing the basis for United States contributions to any future deep seabed regime established by a Law of the Sea Treaty. It recalled that during its consideration of S. 2053 last year, the Committee had decided to recommend a royalty figure of 10 percent of imputed value, rather than the 3.75 percent contained in S. 493. However, the Committee took note of the fact that the Administration was not supporting this higher royalty figure and that the mining industry was strongly opposed to it. No changes were made in Title V.

* * * * *

Public Law 96-293
96th Congress, H.R. 7685
June 30, 1980

An Act to amend title IV of the Employee Retirement Income Security Act of 1974 [Pub. L. 93-406, 1974-3 C.B. 1] to postpone for one month the date on which the corporation must pay benefits under terminated multiemployer plans.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 4082(c) of title IV of the Employee Retirement Income Security Act of 1974 (relating to effective dates; special rules) as amended by Public Law 95-214, Public Law 96-24 [1979-2 C.B. 471], and Public Law 96-239 [1980-1 C.B. 566] is further amended—

(1) by striking "July 1, 1980" in paragraphs (1), (2), and (4) and substituting "August 1, 1980" in each such paragraph; and

(2) by striking "June 30, 1980" in paragraphs 2(B) and 4(D) and substituting "July 31, 1980" in each such paragraph.

Approved June 30, 1980.

Pub. L. 96-294 [1]
96th Congress, S. 932
June 30, 1980

An Act to extend the Defense Production Act of 1950, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Energy Security Act".

TITLE I—SYNTHETIC FUEL

* * * * *

Part B—United States Synthetic Fuels Corporation

Subtitle A—General Provisions

SHORT TITLE

Sec. 111. This part may be cited as the "United States Synthetic Fuels Corporation Act of 1980".

* * * * *

Subtitle F—Capitalization and Finance

* * * * *

TAX STATUS

Sec. 155. (a) The Corporation, its franchise, capital, reserves, surplus, income, and intangible property shall be exempt from all taxation now or hereafter imposed by the United States, or by any State, county, municipality, or local taxing authority, except that—

(1) any real property owned in fee by the Corporation shall be subject to State, territorial, county, municipal, or other local taxation to the same extent, according to its value, as other similarly situated and used real property, without discrimination in the valuation, classification, or assessment thereof;

(2) the Corporation and its employees shall be subject to any nondiscriminatory payroll and employment taxes intended to finance benefits based upon employment (such as social security and unemployment benefits) to the same extent as any privately owned corporation; and

(3) with respect to any Corporation construction project undertaken pursuant to subtitle E, the Corporation shall be subject to any nondiscriminatory tax levied or imposed by any State, county, municipality, or local taxing authority on—

(A) the extraction or severance of minerals owned or leased by the Corporation; and

(B) the purchase or lease of tangible personal property.

(b) With respect to any loan or debt obligation which is (1) issued after the enactment of this part by, or on behalf of, any State or any political subdivision or governmental entity thereof, (2) guaranteed or otherwise secured by the Corporation prior to the approval of a comprehensive strategy under section 126(c), and (3) not supported by the full faith and credit of the issuer as a general obligation of the issuer, the interest paid on such obligation and received by the purchaser thereof (or the purchaser's successors in interest) shall be included in gross income for the purposes of chapter 1 of the Internal Revenue Code of 1954: *Provided,* That with respect to the amount of such obligations that the issuer would have been able to issue as tax exempt obligations (other than obligations secured by the full faith and credit of the issuer as a general obligation of the issuer), the Corporation is authorized to pay only to the issuer any portion of the interest on such obligations, as determined by the Secretary of the Treasury after taking into account the interest rate which would have been paid on the obligations had they been issued as tax exempt obligations without being so guaranteed or otherwise secured by the Corporation and the interest rate actually paid on the obligations when issued as taxable obligations. Such payments shall be made in amounts determined by the Corporation, and in accordance with such terms and conditions as the Secretary of the Treasury shall require.

* * * * *

TITLE II—BIOMASS ENERGY AND ALCOHOL FUELS

SHORT TITLE

Sec. 201. This title may be cited as the "Biomass Energy and Alcohol Fuels Act of 1980".

* * * * *

Subtitle B—Municipal Waste Biomass Energy

* * * * *

GUARANTEED CONSTRUCTION LOANS

Sec. 233. * * *

* * * * *

(g)(1) With respect to any loan or debt obligation which is—

(A) issued after the date of the enactment of this Act by, or on behalf of, any State or any political subdivision or governmental entity thereof,

(B) guaranteed by the Secretary of Energy under this section, and

(C) not supported by the full faith and credit of the issuer as a general obligation of the issuer,

the interest paid on such obligation and received by the purchaser thereof (or the purchaser's successors in interest) shall be included in gross income for the purposes of chapter 1 of the Internal Revenue Code of 1954.

* * * * *

TITLE V—SOLAR ENERGY AND ENERGY CONSERVATION

SHORT TITLE

Sec. 501. This title may be cited as the "Solar Energy and Energy Conservation Act of 1980".

Subtitle A—Solar Energy and Energy Conservation Bank

SHORT TITLE

Sec. 502. This subtitle may be cited as the "Solar Energy and Energy Conservation Bank Act".

* * * * *

[1] This publication of the law is restricted to excerpts involving tax matters; Senate Report No. 96-824 published in part, page 430; House Reports No. 96-165 and 96-1104 and Senate Reports No. 96-166 and 96-387 are not published.

Part 1—Establishment and Operation of the Bank

* * * * *

BOARD OF DIRECTORS

SEC. 506. (a) The Bank shall be governed by a Board of Directors. The Board shall consist of the Secretary of Housing and Urban Development, the Secretary of Energy, the Secretary of the Treasury, the Secretary of Agriculture, and the Secretary of Commerce.

(b) Three members of the Board shall constitute a quorum.

(c) The Chairperson of the Board shall be the Secretary of Housing and Urban Development.

(d) The President of the Bank shall be the Secretary of the Board.

(e) The Board shall carry out the functions of the Bank as set forth in this subtitle and shall adopt such regulations, subject to the provisions of section 7(o) of the Department of Housing and Urban Development Act (42 U.S.C. 3535(o)), as the Board determines are necessary to carry out such functions.

(f) The Board shall provide to the Secretary of the Treasury such information as the Secretary of the Treasury determines is necessary to insure that no individual is allowed for the same expenditure both—

(1) a credit against taxes under section 38 or section 44C of the Internal Revenue Code of 1954; and

(2) financial assistance under this subtitle.

* * * * *

PROVISION OF FINANCIAL ASSISTANCE

SEC. 509. * * *

* * * * *

(b) Financial assistance may be provided under subsection (a) only if—

* * * * *

(2) the financial assistance is provided in the form described in paragraph (1) or (2) of subsection (a) and—

* * * * *

(E) the owner or tenant receiving such loan has not applied for or received any credit against taxes allowed by section 38 or section 44C of the Internal Revenue Code of 1954 for the expenditures made with the proceeds of such loan, or portion of a loan.

(c) The amount of any financial assistance provided under this subtitle shall not be included in the gross income of any person for purposes of the Internal Revenue Code of 1954, and such person shall not receive any increase in basis under the Internal Revenue Code of 1954 which is attributable to the amount of any financial assistance provided under this subtitle.

* * * * *

CONDITIONS ON FINANCIAL ASSISTANCE FOR SOLAR ENERGY SYSTEMS

SEC. 515. * * *

(b)(1) In addition to the conditions contained in section 513 and subsection (a), financial assistance may be provided by a financial institution to a builder under this subtitle for the purchase and installation of a solar energy system in a residential building only if—

(A) the Board determines that—

(i) in order to encourage the construction or substantial rehabilitation of a greater number or residential buildings containing solar energy systems it is necessary to provide financial assistance under this subtitle directly to builders;

(ii) providing any financial assistance under this subtitle directly to builders is a more effective expenditure of such assistance to encourage the construction or substantial rehabilitation of residential buildings containing solar energy systems than providing such assistance only to the purchasers of such buildings; and

(iii) the Board, in consultation with the Secretary of the Treasury, is able to establish a procedure which will prevent the purchaser (who buys the building from the builder) of a residential building for which a builder received financial assistance under this subtitle from receiving additional assistance under this subtitle for the same expenditures for which the builder received assistance and from being allowed a credit against taxes under section 38 or section 44C of the Internal Revenue Code of 1954 for such expenditures;

(B) the Board establishes a procedure which prevents the purchaser (who buys the building from the builder) of a residential building for which a builder received financial assistance under this subtitle from receiving additional assistance under this subtitle for the same expenditures for which the builder received assistance and from being allowed a credit against taxes under section 38 or section 44C of the Internal Revenue Code of 1954 for such expenditures;

(C) the builder agrees to, and does, disclose to the purchaser (who buys the building from the builder) in writing at the time of signing the sales contract for such building—

(i) the expenditures with respect to such building for which the builder received financial assistance under this subtitle; and

(ii) that the purchaser may not be allowed a credit against taxes for such expenditures under section 38 or section 44C of the Internal Revenue Code of 1954; and

(D) in addition to any other information required by this subtitle to be provided, the builder agrees to, and does, provide to the Bank such information as the Board determines, in consultation with the Secretary of the Treasury, is necessary to assure that the purchaser (who buys the building from the builder) is not allowed a credit against taxes for such expenditures under section 38, or section 44C, of the Internal Revenue Code of 1954.

(2) Any expenditures, made by a builder for the purchase and installation of a solar energy system in a building, for which the builder received financial assistance under this subtitle shall be considered expenditures from subsidized energy financing by the purchaser (who buys such building from the builder) for pur-

poses of section 38 and section 44C of the Internal Revenue Code of 1954.

* * * * *

SUBTITLE B—UTILITY PROGRAM

* * * * *

TAX TREATMENT

SEC. 545. Section 216 of the National Energy Conservation Policy Act is amended by adding the following new subsection at the end thereof:

"(i) TAX TREATMENT.—The value of any subsidy provided by a utility to any residential customer for the purchase and installation of residential energy conservation measures shall not be included in the gross income of such customer for purposes of the Internal Revenue Code of 1954, and such customer shall not receive any increase in basis under the Internal Revenue Code of 1954 which is attributable to any such subsidy.".

* * * * *

Approved June 30, 1980.

Senate Report No. 96-824 2d Session

[Bracketed numerals indicate official report page numbers]

ENERGY SECURITY ACT

JUNE 19 (legislative day, JUNE 12), 1980.

Mr. JOHNSON, from the committee of conference, submitted the following conference report to accompany S. 932.[1]

* * * * *

[180] JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE

* * * * *

[185] TITLE I—SYNTHETIC FUELS

* * * * *

[200] PART B—UNITED STATES SYNTHETIC FUELS CORPORATION

* * * * *

[1] Public Law 96-294, page 428.

[227] SUBTITLE F—CAPITALIZATION AND FINANCE

* * * * *

[229] *Tax Status (Sec. 155)*

Section 155(a) provides that the Corporation, its franchise, capital, reserve, surplus, income and intangible property shall be exempt from all Federal, State and local taxes, except that (1) any real property owned in fee by the Corporation shall be subject to nondiscriminatory State and local taxes to the same extent as other similarly situated and used property; and (2) its employees shall be subject to any non-discriminatory payroll and employment tax levied for the purpose of employee benefits and to the same extent as any privately owned corporation. In addition, the Corporation construction projects shall be subject to any non-discriminatory tax levied or imposed by any State, county, municipality, or local taxing authority on those assets of the Corporation construction project pursuant to Subtitle E, including only

(i) the extraction or severance of minerals owned or leased by the Corporation, and

(ii) on the purchase or lease of tangible personal property.

Subsection 155(b)

Section 155(b) establishes debt obligations the Federal tax policy to be followed for Federal taxation of gross income from State and local bonds, which are guaranteed by the Corporation pursuant to Section 133 or which are secured by financial assistance from the Corporation pursuant to Subtitle D during Phase I. The interest paid on any such State or local loan or debt obligations issued after the enactment of this Title is to be included in the gross income of obligation purchasers to the extent that such obligations are not supported by the full faith and credit as a general obligation of the issuer. Because it is anticipated that the taxation of this interest will impose additional costs on issuers than would otherwise be paid in connection with tax-exempt issuances, the Secretary of the Treasury is authorized to determine, and the Corporation is authorized to pay an interest differential payment to issuers for the purpose of compensation for these increased costs incurred as the consequence of taxable status of interest on the obligations. In calculating the amount of the payment which may be made respecting each specific issue of obligation, the Secretary of the Treasury shall take into account the interest which would have been paid if the obligations were issued as tax exempt obligations, and the interest rate actually paid on the taxable obligations.

A price support commitment from the Corporation may be used for a project financed tax exempt bond if, but only if, there is no pledge of the price support commitment as security for the bonds. It is the intention of the Conference Committee that a bond be considered secured by a price support and thus taxable if the bondholders are given a pledge of the price support payments which would entitle the bondholders to receive the prize support payments prior to any other creditors of the owners and/or operators of the facility subject to the price support payments. Where bondholders have rights [230] to the price support payments only as general creditors of the owners or operators of the facility, the Conference Committee does not intend that such bonds be deemed to be "otherwise secured" and thus taxable under Section 155(b).

In order that this interest differential payment authority shall not have the effect of encouraging applicants to seek project financing through State and local governments or agencies, the Conferees intend that the Corporation will exercise this payment authority only where there are clear public benefits to be derived from a project in excess of the benefits which would be derived if the pyament were not made. The Conferees do not expect the Corporation to make extensive use of this payment provision. Nor is it expected that the full amount of the interest differential will be paid in all cases.

Further, the Conferees direct the Corporation to assure in each instance that the entire value of the payment will be used to reduce the debt service cost of the project.

* * * * *

[278] TITLE V—SOLAR ENERGY AND ENERGY CONSERVATION

* * * * *

[293] SUBTITLE B—UTILITY PROGRAM

* * * * *

[294] *Tax treatment*

Section 545 provides that any subsidy provided to a customer by a utility's financing program for residential energy conservation measures shall not be treated as income or as an increase in the basis of the customer's residence for tax purposes.

The conferees intend that any financial assistance which is provided to a customer by a utility for residential energy conservation measures and which does not include Federal, State or local governmental financial assistance (such as assistance from the Solar Energy and Energy Conservation Bank) shall not be considered subsidized energy financing for the purposes of the Internal Revenue Code, and shall not, therefore, disqualify such a customer from receiving the relevant tax credits for expenditures so financed.

* * * * *

Public Law 96-298
96th Congress, H.R. 7477 [1]
July 1, 1980

An Act to amend the Internal Revenue Code of 1954 to provide a three-month extension of the taxes which are transferred to the Airport and Airway Trust Fund.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. EXTENSION OF TAXES.

(a) TAX ON FUEL USED IN NONCOMMERCIAL AVIATION. — Paragraph (5) of section 4041(c) of the Internal Revenue Code of 1954 (relating to termination of tax on fuel for noncommercial aviation) is amended by striking out "July 1, 1980" and inserting in lieu thereof "October 1, 1980".

(b) TAX ON TRANSPORTATION BY AIR.—Sections 4261(e) and 4271(d) of such Code are each amended by striking out "June 30, 1980" and inserting in lieu thereof "September 30, 1980".

(c) TAX ON USE OF AIRCRAFT.—

(1) IN GENERAL.—Subsection (e) of section 4491 of such Code (relating to termination of tax on use of aircraft) is amended by striking out "July 1, 1980" and inserting in lieu thereof "October 1, 1980".

(2) TRANSITIONAL RULE.—For the period beginning on July 1, 1980, and ending on October 1, 1980—

(A) subsection (a) of section 4491 of such Code shall be applied by substituting "$6.25" for "$25", "½ cent" for "2 cents", and "⅞ cent" for "3½ cents", and

(B) such section 4491 shall be applied by treating such period as a year.

(3) POSTPONEMENT OF DUE DATE FOR FILING RETURN.—The due date for filing any return of the tax imposed by section 4491 of the Internal Revenue Code of 1954 with respect to any use after June 30, 1980, shall not be earlier than October 31, 1980.

(d) EXTENSION OF AIRPORT AND AIRWAY TRUST FUND.—Subsection (b) of section 208 of the Airport and Airway Revenue Act of 1970 [1970-1 C.B. 361, 368] is amended by striking out "July 1, 1980" each place it appears and inserting in lieu thereof "October 1, 1980".

Approved July 1, 1980.

House of Representatives
Report No. 96-1077
2d Session

[Bracketed numerals indicate official report page numbers]

THREE-MONTH EXTENSION OF THE TAXES WHICH ARE TRANSFERRED TO THE AIRPORT AND AIRWAY TRUST FUND

JUNE 5, 1980.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed.

Mr. ULLMAN, from the Committee on Ways and Means, submitted the following report to accompany H.R. 7477.[1]

The Committee on Ways and Means, to whom was referred the bill (H.R. 7477) to amend the Internal Revenue Code of 1954 to provide a 3-month extension of the taxes which are transferred to the Airport and Airway Trust Fund, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment—stated in terms of the page and line numbers of the introduced bill—is as follows:

Page 2, after line 18, insert the following:

(3) POSTPONEMENT OF DUE DATE FOR FILING RETURN.—The due date for filing any return of the tax imposed by section 4491 of the Internal Revenue Code of 1954 with respect to any use after June 30, 1980, shall not be earlier than October 31, 1980.

I. SUMMARY

Under present law, the aviation-related excise taxes now transferred to the Airport and Airway Trust Fund are scheduled either to expire or be reduced on July 1, 1980.

The bill extends the present law aviation excise taxes at their present rate structure for a 3-month period, July 1, 1980-September 30, 1980, in order to provide additional time for the Congress to complete its consideration of the trust fund extension legislation. The Committee on Ways and Means has approved an amendment for a 5-year extension of the trust fund which will be offered as a separate title

[1] House Report No. 96-1077, this page.

[1] Public Law 96-298, this page.

to H.R. 6721. The bill, H.R. 7477, also extends the transfer of the aviation excise tax revenues to the trust fund for the same 3-month period. In addition, the bill provides that the due date for filing a return for payment of the aircraft use tax for the 3-month period will not be earlier than October 31, 1980.

[2] II. EXPLANATION OF BILL

Present law

Under present law, the aviation-related excise taxes now transferred to the Airport and Airway Trust Fund are scheduled either to expire or be reduced on July 1, 1980. The following table shows the present law aviation excise taxes and the rates scheduled for July 1, 1980, under present law.

SCHEDULE OF AIRPORT AND AIRWAY TRUST FUND EXCISE TAXES UNDER PRESENT LAW

Tax (and Code section)	Present rate	Rate scheduled for July 1, 1980
Air passenger ticket tax (secs. 4261(a) and (b))	8%	5%
Air freight waybill tax (sec. 4271)	5%	----
International departure tax (sec. 4261(c))	$3	----
Fuels tax for noncommercial (general) aviation (per gallon) (sec. 4041(c))[1]	7¢	[4] 4¢
Aircraft use tax (sec. 4491)[1]	([2])	----
Aircraft tires and tubes tax (secs. 4071)	([3])	([3])

[1] The tax does not apply to aircraft, owned by a tax-exempt aircraft museum defined in sec. 404(h), which are operated exclusively for the procurement, care, and exhibition of World War II aircraft.

[2] A tax of two parts: (1) $25 annual per plane registration tax, plus (2) a weight tax of 3½ cents per pound for turbine-powered (jet) aircraft and 2 cents per pound for nonturbine-powered aircraft for each pound in excess of 2,500 pounds of "maximum certificated takeoff weight."

[3] Taxed at the general rates for nonhighway tires (5 cents per pound) and tubes (10 cents per pound) under Code sec. 4071.

[4] Tax on gasoline fuel only. As of July 1, 1980, the additional 3-cents-per-gallon tax on gasoline used in noncommercial aviation aircraft would expire, and the 7-cents-per-gallon tax on non-gasoline fuels (e.g. kerosene—jet fuel) would also expire.

Ways and Means Committee amendment to H.R. 6721

On May 28, 1980, the Ways and Means Committee approved an amendment, which is to be offered as a separate title to H.R. 6721 (the Airport and Airway Improvement Act of 1980), as reported by the Public Works and Transportation Committee and the Science and Technology Committee.

The Ways and Means Committee amendment generally extends the Airport and Airway Trust Fund and the aviation excise taxes transferred to the trust fund through September 30, 1985 (fiscal year 1985). However, certain modifications were made to the aviation taxes: (1) the air passenger ticket tax was extended at 8 percent through September 30, 1982, with a reduction to 5 percent on October 1, 1982; (2) the [3] aircraft use tax was repealed for noncommercial aircraft (i.e., allowed to expire on July 1, 1980), while the use tax on commercial aircraft was extended through September 30, 1985; (3) the fuels tax on noncommercial aviation was increased to 8½ cents per gallon on July 1, 1980 through September 30, 1985, and (4) other amendments were made relating to the 225-mile zone rule for air transportation between the United States, and Canada, and Mexico, the treatment of international uninterrupted flights, and the manner in which airline tickets must show the air fare and the ticket tax.

Reasons for change

The committee concluded that the present law aviation excise taxes should be extended at their present rates for the 3-month period, July 1, 1980-September 30, 1980, in order to provide additional time for orderly Congressional consideration of H.R. 6721. If present law is not extended, the 8-percent air passenger ticket tax will drop to 5 percent on July 1, and the revenues will go into the general fund. Also, the 5-percent waybill tax, the $3 departure tax, and the aircraft use tax will expire on July 1. In addition, the fuels tax on noncommercial aviation jet fuel will expire, and the tax on noncommercial aviation gasoline will drop to 4 cents per gallon. In view of the closeness of the July 1 date, the committee believes that expeditious Congressional action is necessary for a short-term extension of the present law tax rates so that there is some certainty as to the applicable tax rates for the coming months while the Congress considers the extension of the trust fund authorizations.

Explanation of provision

The bill extends the present law aviation taxes at the present tax rates for a 3-month period, or July 1, 1980-September 30, 1980. For purposes of the aircraft use tax, the bill treats the 3-month period as a taxable year at one-fourth the annual tax rate now imposed.[1] (i.e., the $25 annual per plane tax will be $6.25, and the respective weight taxes on jet and non-jet aircraft will be at one-fourth the present tax rates.) Also, the bill provides that the due date for filing a return for the aircraft use tax for the period beginning after June 30, 1980, will not be due earlier than October 31, 1980.

In addition, the bill extends for the 3-month period the transfer of the aviation excise tax revenues to the Airport and Airway Trust Fund.

Effective date

The provisions of the bill are gen-

[1] Under Code section 4491, the taxable year for purposes of the annual aircraft use tax presently is July 1-June 30, with the use tax being imposed (on a prorated basis for the weight portion of the tax) on an aircraft in the month the plane is first used. Payment of the use tax is due generally by the end of the month following the month of first use.

erally effective for the 3-month period July 1, 1980-September 30, 1980. The amendment with respect to the time of filing a return for payment of the aircraft use tax for the 3-month period provides that the due date for such a return will not be earlier than October 31, 1980.

Public Law 96-304
96th Congress, H.R. 7542 [1]
July 8, 1980

An Act making supplemental appropriations for the fiscal year ending September 30, 1980, rescinding certain budget authority, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

* * * * *

CHAPTER XIV
DEPARTMENT OF THE TREASURY

* * * * *

INTERNAL REVENUE SERVICE

PAYMENT WHERE ENERGY CREDIT EXCEEDS LIABILITY FOR TAX

For an additional amount for "Payment where energy credit exceeds liability for tax", $1,000,000.

GENERAL PROVISION

(INCLUDING TRANSFER OF FUNDS)

SEC. 1. Any appropriation made available to the Internal Revenue Service for the current fiscal year by this Act may be transferred to any other Internal Revenue Service appropriation only to the extent necessary for increased pay costs authorized by or pursuant to law:

Provided, however, That no funds may be transferred into or out of the account entitled "Payment where energy credit exceeds liability for tax": *Provided further,* That none of the funds made available pursuant to the provisions of this Act shall be used to formulate or carry out any rule, policy, procedure, guideline, regulation, standard, or measure which would cause the loss of tax-exempt status to private, religious, or church-operated schools under section 501(c)(3) of the Internal Revenue Code of 1954 unless in effect prior to August 22, 1978.

* * * * *

Approved July 8, 1980.

[1] House Report No. 96-1149, Senate Report No. 96-829, and Conference Report No. 96-934 are not published.

Public Law 96-320
96th Congress, S. 2492[1]
August 3, 1980

An Act to regulate commerce, promote energy self-sufficiency, and protect the environment, by establishing procedures for the location, construction, and operation of ocean thermal energy conversion facilities and plantships to produce electricity and energy-intensive products off the coasts of the United States; to amend the Merchant Marine Act, 1936, to make available certain financial assistance for construction and operation of such facilities and plantships; and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Ocean Thermal Energy Conversion Act of 1980".

* * * * *

SEC. 3. DEFINITIONS

As used in this Act, unless the context otherwise requires, the term—

* * * * *

(10) "licensee" means the holder of a valid license for the ownership, construction, and operation of an ocean thermal energy conversion facility or plantship that was issued, transferred, or renewed pursuant to this Act;

(11) "ocean thermal energy conversion facility" means any facility which is standing or moored in or beyond the territorial sea of the United States and which is designed to use temperature differences in ocean water to produce electricity or another form of energy capable of being used directly to perform work, and includes any equipment installed on such facility to use such electricity or other form of energy to produce, process, refine, or manufacture a product, and any cable or pipeline used to deliver such electricity, freshwater, or product to shore, and all other associated equipment and appurtenances of such facility, to the extent they are located seaward of the highwater mark;

(12) "ocean thermal energy conversion plantship" means any vessel which is designed to use temperature differences in ocean water while floating unmoored or moving through such water, to produce electricity or another form of energy capable of being used directly to perform work, and includes any equipment installed on such vessel to use such electricity or other form of energy to produce, process, refine, or manufacture a product, and any equipment used to transfer such product to other vessels for transportation to users, and all other associated equipment and appurtenances of such vessel;

(13) "plantship" means an ocean thermal energy conversion plantship;

* * * * *

(18) "United States citizen" means (A) any individual who is a citizen of the United States by law, birth, or naturalization; (B) any Federal, State, or local government in the United States, or any entity of any such government; or (C) any corporation, partnership, association, or other entity, organized or existing under the laws of the United States, or of any State, which has as its president or other executive officer and as its chairman of the board of directors, or holder of similar office, an individual who is a United States citizen and which has no more of its directors who

[1] This publication of the law and House Report No. 96-994, page 434, is restricted to excerpts involving tax matters. Senate Report No. 96-721 is not published.

are not United States citizens than constitute a minority of the number required for a quorum necessary to conduct the business of the board.

* * * * *

TITLE II—MARITIME FINANCING FOR OCEAN THERMAL ENERGY CONVERSION

SEC. 201. DETERMINATIONS UNDER THE MERCHANT MARINE ACT, 1936.

(a)(1) For the purposes of section 607 of the Merchant Marine Act, 1936 [amended by Pub. L. 91-469, 1970-2 C.B. 372] (46 U.S.C. 1177), any ocean thermal energy conversion facility or plantship licensed pursuant to this Act, and any vessel providing shipping service to or from such an ocean thermal energy conversion facility or plantship, shall be deemed to be a vessel operated in the foreign commerce of the United States.

(2) The provisions of paragraph (1) of this subsection shall apply for taxable years beginning after December 31, 1981.

(b) For the purposes of the Merchant Marine Act, 1936 (46 U.S.C. 1177 et seq.) any vessel documented under the laws of the United States and used in providing shipping service to or from any ocean thermal energy conversion facility or plantship licensed pursuant to the provisions of this Act shall be deemed to be used in, and used in an essential service in, the foreign commerce or foreign trade of the United States, as defined in section 905 (a) of the Merchant Marine Act, 1936 (46 U.S.C. 1244(a)).

* * * * *

SEC. 203. OTEC DEMONSTRATION FUND.

(a) Title XI of the Merchant Marine Act, 1936 (46 U.S.C. 1271-1279b) is further amended by adding at the end thereof a new section 1110 to read as follows:

"SEC. 1110. (a) Pursuant to the authority granted under section 1103(a) of this title, the Secretary of Commerce, upon such terms as he shall prescribe, may guarantee or make a commitment to guarantee, payment of the principal of and interest on an obligation which aids in financing, including reimbursement of an obligor for expenditures previously made for, construction, reconstruction, or reconditioning of a commercial demonstration ocean thermal energy conversion facility or plant-ship owned by citizens of the United States. Guarantees or commitments to guarantee under this subsection shall be subject to all the provisos, requirements, regulations, and procedures which apply to guarantees or commitments to guarantee made pursuant to section 1104(a)(1) of this title, except that—

"(1) no guarantees or commitments to guarantee may be made by the Secretary of Commerce under this subsection before October 1, 1981;

"(2) the provisions of subsection (d) of section 1104 of this title shall apply to guarantees or commitments to guarantee for that portion of a commercial demonstration ocean thermal energy conversion facility or plantship not to be supported with appropriated Federal funds;

"(3) guarantees or commitments to guarantee made pursuant to this section may be in an aggregate principal amount which does not exceed 87½ percent of the actual cost or depreciated actual cost of the commercial demonstration ocean thermal energy conversion facility or plantship: *Provided,* That, if the commercial demonstration ocean thermal energy conversion facility or plantship is supported with appropriated Federal funds, such guarantees or commitments to guarantee may not exceed 87½ percent of the aggregate principal amount of that portion of the actual cost or depreciated actual cost for which the obligor has an obligation to secure financing in accordance with the terms of the agreement between the obligor and the Department of Energy or other Federal agency; and

"(4) the provisions of this section may be used to guarantee obligations for a total of not more than 5 separate commercial demonstration ocean thermal energy conversion facilities and plantships or a demonstrated 400 megawatt capacity, whichever comes first.

* * * * *

"(e) The interest on any obligation guaranteed under this section shall be included in gross income for purposes of chapter 1 of the Internal Revenue Code of 1954.".

* * * * *

Approved August 3, 1980.

House of Representatives Report No. 96-994 2d Session

[Bracketed numerals indicate official report page numbers]

OCEAN THERMAL ENERGY CONVERSION ACT OF 1980

Mr. MURPHY of New York, from the Committee on Merchant Marine and Fisheries, submitted the following report to accompany H.R. 6154.[1]

* * * * *

The Committee on Merchant Marine and Fisheries, to whom was referred the bill (H.R. 6154) to regulate commerce, promote energy self-sufficiency, and protect the environment, by establishing procedures for the location, construction, and operation of ocean thermal energy conversion facilities and plantships to produce electricity and energy-intensive products off the coast of the United States; to amend the Merchant Marine Act, 1936, to make available certain financial assistance for construction and operation of such facilities and plantships; and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

* * * * *

[38] SECTION-BY SECTION ANALYSIS

* * * * *

[1] Public Law 96-320, page 433.

[39] *Section 3. Definitions*

Unless the context requires otherwise—

* * * * *

[40] (11) "Ocean thermal energy facility," or OTEC facility, means any facility which is standing or moored in or beyond the territorial sea of the United States and which is designed to use temperature differences in ocean water to produce electricity or another form of energy capable of being used directly to perform work, and includes any equipment installed on such facility to use such electricity or other form of energy to produce, process, refine, or manufacture a product, and any cable or pipeline used to deliver fresh water or such electricity or product to shore, and all other associated equipment and appurtenances of such facility, to the extent they are located seaward of the highwater mark. The Committee intends that the waters of the Atlantic, Pacific, and Arctic Oceans, the Gulf of Mexico, and the Great Lakes be considered as ocean waters for the purposes of this definition. The definition is intended to include all types of OTEC cycles. If an OTEC facility is built on land with warm and cold water pipes extending out into the ocean, the definition includes that portion of the warm and cold water pipes, and any other parts of the facility, located seaward of the highwater mark.

(12) "Ocean thermal energy conversion plantship", or OTEC plantship, means any vessel which is designed to use temperature differences in ocean water, while floating unmoored or moving through such water, to produce electricity or another form of energy capable of being used directly to perform work, and includes any equipment installed on such vessel to use such electricity or other form of energy to produce, process, refine, or manufacture a product, and any equipment used to transfer such product to other vessels for transportation to users, and all other associated equipment and appurtenances of such vessel. The Commitee intends that the waters of the Great Lakes and all Oceans, Gulfs, and other bodies of water at least part of which are included within the definition of "high seas" be considered as ocean waters for the purposes of this definition. The definition is intended to include all types of OTEC cycles, and all types of OTEC vessels, whether mobile or dynamically positioned.

* * * * *

[50] TITLE II—MARITIME FINANCING FOR OCEAN THERMAL ENERGY CONVERSION FACILITIES AND PLANTSHIPS

Section 201. Determinations under Merchant Marine Act, 1936

Subsection (a) states that for the purposes of section 607 of the Merchant Marine Act, 1936, any OTEC facility or plantship licensed under this Act, and any vessel providing shipping services to or from such an OTEC facility or plantship, is deemed to be a vessel operated [51] in the foreign commerce of the United States. This interpretation of section 607 will apply for taxable years beginning after December 31, 1981. The substantive effect of this statement in the bill is to clarify that OTEC facilities and plantships, and vessels serving them, are eligible to use the capital construction fund provisions of the 1936 Act.

Subsection (b) states that for the purposes of the Merchant Marine Act, 1936, any vessel documented under the laws of the United States and used in providing shipping service to or from an OTEC facility or plantship licensed under this Act shall be deemed to be used in, and used in an essential service in, the foreign commerce or foreign trade of the United States, as defined in section 905(a) of the 1936 Act. The substantive effect of this statement in the bill is to clarify that vessels serving OTEC facilities and plantships are eligible for the same financing and financial assistance programs (including construction differential subsidy and operating differential subsidy) which apply to vessels carrying cargo between United States and foreign ports under the provisions of the 1936 Act, if they meet the specific requirements for receipt of such assistance.

* * * * *

Section 203. OTEC Demonstration Fund

This section amends Title XI of the Merchant Marine Act, 1936, to set up a special subfund within the Federal Ship Financing Fund to apply to mortgage obligation guarantees for pilot or demonstration OTEC facilities and plantships which would not satisfy the "economically sound" criterion which is required for the regular Title XI program by section 1104(d). Such pilot or demonstration projects would have to be approved or participated in by the Department of Energy, and the mortgage obligation guarantee could cover no more than 87½ percent of the amount of private capital invested in the project. The limit on all mortgage obligation guarantees for OTEC pilot and demonstration plants is set at $2 billion, and the special provisions of this section could be used for not more than 5 OTEC pilot or demonstration projects. The special subfund would not be set up, and the loan guarantees could not be committed, until October 1, [52] 1981. Bonds or other obligations guaranteed under this section will be subject to regular income tax treatment, and may not be tax exempt.

* * * * *

Public Law 96-330
96th Congress, H.R. 7102 [1]
August 26, 1980

An Act to amend title 38, United States Code, to promote the recruitment and retention of physicians, dentists, nurses, and other health-care personnel in the Department of Medicine and Surgery of the Veterans' Administration, and for other purposes.

Be it enacted by the Senate and

[1] This publication of the law and House Report No. 96-958, page 436, is restricted to excerpts involving tax matters. Senate Report No. 96-747 is not published.

House of Representatives of the United States of America in Congress assembled, That (a) this Act may be cited as the "Veterans' Administration Health-Care Amendments of 1980".

(b) Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of title 38, United States Code.

* * * * *

TITLE II—VETERANS' ADMINISTRATION HEALTH PROFESSIONAL SCHOLARSHIP PROGRAM

ESTABLISHMENT OF HEALTH PROFESSIONAL SCHOLARSHIP PROGRAM

SEC. 201. (a)(1) Chapter 73 is amended by adding at the end thereof the following new subchapter

"SUBCHAPTER IV—VETERANS' ADMINISTRATION HEALTH PROFESSIONAL SCHOLARSHIP PROGRAM

"§ 4141. Establishment of program; purpose; duration

"(a) There is hereby established a program to be known as the Veterans' Administration Health Professional Scholarship Program (hereinafter in this subchapter referred to as the 'Scholarship Program'). The purpose of the Scholarship Program is to assist in providing an adequate supply of trained physicians and nurses for the Veterans' Administration and for the Nation and, if needed by the Veterans' Administration, other health-care professionals appointed under subchapter I of this chapter.

* * * * *

"4145. Exemption of scholarship payments from taxation

"Notwithstanding any other law, any payment to, or on behalf of, a participant in the Scholarship Program for tuition, education expenses, or a stipend under this subchapter shall be exempt from taxation.

* * * * *

IN THE HOUSE OF REPRESENTATIVES, U.S.,

August 26, 1980.

The House of Representatives having proceeded to reconsider the bill (H.R. 7102) entitled "An Act to amend title 38, United States Code, to promote the recruitment and retention of physicians, dentists, nurses, and other health-care personnel in the Department of Medicine and Surgery of the Veterans' Administration, and for other purposes", returned by the President of the United States with his objections, to the House of Representatives, in which it originated, it was

Resolved, That the said bill pass, two-thirds of the House of Representatives agreeing to pass the same.

EDMUND L. HENSHAW, JR.
Clerk.

By Thomas E. Ladd
Assistant to the Clerk.

I certify that this Act originated in the House of Representatives.

EDMUND L. HENSHAW, JR.
Clerk.

By W. Raymond Colley
Deputy Clerk.

IN THE SENATE OF THE UNITED STATES,

August 26 (legislative day, June 12), 1980.

The Senate having proceeded to reconsider the bill (H.R. 7102) entitled "An Act to amend title 38, United States Code, to promote the recruitment and retention of physicians, dentists, nurses, and other health-care personnel in the Department of Medicine and Surgery of the Veterans' Administration, and for other purposes", returned by the President of the United States with his objections, to the House of Representatives, in which it originated, and passed by the House of Representatives on reconsideration of the same, it was

Resolved, That the said bill pass, two-thirds of the Senators present having voted in the affirmative.

Attest:

J. S. KIMMITT
Secretary.

House of Representatives Report No. 96-958 2d Session

[Bracketed numerals indicate official report page numbers]

VETERANS' ADMINISTRATION HEALTH-CARE PERSONNEL ACT OF 1980

MAY 14, 1980.

Mr. ROBERTS, from the Committee on Veterans' Affairs, submitted the following report to accompany H.R. 7102.[1]

* * * * *

TITLE II—VETERANS ADMINISTRATION HEALTH PROFESSIONAL SCHOLARSHIP PROGRAM

Section 201(a) of the bill would amend chapter 73 of title 38 by adding thereto a new subchapter IV. This new subchapter would create the Veterans Administration Health Personnel Scholarship Program.

The first section of the proposed new subchapter (section 4141) would establish the Scholarship Program "to assist in providing an adequate supply of trained health care personnel for the Veterans' Administration and the Nation." The main purpose of the bill would be to enhance the Veterans Administration's ability to recruit and retain physicians, dentists, and certain other health care professionals. An incidental effect of the bill would be to increase the number of health professionals nationwide. Scholarships to new participants in this program would not be furnished after the last day of the tenth fiscal year following the fiscal year in which the program is initiated. The date of initiation of

[1] Public Law 96-330, page 435.

the program would be the date the first scholarship is approved by the Administrator.

* * * * *

Section 4145 of the proposed new subchapter would, notwithstanding any other provision of law, exempt from taxation any payments to, or on behalf of, a participant for tuition, reasonable education expenses, or monthly stipend under the Scholarship Program.

* * * * *

Public Law 96-364
96th Congress, H.R. 3904 [1]
September 26, 1980

An act to amend the Employee Retirement Income Security Act of 1974 [Pub. L. 93-406, 1974-3 C.B. 1] and the Internal Revenue Code of 1954 to improve retirement income security under private multiemployer pension plans by strengthening the funding requirements for those plans, to authorize plan preservation measures for financially troubled multiemployer pension plans, and to revise the manner in which the pension plan termination insurance provisions apply to multiemployer plans, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE

This Act may be cited as the "Multiemployer Pension Plan Amendments Act of 1980".

* * * * *

SEC. 3. FINDINGS AND DECLARATION OF POLICY

(a) The Congress finds that—

(1) multiemployer pension plans have a substantial impact on interstate commerce and are affected with a national public interest;

(2) multiemployer pension plans have accounted for a substantial portion of the increase in private pension plan coverage over the past three decades;

(3) the continued well-being and security of millions of employees, retirees, and their dependents are directly affected by multiemployer pension plans; and

(4)(A) withdrawals of contributing employers from a multiemployer pension plan frequently result in substantially increased funding obligations for employers who continue to contribute to the plan, adversely affecting the plan, its participants and beneficiaries, and labor-management relations, and

(B) in a declining industry, the incidence of employer withdrawals is higher and the adverse effects described in subparagraph (A) are exacerbated.

(b) The Congress further finds that —

(1) it is desirable to modify the current multiemployer plan termination insurance provisions in order to increase the likelihood of protecting plan participants against benefit losses; and

(2) it is desirable to replace the termination insurance program for multiemployer pension plans with an insolvency-based benefit protection program that will enhance the financial soundness of such plans, place primary emphasis on plan continuation, and contain program costs within reasonable limits.

(c) It is hereby declared to be the policy of this Act—

(1) to foster and facilitate interstate commerce,

(2) to alleviate certain problems which tend to discourage the maintenance and growth of multiemployer pension plans,

(3) to provide reasonable protection for the interests of participants and beneficiaries of financially distressed multiemployer pension plans, and

(4) to provide a financially self-sufficient program for the guarantee of employee benefits under multiemployer plans.

* * * * *

TITLE II—AMENDMENTS TO THE INTERNAL REVENUE CODE OF 1954

SEC. 201. AMENDMENT OF THE INTERNAL REVENUE CODE OF 1954

Except as otherwise expressly provided, whenever in this title an amendment is expressed in terms of an amendment to a section or other provision, the reference is to a section or other provision of the Internal Revenue Code of 1954.

SEC. 202. MULTIEMPLOYER PLANS IN REORGANIZATION

(a) GENERAL RULE.—Part I of subchapter D of chapter 1 (relating to pension, profit sharing, stock bonus plans, etc.) is amended by inserting at the end thereof the following new subpart:

"Subpart C—Special Rules for Multiemployer Plans

"Sec. 418. Reorganization status.
"Sec. 418A. Notice of reorganization and funding requirements.
"Sec. 418B. Minimum contribution requirement.
"Sec. 418C. Overburden credit against minimum contribution requirement.
"Sec. 418D. Adjustments in accrued benefits.
"Sec. 418E. Insolvent plans.

"SEC. 418. REORGANIZATION STATUS

"(a) GENERAL RULE.—A multiemployer plan is in reorganization for a plan year if the plan's reorganization index for that year is greater than zero.

"(b) REORGANIZATION INDEX.—For purposes of this subpart—

"(1) IN GENERAL.—A plan's reorganization index for any plan year is the excess of—

"(A) the vested benefits charge for such year, over

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[1] This publication of the law and House Report No. 96-869 Part II, page 451, are restricted to excerpts involving tax matters. House Report No. 96-869 Part I, and Conference Report No. 96-1343 are not published.

"(B) the net charge to the funding standard account for such year.

"(2) NET CHARGE TO FUNDING STANDARD ACCOUNT.—The net charge to the funding standard account for any plan year is the excess (if any) of—

"(A) the charges to the funding standard account for such year under section 412(b)(2), over

"(B) the credits to the funding standard account under section 412(b)(3)(B).

"(3) VESTED BENEFITS CHARGE.—The vested benefits charge for any plan year is the amount which would be necessary to amortize the plan's unfunded vested benefits as of the end of the base plan year in equal annual installments—

"(A) over 10 years, to the extent such benefits are attributable to persons in pay status, and

"(B) over 25 years, to the extent such benefits are attributable to other participants.

"(4) DETERMINATION OF VESTED BENEFITS CHARGE.—

"(A) IN GENERAL.—The vested benefits charge for a plan year shall be based on an actuarial valuation of the plan as at the end of the base plan year, adjusted to reflect—

"(i) any—

"(I) decrease of 5 percent or more in the value of plan assets, or increase of 5 percent or more in the number of persons in pay status, during the period beginning on the first day of the plan year following the base plan year and ending on the adjustment date, or

"(II) at the election of the plan sponsor, actuarial valuation of the plan as of the adjustment date or any later date not later than the last day of the plan year for which the determination is being made,

"(ii) any change in benefits under the plan which is not otherwise taken into account under this subparagraph and which is pursuant to any amendment—

"(I) adopted before the end of the plan year for which the determination is being made, and

"(II) effective after the end of the base plan year and on or before the end of the plan year referred to in subclause (I), and

"(iii) any other event (including an event described in subparagraph (B)(i)(I) which, as determined in accordance with regulations prescribed by the Secretary, would substantially increase the plan's vested benefit charge.

"(B) CERTAIN CHANGES IN BENEFIT LEVELS.—

"(i) IN GENERAL.—In determining the vested benefits charge for a plan year following a plan year in which the plan was not in reorganization, any change in benefits which—

"(I) results from the changing of a group of participants from one benefit level to another benefit level under a schedule of plan benefits as a result of changes in a collective bargaining agreement, or

"(II) results from any other change in a collective bargaining agreement,

shall not be taken into account except to the extent provided in regulations prescribed by the Secretary.

"(ii) PLAN IN REORGANIZATION.—Except as otherwise determined by the Secretary, in determining the vested benefits charge for any plan year following any plan year in which the plan was in reorganization, any change in benefits—

"(I) described in clause (i)(I), or

"(II) described in clause (i)(II)

as determined under regulations prescribed by the Secretary,

shall, for purposes of subparagraph (A)(ii), be treated as a change in benefits pursuant to an amendment to a plan.

"(5) BASE PLAN YEAR.—

"(A) IN GENERAL.—The base plan year for any plan year is—

"(i) if there is a relevant collective bargaining agreement, the last plan year ending at least 6 months before the relevant effective date, or

"(ii) if there is no relevant collective bargaining agreement, the last plan year ending at least 12 months before the beginning of the plan year.

"(B) RELEVANT COLLECTIVE BARGAINING AGREEMENT.—A relevant collective bargaining agreement is a collective bargaining agreement—

"(i) which is in effect for at least 6 months during the plan year, and

"(ii) which has not been in effect for more than 36 months as of the end of the plan year.

"(C) RELEVANT EFFECTIVE DATE.—The relevant effective date is the earliest of the effective dates for the relevant collective bargaining agreements.

"(D) ADJUSTMENT DATE. — The adjustment date is the date which is—

"(i) 90 days before the relevant effective date, or

"(ii) if there is no relevant effective date, 90 days before the beginning of the plan year.

"(6) PERSON IN PAY STATUS.—The term 'person in pay status' means—

"(A) a participant or beneficiary on the last day of the base plan year who, at any time during such year, was paid an early, late, normal, or disability retirement benefit (or a death benefit related to a retirement benefit), and

"(B) to the extent provided in regulations prescribed by the Secretary, any other person who is entitled to such a benefit under the plan.

"(7) OTHER DEFINITIONS AND SPECIAL RULES.—

"(A) UNFUNDED VESTED BENEFITS.—The term 'unfunded vested benefits' means, in connection with a plan, an amount (determined in accordance with regulations prescribed by the Secretary) equal to—

"(i) the value of vested benefits under the plan, less

"(ii) the value of the assets of the plan.

"(B) VESTED BENEFITS.—The term 'vested benefits' means any nonforfeitable benefit (within the meaning of section 4001(a)(8) of the Employee Retirement Income Security Act of 1974).

"(C) ALLOCATION OF ASSETS.—In determining the plan's unfunded vested benefits, plan assets shall first be

allocated to the vested benefits attributable to persons in pay status.

"(D) TREATMENT OF CERTAIN BENEFIT REDUCTIONS.—The vested benefits charge shall be determined without regard to reductions in accrued benefits under section 418D which are first effective in the plan year.

"(E) WITHDRAWAL LIABILITY.—For purposes of this part, any outstanding claim for withdrawal liability shall not be considered a plan asset, except as otherwise provided in regulations prescribed by the Secretary.

"(c) PROHIBITION OF NONANNUITY PAYMENTS.—Except as provided in regulations prescribed by the Pension Benefit Guaranty Corporation, while a plan is in reorganization a benefit with respect to a participant (other than a death benefit) which is attributable to employer contributions and which has a value of more than $1,750 may not be paid in a form other than an annuity which (by itself or in combination with social security, railroad retirement, or workers' compensation benefits) provides substantially level payments over the life of the participant.

"(d) TERMINATED PLANS. — Any multiemployer plan which terminates under section 4041A(a)(2) of the Employee Retirement Income Security Act of 1974 shall not be considered in reorganization after the last day of the plan year in which the plan is treated as having terminated.

"SEC. 418A. NOTICE OF REORGANIZATION AND FUNDING REQUIREMENTS

"(a) NOTICE REQUIREMENT.—

"(1) IN GENERAL.—If—

"(A) a multiemployer plan is in reorganization for a plan year, and

"(B) section 418B would require an increase in contributions for such plan year,

the plan sponsor shall notify the persons described in paragraph (2) that the plan is in reorganization and that, if contributions to the plan are not increased, accrued benefits under the plan may be reduced or an excise tax may be imposed (or both such reduction and imposition may occur).

"(2) PERSONS TO WHOM NOTICE IS TO BE GIVEN.—The persons described in this paragraph are—

"(A) each employer who has an obligation to contribute under the plan (within the meaning of section 4212(a) of the Employee Retirement Income Security Act of 1974), and

"(B) each employee organization which, for purposes of collective bargaining, represents plan participants employed by such an employer.

"(3) OVERBURDEN CREDIT NOT TAKEN INTO ACCOUNT.—The determination under paragraph (1)(B) shall be made without regard to the overburden credit provided by section 418C.

"(b) ADDITIONAL REQUIREMENTS. —The Pension Benefit Guaranty Corporation may prescribe additional or alternative requirements for assuring, in the case of a plan with respect to which notice is required by subsection (a)(1), that the person described in subsection (a)(2)—

"(1) receive appropriate notice that the plan is in reorganization,

"(2) are adequately informed of the implications of reorganization status, and

"(3) have reasonable access to information relevant to the plan's reorganization status.

"SEC. 418B. MINIMUM CONTRIBUTION REQUIREMENT

"(a) ACCUMULATED FUNDING DEFICIENCY IN REORGANIZATION.—

"(1) IN GENERAL.—For any plan year in which a multiemployer plan is in reorganization—

"(A) the plan shall continue to maintain its funding standard account, and

"(B) the plan's accumulated funding deficiency under section 412(a) for such plan year shall be equal to the excess (if any) of—

"(i) the sum of the minimum contribution requirement for such plan year (taking into account any overburden credit under section 418C(a)) plus the plan's accumulated funding deficiency for the preceding plan year (determined under this section if the plan was in reorganization during such plan year or under section 412(a) if the plan was not in reorganization), over

"(ii) amounts considered contributed by employers to or under the plan for the plan year (increased by any amount waived under subsection (f) for the plan year).

"(2) TREATMENT OF WITHDRAWAL LIABILITY PAYMENTS.—For purposes of paragraph (1), withdrawal liability payments (whether or not received) which are due with respect to withdrawals before the end of the base plan year shall be considered amounts contributed by the employer to or under the plan if, as of the adjustment date, it was reasonable for the plan sponsor to anticipate that such payments would be made during the plan year.

"(b) MINIMUM CONTRIBUTION REQUIREMENT.—

"(1) IN GENERAL.—Except as otherwise provided in this section, for purposes of this subpart the minimum contribution requirement for a plan year in which a plan is in reorganization is an amount equal to the excess of—

"(A) the sum of—

"(i) the plan's vested benefits charge for the plan year; and

"(ii) the increase in normal cost for the plan year determined under the entry age normal funding method which is attributable to plan amendments adopted while the plan was in reorganization, over

"(B) the amount of the overburden credit (if any) determined under section 418C for the plan year.

"(2) ADJUSTMENT FOR REDUCTIONS IN CONTRIBUTION BASE UNITS. —If the plan's current contribution base for the plan year is less than the plan's valuation contribution base for the plan year, the minimum contribution requirement for such plan year shall be equal to the product of the amount determined under paragraph

(1) (after any adjustment required by this subpart other than this paragraph) multiplied by a fraction—

"(A) the numerator of which is the plan's current contribution base for the plan year, and

"(B) the denominator of which is the plan's valuation contribution base for the plan year.

"(3) SPECIAL RULE WHERE CASH-FLOW AMOUNT EXCEEDS VESTED BENEFITS CHARGE.—

"(A) IN GENERAL.—If the vested benefits charge for a plan year of a plan in reorganization is less than the plan's cash-flow amount for the plan year, the plan's minimum contribution requirement for the plan year is the amount determined under paragraph (1) determined before the application of paragraph (2)) after substituting the term 'cash-flow amount' for the term 'vested benefits charge' in paragraph (1)(A).

"(B) CASH-FLOW AMOUNT.—For purposes of subparagraph (A), a plan's cash-flow amount for a plan year is an amount equal to—

"(i) the amount of the benefits payable under the plan for the base plan year, plus the amount of the plan's administrative expenses for the base plan year, reduced by

"(ii) the value of the available plan assets for the base plan year determined under regulations prescribed by the Secretary,

adjusted in a manner consistent with section 418(b)(4).

"(c) CURRENT CONTRIBUTION BASE; VALUATION CONTRIBUTION BASE.—

"(1) CURRENT CONTRIBUTION BASE.—For purposes of this subpart, a plan's current contribution base for a plan year is the number of contribution base units with respect to which contributions are required to be made under the plan for that plan year, determined in accordance with regulations prescribed by the Secretary.

"(2) VALUATION CONTRIBUTION BASE.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), for purposes of this subpart a plan's valuation contribution base is the number of contribution base units for which contributions were received for the base plan year—

"(i) adjusted to reflect declines in the contribution base which have occurred (or could reasonably be anticipated) as of the adjustment date for the plan year referred to in paragraph (1),

"(ii) adjusted upward (in accordance with regulations prescribed by the Secretary) for any contribution base reduction in the base plan year caused by a strike or lockout or by unusual events, such as fire, earthquake, or severe weather conditions, and

"(iii) adjusted (in accordance with regulations prescribed by the Secretary) for reductions in the contribution base resulting from transfers of liabilities.

"(B) INSOLVENT PLANS.—For any plan year—

"(i) in which the plan is insolvent (within the meaning of section 418 E(b)(1)), and

"(ii) beginning with the first plan year beginning after the expiration of all relevant collective bargaining agreements which were in effect in the plan year in which the plan became insolvent,

the plan's valuation contribution base is the greater of the number of contribution base units for which contributions were received for the first or second plan year preceding the first plan year in which the plan is insolvent, adjusted as provided in clause (ii) or (iii) of subparagraph (A).

"(3) CONTRIBUTION BASE UNIT.—For purposes of this subpart, the term 'contribution base unit' means a unit with respect to which an employer has an obligation to contribute under a multiemployer plan (as defined in regulations prescribed by the Secretary).

"(d) LIMITATION ON REQUIRED INCREASES IN RATE OF EMPLOYER CONTRIBUTIONS.—

"(1) IN GENERAL.—Under regulations prescribed by the Secretary, the minimum contribution requirement applicable to any plan for any plan year which is determined under subsection (b) (without regard to subsection (b)(2)) shall not exceed an amount which is equal to the sum of—

"(A) the greater of—

"(i) the funding standard requirement for such plan year, or

"(ii) 107 percent of—

"(I) if the plan was not in reorganization in the preceding plan year, the funding standard requirement for such preceding plan year, or

"(II) if the plan was in reorganization in the preceding plan year, the sum of the amount determined under this subparagraph for the preceding plan year and the amount (if any) determined under subparagraph (B) for the preceding plan year, plus

"(B) if for the plan year a change in benefits is first required to be considered in computing the charges under section 412(b)(2)(A) or (B), the sum of—

"(i) the increase in normal cost for a plan year determined under the entry age normal funding method due to increases in benefits described in section 418(b)(4)(A)(ii) (determined without regard to section 418 (b)(4)(B)(ii)), and

"(ii) the amount necessary to amortize in equal annual installments the increase in the value of vested benefits under the plan due to increases in benefits described in clause (i) over—

"(I) 10 years, to the extent such increase in value is attributable to persons in pay status, or

"(II) 25 years, to the extent such increase in value is attributable to other participants.

"(2) FUNDING STANDARD REQUIREMENT.—For purposes of paragraph (1), the funding standard requirement for any plan year is an amount equal to the net charge to the funding standard account for such plan year (as defined in section 418(b)(2)).

"(3) SPECIAL RULE FOR CERTAIN PLANS.—

"(A) IN GENERAL.—In the case of a plan described in section 4216(b) of the Employee Retirement Income Security Act of 1974, if a plan amendment which increases benefits is adopted after January 1, 1980—

"(i) paragraph (1) shall apply only if the plan is a plan described in subparagraph (B), and

"(ii) the amount under paragraph (1) shall be determined without regard to subparagraph (1)(B).

"(B) ELIGIBLE PLANS.—A plan is described in this subparagraph if—

"(i) the rate of employer contributions under the plan for the first plan year beginning on or after the date on which an amendment increasing benefits is adopted, multiplied by the valuation contribution base for that plan year, equals or exceeds the sum of—

"(I) the amount that would be necessary to amortize fully, in equal annual installments, by July 1, 1986, the unfunded vested benefits attributable to plan provisions in effect on July 1, 1977 (determined as of the last day of the base plan year); and

"(II) the amount that would be necessary to amortize fully, in equal annual installments, over the period described in subparagraph (C), beginning with the first day of the first plan year beginning on or after the date on which the amendment is adopted, the unfunded vested benefits (determined as of the last day of the base plan year) attributable to each plan amendment after July 1, 1977; and

"(ii) the rate of employer contributions for each subsequent plan year is not less than the lesser of—

"(I) the rate which when multiplied by the valuation contribution base for that subsequent plan year produces the annual amount that would be necessary to complete the amortization schedule described in clause (i), or

"(II) the rate for the plan year immediately preceding such subsequent plan year, plus 5 percent of such rate.

"(C) PERIOD.—The period determined under this subparagraph is the lesser of—

"(i) 12 years, or

"(ii) a period equal in length to the average of the remaining expected lives of all persons receiving benefits under the plan.

"(4) EXCEPTION IN CASE OF CERTAIN BENEFIT INCREASES.—Paragraph (1) shall not apply with respect to a plan, other than a plan described in paragraph (3), for the period of consecutive plan years in each of which the plan is in reorganization, beginning with a plan year in which occurs the earlier of the date of the adoption or the effective date of any amendment of the plan which increases benefits with respect to service performed before the plan year in which the adoption of the amendment occurred.

"(e) CERTAIN RETROACTIVE PLAN AMENDMENTS.—In determining the minimum contribution requirement with respect to a plan for a plan year under subsection (b), the vested benefits charge may be adjusted to reflect a plan amendment reducing benefits under section 412(c)(8).

"(f) WAIVER OF ACCUMULATED FUNDING DEFICIENCY.—

"(1) IN GENERAL.—The Secretary may waive any accumulated funding deficiency under this section in accordance with the provisions of section 412(d)(1).

"(2) TREATMENT OF WAIVER.—Any waiver under paragraph (1) shall not be treated as a waiver funding deficiency (within the meaning of section 412(d)(3)).

"(g) ACTUARIAL ASSUMPTIONS MUST BE REASONABLE.—For purposes of making any determination under this subpart, the requirements of section 412(c)(3) shall apply.

"SEC. 418C. OVERBURDEN CREDIT AGAINST MINIMUM CONTRIBUTION REQUIREMENT

"(a) GENERAL RULE.—For purposes of determining the contribution under section 418B (before the application of section 418B(b)(2) or (d)), the plan sponsor of a plan which is overburdened for the plan year shall apply an overburden credit against the plan's minimum contribution requirement for the plan year (determined without regard to section 418B(b)(2) or (d) and without regard to this section).

"(b) DEFINITION OF OVERBURDENED PLAN.—A plan is overburdened for a plan year if—

"(1) the average number of pay status participants under the plan in the base plan year exceeds the average of the number of active participants in the base plan year and the 2 plan years preceding the base plan year, and

"(2) the rate of employer contributions under the plan equals or exceeds the greater of—

"(A) such rate for the preceding plan year, or

"(B) such rate for the plan year preceding the first year in which the plan is in reorganization.

"(c) AMOUNT OF OVERBURDEN CREDIT.—The amount of the overburden credit for a plan year is the product of—

"(1) one-half of the average guaranteed benefit paid for the base plan year, and

"(2) the overburden factor for the plan year.

The amount of the overburden credit for a plan year shall not exceed the amount of the minimum contribution requirement for such year (determined without regard to this section).

"(d) OVERBURDEN FACTOR.—For purposes of this section, the overburden factor of a plan for the plan year is an amount equal to—

"(1) the average number of pay status participants for the base plan year, reduced by

"(2) the average of the number of active participants for the base plan year and for each of the 2 plan years preceding the base plan year.

"(e) DEFINITIONS.—For purposes of this section—

"(1) PAY STATUS PARTICIPANT.—The term 'pay status participant' means, with respect to a plan, a participant receiving retirement benefits under the plan.

"(2) NUMBER OF ACTIVE PARTICIPANTS.—The number of active participants for a plan year shall be the sum of—

"(A) the number of active employees who are participants in the plan and on whose behalf contributions are required to be made during the plan year;

"(B) the number of active employees who are not participants in the plan but who are in an employment unit covered by a collective bargaining agreement which requires the employees' employer to contribute to the plan unless service in such employment unit was never covered under the plan or a predecessor thereof, and

"(C) the total number of active employees attributed to employers who made payments to the plan for the plan year of withdrawal liability pursuant to part 1 of subtitle E of title IV of the Employee Retirement Income Security Act of 1974, determined by dividing—

"(i) the total amount of such payments, by

"(ii) the amount equal to the total contributions received by the plan during the plan year divided by the average number of active employees who were participants in the plan during the plan year.

The Secretary shall by regulations provide alternative methods of determining active participants where (by reason of irregular employment, contributions on a unit basis, or otherwise) this paragraph does not yield a representative basis for determining the credit.

"(3) AVERAGE NUMBER.—The term 'average number' means, with respect to pay status participants for a plan year, a number equal to one-half the sum of—

"(A) the number with respect to the plan as of the beginning of the plan year, and

"(B) the number with respect to the plan as of the end of the plan year.

"(4) AVERAGE GUARANTEED BENEFIT.—The average guaranteed benefit paid is 12 times the average monthly pension payment guaranteed under section 4022A(c)(1) of the Employee Retirement Income Security Act of 1974 determined under the provisions of the plan in effect at the beginning of the first plan year in which the plan is in reorganization and without regard to section 4022A(c)(2).

"(5) FIRST YEAR IN REORGANIZATION.—The first year in which the plan is in reorganization is the first of a period of 1 or more consecutive plan years in which the plan has been in reorganization not taking into account any plan years the plan was in reorganization prior to any period of 3 or more consecutive plan years in which the plan was not in reorganization.

"(f) NO OVERBURDEN CREDIT IN CASE OF CERTAIN REDUCTIONS IN CONTRIBUTIONS.—

"(1) IN GENERAL.—Notwithstanding any other provision of this section, a plan is not eligible for an overburden credit for a plan year if the Secretary finds that the plan's current contribution base for any plan year was reduced, without a corresponding reduction in the plan's unfunded vested benefits attributable to pay status participants, as a result of a change in an agreement providing for employer contributions under the plan.

"(2) TREATMENT OF CERTAIN WITHDRAWALS.—For purposes of paragraph (1), a complete or partial withdrawal of an employer (within the meaning of part 1 of subtitle E of title IV of the Employee Retirement Income Security Act of 1974) does not impair a plan's eligibility for an overburden credit, unless the Secretary finds that a contribution base reduction described in paragraph (1) resulted from a transfer of liabilities to another plan in connection with the withdrawal.

"(g) MERGERS.—Notwithstanding any other provision of this section, if 2 or more multiemployer plans merge, the amount of the overburden credit which may be applied under this section with respect to the plan resulting from the merger for any of the 3 plan years ending after the effective date of the merger shall not exceed the sum of the used overburden credit for each of the merging plans for its last plan year ending before the effective date of the merger. For purposes of the preceding sentence, the used overburden credit is that portion of the credit which does not exceed the excess of the minimum contribution requirement determined without regard to any overburden credit under this section over the employer contributions required under the plan.

"SEC. 418D ADJUSTMENTS IN ACCRUED BENEFITS.

"(a) ADJUSTMENTS IN ACCRUED BENEFITS.—

"(1) IN GENERAL.—Notwithstanding section 411, a multiemployer plan in reorganization may be amended, in accordance with this section, to reduce or eliminate accrued benefits attributable to employer contributions which, under section 4022A(b) of the Employee Retirement Income Security Act of 1974, are not eligible for the Pension Benefit Guaranty Corporation's guarantee. The preceding sentence shall only apply to accrued benefits under plan amendments (or plans) adopted after March 26, 1980, or under collective bargaining agreement entered into after March 26, 1980.

"(2) ADJUSTMENT OF VESTED BENEFITS CHARGE.—In determining the minimum contribution requirement with respect to a plan for a plan year under section 418B(b), the vested benefits charge may be adjusted to reflect a plan amendment reducing benefits under this section or section 412(c)(8), but only if the amendment is adopted and effective no later than 2½ months after the end of the plan year, or within such extended period as the Secretary may prescribe by regulations under section 412(c)(10).

"(b) LIMITATION ON REDUCTION.—

"(1) IN GENERAL.—Accrued benefits may not be reduced under this section unless—

"(A) notice has been given, at least 6 months before the first day of the plan year in which the amendment reducing benefits is adopted, to—

"(i) plan participants and beneficiaries,

"(ii) each employer who has an obligation to contribute (within the meaning of section 4212(a) of the Employee Retirement Income Security Act of 1974) under the plan, and

"(iii) each employee organization which, for purposes of collective bargaining, represents plan participants employed by such an employer,

that the plan is in reorganization and that, if contributions under the plan are not increased, accrued benefits under the plan will be reduced or an excise tax will be imposed on employers;

"(B) in accordance with regulations prescribed by the Secretary—

"(i) any category of accrued benefits is not reduced with respect to inactive participants to a greater extent proportionally that such category of accrued benefits is reduced with respect to active participants,

"(ii) benefits attributable to employer contributions other than accrued benefits and the rate of future benefit accruals are reduced at least to an extent equal to the reduction in accrued benefits of inactive participants, and

"(iii) in any case in which the accrued benefit of a participant or beneficiary is reduced by changing the benefit form or the requirements which the participant or beneficiary must satisfy to be entitled to the benefit, such reduction is not applicable to—

"(I) any participant or beneficiary in pay status on the effective date of the amendment, or the beneficiary of such a participant, or

"(II) any participant who has attained normal retirement age, or who is within 5 years of attaining normal retirement age, on the effective date of the amendment, or the beneficiary of any such participant; and

"(C) the rate of employer contributions for the plan year in which the amendment becomes effective and for all succeeding plan years in which the plan is in reorganization equals or exceeds the greater of—

"(i) the rate of employer contributions, calculated without regard to the amendment, for the plan year in which the amendment becomes effective, or

"(ii) the rate of employer contributions for the plan year preceding the plan year in which the amendment becomes effective.

"(2) INFORMATION REQUIRED TO BE INCLUDED IN NOTICE.—The plan sponsors shall include in any notice required to be sent to plan participants and beneficiaries under paragraph (1) information as to the rights and remedies of plan participants and beneficiaries as well as how to contact the Department of Labor for further information and assistance where appropriate.

"(c) NO RECOUPMENT.—A plan may not recoup a benefit payment which is in excess of the amount payable under the plan because of an amendment retroactively reducing accrued benefits under this section.

"(d) BENEFIT INCREASES UNDER MULTIEMPLOYER PLAN IN REORGANIZATION.—

"(1) RESTORATION OF PREVIOUSLY REDUCED BENEFITS.—

"(A) IN GENERAL.—A plan which has been amended to reduce accrued benefits under this section may be amended to increase or restore accrued benefits, or the rate of future benefit accruals, only if the plan is amended to restore levels of previously reduced accrued benefits of inactive participants and of participants who are within 5 years of attaining normal retirement age to at least the same extent as any such increase in accrued benefits or in the rate of future benefit accruals.

"(B) BENEFIT INCREASES AND BENEFIT RESTORATIONS.—For purposes of this subsection, in the case of a plan which has been amended under this section to reduce accrued benefits—

"(i) an increase in a benefit, or in the rate of future benefit accruals, shall be considered a benefit increase to the extent that the benefit, or the accrual rate, is thereby increased above the highest benefit level, or accrual rate, which was in effect under the terms of the plan before the effective date of the amendment reducing accrued benefits, and

"(ii) an increase in a benefit, or in the rate of future benefit accruals, shall be considered a benefit restoration to the extent that the benefit, or the accrual rate, is not thereby increased above the highest benefit level, or accrual rate, which was in effect under the terms of the plan immediately before the effective date of the amendment reducing accrued benefits.

"(2) UNIFORMITY IN BENEFIT RESTORATION.—If a plan is amended to partially restore previously reduced accrued benefit levels, or the rate of future benefit accruals, the benefits of inactive participants shall be restored in at least the same proportions as other accrued benefits which are restored.

"(3) NO BENEFIT INCREASES IN YEAR OF BENEFIT REDUCTION.—No benefit increase under a plan may take effect in a plan year in which an amendment reducing accrued benefits under the plan, in accordance with this section, is adopted or first becomes effective.

"(4) RETROACTIVE PAYMENTS.—A plan is not required to make retroactive benefit payments with respect to that portion of an accrued benefit which was reduced and subsequently restored under this section.

"(e) INACTIVE PARTICIPANT.—For purposes of this section, the term 'inactive participant' means a person not in covered service under the plan who is in pay status under the plan or who has a nonforfeitable benefit under the plan.

"(f) REGULATIONS.—The Secretary may prescribe rules under which, notwithstanding any other provision of this section, accrued benefit reductions or benefit increases for different participant groups may be varied equitably to reflect variations in contribution rates and other relevant factors reflecting differences in negotiated levels of financial support for plan benefit obligations.

"SEC. 418E. INSOLVENT PLANS.

"(a) SUSPENSION OF CERTAIN BEN-

EFIT PAYMENTS. — Notwithstanding section 411, in any case in which benefit payments under an insolvent multiemployer plan exceed the resource benefit level, any such payments of benefits which are not basic benefits shall be suspended, in accordance with this section, to the extent necessary to reduce the sum of such payments and the payments of such basic benefits to the greater of the resource benefit level or the level of basic benefits, unless an alternative procedure is prescribed by the Pension Benefit Guaranty Corporation under section 4022A(g)(5) of the Employee Retirement Income Security Act of 1974.

"(b) DEFINITIONS.—For purposes of this section, for a plan year—

"(1) INSOLVENCY. — A multiemployer plan is insolvent if the plan's available resources are not sufficient to pay benefits under the plan when due for the plan year, or if the plan is determined to be insolvent under subsection (d).

"(2) RESOURCE BENEFIT LEVEL.—The term 'resource benefit level' means the level of monthly benefits determined under subsections (c)(1) and (3) and (d)(3) to be the highest level which can be paid out of the plan's available resources.

"(3) AVAILABLE RESOURCES.—The term 'available resources' means the plan's cash, marketable assets, contributions, withdrawal liability payments, and earnings, less reasonable administrative expenses and amounts owed for such plan year to the Pension Benefit Guaranty Corporation under section 4261(b)(2) of the Employee Retirement Income Security Act of 1974.

"(4) INSOLVENCY YEAR.—The term 'insolvency year' means a plan year in which a plan is insolvent.

"(c) BENEFIT PAYMENTS UNDER INSOLVENT PLANS.—

"(1) DETERMINATION OF RESOURCE BENEFIT LEVEL.—The plan sponsor of a plan in reorganization shall determine in writing the plan's resource benefit level for each insolvency year, based on the plan sponsor's reasonable projection of the plan's available resources and the benefits payable under the plan.

"(2) UNIFORMITY OF THE BENEFIT SUSPENSION.—The suspension of benefit payments under this section shall, in accordance with regulations prescribed by the Secretary, apply in substantially uniform proportions to the benefits of all persons in pay status (within the meaning of section 418(b)(6)) under the plan, except that the Secretary may prescribe rules under which benefit suspensions for different participant groups may be varied equitably to reflect variations in contribution rates and other relevant factors including differences in negotiated levels of financial support for plan benefit obligations.

"(3) RESOURCE BENEFIT LEVEL BELOW LEVEL OF BASIC BENEFITS.—Notwithstanding paragraph (2), if a plan sponsor determines in writing a resource benefit level for a plan year which is below the level of basic benefits, the payment of all benefits other than basic benefits shall be suspended for that plan year.

"(4) EXCESS RESOURCES.—

"(A) IN GENERAL.—If, by the end of an insolvency year, the plan sponsor determines in writing that the plan's available resources in that insolvency year could have supported benefit payments above the resource benefit level for that insolvency year, the plan sponsor shall distribute the excess resources to the participants and beneficiaries who received benefit payments from the plan in that insolvency year, in accordance with regulations prescribed by the Secretary.

"(B) EXCESS RESOURCES.—For purposes of this paragraph, the term 'excess resources' means available resources above the amount necessary to support the resource benefit level, but no greater than the amount necessary to pay benefits for the plan year at the benefit levels under the plan.

"(5) UNPAID BENEFITS.—If, by the end of an insolvency year, any benefit has not been paid at the resource benefit level, amounts up to the resource level which were unpaid shall be distributed to the participants and beneficiaries, in accordance with regulations prescribed by the Secretary, to the extent possible taking into account the plan's total available resources in that insolvency year.

"(6) RETROACTIVE PAYMENTS.—Except as provided in paragraph (4) or (5), a plan is not required to make retroactive benefit payments with respect to that portion of a benefit which was suspended under this section.

"(d) PLAN SPONSOR DETERMINATION.—

"(1) TRIENNIAL TEST.—As of the end of the first plan year in which a plan is in reorganization, and at least every 3 plan years thereafter (unless the plan is no longer in reorganization), the plan sponsor shall compare the value of plan assets (determined in accordance with section 418B(b)(3)(B)(ii)) for that plan year with the total amount of benefit payments made under the plan for that plan year. Unless the plan sponsor determines that the value of plan assets exceeds 3 times the total amount of benefit payments, the plan sponsor shall determine whether the plan will be insolvent in any of the next 3 plan years.

"(2) DETERMINATION OF INSOLVENCY.—If, at any time, the plan sponsor of a plan in reorganization reasonably determines, taking into account the plan's recent and anticipated financial experience, that the plan's available resources are not sufficient to pay benefits under the plan when due for the next plan year, the plan sponsor shall make such determination available to interested parties.

"(3) DETERMINATION OF RESOURCE BENEFIT LEVEL.—The plan sponsor of a plan in reorganization shall determine in writing for each insolvency year the resource benefit level and the level of basic benefits no later than 3 months before the insolvency year.

"(e) NOTICE REQUIREMENTS.—

"(1) IMPENDING INSOLVENCY.—If the plan sponsor of a plan in reorganization determines under subsection (d)(1) or (2) that the plan may become insolvent (within the meaning of

subsection (b)(1)), the plan sponsor shall—

"(A) notify the Secretary, the Pension Benefit Guaranty Corporation, the parties described in section 418A(a)(2), and the plan participants and beneficiaries of that determination, and

"(B) inform the parties described in section 418A(a)(2) and the plan participants and beneficiaries that if insolvency occurs certain benefit payments will be suspended, but that basic benefits will continue to be paid.

"(2) RESOURCE BENEFIT LEVEL.—No later than 2 months before the first day of each insolvency year, the plan sponsor of a plan in reorganization shall notify the Secretary, the Pension Benefit Guaranty Corporation, the parties described in section 418A(a)(2), and the plan participants and beneficiaries of the resource benefit level determined in writing for that insolvency year.

"(4) POTENTIAL NEED FOR FINANCIAL ASSISTANCE.—In any case in which the plan sponsor anticipates that the resource benefit level for an insolvency year may not exceed the level of basic benefits, the plan sponsor shall notify the Pension Benefit Guaranty Corporation.

"(4) REGULATIONS. — Notice required by this subsection shall be given in accordance with regulations prescribed by the Pension Benefit Guaranty Corporation, except that notice to the Secretary shall be given in accordance with regulations prescribed by the Secretary.

"(5) CORPORATION MAY PRESCRIBE TIME.—The Pension Benefit Guaranty Corporation may prescribe a time other than the time prescribed by this section for the making of a determination or the filing of a notice under this section.

"(f) FINANCIAL ASSISTANCE.—

"(1) PERMISSIVE APPLICATION.—If the plan sponsor of an insolvent plan for which the resource benefit level is above the level of basic benefits anticipates that, for any month in an insolvency year, the plan will not have funds sufficient to pay basic benefits, the plan sponsor may apply for financial assistance from the Pension Benefit Guaranty Corporation under section 4261 of the Employee Retirement Income Security Act of 1974.

"(2) MANDATORY APPLICATION.—A plan sponsor who has determined a resource benefit level for an insolvency year which is below the level of basic benefits shall apply for financial assistance from the Pension Benefit Guaranty Corporation under section 4261 of the Employee Retirement Income Security Act of 1974.

"(g) FINANCIAL ASSISTANCE.—Any amount of any financial assistance from the Pension Benefit Guaranty Corporation to any plan, and any repayment of such amount, shall be taken into account under this subpart in such manner as determined by the Secretary.".

(b) CLERICAL AMENDMENT.—The table of subparts for part I of subchapter D of chapter 1 is amended by adding at the end thereof the following new subpart:

"Subpart C. Special rules for multiemployer plans.".

SEC. 203. MINIMUM FUNDING REQUIREMENTS

Section 412 (relating to minimum funding standards) is amended—

(1) in subsection (b), by striking out "(40 plan years in the case of a multiemployer plan)" and "(20 plan years in the case of a multiemployer plan)" each place they appear;

(2) by adding at the end of subsection (b) the following new paragraphs:

"(6) CERTAIN AMORTIZATION CHARGES AND CREDITS.—In the case of a plan which, immediately before the date of the enactment of the Multiemployer Pension Plan Amendments Act of 1980, was a multiemployer plan (within the meaning of section 414(f) as in effect immediately before such date)—

"(A) any amount described in paragraph (2)(B)(ii), (2)(B)(iii), or (3)(B)(i) of this subsection which arose in a plan year beginning before such date shall be amortized in equal annual installments (until fully amortized) over 40 plan years, beginning with the plan year in which the amount arose;

"(B) any amount described in paragraph (2)(B)(iv) or (3)(B)(ii) of this subsection which arose in a plan year beginning before such date shall be amortized in equal annual installments (until fully amortized) over 20 plan years, beginning with the plan year in which the amount arose;

"(C) any change in past service liability which arises during the period of 3 plan years beginning on or after such date, and results from a plan amendment adopted before such date, shall be amortized in equal annual installments (until fully amortized) over 40 plan years, beginning with the plan year in which the change arises; and

"(D) any change in past service liability which arises during the period of 2 plan years beginning on or after such date, and results from the changing of a group of participants from one benefit level to another benefit level under a schedule of plan benefits which—

"(i) was adopted before such date, and

"(ii) was effective for any plan participant before the beginning of the first plan year beginning on or after such date,

shall be amortized in equal annual installments (until fully amortized) over 40 plan years, beginning with the plan year in which the change arises.

"(7) SPECIAL RULES FOR MULTIEMPLOYER PLANS.—For purposes of this section—

"(A) WITHDRAWAL LIABILITY. — Any amount received by a multiemployer plan in payment of all or part of an employer's withdrawal liability under part 1 of subtitle E of title IV of the Employee Retirement Income Security Act of 1974 shall be considered an amount contributed by the employer to or under the plan. The Secretary may prescribe by regulation additional charges and credits to a multiemployer plan's funding standard account to the extent necessary to prevent withdrawal liability payments

from being unduly reflected as advance funding for plan liabilities.

"(B) ADJUSTMENTS WHEN A MULTIEMPLOYER PLAN LEAVES REORGANIZATION.—If a multiemployer plan is not in reorganization in the plan year but was in reorganization in the immediately preceding plan year, any balance in the funding standard account at the close of such immediately preceding plan year—

"(i) shall be eliminated by an offsetting credit or charge (as the case may be), but

"(ii) shall be taken into account in subsequent plan years by being amortized in equal annual installments (until fully amortized) over 30 plan years.

The preceding sentence shall not apply to the extent of any accumulated funding deficiency under section 418B(a) as of the end of the last plan year that the plan was in reorganization.

"(C) PLAN PAYMENTS TO SUPPLEMENTAL PROGRAM OR WITHDRAWAL LIABILITY PAYMENT FUND.—Any amount paid by a plan during a plan year to the Pension Benefit Guaranty Corporation pursuant to section 4222 of such Act or to a fund exempt under section 501(c)(22) pursuant to section 4223 of such Act shall reduce the amount of contributions considered received by the plan for the plan year.

"(D) INTERIM WITHDRAWAL LIABILITY PAYMENTS.—Any amount paid by an employer pending a final determination of the employer's withdrawal liability under part 1 of subtitle E of title IV of such Act and subsequently refunded to the employer by the plan shall be charged to the funding standard account in accordance with regulations prescribed by the Secretary.

"(E) For purposes of the full funding limitation under subsection (c)(7), unless otherwise provided by the plan, the accrued liability under a multiemployer plan shall not include benefits which are not nonforfeitable under the plan after the termination of the plan (taking into consideration section 411(d)(3))."; and

(3) by adding at the end thereof the following new subsection:

"(j) CERTAIN TERMINATED MULTIEMPLOYER PLANS.—This section applies with respect to a terminated multiemployer plan to which section 4021 of the Employee Retirement Income Security Act of 1974 applies, until the last day of the plan year in which the plan terminates, within the meaning of section 4041A(a)(2) of that Act.

"(k) FINANCIAL ASSISTANCE.—Any amount of any financial assistance from the Pension Benefit Guaranty Corporation to any plan, and any repayment of such amount, shall be taken into account under this section in such manner as determined by the Secretary.".

SEC. 204. EXCISE TAXES

Section 4971 (relating to taxes on failure to meet minimum funding standard) is amended—

(1) by striking out "last sentence" in subsection (c) and inserting in lieu thereof "last two sentences"; and

(2) by adding at the end of subsection (d) the following new sentence: "In the case of a multiemployer plan which is in reorganization under section 418, the same notice and opportunity shall be provided to the Pension Benefit Guaranty Corporation.".

SEC. 205. DEDUCTIBILITY OF EMPLOYER LIABILITY PAYMENTS

Subsection (g) of section 404 (relating to certain employer liability payments considered as contributions) is amended to read as follows:

"(g) CERTAIN EMPLOYER LIABILITY PAYMENTS CONSIDERED AS CONTRIBUTIONS.—

"(1) IN GENERAL.—For purposes of this section, any amount paid by an employer under section 4062, 4063, or 4064, or part 1 of subtitle E of title IV of the Employee Retirement Income Security Act of 1974 shall be treated as a contribution to which this section applies by such employer to or under a stock bonus, pension, profit-sharing, or annuity plan.

"(2) CONTROLLED GROUP DEDUCTIONS.—In the case of a payment described in paragraph (1) made by an entity which is liable because it is a member of a commonly controlled group of corporations, trades, or businesses, within the meaning of subsection (b) or (c) of section 414, the fact that the entity did not directly employ participants of the plan with respect to which the liability payment was made shall not affect the deductibility of a payment which otherwise satisfies the conditions of section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income).

"(3) COORDINATION WITH SUBSECTION (a).—Any payment described in paragraph (1) shall (subject to the last sentence of subsection (a)(1)(A)) be deductible under this section when paid.".

SEC. 206. MINIMUM VESTING REQUIREMENTS

Section 411 (relating to minimum vesting standards) is amended—

(1) by adding at the end of subsection (a)(3) the following new subparagraphs:

"(E) CESSATION OF CONTRIBUTIONS UNDER A MULTIEMPLOYER PLAN.—A right to an accrued benefit derived from employer contributions under a multiemployer plan shall not be treated as forfeitable solely because the plan provides that benefits accrued as a result of service with the participant's employer before the employer had an obligation to contribute under the plan may not be payable if the employer ceases contributions to the multiemployer plan.

"(F) REDUCTION AND SUSPENSION OF BENEFITS BY A MULTIEMPLOYER PLAN.—A participant's right to an accrued benefit derived from employer contributions under a multiemployer plan shall not be treated as forfeitable solely because—

"(i) the plan is amended to reduce benefits under section 418D or under section 4281 of the Employee Retirement Income Security Act of 1974, or

"(ii) benefit payments under the plan may be suspended under section 418E or under section 4281 of the Em-

ployee Retirement Income Security Act of 1974.";

(2) in subsection (a)(4)(E), by striking out "and";

(3) in subsection (a)(4)(F), by striking out the period and inserting in lieu thereof "; and";

(4) by adding at the end of subsection (a)(4) the following new subparagraph:

"(G) in the case of a multiemployer plan, years of service—

"(i) with an employer after—

"(I) a complete withdrawal of that employer from the plan (within the meaning of section 4203 of the Employee Retirement Income Security Act of 1974), or

"(II) to the extent permitted in regulations prescribed by the Secretary, a partial withdrawal described in section 4205(b)(2)(A)(i) of such Act in conjunction with the decertification of the collective bargaining representative, and

"(ii) with any employer under the plan after the termination date of the plan under section 4048 of such Act."; and

(5) in subsection (d)(6), by striking out "section 412(c)(8)" and inserting in lieu thereof "section 412(c)(8), or section 4281 of the Employee Retirement Income Security Act of 1974".

SEC. 207. DEFINITION OF MULTIEMPLOYER PLAN

(a) Section 414 (relating to definitions and special rules) is amended by striking out subsection (f) and inserting in lieu thereof the following:

"(f) MULTIEMPLOYER PLAN.—

"(1) DEFINITION.—For purposes of this part, the term 'multiemployer plan' means a plan—

"(A) to which more than one employer is required to contribute,

"(B) which is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer, and

"(C) which satisfies such other requirements as the Secretary of Labor may prescribe by regulation.

"(2) CASES OF COMMON CONTROL.—For purposes of this subsection, all trades or businesses (whether or not incorporated) which are under common control within the meaning of subsection (c) are considered a single employer.

"(3) CONTINUATION OF STATUS AFTER TERMINATION.—Notwithstanding paragraph (1), a plan is a multiemployer plan on and after its termination date under title IV of the Employee Retirement Income Security Act of 1974 if the plan was a multiemployer plan under this subsection for the plan year preceding its termination date.

"(4) TRANSITIONAL RULE.—For any plan year which began before the date of the enactment of the Multiemployer Pension Plan Amendments Act of 1980, the term 'multiemployer plan' means a plan described in this subsection as in effect immediately before that date.

"(5) SPECIAL ELECTION.—Within one year after the date of the enactment of the Multiemployer Pension Plan Amendments Act of 1980, a multiemployer plan may irrevocably elect, pursuant to procedures established by the Pension Benefit Guaranty Corporation and subject to the provisions of section 4403(b) and (c) of the Employee Retirement Income Security Act of 1974, that the plan shall not be treated as a multiemployer plan for any purpose under such Act or this title, if for each of the last 3 plan years ending prior to the effective date of the Multiemployer Pension Plan Amendments Act of 1980—

"(A) the plan was not a multiemployer plan because the plan was not a plan described in section 3(37)(A)(iii) of the Employee Retirement Income Security Act of 1974 and section 414(f)(1)(C) (as such provisions were in effect on the day before the date of the enactment of the Multiemployer Pension Plan Amendments Act of 1980); and

"(B) the plan had been identified as a plan that was not a multiemployer plan in substantially all its filings with the Pension Benefit Guaranty Corporation, the Secretary of Labor and the Secretary.".

SEC. 208. RELATED TECHNICAL AMENDMENTS

(a) Sections 401(a)(12) and 414(l) are each amended by striking out the last sentence and inserting in lieu thereof the following: "The preceding sentence does not apply to any multiemployer plan with respect to any transaction to the extent that participants either before or after the transaction are covered under a multiemployer plan to which title IV of the Employee Retirement Income Security Act of 1974 applies."

(b) Subsection (d) of section 4975 is amended—

(1) by striking out "or" at the end of paragraph (12);

(2) by striking out the period at the end of paragraph (13) and inserting in lieu thereof a semicolon; and

(3) by inserting after paragraph (13) the following new paragraphs:

"(14) any transaction required or permitted under part 1 of subtitle E of title IV or section 4223 of the Employee Retirement Income Security Act of 1974, but this paragraph shall not apply with respect to the application of subsection (c)(1)(E) or (F); or

"(15) a merger of multiemployer plans, or the transfer of assets or liabilities between multiemployer plans, determined by the Pension Benefit Guaranty Corporation to meet the requirements of section 4231 of such Act, but this paragraph shall not apply with respect to the application of subsection (c)(1)(E) or (F).".

(c) Section 412(a) is amended by adding at the end thereof the following new sentence: "In any plan year in which a multiemployer plan is in reorganization, the accumulated funding deficiency of the plan shall be determined under section 418B.".

(d) Section 413(b)(6) is amended by adding at the end thereof the following new sentence: "For purposes of this subsection and the last sentence of section 4971(a), an employer's withdrawal liability under part 1 of

subtitle E of title IV of the Employee Retirement Income Security Act of 1974 shall not be treated as a liability for contributions under the plan.'.

(e) Section 401(a)(2), as amended by section 411(b) of this Act, is amended by inserting ", or the return of any withdrawal liability payment determined to be an overpayment within 6 months of such determination" after "501(a)".

SEC. 209. WITHDRAWAL LIABILITY PAYMENT FUNDS

(a) Subsection (c) of section 501 (relating to list of exempt organizations) is amended by adding at the end thereof the following new paragraph:

"(22) A trust created or organized in the United States and established in writing by the plan sponsors of multiemployer plans if—

"(A) the purpose of such trust is exclusively—

"(i) to pay any amount described in section 4223(c) or (h) of the Employee Retirement Income Security Act of 1974, and

"(ii) to pay reasonable and necessary administrative expenses in connection with the establishment and operation of the trust and the processing of claims against the trust,

"(B) no part of the assets of the trust may be used for, or diverted to, any purpose other than—

"(i) the purposes described in subparagraph (A), or

"(ii) the investment in securities, obligations, or time or demand deposits described in clause (ii) of paragraph (21)(B),

"(C) such trust meets the requirements of paragraphs (2), (3), and (4) of section 4223(b), 4223(h), or, if applicable, section 4223(c) of the Employee Retirement Income Security Act of 1974, and

"(D) the trust instrument provides that, on dissolution of the trust, assets of the trust may not be paid other than to plans which have participated in the plan or, in the case of a trust established under section 4223(h) of such Act, to plans with respect to which employers have participated in the fund.".

(b) Subsection (e) of section 4975 (relating to tax on prohibited transactions) is amended by adding at the end thereof the following new paragraph:

"(9) SECTION MADE APPLICABLE TO WITHDRAWAL LIABILITY PAYMENT FUNDS.—For purposes of this section—

"(A) IN GENERAL. — The term 'plan' includes a trust described in section 501(c)(22).

"(B) DISQUALIFIED PERSON. — In the case of any trust to which this section applies by reason of subparagraph (A), the term 'disqualified person' includes any person who is a disqualified person with respect to any plan to which such trust is permitted to make payments under section 4223 of the Employee Retirement Income Security Act of 1974.".

(c)(1) Part VI of subchapter B of chapter 1 (relating to itemized deductions for individuals and corporations) is amended by adding at the end thereof the following new section:

"SEC. 194. CONTRIBUTIONS TO EMPLOYER LIABILITY TRUSTS

"(a) ALLOWANCE OF DEDUCTION. —There shall be allowed as a deduction for the taxable year an amount equal to the amount—

"(1) which is contributed by an employer to a trust described in section 501(c)(22) (relating to withdrawal liability payment fund) which meets the requirements of section 4223(h) of the Employee Retirement Income Security Act of 1974, and

"(2) which is properly allocable to such taxable year.

"(b) ALLOCATION TO TAXABLE YEAR.—In the case of a contribution described in subsection (a) which relates to any specified period of time which includes more than one taxable year, the amount properly allocable to any taxable year in such period shall be determined by prorating such amounts to such taxable years under regulations prescribed by the Secretary.

"(c) DISALLOWANCE OF DEDUCTION.—No deduction shall be allowed under subsection (a) with respect to any contribution described in subsection (a) which does not relate to any specified period of time.".

(2) The table of sections for such part VI is amended by adding at the end thereof the following new item:

"Sec. 194. Contributions to employer liability trusts.".

SEC. 210. EFFECTIVE DATE

(a) Except as otherwise provided in this section, the amendments made by this title shall take effect on the date of the enactment of this Act.

(b) Subpart C of part I of subchapter D of chapter 1 of such Code (as added by this Act) shall take effect, with respect to each plan, on the first day of the first plan year beginning on or after the earlier of—

(1) the date on which the last collective-bargaining agreement providing for employer contributions under the plan, which was in effect on the date of the enactment of this Act, expires, without regard to extensions agreed to after such date of enactment, or

(2) 3 years after the date of the enactment of this Act.

(c) The amendments made by section 209 shall apply to taxable years ending after the date of the enactment of this Act.

* * * * *

TITLE IV—MISCELLANEOUS PROVISIONS

* * * * *

SEC. 405. ACTION TAKEN BEFORE REGULATIONS ARE PRESCRIBED

(a) Except as otherwise provided in the amendments made by this Act and in subsection (b), if the way in which any such amendment will apply to a particular circumstance is to be set forth in regulations, any reasonable action during the period before such regulations take effect shall be treated as complying with such regulations for such period.

(b) Subsection (a) shall not apply to any action which violates any instruction issued, or temporary rule prescribed, by the agency having jurisdiction but only if such instruction or rule

was published, or furnished to the party taking the action, before such action was taken.

* * * * *

SEC. 407. CHURCH PLANS

* * * * *

(b) Section 414(e) of the Internal Revenue Code of 1954 (defining church plan) is amended to read as follows:

"(e) CHURCH PLAN.—

"(1) IN GENERAL.—For purposes of this part, the term 'church plan' means a plan established and maintained (to the extent required in paragraph (2)(B)) for its employees (or their beneficiaries) by a church or by a convention or association of churches which is exempt from tax under section 501.

"(2) CERTAIN PLANS EXCLUDED.—The term 'church plan' does not include a plan—

"(A) which is established and maintained primarily for the benefit of employees (or their beneficiaries) of such church or convention or association of churches who are employed in connection with one or more unrelated trades or businesses (within the meaning of section 513); or

"(B) if less than substantially all of the individuals included in the plan are individuals described in paragraph (1) or (3)(B) (or their beneficiaries).

"(3) DEFINITIONS AND OTHER PROVISIONS.—For purposes of this subsection—

"(A) TREATMENT AS CHURCH PLAN.—A plan established and maintained for its employees (or their beneficiaries) by a church or by a convention or association of churches includes a plan maintained by an organization, whether a civil law corporation or otherwise, the principal purpose or function of which is the administration or funding of a plan or program for the provision of retirement benefits or welfare benefits, or both, for the employees of a church or a convention or association of churches, if such organization is controlled by or associated with a church or a convention or association of churches.

"(B) EMPLOYEE DEFINED. — The term employee of a church or a convention or association of churches shall include—

"(i) a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry, regardless of the source of his compensation;

"(ii) an employee of an organization, whether a civil law corporation or otherwise, which is exempt from tax under section 501 and which is controlled by or associated with a church or a convention or association of churches; and

"(iii) an individual described in subparagraph (E).

"(C) CHURCH TREATED AS EMPLOYER.—A church or a convention or association of churches which is exempt from tax under section 501 shall be deemed the employer of any individual included as an employee under subparagraph (B).

"(D) ASSOCIATION WITH CHURCH. —An organization, whether a civil law corporation or otherwise, is associated with a church or a convention or association of churches if it shares common religious bonds and convictions with that church or convention or association of churches.

"(E) SPECIAL RULE IN CASE OF SEPARATION FROM PLAN.—If an employee who is included in a church plan separates from the service of a church or a convention or association of churches or an organization described in clause (ii) of paragraph (3)(B), the church plan shall not fail to meet the requirements of this subsection merely because the plan—

"(i) retains the employee's accrued benefit or account for the payment of benefits to the employee or his beneficiaries pursuant to the terms of the plan; or

"(ii) receives contributions on the employee's behalf after the employee's separation from such service, but only for a period of 5 years after such separation, unless the employee is disabled (within the meaning of the disability provisions of the church plan or, if there are no such provisions in the church plan, within the meaning of section 72(m)(7)) at the time of such separation from service.

"(4) CORRECTION OF FAILURE TO MEET CHURCH PLAN REQUIREMENTS.—

"(A) IN GENERAL.—If a plan established and maintained for its employees (or their beneficiaries) by a church or by a convention or association of churches which is exempt from tax under section 501 fails to meet one or more of the requirements of this subsection and corrects its failure to meet such requirements within the correction period, the plan shall be deemed to meet the requirements of this subsection for the year in which the correction was made and for all prior years.

"(B) FAILURE TO CORRECT.—If a correction is not made within the correction period, the plan shall be deemed not to meet the requirements of this subsection beginning with the date on which the earliest failure to meet one or more of such requirements occurred.

"(C) CORRECTION PERIOD DEFINED. —The term 'correction period' means—

"(i) the period ending 270 days after the date of mailing by the Secretary of a notice of default with respect to the plan's failure to meet one or more of the requirements of this subsection;

"(ii) any period set by a court of competent jurisdiction after a final determination that the plan fails to meet such requirements, or, if the court does not specify such period, any reasonable period determined by the Secretary on the basis of all the facts and circumstances, but in any event not less than 270 days after the determination has become final; or

"(iii) any additional period which the Secretary determines is reasonable or necessary for the correction of the default,

whichever has the latest ending date.".

(c) The amendments made by this section shall be effective as of January 1, 1974.

SEC. 408. DEDUCTIBILITY OF PAYMENTS TO PLAN BY A CORPORATION OPERATING PUBLIC TRANSPORTATION SYSTEM ACQUIRED BY A STATE

(a) For purposes of subsection (g) of section 404 of the Internal Revenue Code of 1954 (relating to certain employer liability payments considered as contributions), as amended by section 205 of this Act, any payment made to a plan covering employees of a corporation operating a public transportation system shall be treated as a payment described in paragraph (1) of such subsection if—

(1) such payment is made to fund accrued benefits under the plan in conjunction with an acquisition by a State (or agency or instrumentality thereof) of the stock or assets of such corporation, and

(2) such acquisition is pursuant to a State public transportation law enacted after June 30, 1979, and before January 1, 1980.

(b) The provisions of this section shall apply to payments made after June 29, 1980.

* * * * *

SEC. 410. REFUND OF MISTAKEN CONTRIBUTIONS

* * * * *

(b) Paragraph (2) of section 401 (a) of the Internal Revenue Code of 1954 (relating to exclusive benefit of employees and beneficiaries) is amended by inserting before the semicolon at the end thereof the following: "(but this paragraph shall not be construed, in the case of a multiemployer plan, to prohibit the return of a contribution within 6 months after the plan administrator determines that the contribution was made by a mistake of fact or law (other than a mistake relating to whether the plan is described in section 401(a) or the trust which is part of such plan is exempt from taxation under section 501(a))".

(c) The amendment made by this section shall take effect on January 1, 1975, except that in the case of contributions received by a collectively bargained plan maintained by more than one employer before the date of enactment of this Act, any determination by the plan administrator that any such contribution was made by mistake of fact or law before such date shall be deemed to have been made on such date of enactment.

* * * * *

SEC. 414. TREATMENT OF CERTAIN RETIREMENT BENEFITS

(a) GENERAL RULE.—Paragraph (15) of section 3304(a) of the Internal Revenue Code of 1954 (relating to requirements for approval of State laws) is amended by striking out the semicolon at the end thereof and inserting in lieu thereof the following:

"except that—

"(A) the requirements of this paragraph shall apply to any pension, retirement or retired pay, annuity, or other similar periodic payment only if—

"(i) such pension, retirement or retired pay, annuity, or similar payment is under a plan maintained (or contributed to) by a base period employer or chargeable employer (as determined under applicable law), and

"(ii) in the case of such a payment not made under the Social Security Act or the Railroad Retirement Act of 1974 (or the corresponding provisions of prior law), services performed for such employer by the individual after the beginning of the base period (or remuneration for such services) affect eligibility for, or increase the amount of, such pension, retirement or retired pay, annuity, or similar payment, and

"(B) the State law may provide for limitations on the amount of any such reduction to take into account contributions made by the individual for the pension, retirement or retired pay, annuity, or other similar periodic payment;".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to certifications of States for 1981 and subsequent years.

* * * * *

SEC. 416. CESSATION OF EXTENDED BENEFITS WHEN PAID UNDER AN INTERSTATE CLAIM IN A STATE WHERE EXTENDED BENEFIT PERIOD IS NOT IN EFFECT

(a) GENERAL RULE.—Section 202 of the Federal-State Extended Unemployment Compensation Act of 1970 [Pub. L. 91-373, 1970-2 C.B. 348, 355] is amended by adding at the end thereof the following new subsection.

"Cessation of Extended Benefits When Paid Under an Interstate Claim in a State Where Extended Benefit Period Is Not in Effect

"(c)(1) Except as provided in paragraph (2), payment of extended compensation shall not be made to any individual for any week if—

"(A) extended compensation would (but for this subsection) have been payable for such week pursuant to an interstate claim filed in any State under the interstate benefit payment plan, and

"(B) an extended benefit period is not in effect for such week in such State.

"(2) Paragraph (1) shall not apply with respect to the first 2 weeks for which extended compensation is payable (determined without regard to this subsection) pursuant to an interstate claim filed under the interstate benefit payment plan to the individual from the extended compensation account established for the benefit year.

"(3) Section 3304(a)(9)(A) of the Internal Revenue Code of 1954 shall not apply to any denial of compensation required under this subsection."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) shall apply to weeks of unemployment beginning after October 1, 1980; except that such amendment shall not be a requirement of any State law under section 3304 (a)(11) of the Internal Revenue Code of 1954 for any week which begins before June 1, 1981.

(2) SPECIAL RULE FOR CERTAIN STATES.—In the case of any State the legislature of which does not meet in a regular session which begins during calendar year 1981 and before April 1, 1981, paragraph (1) shall be applied

by substituting "June 1, 1982" for "June 1, 1981".

Approved September 26, 1980.

House of Representatives Report No. 96-869 Part II 2d Session

[Bracketed numerals indicate official report page numbers]

Multiemployer Pension Plan Amendments Act of 1980

April 23, 1980

Mr. ULLMAN, from the Committee on Ways and Means, submitted the following report together with supplemental and minority views to accompany H.R. 3904 which on May 3, 1979, was referred jointly to the Committee on Education and Labor and the Committee on Ways and Means.[1]

[Including cost estimate of the Congressional Budget Office]

The Committee on Ways and Means, to whom was referred the bill (H.R. 3904) to amend the Employee Retirement Income Security Act of 1974 [Pub. L. 93-406, 1974-3 C.B. 1] and the Internal Revenue Code of 1954, as amended, for the purpose of improving retirement income security under private multiemployer pension plans by strengthening the funding requirements for those plans, authorizing plan preservation measures for financially troubled multiemployer pension plans, and revising the manner in which the pension plan termination insurance provisions apply to multiemployer plans, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendment to the text of the bill is a complete substitute therefor and appears in boldface roman type in the reported bill.

The title of the bill is amended to reflect the amendment to the text of the bill.

[1] Public Law 96-364, page 437.

[2] I. OVERVIEW

Background

The Employee Retirement Income Security Act of 1974 (ERISA) established a program of insurance for employee benefits under most tax-qualified, private, domestic, defined benefit pension plans.[1] The program is administered by the Pension Benefit Guaranty Corporation (PBGC), a corporation within the Department of Labor. The Board of Directors of the PBGC consists of the Secretary of Labor (Chairman), the Secretary of the Treasury, and the Secretary of Commerce.

The PBGC maintains a trust fund and a revolving fund for insurance of benefits under terminated multiemployer defined benefit pension plans (multiemployer plans), as well as a trust fund and a revolving fund for insurance of benefits under all other terminated defined benefit pension plans (referred to as "single-employer plans"). The PBGC presently is not "on budget" and the United States is not liable for debts of the PBGC.

The insurance program (referred to as "termination insurance") is funded by (1) premiums paid by plans, (2) assets of plans that have terminated with insufficient funds to provide insured benefits, (3) payments by employers who maintained plans which terminated with insufficient funds to provide insured benefits, and (4) earnings on investments. The funds maintained for multiemployer plans are the sole source of guaranteed benefits under terminated multiemployer plans. Similarly, the funds maintained for single-employer plans are the sole source of guaranteed benefits under single-employer plans.

Under present law, the guarantee by the PBGC of benefits under a multiemployer plan is within the discretion of the PBGC until April 30, 1980. Beginning on May 1, 1980, the guarantee of these benefits becomes mandatory.

[1] See ERISA sec. 4021. A defined benefit pension plan provides a specified level of benefits for participants (e.g., the Federal Civil Service Retirement plan). A church pension plan is generally exempt from the insurance program unless the plan has elected to be subject to ERISA standards. Also, plans of certain professional service employers are excluded from the program.

Consideration by Education and Labor Committee

The bill (H.R. 3904), as approved by the House Committee on Education and Labor, provides a new definition for the term "multiemployer plan," imposes liability for unfunded benefits upon employers who withdraw from a multiemployer plan and allows a deduction for payments of the liability, permits multiemployer plans in financial distress to reduce certain benefits for workers, retirees and beneficiaries, imposes funding requirements for multiemployer plans, provides new rules for mergers and transfers of assets or liabilities involving multiemployer plans, authorizes the PBGC to provide financial assistance [3] to insolvent multiemployer plans, and provides new enforcement powers for the PBGC and others. In addition, the bill increases premiums payable to the PBGC by multiemployer plans, makes insurance of basic benefits under multiemployer plans by the PBGC mandatory, but modifies the level of plan benefits guaranteed by the PBGC, modifies the rules relating to employer liability to the PBGC and the plan in the event of the insolvency or termination of a multiemployer plan, and changes the insurable event to plan insolvency. The amendments made by the bill are generally effective upon enactment.

Ways and Means Committee Amendment

The Ways and Means Committee considered H.R. 3904 as approved by the Education and Labor Committee. The Ways and Means Committee further amended the bill, with an amendment in the nature of a substitute for the bill as amended by the Education and Labor Committee.

The Ways and Means Committee amendment provides additional safeguards for employee benefits and pro-

vides additional protection for employers against escalating increases in the cost of maintaining a multiemployer plan. The Committee amendment also provides rules (1) to ease the computation and collection of liability with respect to a withdrawing employer, and (2) to provide relief from the retroactive application of withdrawal liability in limited circumstances. Additionally, the Committee amendment provides for Congressional review of premiums for certain new guarantees provided by the bill and clarifies the effect of the bill with respect to premiums for single-employer plans. Further, the Committee amendment includes the receipts and disbursements of the PBGC in the budget of the United States (i.e., places the PBGC "on budget"). The amendment also makes numerous technical changes in the bill.

* * * * *

[10] III. GENERAL REASONS FOR THE BILL

During the period following the enactment of ERISA, the PBGC has learned that a significant number of multiemployer plans which would automatically be covered by termination insurance on May 1, 1980, are experiencing financial difficulty.

The termination insurance program was established by ERISA because of concern that the Act could not otherwise secure employee pension benefits against loss due to premature plan termination. The program was designed, in part, on the basis of an Administration study[1] which considered the effects of the termination of single-employer and multiemployer pension plans during a period preceding the enactment of ERISA. Because of substantial uncertainty as to the need for the insurance in the case of multiemployer plans and the effects of insuring such plans, the insurance of benefits under multiemployer plans was generally left to the discretion of the PBGC until January 1, 1978. The date for nondiscretionary insurance of benefits under multiemployer plans was subsequently delayed until May 1, 1980, because of concerns that the program, if nondiscretionary, might encourage the premature termination of multiemployer plans.

Under ERISA, an employer who has paid all required contributions to a multiemployer plan can withdraw from the plan and, if the plan does not terminate within 5 years after the withdrawal, the employer will have no further responsibility for any part of the unfunded liabilities of the plan. Where this occurs, employers who continue to maintain the plan "inherit" the liability which would have been satisfied by the withdrawing employer. The committee believes that, in this regard, present law provides an undesirable incentive for employers to withdraw from plans and an unfair burden on the employers who continue to maintain the plans.

Before ERISA, multiemployer plans in financial distress sometimes delayed funding, reduced benefits, or imposed further restrictions on eligibility for benefits. The ERISA standards designed to require systematic plan funding, and to protect employee benefits, have accordingly reduced the ability of multiemployer plans to deal with financial distress. The PBGC has indicated that the combined effect of the availability of guaranteed benefits, limited employer liability on termination, and ERISA restrictions on the ability of a plan to reduce its liabilities has made termination attractive for multiemployer plans covering workers in declining industries. According to the PBGC, in a significant number of cases, plan termination will be less expensive for employers maintaining a particular multiemployer plan than continuation of the plan. H.R. 3904 deals with these problems of multiemployer [11] plans by (1) increasing the funding requirements for multiemployer plans in most cases, (2) requiring further, accelerated funding of plans in financial distress, subject to restrictions designed to avoid undue financial strain on employers maintaining seriously overburdened plans, (3) relaxing the vesting rules of ERISA to permit benefit reductions in limited circumstances, (4) modifying the level of benefits guaranteed so that in most cases, contiuation of a plan will be more beneficial to employees than plan termination, (5) requiring continued funding of terminated plans, and (6) making plan insolvency the only insurable event. The bill also provides for increased termination insurance premiums, additional reporting requirements, and enforcement authority.

[12] IV. EXPLANATION OF PROVISIONS

A. Findings and Declaration of Policy (Sec. 3 of the Bill)

The statement of policy included in ERISA does not specifically provide that ERISA is for the purpose of encouraging the growth and maintenance of multiemployer plans.

The policy of the bill, as declared therein, is to make specified changes in the pension rules applicable to multiemployer plans (1) to protect the interests of participants and beneficiaries in financially distressed multiemployer plans, and (2) to encourage the growth and maintenance of multiemployer plans.

B. Definition of Multiemployer Plan (Secs. 108(d), 207, and 302 of the Bill and Sec. 414(f) of the Code, and Secs. 3(37) and 4403 of ERISA)

Present law

Under present law, a plan is a multiemployer plan for a year if (1) more than one employer is required to contribute to the plan, (2) the plan is maintained pursuant to a collective bargaining agreement between employee representatives and more than one employer, (3) the amount of contributions made under the plan for the year by each employer is less than 50 percent of the aggregate employer contributions for that year (unless a special rule is satisfied), (4) benefits under the plan are payable to each

[1] Department of the Treasury and Department of Labor, *Study of Pension Plan Terminations, 1972—Interim Report,* February 1973.

participant without regard to the cessation of contributions by the employer of the participant except to the extent the benefits accrued because of service with the employer before the employer was required to contribute to the plan, and (5) the plan satisfies other requirements imposed by Labor Department regulations.[1]

All corporations, which are members of a controlled group of corporations, are treated as a single employer in determining the status of a plan as a multiemployer plan for purposes of the tax law.

Reasons for change

The Ways and Means Committee believes that the definition of a multiemployer plan under ERISA which is limited to a plan in which (1) no employer contributes more than 50 percent of the total employer contributions for the year and (2) employers share liability for participants' benefits accrued for service while the employer maintained the plan creates two major problems. First, not all plans that share the basic characteristics of multiemployer plans (i.e., plans to which more than one employer is required to contribute and which are maintained pursuant to a collective bargaining agreement) are considered multiemployer plans under the definition pres-[13]ently in ERISA. Second, a plan could move in and out of multiemployer plan status from year to year. The Committee has determined to remove the limitations from the definition of multiemployer plan so that generally plans which share the basic characteristics of multiemployer plans are treated consistently under the law.

Explanation of provisions

Under the bill, the test relating to proportionate employer contributions (the 50-percent test) is deleted, and the test relating to continuity of benefits in the event of a cessation of employer contributions is preserved in the minimum vesting standard of ERISA. The bill provides that all trades and businesses (whether or not incorporated) under common control are considered a single employer for purposes of testing the status of a plan as a multiemployer plan. In addition, the bill provides that a plan continues to be a multiemployer plan after its termination if it was a multiemployer plan for the plan year ending before its termination date.

A plan which is a single-employer plan under present law (even though more than one employer maintains the plan) and which has paid PBGC premiums for the three plan years preceding the date of enactment as a single-employer plan is permitted to irrevocably elect to be considered a single-employer plan where the plan would otherwise be a multiemployer plan under the bill.

Effective date

The provision will apply upon enactment, except that the present law definition will continue for plan years beginning before enactment.

[14] C. Employer Withdrawal Liability, Mergers, Etc. (Secs. 104 and 108 of the Bill, Secs. 411, 412, 418-418F and 4917 of the Code, and Secs. 4201-4206, 4221-4224, 4241-4246, 4261, 4281, 4301 and 4303 of ERISA)

Present law

Employer liability

Under present law, if an employer maintained or contributed to a multiemployer plan (or a single-employer plan to which more than one employer contributes) during the 5-year period preceding the termination of the plan, and if the plan terminates with insufficient assets to provide benefits at the level guaranteed by the PBGC, the employer is liable to the PBGC for a share of the insufficiency. The insufficiency is generally allocated to employers on the basis of each employer's proportionate share of the total contributions required under the plan during the 5-year period. The liability of any particular employer, however, is limited to 30 percent of that employer's net worth (before taking the liability to the PBGC into account.[1] In addition, if a "substantial employer" withdraws from a plan to which more than one employer contributes, the employer is required to pay to the PBGC (or to post a bond for payment of) an amount equal to the employer's share of the insufficiency which would arise if the plan were to terminate. The payment is returned to the employer (or the bond is cancelled) if the plan does not terminate within 5 years after the withdrawal. Under present law, an employer is a substantial employer for a plan year if the employer's contributions during (1) each of the two preceding plan years, or (2) both the second and third preceding plan years were at least equal to 10 percent of the total contributions paid to the plan for each of such years.[2]

In the case of a single-employer plan to which only one employer contributes, liability for an insufficiency is allocated in full to that employer, subject to the "30 percent of net worth" limit. The substantial employer rules do not apply in such a case.[3]

Mergers, transfers, etc.

Under the Code and under the nontax provisions of ERISA, a plan is not permitted to merge or consolidate with, or transfer its assets or liabilities to, another plan unless certain conditions are met. The applicable conditions require that the benefits which each participant in the plan would receive if the plan were to terminate immediately after the merger, etc., will not be less than the benefits the participant would receive under the merged plan if that plan terminated immediately before the merger, etc.

[15] In the case of a single-employer plan to which only one employer contributes, liability for an insufficiency is allocated in full to that employer, subject to the "30 percent of net worth" limit. The substantial employer rules do not apply in such a case.

[1] See DOL Regs. § 2510. 3-37.

[1] See ERISA secs. 4062 and 4064.
[2] See ERISA secs. 4001(a)(2) and 4063.
[3] See ERISA sec. 4062.

Reasons for change

The Ways and Means Committee believes that the current rules governing an employer's liability upon withdrawal from a multiemployer plan fail to adequately protect plan participants, the employers who remain in the plan and the PBGC premium payers. The present-law rules have the effect of increasing the liabilities of employers who remain with a plan until it terminates and rewarding those employers who leave the plan early. When an employer withdraws from a multiemployer plan, the remaining employers must assume the burden for funding benefit liabilities left by the withdrawing employer. In addition, a withdrawal may reduce the plan's contribution base and necessitate an increase in the rate of contributions to the plan.

The Committee finds it necessary to adopt statutory withdrawal rules to protect a multiemployer plan from the adverse financial impact of employer withdrawal. The Committee believes that a rule which requires an employer who withdraws from a multiemployer plan to continue funding a share of the plan's unfunded benefit obligations removes the present incentive for employer withdrawals and provides protection to remaining employers where withdrawals nevertheless occur. The Committee, however, intends that these rules not deter new employers from entering a multiemployer plan.

The Committee believes that, because in the construction industry and in certain segments of the entertainment industry, the withdrawal of an employer from a plan may not eliminate jobs from a plan's contribution base unless the employer continues working in the area, liability for employers in these industries should be narrowly limited.

Under present law, the PBGC is authorized to determine the extent to which the statutory rules governing mergers and transfers of assets and liabilities apply to multiemployer plans. The Committee believes that these statutory rules are not readily adaptable to multiemployer plans. Accordingly, appropriate rules are needed to protect participants in multiemployer plans when a merger or transfer of assets occurs. In addition, the rules should prevent transfers that would create unnecessary liability for the PBGC. The Committee believes that the rules contained in the bill protect plan participants and PBGC premium payers.

The Committee understands that the purpose of plan reorganization is to require a plan facing financial difficulties to take corrective action to stabilize or improve its financial condition. Generally, reorganization would (1) prevent plans in financial distress from funding new past service liabilities over unreasonably long periods of time, and (2) require plans with severe financial difficulties to raise contributions.

However, with respect to plans in declining industries, the contribution requirements could result in inappropriately high and escalating pension costs. The Committee therefore believes that the funding standard for plans in reorganization should be adjusted in certain circumstances for overburdened plans. To encourage the continuation [16] of plans, the Committee believes that PBGC funds should be available to make up the difference between the guaranteed level of benefits and the level supportable by the plan. The Committee believes that through the mechanism of reorganization, PBGC involvement and assistance will be deferred until absolutely necessary, which will result in significant premium savings. In addition, administrative responsibility would largely remain with the plan, thereby simplifying administration of the guarantee program.

Explanation of provisions

1. Employer withdrawal liability

Under the bill, an employer who withdraws from a multiemployer plan generally is liable to the plan for the portion of the plan's unfunded benefit obligations (if any) assigned to the employer. The bill provides four alternative methods, any of which a plan could uniformly use to determine this liability. In addition, a plan could devise its own method of computation subject to the approval of the PBGC.

a. Definition of withdrawal

(1) Complete withdrawal

The bill treats an employer as withdrawing from a multiemployer plan when the employer (1) permanently ceases to have an obligation to contribute under the plan, or (2) permanently ceases all covered operations under the plan. A withdrawal does not occur, however, where an employer ceases to exist merely by reason of a change in form or structure, as long as the employer is replaced by a successor employer and there is no interruption in the successor employer's contributions to the plan or obligation to contribute under the plan. For example, if P Corporation owns 100 percent of the stock of S Corporation, a subsidiary that has an obligation to contribute to a multiemployer plan on behalf of its employees, the controlled group consisting of P and S would be considered an employer with an obligation to contribute to the plan. If P sells all of its interest in S to an unrelated party, the controlled group consisting of P and S would cease to exist. However, if S continues to have an obligation to contribute to the plan, no withdrawal would be considered to have taken place merely because of the change in ownership of S.

In addition, a withdrawal does not take place merely because an employer suspends making plan contributions during a labor dispute which involves its employees.

Generally if a withdrawal occurs, the date of the withdrawal is considered to be the last day of the plan year in which the employer permanently ceased to have an obligation to contribute under the plan (other than for delinquent contributions or withdrawal liability) or permanently ceased all covered operations under the plan.

Under certain circumstances the date of the withdrawal of an employer who has an obligation to contribute under a plan for work performed in the building and construction industry or in certain segments of the entertainment industry is the date on which the employer's obligation to contribute under the plan ceases.

[17] With respect to an employer who has completely withdrawn from a multiemployer plan and who subsequently resumes covered operations under the plan or renews an obligation to contribute to the plan, the PBGC is to prescribe regulations regarding the reduction or waiver of the employer's withdrawal liability to the extent consistent with the policy of protecting remaining employers, beneficiaries, and other participants. In addition, the PBGC is to prescribe regulations or a procedure under which a plan can provide rules for the reduction or waiver of withdrawal liability with respect to such an employer in appropriate circumstances.

(2) *Partial withdrawal*

Under the bill, an employer becomes subject to withdrawal liability in some cases in the event of a partial withdrawal, that is, where the employer neither completely ceases to have an obligation to contribute under the plan nor permanently ceases all covered operations under the plan. Under the bill, a partial withdrawal arises because of the occurrence of any of several specified events which could significantly decrease the employer's obligations for contributions under the plan. Under the bill, a partial withdrawal occurs—

(1) if the number of contribution base units (e.g., hours worked) with respect to which the employer is required to contribute for each of three consecutive plan years does not exceed 40 percent of the number of contribution base units with respect to which the employer was obligated to contribute under the plan for any one of the five plan years preceding the three-year period (a 60-percent decline in contribution base units);

(2) if, because the employer ceased substantially all of its covered operations at one or more facilities, the number of contribution base units with respect to which the employer is required to contribute under the plan for the plan year does not exceed 75 percent of the number of contribution base units with respect to which the employer was required to contribute under the plan for any one of the preceding five plan years; or

(3) if any employer who is required to contribute to a plan under two or more collective bargaining agreements ceases to have an obligation to contribute under at least one but not all of the agreements.

The liability which an employer incurs in the case of a partial withdrawal is to be a *pro rata* portion of the liability which the employer would incur in the event of a complete withdrawal on the same date. In addition, the bill provides that there is to be no obligation for withdrawal liability in the case of a partial withdrawal of an employer who made less than two percent of the average annual contributions to the plan in the five-year period immediately preceding the withdrawal, except where the plan specifically provides for liability in such a case.

Whenever an event giving rise to a partial withdrawal occurs, the date of the partial withdrawal is generally the last day of the plan year in which the event takes place. However, if a partial withdrawal takes place under the 3-year/40-percent rule described above, for purposes of calculating the amount of an employer's liability, the first plan [18] year of the 3-year period is considered the year in which the employer partially withdrew.

The bill provides that a plan may be amended to eliminate partial withdrawal liability, in whole or in part, to the extent permitted by PBGC regulations. Also, PBGC regulations may prescribe a procedure by which a plan may, by amendment, adopt rules providing for alternative events which will trigger partial withdrawal liability.

For purposes of the partial withdrawal rules, unless a plan provides another definition of "facility", the term means an economic unit, generally at a single physical location, where business is conducted or industrial operations are performed.

The bill provides for abatement of all or part of an employer's partial withdrawal liability in the event of (1) a two-year 90 percent restoration of contributions, (2) a one-year complete restoration of contributions, (3) a two-year reversal of the reduction of contributions which triggered the liability, or (4) a ten percent contribution increase. In addition, the PBGC is authorized to prescribe regulations providing for the reduction or elimination of partial withdrawal liability under conditions where the PBGC determines that such an abatement is consistent with the policy of protecting remaining employers. Also, under a PGBC regulatory procedure, a plan may adopt rules for abatement of partial withdrawal liability under any other conditions, subject to PBGC approval to be based on a determination that the rules are consistent with the policy of protecting remaining employers.

A two-year 90 percent restoration of contributions occurs where, for any two consecutive plan years after the partial withdrawal, the number of contribution base units applied to determine the employer's required plan contributions is at least 90 percent of the number of contribution base units to determine the employer's required contributions for any one of the five plan years (1) immediately preceding the three consecutive plan years used to test for a partial withdrawal in the case of a partial withdrawal caused by a 60 percent decline in contribution base units, or (2) immediately preceding the year of the partial withdrawal in the case of a partial withdrawal caused by a facility closing or the cessation of contribution obligations under a collective bargaining agreement (the five-year base period). An abatement under this rule completely eliminates the employer's partial withdrawal liability for plan years

following the two consecutive plan years in which the 90-percent restoration of contributions takes place.

A one-year complete restoration of contributions occurs where the number of contribution base units used to determine the employer's required contributions for a plan year equals or exceeds the number of such units for the year in the five-year base period for which such units were the highest. Where such a restoration takes place, the employer may, in lieu of continuing to pay partial withdrawal liability, post a bond to the plan for an amount determined by the plan sponsor not exceeding 50 percent of the otherwise required annual partial withdrawal liability payment. If the plan sponsor determines that the employer has no further partial withdrawal liability, the liability is completely eliminated and the bond is cancelled. If the plan sponsor determines that the employer continues to have partial withdrawal liability, [19] (1) the plan may realize on the bond, (2) the employer remains liable for the amount of the year's liability not covered by the bond, and (3) no abatement takes place.

A two-year reversal of the reduction in contributions which triggered the liability occurs where for any two consecutive plan years after the partial withdrawal (1) the number of contribution base units applied to determine the employer's required plan contributions exceeds (a) 40 percent of the number of such units for the year in the five-year base period for which such units were the highest, in the case of a partial withdrawal caused by a 60 percent decline in contribution base units, or (b) 75 percent of the number of such units for the year in the base period for which such units were the highest, in the case of a partial withdrawal caused by a facility closing or the cessation of contributions under a collective bargaining agreement, and (2) the total number of contribution base units applied to determine required plan contributions for all employers is not less than 90 percent of the total number of such units for the year of the partial withdrawal. An abatement under this rule completely eliminates the employer's partial withdrawal liability for plan years following the two consecutive years in which the reversal of the reduction in contributions takes place.

A ten percent contribution increase occurs where, for a plan year following the partial withdrawal, the number of contribution base units applied to determine the employer's required plan contributions exceeds the number of such units for the year of the partial withdrawal by at least 10 percent. In the case of an abatement under this rule, the employer's partial withdrawal liability payment for the year of the abatement is reduced *pro rata* under PBGC regulations. A plan may use a percentage other than 10 percent in applying this rule, except for a percentage prohibited by PBGC regulations.

(3) Construction etc., industry exception

In the case of certain plans under which an employer has an obligation to contribute for work performed in the building and construction industry, a withdrawal is considered to take place only if an employer ceases to have an obligation to contribute under the plan, and (1) continues to perform work in the jurisdiction of the collective bargaining agreement, of the type for which contributions were previously required, or (2) resumes work in the jurisdiction within five years after the date the employer's obligation to contribute under the plan ceased without renewing such obligation if, when the employer resumes work, (i) other employers have an obligation to contribute under the plan, and (ii) the plan would have permitted the employer to contribute.

An employer contributing to a plan is subject to these special rules only if substantially all of the employees for whom the employer has an obligation to contribute perform work in the building and construction industry, and (1) the plan covers primarily employees in the building and construction industry, or (2) the plan is amended to provide that the rules apply to employers with an obligation to contribute for work performed in the building and constuction industry.

The partial withdrawal rules apply to an employer subject to the special building and construction industry rules only where the em-[20]ployer so substantially reduces its involvement with a plan that the employer's continuing obligation to make contributions is for only a token portion of its work of the type for which contributions to the plan are required in the craft and area jurisdiction of the particular collective bargaining agreement. The partial withdrawal rules apply to an employer subject to the special entertainment industry rules only to the extent provided in PBGC regulations.

(4) De minimis rules

(a) General de minimis rule.—In any case where the withdrawal liability of an employer (computed before any *pro rata* reduction in the case of a partial withdrawal) the greater of (a) $25,000, or (b) 0.75 percent of the plan's unfunded benefit obligations determined as of the close of the plan year immediately preceding the withdrawal, the bill does not impose any withdrawal liability on the employer. A plan may provide, however, for a lower *de minimis* amount or for no *de minimis* amount.

The *de minimis rule* under the bill does not apply in the case of a mass withdrawal from a plan. Thus, the rule does not apply to an employer who withdraws from a plan in a plan year in which substantially all employers withdraw, or to an employer who withdraws under an agreement or arrangement under which substantially all employers withdraw from the plan in one or more plan years. Where substantially all employers withdraw from a plan within a period of three plan years, it is presumed that such an agreement or arrangement exists unless the contrary is shown by a preponderance of the evidence.

(b) Two-percent de minimis rule.—Under the bill, an employer will not incur withdrawal liability in the case

of a partial withdrawal if the average annual contributions during the five plan years preceding the year of withdrawal were less than two percent of the total average annual contributions of all employers contributing to the plan. However, the bill permits a plan to provide that this two percent exception to partial withdrawal liability will not apply.

(5) Exception for new employers

The bill provides a rule under which an employer first entering a plan would not be subject to withdrawal liability, either in the case of a complete withdrawal or of a partial withdrawal, if certain conditions are met. The applicable conditions are as follows:

a. the employer was first obligated to make plan contributions after the date of enactment of the bill;

b. the employer was not required to make plan contributions for more than the lesser of (1) six consecutive plan years preceding the date of withdrawal or (2) the number of years required for vesting under the plan;

c. for each plan year for which contributions by the employer were required, the employer's contributions were less than 2 percent of all employer contributions to the plan for the plan year;

d. the plan does not primarily cover employees in the building and construction industry; and

e. the employer did not previously have the benefit of this exception with respect to the plan.

[21] In addition, the exception applies only if (1) the plan provides for its application; (2) the plan provides that benefits of participants accrued on the basis of service for the employer before the employer was required to contribute to the plan may not be payable if the employer ceases contributions to the plan and (3) the ratio of plan assets to benefit payments during the plan year preceding the first plan year for which the employer was required to make plan contributions was at least 8 to 1. Of course, the rule requiring that a plan provide for cancellation of benefits where the employer ceases contributions to the plan would not require any reduction of benefits to participants or beneficiaries whose benefits are in pay-status at the time of the cessation and who are not working in employment covered by the plan.

b. Computation of withdrawal liability

(1) Presumptive method

The bill, in its presumptive method for computing withdrawal liability, draws a distinction between employers who contributed to a plan for a plan year ending before February 28, 1979, and employers who did not contribute to the plan for such a year. As to employers who contributed to a plan for such a year, the computation of withdrawal liability is based on (1) the unfunded benefit obligations [4] of the plan attributable to those years, as well as on (2) changes in the unfunded benefit obligations of the plan for plan years ending on or after February 28, 1979, in which the employer was required to contribute to the plan. In the case of an employer who was not required to contribute to the plan for a plan year ending before February 28, 1979, the employer's withdrawal liability is computed solely with reference to changes in the unfunded benefit obligations under the plan for plan years ending on or after February 28, 1979, in which the employer was required to contribute to the plan. Under the bill, the presumptive method generally applies unless a plan adopts one of the alternative methods.

In particular, withdrawal liability under the presumptive method is divided into two parts, as follows:

(1) liability with respect to changes in unfunded benefit obligations for plan years ending on or after February 28, 1979, in which the employer was obligated to contribute under the plan; and

(2) liability with respect to unfunded benefit obligations for plan years ending before February 28, 1979.

In the case of an employer who was not required to contribute to a plan until a plan year ending on or after February 28, 1979, the second component of withdrawal liability does not apply.

The portion of an employer's withdrawal liability attributable to plan years ending after February 28, 1979, is computed in four steps, as follows:

(1) The first step is to determine what is known as the "change in a plan's unfunded benefit obligations" for each plan year [22] ending on or after February 28, 1979. Under the bill, this amount is calculated for each plan year as the difference between (a) the unfunded benefit obligations as of the end of the plan year which precedes the plan year, and (b) the sum of (i) the unfunded benefit obligations on the last day of the last plan year ending before February 28, 1979, reduced by five percent for each succeeding plan year which precedes the plan year, and (ii) the sum of the changes in unfunded benefit obligations for each plan year ending on or after February 28, 1979, and preceding the plan year (computed with each such change reduced by five percent for each succeeding plan year preceding the plan year).

(2) The second step is to determine what is known as "the unamortized amount of the change in a plan's unfunded benefit obligations with respect to a plan year". This amount is determined by reducing the change in a plan's unfunded benefit obligations for a plan year (determined under step (1)) by five percent for each succeeding plan year.

(3) The third step is to calculate the employer's "proportional share" of the unamortized amount of the change in the plan's unfunded benefit obligations for each plan year involved. This is accomplished by multiplying

[4] Generally, the term "unfunded benefit obligations" is intended to mean the plan's unfunded liability for benefits for which participants have met service requirements (including early retirement subsidies, Social Security supplements, and vested accrued benefits).

the unamortized amount of the change for each plan year, determined as of the end of the plan year in which the employer withdraws from the plan, by a fraction. The numerator of the fraction is the sum of contributions which the employer was required to make to the plan for the year of the change and for the preceding four plan years. The denominator of the fraction is the sum of contributions which all employers made to the plan for the year of the change and for the preceding four plan years.

(4) The final step is to add up the employer's proportional share of the unamortized amount of the change in the plan's unfunded benefit obligations for each of the plan years. This total is the employer's proportional share of the unamortized amount of the change in the plan's unfunded benefit obligations for all plan years ending on or after February 28, 1979.

The portion of an employer's withdrawal liability with respect to plan years ending before February 28, 1979, is determined by multiplying (1) the amount of the unfunded benefit obligations under the plan at the close of the last plan year ending before February 28, 1979 (reduced by five percent for each succeeding plan year) by (2) a fraction. The numerator of the fraction is the sum of contributions which the employer was required to make to the plan for the last five plan years ending before February 28, 1979. The denominator of the fraction is the sum, for the same five plan years, of plan contributions made by all employers who (a) had an obligation to contribute under the plan for the first plan year ending on or after February 28, 1979, and (b) had not withdrawn from the plan before February 28, 1979.

Under the bill, except as otherwise provided by PBGC regulations, the plan's unfunded benefit obligations will be increased by (1) the present value of uncollectible withdrawal liability if the plan sponsor [23] determines the withdrawal liability to be uncollectible, and (2) an amount equal to an employer's potential withdrawal liability if the plan sponsor determines that the employer is not liable for the withdrawal liability because of the bill's *de minimis* rule.

(2) *First alternative method*

The first alternative method also draws a distinction between employers who contributed to a plan for plan years ending before February 28, 1979, and employers who did not contribute to the plan for such years. As in the case of the presumptive method, only employers who contributed for years ending before February 28, 1979, are to have their withdrawal liability computed with reference to unfunded benefit obligations under the plan attributable to such years. Other employers are to have their withdrawal liability computed solely with reference to the plan's unfunded benefit obligations attributable to plan years ending on or after February 28, 1979. However, unlike the presumptive method, under the first alternative method, an employer's withdrawal liability is to be based on the aggregate change in unfunded benefit obligations with respect to all plan years ending on or after February 28, 1979, rather than on the changes in unfunded benefit obligations for each separate plan year for which the employer was required to contribute to the plan.

In particular, the first component of withdrawal liability under the first alternative method is to be obtained by multiplying (1) the plan's unfunded benefit obligations as of the end of the last plan year ending before February 28, 1979, reduced as if that amount were being amortized thereafter in level annual installments over 15 years, by (2) a fraction. The numerator of the fraction is the sum of the plan contributions required of the employer for the last plan year ending before February 28, 1979, and for the preceding four plan years. The denominator of the fraction is the sum of the contributions made by included employers for that period of five plan years. An employer is included if (1) the employer was required to contribute to the plan for the first plan year ending on or after February 28, 1979, and (2) the employer had not withdrawn from the plan before that date.

The second component of withdrawal liability under the first alternative method is to be obtained by computing the excess of the plan's unfunded benefit obligations (as of the last day of the plan year in which the employer withdraws) over the sum of (1) the value on such date of all outstanding claims for withdrawal liability (with respect to employers withdrawing before the plan year) which can reasonably be expected to be collected and (2) the portion of the plan's unfunded benefit obligations as of the last day of the last plan year ending before February 28, 1979 (as reduced by 15-year amortization) which is allocable to remaining included employers and multiplying such excess by a fraction. The numerator of the fraction is the total amount required to be contributed by the employer for the last plan year ending before withdrawal and for the four preceding four plan years. The denominator of the fraction is the total amount contributed by all employers for those five plan years, increased by employer contributions for earlier periods that are collected during the [24] five plan years, and reduced by the contributions made by any employer who withdrew from the plan during any of the five plan years. An employer is included in this case if the employer was required to contribute to the plan for the first plan year ending on or after February 28, 1979, as well as for the plan year of the withdrawal.

(3) *Second alternative method*

The second alternative method for computing withdrawal liability draws no distinction between employers who were required to contribute to a plan for plan years ending before February 28, 1979, and employers who were required to contribute only for plan years ending on or after February 28, 1979. Accordingly, employers in both categories are to have their withdrawal liability computed with refer-

ence to all of a plan's unfunded benefit obligations.

Under this method, withdrawal liability is to be determined by multiplying (1) the plan's unfunded benefit obligations as of the end of the plan year of the withdrawal, reduced by the value as of such date of outstanding claims for withdrawal liability (with respect to employers withdrawing before the plan year) which can reasonably be expected to be collected by (2) a fraction. The numerator of the fraction is the amount which the employer was required to contribute to the plan for the five plan years preceding the plan year of the withdrawal. The denominator of the fraction is the total amount contributed by all employers for those five plan years, increased by employer contributions for earlier periods that are collected during the five plan years, and reduced by the contributions made by any employer who withdrew from the plan during any of the five plan years.

(4) Third alternative method

The third alternative method takes a substantially different approach to computing withdrawal liability. Rather than determining the liability based upon the employer's share of plan contributions during a five-year period, the method is intended to compute the portion of the plan's unfunded benefit obligations which are attributable to service of plan participants with the employer. This is generally to be done by attributing portions of the unfunded benefit obligations to each employer in accordance with specified rules. In addition, the plan's unfunded benefit obligations which are not attributable to any present employer is also to be computed. A portion of those "unattributable obligations" is then to be allocated to the employer. An employer's withdrawal liability is then to be determined as the sum of (1) the portion of the plan's unfunded benefits obligations which are attributable to plan participants' service with the employer, and (2) the portion of "unattributable obligations" which is allocated to the employer. All determinations are to be made as of the end of the plan year of the withdrawal.

The portion of an employer's withdrawal liability arising from plan unfunded benefit obligations attributable to plan participants' service with the employer is computed in four steps, as follows:

(1) The first step is to determine the actuarial present value of benefit entitlements under the plan which are attributable to [25] participants' service with the employer (attributable entitlements).

(2) The second step is to determine the value of plan assets allocated to benefit entitlements attributable to service with the employers with an obligation to contribute under the plan in the plan year of the withdrawal (obligated employers). This is accomplished by multiplying (a) the value of plan assets as of the end of the year of the withdrawal, by (b) a fraction. The numerator of the fraction is the actuarial present value of benefit entitlements attributable to service with obligated employers. The denominator of the fraction is the actuarial present value of all benefit entitlements for the year of the withdrawal.

(3) The third step is to determine the share of the value of the assets (determined under step (2)) which is allocated to the withdrawn employer. This is done by multiplying the value of such assets by one of three alternative fractions. The fraction used by a particular plan is to be designated by plan amendment. Under the first alternative fraction, (1) the numerator is the actuarial present value of benefit entitlements attributable to service with the employer, and (2) the denominator is the actuarial present value of benefit entitlements attributable to service with all employers required to contribute in the plan year of the withdrawal. Under the second alternative fraction, (1) the numerator is the actuarial present value of all plan contributions by the employer for the plan year of the withdrawal and all preceding plan years, and (2) the denominator is the actuarial present value of all plan contributions, for the plan year of the withdrawal and all preceding plan years, by employers required to contribute in the plan year of the withdrawal. Under the third alternative fraction, (1) the numerator is the difference between (a) the amount determined as the numerator of the second alternative fraction, and (b) the actuarial present value of plan benefit payments, for the plan year of the withdrawal and preceding plan years, attributable to service with the employer; and (2) the denominator is the difference between (a) the amount determined as the denominator of the second alternative fraction, and (b) the actuarial present value of plan benefit payments, for the plan year of the withdrawal and all preceding plan years, attributable to service with employers required to contribute in the plan year of the withdrawal.

(4) The final step is to subtract (1) the employer's share of the plan assets (determined under step (3)) from (2) the employer's attributable entitlements (determined under step (1)).

The portion of unattributable obligations which is allocated to the employer is determined in two steps, as follows:

(1) The first step is to calculate the unattributable obligations. This is accomplished by subtracting from the difference between two amounts the value of outstanding claims for withdrawal liability (with respect to employers withdrawing before the plan year of the withdrawal) which can reasonably be expected to be collected. The first amount is equal to (a) the actuarial present value of all plan benefit entitlements at the end of the year of the [26] withdrawal, less (b) the actuarial present value of plan benefit entitlements on that date attributable to participants' service with employers required to contribute to the plan for the year of the withdrawal. The second amount is equal to (a) the value of plan assets at the end of the year of the withdrawal, less (b) the value of plan assets computed at such date under step (2) of the cal-

culation of the portion of the plan's unfunded benefit obligations which are attributable to plan participants' service with the employer.

(2) The second step is to allocate the amount determined under step (1) under any allocation method used under the presumptive method or any of the other alternative methods. The plan must provide for the specific method of allocation to be utilized.

The PBGC is authorized by the bill to prescribe regulations setting forth other methods a plan may adopt to allocate assets in determining withdrawal liability for (1) unfunded benefit obligations attributable to service with the employer, and (2) unattributable obligations.

(5) Other methods

The bill authorizes the PBGC to prescribe by regulations a procedure by which a plan may adopt other methods for determining withdrawal liability. The PBGC, before approving any such method, is to be required to determine that the method would not significantly increase the risk of loss to plan participants, beneficiaries, or the PBGC. In addition, the PBGC is to be authorized to prescribe standard approaches for alternative methods for which approval would either not be necessary or would be necessary only under a modified procedure. Any such alternative method is to be required to allocate to employers all of the plan's unfunded benefit obligations.

In determining an employer's withdrawal liability under the presumptive method or any of the alternative methods, if the method specifies the use of a five plan year period in the numerator or denominator of a fraction, the plan could provide instead for the use of a period of more than five, but not more than 10, plan years, unless PBGC regulations provide otherwise.

(6) Other rules.

Under the bill, in the event of a transfer of liabilities from the plan from which a withdrawal takes place to another plan in connection with a withdrawal, withdrawal liability is to be reduced by an amount equal to the actuarial present value, determined at the end of the last plan year ending on or before the date of the withdrawal, of the transferred unfunded benefit obligations.

In the case of a withdrawal by an employer following a merger of multiemployer plans, withdrawal liability is to be computed under the applicable method in accordance with PBGC regulations. However, in the case of a withdrawal in the first plan year beginning after the merger, withdrawal liability is determined as if the plans had remained separate.

Under the bill, a plan may be amended to adopt rules, consistent with the interests of plan participants, beneficiaries and contributing employers, which provide for reduction or waiver of withdrawal liability to the extent the employer's obligation to contribute under [27] the plan or make withdrawal liability payments is assumed by another employer.

In the case of certain plans established prior to January 1, 1954, as a result of an agreement between employee representatives and the Government of the United States during a period of government operation, under seizure powers, of a major part of the productive facilities of an industry (Code sec. 404(c)), the presumptive method for determining withdrawal liability is the second alternative method for computing such liability. In addition, (1) the general *de minimis* rule, and (2) the exception for new employers, do not apply to such a plan unless the plan is amended to provide for their application.

c. Payment of withdrawal liability

(1) In general

An employer who withdraws from a multiemployer plan is to be required to pay its withdrawal liability to the plan in accordance with a payment schedule to be determined by the plan sponsor under standards set forth in the bill.[5] As soon as practicable after a withdrawal, the plan sponsor is to be required to notify the employer of (1) the amount of withdrawal liability, and (2) the payment schedule. In addition, the plan sponsor is to be required to demand that the employer make payment of withdrawal liability in accordance with the payment schedule.

In calculating the payment schedule, the plan is to compute the annual payment under a formula set forth in the bill. The employer is generally to be required to make this payment to the plan for the lesser of (1) the number of years it would take to amortize its withdrawal liability (determined under the assumptions used for the most recent actuarial valuation for the plan) or (2) 30 years. The amount of each annual payment under the formula is to be determined as the product of two amounts. The first amount is the average number of contribution base units (*e.g.*, hours worked, tons of coal mined) for the three consecutive plan years, during the period of 10 plan years ending with the plan year in which withdrawal occurs, in which the number of units was the highest. The second amount is the highest contribution rate (*e.g.*, cents per hour) which the employer had an obligation to contribute under the plan during the period of 10 plan years ending with the year of withdrawal.

However, with respect to these two amounts a plan could provide that for the first plan year ending on or after February 28, 1979, the number "5" is substituted for the number "10" and is increased by one for each succeeding plan year until it becomes 10.

For example, assume that an employer's withdrawal liability is $1 million and that the plan's valuation rate of interest is 6 percent. Assume that in the 3 years for which the contribution base units were the highest during the 10 most recent plan years during which the employer was obligated to

[5] The plan sponsor of a multiemployer plan is generally a Joint Board of Trustees which administers the plan.

contribute to the plan, the number of such units were 80,000 hours, 85,000 hours and 90,000 hours respectively, and that during the last ten plan years the highest contribution [28] rate applicable to the employer under the plan was 75 cents an hour. The product of 85,000 hours (the average of 80,000, 85,000, and 90,000) and 75 cents an hour is $63,750. This would result in the amortization of the liability over approximately 49 years. Because the 49-year schedule is longer than 30 years, the employer would be liable to the plan for 30 annual payments of $63,750.

In the event that a multiemployer plan terminates upon (1) withdrawal of all employers in the plan or (2) withdrawal of substantially all employers in the plan pursuant to an agreement or arrangement to withdraw (a "mass withdrawal"), the annual amount of withdrawal liability payable by each employer is to be computed without regard to the 30-year limit, and total unfunded benefit obligations of the plan are allocated to all employers under PGBC regulations. Thus in the above example, if all employers were to withdraw, the liability of the employer would be $63,750 a year for approximately 49 years, unless the amount or payment period were to differ because of PBGC regulations which allocate unfunded benefit obligations.

In the case of a "partial withdrawal," withdrawal liability payments are to be made in the same fashion as in the instance of a complete withdrawal, but the amount payable would be only a *pro rata* portion of the payment required in the case of a complete withdrawal.

(2) Time for payment

Payment of withdrawal liability is to begin no later than 60 days after the date on which a demand for payment is made by the plan sponsor. Under the bill, payments are generally to be made in four equal quarterly installments unless a particular plan provides for payment at other intervals. In any case where payment is not made when due, the bill requires interest to accrue with respect to the unpaid amount based on the prevailing market rate.

An employer is to be permitted to prepay its withdrawal liability obligations plus accrued interest, if any, in whole or in part without penalty.

In the event of default by an employer in payment of its withdrawal liability, the plan sponsor is to be permitted to require immediate payment of the balance of the employer's withdrawal liability plus any accrued interest thereon. Default is generally considered to occur where an employer fails to make any payment with respect to withdrawal liability when due, and further fails to make payment within 60 days after receiving written notice from the plan sponsor that payment of withdrawal liability is due but unpaid. In addition, the plan is to be permitted to adopt rules which would provide for other instances of default where it is indicated that there is a reasonable likelihood that an employer will be unable to pay its withdrawal liability.

A multiemployer plan may adopt rules consistent with the bill which set forth other terms and conditions for the satisfaction of an employer's withdrawal liability.

In the case of a multiemployer plan which terminates, each employer's obligation to make withdrawal liability payments for the future is to cease at the plan year in which the plan's assets, exclusive of outstanding withdrawal liability claims, are sufficient to meet all of its obligations. This determination of sufficiency is to be made by the PBGC.

[29] *(3) Notice requirements and furnishing of information*

Withdrawal liability is to be collectible upon notice and demand to the withdrawn employer by the plan sponsor. In order for the plan sponsor to be in a position to accurately determine liability, the bill requires the employer to furnish information to the plan sponsor. After an employer withdraws from a plan, the plan sponsor is to request in writing that the employer furnish such information as the plan sponsor reasonably considers necessary for it to fulfill its duties in computing and collecting withdrawal liability. The bill requires an employer to furnish the requested information within 30 days after such a written request from the plan sponsor.

The actual demand for payment of liability in accordance with the payment schedule is to be made by the plan sponsor. The bill requires that before the plan sponsor demands payment the plan must afford the employer a reasonable opportunity (1) to identify errors in the determination of withdrawal liability, (2) to identify errors in the payment schedule, and (3) to furnish to the plan sponsor any additional pertinent information. The plan sponsor also is required, if requested, to make relevant plan records reasonably available to the employer for review and duplication.

After the plan sponsor demands payment of withdrawal liability, an employer is permitted to request the plan sponsor to review any item relating to the calculation of the liability and the payment schedule. Any such request for review is to be made within 90 days after the employer receives the initial notice and demand for payment of the liability. In response to such a request by an employer, the plan sponsor is required to conduct a reasonable review of any matter questioned and to notify the employer of (1) its decision, (2) the grounds for its decision, and (3) the reason for any modification in the employer's withdrawal liability or of the payments schedule.

(4) Determination of actuarial assumptions, etc.

The PBGC is authorized to prescribe regulations setting forth actuarial assumptions which a plan may use in calculating withdrawal liability. However, a plan may provide instead that its own assumptions will be used to determine withdrawal liability

rather than those developed by the PBGC.

In determining the unfunded benefit obligations under a plan, the plan's actuary and the plan administrator are permitted to rely on data available or on data secured by certain sampling techniques in situations where complete and definitive data is absent, provided such data can reasonably be expected to be representative of the status of the entire plan. In addition, a complete valuation of the plan is not required by the bill to be made more often than once every three years for the purpose of computing unfunded benefit obligations under the withdrawal liability provisions and reasonable estimates would be permitted in the interim years. However, the bill continues the authority of the Internal Revenue Service to require more frequent valuations in appropriate cases.

Under the bill, the plan sponsor may initially determine withdrawal liability on the basis of the latest available determination of contributions made to the plan by employers and the latest available actuarial valuation or, if later, the latest actuarial estimate.

[30] (*5*) *Plan rules and amendments*

There are several situations where plans, in the application of their own rules, either initially or by amendment, are permitted a wide degree of latitude in allocating and calculating withdrawal liability. In order to protect an employer from certain retroactive changes in a plan's rules, the bill prohibits the retroactive application of a plan rule or amendment relating to withdrawal liability from applying to a withdrawal occurring before its date of adoption, unless the employer consents to its earlier application.

The bill also requires that plan rules and amendments operate and be applied uniformly with respect to all employers except to the extent that lack of uniformity would be required to take into account employers' credit ratings.

Under the bill, when a plan rule or amendment affects withdrawal liability, the plan sponsor is required to give notice of the adoption of the rule or amendment to all employers required to contribute to the plan and to all employee organizations representing employees covered by the plan.

(*6*) *Notice to the PBGC*

Under regulations the PBGC is permitted to require a plan sponsor to notify the PBGC in any case where the withdrawal from a plan of an employer has resulted, or will result, in a significant reduction in total contributions to the plan.

(*7*) *Relationship to other rules*

Actions taken under the bill pursuant to the withdrawal liability rules are not to be considered prohibited self-dealing transactions for purposes of the nontax provision of ERISA.

In addition payments of withdrawal liability are not to be considered employer contributions for purposes of calculating withdrawal liability.

(*8*) *Approval of amendments*

If an amendment to a multiemployer plan authorized under the withdrawal liability provisions is adopted more than 36 months after the effective date of the bill, the amendment will be effective only if (1) the PBGC approves the amendment, or (2) within 90 days after it receives notice of the amendment from the plan sponsor, the PBGC fails to disapprove the amendment. However, certain amendments regarding methods for computing withdrawal liability could be adopted only in accordance with the section of the bill authorizing the amendments. The PBGC is to disapprove of a plan amendment only where it determines that the amendment creates an unreasonable risk of loss to plan participants, beneficiaries, or the PBGC.

(*9*) *Determinations presumed correct*

Under the bill, a determination of withdrawal liability by a plan would be presumed correct unless the party seeking to contest the determination shows by a preponderance of the evidence that the determination is unreasonable or clearly erroneous.

The determination by a plan as to the amount of its unfunded benefit obligations for a plan year is to be presumed correct, unless a party [31] seeking to contest the determination shows by a preponderance of the evidence that (1) the actuarial assumptions and methods used in the determination were unreasonable in the aggregate, or (2) a significant error was made by the plan's actuary in applying actuarial assumptions or methods.

(*10*) *Supplemental fund for reimbursement for uncollectible withdrawal liability*

Under the bill, the PBGC is required to establish a supplemental program by May 1, 1982, to reimburse multiemployer plans for withdrawal liability payments which are uncollectible because of bankruptcy or similar proceedings involving the employer. Under the program, the PBGC could also provide for reimbursement of a plan for withdrawal liability which is uncollectible for any other appropriate reason. A plan could elect coverage under the supplemental program and, if it did so, would be charged a premium for such coverage. The cost of the program (including appropriate administrative and legal costs) could be paid only out of premiums collected under the program. The PBGC could carry out the program in whole or in part under an arrangement with private insurers.

(*11*) *Definition of obligation to contribute*

For purposes of the withdrawal liability rules, an employer has an obligation to contribute if its obligation arises under one or more collective bargaining (or related) agreements or as a result of a duty under applicable labor-management relations law. An obligation to pay withdrawal liability

or delinquent contributions is not considered an obligation to contribute.

2. Merger or transfer of plan assets or liabilities

a. Mergers and transfers to multiemployer plans

Under the bill, unless otherwise provided in PBGC regulations, a plan sponsor is not to be permitted to allow a multiemployer plan to merge (or consolidate) with one or more other multiemployer plans or to engage in a transfer of assets or liabilities to or from another multiemployer plan unless certain conditions are met. The applicable conditions are that:

(1) The accrued benefit of any participant or beneficiary will not be lower after the merger or transfer than it was before the merger or transfer;

(2) the benefits of participants and beneficiaries are not reasonably expected to be reduced under the reorganization or insolvency provisions of the bill during the five-year period following the year in which the merger or transfer is effective;

(3) it is not reasonably expected that the risk of loss to the PBGC with respect to any of the affected plans will increase significantly;

(4) an actuarial valuation of assets and liabilities of each of the affected plans for the plan year preceding the merger or transfer has been performed and the valuation is based on data not more than two years old; and

(5) the merger or transfer is agreed to by the plan sponsors of all the affected plans.

[32] Under the bill, action taken under the merger, etc. provisions does not constitute a prohibited self-dealing transaction under the nontax provisions of ERISA.

The plan sponsor of a multiemployer plan which is affected by a proposed merger is to be permitted to request an advisory opinion from the PBGC that the proposed merger complies with the requirements of the bill.

b. Transfers between a multiemployer plan and a single-employer plan

The bill provides that, in the case of a transfer of assets or liabilities from a multiemployer plan to a single-employer plan, the accrued benefit of any participant could not be lower immediately after the transfer than it was immediately before the transfer. In addition, in the case of a transfer of liabilities from a single-employer plan to a multiemployer plan or a merger of a single-employer plan into a multiemployer plan, no accrued benefit could be lower immediately after the transfer or merger than it was immediately before the transfer or merger.

As a general rule, the bill requires that, where a multiemployer plan transfers liabilities to a single-employer plan, the multiemployer plan is to be liable to the PBGC in the event of the termination of the single-employer plan within 60 months after the transfer. Under the bill, the amount of the liability is to be the lesser of (1) the excess of the insufficiency of plan assets of the terminated single-employer plan over 30 percent of the net worth of the employer maintaining the single-employer plan, or (2) the actuarial present value of the unfunded benefits transferred to the single-employer plan and guaranteed by the PBGC (such present value to be determined at the time of the transfer). This liability is to apply to a multiemployer plan unless the PBGC determines that the interests of the participants and the PBGC are otherwise adequately protected or the PBGC fails to make a determination. The PBGC is to make such determination within 120 days after receipt of a complete application from the plan sponsor of the multiemployer plan that such a determination be made. If the PBGC fails to make the determination within the prescribed period, the multiemployer plan is not to have contingent liability. A multiemployer plan is not to be liable under the bill because of the transfer of liabilities to a single-employer plan where (1) the liabilities had previously accrued under a single-employer plan that merged with the multiemployer plan, (2) the present value of the liabilities is not greater than the present value of liabilities for benefits which accrued before the single-employer plan merged with the multiemployer plan, and (3) the value of the assets which would have been in the single-employer plan if the employer had maintained and funded it as a separate plan under which no benefits accrued after the merger. This exception to the liability provision is sometimes referred to as the "in and out rule" because it is designed to protect multiemployer plans which merge with but later spin off single-employer plans.

In any case where a multiemployer plan is liable under the bill because of a merger or transfer, the PBGC is authorized to make arrangements for satisfaction of the liability.

[33] Where benefits are transferred to a single-employer plan under the merger or transfer rules, the benefits are thereafter to be governed by the termination insurance rules applicable to single-employer plans.

As a general rule, a multiemployer plan is not to be permitted to transfer assets to a single-employer plan unless the plan sponsor of the single-employer plan agrees to the transfer. In the case of a transfer under the "in and out" rule, however, the plan sponsor need not so consent if advance agreement is obtained from the employer who, after the transfer, will be obligated to contribute to the single-employer plan.

c. Partition

Partition could occur under the bill when, pursuant to court order obtained by the PBGC, a portion of the assets and liabilities of a multiemployer plan is segregated and held as a separate fund. Under the bill, a plan sponsor is permitted to request the PBGC to petition a Federal District Court for an order of partition upon a showing of certain facts. The plan sponsor would have to show that (1) a bankruptcy or similar proceeding with respect to an employer has resulted or will result in a subtantial reduction in the aggregate amount of contributions

to the plan, and (2) it has determinel that the participants and beneficiaries' vested benefits which would be partitioned are directly attributable to service with the employer involved in the bankruptcy or similar proceeding.

If the PBGC determines that a multiemployer plan is likely to become insolvent as a result of a reduction of contributions because an employer is involved in a bankruptcy or similar proceeding, the PBGC may petition the Federal District Court for partition, if the PBGC determines that partition will significantly decrease the risk that insolvency of the multiemployer plan will occur. In such a case, the PBGC is required to notify the plan sponsor and the plan participants and beneficiaries whose benefits would be partitioned. The PBGC, in its petition, is to be permitted to propose a transfer of only vested benefits directly attributable to service with the employer involved in the bankruptcy or similar proceeding and an equitable share of the plan's assets.

The portion of the multiemployer plan which is partitioned is treated under the bill as a terminated multiemployer plan under which only the employer involved in the bankruptcy or similar proceeding would have withdrawal liability.

d. Assets transferable

Under the bill, multiemployer plans are required to provide rules regarding the transfer of assets to another plan. The rules could not restrict unreasonably the transfer of plan assets in connection with a transfer of plan liabilities and are to operate and be applied uniformly with respect to all transfers, except that reasonable variations are to be permitted to take into account the potential financial impact of a particular transfer on a multiemployer plan.

e. Other rules

Under the bill, the PBGC is required to prescribe regulations exempting *de minimis* transfers of assets from the merger, etc. rules. In addition, the merger, etc. rules do not apply to transfers of assets [34] pursuant to written reciprocity agreements except to the extent provided in PBGC regulations.

3. Reorganization and minimum contribution requirement

a. In general

Under the bill, certain financially troubled multiemployer plans are to be considered in a status of "reorganization." Once a plan enters a status of reorganization (1) benefits under the plan, including benefits currently being paid to retirees or their beneficiaries, could be reduced, (2) certain modifications to the otherwise applicable funding requirements of ERISA are to apply, and (3) certain prohibitions against increases in benefits are to apply if reductions are made.

b. Reorganization status

Under the bill, if the financial condition of a multiemployer plan becomes sufficiently poor under standards set forth in the bill, the plan is to be considered in reorganization and become subject to certain special rules regarding funding and adjustments in accrued benefits.

A multiemployer plan is to be in reorganization for a year if the plan's reorganization index is greater than zero. The reorganization index is the excess of the "benefit entitlements charge" of the plan over the net charge to the plan's funding standard account (see I. Minimum Funding Requirements) for the year without taking into account (1) credits for actual contributions to the plan for the year, (2) credits with respect to any waived funding deficiency for the year, and (3) credits with respect to any switchback liability for the year.[6] "Benefit entitlements charge" is defined as the amount necessary to amortize, in equal annual installments, the unfunded benefit obligations of the plan, determined as of the close of the plan year, (1) over 10 years in the case of obligations attributable to persons whose benefits are in pay status, and (2) over 25 years in the case of unfunded benefit obligations for other participants.

Under the bill, the determination of unfunded benefit obligations for purposes of calculating the benefit entitlements charge is based on a valuation of the plan performed as of the last day of the "base plan year", with certain adjustments. The "base plan year" for any plan year is the last plan year ending at least six months before the earliest of the effective dates of the "relevant collective bargaining agreements". A relevant collective bargaining agreement is a collective bargaining agreement (1) which is in effect for more than six months during the plan year for which the charge is determined and (2) which has not been in effect for more than three years as of the end of the plan year.[7] In any case where there is no relevant collective bargaining agreement, the base plan year is the plan year ending at least one year before the beginning of the plan year in which the determination of unfunded benefit obligations is made. Of course, the Secretary of the Treasury is to have the authority to require that the benefit entitlements charge and the charges and credits to the funding standard account are computed on a consistent basis.

[35] *c. Prohibition of certain payments*

Under the bill, while a plan is in reorganization, the present value of a participant's vested benefits derived from employer contributions is not to be permitted to be distributed in a form other than substantially level pension payments for life if the present value distribution would exceed $1,750. This prohibition is not to apply (1) in the case of a death benefit distribution, or (2) if the PBGC ap-

[6] In the case of a multiemployer plan using the "shortfall" method in computing actuarial costs, shortfall gains and losses in that plan year are to be taken into account in computing the net charge for the plan year.

[7] The six-month period may be, for example, the first six months or last six months of a particular agreement.

proves the payment of benefits in accordance with the plan in a greater amount after determining that the payment is in the interest of the plan's participants and beneficiaries and does not unreasonably add to the PBGC's risk of loss with respect to the plan.

d. Termination of reorganization status

A terminated multiemployer plan is not considered to be in reorganization after the date on which the last employer maintaining the plan withdraws from the plan. For this purpose, the determination of whether a withdrawal takes place is to be made in accordance with the definition of withdrawal contained in the bill's withdrawal liability provisions (see C. Employer Withdrawal Liability, Mergers, Etc., *Explanation of provisions, 1. Employer withdrawal liability, a. Definition of withdrawal, (1) Complete withdrawal*) and partial withdrawals are not to be taken into account.

e. Notice of reorganization

Under the bill when a multiemployer plan is in reorganization and would require an increase in contributions (before taking into account the credit for overburdened plans and accrued benefit reductions permitted under the reorganization provisions), the plan sponsor is required to notify interested parties of the reorganization status in the plan's summary annual report. The persons to be notified are (1) plan participants and beneficiaries, (2) employers required to contribute to the plan, and (3) employee organizations representing plan participants with respect to the plan. In addition to stating that the plan is in reorganization status, the notice must state that if contributions to the plan are not increased, then accrued benefits under the plan may be reduced or an excise tax may be imposed on employers if they fail to increase plan contributions.

In addition, the PBGC is to be authorized to issue regulations prescribing additional or alternative requirements for assuring adequate notice to, and access to relevant information, by interested parties.

f. Minimum contribution requirement

(1) In general

Under the bill, a plan in reorganization or a plan under which plan assets are not more than a specified multiple of benefit payments is to continue to maintain its funding standard account, but such a plan is also to be required to meet special minimum funding requirements. These requirements are to be met for a plan year if the sum of the "minimum contribution requirement" plus any accumulated funding deficiency for the preceding plan year did not exceed the amounts contributed by employers to the plan year, including amounts contributed to meet withdrawal liability obligations. If these requirements are not met, the accumulated funding deficiency for that plan year is to be the excess of the sum of the "minimum contribution re-[36]quirement" and the accumulated funding deficiency for the preceding plan year over the plan contributions, and employers are to be subject to the current excise taxes on accumulated funding deficiencies (or subject to the current conditions for having such deficiencies waived by the Internal Revenue Service).

The bill defines the minimum contribution requirement as the sum of (1) the plan's benefit entitlements charge,[8] and (2) in certain cases where the plan has been amended to increase benefits while the plan is in reorganization, the excess, if any, of the normal cost attributable to such plan amendment reduced by 15 percent of the normal cost computed without regard to the amendment. The minimum contribution requirement is reduced proportionately where the plan's current contribution base (*e.g.*, hours of service) for which employer contributions are required for the plan year is less than the plan's valuation contribution base. A plan's "valuation contribution base" is generally equal to the plan's contribution base for the plan year for which the actuarial valuation used to determine unfunded benefit obligations under the plan was made, with certain adjustments for upward or downward trends. Special rules apply for determining a plan's valuation contribution base for a plan year in which the plan is insolvent.

In the case of a plan in reorganization, if the plan's benefit entitlements charge is less than the plan's "cash flow amount" for a plan year, the minimum contribution requirement is determined by substituting the "cash flow amount" for the benefit entitlements charge. For this purpose, "cash flow amount" is the aggregate amount of benefits payable under the plan increased by the plan's administrative expenses for the plan year and decreased by the value of available plan assets, as determined under regulations prescribed by the Secretary of the Treasury. Also, in determining a plan's minimum contribution requirement for a plan year, the benefit entitlements charge may be adjusted to reflect a subsequent plan amendment which reduces benefits under the reorganization or plan termination provisions of the bill or under the funding standard. This adjustment would only take place, however, if the amendment is adopted and effective no later than 2½ months after the close of the plan year, or within an extended period for making the amendment as prescribed in regulations issued by the Secretary of the Treasury.

In addition, during the period that a plan is required to meet the "minimum contribution requirement," a credit or charge balance may build up in the plan's funding standard account which is being maintained. The bill provides that if a plan is not required to meet the "minimum contribution requirement" for a plan year but was required to meet such requirement for the preceding plan year, any balance

[8] Where the benefit entitlements charge is less than 115 percent of the amount of benefits payable during a plan year, reduced by the plan's investment income for the year, and plan reserves are very low, such amount is substituted for the benefit entitlements charge.

in the funding standard account is to be eliminated by an offsetting credit or charge (as appropriate) which is to be amortized over the following 30 years.

[37] Under the bill, a multiemployer plan is considered not to have a reorganization deficiency for a plan year if the rate of employer contributions under the plan equals or exceeds (1) the net charges to the funding standard account plus (2) seven percent of such amount for each year for which the minimum contribution requirement has applied to the plan. This seven percent limitation does not apply if a plan amendment is adopted while the plan is in reorganization and the amendment increases benefits with respect to service performed before the date the amendment is adopted.

(2) *Credit for overburdened plans*

Where a plan is considered to be financially overburdened for a plan year (determined under standards set forth in the bill), the plan is required to apply an "overburden credit" against its minimum contribution requirement for the plan year. Accordingly, the overburden credit would reduce the additional funding needed to satisfy the minimum contribution requirement.

A plan is considered overburdened for a plan year under the bill if (1) the average number of participants in pay status in the year exceeds the average of the average number of active participants in that year and in the preceding two plan years, and (2) the rate of employer contributions to the plan is at least equal to the greater of the rate of contributions for the preceding plan year or the rate of contributions for the year before the first plan year in which the plan was in reorganization (or in which the plan assets were not more than a specified multiple of benefit payments). For purposes of this rule, "pay status participant" means a retired employee receiving pension payments as an annuity, and "active participant" means (1) any plan participant who has not failed to accrue a benefit for the year because of insufficient active employment, (2) any active employee who is not a plan participant but who is in an employment unit covered by a collective bargaining agreement requiring the employee's employer to contribute to the plan, and (3) any active employee considered an employee of the employer under a special formula in the bill which treats certain employees as the employer's employees on the basis of the employer's withdrawal liability contributions to the plan. Also, for purposes of applying the overburden credit rules, in determining the first plan year in which a plan is in reorganization, years in which the plan was previously in reorganization are disregarded if followed by three consecutive plan years in which the plan is not in reorganization.

The amount of overburden credit for a plan year is to be the product of two amounts. The first amount is one-half of the "average guaranteed benefit paid" in the base plan year and the second amount is the "overburden factor" for the plan year. The "average guaranteed benefit paid" is 12 times the average monthly pension payments guaranteed under the bills, computed by dividing (1) the total guaranteed annuity pension payments under the plan by (2) the number of pay status participants in the plan for the plan year. The "overburden factor" for a plan for a plan year is the excess of (1) the average number of pay status participants for the base plan year over (2) the average of the average number of active participants in the plan in that plan year and the two preceding plan years.

[38] Under the bill, the Secretary of the Treasury could deny a plan an overburden credit for a plan year upon a finding that (1) the plan's current contribution base was reduced without a correlative reduction in the plan's unfunded benefit obligations attributable to pay status participants, and (2) such reduction resulted from a change in an agreement providing for employer contributions to the plan. Accordingly, a plan that has excluded active employees is not to be eligible for the overburden credit. However, an employer withdrawal from a plan is not to prevent the plan from being eligible for the overburden credit, unless the Secretary of the Treasury finds that in connection with the withdrawal a contribution base reduction resulted from a transfer of plan liabilities to another plan.

Under the bill, in the case of the merger of plans involving one or more multiemployer plans which are in reorganization, there is to be a limit on the amount of overburden credit which could be applied to the minimum contribution requirement of the merged plan. The maximum credit for any of the first three plan years ending after the merger could not exceed the sum of the overburden credits applied by each of the plans to avoid a reorganization deficiency for the last plan year ending before the merger. Of course, the rules relating to mergers also apply in computing the overburden credit in the case of a consolidation of plans.

g. Adjustments in accrued benefits

With very limited exceptions, under present law, plan amendments are not permitted to reduce benefits already accrued by an employee. However, in the case of a multiemployer plan in reorganization, the bill permits plan amendments to reduce accrued benefits attributable to employer contributions under specified circumstances. The accrued benefits which are subject to reduction are those which have been in effect under the plan for less than 60 months and are not eligible for guarantee by the PBGC.

The conditions which must be met in order for a plan's accrued benefits to be reduced are as follows:

a. A notice must be given, at least six months in advance of the first day of the plan year in which the amendment reducing accrued benefits is adopted, to plan participants and beneficiaries, to each employer with an obligation to contribute to the plan, and to each affected employee organi-

zation. The notice must state that the plan is in reorganization and that if contributions to the plan are required to be increased and the increase is not made, accrued benefits under the plan are required to be reduced or the failure to increase employer contributions to the plan may result in an excise tax for failure to meet the minimum funding standard.

b. Under regulations to be issued by the Secretary of the Treasury—

(i) accrued benefits of inactive participants are not to be reduced to a greater extent proportionally than accrued benefits for active participants are reduced;

(ii) benefits attributable to employer contributions other than accrued benefits (such as death benefits or health benefits) and the rate of future benefit accruals are to be decreased [39] at least as much as accrued benefits of active participants are decreased; and

(iii) if the reduction in accrued benefits takes the form of a change in the mode of benefit or the requirements for benefit entitlements, the reduction may not affect benefits in pay status on the effective date of the amendment or benefits of any participant who has reached, or is within five years of reaching, normal retirement age on the effective date of the amendment.

c. The rate of employer contributions for the plan year in which the amendment becomes effective and for all future years while the plan is in reorganization must at least equal the greater of (i) the rate of employer contributions (without regard to the amendment) for the plan year in which the amendment becomes effective, or (ii) the rate of employer contributions for the preceding plan year.

Where accrued benefits are decreased by a plan amendment, a plan is not to be permitted to recapture a benefit payment which has already been made under the plan's accrued benefit provisions determined before the amendment is adopted.

Once a plan has been amended to decrease accrued benefits, a future plan amendment is not to be permitted to increase (1) accrued benefits, or (2) the rate of future benefit accrual, only if the plan is first amended to restore previously eliminated accrued benefits of inactive participants and participants within five years of normal retirement age at least to the extent of the amount or rate by which the plan amendment increases benefit accruals. Moreover, where a plan is amended so that it partially restores previously accrued benefit levels or the previous rate of accrual, the benefits of inactive participants must be restored in at least the same proportion as accrued benefits are restored overall.

Under the bill, no increase in benefits under a plan is to be permitted to take effect in a plan year in which an amendment reducing accrued benefits is adopted or first becomes effective.

Where a benefit is reduced and later restored, a plan is not required to make retroactive benefit payments to participants who received payment under the reduced accrued benefit levels.

For purpose of applying the benefit reduction rules, an inactive participant is an individual whose benefits are in pay status under the plan or an individual not currently in service under the plan but who nevertheless has a vested plan benefit.

The Secretary of the Treasury is authorized to prescribe regulations permitting benefit reductions or increases for different groups of participants on an equitable basis to reflect variations in contribution rates and other relevant factors reflecting differences in bargained-for levels of financial support for plan benefit obligations.

h. Insolvent plans

Under the bill, if a multiemployer plan is insolvent for a plan year, the plan is to be required to suspend the payment of benefits, other than basic benefits, which exceed the "resource benefit level." The suspension rule does not apply, however, if the PBGC prescribes a procedure for the guarantee of supplemental benefits (retirement ben-[40]efits exceeding basic benefits) to the extent supplemental benefits are guaranteed by the PBGC. A multiemployer plan is considered insolvent for a plan year if (1) it is in reorganization, (2) it has been amended to reduce benefits to the level of basic benefits, and (3) it does not have available resources sufficient to pay benefits under the plan when due for the plan year. The term "resource benefit level" means the highest level of monthly benefits which the plan could pay out of its available resources.

For each year for which a multiemployer plan is insolvent, the plan sponsor is to be required to determine and certify the resource benefit level of the plan, based on its reasonable projection of available resources and benefits payable. Where the suspension of benefits above the resource benefit level takes place, benefits are to be suspended in substantially uniform proportions with respect to all persons whose benefits are in pay status under the plan. The proportionate suspension is to be done in a manner consistent with regulations prescribed by the Secretary of the Treasury. In addition, the Secretary of the Treasury is to be authorized to prescribe rules under which the benefits of different participant groups could be suspended in disproportionate fashion if varied equitably to reflect variations in contribution rates and other relevant factors reflecting differences in bargained-for levels of financial support for plan benefit obligations.

A plan sponsor is not to be permitted to determine and certify a resource benefit level which is below the level of basic benefits for a plan year, except in a case where payment of all benefits other than basic benefits was suspended for the plan year.

If, by the end of a plan year for which a plan is insolvent, the plan sponsor determines that benefits can be paid above the resource benefit

level, the plan sponsor is required to direct the distribution of such additional benefits in accordance with regulations prescribed by the Secretary of the Treasury. Where by the end of the year, benefits up to the resource benefit level have not been paid, the amount necessary to bring benefits up to that level are required to be distributed in accordance with regulations prescribed by the Secretary of the Treasury, to the extent possible, considering the plan's available resources.

Every three years during the period when a plan is in reorganization, beginning with the end of the first such plan year, the plan sponsor is required to compare the value of plan assets with the total amount of benefit payments for the year. Except where plan assets exceed three times the total amount of benefit payments, the plan sponsor is to be required to make a determination regarding whether the plan will be insolvent during any of the next three plan years. In addition, if at any time the plan sponsor determines, on the basis of experience, that available resources are not sufficient to pay benefits when due for the forthcoming plan year, the sponsor is required to certify that the plan will be insolvent for that year. Such certification is required no later than three months before the commencement of the plan year.

For each year for which a plan is insolvent, the plan sponsor is required to determine and certify the resource benefit level and the level of basic benefits no later than three months before the commencement of the plan year. In addition, if the plan sponsor determines that [41] the plan may be insolvent any time in the next three plan years, the sponsor is to be required to so notify (1) the Secretary of the Treasury, (2) the PBGC, (3) plan participants and beneficiaries, (4) each employer required to contribute to the plan, and (5) each affected employee organization. In addition, the above parties other than the Secretary of the Treasury and the PBGC are to be informed that, in the event of insolvency, payments in excess of basic benefits are to be suspended (unless guaranteed as supplemental benefits). No later than two months before the first day of a year for which a plan is insolvent, the plan sponsor is required to notify each of the above parties of the plan's resource benefit level.

Where the plan sponsor believes that the resource benefit level for a plan year for which a plan is insolvent may not exceed the level of basic benefits, the plan sponsor is to so notify PBGC no later than six months before the first day of the plan year.

Where a plan sponsor determines and certifies a resource benefit level below the level of basic benefits, the sponsor is to apply for PBGC financial assistance. Where the plan sponsor determines a resource benefit level above the level of basic benefits but anticipates that for any month during a year for which the plan is insolvent the plan will not have sufficient assets to pay basic benefits, the plan sponsor is to be permitted to apply to the PBGC for financial assistance.

4. Financial assistance

Under the bill, if the PBGC receives an application for financial assistance from a plan and verifies that the plan will be insolvent and unable to pay basic benefits when due, the PBGC is to provide financial assistance to the plan in an amount sufficient to permit the plan to pay its basic benefits. Such financial assistance is to be provided under such conditions as the PBGC determines to be equitable and appropriate to prevent unreasonable loss to the PBGC with respect to the plan. Where a plan receives financial assistance from the PBGC, it is to repay the PBGC for such assistance on reasonable terms which are consistent with regulations to be issued by the PBGC.

While the PBGC is determining the amount of assistance necessary to permit a plan to pay basic benefits, the PBGC is to be permitted to provide interim financial assistance in an amount appropriate to avoid undue hardship to plan participants and beneficiaries.

5. Benefits under certain terminated plans

Under the bill, where a plan terminates by a mass withdrawal of employers the plan sponsor is required to amend the plan (1) to reduce benefits, and (2) to suspend certain benefit payments. The reduction in benefits is to be to a level at which plan assets will be sufficient to discharge the plan's obligations when due, but not to a level of benefits below the level eligible for guarantee. In making the determination of this level, the present value of vested benefits under the plan and the value of plan assets are to be determined and certified as of the end of the plan year in which the plan terminates, and as of the end of every plan thereafter. For this purpose, (1) plan assets include the value of outstanding claims for withdrawal liability that are not uncollectible, and (2) for the year in which the plan terminates and for the following two plan years plan assets also include certain additional assets [42] attributable to employer withdrawal liability, as prescribed in regulations issued by the PBGC in order to avoid premature benefit reductions.

Any plan amendment reducing benefits as to (1) limit the reduction to the extent necessary to permit the payment of vested benefits, (2) eliminate or reduce only those accrued benefits which are not guaranteed by the PBGC, (3) except to the extent permitted by the PBGC, make reductions only in accordance with the reorganization rules and only to the extent permitted under such rules, and (4) become effective no later than six months after the plan year in which it was determined that the present value of vested benefits exceeds plan assets. The Committee expects that a reduction of benefits for a participant or beneficiary to a greater extent than is permitted under the bill will be considered a violation of the minimum

standards of ERISA (*e.g.*, the vesting and fiduciary standards) and that fiduciaries will act prudently in discharging their duties to retirees and other participants and beneficiaries.

The benefit payments which are to be suspended where a plan terminates are all nonbasic benefits that cannot be provided out of plan resources.

6. Enforcement

a. Civil actions

Under the bill, certain parties could bring a civil action for appropriate legal relief, equitable relief, or both. These parties are (1) a plan fiduciary, an employer, a plan participant, or a plan beneficiary, any of whom are adversely affected by an act or omission of any party under the provisions of the bill with respect to multiemployer plans, as well as (2) an employee organization which represents an affected plan participant. However, no such action could be brought against the Secretary of the Treasury or the Commissioner of Internal Revenue.

In any case where a civil action is brought to compel an employer to pay withdrawal liability, the court may award (1) the unpaid liability plus interest as well as (2) liquidated damages payable to the plan. In general, the district courts of the United States have exclusive jurisdiction for civil actions under the bill without regard to the amount in controversy. In the case of an action brought by a plan fiduciary to collect withdrawal liability, State courts of competent authority are also to have jurisdiction.

The proper venues in Federal district court for bringing an action under the bill are to be (1) the district where the plan is administered, (2) the district where a defendant resides, or (3) the district where a defendant does business. Service of process is to be permitted in any district where a defendant (1) resides, (2) does business, or (3) may be found. In addition, a copy of the complaint in any action brought under the bill is to be served on the PBGC by certified mail. The PBGC may intervene in any action brought under the bill.

In the case of an action under the bill, the court is permitted to award to the prevailing party all or a portion of costs and expenses in connection with the action, including reasonable attorney's fees.

The period of limitations for the commencement of an action under the bill is to expire six years after the date on which the cause of action arose.

[43] *b. Penalty for failure to provide notice*

If any person fails without reasonable cause to provide any notice required under the termination insurance program for multiemployer plans or under implementing regulations the bill provides that the person is to be liable to the PBGC in an amount up to $100 for each day that the failure continues. The PBGC is authorized to bring a civil action against the person failing to give notice. The action could be brought in the United States District Court for the District of Columbia or in any United States district court within the jurisdiction where (1) the plan assets are located, (2) the plan is administered, or (3) a defendant resides or does business. Service of process for such an action may take place in any district where a defendant (1) resides, (2) does business, or (3) may be found.

General effective date

The provisions of the bill generally apply on the date of enactment. One exception is that the withdrawal liability rules take effect as of February 27, 1979. For purposes of determining whether an employer has withdrawn from a multiemployer plan, the definition of multiemployer plan in effect at the time of the withdrawal is to be applied. Another exception is that the reorganization provisions take effect on the first day of the first plan year beginning after the earlier of (1) the expiration date of the last collective bargaining agreement in effect on the date of enactment of the bill or (2) 3 years after the date of enactment of the bill.

Also, the bill provides that where an employer has withdrawn from a multiemployer plan before the date of enactment of the bill, and a bond or escrow has been provided by the employer under present law, the PBGC is to pay the bond or escrow to the plan if, because of the withdrawal of all employers from the plan, the plan terminates before February 27, 1984. In any case in which the plan is not terminated before February 27, 1984, the liability of the employer is abated and any payment held in escrow is to be refunded without interest to the employer or the employer's bond is to be cancelled.

[44] *Ways and Means Committee Amendment*

1. Definition of withdrawal—two-percent de minimis rule

Under the bill, an employer who is obligated to make less than two percent of the total contributions to a plan is generally not charged with withdrawal liability for a partial withdrawal from the plan. The Committee determined that it is inappropriate automatically to relieve employers of partial withdrawal liability where a plan has substantial unfunded benefit obligations.

The Committee amendment revises the two-percent *de minimis* rule for partial withdrawals. Under the amendment, the rule automatically applies only in the case of a plan with unfunded benefit obligations, determined as of the close of the plan year of a partial withdrawal, not exceeding $1.25 million. In the case of a plan with unfunded benefit obligations of more than $1.25 million, the two-percent *de minimis* rule applies only if the plan provides for its application.

2. Computation of withdrawal liability—West Coast longshore labor

Under the bill, withdrawal liability is imposed on employers who maintain multiemployer pension plans. Also under the bill, withdrawal liability,

absent a plan provision to the contrary, is generally computed under a rule which draws a distinction between unfunded benefit obligations created in plan years ending before February 28, 1979, and unfunded benefit obligations incurred in plan years ending on or after February 28, 1979.

The Committee has concluded that in the case of multiemployer plans covering West Coast longshore labor the PBGC should be authorized to define the term "employer". In addition the Committee has concluded that the presumptive method for computing withdrawal liability under the bill is inappropriate for a plan covering West Coast longshore labor and that withdrawal liability under such a plan should be computed under a method which draws no distinction with respect to whether unfunded benefit obligations are incurred in plan years ending before February 28, 1979, or in plan years ending on or after February 28, 1979.

The Committee amendment provides special rules for a West Coast longshore labor plan. Under the amendment (1) a West Coast longshore labor plan is to be required to use the second alternative method of computing withdrawal liability, and (2) the term "employer" with respect to such a plan will be defined under regulations prescribed by the PBGC. The amendment defines a West Coast longshore labor plan as a plan which covers longshore labor in all major ports with the western coastal area of the United States between Canada and Mexico.

[45] *3. Payment of withdrawal liability*

a. Determination by reference to prior average contributions

Under the bill, the annual amount of the withdrawal liability payments of an employer is based on the product of the average contribution base units and the employer's rate of contribution to the plan, determined with reference to a prior period.

The Ways and Means Committee recognizes that for purposes of computing the amount of an employer's annual withdrawal liability payments, a plan, at this time, may not have ready access to the records necessary to compute such payment based on the average number of contribution-base units during a prior period. For this reason, the Committee has decided for a transition period to permit plans to base the computation on the average required employer contributions during the prior period.

Under the amendment, a plan could provide that for any plan year ending before 1986, the amount of an employer's annual withdrawal liability payment would be the average of the required employer contributions under the plan for the period of three consecutive plan years for which such contributions were the highest during the period of ten consecutive plan years ending with the plan year in which the withdrawal occurs. This method could not be used by a plan for determining withdrawal liability payments in any case in which the plan terminates because of mass withdrawal. If a plan provides the computation method permitted by the Committee amendment and then the plan is amended to provide for use of the original method provided under the bill, the plan must use the original method thereafter.

b. Charge to employer for calculating withdrawal liability

Under the bill, because an employer who withdraws from a multiemployer plan may incur withdrawal liability, employers may be expected to request plan sponsors periodically to calculate potential withdrawal liabilities. The Committee has concluded that the expense of such calculations should not necessarily be borne by the plans.

Under the amendment, if any employer requests the plan sponsor to make an estimate of the employer's potential liability upon withdrawal from the plan, the plan sponsor may require the employer to pay the reasonable cost of providing the estimate. This specific authorization to adopt a plan provision under which a reasonable charge may be imposed for providing estimates of withdrawal liability is not intended by the Committee to limit the right of a plan to adopt other provisions for other reasonable charges authorized by the bill.

c. Withdrawal liability payment fund

Under the bill, a fund would be established to pay uncollectible employer withdrawal liability. The fund would be established and administered by the PBGC.

The Committee has concluded that a privately established fund for payment of withdrawal liability should be available as an alternative to a fund administered by the PBGC. In addition, the Committee has concluded that premiums for the PBGC maintained fund should be subject to Congressional review. The Committee believes that the [46] PBGC should not be permitted to set unrealistically low premiums because such conduct could attract additional plan participation in the voluntary program in reliance on low premium levels.

Accordingly, the Committee amendment permits plan sponsors of multiemployer plans to establish and participate in private funds for the purpose of paying withdrawal liabilities under certain circumstances. Any such fund which meets the applicable requirements is to be a tax-exempt organization. The fund could be required to maintain agreements for collection of premiums and payment of withdrawal liability with respect to a substantial portion of the participants in the multiemployer plan eligible to participate in the fund. The fund is to be administered by a board of trustees on which there is equal representation of employers and employees.

Under the Committee amendment, the fund would receive contributions from participating plans. Contributions by a plan to the fund during a plan year are to reduce the amount considered contributed to the plan for the year for purposes of the minimum funding standard and the minimum

contribution requirement. The Committee expects that, in considering whether to approve a waiver of the funding requirements for a plan under section 412(d) of the Code for a plan year during which the plan has made a contribution to a withdrawal liability payment fund, the amount and nature of the payment will be taken into account.

The eligibility of a plan to participate in a fund is to be determined by the rules of the fund. Where an employer has withdrawn from a participating multiemployer plan and has incurred withdrawal liability, the fund would pay to the plan on behalf of the employer an amount not exceeding the portion of the employer's withdrawal liability which is not attributable to plan participants' service with an employer who was obligated to contribute to the plan on or after February 28, 1980 (unattributable liability). The fund could also pay withdrawal liability-type amounts which are not due from an employer solely because of (1) the special two-percent *de minimis* rule for partial withdrawal, (2) the general *de minimis* rule, or (3) the 30-year cap on withdrawal liability payments. In addition, the fund could pay withdrawal liability payments to the extent that they are uncollectible. The extent to which these types of amounts would be paid by the fund is generally to be determined under the rules of the fund. These payments are to be treated in the same manner as payments of withdrawal liability to the plan.

To the extent the fund pays unattributable withdrawal liability incurred by an employer, the employer is to be relieved of the liability.

Where a fund has paid uncollectible withdrawal liability to a plan, the fund is to be subrogated to the rights of the plan against the employer. If a withdrawal liability payment fund is terminated, any assets of the fund at termination are to revert to the participating plans and are not to revert to employers. Under the Committee amendment, the fund is not to lend its assets to participating plans or to the PBGC and the fund is not to borrow from participating plans or the PBGC.

The Committee amendment authorizes the PBGC to prescribe regulations with respect to withdrawal liability payment funds. The [47] Committee expects that such regulations will assure that the funds do not have the effect of undermining the purposes of the withdrawal liability rules. For example, the Committee expects the PBGC regulations will assure that payments by a fund with respect to unattributable liability are not in excess of appropriate levels. Of course, PBGC rules with respect to the withdrawal liability payment fund and with respect to the PBGC-administered fund are not to be designed or administered for the purpose of providing either of the arrangements a competitive advantage over the other.

The fund is to be maintained for the exclusive purpose of paying the specified withdrawal liability and withdrawal liability-type payments to plans as well as paying reasonable administrative expenses in connection with its operation.

Payments are not to be permitted from a withdrawal liability payment fund to a plan in the event of a withdrawal or partial withdrawal where the employees in the bargaining unit that has withdrawn from the plan continue, after the withdrawal, to be represented in negotiations with the employer by the labor organization representing the employees immediately before the withdrawal.

The amendment also provides for Congressional review of premiums for coverage under the PBGC maintained fund. Under the amendment, no revision of the premium schedule for this coverage could be adopted by the PBGC unless the revised schedule has been submitted to the Congress. The PBGC could adopt the revised schedule unless, within 60 days after the submission, the Congress disapproves of the revised schedule by a concurrent resolution which has been referred to the Committee on Ways and Means and the Committee on Education and Labor of the House, and to the Committee on Finance and the Committee on Labor and Human Resources of the Senate. The Committee expects that if the Congress disapproves of a revised premium schedule recommended by the PBGC, the PBGC will make appropriate adjustments to payments from the fund.

4. Notice of reorganization—content of notice to encompass beneficiary rights and remedies

Under the bill, a multiemployer plan in reorganization must notify interested parties of potential benefit reductions. Under the Committee amendment, the notices are to inform plan participants and beneficiaries of their rights and remedies and of the manner in which they may contact the Department of Labor for certain information. The Committee expects that the Department of Labor will refer inquiries from participants and beneficiaries to the Internal Revenue Service or to the PBGC in appropriate cases.

5. Minimum contribution requirement —seven-percent limitation on annual increase in contribution rate

Under the bill, a plan in reorganization is subject to a minimum contribution requirement which may require contributions greater than would be required under the minimum funding standard of ERISA, generally not to exceed the net charges to the funding standard account plus 7 percent of such amount for each year the minimum contribution requirements have applied to the plan. The Committee has determined that the minimum contribution requirement should not be [48] permitted to increase the rate of plan contributions above those required for the prior year by more than a reasonable amount.

Under the amendment, the minimum contribution requirement applicable to a plan for a particular plan year could not exceed an amount which would require a rate of employer contributions in excess of the rate which would be required to meet

the greater of (1) the net charges under the plan's funding standard account as if it were not in reorganization (without regard to any credit balance in the funding standard account) or (2) 107 percent of the amount required for the preceding year. This limitation does not apply with respect to a plan if, while the plan is in reorganization, a plan amendment is adopted which increases benefits with respect to service performed before the date the amendment is adopted.

6. Adjustments in accrued benefits—prohibition against reducing benefits scheduled on or before March 26, 1980

Under the bill, a multiemployer plan in reorganization may reduce certain accrued benefits. The Committee has determined that retroactive application of the accrued benefit reduction provision to a date before the day following the date the Committee considered the provision is not appropriate.

The Committee's amendment limits the reduction in accrued benefits which could be made by a plan in reorganization. Under the amendment, only a net increase in accrued benefits due to plan amendments (or plans) adopted after March 26, 1980, or under collective bargaining agreements entered into after March 26, 1980, could be reduced. The Committee intends that benefit increases which occur after March 26, 1980, but which were bargained for before that date, would be protected from reduction under the reorganization rules. However, the Committee does not intend to protect increases in benefits which are provided for under a plan before March 26, 1980, as part of a schedule of benefits which could be bargained for, but which are bargained for after March 26, 1980 (so called "bargaining-up").

7. Enforcement — liquidated damages with respect to delinquent contributions

Under the bill, in the case of an action to collect withdrawal liability, a court may award a plan liquidated damages. The Committee has concluded that in certain situations, reasonable attorney's fees, court costs, and liquidated damages should be awarded to a plaintiff in an action to collect delinquent plan contributions.

The Committees amendment provides that in the case of a civil action by any person to collect delinquent multiemployer plan contributions, regardless of otherwise applicable law, the court before which the action is brought may award the plaintiff (1) reasonable attorney's fees, (2) court costs, and (3) liquidated damages not to exceed 20 percent of the amount of delinquent contributions as determined by the court. However, these items are to be awarded to a plaintiff only to the extent that the multiemployer plan in question provided for such an award. The bill preempts any State or other law which would prevent the award of reasonable attorney's fees, court costs or liquidated damages or which would limit liquidated damages to an amount below the 20 percent level. However, the bill does not [49] preclude the award of liquidated damages in excess of the 20 percent level where an award of such a higher level of liquidated damages is permitted under applicable State or other law. The Committee amendment does not change any other type of remedy permitted under State or Federal law with respect to delinquent multiemployer plan contributions.

a. Certain withdrawals completed before July 31, 1979

Under the bill, the withdrawal liability rules are generally effective on February 27, 1979. The Committee has concluded, however, that the rules should not apply to certain partial or complete withdrawals completed before July 31, 1979.

The Committee's amendment creates an exception to the general effective date for withdrawal liability. Under the amendment, if (1) on March 23, 1979, an employer publicly announced (for example, by a press release or other appropriate means) a decision to cease covered operations at a number of facilities, (2) before May 3, 1979, such decision was communicated to the labor organizations which represented employees at the facilities, and (3) before July 31, 1979, the employer ceased all covered operations at any of the facilities, then the employer's withdrawal liability, if any, attributable to such facilities, could not exceed the amount determined under a special formula. The Committee intends that notice given at the national or local level of a labor organization is adequate notice to the labor organization for purposes of the amendment.

The special formula generally would limit withdrawal liability to the excess of an amount deemed to be the employer's liability to the plan less an amount deemed to be an accumulation of the employer's contributions to the plan. In addition, for a partial withdrawal, the employer, in the event of any future withdrawal, is to have its withdrawal liability computed as if it had paid its full liability for the partial withdrawal rather than only the amount determined under the special formula.

b. Certain partial withdrawals announced before December 13, 1979

Under the bill, in the case of a partial withdrawal, the withdrawal liability rules are generally effective on February 27, 1979. The Committee has concluded that the rules should not apply to certain withdrawals announced before December 13, 1979.

The Committee's amendment creates an exception to the general effective date for partial withdrawal liability. Under the amendment, if an employer (1) publicly announced the total cessation of covered operations at a facility before December 13, 1979, and such cessation occurs within 12 months after the announcement; (2) had not been obligated to make contributions to the multiemployer plan on behalf of the employees at such facility for more than eight years; and (3) after the cessation, does not commence operations which would be cov-

ered by the plan within the same State for one year, then the employer's partial withdrawal liability attributable to such facility could not exceed the amount determined under a special formula. The special formula generally would limit partial withdrawal liability to the excess of the present value of vested benefits under the plan considered [50] to be attributable to the withdrawing employer (determined on the basis of actual employee data for the period preceding the date of the partial withdrawal and on the basis of actuarial estimates thereafter) less an amount deemed to be an accumulation of employers' contributions to the plan.

8. Related technical changes

a. Notice provisions in connection with collection of withdrawal liability

Under the bill, an employer is permitted a 90-day period to request a review of a plan sponsor's determination of the employer's withdrawal liability and schedule payments. The Committee amendment makes it clear that the 90-day period begins to run the day after the employer receives notice from the plan sponsor of the amount of its withdrawal liability, and of the payment schedule.

b. Determination of reorganization status

The bill provides a test to determine whether a plan is in reorganization. Under the test, as a general rule, a plan will be in reorganization for a plan year unless the net charges to the funding standard account under the plan for the year are sufficient to amortize the plan's unfunded benefit obligations in equal annual installments over 10 years in the case of obligations attributable to persons in pay status and over 25 years in the case of other obligations.

The Committee amendment clarifies the precise tests to be applied under the bill in determining whether a plan is in reorganization for a year.

c. Partial withdrawal liability

Under the bill, an employer will generally be liable to a multiemployer plan for withdrawal liability in the event of what is known as a "partial withdrawal." A partial withdrawal occurs where the employer does not completely withdraw from the plan but where an event occurs indicating a meaningful reduction in the base for computing the employer's contributions to the plan. Under the bill, the amount of withdrawal liability in the case of a partial withdrawal is a pro rata portion of the amount of liability which would be applicable if the withdrawal were a complete withdrawal.

The Committee amendment clarifies the three events which trigger a partial withdrawal and the rules for computing the liability for a partial withdrawal.

Under the amendment, as under the bill, the three events which will trigger a partial withdrawal from a multiemployer plan are (1) a 60-percent decline in contribution base units; (2) a facility closing resulting in a 25-percent decline in contribution base units; and (3) a cessation of an employer's obligation to contribute to a plan under one but not all of the collective bargaining agreements obligating the employer to contribute to the plan.

(1) 60-percent decline.—

Under the amendment, a 60-percent decline in contribution base units is considered to take place in a plan year if during the plan year and during the preceding two plan years (the "3-year testing period") the number of contribution base units (*e.g.*, hours worked) [51] with respect to which the employer was required to make plan contributions did not exceed 40 percent of the number of such contribution base units during the plan year (in a five-year base period) during which contribution base units were the highest. For example, assume a determination is to be made as to whether a partial withdrawal takes place under this rule for the plan year which is the calendar year 1987. Assume that the employer's contribution base units for 1985, 1986 and 1987 are 35,000 hours, 36,000 hours, and 37,000 hours respectively, and that the employer's contribution base units for 1980, 1981, 1982, 1983 and 1984 are 100,000 hours, 98,000 hours, 95,000 hours, 91,000 hours, and 85,000 hours, respectively.

Contribution base units are the highest in 1980 when such units are 100,000 hours. Accordingly, to determine if a partial withdrawal occurs in 1987, it must be determined whether the number of contribution base units in each of 1985, 1986 and 1987 does not exceed 40 percent of the number of contribution base units in 1980. Because contribution base units in 1980 are 100,000 hours, a withdrawal does not occur unless contribution base units do not exceed 40,000 hours in each of 1985, 1986 and 1987. In this case, contribution base units are less than 40,000 hours in each year during the three-year testing period. Accordingly, a partial withdrawal in this case would be considered to take place as of the close of 1987.

(2) 25-percent decline.—

Under the amendment, a facility closing resulting in a 25-percent decline in contributions is considered to take place where (1) the facilities closed by an employer during the plan year and during the five preceding plan years accounted in the aggregate for at least 25 percent of that employer's contribution base units under the plan and (2) the employer's contribution base units for the plan year are 75 percent or less of the employer's contribution base units in the plan year during the five plan years preceding the plan year during which contribution base units were the highest. For purposes of this rule, a facility closing means the cessation of substantially all of the employer's covered operations at a facility.

In determining whether facility closing in the plan year and in the five preceding plan years resulted in a 25-percent reduction in contribution base units a formula is applied. Under the formula, a percentage is determined for each particular facility closing during the six-year period. If the sum of the percentages equals or exceeds 25

percent, a 25-percent decline in contribution base units is considered to have occurred. The percentage for each separate facility closing is determined by dividing (1) the number of contribution base units for the facility for the year during the six-year period encompassing the year of the closing and the preceding five years in which the number of such units were the highest (the "high six years") by (2) the number of contribution base units for all facilities with covered operations under the plan for the high six years.

(3) Cessation of an employer's obligation.—

A cessation of an employer's obligation to contribute to a plan under one but not all the collective bargaining agreements obligating the employer to contribute to the plan will not be considered to take [52] place in any case where there is a mere substitution of an agreement with one collective bargaining agent for an agreement with another collective bargaining agent under the same plan.

Once it has been determined that a partial withdrawal has occurred, the amount of withdrawal liability is determined by multiplying the amount of withdrawal liability which would have applied in the case of a complete withdrawal on the same date (or, in the case of a partial withdrawal in the nature of a 60-percent decline in contributions, on the last day of the first plan year in the three-year testing period) by (1) one minus (2) a fraction. The numerator of the fraction is the employer's contribution base units for the plan year following the plan year of the partial withdrawal. The denominator of the fraction is the average of the employer's contribution base units for the five plan years immediately preceding the plan year of the partial withdrawal. However, in the case of a partial withdrawal because of a 60-percent decline in contributions, the denominator of the fraction is the average of the employer's contribution base units for the five plan years immediately preceding the three-year testing period.

Under the amendment, if withdrawal liability is determined on account of a partial withdrawal, the amount of the liability is applied as a credit against withdrawal liability for any future withdrawal from the plan, whether partial or complete. In addition, the future withdrawal will not relieve the employer from continuing to make its payments for withdrawal liability with respect to the earlier partial withdrawal. The PBGC is authorized to prescribe regulations necessary to make appropriate adjustments in the credit for future events so that withdrawal liability in the event of a future withdrawal properly reflects the employer's proper share of the plan's unfunded benefits obligations.

For purposes of computing an employer's annual withdrawal liability payment, a partial withdrawal in the nature of a 60-percent decline in contributions is deemed to occur on the last day of the first plan year in the three-year testing period.

* * * * *

[64] I. Minimum Funding Requirements (Secs. 203 and 304 of the Bill, Sec. 412 of the Code and Secs. 301 and 302 of ERISA)

Present law

In general

Under the Code and the nontax provisions of ERISA,[1] multiemployer pension plans are required to meet a minimum funding standard on an annual basis. As an administrative aid in the application of this standard, ERISA requires that each plan must establish and maintain a special account called a "funding standard account" to which specified charges and credits (including credits for contributions to the plan) must be made for each plan year. If, as of the close of a plan year, the account does not have a balance of charges, the plan is treated as satisfying the minimum funding standard for that year. Thus, as a general rule, the minimum contribution for a year is determined as the amount by which charges to the account would exceed credits to the account if no contribution were made to the plan.

For example, in the case of a plan the plan year of which is the calendar year, if, as of the close of 1980, charges to the plan's funding standard account would exceed credits to the account by $200,000 if no contribution were made to the plan for 1980, a minimum contribution for the year of that amount would generally be required for the plan to meet the minimum funding standard for 1980.

If, as of the close of any plan year, charges to the funding standard account exceed credits to the account, the excess is called an "accumulated funding deficiency." The deficiency is subject to a five-percent nondeductible excise tax and, if not corrected within a specified correction period, is also subject to a 100-percent nondeductible excise tax. The tax is payable by the employers responsible for contributing to the plan for the year.

Actuarial cost methods

In computing the amounts which are required to be contributed to a defined benefit pension plan for a plan year in order to meet the minimum funding standard for the year, the plan utilizes what is known as an "actuarial cost method." [2] Generally, an actuarial cost method breaks up the cost of the benefits into annual charges consisting of two elements with respect to benefits that are effective for the plan year. These elements are called (1) normal cost, and (2) past service cost. Normal cost generally represents the cost of future benefits under the plan for current employees and, under some funding methods, for separated employees, which will be funded by fu-

[1] See sec. 412 of the Code and part 3, Title I of ERISA.

[2] See Temp. Treas. Regs. §§ 11.412(c)(1)-1 and 11.412(c)(1)-2, and Prop. Treas. Regs. §§ 1.412(c)(2)-1 and 1.412(c)(3)-1.

ture con-[65]tributions to the plan (1) in level dollar amounts, (2) as a uniform percentage of payroll, (3) as a uniform amount per unit of service (*e.g.*, 50 cents per hour), or (4) on the basis of the actuarial present values of benefits accruing under the plan in particular plan years. Past service liability represents the cost of future benefits under the plan (1) on the date the plan is first effective, or (2) on the date a plan amendment increasing plan benefits is first effective, which will not be funded by future plan contributions to meet normal cost.

Normal cost and past service cost are key elements in computations under the minimum funding standard. While these costs may differ substantially, depending upon the actuarial cost method used to value a plan's assets and liabilities, they must be determined under an actuarial cost method permitted by ERISA. ERISA enumerates six acceptable actuarial cost methods and provides that additional methods may be permitted under Treasury regulations. Normal cost and past service costs under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. Generally, an actuarial valuation is required at least once during each period of 3 plan years. More frequent valuations may be required by the Internal Revenue Service.

Charges to funding standard account
Normal cost

Each plan year, the plan's funding standard account must be charged with the normal cost assigned to that year under the plan's actuarial cost method. This will generally mean that the employers maintaining the plan will have to contribute to the plan an amount at least equal to the normal cost to create a credit in the funding standard account to balance off the charge for normal cost.

For example, if the normal cost for a plan for the plan year ending December 31, 1980, is $150,000, the funding standard account is charged for that amount. Assuming there are no credits to the account to offset that charge, an employer contribution to the plan of $150,000 would be required for 1980 in order to avoid an accumulated funding deficiency for that year.

Past service liability

There are three separate charges to the funding standard account which may arise as the result of past service liabilities. The first applies only to a plan in existence on January 1, 1974; the second applies only to a plan which came into existence after January 1, 1974; and the third applies to a plan under which past service liability has increased due to a plan amendment made after January 1, 1974.

In the case of a plan in existence on January 1, 1974, the funding standard account is charged with a portion of the past service liability under the plan determined as of the first day of the plan year beginning in the first year the funding standard applied to the plan (generally 1976). The amount of the liability with which the account is charged in the case of a multiemployer plan is based on amortization of past service liabilities over a period of 40 years. The liability must be amortized (in much the same manner as a mortgage) in equal annual installments over the 40-year amortization period.

[66] For example, assume that a plan in existence on January 1, 1974, uses the calendar year as its plan year and has a past service liability of $500,000 determined as of January 1, 1976. The plan's actuary uses an interest rate of six percent in determining plan costs. The 40-year schedule requires that $31,350 be charged against the funding standard account each year to amortize this liability. Thus, for each year in the 40-year period commencing with 1976, the plan's funding standard account is charged with the amount of $31,350. This will require the employers maintaining the plan to make a contribution to the plan of that amount for each year in the 40-year period to generate a credit to the account to offset the charge, unless it is offset by some other credit to the account or the plan becomes fully funded.

In the case of a plan not in existence on January 1, 1974, the plan is generally required to determine past service liability as of the first day of its first plan year beginning after September 2, 1974. This liability must be amortized by a multiemployer plan in equal annual installments over 40 years (30 years, in the case of a single-employer plan) in the same manner as past service liability is amortized for a plan in existence on January 1, 1974. Each year during the 40-year period, the funding standard is charged with the amount of past service liability amortized in that year unless the plan becomes fully funded.

In any case where a net increase in benefits under a plan takes place as a result of plan amendments in a year, the unfunded past service liability attributable to the net increase is determined and amortized over a period of 40 years in the case of a multiemployer plan (30 years for a single-employer plan). Each year during the 40-year period, the funding standard account is charged with the amount of the amortization for that year, and the employers are required to make sufficient contributions to offset the charge unless it is offset by another credit or the plan becomes fully funded.

Experience losses

In determining plan funding under an actuarial cost method, the plan's actuary generally makes certain assumptions regarding rates of interest, mortality, disability, salary increases, etc. If on the basis of these assumptions the contributions made to the plan result in unfunded liabilities less than that anticipated by the actuary, the excess of the expected unfunded liabilities over the actual unfunded liabilities is called an "experience gain."

On the other hand, if the expected

unfunded liabilities fall short of the actual unfunded liabilities, the shortfall is considered an "experience loss." The minimum funding standard requires that an experience loss be amortized in equal installments over a period of 20 years (15 years for a single-employer plan) and that the funding standard account be charged with each year's amortization unless the plan becomes fully funded. (Some funding methods do not separately determine experience gains or losses.)

Changes in actuarial assumptions

If the actuarial assumptions used for funding a plan are revised and under the new assumptions the accrued liability of the plan is less than the accrued liability computed under the old assumptions, the decrease [67] in accrued liability is considered a "gain from changes in actuarial assumptions." "Accrued liability" refers to the actuarial present value of projected pension benefits under the plan which will not be funded by future contributions to meet normal cost. On the other hand, if, after the change in assumptions, accrued liability exceeds accrued liability computed under the old assumptions, the excess is considered a "loss from changes in actuarial assumptions." The amount of the loss from changes in actuarial assumptions must be amortized in equal annual installments over a period of 30 years, and the amount of each year's amortization must be charged to the funding standard account unless the plan becomes fully funded.

Waived funding deficiency

If 10 percent or more of the employers contributing to a multiemployer plan are unable to make contributions which will satisfy the minimum funding standard for a plan year without substantial business hardship, the Internal Revenue Service is permitted to waive all or a portion of the contribution requirements of the minimum funding standard for the plan year if it is determined that requiring the contributions would be adverse to the interests of plan participants in the aggregate. However, the Service is not permitted to grant such a waiver for a plan for more than five plan years in any period of 15 consecutive plan years. The amount of the contribution not required as a result of the waiver is called a "waived funding deficiency."

Under the funding standard, the amount of a waived funding deficiency must be amortized in equal annual installments over a period of 15 years commencing with the year first following the year for which the waiver is granted, and the funding standard account must be charged each year with the amount amortized for that year unless the plan becomes fully funded.

Switchback liability

ERISA provides that certain plans may elect to use an alternative minimum funding standard account for any year in lieu of the funding standard account, and prescribes specified annual charges and credits to the alternative account. If it would take a smaller contribution to balance charges and credits in the alternative account than it would take to balance the funding standard account for a plan year, no accumulated funding deficiency is considered to exist for the year if a contribution satisfying the requirements of the alternative account is made. During years for which contributions are made under the alternative account, an excess of charges over credits may build up in the funding standard account. If the plan later switches back from the alternative account to the funding standard account, this excess of charges over credits must be amortized over a period of five plan years. This amount is known as a "switchback liability."

Credits to funding standard account

Employer contributions

Each plan year, the funding standard account is credited with the amount considered contributed to a plan by employers maintaining the plan for the year. This amount includes contributions made during [68] the year as well as contributions made on account of the year up to two and one-half months after the close of the year. (The Internal Revenue Service can extend the period for an additional six months.)[8]

Past service liability

If plan amendments in a year result in a net decrease in past service liability, the amount of the decrease must be amortized in equal annual installments over a period of 40 years, and each year's amortization during the 40-year period (30 years for a single-employer plan) must be credited to the funding standard account unless the plan becomes fully funded. These credits will help offset charges to the account and will decrease otherwise required contributions to the plan.

Experience gains

If a net experience gain is determined in a plan year, the gain must be amortized in equal annual installments over a period of 20 years (15 years for a single employer plan), and the amount amortized each year must be credited to the funding standard account unless the plan becomes fully funded. These credits also offset charges to the account and thus decrease contribution requirements.

Changes in actuarial assumptions

If a change in actuarial assumptions results in a gain because of a decrease in plan accrued liability under the new assumptions, the gain must be amortized in equal annual installments over a period of 30 years. The amount amortized each year must be credited to the funding standard account unless the plan becomes fully funded and the credit will reduce plan contributions otherwise required for the year.

Switchback liability

When a plan switches back from the alternative minimum funding standard account to the funding standard account, the funding standard ac-

[8] See Temp. Treas. Regs. § 11.412(c)-12.

count is credited with the excess of charges over credits which have built up in that account. If this were not done, the entire excess would have to be offset by a contribution (or other credit) to the account in the year of the switchback to prevent an accumulated funding deficiency.

Extension of amortization periods

The Internal Revenue Service is permitted to extend for up to 10 years the period for amortizing any unfunded past service liability under a multiemployer plan.[4] If such an extension is granted, the period over which the funding standard account is charged with amortization of the liability is similarly extended. Before granting such an extension, the Service must determine that (1) the extension will carry out the purposes of ERISA, (2) the extension will provide adequate protection to plan participants and beneficiaries, and (3) the failure to grant the extension will (a) result in a substantial risk of plan termination or in substantial reduction of pension benefits or [69] compensation, and (b) be adverse to the interest of plan participants in the aggregate.

Reasons for change

The Ways and Means Committee believes that existing minimum funding requirements may not provide adequate safeguards to insure that multiemployer plans will be able to meet their pension obligations. However, the Committee is also concerned that when applied to an overburdened multiemployer plan, the present funding requirements may result in an undue financial burden on employers.

Explanation of provisions

1. In general

The bill modifies the periods over which past service liabilities and experience gains and losses under multiemployer plans would be required to be amortized for the purpose of making charges and credits to the funding standard account. In general, the new amortization periods follow those required of single-employer plans for funding purposes. However, certain transitional rules are provided under which the present law amortization periods continue to apply to multiemployer plans in certain circumstances.

In addition, the Secretary of the Treasury is to be authorized to prescribe regulations requiring additional charges and credits to the funding standard account to prevent withdrawal liability payments from being unduly reflected as advance funding of plan liabilities.

The bill also makes conforming amendments to the funding rules to take account of changes made in other parts of the bill.

2. Modification of charges to funding standard account

a. Past service liability

Under the bill, certain amounts of unfunded past service liability are to be amortized in equal annual installments over 30 years for purposes of determining charges to the funding standard account. These changes are (1) unfunded past service liability determined as of the first day of the first plan year of a plan not in existence on enactment, and (2) any net increase in unfunded past service liability arising from plan amendments adopted during a plan year.

b. Experience losses

Under the bill, a net experience loss is to be amortized in equal annual installments over 15 years for purposes of determining charges to the funding standard account.

3. Modification of credits to funding standard account

a. Past service liability

Under the bill, any decrease in unfunded past service liability arising from plan amendments adopted during a plan year is to be amortized in equal annual installments over 30 years for purposes of determining credits to the funding standard account.

b. Experience gains

Under the bill, a net experience gain is to be amortized in equal annual installments over 15 years for purposes of determining credits to the funding standard account.

[70] *c. Withdrawal liability*

Under the bill, any withdrawal liability payment to a plan for a plan year is to be treated as an amount contributed to the plan for the year. Accordingly, it will generate a credit to the funding standard account.

4. Prior amortizable amounts and transitional rules

Under the bill, any amortizable amounts described above that arose in a plan year beginning before the date the bill was enacted are to continue to be amortized over their respective previously established amortization periods. The bill also provides transitional rules under which the amortization periods of present law apply to certain future changes in past service liability.

5. Application of minimum funding standards to terminated multiemployer plan

Under the bill, the minimum funding standard applies with respect to a terminated multiemployer plan until the date on which the last remaining employer withdraws from the plan.

Effective date

These provisions of the bill apply on the date of enactment.

[71] J. Excise Taxes (Sec. 204 of the Bill and Sec. 4971 of the Code)

Present law

Under present law, an employer who maintains a plan to which the ERISA minimum funding standard applies is subject to a two-tier annual

[4] Under Reorganization Plan No. 4 of 1978, referral to the Secretary of Labor may be required.

nondeductible excise tax on any accumulated funding deficiency under the plan. The initial tax is 5 percent of the deficiency. If the deficiency is not corrected within a correction period, an additional excise tax equal to 100 percent of the deficiency is imposed.

Before issuing a notice of deficiency under this provision, the Internal Revenue Service is required to notify the Secretary of Labor and afford to the Secretary of Labor an opportunity to (1) require the responsible employer to eliminate the deficiency and (2) to comment on the imposition of the tax.

Reason for change

Under the bill, a required contribution to a multiemployer plan may, under certain circumstances (*e.g.*, reorganization) differ from the amount required to satisfy the minimum funding standard of ERISA.

Explanation of provisions

The bill conforms the penalty excise tax provisions relating to the ERISA funding standard to the plan reorganization provisions of the bill by changing the accumulated funding deficiency of a plan in reorganization (the amount to which the excise tax applies) to the reorganization deficiency computed under the bill. The bill also provides that in the case of a multiemployer plan in reorganization, the notice issued by the Internal Revenue Service to the Secretary of Labor with respect to a notice of deficiency for a tax on an accumulated funding deficiency, and the opportunity to comment on the imposition of the tax, are to be provided to the PBGC.

Effective date

These provisions of the bill apply on the date of enactment.

Revenue effect

It is estimated that this provision will result in a negligible net decrease in budget receipts.

[72] K. Deductibility of Employer Liability Payments (Sec. 205 of the Bill and Sec. 404 of the Code)

Present law

Under present law, an employer is allowed a deduction for a contribution to a qualified pension plan for its employees. The deduction is allowed (within limits) in the taxable year for which the contribution is made.[1] Payments of employer liability under the termination insurance program are treated as employer contributions.[2]

Reason for change

The Ways and Means Committee has determined that the payment of withdrawal liability by an employer should be treated as a contribution to the plan by the employer without regard to the usual limitation on employer deductions for contributions to a tax qualified plan.

Explanation of provision

The bill generally allows a deduction for amounts paid by a taxpayer under the employer withdrawal liability provisions of the termination insurance program without regard to the usual limitations on employer deductions for contributions to a tax qualified plan.

Under the bill, for employer tax deduction purposes, withdrawal liability payments are treated as employer contributions to the plan. Thus, the deduction of total plan contributions, including withdrawal liability payments, is subject to the full funding limitation. In addition, withdrawal liability payments are deductible only if paid for a taxable year which ends with or within a taxable year of the plan for which the plan is qualified. Of course, an employer's total contribution to the plan, including withdrawal liability payments, must be ordinary and necessary business expenses of the employer to be deductible. Special rules are provided which allow a deduction for employer liability payments to a taxpayer whose liability for the payments arises out of the liability of an employer who is a member of the same controlled group of companies that includes the taxpayer.

Effective date

This provision of the bill is effective upon enactment.

Revenue effect

It is estimated that this provision will decrease budget receipts by a negligible amount per year.

[73] L. Minimum Vesting Requirements (Secs. 206 and 303 of the Bill, Sec. 411 of the Code, and Sec. 203 of ERISA)

Present law

Under present law, benefits under a plan which are vested may be forfeited only (1) in the case of death, (2) where benefits are suspended upon reemployment, (3) in the case of certain retroactive plan amendments which reduce benefits, or (4) in the case of certain withdrawals of mandatory employee contributions. Also, under present law, with certain very limited exceptions, all of a participant's years of service with an employer must be taken into account for vesting purposes.

Reason for change

The changes made under the reorganization provisions and the provisions relating to the definition of multiemployer plan require conforming changes in the ERISA rules relating to vesting.

Explanation of provisions

In general

The bill provides for additional circumstances under which vested benefits under a multiemployer plan, which are nonforfeitable under present law, could be forfeited. The bill provides that certain of a participant's years of

[1] See Code sec. 404(a)(1)(A) and Prop. Treas. Reg. § 1.404(a)-14.

[2] See Code sec. 404(g).

service with an employer, currently taken into account for vesting purposes, could be disregarded in the case of a multiemployer plan. (Also, see C., Employer Withdrawal Liability Mergers, Etc. *3. Reorganization and minimum contribution requirement, g. Adjustments in accrued benefits.*) In addition, the bill conforms the vesting provisions of ERISA to changes made in other parts of the bill.

Cessation of contributions under a multiemployer plan

Under the bill, a multiemployer plan does not fail to meet the vesting requirements of ERISA merely because the plan provides for the forfeiture of accrued benefits attributable to service with a participant's employer before the employer was required to contribute to the plan in the event that the employer ceases making contributions to the plan.

Reduction and suspension of benefits

Under the bill, a multiemployer plan does not fail to meet the vesting requirements of ERISA merely because (1) it is amended to reduce accrued benefits, but not below the level of benefits eligible for the PBGC guarantee, in the event of plan reorganization or plan determination, or (2) benefits payments under the plan, other than basic benefits, are suspended in the event of plan reorganization or plan termination.

[74] *Authority to disregard service after withdrawal or plan termination*

Under the bill, if an employer withdraws from a multiemployer plan, a participant's years of service with the employer completed after the withdrawal would not have to be taken into account in determining the participant's vested percentage in his accrued benefits under the plan. This rule applies to partial withdrawals only to the extent permitted in regulations prescribed by the Secretary of the Treasury.

Also, under the bill, if a multiemployer plan terminates for purposes of termination insurance, an employee's years of service completed after the date of termination do not have to be taken into account in determining a participant's vested percentage in his accrued benefits under the plan.

Effective date

This provision of the bill applies on the date of enactment.

Revenue effect

It is estimated that this provision will have no effect on budget receipts.

* * * * *

[76] M. Action Taken Before Regulations are Prescribed (Sec. 405 of the Bill)

Present law

No provision.

Reason for change

The bill requires that many regulations be prescribed in the effectuation of its rules. The Ways and Means Committee has concluded that the parties affected by the bill should be permitted, pending the issuance of regulations, to act under the bill's provisions in the absence of regulations provided any action so taken is reasonable.

Explanation of provision

Where the manner in which a provision of the bill is to apply is to be set forth in regulations, any reasonable action taken before the regulations are issued is to be treated as complying with the regulations for the period preceding their issuance. However, this rule does not apply if the action is in violation of an instruction or temporary rule which is issued before the action is taken.

Effective date

This provision of the bill is effective upon enactment.

* * * * *

Public Law 96-369
96th Congress, H. J. Res. 610 [1]
October 1, 1980

Joint Resolution

Making continuing appropriations for the fiscal year 1981, and for other purposes.

* * * * *

SEC. 123. No funds appropriated by this Act may be used to implement or enforce provisions of any regulation or ruling with respect to section 280A of the Internal Revenue Code of 1954 which relate to—

(1) the rental of a dwelling unit to a member of the family of a taxpayer,

(2) the determination of the principal place of business of the taxpayer, or

(3) the circumstances under which use of the dwelling unit for repairs and maintenance constitutes personal use by the taxpayer.

* * * * *

Approved October 1, 1980.

Public Law 96-449
96th Congress, H.R. 7085 [2]
October 14, 1980

An Act to provide certain benefits to individuals held hostage in Iran and to similarly situated individuals, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Hostage Relief Act of 1980".

* * * * *

TITLE II—TAX PROVISIONS

SEC. 201. COMPENSATION EXCLUDED FROM GROSS INCOME

For purposes of the Internal Reve-

[1] This publication of the law is restricted to excerpts involving tax matters. House Report Nos. 96-1327 and 96-1443 are not published.

[2] This publication of the law, House Report No. 96-1349, Part 2, page 481, and House Report No. 96-1349, Part 3, page 483, are restricted to excerpts involving tax matters. House Report No. 96-1349, Part 1, is not published.

nue Code of 1954, the gross income of an individual who was at any time an American hostage does not include compensation from the United States received for any month during any part of which such individual was—

(1) in captive status, or

(2) hospitalized as a result of such individual's captive status.

SEC. 202. INCOME TAXES OF HOSTAGES WHERE DEATH RESULTS FROM CAPTIVE STATUS

(a) GENERAL RULE.—In the case of an individual who was at any time an American hostage and who dies as a result of injury or disease or physical or mental disability incurred or aggravated while such individual was in captive status—

(1) any tax imposed by subtitle A of the Internal Revenue Code of 1954 shall not apply with respect to—

(A) the taxable year in which falls the date of such individual's death, or

(B) any prior taxable year ending on or after the first day such individual was in captive status, and

(2) any tax imposed under such subtitle A for taxable years preceding those specified in paragraph (1) which is unpaid at the date of such individual's death (including interest, additions to the tax, and additional amounts)—

(A) shall not be assessed,

(B) if assessed, the assessment shall be abated, and

(C) if collected, shall be credited or refunded as an overpayment.

(b) DEATH MUST OCCUR WITHIN 2 YEARS OF CESSATION OF CAPTIVE STATUS.—This section shall not apply unless the death of the individual occurs within 2 years after such individual ceases to be in captive status.

SEC. 203. SPOUSE MAY FILE JOINT RETURN

(a) GENERAL RULE.—If an individual is an American hostage who is in captive status, such individual's spouse may elect to file a joint return under section 6013(a) of the Internal Revenue Code of 1954 for any taxable year—

(1) which begins on or before the day which is 2 years after the date on which the hostage period ends, and

(2) for which such spouse is otherwise entitled to file such a joint return.

(b) CERTAIN RULES MADE APPLICABLE.—For purposes of subsection (a), paragraphs (2) and (4) of section 6013(f) of such Code (relating to joint return where individual is in missing status) shall apply as if the election described in subsection (a) of this section were an election described in paragraph (1) of such section 6013(f).

SEC. 204. TIME FOR PERFORMING CERTAIN ACTS POSTPONED BY REASON OF CAPTIVE STATUS

(a) GENERAL RULE.—In the case of any individual who was at any time an American hostage, any period during which he was in captive status (and any period during which he was outside the United States and hospitalized as a result of captive status), and the next 180 days thereafter, shall be disregarded in determining, under the internal revenue laws, in respect of any tax liability (including any interest, penalty, additional amount, or addition to the tax) of such individual—

(1) whether any of the acts specified in paragraph (1) of section 7508 (a) of the Internal Revenue Code of 1954 was performed within the time prescribed therefor, and

(2) the amount of any credit or refund (including interest).

(b) APPLICATION TO SPOUSE.—The provisions of this section shall apply to the spouse of any individual entitled to the benefits of subsection (a). The preceding sentence shall not cause this section to apply to any spouse for any taxable year beginning more than 2 years after the date on which the hostage period ends.

(c) SECTION 7508(d) MADE APPLICABLE.—Subsection (d) of section 7508 of the Internal Revenue Code of 1954 shall apply to subsection (a) in the same manner as if the benefits of subsection (a) were provided by subsection (a) of such section 7508.

SEC. 205. DEFINITIONS AND SPECIAL RULES

(a) AMERICAN HOSTAGE.—For purposes of this title, the term "American hostage" means any individual who, while—

(1) in the civil service or the uniformed service of the United States, or

(2) a citizen or resident alien of the United States rendering personal service to the United States abroad similar to the service of a civil officer or employee of the United States (as determined by the Secretary of State),

is placed in a captive status during the hostage period.

(b) HOSTAGE PERIOD.—For purposes of this title, the term "hostage period" means the period beginning on November 4, 1979, and ending on whichever of the following dates is the earlier:

(1) the date the President specifies, by Executive order, as the date on which all citizens and resident aliens of the United States who were placed in a captive status due to the seizure of the United States Embassy in Iran have been returned to the United States or otherwise accounted for, or

(2) December 31, 1981.

(c) CAPTIVE STATUS.—For purposes of this title—

(1) IN GENERAL.—The term "captive status" means a missing status arising because of a hostile action abroad—

(A) which is directed against the United States during the hostage period, and

(B) which is identified by the Secretary of State in the Federal Register.

(2) MISSING STATUS DEFINED.—The term "missing status"—

(A) in the case of employees, has the meaning given it in section 5561 (5) of title 5, United States Code,

(B) in the case of members of the uniformed services, has the meaning given it in section 551(2) of title 37, United States Code, and

(C) in the case of other individuals, has a similar meaning as that provided under such sections, as determined by the Secretary of State.

For purposes of the preceding sentence, the term "employee" has the meaning given to such term by section 5561(2) of title 5, United States Code.

(d) HOSPITALIZED AS A RESULT OF CAPTIVE STATUS.—

(1) IN GENERAL.—For purposes of this title, an individual shall be treated as hospitalized as a result of captive status if such individual is hospitalized as a result of injury or disease or physical or mental disability incurred or aggravated while such individual was in captive status.

(2) 2-YEAR LIMIT.—Hospitalization shall be taken into account for purposes of paragraph (1) only if it is hospitalization—

(A) occurring on or before the day which is 2 years after the date on which the individual's captive status ends (or, if earlier, the date on which the hostage period ends), or

(B) which is part of a continuous period of hospitalization which began on or before the day determined under subparagraph (A).

(e) CIVIL SERVICE UNIFORMED SERVICES.—For purposes of this section, the terms "civil service" and "uniformed services" have the meanings given to such terms by section 2101 of title 5, United States Code.

(f) APPLICATION OF TITLE TO ALL TEHRAN HOSTAGES.—In the case of any citizen or resident alien of the United States who is determined by the Secretary of State to have been held hostage in Tehran at any time during November 1979, for purposes of this title—

(1) such individual shall be treated as an American hostage whether or not such individual meets the requirements of paragraph (1) or (2) of subsection (a), and

(2) if such individual was not in the civil service or the uniformed services of the United States—

(A) Section 201 shall be applied by substituting "earned income (as defined in section 911(b) of the Internal Revenue Code of 1954) attributable to" for "compensation from the United States received for", and

(B) the amount excluded from gross income under section 201 for any month shall not exceed the monthly equivalent of the annual rate of basic pay payable for level V of the Executive Schedule.

(g) APPLICATION OF TITLE TO INDIVIDUAL HELD CAPTIVE IN COLOMBIA. —For purposes of this title, Richard Starr of Edmonds, Washington, who, as a Peace Corps volunteer, was held captive in Colombia, shall be treated as an American hostage who was in captive status beginning on November 4, 1979, and ending on February 10, 1980.

(h) SPECIAL RULES.—

(1) COMPENSATION.—For purposes of this title, the term "compensation" shall not include any amount received as an annuity or as retirement pay.

(2) WAGE WITHHOLDING — Any amount excluded from gross income under section 201 shall not be treated as wages for purposes of chapter 24 of the Internal Revenue Code of 1954.

SEC. 206. STUDY OF TAX TREATMENT OF HOSTAGES

(a) STUDY.—The Chief of Staff of the Joint Committee on Taxation shall study all aspects of the tax treatment of citizens and resident aliens of the United States who are taken hostage or are otherwise placed in a missing status.

(b) REPORT.—The Chief of Staff of the Joint Committee on Taxation shall, before July 1, 1981, report the results of the study made pursuant to subsection (a) to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.

* * * * *

Approved October 14, 1980.

House Report No. 96-1349, Part 2
2d Session

[Bracketed numerals indicate official report page numbers]

HOSTAGE RELIEF ACT OF 1980

SEPTEMBER 19, 1980

Mr. FASCELL, from the Committee on Foreign Affairs, submitted the following report to accompany H.R. 7085 [1] which on April 17, 1980, was referred jointly to the Committee on Foreign Affairs, the Committee on Post Office and Civil Service, and the Committee on Ways and Means

The Committee on Foreign Affairs, to whom was referred the bill (H.R. 7085) to amend title 5 of the United States Code and the Internal Revenue Code of 1954 to provide certain benefits to individuals held hostage in Iran and to similarly situated individuals, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

* * * * *

COMMITTEE ACTION

[5] On April 17, 1980, Hon. Dante B. Fascall (for himself and Mr. Ullman, Mr. Zablocki, Mr. Broomfield, Mr. Buchanan, and Mr. Derwinski) introduced H.R. 7085, which was jointly referred to the Committee on Foreign Affairs, Committee on Post Office and Civil Service, and the Committee on Ways and Means. On April 22, 1980, the bill was referred to the Subcommittee on International Operations by Hon. Clement J. Zablocki, chairman of the Committee on Foreign Affairs.

[6] On July 24, 1980, the Subcommittee on International Operations held an open hearing on H.R. 7085 during which testimony was received from Hon. Ben H. Read, Under Secretary of State for Management; Maj. Gen. R. Dean Tice, Deputy Assistant Secretary of Defense for Military and Personnel Policy; and Louisa L. Ken-

[1] Public Law 96-449, page 479.

nedy, spokesperson for FLAG (Family Liaison Action Group), which is composed of families and relatives of the hostages being held in Iran.

The subcommittee held an open markup session on September 3 on the legislation and reported to the full committee, H.R. 7085, as amended. On September 10 the full committee met in open session to consider the bill and ordered it favorably reported, as amended, by voice vote, a quorum being present.

Purpose

The purpose of the legislation, as amended, is to provide certain relief benefits to U.S. hostages in Iran and their families, as well as to U.S. Government employees in future hostage situations. The benefits provided would apply to civilian and military employees of the U.S. Government and are based on those benefits available to U.S. military prisoners of war from the Vietnam era. The benefits include the following: (1) establishment of a special interest-bearing savings fund for deposit of hostages' salaries; (2) reimbursement for expenses of family members, spouses, dependents, or the hostages for medical and health care which are incurred because of the ordeal; (3) protection of civilian Government employees from civil suit while they are in a missing status; (4) educational benefits for the spouse and dependent children for the duration of the hostile action against the United States, except in certain circumstances where the benefits could be extended; (5) educational benefits, under special circumstances, for the hostages themselves; (6) educational benefits for the spouse and dependent children of a hostage should the hostage die while being held hostage; (7) exemption from taxes on compensation received while a military or civilian Government employee is a hostage or missing as a result of a hostile action abroad against the United States; (8) complete income tax exclusion for income received by an employee who dies as a result of a hostile action; and (9) clarification of authority to allow the spouse of a hostage to file a joint tax return and to defer payment of certain taxes for up to 180 days after the return of a hostage or missing military or civilian employee.

Background and Committee Comment

H.R. 7085 was introduced on April 17, 1980, the 166th day of captivity of American citizens in Iran. At this writing, the hostages have been held 321 days.

This legislation is intended as an expression of the Nation's recognition of the difficulties faced by those held hostage as a result of their Government service. While such legislation has been enacted in the past for those in the military service, the Congress has not had reason until today to expand such protection to civilians in Government service. The benefits contained in H.R. 7085, as amended, are based on those which were given to POW's as a result of the Vietnam [7] war. Some of those benefits are still in effect and thus give the military who are being held hostage some relief, but the civilian Government employees have no such relief for themselves or their families.

Despite intensive diplomatic efforts of our Government, U.S. Government personnel continue to be held in Iran in gross violation of international law. These hostages have been incarcerated cruelly and unjustly since November 4, 1979. In addition to the prisoners' intolerable situation, the families of these individuals have also undergone severe mental, and in some cases financial, strain due to this forced separation.

The Congress must act now to alleviate, to the extent possible, the burdens of the hostages and their families and to make certain that all necessary assistance is provided upon their return home. It must assure that any assistance these families require is readily available.

The executive branch has suggested that the benefits contained in the legislation be temporary to permit further study before permanent legislation is proposed.

The committee feels that the problems dealt with in H.R. 7085 have been sufficiently studied in the 10 months that our hostages have been held in Iran. The legislation has been written to apply to hostage situations, generally, as well as to the Iran problem specifically. The authorities are available to be used as needed, and can certainly be amended at a later date if the need arises. The important point now is to insure that protections are in place for individuals caught in any future hostage situation.

The recent attacks on the U.S. Ambassador in Lebanon and on the U.S. Embassy in El Salvador underline the increasingly hostile environment in which U.S. personnel serve and, therefore, the increased likelihood of additional hostage situations. Experience with the problems confronting American POW's in the past, coupled with the more recent hostage situations in Latin America and Iran, provide sufficient background upon which to formulate permanent legislation Permanent legislation would avoid unnecessary delays in future situations and enable the provision of benefits as they are needed by the hostage and hostage family rather than at a later date.

The benefits provided by H.R. 7085, as amended, such as access to the Soldiers' and Sailors' Civil Relief Act, which has been in effect for the military for over 40 years, are not extraordinary. The legislation has also been written to give the President sufficient discretion to adjust to the vagaries of any future case.

The committee feels that legislation is needed which will be effective not only after a hostage situation is over, but also during the period of captivity, since the hostages' families are affected from the beginning. The committee is therefore convinced that permanent legislation is the desirable course to follow.

SECTION-BY-SECTION ANALYSIS OF THE BILL AS AMENDED

SHORT TITLE

The short title of H.R. 7085 is the Hostage Relief Act of 1980.

[11] TITLE II—AMENDMENTS TO THE INTERNAL REVENUE OF 1954

Title II contains amendments to the Internal Revenue Code of 1954 which would provide certain tax benefits to hostages or persons missing as a result of hostile action against the United States. The committee did not consider this title of the legislation since it falls within the jurisdiction of the Committee on Ways and Means. However, a summary of the provisions is included here in order to provide a complete analysis of the bill.

Section 201—Exemption from Income Taxes

Section 201 of H.R. 7085 would add a new subsection (e) to section 112 of the Internal Revenue Code regarding certain combat pay of members of the Armed Forces.

New subsection (e)(1) would exempt from gross income all compensation received for active service as a Government employee during any month the employee was in a missing status as a result of a hostile action against the United States in a foreign area. It would also exempt from gross income compensation received for any month during any part of which such employee was hospitalized as a result of such hostile action, but within 2 years of the date of termination of the hostile action.

Subsection (e)(2)(A) defines "hostile action against the United States" as an action abroad which is directed against the United States that occurs on or after November 1, 1979, which the Secretary of State identifies for this purpose in a letter published in the Federal Register.

Subsection (e)(2)(B) defines "Federal employee" to include any person who is an employee, whether direct or indirect, of any agency or instrumentality of the United States. The term would include any person whose presence abroad is for the purpose of implementing a federally funded program as determined by the Secretary of State.

Section 202—Income Taxes on Government Employees on Death

Section 202 amends section 692 of the Internal Revenue Code of 1954 by adding a new subsection relating to foreign hostile actions.

New subsection 692(c)(1) provides for exclusion from payment of federal income tax if a Government employee should die as a result of injuries sustained during a hostile action against the United States. Under subsection 692(c)(1)(A), this exclusion would be effective only for income received during the year of death and during any prior year the Government employee first entered into a missing status as a result of such hostile action.

Subsection 692(c)(1)(B) stipulates that any unpaid tax (including interest, additions to the tax, and additional amounts) will not be assessed, that any assessment will be voided, and that any tax collected will be credited or refunded as an overpayment.

The subsection also provides that the date of death of the employee shall be determined under 5 U.S.C. 5565 (agency review), but that the provisions shall not apply for any taxable year beginning more than 2 years after the date of termination of the hostile action.

Subsection 692(c)(2) defines "active service", "employee", and "hostile action against the United States" for the purposes of the section.

[12] *Section 203—Joint Return Where Individual is in a Missing Status*

Section 203 amends section 6013(f)(1) of the Internal Revenue Code of 1954 to permit an individual otherwise entitled to file a joint return to file such a return if the individual's spouse is in a missing status as a result of a hostile action against the United States.

Section 204—Federal Tax Deferment

Section 204 would amend section 7508(a) of the Internal Revenue Code of 1954 to include within that section U.S. citizens or resident aliens who are in a missing status because of a hostile action against the United States or who are hospitalized outside the United States because of such hostile action. Specifically, section 7508(a) relates to exemptions from time deadline for filing tax returns in meeting other time requirements relating to tax liability.

Section 205—Applicability to all Teheran Hostages

Section 205 would make the bill's amendments to the Internal Revenue Code of 1954 applicable to all citizens and resident aliens of the United States held hostage in Iran, as determined by the Secretary of State, at any time during November 1979, whether or not they are Federal employees. The exemptions would apply only to those who file an income tax return for the period in question.

Section 206—Effective Date

Section 206 provides that the title II tax provisions shall apply to taxable years ending on or after December 31, 1979.

* * * * *

House Report No. 96-1349, Part 3
2d Session

[Bracketed numerals indicate official report page numbers]

HOSTAGE RELIEF ACT OF 1980

SEPTEMBER 19, 1980

Mr. ULLMAN, from the Committee on Ways and Means, submitted the following report to accompany H.R. 7085[1] which on April 17, 1980, was referred jointly to the Committee on Foreign Affairs, the Committee on Post Office and Civil Service, and the Committee on Ways and Means.

The Committee on Ways and Means, to whom was referred the bill (H.R. 7085) to amend title 5 of the

[1] Public Law 96-449, page 479.

United States Code and the Internal Revenue Code of 1954 to provide certain benefits to individuals held hostage in Iran and to similarly situated individuals, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendment to the text of the bill is shown in the reported bill, with the matter proposed to be stricken shown in linetype and the matter proposed to be inserted shown in italic type.

The title of the bill is amended to conform to the amendment to the text of the bill.

[2] I. SUMMARY

The tax provisions of the bill provide tax relief to the American hostages in Iran and other American hostages. Federal employees held hostage could exclude from income their Federal compensation. If death results from captivity, all income tax liability of that individual from the initial year of captivity to the year of death would be forgiven. The spouse of a hostage would be permitted to file a joint return. Various deadlines under the tax laws would be postponed during the period of captivity for 180 days thereafter. Finally, the staff of the Joint Committee on Taxation is directed to make a study of this area.

II. EXPLANATION OF THE BILL

Tax Treatment of Hostages

Present law

Gross income does not include certain combat pay of members of the Armed Forces. (The exclusion is limited to $500 monthly in the case of officers.) Also, if a member of the Armed Forces dies as a result of service in a combat zone, he is not subject to Federal income tax on any of his income beginning with the first year he served in the combat zone and ending with the year of his death. Comparable rules do not apply to civilian employees.

If a member of the Armed Forces serves in a combat zone or is hospitalized as a result of that service, he generally is excused from meeting a variety of deadlines under the Internal Revenue Code for the period of service or hospitalization and 180 days thereafter.

More limited relief is provided for other Federal employees. Generally, if such an individual is in a missing status, no return need be filed, and no tax need be paid, until three months and fifteen days following the cessation of his missing status. (Other deadlines, however, are not waived.) The Internal Revenue Service has announced that this provision will apply in the case of the American hostages in Iran.

Ordinarily, if married individuals elect to file a joint return rather than separate returns, the return must actually be signed by both spouses. The Internal Revenue Service has announced that it will accept joint returns signed by only one spouse if the other is being held in Iran.

Reasons for change

[The committee believes that it is important to extend tax relief to] the American hostages in Iran and their families beyond the limited relief which is permitted by current law. In many ways, the ordeal suffered by these hostages is comparable to that of members of Armed Forces in combat zones. The committee believes that, at least insofar as matters within its jurisdiction are involved, comparable treatment is warranted. The relief provided by the committee's bill would also extend to other Americans being held hostage.

[3] At the same time, the committee has made the provisions of the bill temporary, rather than permanent, to facilitate a further review by the committee of the issues presented. While no one disputes the need to provide relief to the American hostages in Iran, the committee believes that permanent legislation should be drawn to deal more clearly with a number of issues should similar incidents arise in the future. Accordingly, the committee bill requires the staff of the Joint Committee on Taxation to conduct a study and to report its findings to the tax-writing committees of the Congress.

Explanation of provisions

Exclusion for compensation

Under the bill, gross income of an individual who was at any time an American hostage would not include compensation from the Federal Government received for any month during any part of which the individual was in captive status or hospitalized as a result of captive status.

For purposes of the tax provisions of the bill, the term "American hostage" means any individual who is placed in a captive status during the "hostage period" while (1) in the civil service or the uniformed services of the United States, or (2) a citizen or resident alien of the United States rendering personal service to the United States abroad similar to the service of a civil officer or employee of the United States (as determined by the Secretary of State). The hostage period began on November 4, 1979. It will end on the earlier of two dates: the date the President specifies, by Executive order, as the date on which all citizens and resident aliens of the United States who are placed in a captive status due to the seizure of the United States Embassy in Iran have been returned to the United States or otherwise accounted for, or December 31, 1981. An individual is in captive status if he is in a missing status arising because of a hostile action abroad which is directed against the United States during the hostage period. An individual is in missing status if he is in that status under the appropriate provision of law (5 U.S.C. § 5561 (5) for civilian Federal employees; 37 U.S.C. § 551 (2) for uniformed Federal employees) or, in the case of other individuals, as determined by the State Department.

Because the hostages held in Iran were placed in a captive status during the hostage period, they could continue to exclude income under this provision so long as they remain in

captive status even in the event that that status extended beyond December 31, 1981.

Death resulting from captive status

In the case of an individual who was at any time an American hostage and who dies as a result of injury or disease or physical or mental disability incurred or aggravated while that individual was in captive status, the bill provides that any income taxes imposed by the Code would not apply with respect to the taxable year in which the individual dies or any prior taxable year ending on or after the first day the individual was in captive status. Moreover, if there were any unpaid income tax liability of the individual from years prior to captivity, it would be forgiven. These provisions would not apply, however, unless death occurred within two years after the individual ceased to be in captive status.

[4] *Joint returns*

The bill provides that, during the period an American hostage is in captive status, the individual's spouse may elect to file a joint return for any taxable year which begins on or before the day which is 2 years after the date on which the hostage period ends, and for which that spouse is otherwise entitled to file a joint return.

Postponement of deadlines

In the case of any individual who was at any time an American hostage, any period during which he was in captive status (and any period during which he was outside the United States and hospitalized as a result of captive status), and the next 180 days thereafter, would be disregarded in determining in respect of any tax liability (including any interest, penalty, additional amount, or addition to the tax) of that individual, whether any of a variety of acts was performed within the time prescribed. These include the time for filing returns, paying tax, filing a refund claim, and filing suit in the Tax Court or other courts. Also, this time period is to be ignored in determining the amount of any credit or refund (including interest).

The relief afforded by this provision also will apply to the spouse of any individual entitled to its benefits. However, the relief to the spouse will not apply for any taxable year beginning more than 2 years after the date on which the hostage period ends.

Also, relief under this provision does not apply in certain limited situations, such as certain situations when collection is in jeopardy.

Special rules

The bill makes it clear that tax provisions apply to any citizen or resident alien of the United States who was held hostage in Tehran at any time during November 1979, whether or not the individual was in the civil or uniformed services of the United States or was performing similar services. If such an individual was not in the civil or uniformed services, he may exclude under section 201 of the bill his earned income while captive or hospitalized as a result of captivity, but not in excess of the monthly equivalent of the annual rate of basic pay for Level V of the Executive Schedule.

It is also provided that the tax portions of the bill will apply to Richard Starr, a Peace Corps volunteer, for the period from November 4, 1979, through February 10, 1980.

The bill provides that an individual is to be treated as hospitalized as a result of captive status if that individual is hospitalized as a result of injury or disease or physical or mental disability incurred or aggravated while that individual was in captive status. However, hospitalization would be taken into account for this purpose only if it occurs on or before the day which is 2 years after the date on which the individual's captive status ends (or, if earlier, the date on which the hostage period ends), or is part of a continuous period of hospitalization which began on or before the earlier of those dates. Thus, for example, if the hostage period ends on December 31, 1981, the hospitalization would have to begin prior to January 1, 1984.

It is also provided that "compensation" which may be excluded under section 201 of the bill does not include any amount received as an annuity or as retirement pay.

[5] *Study by Joint Committee staff*

The bill requires the Chief of Staff of the Joint Committee on Taxation to study all aspects of the tax treatment of citizens and resident aliens of the United States who are taken hostage or are otherwise placed in a missing status. The Chief of Staff is to report before July 1, 1981, the results of the study to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.

Effective date

The tax provisions of the bill are effective for all years affected by the legislation.

Revenue effect

It is estimated that the tax provisions of the bill will decrease receipts by less than $1 million annually.

* * * * *

Public Law 96-451
96th Congress, H.R. 4310 [1]
October 14, 1980

An Act to amend the Federal Boat Safety Act of 1971 to promote recreational boating safety through the development, administration, and financing of a national recreational boating safety improvement program, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress Assembled,

* * * * *

[1] The publication of this law and Conference Report No. 96-1320, page 487, is restricted to excerpts involving tax matters. House Report 96-591 Pt. I and Pt. II is not published.

TITLE III—REFORESTATION

SEC. 301. AMORTIZATION OF REFORESTATION EXPENDITURES.

(a) IN GENERAL.—Part IV of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to itemized deductions for individuals and corporations) is amended by adding at the end thereof the following new section:

"SEC. 194. AMORTIZATION OF REFORESTATION EXPENDITURES.

"(a) ALLOWANCE OF DEDUCTION.—In the case of any qualified timber property with respect to which the taxpayer has made (in accordance with regulations prescribed by the Secretary) an election under this subsection, the taxpayer shall be entitled to a deduction with respect to the amortization of the amortizable basis of qualified timber property based on a period of 84 months. Such amortization deduction shall be an amount, with respect to each month of such period within the taxable year, equal to the amortizable basis at the end of such month divided by the number of months (including the month for which the deduction is computed) remaining in the period. Such amortizable basis at the end of the month shall be computed without regard to the amortization deduction for such month. The 84-month period shall begin on the first day of the first month of the second half of the taxable year in which the amortizable basis is acquired.

"(b) LIMITATIONS.—

"(1) MAXIMUM DOLLAR AMOUNT.—The aggregate amount of amortizable basis acquired during the taxable year which may be taken into account under subsection (a) for such taxable year shall not exceed $10,000 ($5,000 in the case of a separate return by a married individual (as defined in section 143)).

"(2) ALLOCATION OF DOLLAR LIMIT.—

"(A) CONTROLLED GROUP.—For purposes of applying the dollar limitation under paragraph (1)—

"(i) all component members of a controlled group shall be treated as one taxpayer, and

"(ii) the Secretary shall, under regulations prescribed by him, apportion such dollar limitation among the component members of such controlled group.

For purposes of the preceding sentence, the term 'controlled group' has the meaning assigned to it by section 1563(a), except that the phrase 'more than 50 percent' shall be substituted for the phrase 'at least 80 percent' each place it appears in section 1563(a)(1).

"(B) PARTNERSHIPS.—In the case of a partnership, the dollar limitation contained in paragraph (1) shall apply with respect to the partnership and with respect to each partner.

"(3) SECTION NOT TO APPLY TO TRUSTS.—This section shall not apply to trusts.

"(4) ESTATES.—The benefit of the deduction for amortization provided by this section shall be allowed to estates in the same manner as in the case of an individual. The allowable deduction shall be apportioned between the income beneficiary and the fiduciary under regulations prescribed by the Secretary. Any amount so apportioned to a beneficiary shall be taken into account for purposes of determining the amount allowable as a deduction under this section to such beneficiary.

"(c) DEFINITIONS AND SPECIAL RULE.—For purposes of this section—

"(1) QUALIFIED TIMBER PROPERTY.—The term 'qualified timber property' means a woodlot or other site located in the United States which will contain trees in significant commercial quantities and which is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products.

"(2) AMORTIZABLE BASIS.—The term 'amortizable basis' means that portion of the basis of the qualified timber property attributable to reforestation expenditures.

"(3) REFORESTATION EXPENDITURES.—

"(A) IN GENERAL.—The term 'reforestation expenditures' means direct costs incurred in connection with forestation or reforestation by planting or artificial or natural seeding, including costs—

"(i) for the preparation of the site;

"(ii) of seeds or seedlings; and

"(iii) for labor and tools, including depreciation of equipment such as tractors, trucks, tree planters, and similar machines used in planting or seeding.

"(B) COST-SHARING PROGRAMS.—Reforestation expenditures shall not include any expenditures for which the taxpayer has been reimbursed under any governmental reforestation cost-sharing program unless the amounts reimbursed have been included in the gross income of the taxpayer.

"(4) BASIS ALLOCATION.—If the amount of the amortizable basis acquired during the taxable year of all qualified timber property with respect to which the taxpayer has made an election under subsection (a) exceeds the amount of the limitation under subsection (b)(1), the taxpayer shall allocate that portion of such amortizable basis with respect to which a deduction is allowable under subsection (a) to each such qualified timber property in such manner as the Secretary may by regulations prescribe.

"(d) LIFE TENANT AND REMAINDERMAN.—In the case of property held by one person for life with remainder to another person, the deduction under this section shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant.".

(b) ADJUSTED GROSS INCOME.—Section 62 of such Code (relating to definition of adjusted gross income) is amended by inserting after paragraph (14) the following:

"(15) REFORESTATION EXPENSES.—The deduction allowed by section 194.".

(c) CONFORMING AMENDMENTS.—

(1)(A) Paragraph (2) of section 1245(a) of such Code (relating to

gain from dispositions of certain depreciable property) is amended by striking out "190, 193" each place it appears and inserting in lieu thereof "190, 193, 194".

(B) Paragraphs (2) and (3)(D) of such section 1245(a) are each amended by striking out "or 193" and inserting "193, or 194".

(C) Section 1245(b) of such Code (relating to exceptions and limitations) is amended by adding at the end thereof the following new paragraph:

"(8) TIMBER PROPERTY.—In determining, under subsection (a)(2), the recomputed basis of property with respect to which a deduction under section 194 was allowed for any taxable year, the taxpayer shall not take into account adjustments under section 194 to the extent such adjustments are attributable to the amortizable basis of the taxpayer acquired before the 10th taxable year preceding the taxable year in which gain with respect to the property is recognized.".

(2) The table of sections for part VI of subchapter B of chapter 1 of such Code is amended by inserting at the end thereof the following new item:

"Sec. 194. Amortization of reforestation expenditures.".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to additions to capital account made after December 31, 1979.

SEC. 302. INVESTMENT CREDIT.

(a) GENERAL RULE.—Paragraph (1) of section 48(a) of the Internal Revenue Code of 1954 (relating to definitions of section 38 property) is amended—

(1) by striking out the period at the end of subparagraph (E) and inserting ", or";

(2) by inserting after subparagraph (E) the following new subparagraph:

"(F) in the case of qualified timber property (within the meaning of section 194(c)(1)), that portion of the basis of such property constituting the amortizable basis acquired during the taxable year (other than that portion of such amortizable basis attributable to property which otherwise qualifies as section 38 property) and taken into account under section 194 (after the application of section 194(b)(1)).";

and

(3) by adding at the end thereof the following new sentence:

"The preceding sentence shall not apply to property described in subparagraph (F) and, for purposes of this subpart, the useful life of such property shall be treated as its normal growing period.".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to additions to capital account made after December 31, 1979.

* * * * *

Approved October 14, 1980.

Conference Report No. 96-1320 2d Session

[Bracketed numerals indicate official report page numbers]

SEPTEMBER 16, 1980

Mr. BIAGGI, from the committee of conference, submitted the following conference report to accompany H.R. 4310.[1]

* * * * *

[16] TITLE III: TAX INCENTIVES FOR REFORESTATION AND REFORESTATION TRUST FUND

This title provides several Federal initiatives to promote reforestation on both private and public timberlands. Reforestation of private lands is encouraged through providing 7-year amortization and the 10-percent regular investment credit for a limited amount of qualifying reforestation expenditures each year. In addition, a trust fund is established to fund reforestation activities in order to eliminate a replanting backlog in the National Forest System.

[1] Public Law 96-451, page 485.

A. TAX INCENTIVES FOR REFORESTATION

Present law

Under present law, direct costs incurred in connection with reforestation of timberlands are treated as capital expenditures. (Treas. Regs. § 1.611-3(a)). Reforestation costs for this purpose are those for site preparation (including girdling, herbicide applications, baiting of rodents, and bush removal), seed or seedlings, plus labor and tool expenses incident to planting or seeding. Depreciation on tractors, trucks and other equipment used in these activities must also be capitalized as a reforestation cost.

These capitalized reforestation costs may not be depreciated but are recovered through a depletion deduction when the timber is harvested fifteen or more years later.

If a private owner of timberland receives funds from the Federal Government or State government under certain reforestation cost sharing programs, these funds are not included in income. In addition, the private owner of timberlands does not receive any depletion, depreciation or other deduction for his reforestation costs paid with [17] these cost-sharing funds, and the owner's basis in the property does not reflect the amount of these payments. These rules apply for grants made after September 30, 1979.

When additional costs are incurred for clearing brush and unwanted trees after the planting or seeding of timberlands, these costs are currently deductible because they are in the nature of maintenance charges.

House bill

The House bill contained no provisions on reforestation.

Senate amendment

Under the Senate amendment a taxpayer may elect to amortize, over a 7-year period, up to $10,000 of qualifying reforestation expenditures incurred during a taxable year in connection with qualified timber property. Amortization deductions claimed under this provision would be allowed as

"above the line" deductions, that is, deductions in computing adjusted gross income, so that this limited amortization provision is equally available to small timberland owners regardless of whether they itemize deductions for income tax purposes.

A taxpayer may elect 7-year (84-month) amortization on up to $10,000 of qualifying reforestation expenditures each year. The election is to be made annually on a property-by-property basis. However, the maximum amount of qualifying forestation or reforestation expenditures paid or incurred during a taxable year which may be amortized is $10,000 for all of the taxpayer's timber properties, and there is no carryover of excess expenditures to subsequent years. If a taxpayer incurs more than $10,000 in qualifying costs in connection with more than one qualified timber property during a taxable year and elects to amortize the costs attributable to these properties, the Secretary is delegated authority to prescribe regulations concerning the allocation of this amortizable basis among these timber properties.

A mandatory half-year convention is provided, under which it is required that the amortization period begins on the first day of the first month of the last half of the taxable year during which the reforestation costs were incurred. (For example, the amortization period begins on July 1 for a taxpayer who uses a calendar year for tax purposes, regardless of whether the reforestation expenditures were incurred in January or December of that year.) The maximum annual amortization deduction for qualifying expenditures incurred in any taxable year is $1,428.57 ($10,000 ÷ 7) and total deductions for any one year under this provision will reach $10,000 only if a taxpayer incurs and elects to amortize the maximum $10,000 of expenditures each year over an 8-year period. (The full $10,000 deduction would be reached in the 8th year.)

In order to be eligible for this elective amortization treatment, qualifying reforestation expenditures must be incurred in connection with a qualifying timber property. A qualifying timber property is defined as property held for purposes of the commercial production of timber in order to exclude, for example, shelter belts (for which current deductions are allowed under Code section 175) and ornamental trees.

Qualifying reforestation expenditures are direct costs incurred to plant or seed for forestation or reforestation purposes, including costs [18] for site preparation, seed or seedlings, and labor and tool costs (including depreciation on equipment used for this purpose). Reforestation expenditures for this purpose exclude costs for which the taxpayer has been reimbursed under a governmental cost-sharing program, unless the amounts reimbursed have been included in the taxpayer's gross income. In addition, the definition of qualifying reforestation expenditures includes only those costs which must be capitalized and become part of the amortizable basis of the property and excludes costs which are currently deductible.

Rules are also provided concerning the general application of this amortization election. For example, it is provided that a life tenant is entitled to the benefit of this amortization provision on qualifying cost incurred by him and any remainder interest in the property is to be ignored for this purpose. Amortization deductions claimed under this provision will be subject to recapture as ordinary income (to the extent of gain) under Code section 1245 where there is a disposition of the timber property to which the amortizable basis (and the amortization deductions) are attributable within ten taxable years from the year in which the amortizable basis was created.

The annual limitation on the dollar amount of expenditures which can be amortized by a taxpayer is intended to insure that these provisions allow only a limited dollar benefit to any enterprise regardless of size. Consequently, where qualifying costs are incurred by a corporation which is a component member of a controlled group of corporations, the $10,000 maximum limitation on costs eligible for amortization applies to the entire controlled group of corporations, and the Secretary is authorized to prescribe regulations concerning allocation of the limitation among members of the controlled group. In determining whether a group of corporations is a controlled group of corporations for purposes of this provision, the standard of control or ownership by the common parent corporation is "at least 50 percent." (This is the same standard as is provided under Code section 179, relating to additional first-year depreciation.)

In applying the $10,000 limitation to partnerships, the dollar limitation is first applied at the partnership level, and then is applied to each partner. Thus, if an individual is a member of a partnership which owns qualified timber property and also owns qualified timber property directly, the maximum amount of amortizable basis acquired during any taxable year on which he can obtain amortization is $10,000.[1]

The Senate amendment would also allow the 10-percent regular investment tax credit on reforestation costs eligible for the amortization election, regardless of whether amortization treatment is elected for these costs. However, the same annual limitation applies so that the amount of qualifying costs eligible for the credit is limited to $10,000 each taxable year, and there is no carryover excess qualifying costs to subsequent years.

The credit also would not be allowed on qualifying reforestation costs attributable to the capitalization of depreciation on property [19] which already qualifies for the regular investment credit.[2] For example, no invest-

[1] The partnership rule is also the same as the rule applicable under Code section 179. As under section 179, this provision is inapplicable to trusts.

[2] This reflects the existing rule relating to qualified investment in new self-constructed property. Under this rule, the taxpayer is required to reduce the basis of self-constructed property by "any depreciation sustained with respect to any other property used in the construction, reconstruction, or erection" for purposes of the investment credit (Treas. Reg. § 1.46-3(c)(1)).

ment credit would be allowed for reforestation costs attributable to depreciation on equipment which itself qualifies for the investment credit.

In applying these rules, the reduction in basis for depreciation sustained with respect to other property used in the reforestation process shall be applied prior to the application of the $10,000 limitation on eligible costs. Thus, for example, if in a taxable year a taxpayer pays or incurs $12,000 of qualifying reforestation costs with respect to properties for which an election is in effect and $2,000 of such costs are attributable to depreciation of the taxpayer's equipment, such $12,000 would first be reduced by the $2,000 of depreciation, and the $10,000 limitation would be applied following such reduction.

The amortization election and investment credit for certain reforestation expenditures would apply to qualifying reforestation expenditures incurred after December 31, 1979.

* * * * *

Conference substitute

The conference substitute is the same as the Senate amendment, with the addition of clarifying and technical amendments.

The conference committee clarified that the $10,000 limit on the amortizable basis applies to a joint return filed by a husband and wife. In cases where a married couple files a separate return, each would be subject to a $5,000 limit on amortizable expenditures.

The term qualified timber property was modified to indicate clearly that eligible property would be a wood lot or other site which will contain trees in significant commercial quantities. For the purposes of this Act, a wood lot may be a one-acre lot planted with trees in the manner normally used in forestation or reforestation.

For determining eligibility for the investment credit, the useful life of a tree will be its normal growing period. The committee waived the requirement that property eligible for the investment credit must be property for which depreciation (or amortization in lieu of depreciation) is allowable.

The conference committee clarified that the provisions apply to reforestation expenditures incurred in the 50 States and the District of Columbia.

* * * * *

Public Law 96-471
96th Congress, H.R. 6883 [1]
October 19, 1980

An Act to amend the Internal Revenue Code of 1954 to revise the rules relating to certain installment sales.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; AMENDMENT OF 1954 CODE

(a) SHORT TITLE.—This Act may be cited as the "Installment Sales Revision Act of 1980".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. INSTALLMENT SALES RULES

(a) GENERAL RULE.—Subpart B of part II of subchapter E of chapter 1 is amended by striking out section 453 and inserting in lieu thereof the following new sections:

"SEC. 453. INSTALLMENT METHOD

"(a) GENERAL RULE.—Except as otherwise provided in this section, income from an installment sale shall be taken into account for purposes of this title under the installment method.

"(b) INSTALLMENT SALE DEFINED.—For purposes of this section—

"(1) IN GENERAL.—The term 'installment sale' means a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.

"(2) EXCEPTIONS.—The term 'installment sale' does not include—

"(A) DEALER DISPOSITION OF PERSONAL PROPERTY.—A disposition of personal property on the installment plan by a person who regularly sells or otherwise disposes of personal property on the installment plan.

"(B) INVENTORIES OF PERSONAL PROPERTY.—A disposition of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year.

"(c) INSTALLMENT METHOD DEFINED.—For purposes of this section, the term 'installment method' means a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

"(d) ELECTION OUT.—

"(1) IN GENERAL.—Subsection (a) shall not apply to any disposition if the taxpayer elects to have subsection (a) not apply to such disposition.

"(2) TIME AND MANNER FOR MAKING ELECTION.—Except as otherwise provided by regulations, an election under paragraph (1) with respect to a disposition may be made only on or before the due date prescribed by law (including extensions) for filing the taxpayer's return of the tax imposed by this chapter for the taxable year in which the disposition occurs. Such an election shall be made in the manner prescribed by regulations.

"(3) ELECTION REVOCABLE ONLY WITH CONSENT.—An election under paragraph (1) with respect to any disposition may be revoked only with the consent of the Secretary.

"(e) SECOND DISPOSITION BY RELATED PERSONS.—

"(1) IN GENERAL.—If—

"(A) any person disposes of property

[1] Senate Report No. 96-1000, page 494; House Report No. 96-1042 is not published.

to a related person (hereinafter in this subsection referred to as the 'first disposition'), and

"(B) before the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property (hereinafter in this subsection referred to as the 'second disposition'),

then, for purposes of this section, the amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition.

"(2) 2-YEAR CUTOFF FOR PROPERTY OTHER THAN MARKETABLE SECURITIES.—

"(A) IN GENERAL.—Except in the case of marketable securities, paragraph (1) shall apply only if the date of the second disposition is not more than 2 years after the date of the first disposition.

"(B) SUBSTANTIAL DIMINISHING OF RISK OF OWNERSHIP.—The running of the 2-year period set forth in subparagraph (A) shall be suspended with respect to any property for any period during which the related person's risk of loss with respect to the property is substantially diminished by—

"(i) the holding of a put with respect to such property (or similar property),

"(ii) the holding by another person of a right to acquire the property, or

"(iii) a short sale or any other transaction.

"(3) LIMITATION ON AMOUNT TREATED AS RECEIVED.—The amount treated for any taxable year as received by the person making the first disposition by reason of paragraph (1) shall not exceed the excess of—

"(A) the lesser of—

"(i) the total amount realized with respect to any second disposition of the property occurring before the close of the taxable year, or

"(ii) the total contract price for the first disposition, over

"(B) the sum of—

"(i) the aggregate amount of payments received with respect to the first disposition before the close of such year, plus

"(ii) the aggregate amount treated as received with respect to the first disposition for prior taxable years by reason of this subsection.

"(4) FAIR MARKET VALUE WHERE DISPOSITION IS NOT SALE OR EXCHANGE.—For purposes of this subsection, if the second disposition is not a sale or exchange, an amount equal to the fair market value of the property disposed of shall be substituted for the amount realized.

"(5) LATER PAYMENTS TREATED AS RECEIPT OF TAX PAID AMOUNTS.—If paragraph (1) applies for any taxable year, payments received in subsequent taxable years by the person making the first disposition shall not be treated as the receipt of payments with respect to the first disposition to the extent that the aggregate of such payments does not exceed the amount treated as received by reason of paragraph (1).

"(6) EXCEPTION FOR CERTAIN DISPOSITIONS.—For purposes of this subsection—

"(A) REACQUISITIONS OF STOCK BY ISSUING CORPORATION NOT TREATED AS FIRST DISPOSITIONS.—Any sale or exchange of stock to the issuing corporation shall not be treated as a first disposition.

"(B) INVOLUNTARY CONVERSIONS NOT TREATED AS SECOND DISPOSITIONS.—A compulsory or involuntary conversion (within the meaning of section 1033) and any transfer thereafter shall not be treated as a second disposition if the first disposition occurred before the threat or imminence of the conversion.

"(C) DISPOSITIONS AFTER DEATH.—Any transfer after the earlier of—

"(i) the death of the person making the first disposition, or

"(ii) the death of the person acquiring the property in the first disposition,

and any transfer thereafter shall not be treated as a second disposition.

"(7) EXCEPTION WHERE TAX AVOIDANCE NOT A PRINCIPAL PURPOSE.—This subsection shall not apply to a second disposition (and any transfer thereafter) if it is established to the satisfaction of the Secretary that neither the first disposition nor the second disposition had as one of its principal purposes the avoidance of Federal income tax.

"(8) EXTENSION OF STATUTE OF LIMITATIONS.—The period for assessing a deficiency with respect to a first disposition (to the extent such deficiency is attributable to the application of this subsection) shall not expire before the day which is 2 years after the date on which the person making the first disposition furnishes (in such manner as the Secretary may be regulations prescribe) a notice that there was a second disposition of the property to which this subsection may have applied. Such deficiency may be assessed notwithstanding the provisions of any law or rule of law which would otherwise prevent such assessment.

"(f) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) RELATED PERSON. — Except for purpose of subsections (g) and (h), the term 'related person' means a person whose stock would be attributed under section 318(a) (other than paragraph (4) thereof) to the person first disposing of the property.

"(2) MARKETABLE SECURITIES.—The term 'marketable securities' means any security for which, as of the date of the disposition, there was a market on an established securities market or otherwise.

"(3) PAYMENT.—Except as provided in paragraph (4), the term 'payment' does not include the receipt of evidences of indebtedness of the person acquiring the property (whether or not payment of such indebtedness is guaranteed by another person).

"(4) PURCHASER EVIDENCES OF INDEBTEDNESS PAYABLE ON DEMAND OR READILY TRADABLE.—Receipt of a bond or other evidence of indebtedness which—

"(A) is payable on demand, or

"(B) is issued by a corporation or a

government or political subdivision thereof and is readily tradable.

shall be treated as receipt of payment.

"(5) READILY TRADABLE DEFINED.—For purposes of paragraph (4), the term 'readily tradable' means a bond or other evidence of indebtedness which is issued—

"(A) with interest coupons attached or in registered form (other than one in registered form which the taxpayer establishes will not be readily tradable in an established securities market), or

"(B) in any other form designed to render such bond or other evidence of indebtedness readily tradable in an established securities market.

"(6) LIKE-KIND EXCHANGES.—In the case of any exchange described in section 1031(b)—

"(A) the total contract price shall be reduced to take into account the amount of any property permitted to be received in such exchange without recognition of gain.

"(B) the gross profit from such exchages shall be reduced to take into account any amount not recognized by reason of section 1031(b), and

"(C) the term 'payment' shall not include any property permitted to be received in such exchange without recognition of gain.

Similar rules shall apply in the case of an exchange which is described in section 356(a) and is not treated as a dividend.

"(7) DEPRECIABLE PROPERTY.—The term 'depreciable property' means property of a character which (in the hands of the transferee) is subject to the allowance for depreciation provided in section 167.

"(g) SALE OF DEPRECIABLE PROPERTY TO SPOUSE OR 80-PERCENT OWNED ENTITY.—

"1) IN GENERAL.—In the case of an installment sale of depreciable property between related persons within the meaning of section 1239(b), subsection (a) shall not apply, and, for purposes of this title, all payments to be received shall be deemed received in the year of the disposition.

"(2) EXCEPTION WHERE TAX AVOIDANCE NOT A PRINCIPAL PURPOSE.—Paragraph (1) shall not apply if it is established to the satisfaction of the Secretary that the disposition did not have as one of its principal purposes the avoidance of Federal income tax.

"(h) USE OF INSTALLMENT METHOD BY SHAREHOLDERS IN SECTION 337 LIQUIDATIONS.—

"(1) RECEIPT OF OBLIGATIONS NOT TREATED AS RECEIPT OF PAYMENT.—

"(A) IN GENERAL.—If, in connection with a liquidation to which section 337 applies, in a transaction to which section 331 applies the shareholder receives (in exchange for the shareholder's stock) an installment obligation acquired in respect of a sale or exchange by the corporation during the 12-month period set forth in section 337(a), then, for purposes of this section, the receipt of payments under such obligation (but not the receipt of such obligation) by the shareholder shall be treated as the receipt of payment for the stock.

"(B) OBLIGATIONS ATTRIBUTABLE TO SALE OF INVENTORY MUST RESULT FROM BULK SALE.—Subparagraph (A) shall not apply to an installment obligation is also described in section 337 (b) (2) (B).

"(C) SPECIAL RULE WHERE OBLIGOR AND SHAREHOLDER ARE RELATED PERSONS.—If the obligor of any installment obligation and the shareholder are related persons (within the meaning of section 1239(b)), to the extent such installment obligation is attributable to the disposition by the corporation of depreciable property—

"(i) subparagraph (A) shall not apply to such obligation, and

"(ii) for purposes of this title, all payments to be received by the shareholder shall be deemed received in the year the shareholder receives the obligation.

"(D) COORDINATION WITH SUBSECTION (e) (1) (A).—For purposes of subsection (e) (1) (A), disposition of property by the corporation shall be treated also as disposition of such property by the shareholder.

"(E) SALES BY LIQUIDATING SUBSIDIARY.—For purposes of subparagraph (A), in any case to which section 337(c) (3) applies, an obligation acquired in respect of a sale or exchange by the selling corporation shall be treated as so acquired by the corporation distributing the obligation to the shareholder.

"(2) DISTRIBUTIONS RECEIVED IN MORE THAN 1 TAXABLE YEAR OF SHAREHOLDER.—If—

"(A) paragraph (1) applies with respect to any installment obligation received by a shareholder from a corporation, and

"(B) by reason of the liquidation such shareholder receives property in more than 1 taxable year,

then, on completion of the liquidation, basis previously allocated to property so received shall be reallocated for all such taxable years so that the shareholder's basis in the stock of the corporation is properly allocated among all property received by such shareholder in such liquidation.

"(i) REGULATIONS.—

"(1) IN GENERAL.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the provisions of this section.

"(2) SELLING PRICE NOT READILY ASCERTAINABLE.—The regulations prescribed under paragraph (1) shall include regulation providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained.

"SEC. 453A. INSTALLMENT METHOD FOR DEALERS IN PERSONAL PROPERTY

"(a) GENERAL RULE.—

"(1) *IN GENERAL.*—Under regulations prescribed by the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price.

"(2) TOTAL CONTRACT PRICE.—For

purposes of paragraph (1), the total contract price of all sales of personal property on the installment plan includes the amount of carrying charges or interest which is determined with respect to such sales and is added on the books of account of the seller to the established cash selling price of such property. This paragraph shall not apply with respect to sales of personal property under a revolving credit type plan.

"(b) CARRYING CHARGES NOT INCLUDED IN TOTAL CONTRACT PRICE.—If the carrying charges or interest with respect to sales of personal property, the income from which is returned under subsection (a)(1), is not included in the total contract price, payments received with respect to such sales shall be treated as applying first against such carrying charges or interest.

"SEC. 453B. GAIN OR LOSS DISPOSITION OF INSTALLMENT OBLIGATIONS

"(a) GENERAL RULE.—If an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and—

"(1) the amount realized, in the case of satisfaction at other than face value or a sale or exchange, or

"(2) the fair market value of the obligation at the time of distribution, transmission, or disposition otherwise than by sale or exchange.

any gain or loss so resulting shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received.

"b) BASIS OF OBLIGATION.—The basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

"(c) SPECIAL RULE FOR TRANSMISSION AT DEATH.—Except as provided in section 691 (relating to recipients of income in respect of decedents), this section shall not apply to the transmission of installment obligations at death.

"(d) EFFECT OF DISTRIBUTION IN CERTAIN LIQUIDATIONS.—

"(1) LIQUIDATIONS TO WHICH SECTION 332 APPLIES.—If—

"(A) an installment obligation is distributed in a liquidation to which section 332 (relating to complete liquidations of subsidiaries) applies, and

"(B) the basis of such obligation in the hands of the distributee is determined under section 334(b)(1),

then no gain or loss with respect to the distribution of such obligation shall be recognized by the distributing corporation.

"(2) LIQUIDATIONS TO WHICH SECTION 337 APPLIES.—If—

"(A) an installment obligation is distributed by a corporation in the course of a liquidation, and

"(B) under section 337 (relating to gain or loss on sales or exchanges in connection with certain liquidations) no gain or the loss would have been recognized to the corporation if the corporation had sold or exchanged such installment obligation on the day of such distribution.

then no gain or loss shall be recognized to such corporation by reason of such distribution. The preceding sentence shall not apply to the extent that under paragraph (1) gain to the distributing corporation would be considered as gain to which section 341(f), 617(d)(1), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a) applies.

"(e) LIFE INSURANCE COMPANIES.—

"(1) IN GENERAL.—In the case of a disposition of an installment obligation by any person other than a life insurance company (as defined in section 801(a)) to such an insurance company or to a partnership of which such an insurance company is a partner, no provision of this subtitle providing for the nonrecognition of gain shall apply with respect to any gain resulting under subsection (a). If a corporation which is a life insurance company for the taxable year was (for the preceding taxable year) a corporation which was not a life insurance company, such corporation shall, for purposes of this subsection and subsection (a), be treated as having transferred to a life insurance company, on the last day of the preceding taxable year, all installment obligations which it held on such last day. A partnership of which a life insurance company becomes a partner shall, for purposes of this subsection and subsection (a), be treated as having transferred to a life insurance company, on the last day of the preceding taxable year of such partnership, all installment obligations which it holds at the time such insurance company becomes a partner.

"(2) SPECIAL RULE WHERE LIFE INSURANCE COMPANY ELECTS TO TREAT INCOME AS INVESTMENT INCOME.—Paragraph (1) shall not apply to any transfer or deemed transfer of an installment obligation if the life insurance company elects (at such time and in such manner as the Secretary may by regulations prescribe) to determine its life insurance company taxable income—

"(A) by returning the income on such installment obligation under the installment method prescribed in section 453, and

"(B) if such income would not otherwise be returnable as an item referred to in section 804(b) or as long-term capital gain, as if the income on such obligations were income specified in section 804(b).

"(f) OBLIGATION BECOMES UNENFORCEABLE.—For purposes of this section, if any installment obligation is canceled or otherwise becomes unenforceable—

"(1) the obligation shall be treated as if it were disposed of in a transaction other than a sale or exchange, and

"(2) if the obligor and obligee are related persons (within the meaning of section 453(f)(1)), the fair market value of the obligation shall be treated as not less than its face amount."

(b) TECHNICAL AMENDMENTS.—

(1) Section 311(a) and section 336 (as in effect on the day before the date of the enactment of the Crude Oil Windfall Profit Tax Act of 1980 [Pub. L. 96-223, 1980-3 C.B. 1]) are each amended by striking out "section 453 (d)" and inserting in lieu thereof "section 453B".

(2) Paragraph (8) of section 381 (c) is amended—

(A) by striking out "has elected, under section 453, to report on the installment basis" and inserting in lieu thereof "reports on the installment basis under section 453 or 453A", and

(B) by striking out "for purposes of section 453" and inserting in lieu thereof "for purposes of section 453 or 453A".

(3) Subsection (d) of section 481 is hereby repealed.

(4) Subsection (f) of section 644 is amended by striking out "elects to report income under section 453" and inserting in lieu thereof "reports income under section 453".

(5) Paragraph (4) of section 691 (a) is amended—

(A) by striking out "received by a decedent on the sale of other disposition of property, the income from which was properly reportable by the decedent on the installment basis under section 453" and inserting in lieu thereof "reportable by the decedent on the installment method under section 453 or 453A", and

(B) by striking out "section 453 (d)" each place it appears and inserting in lieu thereof "section 453B".

(6) Paragraph (2) of section 1255 (b) is amended by striking out "453 (d)(4)(B)" and inserting in lieu thereof "453B(d)(2)".

(c) CONFORMING AMENDMENTS.—

(1) Subsection (a) of section 336 (as amended by the Crude Oil Windfall Profit Tax Act of 1980 [*supra* at 76]) is amended by striking out "section 453(d)" and inserting in lieu thereof "section 453B".

(2) Paragraph (3) of section 337 (f) is amended by striking out "section 453(d)(1)" and inserting in lieu thereof "section 453B(a)".

(3) Paragraph (2) of section 453 (d) is amended by adding at the end thereof the following new sentence: "In the case of any installment obligation which would have met the requirements of subparagraphs (A) and (B) of the first sentence of this paragraph but for section 337(f), gain shall be recognized to such corporation by reason of such distribution only to the extent gain would have been recognized under section 337(f) is such corporation had sold or exchanged such installment obligation on the date of such distribution."

(4) Subparagraph (B) of section 403(b)(2) of the Crude Oil Windfall Profit Tax Act of 1980 is hereby repealed.

(d) CLERICAL AMENDMENT.—The table of sections for such subpart B is amended by striking out the item relating to section 453 and inserting in lieu thereof the following:

"Sec 453. Installment method.

"Sec. 453A. Installment methods for dealers in personal property.

"Sec. 453B. Gain or loss on disposition of installment obligations.".

SEC. 3. COORDINATION WITH SECTION 691

Subsection (a) of section 691 (relating to income in respect of a decedent) is amended by adding at the end thereof the following new paragraph:

"(5) OTHER RULES RELATING TO INSTALLENT OBLIGATIONS.—

"(A) IN GENERAL.—In the case of an installment obligation reportable by the decedent on the installment method under section 453 or 453(A), for purposes of paragraph (2)—

"(i) the second sentence of paragraph (2) shall be applied by inserting '(other than the obligor)' after 'or a transfer to a person',

"(ii) any cancellation of such an obligation shall be treated as a transfer, and

"(iii) any cancellation of such an obligation occurring at the death of the decedent shall be treated as a transfer by the estate of the decedent (or, if held by a person other than the decedent before the death of the decedent, by such person).

"(B) FACE AMOUNT TREATED AS FAIR MARKET VALUE IN CERTAIN CASES.—In any case to which the first sentence of paragraph (2) applies by reason of subparagraph (A), if the decedent and the obligor were related persons (within the meaning of section 453(f)(1)), the fair market value of the installment obligation shall be treated as not less than its face amount.

"(C) CANCELLATION INCLUDES BECOMING UNENFORCEABLE.—For purposes of subparagraph (A), an installment obligation which becomes unenforceable shall be treated as if it were canceled.".

SEC. 4. AMENDMENT OF SECTION 1038.

Section 1038 (relating to certain reacquisitions of real property) is amended by adding at the end thereof the following new subsection:

"(g) ACQUISITION BY ESTATE, ETC., OF SELLER.—Under regulations prescribed by the Secretary, if an installment obligation is indebtedness to the seller which is described in subsection (a), and if such obligation is, in the hands of the taxpayer, an obligation with respect to which section 691(a)(4)(B) applies, then—

"(1) for purposes of subsection (a), acquisition of real property by the taxpayer shall be treated as reacquisition by the seller, and

"(2) the basis of the real property acquired by the taxpayer shall be increased by an amount equal to the deduction under section 691(c) which would (but for this subsection) have been allowable to the taxpayer with respect to the gain on the exchange of the obligation for the real property."

SEC. 5. COORDINATION WITH SECTION 1239.

Subsections (b) and (c) of section 1239 (defining related persons) are amended to read as follows:

"(b) RELATED PERSONS.—For purposes of subsection (a), the term 'related persons' means—

"(1) the taxpayer and the taxpayer's spouse,

"(2) the taxpayer and an 80-percent owned entity, or

"(3) two 80-percent owned entities.

"(c) 80-PERCENT OWNED ENTITY DEFINED.—

"(1) GENERAL RULE.—For purposes of this section, the term '80-percent owned entity' means—

"(A) a corporation 80 percent or more in value of the outstanding stock of which is owned (directly or indirectly) by or for the taxpayer, and

"(B) a partnership 80 percent or more of the capital interest or profits interest in which is owned (directly or indirectly) by or for the taxpayer.

"(2) CONSTRUCTIVE OWNERSHIP.—For purposes of subparagraph (A) and (B) of paragraph (1), the principles of section 318 shall apply, except that—

"(A) the members of an individual's family shall consist only of such individual and such individual's spouse, and

"(B) paragraphs (2)(C) and (3)(C) of section 318(a) shall be applied without regard to the 50-percent limitation contained therein.".

SEC. 6. EFFECTIVE DATES.

(a) FOR SECTIONS 2 AND 5.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by section 2 and 5 shall apply to dispositions made after the date of the enactment of this Act in taxable years ending after such date.

(2) FOR SECTION 453(e).—Section 453(e) of the Internal Revenue Code of 1954 (as amended by section 2) shall apply to first dispositions made after May 14, 1980.

(3) FOR SECTION 453(h).—Paragraphs (1) and (2) of section 453(h) of such Code (as amended by section 2) shall apply in the case of distributions of installment obligations after March 31, 1980.

(4) FOR SECTION 453A.—Section 453A of the Internal Revenue Code of 1954 (as amended by section 2) shall apply to taxable years ending after the date of enactment of this Act.

(5) FOR SECTION 453B(f).—Section 453B(f) of the Internal Revenue Code of 1954 (as amended by section 2) shall apply to installment obligations becoming unenforceable after the date of the enactment of this Act.

(6) FOR SECTION 2(c).—The amendments made by section 2(c) shall take effect as if included in the amendments made by section 403(b) of the Crude Oil Windfall Profit Tax Act of 1980.

(7) SPECIAL RULE FOR APPLICATION OF FORMER SECTION 453 TO CERTAIN DISPOSITIONS.—In the case of any disposition made on or before the date of the enactment of this Act in any taxable year ending after such date, the provisions of section 453(b) of the Internal Revenue Code of 1954, as in effect before such date, shall be applied with respect to such disposition without regard to—

(A) paragraph (2) of such section 453(b), and

(B) any requirement that more than 1 payment be received.

(b) FOR SECTION 3.—The amendment made by section 3 shall apply in the case of decedents dying after the date of the enactment of this Act.

(c) FOR SECTION 4.—The amendment made by section 4 shall apply to acquisitions of real property by the taxpayer after the date of the enactment of this Act.

Approved October 19, 1980.

Senate Report No. 96-1000 2d Session

[Bracketed numerals indicate official report page numbers]

INSTALLMENT SALES REVISION ACT OF 1980

SEPTEMBER 26 (legislative day, JUNE 12), 1980.

Mr. LONG, from the Committee on Finance, submitted the following report to accompany H.R. 6883.[1]

The Committee on Finance, to which was referred the bill (H.R. 6883) to amend the Internal Revenue Code of 1954 to revise the rules relates to certain installment sales, having considered the same, reports favorably thereon with an amendment and recommends that the bill as amended do pass.

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

House bill.—H.R. 6883, as it passed the House, amends the rules for reporting gains under the installment method for sales of real property and casual sales of personal property. The bill would (1) make structural improvements to these provisions, (2) eliminate the 30-percent initial payment limitation, (3) eliminate the requirement that an eligible sale be for two or more payments, (4) eliminate the selling price requirement for nondealer sales of personal property, (5) provide that installment reporting automatically applies to a deferred payment sale unless the taxpayer elects otherwise, (6) prescribe special rules for sales to certain related parties, (7) provide that the receipt of like-kind property in connection with an installment sale will not accelerate recognition of gain, (8) provide nonrecognition treatment for distributions of installment obligations received in connection with a 12-month corporate liquidation, (9) permit installment method reporting for sales for a contingent selling price, (10) clarify the treatment of gift cancellations of an installment obligation, (11) clarify the treatment of an installment obligation which is cancelled at the death of the seller, and (12) permit an executor or beneficiary to succeed the decedent for purposes of qualifying for nonrecognition treatment if real property sold by the decedent is reacquired in cancellation of an installment obligation.

[2] *Committee amendment.* — The committee amended the bill to (1) clarify and coordinate the provisions relating to sales of depreciable property between closely related parties, (2) clarify that a third party guarantee (including a standby letter of

[1] Public Law 96-471, page 489.

credit) securing a deferred payment sale will not constitute payment to the seller, (3) eliminate any potential for double taxation when a dealer changes from an accrual method of accounting for sales to the installment method of reporting, (4) provide that existing special disposition rules for transfers of installment obligations to a life insurance company will not apply if the company reports any remaining gain as taxable investment income when it receives payments on the obligation, and (5) make the repeal of the 30-percent initial payment and two or more payment requirements effective for transactions occurring in taxable years ending after the date of enactment rather than for transactions occurring after that date.

[3] I. SUMMARY

The bill (H.R. 6883) amends the rules for reporting gain under the installment method for sales of real property and casual sales of personal property, the rules for electing the installment method by an accrual basis taxpayer, and the special disposition rules for obligations transferred to a life insurance company.

The bill makes the following changes:

(1) Structural improvements. — Under present law, a single provision (Code sec. 453) prescribes rules for installment method reporting for dealers in personal property, for sales of real property and nondealer personal property, and special disposition rules. Under the bill, the basic rules for nondealer transactions will be contained in one Code section (sec. 453), the rules for dealer transactions will be contained in another section (sec. 453A), and generally applicable installment obligation disposition rules will be contained in a third section (sec. 453B).

(2) Initial payment limitation. — The bill eliminates the requirement that no more than 30 percent of the selling price be received in the taxable year of sale to qualify for installment sale reporting for gains from sales of realty and nondealer personal property.

(3) Two-payment rule. — The bill eliminates the requirement that a deferred payment sale be for two or more payments. Thus, a sale will be eligible for installment reporting even if the purchase price is to be paid in a single lump sum amount in a year subsequent to the taxable year in which the sale is made.

(4) Selling price requirements. — The bill eliminates the requirement that the selling price for casual sales of personal property must exceed $1,000 to qualify for installment sale reporting.

(5) Election. — The bill eliminates the present law requirement that the installment method must be elected for reporting gains from sales of realty and nondealer personal property. Instead, the provision will automatically apply to a qualified sale unless the taxpayer elects not to have the provision apply with respect to a deferred payment sale.

(6) Related party sales. — The bill prescribes special rules for situations involving installment sales to certain related parties who also dispose of the property and for situations involving installment sales of depreciable property between a taxpayer and his spouse or certain 80-percent owned corporations or partnerships.

Sales other than sales of depreciable property between certain closely-related parties.—Under the bill, the amount realized upon a resale by the related party installment purchaser will trigger recognition of gain by the initial seller, based on his gross profit ratio, only to the extent the amount realized from the second disposition exceeds actual payments made under the installment sale. Thus, acceleration of recognition of the installment gain from the first sale will generally result only to the extent additional cash and other property [4] flows into the related group as a result of a second disposition of the property.

The excess of any amount realized from resales over payment received on the first sale as of the end of a taxable year will be taken into account. If, under these rules, a resale results in the recognition of gain to the initial seller, subsequent payments actually received by that seller will be recovered tax-free until they equal the amount realized from the resale which resulted in the acceleration of recognition of gain.

In the case of property other than marketable stock and securities, the resale rule will apply only with respect to second dispositions occurring within 2 years of the initial installment sale. In the case of marketable stock and securities, the resale rule will apply without a time limit for resales occurring before the installment obligation is satisfied.

The bill also contains several exceptions to the application of these rules. Since gain from the sale of a corporation's treasury stock is nontaxable and therefore its basis in the stock is irrelevant, the related party rule will not apply to any sale or exchange of stock to the issuing corporation. In addition, there generally will be no acceleration of recognition of gain as a result of a second disposition which is an involuntary conversion of the property or which occurs after the death of the installment seller or purchaser. Finally, the resale rules will not apply in any case where it is established to the satisfaction of the Internal Revenue Service that none of the dispositions had as one of its principal purposes the avoidance of Federal income taxes.

For purposes of the related party rules, the bill adopts a definition of related parties which will include spouses, children, grandchildren, and parents but will exclude brothers and sisters. It is to be understood that the Internal Revenue Service is not precluded from asserting the proper tax treatment to transactions that are shams. A corporation will be considered to be related to another taxpayer if stock of another corporation which is or might be owned by it would be treated as owned by the taxpayer under the general corporate attribution rules. Generally, a related corporation

will be one in which a person directly or indirectly owned 50 percent or more in value of the stock in the corporation. Also for this purpose, the principles of the general corporate stock ownership attribution rules will apply in determining the related party status of partnerships, trusts, and estates.

Sales of depreciable property between certain closely-related parties.—Under the bill, the accrual method of accounting in effect is required for deferred payment sales of depreciable property between certain closely-related parties.

In general, this rule is intended to deter transactions which are structured in such a way as to give the related purchaser the benefit of depreciation deductions (measured from a stepped-up basis) prior to the time the seller is required to include in income the corresponding gain on the sale. For these transactions the deferred payments will be deemed to be received in the taxable year in which the sale occurs.

This special rule will apply only to deferred payment sales between a taxpayer and the taxpayer's spouse, the taxpayer and a partnership [5] or corporation which is 80-percent owned by the taxpayer and/or the taxpayer's spouse, and between partnerships and corporations which are 80-percent owned by the taxpayer and/or the taxpayer's spouse.

The rule will not apply if it is established to the satisfaction of the Internal Revenue Service that the sale did not have as one of its principal purposes the avoidance of Federal income taxes. Thus, the rule will not apply with respect to a sale incident to a divorce or separation or generally when no significant tax deferral benefits will be derived from the sale.

(7) Treatment of third party guarantee.—Under the bill, a third party guarantee (including a standby letter of credit) used for security of a deferred payment sale will not be treated as payment received on an installment obligation.

(8) Like-kind exchanges.—The bill provides that the receipt of like-kind property in connection with a disposition will not be taken into account in determining gain recognized for installment sale reporting purposes. Under the present Internal Revenue Service position, the receipt of like-kind property results in the recognition of installment gain before cash is received by the taxpayer because the value of such property is treated as a payment received. The bill reverses this rule.

(9) Installment obligations distributed in a corporation liquidation.—In general, the bill provides nonrecognition of gain treatment for a shareholder who receives installment obligations as liquidating distributions from a corporation liquidating within 12 months of adoption of a plan of complete liquidation. In general, this rule will apply to obligations arising from sales by a corporation during the 12-month period. Obligations from the sale of inventory will qualify only if the inventory of that trade or business is sold in bulk. The gain realized by the shareholder on his stock will be recognized as payments are received on the installment obligation. Thus, in most significant aspects, the tax consequences to a shareholder will be essentially the same whether the corporation sells its assets and then distributes installment obligations in complete liquidation or the shareholder makes an installment sale of the stock.

Under the bill, nonrecognition treatment will not be available to the extent the obligation is attributable to sales of depreciable property by the corporation if the installment purchaser is either the shareholder-distributee's spouse, or a corporation or a partnership which is 80-percent owned by the shareholder-distributee and/or his spouse.

(10) Sales subject to a contingency.—The bill permits installment method reporting for sales for a contingent selling price. Under present law, these sales are not eligible for installment reporting. In extending eligibility, the bill does not prescribe specific rules which would apply to every conceivable transaction. Rather, the bill provides that the specific rules will be prescribed under regulations.

However, it is intended that, for sales under which there is a stated maximum selling price, the regulations will permit basis recovery on the basis of a gross profit ratio determined by reference to the stated maximum selling price. In cases where the sales price is indefinite but payable over a fixed period of time, it is generally intended that the basis of the property sold would be recovered ratably over that fixed period. In cases where the selling price and payment period are both indefinite, it is intended that the regulations would permit ratable [6] basis recovery over some reasonable period of time. Also, in appropriate cases, it is intended that basis recovery would be permitted under an income forecast type method.

(11) Election of installment method by accrual method dealer.—Under the bill, an election of installment method reporting by an accrual method dealer would apply only to payments received from sales made on or after the effective date of the election and thereby eliminate the possibility of double taxation which exists under present law.

(12) Transfers of installment obligations to life insurance companies.—Under the bill, the special disposition rules for triggering the recognition of gain for obligations transferred to a life insurance company in an otherwise tax-free transfer will not apply if the transferee company elects to report any remaining gain as investment income as payments are received.

(13) Cancellation of installment obligation.—The bill makes it clear that the cancellation of an installment obligation is treated as a disposition of the obligation by the holder of the obligation.

(14) Bequest of obligation to obligor.—The bill provides that the installment obligation disposition rules cannot be avoided by the bequest of an obligation to the obliger.

(15) Foreclosure of real property

sold on installment method by deceased taxpayer.—The bill provides that an executor or beneficiary who receives a secured installment obligation from a decedent will succeed the decedent for purposes of qualifying for nonrecognition treatment if the real property sold by the decedent is reacquired in cancellation of the obligation.

(16) Treatment of gain from sales of depreciable property between related parties.—Under the bill, the ordinary income characterization rules for sales of depreciable property between related parties would be revised to generally apply the usual corporate constructive ownership rules and to prescribe new rules for transactions with entities which are 80 percent controlled by a taxpayer and his spouse. For purposes of this provision, the attribution rules would be narrowed to exclude attribution from a family member other than the taxpayer's spouse.

(17) Effective dates.—In general, the bill is effective for sales, dispositions, cancellations, bequests, and reacquisitions of real property, as the case may be, occurring after the date of enactment. The provisions which eliminate the 30-percent initial payment and the two or more payments requirements are effective for transactions occurring in taxable years ending after the date of enactment. However, the related party installment sale rules apply to installment sales after May 14, 1980. The provision relating to the distribution of installment obligations in connection with a 12-month corporate liquidation apply with respect to installment obligations distributed after March 31, 1980.

(18) Revenue effects.—Due to the interaction between the provisions of this bill, revenue effects for each specific provision cannot be determined independently. It is estimated that on balance the provisions of this bill (except related party sales) will not have a significant revenue effect on budget receipts.

Due to the extensive litigation and controversy concerning the treatment of related party sales under present law, the revenue gain for the related party provision of the bill is indeterminant.

[7] II. EXPLANATION OF THE BILL

A. Installment Sales Generally (sec. 2 of the bill and sec. 453 of the Code)

Present law

Generally, under present law (Code sec. 453), income from a sale of property on the installment basis may be reported as the payments are received. If the installment method is elected for qualifying sales, the gain reported for any taxable year is the proportion of the installment payment received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price. In general, the contract price is the amount which will be paid to the seller.

The function of the installment method of reporting income is to permit the spreading of the income tax over the period during which payments of the sales price are received. Thus, the installment method alleviates possible liquidity problems which might arise from the bunching of gain in the year of sale when a portion of the selling price has not been actually received.

Reasons for change

The committee believes that present law would be simplified by making structural improvements to existing law so that the basic rules relating to nondealer transactions would be contained in one section of the Code, the basic rules relating to dealer transactions in another section, and the special rules relating to dispositions of installment obligations in a third section.

Explanation of provision

In general

Although the bill makes structural revisions of existing law and makes the specific changes described below, most of the basic concepts of existing law are continued. As under present law, the provisions relate to installment reporting of gains and do not affect the time for recognizing losses from the sale or exchange of property for deferred payments.

Except as otherwise provided for sales subject to a contingency or for sales to certain related persons, gain from an installment sale would continue to be recognized for any taxable year with respect to the payments received in the year in the same proportion as the gross profit from the sale bears to the total contract price. The payments taken into account as being received in a taxable year would not include the purchaser's obligation of future payment, whether dischargeable in money or other property (including foreign currency), unless that obligation is a bond or other evidence of indebtedness which is either payable on demand or has been issued by a corporation or government and is readily tradable.

[8] *Structural improvements*

Under present law, a single provision (Code sec. 453) prescribes rules for installment method reporting for dealers in personal property, for sales of real property and nondealer personal property, and special disposition rules. Under the bill, the rules for nondealer transactions are contained in one Code section (sec. 453), the rules for personal property dealer transactions are contained in another section (sec. 453A), and generally applicable installment obligation disposition rules are contained in a third section (sec. 453B).

Generally, in making these structural changes and certain language changes are intended to be made by the bill with respect to the provisions relating to installment sales by dealers in personal property. Except for an amendment relating to the election of the installment method by an accrual basis dealer, the substantive changes under the bill relate only to sales of

realty and casual sales of personal property.

Under the bill, gain from the sale of property which is not required to be inventories by a farmer under his method of accounting will be eligible for installment method reporting as gain from a casual sale of personal property even though such property is held for sale by the farmer. The committee also intends that deferred payment sales to farmer cooperatives are to be eligible for installment reporting as under present law (Rev. Rul. 73-210, 1973-1 C.B. 211).

B. Initial Payment Limitation (sec. 2 of the bill and sec. 453(b)(2) of the Code)

Present law

Under present law, gain from the sale of realty or nondealer personal property may not be reported under the installment method if the payments received in the taxable year of sale exceed 30 percent of the selling price.

Reasons for change

A number of problems have arisen in connection with the 30-percent initial payment requirement which was designed to limit installment sale reporting to transactions where hardships might result from current imposition of tax on uncollected amounts. Some have argued that it is an arbitrary limitation which has unduly complicated and interfered with normal business transactions. In addition, it has been argued that the limitation has operated as a trap for the unwary. If a taxpayer fails to secure competent advice and inadvertently exceeds the 30-percent limitation, however slightly, the entire gain must be recognized in the year of sale. The limitation has produced an inordinate amount of litigation and confusion.

In applying the 30-percent limitation, the problem areas generally involve interpretations of the terms "selling price" and "payment." Where the imputed interest provision applies (Code sec. 483), the limitation may not be satisfied if the selling price is reduced by the amount required to be treated as unstated interest (Treas. reg. § 1.453(b)(2)). Thus, after reduction of the selling price for unstated interest, the payments received in the year of sale may exceed 30 percent of the selling price although the limitation appeared to be satisfied on the basis of the written sales agreement. A similar disqualification [9] can arise when the installment obligation is a corporate obligation issued at a discount because the amount treated as original issue discount is not included as part of the selling price (Treas. reg. § 1.453-1(b)(3)).

Another problem arises under present law in connection with the sale of property which is subject to an existing mortgage which is assumed by the installment buyer. Generally, the amount of the mortgage is taken into account as part of the selling price but is not taken into account for purposes of determining the contract price or the amount of payments received by the seller. However, to the extent the mortgage exceeds the seller's basis in the property, the excess is considered as a payment received and correspondingly is included in the contract amount. (Treas. reg. § 1.453-4(c)). The problem arising from this treatment does not involve its correctness but rather the inadvertent disqualification of the sale for installment method reporting for failing to take the amount of the mortgage in excess of basis into account for the 30-percent initial payment requirement. Where the taxpayers are cognizant of problems of this type, the 30-percent requirement has fostered ingenious "wraparound" mortgage arrangements to qualify for installment method reporting.[1]

Under the wraparound arrangement, the buyer does not assume the mortgage and agrees not to make direct payments to the mortgagee but agrees to make the payments to the seller who will continue to pay the mortgage debt. In one case, the wraparound technique was used by having the seller retain title to the property for a period of years so there would be no transfer of property "subject to" the existing mortgage.[2] If title passes in the year of sale, the Internal Revenue Service will treat the mortgage debt in excess of basis as a payment received in the year of the sale.[3] This issue is said to be another instance of the 30-percent initial payment rule fostering uncertainty and litigation.

Another problem area relates to the treatment of selling expenses when determining whether the mortgage assumed by the buyer exceeds the adjusted basis of the property sold. Under the regulations, commissions and selling expenses are taken into account as an offset to selling price for purposes of determining the gross profit from a sale by a nondealer (Treas. reg. § 1.453-1(b)), but do not reduce the amount of the payments, the total contract price, or the selling price (Treas. reg. § 1.453-4(c)). However, the Ninth Circuit has held that selling expenses are to be added to basis for this purpose.[4] The Internal Revenue Service has announced that it will not follow the Ninth Circuit's decision on the treatment of selling expenses.[5] Thus, this is another area where the 30-percent initial payment requirement may foster litigation and confusion.

Another problem area involves the case where the buyer pays some of the seller's obligations in the year of sale. The Service has ruled that, in the case of a casual sale of personal property, the assumption [10] and payment of secured and general unsecured liabilities by the purchaser will not be con-

[1] Wyndelts and Campbell, "Installment Reporting Need Not Be Lost When Year-Of-Sale Payments Are More Than 30%," *20 Taxation for Accountants* 328 (1978); Ginsberg, "Taxing the Sale for Future Payment," 30 *Tax Law Review* 469, 488 (1975).

[2] *Stonecrest*, 24 TC 659 (1955) *nonacq.* 1956-1 C.B. 6.

[3] Letter rulings 7814010 and 7814011.

[4] *Kirschenmann v. United States*, 488 F.2d 270 (9th Cir. 1973).

[5] Rev. Rul. 74-384, 1974-2 C.B. 152.

sidered as a payment to the seller for installment sale reporting qualification purposes if the seller establishes that the liabilities were incurred in the ordinary course of business and not for purposes of avoiding the 30-percent initial payment limitation.[6] The avoidance test under the ruling would involve a subjective determination of motive. Thus, this is another area where the initial payment rule may foster litigation and confusion.

For these reasons, the committee believes that the 30-percent initial payment limitation should be repealed.

Explanation of provision

The bill eliminates the 30-percent initial payment limitation for reporting gain on the installment method from the disposition of real property or nondealer personal property.

C. Two-Payment Rule (sec. 2 of the bill and sec. 453 of the Code)

Present law

Under present law, it is the position of the Internal Revenue Service that a taxpayer may not elect to report income from the sale of real property on the installment method if the total purchase price is payable in a lump sum in a taxable year subsequent to the year of sale.[7] The same issue may arise with respect to casual sales of personal property. The rationale for the ruling is that the installment concept generally calls for two or more payments of the purchase price in two or more taxable years and that a single payment sale cannot be considered to be payable in installments. The courts have agreed with the Service's interpretation.[8]

Reasons for change

The two-payment rule is a trap for the unwary and results in different tax results for transactions that are substantially similar. For example, installment method reporting would be available for a taxpayer who sells for a modest down payment with the balance due in 5 years but would not be available for a taxpayer who receives no down payment with the entire balance due in 5 years. In these situations, the ability to pay income taxes from the sales proceeds is essentially the same. Thus, to the extent the rationale for installment method reporting is based on ability to pay concepts, both sales should qualify for installment reporting.

Accordingly, the committee believes that the two-payment requirement should be repealed.

Explanation of provision

The bill eliminates the requirement that a sale must be for two or more payments to qualify for installment method reporting. Thus, under the bill, income from the sale of qualifying property for a purchase price payable in a lump sum in a taxable year subsequent to the year of sale may be reported in the year in which payment is received.

[11] It is anticipated that the Treasury Department will prescribe regulations to extend a similar rule to deferred payment sales by dealers in personal property.

D. Selling Price Limitation for Casual Sales of Personal Property (sec. 2 of the bill and sec. 453(b)(1)(B) of the Code)

Present law

Under present law, a casual sale of personal property must be for a selling price in excess of $1,000 to qualify for installment reporting.

Reasons for change

In certain situations, the selling price requirement may be difficult to apply because questions may arise as to whether there is a single sale of several items for more than $1,000, which satisfies the requirement, or a number of sales of individual items for $1,000 or less for each item. In addition, the committee believes that taxpayer compliance will be facilitated by repealing this requirement.

Explanation of provision

The bill eliminates the selling price requirement to qualify for installment reporting.[9]

E. Election of Installment Reporting (sec. 2 of the bill and new sec. 453(d) of the Code)

Present law

Under present law, an election may be made to report gain from an installment sale on a timely filed return, a delinquent return, or on an amended return for the year of sale not barred by the statute of limitations, if the facts indicate no position inconsistent with the installment election had been taken with respect to the sale (Rev. Rul. 65-297, 1965-2 C.B. 152). If a return is filed which includes in gross income the entire gain from an installment sale, an amended return or claim for refund cannot be used to elect installment sale reporting for the sale because the election to report the gain in full is treated as a binding election not to report on the installment method.[10]

Reasons for change

The committee believes that the present law requirements for electing installment reporting may represent a trap for taxpayers who attempt an election which is invalid because of technical deficiencies. Further, the committee believes that present law creates a whip-saw problem for the Internal Revenue Service, e.g., where the taxpayer does not report gain from a sale for the year of sale but later

[6] Rev. Rul. 73-555, 1973-2 C.B. 159.

[7] Rev. Rul. 69-462, 1969-2 C.B. 107, amplified by Rev. Rul. 71-595, 1971-2 C.B. 223.

[8] *Baltimore Baseball Co., Inc.*, v. *U.S.*, 481 F.2d 1283 (Ct. Cl. 1973); *10-42 Corp.*, 55 TC 593 (1971).

[9] If, for practical reasons, it is not feasible to report gain from sales for relatively small amounts, a taxpayer could elect not to report gain under the installment method and thereby eliminate compliance burdens. See the following discussion relating to installment sale elections under the bill.

[10] *Robert F. Kock*, T.C. Memo 1978-271; *Pacific National Co.* v. *Welch*, 304 U.S. 191 (1938).

attempts to retroactively elect installment treatment if the omission is discovered on audit, or, if the statute of limitations has run, contends that the full amount of gain should have been reported for the year of sale.

Explanation of provision

The bill eliminates the present law requirement that the installment method must be elected for reporting gains from sales of realty and nondealer personal property. Instead, installment reporting would [12] automatically apply to a qualified sale unless the taxpayer elects not to have the provision apply with respect to a deferred payment sale. Generally, the election not to have installment method reporting apply to a deferred payment sale must be made in the manner prescribed by regulations on or before the due date (including extensions of time for filing) for filing the income tax return for the year in which the sale occurs. It is anticipated that reporting the entire gain in gross income for the taxable year in which the sale occurs will operate as an election not to have installment sale reporting apply. It is anticipated that, under regulations, late elections will be permitted in rare circumstances when the Internal Revenue Service finds that reasonable cause for failing to make a timely election exists under the particular circumstances of each case.

Generally, an election made under this provision is to be irrevocable. However, an election may be revoked with the consent of the Internal Revenue Service. Generally, it is anticipated that consent would be given by the Internal Revenue Service in circumstances when a revocation does not have as one of its purposes the avoidance of income taxes. Also it is anticipated that consent to revocation will generally be granted in cases involving a contingent selling price if the election is made prior to adoption of final regulations under the provisions of the bill relating to contingent selling price sales and the request for revocation is filed within a reasonable time after the regulations are adopted.

It is anticipated that the regulations will prescribe election rules relating to the treatment of gains from deferred payments sales of property by a nonresident alien. Under the installment method rules of present law, these gains do not become taxable as payments are received after the seller becomes a resident or citizen subject to U.S. income tax for a taxable year subsequent to the year in which the sale was made. It is intended that the election regulations will continue this treatment in appropriate cases. Further, it is intended that similar treatment will be provided for a deferred payment sale made by a tax-exempt organization which later receives payments after losing its tax-exempt status.

F. Related Party Sales (sec. 2 of the bill and new sec. 453(e), (f), and (g) of the Code)

Present law

Under present law, the installment sale statutory provision does not preclude installment sale reporting for sales between related parties. Further, the statutory provision does not preclude installment sale reporting for sales of marketable securities although the seller might readily obtain full cash proceeds by market sales.[11]

Under the existing statutory framework, taxpayers have used the installment sale provision as a tax planning device for intra-family transfers of appreciated property, including marketable securities.[12] [13] There are several tax advantages in making intra-family installment sales of appreciated property. The seller would achieve deferral of recognition of gain until the related buyer actually pays the installments to the seller, even if cash proceeds from the property are received within the related party group from a subsequent resale by the installment buyer shortly after making the initial purchase. In addition to spreading out the gain recognized by the seller over the term of the installment sale, the seller may achieve some estate planning benefits since the value of the installment obligation generally will be frozen for estate tax purposes. Any subsequent appreciation in value of the property sold, or in property acquired by reinvestment of the proceeds from the property sold on the installment basis, would not affect the seller's gross estate since the value of the property is no longer included in his gross estate.

With respect to the related buyer, there is usually no tax to be paid if the appreciated property is resold shortly after the installment purchase. Since the buyer's adjusted basis is a cost basis which includes the portion of the purchase price payable in the future, the gain or loss from the buyer's resale would represent only the fluctuation in value occurring after the installment purchase. Thus, after the related party's resale, all appreciation has been realized within the related group but the recognition of the gain for tax purposes may be deferred for along period of time.

In the leading case, *Rushing* v. *Commissioner*,[13] the test was held to be that, in order to receive the installment benefits, the "seller may not directly or indirectly have control over the proceeds or possess the economic benefit therefrom." In this case, a sale of corporate stock was made to the trustee of trusts for the benefit of the seller's children. Since the sales were made to trusts created after the corporations had adopted plans of liquidation, the Government made an assignment of income argument. The Court upheld installment sale treatment for

[11] The receipt of the buyers obligation payable on demand or a readily tradable evidence of indebtedness is treated as the receipt of payment by the seller. For this purpose, readily tradable items include bonds and notes issued by a corporation or governmental unit with interest coupons attached or in registered form or in any other form designed to make the bond or note readily tradable in an established securities market.

[12] Another technique used for intra-family transfers involves the so-called "private annuity" arrangement. The bill does not deal directly with this type of arrangement.

[13] 441 F. 2d 593 (5th Cir. 1971), *aff'g*, 52 T.C. 888 (1969).

the stock sold to the trustee under the "control or enjoyment" test because the trustee was independent of the taxpayer and owed a fiduciary duty to the children. The Court rejected the assignment of income argument because it found that no income was being assigned.

The *Rushing* case has been followed in another case where the stock sold to a family trust was that of a corporation which was to be liquidated after the sale.[14] The liquidation was formally authorized after the sale to the trust. In other cases, the Tax Court has rejected the Service's substance over form and constructive receipt arguments and held that sales to a family trust qualified for installment method reporting.[15] In the *Pityo* case, the taxpayer's wife was the beneficiary of one of the trusts to which the installment sale was made. In the *Roberts* case, the trustees were the seller's brother and personal accountant. In both cases, installment sale reporting was allowed because the Tax [14] Court held that the trustees were independent of the seller and satisfied the *Rushing* control or enjoyment test.

In another case, installment method reporting was allowed for a sale of marketable stock by a wife to her husband although a resale by the husband was contemplated.[16] In this case, the Court held that the husband could not be considered a mere conduit for the wife's sale of the stock since both were "very healthy economic entities" and the husband had an independent purpose for obtaining needed funds for an investment at a low rate of interest.

In the few cases in which the Service has prevailed, installment method reporting has been denied with respect to transactions involving a controlled corporation,[17] a sale to a son where the son was forced to resell the stock and invest the proceeds in other securities held in escrow,[18] and, in the case of a sale by a husband to his wife where the Court found there was no bona fide purpose for the transaction other than tax avoidance.[19]

Reasons for change

The committee appreciates the fact that denial of installment sale treatment may be harsh for a shareholder who receives liquidating distributions of the installment obligations received by the corporation from the sale of its assets. In that case, the shareholder may incur a substantial tax on the gain from the stock without having received current funds from the corporate liquidation with which to pay the tax. Accordingly, the committee's bill, as later described, includes a provision to deal with that potential hardship. However, the committee believes that the application of the judicial decisions, involving corporate liquidations, to intra-family transfers of appreciated property has led to unwarranted tax avoidance by allowing the realization of appreciation within a related group without the current payment of income tax.

Explanation of provision

The bill prescribes special rules for situations involving installment sales to certain related parties who also dispose of the property and for situations involving installment sales of depreciable property between a taxpayer and his spouse or certain trusts, and 80-percent owned corporations or partnerships.

Sales other than sales of depreciable property between certain closely-related parties

Under the bill, the amount realized upon certain resales by the related party installment purchaser will trigger recognition of gain by the initial seller, based on his gross profit ratio, only to the extent the amount realized from the second disposition exceeds actual pay- [15] ments made under the installment sale. Thus, acceleration of recognition of the installment gain from the first sale will generally result only to the extent additional cash and other property flows into the related group as a result of a second disposition of the property. In the case of a second disposition which is not a sale or exchange, the fair market value of the property disposed of is treated as the amount realized for this purpose. For these purposes, the portion of the amount realized from a second disposition will not be taken into account to the extent attributable to any improvements which had been made by the related installment purchaser.

The excess of any amount realized from resales over payments received on the first sale as of the end of a taxable year will be taken into account. Thus, the tax treatment would not turn on the strict chronological order in which resales or payments are made. If, under these rules, a resale results in the recognition of gain to the initial seller, subsequent payments actually received by that seller would be recovered tax-free until they have equaled the amount realized from the resale which resulted in the acceleration of recognition and gain.

In the case of property other than marketable securities, the resale rule will apply only with respect to second dispositions occurring within 2 years of the initial installment sale. For this purpose, the running of the 2-year period would be suspended for any period during which the related purchaser's risk of loss with respect to the

[14] *Carl E. Weaver,* 71 T.C. 443 (1978).

[15] *William D. Pityo,* 70 T.C. 225 (1978); *Clair E. Roberts,* 71 T.C. 311 (1978). Also, in *William J. Goodman,* 74 T.C. No. 53 (July 16 1980), a prearranged resale was made by the trustees of a family trust one day after the installment sale were made to the trusts of which the installment sellers were the trustees. The two-step installment sales were used because the taxpayers believed that "a cash sale was not attractive because of the income tax liability on such a sale."

[16] *Nye* v. *U.S.,* 407 F.Supp. 1345, 75-1 USTC ¶ 9150 (M.D.N.C. 1975).

[17] *Griffiths* v. *Helvering,* 308 U.S. 355 (1939). This case involved the creation of a corporation to receive the assignment of a settlement owed to the taxpayer with the corporation agreeing to pay the money received from the settlement to the taxpayer over a 40-year term. The Court held that there had been an anticipatory assignment of income and therefore the income was taxable to the shareholder rather than the corporation.

[18] *Paul G. Lustgarten,* 71 T.C. 303 (1978). The Court held that the taxpayer had constructively received the proceeds from the "resale."

[19] *Phillip W. Wrenn,* 67 T.C. 576 (1976).

property is substantially diminished. This rule will apply with respect to the holding of a put, the holding of an option by another person, a short sale, or any other transaction which has the effect of substantially diminishing the risk of loss. However, for this purpose, a typical close corporation shareholders' agreement is not intended to be taken into account. Further, the holding of an option is not to be considered to have the effect of substantially diminishing risk of loss if the option purchase price is to be determined by reference to the fair market value of the property at the time the option is exercised.

In the case of marketable securities, the resale rule would apply without a time limit for resales occurring before the installment obligation is satisfied. For this purpose, the term "marketable security" means any security for which, as of the date of disposition, there was a market on an established securities market, [or] otherwise.[20]

The bill also contains several exceptions to the application of these rules. Since gain from the sale of a corporation's treasury stock is nontaxable and therefore its basis in the stock is irrelevant, this related party rule will not apply to any nonliquidating installment sale of stock to the issuing corporation. In addition, there would be no acceleration of recognition of gain as a result of a second disposition which is an involuntary conversion of the property if the first sale occurred before the threat or imminence of the conversion. Further [16] there would be no acceleration of recognition of gain from a second disposition which occurs after the death of the installment seller or purchaser. Generally, it is intended that this exception will apply after the death of either spouse when the spouses hold their interests in the installment obligation or the purchased property as community property or as equal undivided joint interests. Finally the resale rules will not apply in any case where it is established to the satisfaction of the Internal Revenue Service that none of the dispositions had as one of its principal purposes the avoidance of Federal income taxes.

In the exceptional cases to which the nonavoidance exception may apply, it is anticipated that regulations would provide definitive rules so that complicated legislation is not necessary to prescribe substituted property or taxpayer rules which would not be of general application. In appropriate cases, it is anticipated that the regulations and rulings under the nontax avoidance exception will deal with certain tax-free transfers which normally would not be treated as a second disposition of the property, e.g., charitable transfers, like-kind exchanges, gift transfers, and transfers to a controlled corporation or a partnership. Generally it is intended that a second disposition will qualify under the nontax avoidance exception when it is of an involuntary nature, e.g., foreclosure upon the property by a judgment lien creditor of the related purchaser or bankruptcy of the related purchaser. In addition it is intended that the exception will apply in the case of a second disposition which is also an installment sale if the terms of payment under the installment resale are substantially equivalent to, or longer than, those for the first installment sale. However, the exception would not apply if the resale terms would permit significant deferral of recognition of gain from the initial sale when proceeds from the resale are being collected sooner.

Under the bill, the period for assessing a deficiency in tax attributable to a second disposition by the related purchaser will not expire before the day which is 2 years after the date the initial installment seller furnishes a notice that there was a second disposition of the property. The notice is to be furnished in the manner prescribed by regulations. Under the bill, a protective notification may be filed to prevent the tolling of the period of limitations for assessing a deficiency in cases where there are questions as to whether a second disposition has occurred (e.g., a lease which might be characterized as a sale or exchange for tax purposes) or whether there is a principal purpose of Federal income tax avoidance.

For purposes of the related party rules, the bill adopts a definition of related parties which will include spouses, children, grandchildren, and parents but will exclude brothers and sisters.

In the case of a corporation, it will be considered to be related to another taxpayer if stock which is or might be owned by it is or would be treated as owned by the other taxpayer under the general corporate attribution rules (Codes sec. 318). Generally, a related corporation will be one in which a person directly or indirectly owns 50 percent or more in value of the stock in the corporation. Also for this purpose, the principles of the general corporate stock ownership attribution rules (Codes sec. 318) will apply in determining the related party status of partnerships, trusts, and estates.

[17]It is to be understood that the provisions governing the use of the installment method to report sales between related parties, and the definition of such relationships, are not intended to preclude the Internal Revenue Service from asserting the proper tax treatment of transactions that are shams.

Sales of depreciable property between certain closely-related parties

Under the bill, the accrual method of accounting in effect is required for deferred payment sales of depreciable property between certain closely-

[20] The term "marketable securities" includes securities which are listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations appear on a daily basis, including foreign securities listed on a recognized foreign national or regional exchange; securities regularly traded in the national or regional over-the-counter market, for which published quotations are available; securities locally traded for which quotations can readily be obtained from established brokerage firms; and units in a common trust fund. Mutual fund shares for which redemption prices are published would also be considered marketable securities.

related parties.[21] In general, this rule is intended to deter transactions which are structured in such a way as to give the related purchaser the benefit of depreciation deductions (measured from a stepped-up basis) prior to the time the seller is required to include in income the corresponding gain on the sale. For transactions to which the special rule will apply, the deferred payments will be deemed to be received in the taxable year in which the sale occurs. In the case of sales for contingent future payments, it is intended that, in general, the amount realized in the year of sale will be equal to the value of the property sold.

This special rule will apply only to deferred payment sales between a taxpayer and the taxpayer's spouse; the taxpayer and a partnership or corporation which is 80-percent owned by the taxpayer and/or the taxpayer's spouse; and between partnerships and corporations which are 80-percent owned by the taxpayer and/or the taxpayer's spouse. The rule will not apply if it is established to the satisfaction of the Internal Revenue Service that the sale did not have as one of its principal purposes the avoidance of Federal income taxes.

Thus, the special rules will not apply if, at the time of the installment sale, the husband and wife are legally separated under a decree of divorce or separate maintenance. Also, they will not apply if the installment sale occurs pursuant to a settlement in a proceeding which culminates in a decree of divorce or separate maintenance. Further, the rule will not apply if no significant tax deferral benefits will be derived from the sale.

[21] In the case of transfers which are treated as tax-free transfers to a controlled corporation or to a partnership. (Code secs. 351, 362, 721, and 723), the provisions of present law would continue to apply and would not be affected by the provision. Also, in the case of transactions which are governed by the doctrine of liquidation-reincorporation under present law, the tax treatment for those transactions would continue to be governed by present law and would not be effected by the provision.

Statement of committee intention

The committee intends that no inference be drawn from these provisions as to the proper treatment of any related party installment sale occurring prior to the effective date provided under the bill.

The Committee on Finance believes that, as a principle of tax policy, a taxpayer should be permitted to contest on an equal footing in the appropriate courts matters in dispute with the government. The Committee recognizes that two sections of the pending legislation (new Code secs. 453 (e)(7) and (g)) put a taxpayer at a disadvantage if he or she should seek a court ruling on the merits of the issue.

The Committee accepts the pending legislation only with the specific understanding that—

[18] (1) The foregoing sections are designed to give an opportunity to taxpayers to qualify who might otherwise not be able to qualify under this legislation for the reporting of income on the installment method,

(2) Under the preceding sections in determining the question of tax avoidance, the Commissioner shall treat taxpayers fairly and equitably in light of all the facts and circumstances of each particular case in a manner consistent with the remedical intent of the preceding sections, and

(3) The preceding sections are not to be considered as a precedent for future legislation.

The Committee shall monitor closely the administration of the sections and the Commissioner shall report annually its actions to the appropriate Congressional committees. Further, the General Accounting Office shall not later than two years after the enactment of this legislation report to the Congress on the manner in which the preceding sections are being administered.

G. Treatment of Third Party Guarantee (sec. 2 of the bill and sec. 453(f)(3) of the Code)

Present law

Generally, under present law (Code sec. 453), income from a sale of property on the installment basis may be reported as the payments are received. If the installment method is elected for qualifying sales, the gain reported for any taxable year is the proportion of the installment payment received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price. In general, the contract price is the amount which will be paid to the seller. The payments taken into account as being received in a taxable year would not include the purchaser's obligation of future payment, whether dischargeable in money or other property (including foreign currency), unless that obligation is a bond or other evidence or indebtedness which is either payable on demand or has been issued by a corporation or government and is readily tradable.

In a recent case, the Tax Court held that, by reason of a standby letter of credit used to secure future payment for the sale of a cotton crop, the taxpayer had received full payment in the year of sale and could not report the transaction on the installment method.[22] However, the Tenth Circuit Court of Appeals has recently held that a letter of credit used to secure payment for the sale of stock did not constitute payment for purposes of the installment sale provisions.[23]

Reasons for change

The committee believes that a third party guarantee (including a standby letter of credit) used as security for a deferred payment sale should not be treated as a payment received on an installment obligation.

Explanation of provision

Under the bill, a third party guarantee (including a standby letter of credit) will not be taken into account in determining if the [19] buyer's evidence of indebtedness constitutes payment to the seller. For this purpose, a

[22] *J. K. Griffith*, 73 T.C. No. 76 (Feb. 28, 1980).

[23] *Sprague* v. *U.S.*, — F.2d — (10th Cir., Aug. 14, 1980).

guarantee which is not treated as payment would not include a third party note (or any other type of third party obligation which is transferable or marketable prior to default in payment by the installment purchaser).

H. Receipt of Like Kind Property (sec. 2 of the bill and new sec. 453(f)(7) of the Code)

Present law

Under present law, the transfer of property for cash payments and like kind property may qualify both for installment method reporting and, with respect to the gain attributable to the like kind exchange, nonrecognition treatment (Code sec. 1031 and Rev. Rul. 65-155, 1965-1. C.B. 356). In this case, the gain to be recognized under installment method reporting is the total gain realized on the transaction less the gain eligible for nonrecognition under the like kind exchange provision. However, the value of the like kind property received by the seller is taken into account in determining the amount of the selling price, the contract price, and payments received for purposes of the installment sale provision.[24] The value of the like kind property received in the taxable year in which the sale or exchange is made.

Reasons for change

The committee believes that, when like kind property and an installment obligation are received, the like kind property should not be treated as payment in order to achieve the basic purpose of installment sale reporting, i.e., gain should be recognized as cash (and other property with respect to which gain is recognized) is received.

Explanation of provision

Under the bill, property permitted to be received without recognition of gain in an exchange described in Code section 1031(b)[25] will not be treated as payment for purposes of reporting income under the installment method.

Thus, in reporting the gain on the exchange under the installment method where an installment obligation is received in addition to the like kind property, the gross profit will be the amount of gain which will be recognized on the exchange if the installment obligation were satisfied in full at its face amount. Also, the total contract price will not include the value of the like kind property but instead will consist solely of the sum of the money and fair market value of other property received plus the face amount of the installment obligation.

The basis of the like kind property received, (determined under section 1031(d)) will be determined as if the obligation had been [20] satisfied at its face amount.[26] Thus, the taxpayer's basis in the property transferred will first be allocated to the like kind property received (but not in excess of its fair market value) and any remaining basis will be used to determine the gross profit ratio.

The bill also provides that similar treatment applies in the case of an exchange under a plan of corporate reorganization described in section 356(a) which is not treated as a dividend.

These provisions may be illustrated by the following example. Assume that the taxpayer exchanges property with a basis of $400,000 for like kind property worth $200,000, and an installment obligation for $800,000 with $100,000 payable in the taxable year of the sale and the balance payable in the succeeding taxable year. The example compares present law, which takes like kind property into account as payment, with the bill which reverses this rule.

	Rev. Rul. 65-155— Like kind property taken into account	*Like kind property not taken into account*
Contract price	$1,000,000	$800,000
Gross profit	600,000	600,000
Gross profit ratio (percent)	(60)	(75)
Gain to be reported for:		
1. Taxable year of sale:		
(a) 60% of $300,000 (payments "received" of $100,000 cash and $200,000 value of like property)	180,000	
(b) 75% of $100,000 (cash payments)		75,000
2. Succeeding taxable year:		
(a) 60% of $700,000 (cash received)	420,000	
(b) 75% of $700,000 (cash received)		525,000
Total gain recognized	600,000	600,000
3. Basis of like kind property received	200,000	200,000

I. Installment Obligations Distributed in a 12-Month Corporate Liquidation (sec. 2 of the bill and new sec. 453(h) of the Code)

Present law

Under present law, gain or loss is not generally recognized at the corporate level for sales and exchanges occurring during the 12-month [21] period after the corporation has elected a plan of complete liquidation (Code sec. 337). A special rule provides that in this situation gain or loss generally is not recognized to the liquidating corporation for distributions of installment obligations (Code sec. 453(d)

[24] Rev. Rul. 65-155, 1965-1 C.B. 356; *Clinton H. Mitchell*, 42 T.C. 953, 965 (1964); *Albert W. Turner*, TC Memo 1977-437. A similar case under present law involves the treatment of an installment obligation received as "boot" in exchange by a shareholder under a plan of corporate reorganization (sec. 356(a)(1)). Present law is unclear whether the exchange qualifies for installment sale reporting.

[25] This provision includes like kind exchanges (sec. 1031), exchanges of certain insurance policies (sec. 1035), certain exchanges of stock of the same corporation (sec. 1036), and certain exchanges of United States obligations (sec. 1037).

[26] This is the same rule as presently set forth in Rev. Rul. 65-155, *supra*.

(4)(B)). Gain or loss is recognized by the shareholders with respect to the liquidating distributions. No special exception applies for the distribution of installment obligations to shareholders so that the shareholders may defer reporting gain from the obligations.

Reasons for change

The committee believes that the treatment of a shareholder receiving installment obligations from a liquidating corporation should be generally similar to the treatment accorded a shareholder selling stock to an unrelated third party purchaser on the installment method. The bill is intended to facilitate the purchase of a corporate business by providing similar installment treatment to the seller whether or not the corporate assets or stock in the corporation is sold.

Explanation of provision

Under the bill, in the case of a corporate liquidation the receipt by a shareholder (under Code sec. 331) of an installment obligation which was received by the corporation during its 12-month liquidation period (under Code sec. 337) generally will not be treated as the receipt of payment by the shareholder.[27] Instead, the shareholder may report gain from the exchange of stock on the installation method, taking gain into account as payments are received on the installment obligation received as a liquidating distribution. Where a parent liquidating corporation had a subsidiary which received an obligation during the subsidiary's liquidation (to which sec. 337(c)(3) applied) that obligation also will qualify for installment reporting by the shareholders of the parent corporation. However, in no event will obligations received by the liquidating corporation from the sale of inventory, other than from the bulk sale, qualify for installment treatment by the shareholder.

Where liquidating distributions are received by a shareholder in more than one taxable year, the shareholder will be required to recompute the gain reported from the liquidation by allocating basis in the stock pro rata over all payments received (or to be received). This may require amended returns if all of the liquidating distributions are not received during the same taxable year of the shareholder.

The following example will illustrate the operation of this rule. Assume that the taxpayer is the sole shareholder of a corporation with an adjusted basis of $200,000 in the stock (all of the stock (all of the stock having been acquired in the same transaction at the same cost), and is a calendar year taxpayer. Also, assume that the corporation adopts a plan of liquidation in July 1982, that the corporation sells all of its assets in August 1982 to an unrelated purchaser for $1 million, consisting of [22] $250,000 in cash and an installment note for $750,000, that the entire gain qualifies for nonrecognition under section 337, that there is no imputed interest income or original issue discount, that the corporation distributes the cash in November 1982 and that the note is distributed in complete liquidation in June 1983. The taxpayer would initially report a gain of $50,000 in 1982 ($250,000 cash received less $200,000 basis in the stock).

After the distribution of the note in 1983, under the installment method, the taxpayer would recompute the gain reported in 1982 by allocating basis according to the installment sales rules. Thus, 75 percent ($750,000 (face amount of installment obligation) divided by $1 million (total distribution)) of the taxpayer's basis in the stock, or $150,000 (75 percent times $200,000) would be allocated to the installment obligation. Further, 25 percent ($250,000 divided by $1 million) of the taxpayer's basis in the stock or $50,000 (25 percent times $200,000) is allocated to the distribution of the cash. The taxpayer thus is required to file an amended return for 1982 to reflect an additional $150,000 of gain (cash received of $250,000 less the sum of $50,000 basis and $50,000 gain initially reported). Eighty percent of each payment on the note (other than interest) must be reported as gain by the taxpayer (gain of $600,000 ($750,000 face amount of obligation less basis of $150,000) divided by $750,000 (contract price)).

Under the bill, nonrecognition treatment will not be available to the extent the obligation is attributed to a sale of depreciable property by the corporation if the installment purchaser is either the shareholder-distributee's spouse, or a corporation or a partnership which is 80-percent owned by the shareholder-distributee and/or his spouse.[28] This provision applies if the property sold by the corporation is depreciable in the hands of the purchaser. Under the provision, gain will be recognized by the shareholder for his taxable year in which the installment obligation is distributed.

Finally, if another related party (a person who is not covered by the preceding special recognition rule but who is related within the meaning of new sec. 453(f)(1)) purchases the corporate assets and then disposes of them, the related party disposition rules (as previously described under part F of this report) will apply to the shareholder who received the related party's installment obligations as a liquidating distribution. In other words, in these cases, the shareholder-distributee will be substituted for the liquidated corporation for purposes of applying the related party resale rules provided under the bill.

[27] This treatment will apply to the target company in an acquisition if it is treated as having liquidated under Code section 337 (Rev. Rul. 69-6, 1969-1 C.B. 104). Further, in the case of a corporate acquisition involving the use of a "transitory" or "phantom" company, the obligations issued by the acquiring parent company would be considered issued by the "purchaser", although the assets of the acquired company are technically transferred to the transitory company set up to effect the acquisition, if that company is disregarded for Federal tax purposes under present law.

[28] In the case of transactions which are governed by the doctrine of liquidation-reincorporation under present law, the tax treatment for those transactions would continue to be governed by present law and would not be affected by this provision.

J. Sales Subject to a Contingency (sec. 2 of the bill and new sec. 453(i) of the Code)

Present law

As a general rule, installment reporting of gain from deferred payments is not available where all or a portion of the selling price is subject to a contingency. The case law holds that the selling price must be fixed and determinable for section 453(b) to apply.[29] An agreement, however, to indemnify the purchaser for breach of certain [23] warranties and representations by offset against the purchase price will not disqualify an installment sale under section 453(b).[30] Exactly how broad such contingencies can be is unclear.

Where an installment sale is subject to a contingency with respect to the price and the installment method is not available, the taxpayer is required to recognize all of the gain in the year of the sale with respect to all of the payments to be made, even though such payments are payable in future taxable years. In the case of a cash-method taxpayer where the future payments have no readily ascertainable fair market value, the taxpayer may treat the transaction with respect to those payments as "open" and use the cost-recovery method under *Burnet* v. *Logan,* 2830 U.S. 404 (1931).

Reasons for change

The committee believes that a taxpayer should be permitted to report gain from a deferred payment sale under the installment method even if the selling price may be subject to some contingency.

Explanation of provision

The bill permits installment sale reporting for sales for a contingent selling price. In extending eligibility, the bill does not prescribe specific rules for every conceivable transaction. Rather, the bill provides that specific rules will be prescribed under regulations.

However, it is intended that, for sales under which there is a stated maximum selling price, the regulations will permit basis recovery on the basis of a gross profit ratio determined by reference to the stated maximum selling price. For purposes of this provision, incidental or remote contingencies are not to be taken into account in determining if there is a stated maximum selling price. In general, the maximum selling price would be determined from the "four corners" of the contract agreement as the largest price which could be paid to the taxpayer assuming all contingencies, formulas, etc., operate in the taxpayer's favor. Income from the sale would be reported on a pro rata basis with respect to each installment payment using the maximum selling price to determine the total contract price and gross profit ratio. If, pursuant to standards prescribed by regulations, it is subsequently determined that the contingency will not be satisfied in whole or in part, thus reducing the maximum selling price, the taxpayer's income from the sale would be recomputed. The taxpayer would then report reduced income, as adjusted, with respect to each installment payment received in the taxable year of adjustment and subsequent taxable years. If the maximum price is reduced in more than one taxable year, *e.g.,* because of successive changes in the status of the contingency, each such year of reduction would constitute an adjustment year.

Where the taxpayer has reported more income from installment payments received in previous taxable years than the total recomputed income, the taxpayer would be permitted to deduct the excesses in the adjustment year as a loss.

In cases where the sales price is indefinite and no maximum selling price can be determined but the obligation is payable over a fixed period of time, it is generally intended that basis of the property sold would be recovered ratably over that fixed period. In a case where the selling price and payment period are both indefinite but a sale has in [24] fact occurred, it is intended that the regulations would permit ratable basis recovery over some reasonable period of time. Also, in appropriate cases, it is intended that basis recovery would be permitted under an income forecast type method.[31]

The creation of a statutory deferred payment option for all forms of deferred payment sales significantly expands the availability of installment reporting to include situations where it has not previously been permitted. By providing an expanded statutory installment reporting option, the Committee believes that in the future there should be little incentive to devise convoluted forms of deferred payment obligations to attempt to obtain deferred reporting. In any event, the effect of the new rules is to reduce substantially the justification for treating transactions as "open" and permitting the use of the cost-recovery method sanctioned by *Burnet* v. *Logan,* 283 U.S. 404 (1931). Accordingly, it is the Committee's intent that the cost-recovery method not be available in the case of sales for a fixed price (whether the seller's obligation is evidenced by a note, contractual promise, or otherwise), and that its use be limited to those rate and extraordinary cases in-

[29] *Gralap* v. *United States,* 458 F.2d 1158 (10th Cir. 1972); *In re Steen,* 509 F.2d 1398 (9th Cir. 1975).

[30] See Rev. Rul. 77-56, 1977-1 C.B. 135.

[31] In general, the income forecast method for basis recovery is considered appropriate for a transaction with respect to which it may be demonstrated that receipts will be greater for the earlier years of the payment period and then decline for the later years of the payment period. It is intended that the regulations will deal with the application of this method with respect to sales of property qualifying for depreciation under the income forecast method (e.g., movies), mineral rights when the selling price is based on production, a sale under which the amount payable to the seller is based on a declining percentage of the purchaser's revenues, and similar sales. In developing these regulations, the committee intends that the Treasury Department will prescribe rules for this method to avoid, whenever possible, leaving a seller with an unrecovered basis in the obligation, and thereby creating a capital loss, after the final payment is received. For qualifying transactions, a more rapid basis recovery under this method is to be allowed even if there is a fixed period over which payments are to be received.

volving sales for a contingent price where the fair market value of the purchaser's obligation cannot reasonably be ascertained.

K. Election of Installment Method by Accrual Method Dealer (sec. 2 of the bill and secs. 453(c) and 481(d) of the Code)

Present law

Under present law (Code sec. 453 (c)), an accrual basis dealer in personal property who elects to change to the installment method of accounting must include in income the gain attributable to payments received with respect to sales which had been included in income for taxable years prior to electing the installment method. In mitigation for double inclusion of income from the sales, an adjustment to tax is permitted. However, the amount of the adjustment is limited to the lesser of the portion of income tax attributable to inclusion in income for the taxable year of sale or the portion of income tax attributable to inclusion of the gross profit for the taxable year in which installment payments are received. The formula for determining the tax "attributable to" the inclusion of the gain in income results in a higher total tax for both years taken together than if the gain had been reported only once.

Reasons for change

The committee believes that the mechansim for adjustment of tax under present law imposes unnecessary complexities upon dealers who [25] elect the installment method of reporting. Further, the committee believes that previously reported gains should not have to be reported for another taxable year because the second inclusion in income is a form of double taxation, notwithstanding the tax adjustments permitted under present law.

Explanation of provision

Under the bill, an accrual method dealer who elects the installment method of reporting will report gain as payments are received only for sales made on or after the effective date of the installment method election (Code sec. 481(a)).

It is intended that, under Treasury regulations, a failure to report the full amount of gain from sales may be treated as an election of the installment method. For example, it is intended that a dealer, who treats a transaction as a lease of personal property and only reports the payments received as rental income, may be eligible for installment reporting under the regulations if the transaction is recharacterized as a sale rather than a lease in an audit by the Internal Revenue Service. However, it is intended that no taxpayer who has reported sales under the accrual method will be required to change from that method under the regulations.

L. Transfers of Installment Obligations to Life Insurance Companies (sec. 2 of the bill and new sec. 453B(e)(2) of the Code)

Present law

Generally, under present law, any unreported gain must be recognized when a taxpayer disposes of an installment obligation. However, in the case of certain tax-free transfers, disposition of an installment obligation will not trigger the recognition of gain. In these cases, the transferee succeeds to the basis of the installment seller and reports the remaining gain as payments are received. Under a special rule (Code sec. 453(d)(5)), transfers of installment obligations to a life insurance company are not eligible for nonrecognition treatment for otherwise tax-free transfers.

Reasons for change

The committee believes that transfers of installment obligations to life insurance companies should be eligible for the same nonrecognition treatment provided for transfers to other taxpayers if any remaining gain will be taken into account by the life insurance company as taxable investment income.

Explanation of provision

Under the bill, the special disposition rules for transfers of obligations to a life insurance company will not apply if the life insurance company elects to report any remaining gain as investment income (under Code sect. 804 (b)) as payments are received.

M. Cancellation of Installment Obligation (sec. 2 of the bill and new sec. 453B(f) of the Code)

Present law

Under present law, some have argued that the installation obligation disposition rules can be avoided by making gift cancellations of the obligation or the installments as they come due. In other words, by making an installment sale and then cancelling the obligation or a [26] number of installment payments, it is argued that the seller will incur no income tax liability, but possibly some gift taxes, and the buyer will have a cost basis in the property sold although no income tax cost will have been incurred on the transaction. If a direct gift is made, the donee's basis is generally the same as the donor's basis rather than a "cost" basis which reflects future payments which will never be made.

This cancellation technique is based on a District Court's decision in *Miller* v. *Usry*.[32] In that case, the court held that the disposition rules for obligations disposed of other than by sale or exchange were directed at corporate transfers and should not be applied to a cancellation of the obligation where there has been no actual, real, or material gain to the taxpayer. The court did not consider the possible benefit to the donee from acquiring a cost basis through the installment sale. Next, the court held that the disposition rules for satisfaction at other than face value did apply to a cancellation but no tax

[32] 160 F. Supp. 368, 58-1 USTC ¶ 9393 (W.D. La. 1958).

was incurred because no amount was realized by the taxpayer.

Reasons for change

The committee believes that present law should be clarified to make it clear that the installment obligation disposition rules cannot be circumvented by cancelling the obligation.

Explanation of provision

The bill makes it clear that the cancellation of an installment obligation is treated as a disposition of the obligation. In the case where the obligor is a related party, the amount taken into account as a disposition triggering recognition of unreported gain attributable to the obligation is not to be less than the face amount of the installment obligation.

N. Bequest of Obligation to Obligor (sec. 3 of the bill and new sec. 691(a)(5) of the Code)

Present law

Under present law, the installment obligation disposition rules do not apply to the transmission of installment obligations at death (Code secs. 453(d)(3) and 691(a)(4)). However, unreported gains, attributable to installment obligations are treated as items of gross income in respect of a decedent so that the recipient in taxed upon receipt of the installment payments in the same manner as the deceased seller would have been had he lived to receive the payments. A special rule allows a deduction for the estate taxes attributable to the unreported gain on the installment obligation (Code sec. 691(c)).

Another provision (Code sec. 691(a)(2)) provides that the transfer of an installment obligation to the estate of the deceased seller will not be treated as a transfer requiring the reporting of gain. In addition, this rule applies to a transfer to a person pursuant to the right of such person to receive the installment obligation by reason of the death of the seller or by bequest, devise, or inheritance from the seller.

Reasons for change

Because of these rules, it has been argued that any unreported gain remaining at the death of the seller will never be taxed if the installment obligation is left to the obligor. In this case, it is argued that [27] there will never be a disposition or collection of the unpaid balance because there has been a merger of interests of obligor and obligee. In other words, the obligor will have acquired a cost basis for depreciation and resale purposes prior to the seller's death, but no income tax cost will have been incurred with respect to the gain unreported by the seller at the time of his death.

The committee believes that present law should be clarified so that the installment obligation disposition rules apply with respect to a cancellation by reason of death of the holder of the obligation.

Explanation of provision

The bill provides that any previously unreported gain from an installment sale will be recognized by a deceased seller's estate if the obligation is transferred or transmitted by bequest, devise, or inheritance to the obligor or is cancelled by the executor.

In the absence of some act of cancelling the obligation by distribution or notation which results in cancellation under the Uniform Commercial Code or other local law, the disposition will be considered to occur no later than the time the period of administration of the estate is concluded.

If the cancellation occurs at the death of the holder of the obligation, the cancellation is to be treated as a transfer by the estate of the decedent. However, if the obligation were held by a person other than the decedent, such as a trust, the cancellation will be treated as a transfer immediately after the decedent's death by that person.

If the decedent and the obligor were related persons (within the meaning of new Code section 453(f)(1)), the fair market value of the obligation for disposition purposes is not to be treated as less than its face amount.

For purposes of this provision, if an installment obligation becomes unenforceable, it will be treated as if it were cancelled.

O. Foreclosure of Real Property Sold on Installment Method by Deceased Taxpayer (sec. 4 of the bill and sec. 1038 of the Code)

Present law

Under present law, the recognition of gain upon a reconveyance of real property to the seller in partial or full satisfaction of purchase money debt is limited (Code sec. 1038). Losses, including bad debt losses, are also not recognized upon a reconveyance of real property. With respect to gains, the amount of gain required to be recognized upon reconveyance of the real property sold generally is limited to the lesser of the amount of any remaining unreported portion of the original gain or the amount by which the sum of the money and fair market value of property received prior to the reacquisition exceeds the amount of gain previously reported. The Internal Revenue Service has ruled that this provision does not apply to a reconveyance to the estate of a deceased taxpayer who made the original sale (Rev. Rul. 69-83, 1969-1, C.B. 202). In other words, a decedent's estate is not permitted to succeed to the tax treatment which would have been available to the decedent had he lived to receive, the reconveyance because the estate is considered to be a separate taxable entity.

Reasons for change

The committee believes that a decedent's estate (or other person inheriting a decedent's installment obligation) should be entitled to [28] the same limitations on recognition of gain upon the reconveyance of real property in satisfaction of an obligation to which the decedent would have been entitled if the decedent had survived.

Explanation of provision

Under the bill, the estate or beneficiary of a deceased seller will be entitled to the same nonrecognition treatment upon the acquisition of real property in partial or full satisfaction of secured purchase money debt as the deceased seller would have been entitled.

The basis of the property acquired will be the same as if the property had been reacquired by the original seller, increased by an amount equal to the section 691(c) deduction for estate taxes which would have been allowable had the repossession been taxable.

The committee intends that no inference is to be drawn from this provisions as to the application of present law.

P. Character of Gain from Sales of Depreciable Property Between Related Parties

(Sec. 5 of the bill and sec. 1239 of the Code)

Present law

Under present law, gain from the sale or exchange of depreciable property between certain related parties is denied capital gains treatment (and is taxed as ordinary income). Related parties include husband and wife, an individual and an 80-percent controlled corporation, and two 80-percent controlled corporations. The attribution rules of Code section 318 are generally applied to determine ownership in a corporation.

Reasons for change

The committee believes that the same related party rules should apply with respect to the characterization of income from sales of depreciable property between a husband and wife or their controlled entity and to the special installment sale rules for sales of depreciable property between husband and wife, or their controlled entity. For these purposes, the committee also believes that the attribution of ownership rules should be narrowed to exclude family members other than husband and wife.

Explanation of provision

Under the bill, the provision of section 1239(a) denying capital gain treatment on the sale or exchange of depreciable property will apply to sales between husband and wife, between the taxpayer and a partnership or corporation which is 80-percent owned by the taxpayer and/or the taxpayer's spouse; and between partnerships and corporations which are 80-percent owned by the taxpayer and/or the taxpayer's spouse. For these purposes, the person treated as the owner of a trust under the grantor trust rules is to be treated as the owner of the assets in the trust.

Under the provision, ownership, is to be attributed in accordance with the principles under the general corporate ownership attribution rules (Code sec. 318) except that an individual's family will only include a spouse and the entity attribution rules will be applied without regard to the percentage of ownership limitations.

[29] Q. Effective Date (sec. 6 of the bill)

In general, the provisions of the bill are effective for dispositions of property, cancellations and reacquisitions of real property, as the case may be, occurring after the date of enactment. The provisions which eliminate the 30-percent initial payment and the two or more payments requirements are effective for transactions occurring in taxable years ending after the date of enactment.

However, the related party installment sale rules would apply to installment sales (first dispositions) after May 14, 1980. The provision relating to the distribution of installment obligations in connection with a 12-month corporate liquidation would apply with respect to installment obligations distributed after March 31, 1980. (A liquidating distribution made after March 31, 1980, will qualify for nonrecognition treatment to a shareholder even if the obligation is from a sale which is ineligible for installment reporting by the corporation because the sale occurred before the effective date of the other rules revised or eliminated under the bill.)

* * * * *

Public Law 96-499
96th Congress, H.R. 7765[1]
December 5, 1980

An Act to provide for reconciliation pursuant to section 3 of the First Concurrent Resolution on the Budget for the fiscal year 1981.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I—SHORT TITLE AND DECLARATION OF PURPOSE

SHORT TITLE

SECTION 101. This Act may be cited as the "Omnibus Reconciliation Act of 1980".

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TITLE III—STUDENT LOAN PROGRAMS

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DISCLOSURE OF LOCATION OF BORROWERS WHO HAVE DEFAULTED ON STUDENT LOANS

SEC. 302. (a) Paragraph (4) of section 6103(m) of the Internal Revenue Code of 1954 (relating to individuals who have defaulted on student loans) is amended to read as follows:

"(4) INDIVIDUALS WHO HAVE DEFAULTED ON STUDENT LOANS.—

"(A) IN GENERAL.—Upon written request by the Secretary of Education, the Secretary may disclose the mailing address of any taxpayer who has defaulted on a loan—

"(i) made under part B or E of title IV of the Higher Education Act of 1965, or

[1] This publication of the law, House Report No. 96-1167, page 530, and Conference Report No. 96-1479, page 575, is restricted to excerpts involving tax matters.

"(ii) made pursuant to section 3(a)(1) of the Migration and Refugee Assistance Act of 1962 to a student at an institution of higher education,

for use only by officers, employees, or agents of the Department of Education for purposes of locating such taxpayer for purposes of collecting such loan.

"(B) DISCLOSURE TO EDUCATIONAL INSTITUTIONS, ETC.—Any mailing address disclosed under subparagraph (A)(i) may be disclosed by the Secretary of Education to—

"(i) any lender, or any State or nonprofit guarantee agency, which is participating under part B of title IV of the Higher Education Act of 1965, or

"(ii) any educational institution with which the Secretary of Education has an agreement under part E of title IV of such Act,

for use only by officers, employees, or agents of such lender, guarantee agency, or institution whose duties relate to the collection of student loans for purposes of locating individuals who have defaulted on student loans made under such loan programs for purposes of collecting such loans.".

(b) The first sentence of section 7213(a)(2) of such Code (relating to unauthorized disclosure of information by State and other employees) is amended to read as follows: "It shall be unlawful for any person (not described in paragraph (1)) willfully to disclose to any person, except as authorized in this title, any return or return information (as defined in section 6103(b)) acquired by him or another person under subsection (d), (l)(6) or (7), or (m)(4) of section 6103.".

(c) The amendments made by subsections (a) and (b) of this section shall take effect on the date of the enactment of this Act.

Subtitle C—Unemployment Compensation Provisions

TERMINATION OF PROVISIONS PROVIDING REIMBURSEMENT FOR UNEMPLOYMENT BENEFITS PAID ON THE BASIS OF PUBLIC SERVICE EMPLOYMENT

SEC. 1021. Part B of title II of the Emergency Jobs and Unemployment Assistance Act of 1974 is amended by adding at the end thereof the following new section:

"TERMINATION

"SEC. 224. Notwithstanding any other provision of this part, the term 'public service wages' shall not include remuneration for services performed in weeks which begin after the date of the enactment of this section."

WAITING PERIOD FOR BENEFITS

SEC. 1022. (a) Section 204(a)(2) of the Federal-State Extended Unemployment Compensation Act of 1970 [Pub. L. 91-373, 1970-2 C.B. 355, 357] is amended—

(1) by inserting "(A)" after "compensation", and

(2) by inserting immediately before the period the following: ", or (B) paid for the first week in an individual's eligibility period for which extended compensation or sharable regular compensation is paid, if the State law of such State provides for payment (at any time or under any circumstances) of regular compensation to an individual for his first week of otherwise compensable unemployment".

(b)(1) Except as provided in paragraph (2), the amendments made by this section shall apply in the case of compensation paid to individuals during eligibility periods beginning on or after the date of the enactment of this Act.

(2) In the case of a State with respect to which the Secretary of Labor has determined that State legislation is required in order to eliminate its current policy of paying regular compensation to an individual for his first week of otherwise compensable unemployment, the amendments made by this section shall apply in the case of compensation paid to individuals during eligibility periods beginning after the end of the first regularly scheduled session of the State legislature ending more than thirty days after the date of the enactment of this Act.

BENEFITS ON ACCOUNT OF FEDERAL SERVICE TO BE PAID BY EMPLOYING FEDERAL AGENCY

SEC. 1023. (a) Title IX of the Social Security Act is amended by adding at the end thereof the following new section:

"FEDERAL EMPLOYEES COMPENSATION ACCOUNT

"SEC. 909. There is hereby established in the Unemployment Trust Fund a Federal Employees Compensation Account which shall be used for the purposes specified in section 8509 of title 5, United States Code. For the purposes provided for in section 904(e), such account shall be maintained as a separate book account.".

(b) Subchapter I of chapter 85, title 5, United States Code, is amended by adding at the end thereof the following new section:

"§ 8509. Federal Employees Compensation Account

"(a) The Federal Employees Compensation Account (as established by section 909 of the Social Security Act, and hereafter in this section referred to as the 'Account') in the Unemployment Trust Fund (as established by section 904 of such Act) shall consist of—

"(1) funds appropriated to or transferred thereto, and

"(2) amounts deposited therein pursuant to subsection (c).

"(b) Moneys in the Account shall be available only for the purpose of making payments to States pursuant to agreements entered into under this subchapter and making payments of compensation under this subchapter in States which do not have in effect such an agreement.

"(c)(1) Each employing agency shall deposit into the Account amounts equal to the expenditures incurred under this subchapter on account of Federal service performed by employees and former employees of that agency.

"(2) Deposits required by paragraph (1) shall be made during each

calendar quarter and the amount of the deposit to be made by any employing agency during any quarter shall be based on a determination by the Secretary of Labor as to the amounts of payments, made prior to such quarter from the Account based on Federal service performed by employees of such agency after December 31, 1980, with respect to which deposit has not previously been made. The amount to be deposited by any employing agency during any calendar quarter shall be adjusted to take account of any overpayment or underpayment of deposit during any previous quarter for which adjustment has not already been made.

"(d) The Secretary of Labor shall certify to the Secretary of the Treasury the amount of the deposit which each employing agency is required to make to the Account during any calendar quarter, and the Secretary of the Treasury shall notify the Secretary of Labor as to the date and amount of any deposit made to such Account by any such agency.

"(e) Prior to the beginning of each fiscal year (commencing with the fiscal year which begins October 1, 1981) the Secretary of Labor shall estimate—

"(1) the amount of expenditures which will be made from the Account during such year, and

"(2) the amount of funds which will be available during such year for the making of such expenditures,

and if, on the basis of such estimate, he determines that the amount described in paragraph (2) is in excess of the amount necessary—

"(3) to meet the expenditures described in paragraph (1), and

"(4) to provide a reasonable contingency fund so as to assure that there will, during all times in such year, be sufficient sums available in the Account to meet the expenditures described in paragraph (1),

he shall certify the amount of such excess to the Secretary of the Treasury and the Secretary of the Treasury shall transfer, from the Account to the general fund of the Treasury, an amount equal to such excess.

"(f) The Secretary of Labor is authorized to establish such rules and regulations as may be necessary or appropriate to carry out the provisions of this section.

"(g) Any funds appropriated after the establishment of the Account, for the making of payments for which expenditures are authorized to be made from moneys in the Account, shall be made to the Account; and there are hereby authorized to be appropriated to the Account, from time to time, such sums as may be necessary to assure that there will, at all times, be sufficient sums available in the Account to meet the expenditures authorized to be made from moneys therein.".

(c) All funds apprpopriated which are available for the making of payments to States after December 31, 1980, pursuant to agreements entered into under subchapter I of chapter 85 of title 5, United States Code, or for the making of payments after such date of compensation under such subchapter in States which do not have in effect such an agreement, shall be transferred on January 1, 1981, to the Federal Employees Compensation Account established by section 909 of the Social Security Act. On and after such date, all payments described in the preceding sentence shall be made from such Account as provided by section 8509 of title 5, United States Code.

LIMITATION ON EXTENDED UNEMPLOYMENT COMPENSATION PROGRAM

SEC. 1024. (a) Section 202(a) of the Federal-State Extended Unemployment Compensation Act of 1970 [Pub. L. 91-373, 1970-2 C.B. 355] is amended by adding at the end thereof the following new paragraphs:

"(3)(A) Notwithstanding the provisions of paragraph (2), payment of extended compensation under this Act shall not be made to any individual for any week of unemployment in his eligibility period—

"(i) during which he fails to accept any offer of suitable work (as defined in subparagraph (c)) or fails to apply for any suitable work to which he was referred by the State agency; or

"(ii) during which he fails to actively engage in seeking work.

"(B) If any individual is ineligible for extended compensation for any week by reason of a failure described in clause (i) or (ii) of subparagraph (A), the individual shall be ineligible to receive extended compensation for any week which begins during a period which—

"(i) begins with the week following the week in which such failure occurs, and

"(ii) does not end until such individual has been employed during at least 4 weeks which begin after such failure and the total of the remuneration earned by the individual for being so employed is not less than the product of 4 multiplied by the individual's average weekly benefit amount (as determined for purposes of subsection (b)(1)(c)) for his benefit year.

"(C) For purposes of this paragraph, the term 'suitable work' means, with respect to any individual, any work which is within such individual's capabilities; except that, if the individual furnishes evidence satisfactory to the State agency that such individual's prospects for obtaining work in his customary occupation within a reasonably short period are good, the determination of whether any work is suitable work with respect to such individual shall be made in accordance with the applicable State law.

"(D) Extended compensation shall not be denied under clause (i) of subparagraph (A) to any individual for any week by reason of a failure to accept an offer of, or apply for, suitable work—

"(i) if the gross average weekly remuneration payable to such individual for the position does not exceed the sum of—

"(I) the individual's average weekly benefit amount (as determined for purposes of subsection (b)(1)(C)) for his benefit year, plus

"(II) the amount (if any) of supplemental unemployment compensation benefits (as defined in section 501(c)(17)(D) of the Internal Revenue Code of 1954) payable to such individual for such week;

"(ii) if the position was not offered to such individual in writing and was not listed with the State employment service;

"(iii) if such failure would not result in a denial of compensation under the provisions of the applicable State law to the extent that such provisions are not inconsistent with the provisions of subparagraphs (C) and (E); or

"(iv) if the position pays wages less than the higher of—

"(I) the minimum wage provided by section 6(a)(1) of the Fair Labor Standards Act of 1938, without regard to any exemption; or

"(II) any applicable State or local minimum wage.

"(E) For purposes of this paragraph, an individual shall be treated as actively engaged in seeking work during any week if—

"(i) the individual has engaged in a systematic and sustained effort to obtain work during such week, and

"(ii) the individual provides tangible evidence to the State agency that he has engaged in such an effort during such week.

"(F) For purposes of section 3304(a)(11) of the Internal Revenue Code of 1954, a State law shall provide for referring applicants for benefits under this Act to any suitable work to which clauses (i), (ii), (iii), and (iv) of subparagraph (D) would not apply.

"(4) No provision of State law which terminates a disqualification for voluntarily leaving employment, being discharged for misconduct, or refusing suitable employment shall apply for purposes of determining eligibility for extended compensation unless such termination is based upon employment subsequent to the date of such disqualification.

"(5) No payment shall be made under this Act to any State in respect of any sharable regular compensation paid to any individual for any week if, under the rules of paragraphs (3) and (4), extended compensation would not have been payable to such individual for such week.".

(b) The amendment made by this section shall apply with respect to weeks of unemployment beginning after March 31, 1981.

CERTIFICATION OF STATE UNEMPLOYMENT LAWS

SEC. 1025. On October 31 of any taxable year after 1980, the Secretary of Labor shall not certify any State, as provided in section 3304(c) of the Internal Revenue Code of 1954, which, after reasonable notice and opportunity for a hearing to the State agency, the Secretary of Labor finds has failed to amend its law so that it contains each of the provisions required by reason of the enactment of the preceding provisions of this subtitle to be included therein, or has with respect to the 12-month period ending on such October 31, failed to comply substantially with any such provision.

ADDITIONAL SAVINGS

SEC. 1026. For provisions of law which reduce spending for fiscal year 1981 under the unemployment compensation program in satisfaction of reconciliation requirements imposed by sections 3(a)(8) and 3(a)(15) of H. Con. Res. 307 (96th Congress), see section 415 and 416 of the Multiemployer Pension Plan Amendments Act of 1980 (Public Law 96-364 [1980-51 I.R.B. 14]).

TITLE XI—REVENUE MEASURES

SEC. 1100. SHORT TITLE.

This title may be cited as the "Revenue Adjustments Act of 1980".

Subtitle A—Housing Bonds

SEC. 1101. SHORT TITLE.

This substitle may be cited as the "Mortgage Subsidy Bond Tax Act of 1980".

SEC. 1102. MORTGAGE SUBSIDY BONDS.

(a) IN GENERAL.—Part III of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to items specifically excluded from gross income) is amended by inserting after section 103 the following new section:

"SEC. 103A. MORTGAGE SUBSIDY BONDS.

"(a) GENERAL RULE.—Except as otherwise provided in this section, any mortgage subsidy bond shall be treated as an obligation not described in subsection (a)(1) or (2) of section 103.

"(b) MORTGAGE SUBSIDY BOND DEFINED.—

"(1) IN GENERAL.—For purposes of this title, the term 'mortgage subsidy bond' means any obligation which is issued as part of an issue a significant portion of the proceeds of which are to be used directly or indirectly for morgtgages on owner-occupied residences.

"(2) EXCEPTIONS.—The following shall not be treated as mortgage subsidy bonds:

"(A) any qualified mortgage bond; and

"(B) any qualified veterans' mortgage bond.

"(c) QUALIFIED MORTGAGE BOND; QUALIFIED MORTGAGE ISSUE; QUALIFIED VETERANS' MORTGAGE BOND.—

"(1) QUALIFIED MORTGAGE BOND DEFINED.—

"(A) IN GENERAL.—For purposes of this title, the term 'qualified mortgage bond' means an obligation which is issued as part of a qualified mortgage issue.

"(B) TERMINATION DECEMBER 31, 1983.—No obligation issued after December 31, 1983, may be treated as a qualified mortgage bond.

"(2) QUALIFIED MORTGAGE ISSUE DEFINED.—

"(A) DEFINITION.—For purposes of this title, the term 'qualified mortgage issue' means an issue by a State or political subdivision thereof of 1 or more obligations, but only if—

"(i) all proceeds of such issue (exclusive of issuance costs and a reasonably required reserve) are to be used to finance owner-occupied residences, and

"(ii) such issue meets the requirements of subsections (d), (e), (f), (g), (h), (i), and (j).

"(B) GOOD FAITH EFFORT TO COMPLY WITH MORTGAGE ELIGIBILITY REQUIREMENTS.—An issue which fails to meet 1 or more of the requirements of subsections (d), (e), and (f) and paragraphs (2) and (3) of subsection (j) shall be treated as meeting such requirements if—

"(i) the issuer in good faith attempted to meet all such requirements before the mortgages were executed,

"(ii) 95 percent or more of the proceeds devoted to owner-financing was devoted to residences with respect to which (at the time the mortgages were executed) all such requirements were met, and

"(iii) any failure to meet the requirements of such subsections and paragraphs is corrected within a reasonable period after such failure is first discovered.

"(C) GOOD FAITH EFFORT TO COMPLY WITH OTHER REQUIREMENTS.—An issue which fails to meet 1 or more of the requirements of subsections (g), (h), and (i), and paragraph (1) of subsection (j) shall be treated as meeting such requirements if—

"(i) the issuer in good faith attempted to meet all such requirements, and

"(ii) any failure to meet such requirements is due to inadvertent error after taking reasonable steps to comply with such requirements.

"(3) QUALIFIED VETERANS' MORTGAGE BOND DEFINED.—For purposes of this section, the term 'qualified veterans' mortgage bond' means any obligation—

"(A) which is issued in registered form as part of an issue substantially all of the proceeds of which are to be used to provide residences for veterans,

"(B) the payment of the principal and interest on which is secured by the general obligation of a State, and

"(C) which is part of an issue which meets the requirements of subsection (j)(2).

"(d) RESIDENCE REQUIREMENTS.—

"(1) FOR A RESIDENCE.—A residence meets the requirements of this subsection only if—

"(A) it is a single-family residence which can reasonably be expected to become the principal residence of the mortgagor within a reasonable time after the financing is provided, and

"(B) it is located within the jurisdiction of the authority issuing the obligation.

"(2) FOR AN ISSUE.—An issue meets the requirements of this subsection only if all of the residences for which owner-financing is provided under the issue meet the requirements of paragraph (1).

"(e) 3-YEAR REQUIREMENT.—

"(1) IN GENERAL.—An issue meets the requirements of this subsection only if each mortgagor to whom financing is provided under the issue had a present ownership interest in a principal residence of such mortgagor at no time during the 3-year period ending on the date the mortgage is executed. For purposes of the preceding sentence, the mortgagor's interest in the residence with respect to which the financing is being provided shall not be taken into account.

"(2) EXCEPTIONS.—Paragraph (1) shall not apply with respect to—

"(A) any financing provided with respect to a targeted area residence,

"(B) any qualified home improvement loan, and

"(C) any qualified rehabilitation loan.

"(f) PURCHASE PRICE REQUIREMENT.—

"(1) IN GENERAL.—An issue meets the requirements of this subsection only if the acquisition cost of each residence the owner-financing of which is to be provided under the issue does not exceed 90 percent of the average area purchase price applicable to such residence.

"(2) AVERAGE AREA PURCHASE PRICE.—For purposes of paragraph (1), the term 'average area purchase price' means, with respect to any residence, the average purchase price of single family residences (in the statistical area in which the residence is located) which were purchased during the most recent 12-month period for which sufficient statistical information is available. The determination under the preceding sentence shall be made as of the date on which the commitment to provide the financing is made (or, if earlier, the date of the purchase of the residence).

"(3) SEPARATE APPLICATION TO NEW RESIDENCES AND OLD RESIDENCES.—For purposes of this subsection, the determination of average area purchase price shall be made separately with respect to—

"(A) residences which have not been previously occupied, and

"(B) residences which have been previously occupied.

"(4) SPECIAL RULE FOR 2 TO 4 FAMILY RESIDENCES.—For purposes of this subsection, to the extent provided in regulations, the average area purchase price shall be made separately with respect to 1 family, 2 family, 3 family, and 4 family residences.

"(5) SPECIAL RULE FOR TARGETED AREA RESIDENCES.—In the case of a targeted area residence, paragraph (1) shall be applied by substituting '110 percent' for '90 percent'.

"(6) EXCEPTION FOR QUALIFIED HOME IMPROVEMENT LOANS.—Paragraph (1) shall not apply with respect to any qualified home improvement loan.

"(g) LIMITATION ON AGGREGATE AMOUNT OF QUALIFIED MORTGAGE BONDS ISSUED DURING ANY CALENDAR YEAR.—

"(1) IN GENERAL.—An issue meets the requirements of this subsection only if the aggregate amount of bonds issued pursuant thereto, when added to the aggregate amount of qualified mortgage bonds previously issued by the issuing authority during the calendar year, does not exceed the applicable limit for such authority for such calendar year.

"(2) APPLICABLE LIMIT FOR STATE

HOUSING AGENCY.—For purposes of this subsection—

"(A) IN GENERAL.—The applicable limit for any State housing finance agency for any calendar year shall be 50 percent of the State ceiling for such year.

"(B) SPECIAL RULE WHERE MORE THAN 1 AGENCY.—If any State has more than 1 State housing finance agency, all such agencies shall be treated as a single agency.

"(3) APPLICABLE LIMIT FOR OTHER ISSUERS.—For purposes of this subsection—

"(A) IN GENERAL.—The applicable limit for any issuing authority (other than a State housing finance agency) for any calendar year is an amount which bears the same ratio to 50 percent of the State ceiling for such year as—

"(i) the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family owner-occupied residences located within the jurisdiction of such issuing authority, bears to

"(ii) an average determined in the same way for the entire State.

"(B) OVERLAPPING JURISDICTIONS.—For purposes of subparagraph (A)(i), if an area is within the jurisdiction of 2 or more governmental units, such area shall be treated as only within the jurisdiction of the unit having jurisdiction over the smallest geographical area unless such unit agrees to surrender all or part of such jurisdiction for such calendar year to the unit with overlapping jurisdiction which has the next smallest geographical area.

"(4) STATE CEILING.—For purposes of this subsection, the State ceiling applicable to any State for any calendar year shall be the greater of—

"(A) 9 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family owner-occupied residences located within the jurisdiction of such State, or

"(B) $200,000,000.

"(5) SPECIAL RULE FOR STATES WITH CONSTITUTIONAL HOME RULE CITIES.—For purposes of this subsection—

"(A) IN GENERAL.—The applicable limit for any constitutional home rule city for any calendar year shall be determined under subparagraph (A) of paragraph (3) by substituting '100 percent' for '50 percent'.

"(B) COORDINATION WITH PARAGRAPHS (2) AND (3).—In the case of any State which contains 1 or more constitutional home rule cities, for purposes of applying paragraphs (2) and (3) with respect to issuing authorities in such State other than constitutional home rule cities, the State ceiling for any calendar year shall be reduced by the aggregate applicable limits determined for such year for all constitutional home rule cities in such State.

"(C) CONSTITUTIONAL HOME RULE CITY.—For purposes of this subsection, the term 'constitutional home rule city' means, with respect to any calendar year, any political subdivision of a State which, under a State constitution which was adopted in 1970 and effective on July 1, 1971, had home rule powers on the first day of the calendar year.

"(6) STATE MAY PROVIDE FOR DIFFERENT ALLOCATION.—

"(A) IN GENERAL.—Except as provided in subparagraph (C), a State may, by law enacted after the date of the enactment of this section, provide a different formula for allocating the State ceiling among the governmental units in such State having authority to issue qualified mortgage bonds.

"(B) INTERIM AUTHORITY FOR GOVERNOR.—

"(i) IN GENERAL.—Except as otherwise provided in subparagraph (C), the Governor of any State may proclaim a different formula for allocating the State ceiling among the governmental units in such State having authority to issue qualified mortgage bonds.

"(ii) TERMINATION OF AUTHORITY.—The authority provided in clause (i) shall not apply after the earlier of—

"(I) the first day of the first calendar year beginning after the first calendar year after 1980 during which the legislature of the State met in regular session, or

"(II) the effective date of any State legislation with respect to the allocation of the State ceiling enacted after the date of the enactment of this section.

"(C) STATE MAY NOT ALTER ALLOCATION TO CONSTITUTIONAL HOME RULE CITIES.—Except as otherwise provided in a State constitutional amendment (or law changing the home rule provision adopted in the manner provided by the State constitution), the authority provided in this paragraph shall not apply to that portion of the State ceiling which is allocated to any constitutional home rule city in the State unless such city agrees to such different allocation.

"(7) TRANSITIONAL RULES.—In applying this subsection to any calendar year, there shall not be taken into account any bond which, by reason of section 1104 of the Mortgage Subsidy Bond Tax Act of 1980, receives the same tax treatment as bonds issued on or before April 24, 1979.

"(h) PORTION OF LOANS REQUIRED TO BE PLACED IN TARGETED AREAS.—

"(1) IN GENERAL.—An issue meets the requirements of this subsection only if at least 20 percent of the proceeds of the issue which are devoted to providing owner-financing is made available (with reasonable diligence) for owner-financing of targeted area residences for at least 1 year after the date on which owner-financing is first made available with respect to targeted area residences.

"(2) LIMITATION.—Nothing in paragraph (1) shall be treated as requiring the making available of an amount which exceeds 40 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family owner-occupied residences located in targeted areas within the jurisdiction of the issuing authority.

"(i) REQUIREMENTS RELATED TO ARBITRAGE.—

"(1) IN GENERAL.—An issue meets the requirements of this subsection only if such issue meets the requirements of paragraphs (2), (3), and (4) of this subsection. Such requirements shall be in addition to the requirements of section 103(c).

"(2) EFFECTIVE RATE OF MORTGAGE INTEREST CANNOT EXCEED BOND YIELD BY MORE THAN 1 PERCENTAGE POINT.—

"(A) IN GENERAL.—An issue shall be treated as meeting the requirements of this paragraph only if the excess of—

"(i) the effective rate of interest on the mortgages provided under the issue, over

"(ii) the yield on the issue,

is not greater than 1 percentage point.

"(B) EFFECTIVE RATE OF MORTGAGE INTEREST.—

"(i) IN GENERAL.—In determining the effective rate of interest on any mortgage for purposes of this paragraph, there shall be taken into account all fees, charges, and other amounts borne by the mortgagor which are attributable to the mortgage or to the bond issue.

"(ii) SPECIFICATION OF SOME OF THE AMOUNTS TO BE TREATED AS BORNE BY THE MORTGAGOR.—For purposes of clause (i), the following items (among others) shall be treated as borne by the mortgagor:

"(I) all points or similar charges paid by the seller of the property, and

"(II) the excess of the amounts received from any person other than the mortgagor by any person in connection with the acquisition of the mortgagor's interest in the property over the usual and reasonable acquisition costs of a person acquiring like property where owner-financing is not provided through the use of qualified mortgage bonds.

"(iii) SPECIFICATION OF SOME OF THE AMOUNTS TO BE TREATED AS NOT BORNE BY THE MORTGAGOR.—For purposes of clause (i), the following items shall not be taken into account:

"(I) any expected rebate of arbitrage profits, and

"(II) any application fee, survey fee, credit report fee, insurance charge, or similar amount to the extent such amount does not exceed amounts charged in such area in cases where owner-financing is not provided through the use of qualified mortgage bonds.

Subclause (II) shall not apply to origination fees, points, or similar amounts.

"(iv) PREPAYMENT ASSUMPTION.—In determining the effective rate of interest, it shall be assumed that the mortgage prepayment rate will be the rate set forth in the most recent mortgage maturity experience table published by the Federal Housing Administration for the State (or, if available, the area within the State) in which the residences are located.

"(C) YIELD ON THE ISSUE.—For purposes of this subsection, the yield on the issue shall be determined on the basis of—

"(i) the issue price (within the meaning of section 1232(b)(2)), and

"(ii) an expected maturity for the bonds which is consistent with the assumption required under subparagraph (B)(iv).

"(3) NON-MORTGAGE INVESTMENT REQUIREMENTS.—

"(A) IN GENERAL.—An issue meets the requirements of this paragraph only if—

"(i) at no time during any bond year may the amount invested in non-mortgage investments with a yield higher than the yield on the issue exceed 150 percent of the debt service on the issue for the bond year, and

"(ii) the aggregate amount invested as provided in clause (i) is promptly and appropriately reduced as mortgages are repaid.

"(B) EXCEPTION FOR TEMPORARY PERIODS.—Subparagraph (A) shall not apply to—

"(i) proceeds of the issue invested for an initial temporary period until such proceeds are needed for mortgages, and

"(ii) temporary investment periods related to debt service.

"(C) DEBT SERVICE DEFINED.—For purposes of subparagraph (A), the debt service on the issue for any bond year is the scheduled amount of interest and amortization of principal payable for such year with respect to such issue. For purposes of the preceding sentence, there shall not be taken into account amounts scheduled with respect to any bond which has been retired before the beginning of the bond year.

"(4) ARBITRAGE AND INVESTMENT GAINS TO BE USED TO REDUCE COSTS OF OWNER-FININCING.—

"(A) IN GENERAL.—An issue shall be treated as meeting the requirements of this paragraph only if an amount equal to the sum of—

"(i) the excess of—

"(I) the amount earned on all non-mortgage investments (other than investments attributable to an excess described in this clause), over

"(II) the amount which would have been earned if the investments were invested at a rate equal to the yield on the issue, plus

"(ii) any income attributable to the excess described in clause (i),

shall be paid or credited to the mortgagors as rapidly as may be practicable.

"(B) INVESTMENT GAINS AND LOSSES.—For purposes of subparagraph (A), in determining the amount earned on all non-mortgage investments, any gain or loss on the disposition of such investments shall be taken into account.

"(j) OTHER REQUIREMENTS.—

"(1) OBLIGATIONS MUST BE REGISTERED.—An issue meets the requirements of this subsection only if each obligation issued pursuant to such issue is in registered form.

"(2) MORTGAGES MUST BE NEW MORTGAGES.—

"(A) IN GENERAL.—An issue meets the requirements of this subsection only if no part of the proceeds of such issue is to be used to acquire or replace existing mortgages.

"(B) EXCEPTIONS.—Under regulations prescribed by the Secretary, the replacement of—

"(i) construction period loans,

"(ii) bridge loans or similar temporary initial financing, and

"(iii) in the case of a qualified rehabilitation, an existing mortgage,

shall not be treated as the acquisition or replacement of an existing mortgage for purposes of subparagraph (A).

"(3) CERTAIN REQUIREMENTS MUST BE MET WHERE MORTGAGE IS ASSUMED.—An issue meets the requirements of this subsection only if a mortgage with respect to which owner-financing has been provided under such issue may be assumed only if the requirements of subsections (d), (e), and (f), are met with respect to such assumption.

"(k) TARGETED AREA RESIDENCES.—

"(1) IN GENERAL.—For purposes of this section, the term 'targeted area residence' means a residence in an area which is either—

"(A) a qualified census tract, or

"(B) an area of chronic economic distress.

"(2) QUALIFIED CENSUS TRACT.—

"(A) IN GENERAL.—For purposes of paragraph (1), the term 'qualified census tract' means a census tract in which 70 percent or more of the families have income which is 80 percent or less of the statewide median family income.

"(B) DATA USED.—The determination under subparagraph (A) shall be made on the basis of the most recent decennial census for which data are available.

"(3) AREA OF CHRONIC ECONOMIC DISTRESS.—

"(A) IN GENERAL.—For purposes of paragraph (1), the term 'area of chronic economic distress' means an area of chronic economic distress—

"(i) designated by the State as meeting the standards established by the State for purposes of this subsection, and

"(ii) the designation of which has been approved by the Secretary and the Secretary of Housing and Urban Development.

"(B) CRITERIA TO BE USED IN APPROVING STATE DESIGNATIONS.—The criteria used by the Secretary and the Secretary of Housing and Urban Development in evaluating any proposed designation of an area for purposes of this subsection shall be—

"(i) the condition of the housing stock, including the age of the housing and the number of abandoned and substandard residential units,

"(ii) the need of area residents for owner-financing under this section, as indicated by low per capita income, a high percentage of families in poverty, a high number of welfare recipients, and high unemployment rates,

"(iii) the potential for use of owner-financing under this section to improve housing conditions in the area, and

"(iv) the existence of a housing assistance plan which provides a displacement program and a public improvements and services program.

"(l) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) MORTGAGE.—The term 'mortgage' includes any other owner-financing.

"(2) BOND.—The term 'bond' includes any obligation.

"(3) STATE.—The term 'State' includes a possession of the United States and the District of Columbia.

"(4) STATISTICAL AREA.—

"(A) IN GENERAL.—The term 'statistical area' means—

"(i) a standard metropolitan statistical area, and

"(ii) any county (or the portion thereof) which is not within a standard metropolitan statistical area.

"(B) STANDARD METROPOLITAN STATISTICAL AREA.—The term 'standard metropolitan statistical area' means the area in and around a city of 50,000 inhabitants or more (or equivalent area) as defined by the Secretary of Commerce.

"(C) DESIGNATION WHERE ADEQUATE STATISTICAL INFORMATION NOT AVAILABLE.—For purposes of this paragraph, if there is insufficient recent statistical information with respect to a county (or portion thereof) described in subparagraph (A)(ii), the Secretary may substitute for such county (or portion thereof) another area for which there is sufficient recent statistical information.

"(D) DESIGNATION WHERE NO COUNTY.—In the case of any portion of a State which is not within a county, subparagraphs (A)(ii) and (C) shall be applied by substituting for 'county' an area designated by the Secretary which is the equivalent of a county.

"(5) ACQUISITION COST.—

"(A) IN GENERAL.—The term 'acquisition cost' means the cost of acquiring the residence as a completed residential unit.

"(B) EXCEPTIONS.—The term 'acquisition cost' does not include—

"(i) usual and reasonable settlement or financing costs,

"(ii) the value of services performed by the mortgagor or members of his family in completing the residence, and

"(iii) the cost of land which has been owned by the mortgagor for at least 2 years before the date on which construction of the residence begins.

"(C) SPECIAL RULE FOR QUALIFIED REHABILITATION LOANS.—In the case of a qualified rehabilitation loan, for purposes of subsection (f), the term 'acquisition cost' includes the cost of the rehabilitation.

"(6) QUALIFIED HOME IMPROVEMENT LOAN.—The term 'qualified home improvement loan' means the financing (in an amount which does not exceed $15,000)—

"(A) of alterations, repairs, and improvements on or in connection with an existing residence by the owner thereof, but

"(B) only of such items as substantially protect or improve the basic livability or energy efficiency of the property.

"(7) QUALIFIED REHABILITATION LOAN.—

"(A) IN GENERAL.—The term 'qualified rehabilitation loan' means any owner-financing provided in connection with—

"(i) a qualified rehabilitation, or

"(ii) the acquisition of a residence with respect to which there has been a qualified rehabilitation,

but only if the mortgagor to whom such financing is provided is the first resident of the residence after the completion of the rehabilitation.

"(B) QUALIFIED REHABILITATION.—For purposes of subparagraph (A), the term 'qualified rehabilitation' means any rehabilitation of a building if—

"(i) there is a period of at least 20 years between the date on which the building was first used and the date on which the physical work on such rehabilitation begins,

"(ii) 75 percent or more of the existing external walls of such building are retained in place as external walls in the rehabilitation process, and

"(iii) the expenditures for such rehabilitation are 25 percent or more of the mortgagor's adjusted basis in the residence.

For purposes of clause (iii), the mortgagor's adjusted basis shall be determined as of the completion of the rehabilitation or, if later, the date on which the mortgagor acquires the residence.

"(8) DETERMINATIONS ON ACTUARIAL BASIS.—All determinations of yield, effective interest rates, and amounts required to be paid or credited to mortgagors under subsection (i)(4)(A) shall be made on an actuarial basis taking into account the present value of money.

"(9) SINGLE-FAMILY AND OWNER-OCCUPIED RESIDENCES INCLUDE CERTAIN RESIDENCES WITH 2 TO 4 UNITS.—Except for purposes of subsections (g) and (h)(2), the terms 'single-family' and 'owner-occupied', when used with respect to residences, include 2, 3, or 4 family residences—

"(A) one unit of which is occupied by the owner of the units, and

"(B) which were first occupied at least 5 years before the mortgage is executed.

"(m) SPECIAL RULE FOR ISSUE USED FOR OWNER-OCCUPIED HOUSING AND RENTAL HOUSING.—In the case of an issue—

"(1) part of the proceeds of which are to be used for mortgages on owner-occupied residences in a manner which meets the requirements of this section, and

"(2) part of the proceeds of which are to be used for rental housing which meets the requirements of section 103(4)(A),

under regulations prescribed by the Secretary, each such part shall be treated as a separate issue.

"(n) ADVANCE REFUNDING OF MORTGAGE SUBSIDY BONDS NOT PERMITTED.—On and after the date of the enactment of this section, no obligation may be issued for the advance refunding of a mortgage subsidy bond (determined without regard to subsection (b)(2))."

(b) CLERICAL AMENDMENT.—The table of sections for part III of subchapter B of chapter 1 of such Code is amended by inserting after the item relating to section 103 the following new item:

"Sec. 163A. Mortgage subsidy bonds."

SEC. 1103. INDUSTRIAL DEVELOPMENT BONDS FOR HOUSING PURPOSES LIMITED TO LOW- OR MODERATE-INCOME RENTAL HOUSING.

(a) IN GENERAL.—Subparagraph (A) of paragraph (5) of section 103 (b) of the Internal Revenue Code of 1954 (relating to industrial development bonds) is amended to read as follows:

"(A) projects for residential rental property if each obligation issued pursuant to the issue is in registered form and if—

"(i) 15 percent or more in the case of targeted area projects, or

"(ii) 20 percent or more in the case of any other project,

of the units in each project are to be occupied by individuals of low or moderate income (within the meaning of section 167(k)(3)(B)),".

(b) TARGETED AREA PROJECT DEFINED.—Paragraph (4) of section 103 (b) of such Code is amended by inserting before the last sentence the following new sentence:

"For purposes of subparagraph (A), the term 'targeted area project' means a project located in a qualified census tract (within the meaning of section 103A(k)(2)) or an area of chronic economic distress (within the meaning of section 103A(k)(3))."

(c) TECHNICAL AMENDMENT.—Paragraph (6) of section 103(b) of such Code (relating to exemption for certain small issues) is amended by adding at the end thereof the following new subparagraph:

"(J) ISSUES FOR RESIDENTIAL PURPOSES.—This paragraph shall not apply to any obligation which is issued as a part of an issue a significant portion of the proceeds of which are to be used directly or indirectly to provide residential real property for family units."

SEC. 1104. EFFECTIVE DATES FOR BOND PROVISIONS.

(a) GENERAL RULE.—

(1) IN GENERAL.—Except as otherwise provided in this section, the amendments made by sections 1102 and 1103 shall apply to obligations issued after April 24, 1979.

(2) EXCEPTIONS FOR CERTAIN OBLIGATIONS ISSUED BEFORE JANUARY 1, 1981.—The amendments made by sections 1102 and 1103 shall not apply to obligations issued before January 1, 1981, if such obligations are part of an issue substantially all the proceeds of which (exclusive of issuance costs and a reasonably required reserve) are, before the date which is 1 year after the date of issue of the obligations, committed—

(A) except as provided in subparagraph (B), by firm commitment letters (similar to those used in financing not provided with tax-exempt bonds), and

(B) in the case of rental housing, by the commencement of construction of the project or by the acquisition of the project.

(b) EXCEPTION FOR OFFICIAL ACTION TAKEN BEFORE APRIL 25, 1979.—

(1) IN GENERAL.—The amendments made by sections 1102 and 1103 shall not apply to obligations if official action before April 25, 1979, of the governing body of the unit having authority to issue such obligations indicated an intent to issue such obligations.

(2) ACTION BY STAFF OF HOUSING AUTHORITY TREATED AS ACTION OF AUTHORITY IN CERTAIN CASES.—For purposes of paragraph (1), if, before April 25, 1979—

(A) the permanent professional staff of a State or local housing authority performed substantial work on a bond issue, and

(B) it was reasonable to expect that the bond issue, as developed by the staff, would be promptly approved by the governing body of the housing authority,

then such action by such staff shall be treated as the official action of such governing body.

(3) SPECIAL RULES RELATING TO SIZE OF ISSUE.—

(A) IN GENERAL.—Except as provided in subparagraph (B), an issue does not qualify for the exception provided by paragraph (1) if the issue size exceeds the intended issue size.

(B) EXCEPTION.—In the case of an issue to provide owner-financing for residences for which as of April 24, 1979, there was no documentation relating to intended issue size, paragraph (1) shall not apply unless—

(i) substantially all of the proceeds of the issue (exclusive of issuance costs and a reasonably required reserve) are to be used to provide owner-financing for one to four family residences (one unit of which is owner occupied) and not to acquire or replace existing mortgages (within the meaning of section 103A(j)(2) of the Internal Revenue Code of 1954), and

(ii) substantially all of the proceeds referred to in clause (i) are committed by firm commitment letters (similar to those used in owner-financing not provided with tax-exempt bonds) to such owner-financing before the day which is 9 months after the date of issue of the obligations.

(C) ISSUE SIZE DEFINED.—For purposes of this paragraph, the term "issue size" means the aggregate face amount of obligations issued pursuant to the issue.

(D) INTENDED ISSUE SIZE.—For purposes of this paragraph, the term "intended issue size" means the aggregate face amount of obligations which a reasonable individual would reasonably conclude from the documentation before April 25, 1979, was the issue size which the governing body of the issuing authority intended to issue.

(4) LOCAL REFERENDUM HELD BEFORE JUNE 13, 1979.—

(A) IN GENERAL.—For purposes of paragraph (1), if—

(i) on April 25, 1979, legislation was pending in a State legislature,

(ii) on April 27, 1979, such legislation was amended to authorize local governmental units to issue tax-exempt obligations,

(iii) before June 13, 1979, such legislation was enacted and a local governmental unit in such State held a referendum with respect to the issuance of obligations to finance owner-occupied residences, and

(iv) any action with respect to the issuance of such obligations by the governing body of such local governmental unit would have met the requirements of paragraph (1) if such legislation had been in effect, and such referendum had been held, when that action was taken,

then such legislation shall be treated as in effect, and such referendum shall be treated as having been held, at the time when such action was taken.

(B) DOLLAR LIMIT FOR LOCAL GOVERNMENTAL UNITS.—The aggregate amount of obligations which may be issued by local governmental units with respect to the area comprising any local governmental area by reason of subparagraph (A) may not exceed—

(i) $35,000,000, reduced by

(ii) the aggregate amount of obligations which are issued (before, on, or after the issue under this paragraph) by local governmental units with respect to such area after April 24, 1979, and to which the amendments made by this subtitle do not apply solely by reason of this subsection (determined without regard to the application of subparagraph (A) of this paragraph).

(C) MORTGAGE REQUIREMENTS.—Subparagraph (A) shall not apply with respect to any issue unless such issue meets the requirements of paragraph (3)(A) of subsection (c).

(5) CERTAIN LOCAL ACTION PURSUANT TO LEGISLATION ENACTED BEFORE SEPTEMBER 29, 1979.—

(A) IN GENERAL.—For purposes of paragraph (1), if—

(i) on April 25, 1979, legislation was pending in a State legislature authorizing a local governmental unit to issue tax-exempt obligations for owner-occupied residences,

(ii) before September 29, 1979, such legislation was enacted, and

(iii) any action with respect to the issuance of such obligations by the local governing body would have met the requirements of paragraph (1) if such legislation had been in effect when that action was taken,

then such legislation shall be treated as in effect at the time when such action was taken.

(B) DOLLAR LIMIT FOR LOCAL GOVERNMENTAL UNITS.—The aggregate amount of obligations which may be issued by local governmental units with respect to the area comprising any local governmental area by reason of subparagraph (A) may not exceed the lesser of—

(i) the aggregate amount authorized by the legislation referred to in subparagraph (A), or

(ii) $150,000,000.

(C) MORTGAGE REQUIREMENTS.—Subparagraph (A) shall not apply with respect to any issue unless such

issue meets the requirements of paragraph (3)(A) of subsection (c).

(c) $150,000,000 EXCEPTION FOR STATE HOUSING FINANCE AGENCIES.—

(1) IN GENERAL.—To the extent of the limit set forth in paragraph (2), the amendments made by this subtitle shall not apply to obligations issued by a State housing finance agency.

(2) DOLLAR LIMIT FOG STATE HOUSING FINANCE AGENCIES.—The aggregate amount of obligations which may be issued by State housing finance agencies with respect to any State by reason of paragraph (1) may not exceed—

(A) $150,000,000, reduced by

(B) the aggregate amount of obligations which are issued (before, on, or after the issue under this subsection) by the housing finance agencies of such State after April 24, 1979, to finance owner-occupied residences and to which the amendments made by this subtitle do not apply solely by reason of subsection (b).

(3) COMMITMENTS.—Paragraph (1) shall not apply with respect to any issue unless substantially all of the proceeds of such issue (exclusive of issuance costs and a reasonably required reserve)—

(A) are to be used to provide owner-financing for 1 to 4 family residences (1 unit of which is owner-occupied) and not to acquire or replace existing mortgages (within the meaning of section 103A(j)(2) of the Internal Revenue Code of 1954), and

(B) are committed by firm commitment letters (similar to those used in owner-financing not provided by tax-exempt bonds) to owner-financing before January 1, 1981.

(4) SPECIAL RULE FOR ACTION IN 1978 PURSUANT TO MORTGAGE PROGRAM ESTABLISHED IN 1970.—

(A) IN GENERAL.—If—

(i) in 1970 State legislation established a program to issue tax-exempt obligations to finance the purchase of existing mortgages from financial institutions,

(ii) in August 1978, as a step toward issuing obligations under such program, the governing body of the housing agency administering the program made a finding that there was a shortage of mortgage funds within the State,

(iii) moneys received by any financial institution on the purchase of mortgages will be reinvested within 90 days in new mortgages, and

(iv) the issue meets the requirements of subparagraphs (B) and (C),

then paragraph (3) shall not apply with respect to an issue of obligations pursuant to the program referred to in clause (i) and the finding referred to in clause (ii).

(B) DOWNPAYMENT REQUIREMENT.—An issue meets the requirements of this subparagraph only if 75 percent or more of the financing provided under the issue is financing for residences where such financing constitutes 95 percent or more of the acquisition cost of the residences.

(C) TARGETED AREA REQUIREMENT.—An issue meets the requirements of this subparagraph only if at least 20 percent of the financing provided under the issue is owner-financing of targeted area residences. For purposes of the preceding sentence, the term "targeted area residence" means a residence in an area which is a census tract in which 70 percent or more of the families have income which is 80 percent or less of the statewide median family income (determined on the basis of the most recent decennial census for which data are available).

(D) DOLLAR LIMIT.—The aggregate amount of obligations which may be issued by a State housing authority by reason of subparagraph (A) may not exceed $125,000,000.

(d) SPECIAL RULES.—

(1) COURT ACTION WAS PENDING TO DETERMINE SCOPE OF AUTHORIZING LEGISLATION.

(A) IN GENERAL.—If—

(i) before April 25, 1979, a State had enacted a law under which counties were authorized to establish public trusts to issue tax-exempt obligations for public purposes,

(ii) on such date the question of whether or not that law authorized the issuance of obligations to finance certain owner-occupied residences was being litigated in a court of competent jurisdiction,

(iii) before July 31, 1979, the Supreme Court of such State held that the counties were so authorized, and

(iv) there is written evidence (which was in existence before April 25, 1979) that before April 25, 1979, the governing body of a county in such State had taken action indicating an intent to issue (or to establish a program for issuing) tax-exempt obligations to finance owner-occupied residences,

then the amendments made by section 1102 shall not apply to obligations issued by the public trust for such county.

(B) DOLLAR LIMIT.—The aggregate amount of obligations which may be issued with respect to any county by reason of subparagraph (A) may not exceed $50,000,000.

(2) STATE LEGISLATION ENACTED BEFORE JUNE 8, 1979, WHERE LOCALITY HAD ESTABLISHED INCOME LIMITATIONS BEFORE APRIL 25, 1979.—

(A) IN GENERAL.—If—

(i) on April 25, 1979, legislation was pending in a State legislature authorizing a local governmental unit to issue tax-exempt obligations for owner-occupied residences,

(ii) there is written evidence (which was in existence before April 25, 1979) that before April 25, 1979, the governing body of the local governmental unit had taken action indicating to its delegation to the State legislature what the income limitation would be for individuals who would be eligible for mortgages under the program, and

(iii) before June 8, 1979, the legislation referred to in clause (i) was enacted,

then the amendments made by section 1102 shall not apply to obligations issued by the local governmental unit.

(B) DOLLAR LIMIT.—The aggregate amount of obligations which may be issued with respect to any local governmental area by reason of subparagraph

(A) may not exceed $150,000,000.

(3) RESOLUTIONS BEFORE CITY COUNCIL BEFORE ENACTMENT OF STATE AUTHORIZING LEGISLATION.—

(A) IN GENERAL.—If—

(i) before April 25, 1979, 2 resolutions were submitted to a city council the first of which would create an urban residential finance authority and the second of which would authorize the appointment of the members of such authority,

(ii) at the time such resolutions were submitted, State authorizing legislation had not been enacted,

(iii) before April 25, 1979, the State authorizing legislation was enacted, and

(iv) after April 24, 1979, and before May 17, 1979, a resolution was adopted by the city council which created an urban residential finance authority and which authorized the appointment of members of the authority,

then the amendments made by section 1102 shall not apply with respect to obligations issued on behalf of such city.

(B) DOLLAR LIMIT.—The aggregate amount of obligations which may be issued with respect to any city by reason of subparagraph (A) may not exceed $50,000,000.

(4) SPECIAL RULE WHERE CITY POSTPONED SECOND HALF OF AUTHORIZED ISSUE TO SAVE INTEREST.—If—

(A) on March 28, 1979, the council of a city adopted a resolution authorizing the issuance of not to exceed $30,000,000 of mortgage revenue bonds.

(B) on or about August 1, 1979, approximately one-half of the obligations authorized by such resolution were issued, and

(C) the reason why the remaining obligations were not issued at that time was to save interest payments until the money was actually needed,

then the amendments made by section 1102 shall not apply with respect to the issuance of the remaining obligations which were authorized by such March 28, 1979, resolution.

(5) STATE WAS IN PROCESS OF PERMITTING LOCALITIES TO ESTABLISH NONPROFIT CORPORATIONS.—

(A) IN GENERAL.—If—

(i) a State law enacted after April 24, 1979, and before June 16, 1979, provides that local governments may establish nonprofit corporations to issue tax-exempt obligations to finance owner-occupied residences,

(ii) pursuant to such State law, a local government establishes such a nonprofit corporation and designates it for purposes of this subsection, and

(iii) on November 7 or 14, 1979, an amount was specified by or for the local government as the maximum amount of obligations which the local government expected the nonprofit corporation to issue with respect to the area under any transitional authority provided by this subtitle,

then the amendments made by section 1102 shall not apply to obligations issued by the nonprofit corporation with respect to the area for which such local government has jurisdiction.

(B) DOLLAR LIMITS.—The aggregate amount of obligations which may be issued with respect to any area by reason of subparagraph (A) may not exceed the amount referred to in subparagraph (A)(iii) which was specified on November 7 or 14, 1979, by or for the local government.

(C) SUBSTITUTION OF HOUSING AUTHORITIES, ETC.—For purposes of applying so much of paragraph (7) as relates to subparagraph (A)—

(i) if the local housing authority had the intent referred to in paragraph (7), such local housing authority shall be substituted for the local government, and

(ii) if the governing body of the local government is a commissioners court, the county judge who was on April 24, 1979, the presiding officer of such court shall be treated as the governing body of such government.

(6) OBLIGATIONS ISSUED UNDER THIS SUBSECTION MUST MEET THE REQUIREMENTS OF SUBSECTION (c)(3).—No obligation may be issued under this subsection unless the issue meets the requirements of subsection (c)(3).

(7) GOVERNING BODY MUST FILE AFFIDAVITS SHOWING INTENT ON APRIL 24, 1979.—No obligation may be issued under this subsection with respect to any area unless a majority of the members of the governing body of the local governmental unit having jurisdiction over that area file affidavits with the Secretary of the Treasury (or his delegate) indicating that it was their intent on April 24, 1979, either that tax-exempt obligations be issued to provide financing for owner-occupied residences or that a program be established to issue such obligations.

(8) LIMITATIONS REDUCED BY CERTAIN OTHER ISSUES.—Any limitation on the amount of obligations which may be issued by any issuer by reason of any paragraph of this subsection shall be reduced by the aggregate amount of obligations which are issued (before, on, or after the issue under this subsection) by local governmental units with respect to the area within the jurisdiction of such issuer after April 24, 1979, and to which the amendments made by this subtitle do not apply solely by reason of subsection (b).

(e) ONGOING LOCAL PROGRAMS FOR REHABILITATION LOANS.—

(1) IN GENERAL.—If before April 25, 1979, a local governmental unit had a qualified rehabilitation loan program, then the amendments made by this subtitle shall not apply to obligations issued by such governmental unit for qualified loans if substantially all of the proceeds of such issue (exclusive of issuance costs and a reasonably required reserve) are committed by firm commitment letters (similar to those used in owner financing not provided by tax-exempt bonds) to qualified loans before January 1, 1981.

(2) LIMITATION.—The aggregate amount of obligations which may be issued by reason of paragraph (1) by local governmental units with respect to the area comprising any local governmental area may not exceed the lesser of—

(A) $10,000,000, or

(B) the aggregate amount of loans made with respect to that area under the qualified rehabilitation loan program during the period beginning on January 1, 1977, and ending on April 24, 1979.

The limitation established by the preceding sentence shall be reduced by the aggregate amount of obligations (if any) which are issued (before, on, or after the issue under this subsection) under the qualified rehabilitation loan program after April 24, 1979, with respect to the same local governmental area and to which the amendments made by this substitle do not apply solely by reason of subsection (b).

(3) QUALIFIED REHABILITATION LOAN PROGRAM.—For purposes of this subsection, the term "qualified rehabilitation loan program" means a program for the financing—

(A) of alterations, repairs, and improvements on or in connection with an existing residence by the owner thereof, but

(B) only of such items as substantially protect or improve the basic livability of the property.

(4) QUALIFIED LOAN.—For purposes of this subsection, the term "qualified loan" means the financing—

(A) of alterations, repairs, and improvements on or in connection with an existing 1 to 4 family residence (1 unit of which is owner-occupied) by the owner thereof, but

(B) only of such items as substantially protect or improve the basic livability of the property.

(5) DOLLAR LIMIT ON QUALIFIED LOANS.—For puropses of this subsection, a loan shall not be treated as a qualified loan if the financing is in an amount which exceeds $20,000 plus $2,500 for each unit in excess of 1.

(f) $50 PER CAPITA EXCEPTION FOR LOCAL GOVERNMENTS.—

(1) IN GENERAL.—To the extent of the limit set forth in paragraph (2), the amendments made by section 1102 shall not apply to mortgage subsidy bonds issued by local governmental units after April 24, 1979.

(2) LIMIT.—

(A) IN GENERAL.—The aggregate amount of obligations issued with respect to any area by reason of paragraph (1) shall not exceed—

(i) the amount equal to the product of $50 and the population of area, reduced by

(ii) the aggregate amount of obligations which are issued (before, on, or after the issue under this subsection) by local governmental units after April 24, 1979, with respect to that area and to which the amendments made by this subtitle do not apply solely by reason of subsections (b), (d), and (e).

(B) DETERMINATION OF POPULATION.—For purposes of subparagraph (A), the population of any area shall be the population as of July 1, 1976, as determined for purposes of the State and Local Fiscal Assistance Act of 1972 [Pub. L. 92-512, 1972-2 C.B. 684].

(3) UNIT MUST ESTABLISH THAT ACTION WAS TAKEN BEFORE APRIL 25, 1979.—Paragraph (1) shall not apply with respect to any obligation issued by any local governmental unit unless—

(A) there is written evidence (which was in existence before April 25, 1979) that before April 25, 1979, the governing body of such local governmental unit had taken action indicating an intent to issue (or to establish a program for issuing) tax-exempt obligations to finance owner-occupied residences,

(B) on October 30, 1979, such local governmental unit had authority to issue obligations to finance owner-occupied residences, and

(C) a majority of the members of the governing body of the local governmental unit file with the Secretary of the Treasury (or his delegate) affidavits that the requirement of such subparagraph (A) is met.

For purposes of subparagraph (A), action of the governing body of a second local governmental unit with respect to the same area shall be treated as action of the issuing governmental unit.

(4) COMMITMENTS. — Paragraph (1) shall not apply with respect to any issue unless such issue meets the requirements of paragraph (3) of subsection (c).

(5) OVERLAPPING JURISDICTIONS.—For purposes of this subsection, if 2 or more local governmental units meet the requirements of paragraph (3) and have authority to issue mortgage subsidy bonds with respect to residences in the same area, only the unit having jurisdiction over the smallest geographical area shall be treated as having issuing authority with respect to such area unless such unit agrees to surrender part or all of the amount permitted under this subsection to the local governmental unit with overlapping jurisdiction which has the next smallest geographical area.

(g) ROLLOVER OF EXISTING TAX-EXEMPT OBLIGATIONS.—

(1) IN GENERAL.—The amendments made by sections 1102 and 1103 shall not apply to the issuance of obligations to refinance for the same purpose tax-exempt indebtedness which was outstanding on April 24, 1979 (or indebtedness which had previously been refinanced pursuant to this subsection), but only if—

(A) on April 24, 1979, there was an agreed on period for the maturity of the mortgages or other financing, and

(B) the new obligations have a maturity date which does not exceed by more than 2 years the agreed on period referred to in subparagraph (A).

(2) AMOUNTS FOR RESERVES, ISSUE COSTS, ETC.—An issue which otherwise meets the requirements of paragraph (1) shall not be treated as failing to meet such requirements solely because the amount of the new indebtedness exceeds the amount of the old indebtedness by such amount as is reasonably necessary to cover construction period interest, reserves, and the costs of issuing the new indebtedness.

(h) SPECIAL RULES FOR PROJECTS UNDER DEVELOPMENT.—

(1) RENTAL HOUSING. — The amendment made by section 1103 shall

not apply to a project which was in the development stage on April 24, 1979, if—

(A) a plan specifying the number and location of rental units was approved on or before such date by a governing body of a State or local government or by a State or local housing agency or similar agency, and

(B) substantial expenditures for site improvement for the project had been incurred on or before such date.

(2) RENTAL HOUSING PROJECTS APPROVED BY SECRETARY OF HUD.—The amendment made by section 1103 shall not apply to a project which was in the development stage on April 24, 1979, if—

(A) a plan specifying the number and location of rental units was preliminarily approved by the Secretary of Housing and Urban Development pursuant to section 221(d)(4) or section 232 of the National Housing Act on or before such date, and

(B) fees for processing the project with the Department of Housing and Urban Development and other expenditures for the project had been incurred on or before such date.

(3) OWNER-OCCUPIED HOUSING.—The amendments made by section 1102 shall not apply to a project which was in the development stage on April 24, 1979, if on or before such date—

(A) substantial expenditures had been made for detailed plans and specifications, and

(B) either tax-exempt construction financing had been issued with respect to the proejct or there is written evidence that a governmental unit intended to issue tax-exempt obligations to finance the acquisition of units by home buyers.

The amendment made by section 1103 shall not apply to construction or other initial temporary financing issued with respect to a project which meets the requirements of the preceding sentence if substantially all of the dwelling units in such project are to be owner-occupied residences.

(4) CERTAIN REDEVELOPMENT MORTGAGE BOND FINANCING PROJECTS.—Subparagraph (B) of paragraph (3) shall be treated as satisfied if, before April 25, 1979—

(A) the developer of a project acquired the land for such project,

(B) there was approval by the mayor's advisory committee of a city of a comprehensive proposal (under a State law authorizing tax-exempt obligations for use only in redevelopment areas) for such project, subject to revisions to be made, and

(C) a revised proposal was submitted to the redevelopment agency and city council containing the revisions.

The aggregate amount of obligations which may be issued by local governmental units with respect to the area comprising any local governmental area by reason of this paragraph may not exceed $20,000,000.

(i) REGISTRATION REQUIREMENTS.—

(1) IN GENERAL.—Notwithstanding any other provision of this section, the amendments made by section 1102 and 1103, insofar as they require obligations to be in registered form, shall apply to obligations issued after December 31, 1981.

(2) BONDS UNDER TRANSITIONAL RULES.—Any obligation issued after December 31, 1981, by reason of this section shall be in registered form.

(j) ADVANCE REFUNDING.—Notwithstanding any other provision of this section—

(1) subsection (n) of section 103A of the Internal Revenue Code of 1954 (as added by section 1102) shall apply to obligations issued after the date of the enactment of this Act to refund obligations issued before, on, or after such date of enactment, and

(2) this section shall not apply to obligations issued after such date of enactment for the advance refunding of obligations issued before, on, or after such date of enactment.

(k) TRANSITIONAL RULE FOR LOW- AND MODERATE-INCOME REQUIREMENT.—In the case of obligations issued after April 24, 1979, and before January 1, 1984, the period for which the low- and moderate-income requirements of section 103(b)(4)(A) of the Internal Revenue Code of 1954 (as amended by section 1103 of this subtitle) is required to be met shall be 20 years.

(l) SUBSTITUTION OF GOVERNMENTAL INSTRUMENTALITY FOR CITY.—

(1) IN GENERAL.—If—

(A) a corporation was created on June 17, 1971, pursuant to State law to provide financing for the construction and rehabilitation of low-income housing,

(B) pursuant to a State law enacted in 1955 a city has made loans to housing developers from the proceeds of short-term bonds and notes issued by the city, and has secured 50-year mortgages from the developers, and

(C) the corporation agrees to acquire from the city certain of the loans referred to in subparagraph (B) by issuing obligations which will be secured by mortgages referred to in subparagraph (B) on 12 projects (11 of which projects are subsidized with interest-reduction subsidies under section 236 of the National Housing Act),

then the amendments made by this subtitle shall not apply to obligations issued by the corporation to acquire the loans (and mortgages) referred to in subparagraph (C).

(2) DOLLAR LIMIT.—The aggregate amount of obligations to which paragraph (1) applies shall not exceed $135,000,000.

(3) TIME LIMIT.—Paragraph (1) shall not apply to any obligation issued after December 31, 1980.

(m) STATE LEGISLATION WAS PENDING ON APRIL 1, 1979, AND ENACTED ON APRIL 26, 1979, WHERE LOCALITY HAD TAKEN ACTION TO UNDERTAKE A STUDY OF LOCAL MORTGAGE MARKET.—

(1) IN GENERAL.—If—

(A) on April 1, 1979, legislation was pending in a State legislature limiting the authority of local governments within such State to issue tax-exempt obligations for owner-occupied resi-

dences under existing home rule authority, and such legislation was enacted on April 26, 1979,

(B) there is written evidence (which was in existence before April 25, 1979) that not earlier than June 1, 1978, but before April 25, 1979, the governing body of a local government in such State had taken action authorizing the undertaking of a demographic or related study of the local mortgage market, which study was intended to serve as a basis for issuance of tax exempt obligations for owner-occupied residences,

(C) on December 20, 1979, an amount was specified by or for the local government as the range of obligations which it expected to issue with respect to the area under any transitional authority provided by the Act, and

(D) a majority of the members of the governing body of the local government certify that the city or county was waiting enactment of the legislation described in subparagraph (A) prior to determining to proceed towards the issuance of tax-exempt obligations for owner-occupied residences,

then the amendments made by section 1102 shall not apply to obligations issued by such city or county.

(2) DOLLAR LIMITS.—The aggregate amount of obligations which may be issued with respect to any area by reason of paragraph (1) may not exceed the maximum amount referred to in paragraph (1)(C) which was specified on December 20, 1979, by or for such local government.

(3) TIME LIMITS.—Paragraph (1) shall not apply with respect to any issue unless substantially all of the proceeds of such issue (exclusive of issuance costs and a reasonably required reserve) are committed by firm commitment letters (similar to those used in owner-financing not provided by tax-exempt bonds) to owner-financing before January 1, 1982.

(n) CERTAIN ADDITIONAL TRANSITIONAL AUTHORITY.—

(1) IN GENERAL.—The amendments made by sections 1102 and 1103 shall not apply to issues described in the following table:

City or county	Ceiling amount	Purpose of issue
Baltimore, Maryland	$100,000,000	Financing owner-occupied residences.
Port Arthur, Texas	175,000,000	For financing on New Town In Town project.
Minneapolis, Minnesota	25,000,000	Financing owner-occupied residences.
Minneapolis-St. Paul, Minnesota	235,000,000	Joint program for financing owner-occupied residences involving some UDAG grants and private financing.
Detroit, Michigan	50,000,000	To issue obligations maturing before 1986 for construction on the Riverfront West project.
Brevard County, Florida	150,000,000	Financing owner-occupied residences.
Chicago, Illinois	235,000,000	For financing on the Presidential Towers project.

(2) ISSUING AUTHORITY.—The authority granted by this subsection with respect to any city or county may be used only by the appropriate issuing authority for that city or county.

(3) CEILING AMOUNT.—The ceiling amount specified in paragraph (1) with respect to any item shall be the maximum aggregate amount of obligations which may be issued by the appropriate issuing authority under the authority granted by such item.

(4) PURPOSE.—The authority under any item may be used to issue obligations only for the purpose set forth in paragraph (1) for such item.

(o) SPECIAL RULE FOR LOANS TO LENDERS PROGRAM.—

(1) IN GENERAL.—In the case of any obligations issued during 1981 or 1982 pursuant to a qualified loans to lender program—

(A) the amendments made by section 1103 shall not apply,

(B) subsection (i) of section 103A of the Internal Revenue Code of 1954 (other than the last sentence of paragraph (1) of such subsection) shall not apply, and

(C) the determination of whether the requirements of subsections (d), (e), (f), (h), (j)(2), and (j)(3) of such section 103A are met with respect to such issue shall be made by taking into account the loans made by the financial institutions with the funds provided by the issue (in lieu of the mortgages acquired from the financial institutions with the proceeds of the issue).

(2) QUALIFIED LOANS TO LENDER PROGRAM.—For purposes of paragraph (1), the term "qualified loans to lender program" means any program established pursuant to legislation enacted by New York State in 1970 which finances the purchase of existing mortgages from financial institutions and requires any money received by a financial institution on the purchase of a mortgage to be reinvested within 90 days in new mortgages.

Subtitle B—Cash Management

SEC. 1111. ESTIMATED INCOME TAX PAYMENTS BY CORPORATIONS.

(a) GENERAL RULE.—Section 6655 of the Internal Revenue Code of 1954 (relating to failure by corporation to pay estimated income tax) is amended by adding at the end thereof the following new subsection:

"(h) LARGE CORPORATIONS REQUIRED TO PAY AT LEAST 60 PERCENT OF CURRENT YEAR TAX.—

"(1) IN GENERAL.—In the case of a large corporation, the amount treated as the estimated tax for the taxable year under paragraphs (1) and (2) of subsection (d) shall in no event be less than 60 percent of—

"(A) the tax shown on the return for the taxable year, or

"(B) if no return was filed, the tax for such year.

"(2) LARGE CORPORATION.—For purposes of this subsection, the term 'large corporation' means any corporation if such corporation (or any predecessor corporation) had taxable income of $1,000,000 or more for any taxable year during the testing period.

"(3) RULES FOR APPLYING PARAGRAPH (2).—

"(A) TESTING PERIOD.—For purposes of this subsection, the term 'testing period' means the 3 taxable years immediately preceding the taxable year involved.

"(B) MEMBERS OF CONTROLLED GROUPS.—For purposes of applying paragraph (2) to any taxable year in the testing period with respect to corporations which are component members of a controlled group of corporations for such taxable year, the $1,000,000 amount specified in paragraph (2) shall be divided among such members under rules similar to the rules of section 1561."

(b) TECHNICAL AMENDMENT.—Subsection (e) of section 6655 of such Code is amended by striking out "subsections (b) and (d)" and inserting in lieu thereof "subsections (b), (d), and (h)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1980.

Subtitle C—Taxation of Foreign Investment in United States Real Property

SEC. 1121. SHORT TITLE.

This subtitle may be cited as the "Foreign Investment in Real Property Tax Act of 1980".

SEC. 1122. TAX ON DISPOSITION OF FOREIGN INVESTMENT IN UNITED STATES REAL PROPERTY.

(a) IN GENERAL.—Subpart C of part II of subchapter N of chapter 1 of the Internal Revenue Code of 1954 (relating to miscellaneous provisions with respect to nonresident aliens and foreign corporations) is amended by adding at the end thereof the following new section:

"SEC. 897. DISPOSITION OF INVESTMENT IN UNITED STATES REAL PROPERTY.

"(a) GENERAL RULE.—

"(1) TREATMENT AS EFFECTIVELY CONNECTED WITH UNITED STATES TRADE OR BUSINESS.—For purposes of this title, gain or loss of a nonresident alien individual or a foreign corporation from the disposition of a United States real property interest shall be taken into account—

"(A) in the case of a nonresident alien individual, under section 871(B)(1), or

"(B) in the case of a foreign corporation, under section 882(a)(1),

as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business.

"(2) 20-PERCENT MINIMUM TAX ON NONRESIDENT ALIEN INDIVIDUALS.—

"(A) IN GENERAL.—In the case of any nonresident alien individual the amount determined under section 55(a)(1)(A) for the taxable year shall not be less than 20 percent of whichever of the following is the least:

"(i) the individual's alternative minimum taxable income (as defined in section 55(b)(1)) for the taxable year,

"(ii) the individual's net United States real property gain for the taxable year, or

"(iii) $60,000.

"(B) NET UNITED STATES REAL PROPERTY GAIN.—For purposes of subparagraph (A), the term 'net United States real property gain' means the excess of—

"(i) the aggregate of the gains for the taxable year from dispositions of United States real property interests, over

"(ii) the aggregate of the losses for the taxable year from dispositions of such interests.

"(b) LIMITATION ON LOSSES OF INDIVIDUALS.—In the case of an individual, a loss shall be taken into account under subsection (a) only to the extent such loss would be taken into account under section 165(c) (determined without regard to subsection (a) of this section).

"(c) UNITED STATES REAL PROPERTY INTEREST.—For purposes of this section—

"(1) UNITED STATES REAL PROPERTY INTEREST.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'United States real property interest' means—

"(i) an interest in real property (including an interest in a mine, well, or other natural deposit) located in the United States, and

"(ii) any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes (at such time and in such manner as the Secretary by regulations prescribes) that such corporation was at no time a United States real property holding corporation during the shorter of—

"(I) the period after June 18, 1980, during which the taxpayer held such interest, or

"(II) the 5-year period ending on the date of the disposition of such interest.

"(B) EXCLUSION FOR INTEREST IN CERTAIN CORPORATIONS.—The term 'United States real property interest' does not include any interest in a corporation if—

"(i) as of the date of the disposition of such interest, such corporation did not hold any United States real property interests, and

"(ii) all of the United States real property interests held by such corporation at any time during the shorter of the periods described in subparagraph (A)(ii)—

"(I) were disposed of in transactions in which the full amount of the gain (if any) was recognized, or

"(II) ceased to be United States real property interests by reason of the

application of this subparagraph to 1 or more other corporations.

"(2) UNITED STATES REAL PROPERTY HOLDING CORPORATION.—The term 'United States real property holding corporation' means any corporation if—

"(A) the fair market value of its United States real property interests equals or exceeds 50 percent of

"(B) the fair market value of—

"(i) its United States real property interests,

"(ii) its interests in real property located outside the United States, plus

"(iii) any other of its assets which are used or held for use in a trade or business.

"(3) EXCEPTION FOR STOCK REGULARLY TRADED ON ESTABLISHED SECURITIES MARKETS.—If any class of stock of a corporation is regularly traded on an established securities market, stock of such class shall be treated as a United States real property interest only in the case of a person who, at some time during the shorter of the periods described in paragraph (1)(A)(ii), held more than 5 percent of such class of stock.

"(4) INTERESTS HELD BY FOREIGN CORPORATIONS AND BY PARTNERSHIPS, TRUSTS, AND ESTATES.—For purposes of determining whether any corporation is a United States real property holding corporation—

"(A) FOREIGN CORPORATIONS.—Paragraph (1)(A)(ii) shall be applied by substituting 'any corporation (whether foreign or domestic)' for 'any domestic corporation'.

"(B) INTERESTS HELD BY PARTNERSHIPS, ETC.—United States real property interests held by a partnership, trust, or estate shall be treated as owned proportionately by its partners or beneficiaries.

"(5) TREATMENT OF CONTROLLING INTERESTS.—

"(A) IN GENERAL.—Under regulations, for purposes of determining whether any corporation is a United States real property holding corporation, if any corporation (hereinafter in this paragraph referred to as the 'first corporation') holds a controlling interest in a second corporation—

"(i) the stock which the first corporation holds in the second corporation shall not be taken into account,

"(ii) the first corporation shall be treated as holding a portion of each asset of the second corporation equal to the percentage of the fair market value of the stock of the second corporation represented by the stock held by the first corporation, and

"(iii) any asset treated as held by the first corporation by reason of clause (ii) which is used or held for use by the second corporation in a trade or business shall be treated as so used or held by the first corporation.

Any asset treated as held by the first corporation by reason of the preceding sentence shall be so treated for purposes of applying the preceding sentence successively to corporations which are above the first corporation in a chain of corporations.

"(B) CONTROLLING INTEREST.—For purposes of subparagraph (A), the term 'controlling interest' means 50 percent or more of the fair market value of all classes of stock of a corporation.

"(6) OTHER SPECIAL RULES.—

"(A) INTEREST IN REAL PROPERTY.—The term 'interest in real property' includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

"(B) REAL PROPERTY INCLUDES ASSOCIATED PERSONAL PROPERTY.—The term 'real property' includes movable walls, furnishings, and other personal property associated with the use of the real property.

"(C) CONSECUTIVE OWNERSHIP RULES.—For purposes of determining under paragraph (3) whether any person holds more than 5 percent of any class of stock and of determining under paragraph (5) whether a person holds a controlling interest in any corporation, section 318(a) shall apply (except that paragraphs (2)(C) and (3)(C) of section 318(a) shall be applied by substituting '5 percent' for '50 percent').

"(d) TREATMENT OF DISTRIBUTIONS.—

"(1) DISTRIBUTIONS.—

"(A) IN GENERAL.—Except to the extent otherwise provided in regulations, notwithstanding any other provision of this chapter, gain shall be recognized by a foreign corporation on the distribution (including a distribution in liquidation or redemption) of a United States real property interest in an amount equal to the excess of the fair market value of such interest (as of the time of the distribution) over its adjusted basis.

"(B) EXCEPTION WHERE THERE IS A CARRYOVER BASIS.—Subparagraph (A) shall not apply if the basis of the distributed property in the hands of the distributee is the same as the adjusted basis of such property before the distribution increased by the amount of any gain recognized by the distributing corporation.

"(2) SECTION 337 NOT TO APPLY.—Section 337 shall not apply to any sale or exchange of a United States real property interest by a foreign corporation.

"(e) COORDINATION WITH NONRECOGNITION PROVISIONS.—

"(1) IN GENERAL.—Except to the extent otherwise provided in subsection (d) and paragraph (2) of this subsection, any nonrecognition provision shall apply for purposes of this section to a transaction only in the case of an exchange of a United States real property interest for an interest the sale of which would be subject to taxation under this chapter.

"(2) REGULATIONS.—The Secretary shall prescribe regulations (which are necessary or appropriate to prevent the avoidance of Federal income taxes) providing—

"(A) the extent to which nonrecognition provisions shall, and shall not, apply for purposes of this section, and

"(B) the extent to which—

"(i) transfers of property in reorganization, and

"(ii) changes in interests in, or distributions from, a partnership, trust, or estate,

shall be treated as sales of property at fair market value.

"(3) NONRECOGNITION PROVISION DEFINED.—For purposes of this subsection, the term 'nonrecognition provision' means any provision of this title for not recognizing gain or loss.

"(f) DISTRIBUTIONS BY DOMESTIC CORPORATIONS TO FOREIGN SHAREHOLDERS.—If a domestic corporation distributes a United States real property interest to a nonresident alien individual or a foreign corporation in a distribution to which section 301 applies, notwithstanding any other provision of this chapter, the basis of such United States real property interest in the hands of such nonresident alien individual or foreign corporation shall not exceed—

"(1) the adjusted basis of such property before the distribution, increased by

"(2) the sum of—

"(A) any gain recognized by the distributing corporation on the distribution, and

"(B) any tax paid under this chapter by the distributee on such distribution.

"(g) SPECIAL RULE FOR SALES OF INTEREST IN PARTNERSHIPS, TRUSTS, AND ESTATES.—Under regulations prescribed by the Secretary, the amount of any money, and the fair market value of any property, received by a nonresident alien individual or foreign corporation in exchange for all or part of its interest in a partnership, trust or estate shall, to the extent attributable to United States real property interests, be considered as an amount received from the sale or exchange in the United States of such property.

"(h) SPECIAL RULES FOR REITS.—For purposes of this section—

"(1) LOOK-THROUGH OF DISTRIBUTIONS.—Any distribution by a REIT to a nonresident alien individual or a foreign corporation shall, to the extent attributable to gain from sales or exchanges by the REIT of United States real property interests, be treated as gain recognized by such nonresident alien individual or foreign corporation from the sale or exchange of a United States real property interest.

"(2) SALE OF STOCK IN DOMESTICALLY-CONTROLLED REIT NOT TAXED.—The term 'United States real property interest' does not include any interest in a domestically-controlled REIT.

"(3) DISTRIBUTIONS BY DOMESTICALLY-CONTROLLED REITS.—In the case of a domestically-controlled REIT, rules similar to the rules of subsection (d) shall apply to the foreign ownership percentage of any gain.

"(4) DEFINITIONS.—

"(A) REIT.—The term 'REIT' means a real estate investment trust.

"(B) DOMESTICALLY-CONTROLLED REIT.—The term 'domestically-controlled REIT' means a REIT in which at all times during the testing period less than 50 percent in value of the stock was held directly or indirectly by foreign persons.

"(C) FOREIGN OWNERSHIP PERCENTAGE.—The term 'foreign ownership percentage' means that percentage of the stock of the REIT which was held (directly or indirectly) by foreign persons at the time during the testing period during which the direct and indirect ownership of stock by foreign persons was greatest.

"(D) TESTING PERIOD.—The term 'testing period' means whichever of the following periods is the shortest:

"(i) the period beginning on June 19, 1980, and ending on the date of the disposition or of the distribution, as the case may be,

"(ii) the 5-year period ending on the date of the disposition or of the distribution, as the case may be, or

"(iii) the period during which the REIT was in existence.

"(i) ELECTION BY FOREIGN CORPORATION TO BE TREATED AS DOMESTIC CORPORATION.—

"(1) IN GENERAL.—If—

"(A) a foreign corporation has a permanent establishment in the United States, and

"(B) under any treaty, such permanent establishment may not be treated less favorably than domestic corporations carrying on the same activities,

then such foreign corporation may make an election to be treated as a domestic corporation for purposes of this section and section 6039C.

"(2) REVOCATION ONLY WITH CONSENT.—Any election under paragraph (1), once made, may be revoked only with the consent of the Secretary.

"(3) MAKING OF ELECTION.—An election under paragraph (1) may be made only subject to such conditions as may be prescribed by the Secretary."

(b) CLERICAL AMENDMENT.—The table of sections for such subpart C is amended by adding at the end thereof the following new item:

"SEC. 897. Disposition of investment in United States real property."

(c) CROSS REFERENCES.—

(1) Subsection (g) of section 871 of such Code (relating to tax on income of nonresident alien individuals) is amended by adding at the end thereof the following new paragraph:

"(8) For special tax treatment of gain or loss from the disposition by a nonresident alien individual of a United States real property interest, see section 897."

(2) Subsection (a) of section 882 of such Code (relating to tax on income of foreign corporation connected with United States business) is amended by adding at the end thereof the following new paragraph:

"(3) For special tax treatment of gain or loss from the disposition by a foreign corporation of a United States real property interest, see section 897."

SEC. 1123. REPORTING REQUIREMENTS.

(a) GENERAL RULE.—Subpart A of part III of chapter 61 of the Internal Revenue Code of 1954 (relating to information returns concerning persons subject to special provisions) is amended by inserting after section 6039B the following new section:

"SEC. 6039C. RETURNS WITH RESPECT TO UNITED STATES REAL PROPERTY INTERESTS.

"(a) RETURN OF CERTAIN DOMESTIC CORPORATIONS HAVING FOREIGN SHAREHOLDERS.—

"(1) GENERAL RULE.—

"(A) RETURN REQUIREMENT.—If this subsection applies to a domestic corporation for the calendar year, such corporation shall make a return for the calendar year setting forth—

"(i) the name and address (if known by the corporation) of each person who was a shareholder at any time during the calendar year and who is known by the corporation to be a foreign person,

"(ii) such information with respect to transfers of stock in such corporation to or from foreign persons during the calendar year as the Secretary may by regulations prescribe, and

"(iii) such other information as the Secretary may by regulations prescribe.

"(B) CORPORATIONS TO WHICH SUBSECTION APPLIES.—This subsection applies to any domestic corporation for the calendar year if—

"(i) at any time during the calendar year 1 or more of the shareholders of such corporation is a foreign person, and

"(ii) at any time during the calendar year or during any of the 4 immediately preceding calendar years, such corporation was a United States real property holding corporation (as defined in section 897(c)(2)).

"(2) SUBSECTION DOES NOT APPLY TO PUBLICLY TRADED CORPORATIONS.—This subsection shall not apply to a corporation the stock of which is regularly traded on an established securities market at all times during the calendar year.

"STOCK HELD BY NOMINEES.—If—

"(A) a nominee holds stock in a domestic corporation for a foreign person, and

"(B) such foreign person does not furnish the information required to be furnished pursuant to paragraph (1)(A) with respect to such stock,

the nominee shall file a return under this subsection with respect to such stock.

"(b) RETURN OF CERTAIN PERSONS HOLDING UNITED STATES REAL PROPERTY INTERESTS.—

"(1) RETURN REQUIREMENT.—If any entity to which this subsection applies has at any time during the calendar year a substantial investor in United States real property, such entity shall make a return for the calendar year setting forth—

"(A) the name and address of each such substantial investor,

"(B) such information with respect to the assets of the entity during the calendar year as the Secretary may by regulations prescribe, and

"(C) such other information as the Secretary may by regulations prescribe.

"(2) EXCEPTION WHERE SECURITY FURNISHED.—This subsection shall not apply to any entity for the calendar year if such entity furnishes to the Secretary such security as the Secretary determines to be necessary to ensure that any tax imposed by chapter 1 with respect to United States real property interests held by such entity will be paid.

"(3) STATEMENTS TO BE FURNISHED TO SUBSTANTIAL INVESTOR IN UNITED STATES REAL PROPERTY.—Every entity making a return under paragraph (1) shall furnish to each substantial investor in United States real property a statement showing—

"(A) the name and address of the entity making such return,

"(B) such substantial investor's pro rata share of the United States real property interests held by such entity, and

"(C) such other information as the Secretary shall be regulations prescribe.

"(4) DEFINITIONS.—For purposes of this subsection—

"(A) ENTITIES TO WHICH THIS SUBSECTION APPLIES.—This subsection shall apply to any foreign corporation and to any partnership, trust, or estate (whether foreign or domestic).

"(B) SUBSTANTIAL INVESTOR IN UNITED STATES REAL PROPERTY.—

"(i) IN GENERAL.—The term 'substantial investor in United States real property' means any foreign person who at any time during the calendar year held an interest in the entity but only if the fair market value of such person's pro rata share of the United States real property interests held by such entity exceeded $50,000.

"(ii) SPECIAL RULE FOR CORPORATIONS.—In the case of any foreign corporation, clause (i) shall be applied by substituting 'person (whether foreign or domestic)' for 'foreign person'.

"(C) INDIRECT HOLDINGS.—The assets of any entity to which this subsection applies shall include its pro rata share of the United States real property interests held by any corporation in which the entity is a substantial investor in United States real property.

"(c) RETURN OF CERTAIN FOREIGN PERSONS HOLDING DIRECT INVESTMENTS IN UNITED STATES REAL PROPERTY INTERESTS.—

"(1) RETURN REQUIREMENT.—If this subsection applies to any foreign person for the calendar year, such person shall make a return for the calendar year setting forth—

"(A) the name and address of such person,

"(B) a description of all United States real property interests held by such person at any time during the calendar year, and

"(C) such other information as the Secretary may by regulations prescribe.

"(2) PERSONS TO WHOM THIS SUBSECTION APPLIES.—This subsection applies to any foreign person for the calendar year if—

"(A) such person did not engage in a trade or business in the United States at any time during the calendar year,

"(B) the fair market value of the United States real property interests held by such person at any time during such year equals or exceeds $50,000, and

"(C) such person is not required to file a return under subsection (b) of such year.

"(d) DEFINITIONS.—For purposes of this section—

"(1) UNITED STATES REAL PROPERTY INTEREST.—The term 'United

States real property interest' has the meaning given to such term by section 897(c).

"(2) FOREIGN PERSON.—The term 'foreign person' means any person who is not a United States person."

"(e) SPECIAL RULES.—

"(1) ATTRIBUTION OF OWNERSHIP.—For purposes of subsection (b)(4) and (c)(2)(B)—

"(A) INTERESTS HELD BY PARTNERSHIPS, ETC.—United States real property interests held by a partnership, trust, or estate shall be treated as owned proportionately by its partners or beneficiaries.

"(B) INTERESTS HELD BY FAMILY MEMBERS.—United States real property interests held by the spouse or any minor child of an individual shall be treated as owned by such individual.

"(2) RETURNS, ETC.—All returns, statements, and information required to be made or furnished under this section shall be made or furnished at such time and in such manner as the Secretary shall by regulations prescribe."

(b) PENALTY FOR FAILURE TO FILE RETURN, ETC.—Section 6652 of such Code (relating to failure to file certain information returns, registration statements, etc.) is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

"(g) RETURNS, ETC., REQUIRED UNDER SECTION 6039C.—

"(1) IN GENERAL.—In the case of each failure—

"(A) to make a return required by section 6039C which contains the information required by such section, or

"(B) to furnish a statement required by section 6039C(b)(3),

on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not to willful neglect, the amount determined under paragraph (2) shall be paid (upon notice and demand by the Secretary and in the same manner as tax) by the person failing to make such return or furnish such statement.

"(2) AMOUNT OF PENALTY.—For purposes of paragraph (1), the amount determined under this paragraph with respect to any failure shall be $25 for each day during which such failure continues.

"(3) LIMITATIONS.—

"(A) FOR FAILURE TO MEET REQUIREMENTS OF SUBSECTION (A) OR (B) OF SECTION 6039C.—The amount determined under paragraph (2) with respect to any person for failing to meet the requirements of subsection (a) or (b) of section 6039C for any calendar year shall not exceed $25,000 with respect to each such subsection.

"(B) FOR FAILURE TO MEET REQUIREMENTS OF SECTION 6039C(c).—The amount determined under paragraph (2) with respect to any person for failing to meet the requirements of subsection (c) of section 6039C for any calendar year shall not exceed the lesser of $25,000 or 5 percent of the aggregate of the fair market value of the United States real property interests owned by such person at any time during such year. For purposes of the preceding sentence, fair market value shall be determined as of the end of the calendar year (or, in the case of any property disposed of during the calendar year, as of the date of such disposition)."

(c) CLERICAL AMENDMENT.—The table of sections for subpart A of part III of chapter 61 of such Code is amended by inserting after the item relating to section 6039B the following new item:

"SEC. 6039C. Returns with respect to United States real property interests."

SEC. 1124. SOURCES WITHIN UNITED STATES.

Paragraph (5) of subsection (a) of section 861 of the Internal Revenue Code of 1954 (relating to income from sources within the United States) is amended to read as follows:

"(5) DISPOSITION OF UNITED STATES REAL PROPERTY INTEREST.—Gains, profits, and income from the disposition of a United States real property interest (as defined in section 897(c))."

SEC. 1125. EFFECTIVE DATE.

(a) IN GENERAL.—Except as provided in subsection (b), the amendments made by this subtitle shall apply to dispositions after June 18, 1980.

(b) REPORTING.—The amendments made by section 1123 shall apply to 1980 and subsequent calendar years. In applying such amendments to 1980, such calendar year shall be treated as beginning on June 19, 1980, and ending on December 31, 1980.

(c) SPECIAL RULE FOR TREATIES.—

(1) IN GENERAL.—Except as provided in paragraph (2), after December 31, 1984, nothing in section 894(a) or 7852(d) of the Internal Revenue Code of 1954 or in any other provision of law shall be treated as requiring, by reason of any treaty obligation of the United States, an exemption from (or reduction of) any tax imposed by section 871 or 882 of such Code on a gain described in section 897 of such Code.

(2) SPECIAL RULE FOR TREATIES RENEGOTIATED BEFORE 1985.—If—

(A) any treaty (hereinafter in this paragraph referred to as the "old treaty") is renegotiated to resolve conflicts between such treaty and the provisions of section 897 of the Internal Revenue Code of 1954, and

(B) the new treaty is signed before January 1, 1985,

then paragraph (1) shall be applied with respect to obligations under the old treaty by substituting for "December 31, 1984" the date (not later than 2 years after the new treaty was signed) specified in the new treaty (or accompanying exchange of notes).

(d) ADJUSTMENT IN BASIS FOR CERTAIN TRANSACTIONS BETWEEN RELATED PERSONS.—

(1) IN GENERAL.—In the case of any disposition after December 31, 1979, of a United States real property interest (as defined in section 897(c) of the Internal Revenue Code of 1954) to a related person (within the meaning of section 453(f)(1) of such Code), the basis of the interest in the

hands of the person acquiring it shall be reduced by the amount of any nontaxed gain.

(2) NONTAXED GAIN.—For purposes of paragraph (1), the term "nontaxed gain" means any gain which is not subject to tax under section 871(b)(1) or 882(a)(1) of such Code—

(A) because the disposition occurred before June 19, 1980, or

(B) because of any treaty obligation of the United States.

Subtitle D—Credit Against Crude Oil Windfall Profit Tax for Royalty Owners

SEC. 1131. CREDIT AGAINST CRUDE OIL WINDFALL PROFIT TAX FOR ROYALTY OWNERS.

(a) CREDIT AGAINST WINDFALL PROFIT TAX FOR ROYALTY OWNERS.—

(1) IN GENERAL.—Subchapter B of chapter 65 of the Internal Revenue Code of 1954 (relating to rules of special application for abatements, credits, and refunds) is amended by adding at the end thereof the following new section:

"SEC. 6429. CREDIT AND REFUND OF CHAPTER 45 TAXES PAID BY ROYALTY OWNERS.

"(a) TREATMENT AS OVERPAYMENT.—In the case of a qualified royalty owner, that portion of the tax imposed by section 4986 which is paid in connection with qualified royalty production shall be treated as an overpayment of the tax imposed by section 4986.

"(b) CREDITS AND REFUNDS.—

"(1) IN GENERAL.—Under regulations prescribed by the Secretary, any amount treated as an overpayment of tax under subsection (a) shall be credited against the tax imposed by section 4986 or refunded to the qualified royalty owner.

"(2) CLAIM FOR CREDIT OR REFUND.—Any claim for credit or refund under this section shall be filed in such form and manner, and at such time, as the Secretary may prescribe by regulations.

"(c) $1,000 LIMITATION ON CREDIT OR REFUND.—

"(1) IN GENERAL.—The aggregate amount which may be treated as an overpayment under subsection (a) with respect to any qualified royalty owner shall not exceed $1,000.

"(2) ALLOCATION WITHIN A FAMILY.—In the case of individuals who are members of the same family (within the meaning of section 4992(e)(3)(C)) at any time during the qualified period, the $1,000 amount in paragraph (1) shall be reduced for each such individual by allocating such amount among all such individuals in proportion to their respective qualified royalty production.

"(3) ALLOCATION BETWEEN CORPORATIONS AND INDIVIDUALS.—

"(A) IN GENERAL.—In the case of an individual who owns at any time during the qualified period stock in a qualified family farm corporation, the $1,000 amount in paragraph (1) applicable to such individual shall be reduced by the amount which bears the same ratio to the credit or refund allowable to the corporation under this section (determined after the application of paragraph (4)) as the fair market value of the shares owned by such individual during such period bears to the fair market value of all shares of the corporation.

"(B) SPECIAL RULE FOR FAMILY MEMBERS.—In the case of individuals who are members of the same family (within the meaning of section 4992(e)(3)(C)) at any time during the qualified period—

"(i) for purposes of subparagraph (A), all such individuals shall be treated as 1 individual, and

"(ii) the amount allocated among such individuals under paragraph (2) shall be $1,000, reduced by the amount determined under subparagraph (A).

"(4) ALLOCATION BETWEEN CORPORATIONS.—If at any time after June 24, 1980, any individual owns stock in two or more qualified family farm corporations, the $1,000 amount in paragraph (1) shall be reduced for each such corporation by allocating such amount among all such corporations in proportion to their respective qualified royalty production.

"(d) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) QUALIFIED ROYALTY OWNER.—The term 'qualified royalty owner' means a producer (within the meaning of section 4996(a)(1)), but only if such producer is an individual, an estate, or a qualified family farm corporation.

"(2) QUALIFIED ROYALTY PRODUCTION.—The term 'qualified royalty production' means, with respect to any qualified royalty owner, taxable crude oil which—

"(A) is attributable to an economic interest of such royalty owner other than an operating mineral interest (within the meaning of section 614(d)), and

"(B) is removed from the premises during the qualified period.

"(3) QUALIFIED PERIOD.—The term 'qualified period' means the period beginning March 1, 1980, and ending December 31, 1980.

"(4) QUALIFIED FAMILY FARM CORPORATION.—The term 'qualified family farm corporation' means a corporation—

"(A) which was in existence on June 25, 1980,

"(B) all of the outstanding shares of stock of which at all times after June 24, 1980, and before January 1, 1981, were held by members of the same family (within the meaning of section 2032A(e)(2)), and

"(C) 80 percent in value of the assets of which (other than royalty interests described in paragraph (2)(A)) were held by the corporation on such date for use for farming purposes (within the meaning of section 2032A(e)(5)).

"(e) CROSS REFERENCE.—

"For the holder of the economic interest in the case of a production payment, see section 636."

(2) TECHNICAL AND CONFORMING AMENDMENTS.—The table of sections for subpart B of chapter 65 of such Code is amended by adding at the end thereof the following new item:

"SEC. 6429. Credit and refund of chapter 45 taxes paid by royalty owners."

(d) DENIAL OF DEDUCTION.—

(1) IN GENERAL.—Part IX of subchapter B of chapter 1 of such Code (relating to items not deductible) is amended by adding at the end thereof the following new section:

"SEC. 280D. PORTION OF CHAPTER 45 TAXES FOR WHICH CREDIT OR REFUND IS ALLOWABLE UNDER SECTION 6429.

"No deduction shall be allowed for that portion of the tax imposed by section 4986 for which a credit or refund is allowable under section 6429."

(2) CONFORMING AMENDMENT.—The table of sections for part IX of subchapter B of chapter 1 of such Code is amended by adding at the end thereof the following new item:

"SEC. 280D. Portion of chapter 45 taxes for which credit or refund is allowable under section 6429."

(3) EFFECTIVE DATE.—The amendments made by this subsection shall apply to taxable years ending after February 29, 1980.

Subtitle E—Inclusion in Wages for Purposes of Social Security and Unemployment Taxes of Employer

SEC. 1141. INCLUSION IN WAGES OF EMPLOYEE TAXES PAID BY EMPLOYER.

(a) SOCIAL SECURITY TAX.—

(1) AMENDMENT OF INTERNAL REVENUE CODE OF 1954.—Paragraph (6) of section 3121(a) of the Internal Revenue Code of 1954 (defining wages) is amended to read as follows:

"(6) the payment by an employer (without deduction from the remuneration of the employee)—

"(A) of the tax imposed upon an employee under section 3101, or

"(B) of any payment required from an employee under a State unemployment compensation law,

with respect to remuneration paid to an employee for domestic service in a private home of the employer or for agricultural labor;".

(2) AMENDMENT OF SOCIAL SECURITY ACT.—Subsection (f) of section 209 of the Social Security Act is amended to read as follows:

"(f) The payment by an employer (without deduction from the remuneration of the employee)—

"(1) of the tax imposed upon an employee under section 3101 of the Internal Revenue Code of 1954, or

"(2) of any payment required from an employee under a State unemployment compensation law,

with respect to remuneration paid to an employee for domestic service in a private home of the employer or for agricultural labor;".

(b) FEDERAL UNEMPLOYMENT TAX.—Paragraph (6) of section 3306(b) of the Internal Revenue Code of 1954 (defining wages) is amended to read as follows:

"(6) the payment by an employer (without deduction from the remuneration of the employee)—

"(A) of the tax imposed upon an employee under section 3101, or

"(B) of any payment required from an employee under a State unemployment compensation law,

with respect to remuneration paid to an employee for domestic service in a private home of the employer or for agricultural labor;".

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply with respect to remuneration paid after December 31, 1980.

(2) EXCEPTION FOR STATE AND LOCAL GOVERNMENTS.—

(A) The amendments made by this section (insofar as they affect the application of section 218 of the Social Security Act) shall not apply to any payment made before January 1, 1984, by any governmental unit for positions of a kind for which all or a substantial portion of the social security employee taxes were paid by such governmental unit (without deduction from the remuneration of the employee) under the practices of such governmental unit in effect on October 1, 1980.

(B) For purposes of subparagraph (A), the term "social security employee taxes" means the amount required to be paid under section 218 of the Social Security Act as the equivalent of the taxes imposed by section 3101 of the Internal Revenue Code of 1954.

(C) For purposes of subparagraph (A), the term "Governmental unit" means a State or political subdivision thereof within the meaning of section 218 of the Social Security Act.

Subtitle F—Telephone Tax

SEC. 1151. TELEPHONE TAX CONTINUED AT 2 PERCENT FOR 1981.

(a) IN GENERAL.—The table contained in paragraph (2) of section 4251(a) of the Internal Revenue Code of 1954 (relating to imposition of tax on communication services) is amended by striking out the last 2 lines of such table and inserting in lieu thereof the following:

"During 1980 or 1981 ---------- 2
During 1982 ---------- 1".

(b) CONFORMING AMENDMENT.—Subsection (b) of section 4251 of such Code is amended by striking out "January 1, 1982" and inserting in lieu thereof "January 1, 1983".

* * * * *

Approved December 5, 1980.

House Report No. 96-1167 2d Session

[Bracketed numerals indicate official report page numbers]

OMNIBUS RECONCILIATION ACT OF 1980

JULY 21, 1980.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. GIAIMO, from the Committee on the Budget, submitted the following report to accompany H.R. 7765.[1]

* * * * *

[1] Public Law 96-499, page 509.

COMMITTEE ON EDUCATION AND LABOR

(Title II)

* * * * *

GUARANTEED STUDENT LOAN PROGRAM—SUBTITLE C

Committee Action

* * * * *

[26] The Committee believes that the consequences of mandating a spending reduction of $350 million in the Guaranteed Student Loan program were not understood by those who made this decision. The Committee rejects denying the availability of Guaranteed Student Loans to 2 million students in fiscal year 1981.

Therefore the Committee provides instead the proposals described below to achieve spending reductions. Two proposals aim at reducing default claims in fiscal year 1981. The first of these provides for reporting student loan defaulters to credit bureaus. This proposal is included in H.R. 5192 as passed by both the House and the Senate. This bill reauthorizes and amends the programs contained in the Higher Education Act of 1965. The proposal is fully described in the Committee reports accompanying H.R. 5192 and S. 1839. The second of these proposals makes the current mailing addresses of student loan defaulters available to the holders of student loans from the Internal Revenue Service. This proposal is identical to H.R. 4155 as passed by the House on June 17, 1980 and is more fully described in the report accompanying that bill.

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COMMITTEE ON WAYS AND MEANS

Titles VIII and IX

II. SUMMARY

* * * * *

[356] B. TITLE IX: REVENUE INCREASES

1. MORTGAGE SUBSIDY BOND TAX ACT OF 1980

Title IX includes the provisions of the Mortgage Subsidy Bond Tax Act of 1980 which is designed generally to direct the subsidy from the use of tax-exempt bonds for housing to those individuals who have the greatest need for the subsidy, to increase the efficiency of the subsidy, and to restrict the overall revenue loss from the use of tax-exempt bonds for housing.

a. Single-Family Owner-Occupied Residences

Except in the case of a qualified mortgage bond or a qualified veterans' mortgage bond, interest on any bond is not tax-exempt if a significant portion of the proceeds are to be used for mortgages (or other financing) of owner-occupied residences.

(1) Qualified mortgage bonds

(*a*) *Principal residence requirement*

All mortgages must be for single family residences which can reasonably be expected to become the principal residences of the mortgagors. The residences must be located within the jurisdiction of the issuing authority.

(*b*) *Three-year requirement*

Each mortgagor must not have been a homeowner within the last 3 years. However, exceptions to the 3-year rule are provided for rehabilitation loans, for home improvement loans, and for mortgages placed in targeted areas.

A loan qualifies as a rehabilitation loan if the residence is at least 20 years old at the time of the rehabilitation, 75 percent or more of the external walls of the residence are retained, and the rehabilitation costs are 25 percent or more of the mortgagor's basis in the residence (after the rehabilitation).

Home improvement loans are loans in an amount not in excess of $15,000 for certain alterations or repairs for existing single family residences.

(*c*) *Income limitations*

The income of each mortgagor must not exceed 115 percent of the median family income in the Standard Metropolitan Statistical Area (SMSA), or county, if not in an SMSA, in which the mortgage is placed. In the case of financing provided under any issue for targeted area residences, one-third of the residences in targeted areas financed from the issue may be for any mortgagor regardless of his income. With respect to the remainder of the residences located within targeted areas, the income of the mortgagor cannot exceed 140 percent of median [357] family income for the State or the SMSA where the residence is located, whichever is higher. Both in targeted and non-targeted areas, 50 percent of the mortgage funds must go to families with incomes of 90 percent or less of the median family income in the SMSA.

(*d*) *Targeted areas*

Targeted areas are defined as follows:

(1) census tracts in which 70 percent of the families have incomes of not more than 80 percent of statewide median income, or

(2) areas of chronic economic distress as defined by States subject to the approval of the Secretaries of Treasury and Housing and Urban Development. Criteria used by Treasury and HUD to evaluate a proposed targeted area designation are: (1) the condition of the housing stock, including age and number of abandoned and substandard units, (2) the need of area residents for owner-financing, as indicated by a high percentage of families in poverty, low per capita income, high numbers of welfare recipients, and high unemployment rates, (3) the potential for use of tax-exempt mortgage bonds to improve conditions in the area, and (4) the existence of a housing assistance plan which provides a displacement program and a public improvements and services program (similar to that required by HUD under its Community Development Block Grant program).

(*e*) *Purchase price limitation*

The purchase price of each residence must not exceed 80 percent of the average purchase price in the preceding year in the SMSA in which the mortgage is placed. In the case of targeted areas, the percentage would be

110 percent of the average purchase price in the SMSA. Average purchase price means average purchase price of a new home, in the case of a purchase of a new home, and average purchase price of an existing home, in the case of the purchase of an existing home. In the case of home improvement loans, the purchase price limitation would not apply.

(*f*) *New mortgage requirement*

Except for construction period loans, bridge loans or similar temporary initial financing, and an existing mortgage in the case of a rehabilitation loan, none of the bond proceeds can be used to acquire or replace an existing mortgage.

(*g*) *Low downpayment requirement*

At least 75 percent of the lendable proceeds (other than for rehabilitation loans and home improvement loans) must be used for mortgages which have a 95-percent loan to value ratio. In addition, certain graduated payment mortgages with as low as a 90-percent loan to value ratio will qualify for purposes of the 75-percent requirement.

(*h*) *Assumptions of mortgages*

Individuals assuming a mortgage originally financed with tax-exempt bonds must meet the principal residence requirement, the three-year requirement, the purchase price limitation, and the income limitation.

[358] (*i*) *Market limitations*

The total amount of housing bonds that could be issued in a State each year would be limited to the greater of $50,000,000 or 5 percent of the average of all mortgages originated in that State in the preceding 3 years. The limit is to be allocated among governmental units within a State first on the basis of mortgages originated in the smallest jurisdiction having authority to issue housing bonds. This allocation can be changed by agreement among issuing subdivisions or by State statute.

(*j*) *Required targeted portion*

If an issuing jurisdiction includes a targeted area, at least 20 percent of the lendable proceeds of a bond issue (but no more than 40 percent of the market share of the targeted areas) must be made available for one year for mortgage loans in the targeted areas in the issuing jurisdiction.

(*k*) *Multiple originators' requirement*

There must be more than one person who originates mortgages from the bond proceeds, unless there is only one willing and able originator or there is a sound public purpose for using only one originator.

(*l*) *Bond issue approval*

All bonds must be submitted to a State agency for the agency's opinion as to whether or not the issue meets the market limitation and targeted portion requirement. The State agency must issue an opinion within 30 days after submission.

(*m*) *Arbitrage restrictions*

The effective interest rate on mortgages to homeowners is limited to 1.0 percentage point above the yield to maturity to the purchasers of the bonds, calculated on the date of issuance. In addition, arbitrage is not permitted on reserves that exceed 150 percent of the annual debt service on the bonds. Finally, arbitrage earnings other than the 1.0 percentage point on home mortgages must be returned to the mortgagors.

(*n*) *Termination*

The issuance of single family, owner-occupied housing bonds will be permitted under the above rules only for 2 years from the date of enactment. Interest on such bonds issued after this 2-year period will be taxable.

(*o*) *Miscellaneous*

All tax-exempt housing bonds issued after the date of enactment must be in registered form. No advance refunding of mortgage subsidy bonds will be permitted after the date of enactment.

(2) Qualified veterans' mortgage bonds

(*a*) *Residences for veterans*

Substantially all of the proceeds from the bonds must be used to provide residences for veterans.

[359] (*b*) *New mortgage requirement*

Except for construction period loans, bridge loans or similar temporary initial financing, and an existing mortgage where the residence is substantially rehabilitated, none of the proceeds of the bonds can be used to replace or acquire an existing mortgage.

(*c*) *General obligation requirement*

Both the principal and interest of the bond must be secured by the general obligation of a State.

(*d*) *Miscellaneous*

All qualified veterans' mortgage bonds issued after the date of enactment must be in registered form. No advance refunding of these bonds will be permitted after the date of enactment.

(3) Effective date and transitional rules

General rule.—The bill applies to bonds issued after April 24, 1979, with eight exceptions:

(*a*) *Official action*

Tax-exempt housing bonds may be issued without complying with the requirements of a qualified mortgage bond if, prior to April 25, 1979, the governing body of the unit having authority to issue the bonds had taken official action which indicated an intent to issue such bonds. A qualifying official action would include an authorization to hire bond counsel, an authorization to hire bond underwriters, or an authorization to make a market analysis with respect to a specified bond issue. Such authorization must be a specific authorization relating to a specified bond issue.

In the case of a sized or tentatively sized bond issue, only the amount of

bonds the issued reasonably intended to issue based on the documentation that existed before April 25, 1979, will qualify under this rule.

In the case of an unsized bond issue, only an amount of bonds (exclusive of issuance costs and a reasonably required reserve) equal to the amount of mortgages for which the lenders had given firm commitments to home buyers within 9 months after the bonds are issued will qualify under this rule. Bond proceeds for which commitments were not made within 9 months from the issuance date of the bonds must be used to redeem bonds. The uncommitted proceeds must be used to redeem obligations within 15 months of the issuance date.

(b) Exception for State housing finance agencies

The bill also provides a special exemption for State housing finance agencies which permit such an agency to issue up to $150 million of tax-exempt indebtedness even though it took no action prior to April 25, 1979. However, the $150 million is reduced by any tax-exempt indebtedness issued under the official action rule for owner-occupied housing by any State housing finance agency within a State which provides owner financing from the proceeds of tax-exempt obligations. In addition, substantially all of the lendable proceeds from the bond issue must be committed by firm commitment letters to home buyers by January 1, 1981.

[360] *(c) Special rules*

The bill contains five special rules which provide that the restrictions on owner-occupied housing do not apply to certain obligations. Each of these rules is subject to dollar limitations. Each of these rules requires that affidavits be filed by a majority of the members of the governing body of the governmental unit in order to qualify under the rule. In addition, substantially all of the lendable proceeds from each bond issue that requires any of these special rules must be committed by firm commitment letters to home buyers by January 1, 1981.

(d) Rehabilitation programs

Tax-exempt indebtedness may be issued without complying with the requirements of a qualified mortgage bond with certain limitations in the case of certain ongoing local governmental programs which provide rehabilitation loans. The maximum amount of tax-exempt indebtedness that can be issued under this rule is the lesser of $10 million or the aggregate amount of loans made under a qualified rehabilitation program from January 1, 1977 until April 24, 1979. This amount is reduced by any indebtedness issued under the official action rule. In addition, substantially all of the lendable proceeds of the indebtedness issued under this rule must be committed by firm commitment letters to home owners by January 1, 1981.

(e) $50 per capita exception for local governments

Tax-exempt housing bonds may be issued without complying with the requirements of a qualified mortgage bond: (1) if there is written evidence that, prior to April 24, 1979, the governing body of the issuing local governmental unit had taken action indicating an intent to issue (or establish a program for issuing) owner-occupied housing bonds, (2) the local government unit had authority to issue such bonds by October 30, 1979, and (3) the majority of the members of the governing body of the local governmental unit file affidavits that the governmental unit intended to issue tax-exempt housing bonds (or establish a program to issue tax-exempt housing bonds). The maximum amount that qualifies under this rule is $50 multiplied by the population in the local governmental unit reduced by the amount of any obligations for owner-occupied housing issued under the other transition rules.

(f) Rollover rule

Tax-exempt indebtedness outstanding on April 24, 1979, may be rolled-over where the maturity date of the tax-exempt housing bond is no longer than 2 years after the life of the initial mortgages on the properties.

(g) Special rule for projects under development

Tax-exempt housing bonds for the financing of projects in the development stage may be issued where, prior to April 25, 1979, (1) substantial expenditures had been made for detailed plans and specifications, and (2) tax-exempt construction financing had been issued with respect to the project or there exists written evidence that a governmental unit intended to issue tax-exempt bonds to finance the acquisition of the unit by home buyers.

[361] *(h) Rule for local governments whose home rule powers were modified on April 26, 1979*

The bill contains an additional rule which provides that the restrictions on owner-occupied housing do not apply to obligations issued by certain local governments whose home rule powers were modified on April 26, 1979. This rule applies where prior to April 25, 1979, the governing body of a local government had authorized a demographic or related study, but was waiting enactment of the legislation modifying its home rule powers prior to issuing tax-exempt housing bonds. Under this rule, substantially all the lendable proceeds of a bond issue must be committed by firm commitment letters to home buyers by January 1, 1981.

b. Multi-Family Rental Housing

(1) Applicable rules

(a) General rules

The present exception for tax-exempt industrial development bonds will be limited to obligations from which substantially all the proceeds are to be used for multi-family rental housing projects in which at least 20 percent of the units are to be occupied by individuals of low or moderate income, determined in a manner con-

sistent with the Leased Housing Program under Section 8 of the United States Housing Act of 1937. In the case of bonds issued before January 1, 1981 (which do not come within the transitional rules), the 20-percent requirement need only be met for a period of 20 years.

(*b*) *Miscellaneous*

All tax-exempt housing bonds issued after the date of enactment must be in registered form.

(2) Effective date and transitional rules

General rule.—The bill applies to bonds issued after April 24, 1979, with three exceptions:

(*a*) *Official action*

Tax-exempt housing bonds may be issued without complying with the requirements of the bill if, prior to April 25, 1979, the governing body of the unit having authority to issue the bonds had taken official action which indicated an intent to issue such bonds. A qualifying official action would include an authorization to hire bond counsel, an authorization to hire bond underwriters, or an authorization to make a market analysis with respect to a specified bond issue. Such authorization must be a specific authorization relating to a specified bond issue.

In the case of a sized or tentatively sized bond issue, only the amount of bonds the issuer reasonably intended to issue based on the documentation that existed before April 25, 1979, will qualify under this rule.

(*b*) *Rollover rule*

Tax-exempt indebtedness outstanding on April 24, 1979, may be rolled-over where the maturity date of the tax-exempt housing bonds [362] is no longer than 2 years after the life of the initial mortgages on the properties.

(*c*) *Special rule for projects under development*

Tax-exempt housing bonds for financing of projects in the development stage may be issued if a plan specifying the number and location of rental units was approved on or before April 24, 1979, by a governing body of a State or local government or a governing body of a State or local housing agency or a similar agency, and substantial expenditures for site improvement for the project had been incurred on or before such date.

As an alternative to this rule, tax-exempt indebtedness may be issued for projects if, prior to April 25, 1979, a plan specifying the number and location of rental units was preliminarily approved by the Secretary of HUD pursuant to section 221(d)(4) or section 232 of the United States Housing Act of 1937 and fees for the processing of the project application and other expenditures had been incurred on or before April 24, 1979.

2. ESTIMATED INCOME TAX PAYMENTS BY LARGE CORPORATIONS

Title IX requires large corporations to pay estimated taxes equal to at least 60 percent of their current year's tax liability, effective for taxable years beginning after December 31, 1980.

Corporations subject to this new requirement are those corporations (including any predecessor corporations) which had taxable income of $1 million or more in any of the three taxable years immediately preceding the taxable year involved.

* * * * *

[363] 4. TELEPHONE EXCISE TAX

Title IX delays by one year the remaining scheduled reductions in the communication services (telephone, etc.) excise tax. Thus, for 1980 and 1981, the tax will be 2 percent. For 1982, the tax will be 1 percent, and the tax will expire on January 1, 1983.

[364] 5. FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT OF 1980

Under present law, capital gains realized by foreign investors on the sale of U.S. property are generally not subject to U.S. tax unless the property is held in connection with a U.S. trade or business.

Title IX includes the provisions of the Foreign Investment in Real Property Tax Act of 1980 which subject foreign investors to U.S. tax on gains on the sale or other disposition of U.S. real property. Foreign investors also will be taxed on gains realized through the sale or exchange of an interest in a corporation, trust, or partnership formed or availed of to hold U.S. real property interests. Reporting requirements are established to identify when taxable transactions have occurred. Title IX contains no withholding provisions—neither the purchaser of the property nor any U.S. agent is required to withhold any tax from the seller or to take any other action to ensure that the foreign seller pays the tax due on the sale.

The provision is effective for sales or other dispositions of U.S. real property interests occurring after June 18, 1980. However, to the extent that a provision conflicts with a U.S. treaty obligation, the provision will not take effect until 1985.

6. INCLUSION IN WAGES OF SOCIAL SECURITY AND UNEMPLOYMENT TAXES PAID BY EMPLOYERS

Title IX provides that an employer payment of an employee's social security or unemployment tax liability (except with respect to domestic service) is includible in wages for purposes of social security and unemployment insurance taxes and social security benefits. Except in cases of employment by certain State or local governmental units, the provision applies with respect to remuneration paid after December 31, 1980. The provision applies with respect to payments by certain State or local governmental units after December 31, 1983.

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III. EXPLANATION OF PROVISIONS

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[430] 3. SUBTITLE C: UNEMPLOYMENT COMPENSATION SAVINGS

a. Termination of Provision Providing Federal Reimbursement From the FUBA Account for Unemployment Benefits Paid To CETA Workers (Sec. 891)

Present Law and Background

The Comprehensive Employment and Training Act (CETA) requires that all persons employed in CETA public service jobs be provided unemployment benefits under the same conditions, and to the same extent, as other employees doing the same type of work. Any unemployment compensation benefits paid to former CETA workers are initially paid out of the State unemployment insurance trust fund. The State is then reimbursed from general revenues contained in the Federal Unemployment Benefit Account (FUBA) for the amount of the unemployment compensation that was based on CETA public service employment. This Federal reimbursement was provided under P.L. 94-444, the Emergency Jobs Program Extension Act of 1976, which amended the Emergency Jobs and Unemployment Assistance Act of 1974 (P.L. 93-567).

Reasons for Change

It is the position of the Committee that the cost of unemployment benefits based on CETA employment should be borne by the CETA program.

Explanation of Provision

The provision terminates Federal reimbursement to States from the FUBA account for unemployment compensation benefits paid to former CETA workers. Title II of the Emergency Jobs and Unemployment Assistance Act of 1974 (P.L. 93-567), which provides such reimbursement, is amended to provide that the term "public service wages" does not include remuneration for service performed in weeks which begin after October 1, 1980.

The Committee assumes that there will be no change in the CETA law requiring CETA workers to have the same unemployment com-[431]pensation protection as other workers. Rather, it is assumed that States will be reimbursed for such benefits from CETA grants to prime sponsors.

Effective Date

The provision is effective for services performed in weeks which begin after October 1, 1980.

b. Increase in Length of Service in Armed Forces Required of Ex-Military Personnel for Purposes of Unemployment Benefits (Sec. 892)

Present Law and Background

Under present law, Federally funded unemployment benefits are provided to former military personnel upon their separation from military service if they meet the qualifying requirements of the State in which they apply for unemployment compensation. The military service of the individual qualifies as wages or employment in the determination of eligibility under the State unemployment compensation law only if (1) the person had served continuously for 90 days or more prior to separation and (2) the individual was separated under other than dishonorable or bad-conduct circumstances. If the individual meets these requirements, the entire period of military service can be counted when determining whether the individual meets the wages or employment qualifications of the State in which he or she files an application for benefits. The 90-day continuous service requirement does not apply where separation was the result of the service-incurred injury or disability.

Reason for Change

In recent years, the number of persons leaving the military before their term of enlistment has expired has been on the increase. Questions have been raised about the number of individuals who serve shortened terms of service on the presumption that unemployment compensation will be available to them after only 90 days of active duty. It is the Committee's position that unemployment compensation should be available only to those persons who have completed a more lengthy period of service.

Explanation of Provision

Title VIII changes the present 90-day continuous service requirement to 365 days.

Effective Date

The provision is effective for individuals who begin active service after October 1, 1980.

c. Termination of Extended Unemployment Insurance Benefits When Paid Under an Interstate Claim in a State Where the Unemployment Level Has Not Triggered the Extended Benefits Period (Sec. 893)

[432] Present Law and Background

In general, States pay unemployment benefits up to a maximum of 26 weeks. In times of high unemployment, the Federal-State extended unemployment compensation program becomes effective. Under the extended benefits program, up to a maximum of 13 additional weeks of benefits are payable to individuals who exhaust regular benefits. This extended benefits program goes into effect on a State-by-State basis if the insured unemployment rate (IUR) in a State reaches a specified level, or in all States if the national IUR exceeds a specified level.

Under present law, a State is required to pay unemployment benefits to individuals who meet the State qualifying requirements even if they are or become residents of another State. If an individual works and qualifies for benefits in a State in which the extended benefits program

is in effect, the State will be required to pay him such benefits (so long as he or she meets the eligibility requirements for such benefits) even if the individual changes residence to a State in which the extended benefits program is not in effect because unemployment in the new State of residence has not reached the extended benefits trigger level.

In general, an individual obtains benefits in a new State by filing an interstate claim under an interstate benefit payment plan against the State in which the individual earned his or her wages.

Reasons for Change

The purpose of the extended benefits program is to provide additional protection to individuals in States with high unemployment by providing those individuals with additional time to find a job. The Committee believes that this additional protection should be provided only to unemployed individuals actually residing in a State with high unemployment.

Explanation of Provision

Title VIII terminates the payment of extended benefits to an individual who changes his or her residence to a State in which such benefits are not being paid because unemployment in the new State has not reached the extended benefit trigger level. Specifically, title VIII terminates an individual's eligibility for extended benefits after he or she has collected two weeks of extended benefits through an interstate claim under an interstate benefit payment plan. The provision does not change other conditions of eligibility or benefit computation that may differ between the two States. Further, the individual will continue to be eligible for regular State unemployment compensation benefits for which he or she qualified in his or her former State of residence.

The intent of the provision is to deny extended benefits to those persons who earn their qualifying wages in one State, move to a State in which the extended benefits program is not in effect, and then file an interstate claim under an interstate benefit payment plan against the first State based upon wages or employment in that State. It is not intended to apply to individuals who have worked in two or more [433] States and file an interstate claim for purposes of combining the wages or employment in those States in order to qualify for benefits under the law of the paying State.

Effective Date

The provision applies to weeks of unemployment beginning after October 1, 1980. However, the provision will not become a requirement of State law for any week which begins before June 1, 1981. Where a State legislature does not meet in 1981 in a regular session which begins before April 1, 1981, the provision is not to be a requirement of State law until June 1, 1982.

[434] B. TITLE IX. REVENUE INCREASES

1. SUBTITLE A: MORTGAGE SUBSIDY BOND TAX ACT OF 1980 [1]

Present Law

(1) Tax-exempt bonds generally

Under present law (Code sec. 103), interest on State and local governmental bonds generally is exempt from Federal income taxation. In contrast, interest on virtually all Federal debt obligations is subject to Federal income taxation. However, in order for the interest on a State or local government bond to qualify for tax exemption, the bond must satisfy certain restrictions placed on the use of its proceeds. One statutory restriction applies to industrial development bonds. Another restriction is the arbitrage provision.

(2) Industrial development bonds (IDBs)

(*a*) *General*

Present law restricts the use of industrial development bonds (IDBs) issued by State and local governments. Prior to 1968, interest on State and local government bonds was exempt from Federal income taxation regardless of the manner in which the governmental unit used the proceeds of its bonds. As a result, State and local governments could issue bonds for the benefit of private industries, that is, industrial development bonds. Such bonds typically were used to finance industrial plants. In the case of an IDB, the State or local government [435] would purchase the facility and either lease or sell (on an installment basis) the facility to a for-profit corporation for the amount needed to pay the interest and amortize the principal on the bond. Usually, the State or local government assumed no liability for payment of the bonds. Instead, payment of the interest and principal was guaranteed from the lease or installment sales contract.

In 1968, in response to the widespread use of industrial development bonds, concern over their potentially adverse effect on interest rates on traditional State and local government obligations, Federal revenues, and interstate competition for the location of new industrial plants, Congress substantially restricted the uses for which tax-exempt industrial development bonds could be issued. Under current law (Code sec. 103(b)), interest on industrial bonds is taxable,[2] with certain exceptions.

(*b*) *Housing bonds*

One exception to the general rule

[1] The Committee on Ways and Means previously reported the provisions of the Mortage Subsidy Bond Tax Act of 1980 as H.R. 5741 (H. Rept. 96-678). The House of Representatives passed H.R. 5741 on March 26, 1980.

[2] Under Code section 103(b), a State or local government obligation is an industrial development bond if all or a major portion of the proceeds are to be used directly or indirectly in a trade or business of a person (other than a State or local governmental unit or a tax-exempt organization) and payment of principal or interest on the obligation is secured by an interest in, or derived from payment with respect to, property used in a trade or business.

of taxability of interest on industrial development bonds is for industrial development bonds used to provide residential property for family units (Code sec. 103(b)(4)(A)).[3] The explanation of this exception in the legislative history of the Revenue and Expenditure Control Act of 1968 makes no distinction between multi-family rental housing and single-family owner-occupied residences. However, at that time, tax-exempt bonds generally were not being issued for single-family residences.

Under this exception, State and local governments currently are allowed to issue tax-exempt bonds for rental housing if the housing is owned and operated by a private party. Since the bond proceeds are used in the trade or business of a private party and the interest and principal are paid by that trade or business, the bonds are industrial development bonds. Nonetheless, interest on these bonds is exempt from Federal income taxation because of the special treatment afforded to industrial development bonds for residential real property for family units. The exemption applies regardless of whether the rental units are leased to low, moderate or high income individuals. However, bond proceeds may not be used to provide housing facilities used on a transient basis, such as a hotel.

State and local governments may also issue tax-exempt bonds for rental housing if the facilities are owned and operated by a governmental unit or a tax-exempt organization. Such bonds are not industrial development bonds because the proceeds are used in a trade or business of an exempt person. As a result, interest on the bonds is exempt from Federal income taxation under the general rule of Code section 103(a). As is the case with industrial development bonds for [436] rental housing, the exemption applies regardless of whether the rental units are leased to low, moderate or high income individuals.

State and local governments are also permitted, under current law, to issue tax-exempt bonds for owner-occupied housing. Both tax-exempt industrial development bonds and bonds which some have considered to be tax-exempt under the general rule of Code section 103(a) have been issued under State and local governments' owner-occupied housing programs. In both instances, the State or local government will issue a bond and lend the bond proceeds to private individuals, at a higher interest rate than that on the bonds, for the purchase or rehabilitation of homes. In general, the procedure used to direct the bond proceeds to individual borrowers will determine whether the bond is an industrial development bond. In addition, whether the bond is a tax-exempt industrial development bond or a tax-exempt bond under the general rule of Code section 103(a), the exemption applies regardless of whether the mortgage loan recipients are low, moderate, or high income individuals.

(3) Arbitrage restrictions

Present law also restricts the tax-exempt use of arbitrage bonds (Code sec. 103(c)). Prior to the enactment of section 103(c) in 1969, it was unclear whether State and local governments could earn profits solely by virtue of their ability to issue tax-exempt bonds. The opportunity to earn such profits arose because the exemption from Federal income tax of the interest on State and local government bonds allowed State and local governments to issue bonds at low interest rates. It was argued by some that the bond proceeds could then, in turn, be invested in taxable securities paying higher interest rates. The differential in interest rates represented a profit to the issuer, commonly referred to as arbitrage.

In 1969, in order to clarify present law and because of Congress' concern that arbitrage bonds represented indirect subsidies to State and local governments, that arbitrage bonds prevented taxation of interest on Treasury obligations where arbitrage bonds proceeds were invested in Treasury obligations and that arbitrage bonds increased interest rates on tax-exempt obligations generally, Congress enacted legislation designed to prohibit the use of tax-exempt bonds for the purpose of generating arbitrage. Sec. 601(a) of the Tax Reform Act of 1969 provided that interest on arbitrage bonds[4] was not exempt from Federal income tax. Under that provision, with two exceptions, bond proceeds may not be invested in securities which pay a materially higher yield than the bonds. The first exception provides that bond proceeds placed in a reasonable reserve account may be invested in securities which pay a higher yield. The second exception provides [437] that bond proceeds may be invested in higher yield securities for a temporary period until such proceeds are needed for the purpose for which the bond was issued.

The regulations under section 103(c) provide three basic rules in determining whether the return on investments is materially higher than the yield on the bonds. The general rule of the regulations allows an issuer to acquire securities with a yield of ⅛ of 1 percentage point higher than the yield of the bonds. This provision is enforced through the denial of tax exemption to a bond the proceeds of which are reasonably expected to be invested in securities on which the yield exceeds the yield on the bond by more than ⅛ of 1 percentage point.

In addition to the ⅛ of 1 percentage point arbitrage, an issuer is

[3] In addition to housing, exempt activities include sports facilities, convention or trade show facilities, airports, docks, and wharves, solid waste disposal facilities, air and water pollution control facilities, and several other activities.

[4] Arbitrage bonds are defined as obligations the proceeds of which are reasonably expected to be used to purchase securities which pay a yield materially higher than the yield on the State or local government obligations. Arbitrage bonds are also defined as obligations the proceeds of which are reasonably expected to be used to replace funds which were used to acquire higher yield securities. The effect of the provision is to limit the investment yield on securities acquired by a State or local government with the proceeds of its own obligations.

also allowed in certain circumstances to recover administrative costs through arbitrage. Current Treasury regulations allow the recovery of such costs by excluding them from the computation of the yield on the obligations acquired with bond proceeds, if such obligations are acquired to carry out the purpose of the governmental program for which bonds are issued. Thus, in the case of an owner-occupied housing program, administrative costs paid by the mortgagor as a part of each mortgage payment are not taken into account in determining the yield on the mortgage notes (i.e., the obligations acquired with the bond proceeds). As a result of this rule, the interest rate on mortgages acquired with bond proceeds may exceed the actual interest rate on the bonds by one-eighth of 1 percentage point plus the amount necessary to recover administrative costs.

In the case of mortgage bonds, administrative costs are defined as: (1) the cost of issuing (such as attorneys' fees, printing costs and other similar costs), carrying, or repaying the bond; (2) the underwriters' discount; and (3) the cost of purchasing, carrying, and selling or redeeming the mortgage bonds. The cost of carrying mortgage bonds has been interpreted by some as including costs which relate to the operation of the mortgage loan program. Such costs, known as program costs, include servicing fees paid to a savings and loan association, bank or mortgage lender, organization fees paid to such entities, special insurance costs, and any other costs relating to the mortgage loans.

Under present law, no restrictions or limitations have been placed on the total amount of administrative costs which may be passed on to the mortgagor.[5] In addition, administrative costs which relate to bond proceeds placed in reserve accounts have customarily been charged to mortgagors. In other words, a mortgaor will typically be required to pay the administrative costs with respect to the bonds used to provide funds for the mortgage loan and the administrative costs with respect to the bonds used to establish a reserve account. These administrative costs are recovered either by requiring the [438] mortgagor to pay the costs at the time of purchase or by increasing the stated interest rate on the mortgage loans.[6]

As indicated above, State and local governments also are able to earn arbitrage under the temporary period and reserve account exceptions to the arbitrage rules. The temporary period exception allows the issuer to invest the entire amount of the bond proceeds without restriction on the yield until the proceeds are needed for home mortgage loans. Treasury regulations provide that a temporary period is the 3-year period beginning on the date of issuance provided the issuer proceeds with due diligence in expending the bond proceeds for their stated purpose.

In addition to the arbitrage under the temporary period exception, an issuer is also able to earn substantial arbitrage under the reserve account exception. That rule allows an issuer to establish a reasonably required reserve account with bond proceeds. Unless the issuer can demonstrate to the IRS that a higher amount is reasonable, the account may not exceed 15 percent of the original face amount of the bonds. Under present law, an issuer is entitled to an unrestricted yield on obligations purchased with those bond proceeds placed in a reserve account.[7]

Under present law, an issuer generally is not required to reduce the size of the reserve accounts as the bonds or mortgages are retired. As a result, the ratio of the mortgage reserve account and debt service account to the actual monthly mortgage payments and to the actual debt service payment on the bonds will increase above 150 percent. Similarly, the ratio of the reserve account to the total outstanding bonds will increase above 15 percent.[8]

[439] Present law also places no restrictions on the use of the arbitrage generated from mortgage loans, or from temporary period and reserve account investments. In some instances, these profits will be used to provide interest rebates to mortgagors. However, in most instances, these profits will revert to the issuers.

[5] As a result of the absence of any limitation or restrictions on issuance costs, the total cost relating to the issuance of bonds and relating to the operation of the mortgage loan program will increase the effective interest rate on a mortgage loan by 1.00 to 1.50 percentage points. Typically, ⅓ of the increases will reflect issuance costs and ⅔ of the increase will reflect program costs.

[6] In a typical transaction, a mortgagor will be required to pay an origination fee, an insurance charge and a participation fee at the time he purchases a house. The amounts which are customarily referred to as points increase the effective interest rate on the mortgage loan by approximately 0.6 percentage point. In addition, a servicing fee to the lending institution which services the mortgages, additional insurance fees and other fees are required to be paid by the mortgagor as part of his monthly payment on the mortgage loan. These costs are included in the stated interest rate on the mortgage loan. As a result of the ability of the issuer to recover the costs by requiring them to be paid by the mortgagor, the effective interest rate on mortgages will exceed the yield on the bonds by approximately 1.125 to 1.625 percentage points.

[7] In a typical single-family housing bond program, the reserve accounts will be 12 to 13 percent of the original face amount of the bond. Customarily, issuers will establish 2 reserve accounts from bond proceeds. The first reserve account is referred to as the mortgage reserve fund. This reserve will generally equal 150 percent of the regularly scheduled monthly payments due on all the mortgage loans. This reserve is designed to provide funds to pay the debt service on the bonds in the event that a major portion of the mortgagors are delinquent on their mortgage payments for the entire month. It also provides a defense in the case of defaults during the time necessary to recover insurance on the mortgage or to liquidate the security for the mortgage. The second reserve, referred to as the debt service reserve fund, will be equal to 150 percent of the highest annual debt service payable on the bonds at the time of issuance. This reserve account is designed to provide funds to pay the debt service on the bonds in the event of an unusually high number of defaults or delinquencies on the mortgage loans.

[8] For example, in a typical program, one-half of the mortgages can reasonably be expected to be retired by the end of 12 years because of prepayments. This, in turn, will cause a portion of the bonds to be retired at the end of 12 years (approximately one-half of the bonds). However, the reserve accounts will remain at their original levels and the bonds used to fund these accounts will remain outstanding for the remainder of the maturity of the bonds.

In addition to the general rule which limits the yield on mortgage loans made with bond proceeds to ⅛ of 1 percentage point plus administrative costs, present law provides two alternative rules.

The first alternative provides that bond proceeds may not be invested in mortgage loans on which the yield exceeds the yield on the bonds by more than ½ of 1 percentage point. The effect of this rule is to limit the amount of arbitrage an issuer may obtain to ½ of 1 percentage point. An issuer which elects to use this alternative rule is, however, not entitled to invest the bond proceeds for a temporary period at an unlimited yield. Thus, all bond proceeds may only be invested in securities (including mortgages) on which the yield exceeds the yield on the bond by ½ of 1 percentage point or less. As with the ⅛ of 1 percentage point rule, administrative costs may be recovered in addition to the permitted arbitrage so that the issuer's arbitrage cannot exceed ½ of 1 percentage point plus an amount necessary to reimburse the issuer for administrative costs. An issuer which elects this ½ of 1 percentage point rule is also allowed to invest bond proceeds placed in a reasonable reserve at an unrestricted yield.

In lieu of the general rule (i.e., ⅛ of 1 percentage point) or the first alternative rule (i.e., ½ of 1 percentage point), an issuer may use a second alternative rule which limits the yield on the securities acquired with bond proceeds to 1½ percentage points above the yield on the bonds. This rule is a special rule that may be used only where the proceeds of the bonds are used to finance governmental programs. Under the 1½ percentage rule, program costs must be recovered by the issuer from this spread rather than added to the permitted spread. In addition to the arbitrage on mortgage loans, an issuer is also allowed to invest the entire bond proceeds at an unrestricted yield under the temporary period rule. Moreover, bond proceeds placed in a reasonable reserve account may be invested in securities at an unrestricted yield.

Background on the Use of Tax-Exempt Bonds for Owner-Occupied Housing

(1) Description of an owner-occupied housing bond program

(*a*) *General*

In a typical housing bond program, a State or local government will issue a revenue bond for the purpose of making low-interest mortgage loans for single-family homes. The lower tax-exempt interest rates on the bonds allow the State or local government to relend the bond proceeds to individuals at approximately one or two percentage points below conventional home mortgage interest rates. The bonds are repaid from the mortgage payments collected from the individual homeowner-mortgagors.

Generally, the sole security for the bonds is the pool of mortgage loans made with the bond proceeds and reserve accounts established [440] from the bond proceeds.[1] In addition, private insurers and the Federal government, through its VA and FHA programs, typically insure repayment of the mortgages and, thus indirectly, the bonds. Usually, there is no general obligation for repayment on the part of the issuing State or local government.

Mortgage loans are typically made through lending institutions.[2] These institutions also service the loans. Loan applicants must satisfy the credit criteria established for the program. A commercial trustee will generally act as trustee of the repayment proceeds and make interest and principal payments to bondholders. Usually, the issuing government's primary role is issuing the bonds and establishing guidelines for eligibility for mortgage loans.

Guidelines for eligibility for mortgage loans under existing mortgage subsidy bond programs have differed for each issuing governmental unit. Usually, these programs limit participation to low- and moderate-income individuals. However, the definition of low to moderate income has been subject to different meanings for each issuer. Some jurisdictions have conducted bond-financed urban renewal and community development programs in which no income restrictions were placed upon participants.

(*b*) *Certain new construction programs*

In addition to making mortgage money available to home purchasers, some State and local governments operate programs that provide low-interest loans to single-family housing developers. Under such a program, the governmental agency will make construction period loans to developers. Typically, the loan proceeds are obtained through the use of short-term tax-exempt notes. In order to qualify for such loans, developers are usually required to construct single-family housing which will be sold to individuals meeting the issuer's income eligibility requirements.

The short-term notes used to provide construction period loans are industrial development bonds since the note proceeds are used in the trade or business of the developers. However, the notes are tax exempt under the exception for industrial development bonds for residential real property for family units.

In certain instances, a program which provides construction period loans to developers has been combined with a program which provides mortgage loans to home purchasers. In such instances, the State or local government will also issue long-term tax-exempt bonds for owner-occupied

[1] Typically, 12 to 13 percent of the bond proceeds are placed in a reserve account. For example, for a $100 million bond issue, $12 to $13 million of the proceeds would be placed in a reserve account. Under the section 103(c) arbitrage rules, bond proceeds placed in a reasonable reserve account (but generally not more than 15 percent) may be invested at an unlimited yield.

[2] Some State housing agencies and at least one local housing agency originate and service their own loans.

housing and designate that the bond proceeds are to be used to provide mortgage loans for the particular housing units constructed by the participating developers. Typically, the bond proceeds [441] will be reloaned to home purchasers through one of the procedures described below.

(c). Relending procedures

Three procedures are generally used to funnel bond proceeds to individuals under an owner-occupied housing program. Under each procedure, the State or local government will issue bonds and lend the proceeds to private individuals for the purchase or rehabilitation of homes. One procedure, commonly called the loan to lenders procedure, involves the use of tax-exempt industrial development bonds and the other two procedures, commonly called the agency procedure and the forward commitment mortgage purchase procedure, involve the use of tax-exempt bonds which are generally not considered to be industrial development bonds.

Loans to lenders procedure

Under the loans to lenders procedure, a State or local government issues bonds and lends the bond proceeds to lending institutions which in turn use the proceeds to finance home mortgage loans. The issuing government agency typically will require that the lending institutions offer mortgage loans at a stipulated interest rate. Additionally, the government agency may establish income eligibility requirements and other restrictions on the loans. The bonds are industrial development bonds since the proceeds are used in the trade or business of the lending institutions. However, the interest on these bonds is exempt from Federal income taxation as a result of the special treatment afforded to industrial development bonds for residential real property for family units.

Agency procedure

Under the agency procedure, bond proceeds are made available for mortgage loans through one or more lending institutions which originate mortgage loans as an agent of the issuer. The issuing government agency determines the interest rates that will be paid by the mortgagors on the loans, as well as the income eligibility criteria, if any, for obtaining a loan. In addition, other restrictions such as purchase price and mortgage ceilings may be imposed. Since the bond proceeds generally are not considered to be used in a trade or business but for the purchase of homes by private individuals, the bonds have not been considered to be industrial development bonds.

Forward commitment mortgage purchase procedure

Under the forward commitment mortgage purchase procedure, lending institutions originate mortgage loans and then sell them to the bond issuer under pre-existing purchase commitments. In effect, the issuer uses the bond proceeds to provide a secondary mortgage market for the lending institutions. Typically, the purchase commitment agreement includes criteria as to the type and amount of the mortgages that will be purchased by the issuer. In addition, the issuer may impose income limitations on mortgagors. Since the bond proceeds are generally not considered to be used in a trade or business of a private [442] party, but for the purchase of mortgage loans, the bonds are not considered to be industrial development bonds.

(d) Factors relating to marketing the bonds

The effectiveness of an owner-occupied housing program will depend on the ability of an issuer to effectively market its bonds at a low interest rate. The mortgage rate charged to individual borrowers typically will be from 1 to 2 percentage points above the interest rate the issuer must pay on the bond issue. Thus, to reduce monthly payments for home buyers, the issuer must obtain a favorable interest rate on the bonds. The rate will, in turn, depend on two factors: the prevailing overall market rate and the rating the bond receives from a rating agency.

In rating a bond issue, a rating agency is generally concerned with three factors: the quality and composition of the mortgage pool that provides collateral for the bonds, the level of collateralization of the bonds, and the treatment of mortgage prepayments.

The quality and composition of the mortgage pool depends on whether the loans are for single family, one to four family, or condominium type properties. It will also depend on loan to value ratios and whether the loans are FHA insured, VA guaranteed, or are conventional loans that are privately insured. Additionally, it will depend upon the past record of the lending institutions which originate and service the loans as well as the financial condition of the borrowers.

To obtain a high quality mortgage pool, a program will be structured so that a mortgage pool contains a substantial portion of loans to moderate or high income homebuyers. Additionally, it will require favorable loan to value ratios which will generally result in a downpayment by the homebuyers in excess of 5 percent.

The level of collateralization of the bonds, i.e., the degree to which the bonds are secured by reserves or mortgages, is generally 95 to 97 percent of the face amount of the bonds. This shortfall results from the underwriting discount and cost of issuance which are paid directly out of bond proceeds. The shortfall will generally be from 3 to 5 percent of the total amount of the bond issue.

One method of making up the shortfall is through the arbitrage earned on the reserve accounts established with a portion of the bond proceeds. Although the arbitrage rules (Code sec. 103(c)), in general, preclude the investment of bond proceeds in materially higher yielding securities, issuers have been able to invest reserves in materially higher-yielding securities as a result of an exception to the arbitrage rules which does not apply those

rules to reasonable reserve accounts. The reserves will generally be 12 to 15 percent of the bond proceeds. If arbitrage profits are not ultimately needed to meet debt service charges, they are typically distributed to the issuing government or split in some fashion between the issuing government and participating lenders.

The shortfall also may be made up through the use of participation fees. These fees are paid by the borrowers at the time they close on their home purchases. In some cases, these fees have been as high as 3½ points.

The final consideration in structuring a bond issue is the treatment of mortgage prepayments. Bond issues may either be structured to [443] require the prepayment to be used to call a portion of the bonds or to be reinvested in additional mortgages. One method of decreasing the volume of prepayments is to allow loan assumptions.

(2) State and local government restrictions on tax-exempt bonds for owner-occupied housing

(a) State programs

The first consideration in any mortgage subsidy bond program is whether any State constitutional prohibition prevents the lending of State credit in such programs. In many States, the courts have ruled that the financing of low- and moderate-income housing is a permissible use of State credit. In some States, the financing of housing for any income group has been upheld on the grounds that housing itself is a public purpose. Absent a constitutional prohibition, State programs are generally established under statutes creating a State housing finance agency authorized to issue bonds.

(b) Local programs

Whether State law permits a local government to issue housing bonds generally depends on specific statutory authorization; the absence of a law prohibiting the bond issues is not sufficient. Exceptions to this rule include such States as Delaware, Illinois, and Kansas, in which localities have the power under home rule provisions to issue mortgage bonds.

The most common type of State authorizing statute is an industrial or economic development revenue bond law. These have been used in Colorado and West Virginia, among others. In many States, these laws have been amended to specifically include residential real property for family units. In other States, such as Louisiana and Oklahoma, mortgage bonds are issued under the authority of public trust laws. Separate authorities, or public trusts, are set up to issue bonds for the benefit of the city or State involved. Finally, there are a number of miscellaneous laws in various States. The State of Minnesota has authorized several cities, including Minneapolis, to exercise the same powers in housing finance as the Minnesota Housing Finance Agency. In California, bond issues are authorized to finance housing in designated redevelopment areas under new construction and rehabilitation programs. State laws may also restrict the type of program which can be operated.

Reasons For Change

In General

The Federal Government has long pursued projects of housing assistance through direct spending programs, specific provisions in the tax laws, and credit policies. The most direct form of housing assistance has traditionally benefited the lowest income groups by providing basic shelter for low-income families. For most of the direct outlay Federal programs, matching funds by State and local governments are required as a specified percentage of the total cost. For other income groups, Federal housing assistance is provided in the form of mortgage insurance, secondary market for mortgage lenders, and various tax provisions. Cost projections for major housing assistance programs for the next five years are shown in Table 1.

[444] TABLE 1.—COST PROJECTIONS FOR MAJOR HOUSING ASSISTANCE PROGRAMS, FISCAL YEARS 1980-84

[Billions of dollars]

Program	1980	1981	1982	1983	1984
Budget outlays:					
Housing Assistance (HUD)[1]	5.07	5.92	6.80	8.07	9.46
Rural Housing (FmHA)	.72	.82	.92	1.02	1.13
Government National Mortgage Assn. (GNMA)	.52	.40	.18	.11	.11
Housing for the Elderly or Handicapped	.64	.69	.73	.77	.82
Community Development Block Grants[2]	.67	.76	.86	.98	1.11
Tax benefits:					
Tax deduction for interest on owner-occupied homes	9.29	10.97	12.94	15.27	18.01
Tax deduction for property taxes on owner-occupied homes	6.62	7.68	8.91	10.33	11.98
Deferral of tax on capital gains on sales on residence	1.01	1.12	1.23	1.35	1.49
Exclusion of gain on sale of residence—for persons age 55 and older	.54	.59	.65	.71	.79
Depreciation and amortization of rental housing in excess of straight line	.35	.36	.37	.38	.40

[1] Includes section 8 rental assistance, public housing, section 235 homeownership assistance, section 236 and other rental assistance.

[2] These figures are 20 percent of the estimated outlays for community development block grants. This is a rough estimate of the proportion of the funds used for housing assistance.

Since the end of World War II, three States—California, Oregon, and Wisconsin—have issued general obligation bonds from which the proceeds are used to provide mortgage financing for veterans. In 1978, $1.2 billion were issued for this purpose.

State housing agencies began to issue some tax-exempt bonds, which were not general obligation bonds, for owner-occupied housing in the early 1970's. However, prior to 1978, most State housing finance agency bonds were issued to provide multifamily rental housing. The volume of their bonds for owner-occupied housing varied between $36 million and $680 million from 1971 through 1976 and was $959 million in 1977. In 1978, the amount of tax-exempt bonds for owner-occupied housing issued by State housing finance agencies increased to $2.8 billion. In addition, since May 1978, numerous localities have begun issuing such bonds.

During 1978, State and local governments issued $3.4 billion of tax-exempt bonds for owner-occupied housing. This amount represented [445] approximately 7.4 percent of the aggregate of the tax-exempt long-term financing for all purposes by State and local governments during 1978. In 1979, State and local governments issued $8.7 billion of tax-exempt bonds for owner-occupied housing.[8] This amount represents 20.4 percent of the aggregate for tax-exempt long-term financing for all purposes by State and local governments during 1979. In addition, between January 1 and June 30, 1980, $7.4 billion of bonds was issued. It is estimated that an additional $4.1 billion of bonds will be issued after June 30, 1980. The relative portions of all borrowings by State and local governments during 1976, 1977, 1978, 1979, and 1980 are shown in Table 2.

[8] Approximately $3.2 billion of this amount was issued prior to April 25, 1979. The remaining $5.5 billion of bonds issued during 1979 was issued pursuant to the transitional rules of the bill.

TABLE 2.—PERCENTAGE DISTRIBUTION OF PURPOSES FOR ISSUING TAX-EXEMPT BONDS BY STATE AND LOCAL GOVERNMENTS, 1976-80

[Percent]

Activity	1976	1977	1978	1979	[1] 1980
Owner-occupied housing	1.8	1.9	7.4	20.4	31.9
Multi-family rental housing	4.3	3.4	5.4	8.5	2.5
Education	15.3	11.3	13.5	11.6	10.4
Water and sewer	9.8	10.0	9.7	8.8	6.8
Highways, bridges, and tunnels	4.6	3.1	4.1	2.2	1.3
Gas and electric	13.2	12.7	13.0	11.1	6.4
Industrial development	1.1	1.1	1.3	3.2	2.4
Pollution control	7.9	8.6	7.5	6.8	5.4
Hospital	8.1	10.4	6.8	8.3	7.1
Various purposes	34.0	37.4	31.2	19.2	25.8

[1] Estimate of distribution through June 30, 1980.

Any change in the level of Federal assistance raises issues of housing, budgetary, economic, and tax policy. Tax-exempt bonds tend to offset the impact of the budgetary and monetary policies on housing and to shift the burden to other sectors of the economy. As a result of the tremendous increase in the use of tax-exempt bonds for housing, the Committee believes it was necessary to reexamine the relevant tax provisions that permit the use of these bonds.

(1) Effect on the tax system

The Committee is concerned with the effect that substantial increases in the amount of tax-exempt bonds would have on the equity and progressivity of the tax system. Higher income individuals are the major purchasers of tax-exempt bonds. As a result, when large amounts of income escape taxation, it makes others who are not able to use tax-exempt bonds or tax shelters dissatisfied with our tax system, and thus, produces a direct threat to our self-assessment system of taxation.

[446] (2) Efficiency of tax-exempt housing bonds

The Committee is also concerned with whether tax-exempt bonds are an efficient method of providing a subsidy to housing. Additional tax-exempt bonds can be sold only if their yields are sufficiently attractive to compete with the after tax yields of other investments. As the supply of tax-exempt bonds grows, issuers must offer higher and higher interest rates to make the bonds attractive to investors in progressively lower tax brackets, because there are only a limited number of taxpayers in the very high tax brackets for whom tax-exempt bonds are an attractive investment at any interest rate. Thus, as the supply of tax-exempt bonds goes up and the interest rate on them rises, the interest rate subsidy provided declines.

Furthermore, there is some evidence from recent issues of mortgage subsidy bonds that the process of financing home mortgages through the use of tax-exempt bonds involves relatively large fees and administrative costs, resulting in substantially less assistance to the home buyer than its cost to the Federal Government. In addition, some issuers appear to have delayed placing the bond proceeds in mortgages in order to earn arbitrage, thus obtaining a further benefit at the cost of the Federal Government.

(3) Effect on the budget process

Increased direct spending for housing assistance and increased tax expenditures for housing of the same magnitude have the same impact on the budget. In an effort to contain future budget outlays for housing assistance, Congress has reduced new budget authority for that purpose from $34 billion in fiscal year 1979 to a target of $26 billion in fiscal year 1980. At the same time, the recent growth of the use of tax-exempt bonds for single-family owner-occupied residences has been dramatic. As a result, the Com-

mittee is concerned that the use of tax-exempt bonds for financing owner-occupied residences provides a means to avoid the budget process through tax expenditures that are not specifically authorized. The revenue loss from these issues is about $23 million per year for each $1 billion of outstanding bonds, and thus the annual revenue loss from the $12.1 billion housing bonds issued in 1978 and 1979 is about $275 million a year. Continuation of that rate of growth in housing bond issues through 1985 is estimated to result in a revenue loss of $16.7 billion in that year. The Committee believes that this bill will permit Congress to determine the amount of tax expenditures that are to be made for housing. The Committee also is concerned that use of tax-exempt bonds for financing items other than housing may proliferate in the future, and the Committee intends to study these uses with great care when they occur.

(4) Effect of tax-exempt bonds on capital formation

An increase in Federal housing assistance directs a larger fraction of total savings into housing and away from other forms of investment. In 1978, 32 percent of total fixed investment was devoted to residential purposes, a higher fraction than is found in most other developed countries. Any further increase in the share of total investment devoted to housing must come at the expense of other types of capital formation in a period of approximately full resource utilization such as the present.

[447] On balance, the combination of current housing-related tax, spending and credit market provisions encourage a shift of investment into housing from plant and equipment. The increment to GNP from housing investment is smaller than from plant and equipment investment because the latter investment is used to produce more additional income. The committee is concerned that further diversions of investment from plant and equipment to housing would decrease the efficiency and productivity of the economy and reduce the overall rate of economic growth.

(5) Effect of tax-exempt housing bonds on other tax-exempt bonds

The absolute amount of housing bonds and their growth in relation to the total tax-exempt bond market have the tendency of increasing the rates of interest for all tax-exempt bond issues, both general obligation and revenue bonds. The amount of the increase is not easily verified, but estimates suggest that, in otherwise stable municipal bond and money markets, the interest rate on tax-exempt bonds will rise by 4 to 7 basis points for each additional $1 billion in issues. In addition, the superior ratings usually earned by mortgage subsidy bonds may make them more attractive than general obligation bonds that are less highly rated, thus adding to upward pressure on general obligation interest rates. The resulting increase in interest costs affects all tax-exempt bond issues, including general obligation bonds for traditional State and local government purposes, such as schools, fire houses, police stations, water and sewer facilities and streets and highways.

For the reasons stated above, the Committee believes that restrictions should be placed on the use of tax-exempt bonds for housing that will direct the subsidy to those families and areas most in need of the subsidy, that will improve the efficiency in using tax-exempt bonds for housing, and that will limit the revenue loss. The specific reasons for the major provisions of Title IX are discussed below.

Owner-Occupied Housing

(1) Limitations targeting subsidy to individuals and areas of greatest need

The Committee believes that the individuals who have the greatest need for the subsidy are those of low or moderate income who have difficulty obtaining mortgage money and who are purchasing their first home. In addition, the Committee believes that it is appropriate to assist certain areas of chronic economic distress. Accordingly, Title IX contains a number of requirements to target the subsidy towards this group of individuals and certain distressed areas.

(*a*) *Income limitations*

First, Title IX requires that the recipients of the subsidy have income levels below certain designated percentages of median area income. The Committee believes that income levels must vary by area of the country because the cost of housing varies substantially by area and, to the extent that income levels also vary by area, use of area income figures will reflect these differences. These rules are designed to insure that the primary beneficiaries from the subsidy are individuals with low and moderate income.

[448] Where the residences are located within certain targeted areas, the Committee believes that higher income limits are appropriate. In these targeted areas, which generally are depressed or blighted areas, the committee believes that it would be beneficial to encourage mixed income neighborhoods. Accordingly, Title IX provides a higher income limitation in targeted areas.

(*b*) *Purchase price limitations*

The Committee also believes that the subsidy should not be used to provide a luxurious home even where the income of the individual is low or moderate. In order to insure that residences purchased with the aid of the subsidy are relatively modest, Title IX limits the purchase price of all of the residences financed with the bonds to a percentage of the average purchase price in the area. Average purchase price for the area is used because purchase prices of homes vary substantially throughout the country. Also, the Committee decided that separate limits should be used for new and used housing to take into account the differences in prices of new and used housing.

As in the case of the income limitations, the Committee believes that a more liberal rule is needed in targeted areas. Because rehabilitation costs are higher and because of the desire to redevelop blighted areas, the Committee concluded that it was appropriate to provide a higher purchase price limitation in targeted areas.

(c) Three-year requirement

As indicated above, the Committee believes that the individuals with the greatest need for the subsidy are those individuals who are buying their first home or have not recently owned a home. Persons who have existing homes generally have sufficient equity to permit them to purchase another home under conventional financing methods. Accordingly, Title IX requires that all of the mortgagors who are receiving financing from tax-exempt bonds must not have had a present interest in a principal residence at any time within the previous three years.

The Committee believes, however, that the three-year rule should not apply in targeted areas. The Committee believes that the revitalization of blighted areas necessitates encouraging individuals to return to the cities and these individuals often will already own their own home. Accordingly, Title IX waives the three-year requirement in targeted areas.

Similarly, the policy underlying the three-year requirement does not apply to certain home improvement loan and rehabilitation loan programs which are designed to encourage individuals already owning homes to improve them. Accordingly, Title IX provides exceptions to the three-year rule in the case of certain home improvement loans and certain rehabilitation loans.

(d) Principal residence requirement

The Committee also concluded that the residences financed with the bonds should become the principal residences of the mortgagors and that the subsidy should not be used to acquire investment properties or for recreational homes.

[449] *(e) New mortgage requirement*

The Committee believes that all of the bond proceeds used for mortgages should provide new mortgages and not refinance existing mortgages. Subsidizing and refinancing of an existing mortgage would just lower the housing costs of persons already able to afford that housing; it would not help persons to obtain home ownership which they could not otherwise afford. However, the Committee felt it is appropriate to waive this rule in the case of rehabilitation loans where refinancing the existing mortgae on the residence is often necessary to insure that the rehabilitation loan is a first mortgage on the residence.

(f) Targeted portion requirement

Finally, the Committee believes that at least some portion of every tax-exempt housing bond should be used for financing in targeted areas. Title IX provides that at least 20 percent of the amount of mortgages financed with bond proceeds be used for mortgages in targeted areas within the jurisdiction of the issuing authority. However, to insure that this does not require more money to be set aside for a small targeted area than can be utilized in that area, Title IX provides that the maximum amount of financing that is required in the targeted area is 40 percent of the mortgage market in the targeted area.

(2) Restrictions designed to increase the amount of the subsidy to home purchasers

As stated above, the Committee is concerned that tax-exempt bonds are an inefficient method of providing a subsidy. The inefficiency results in part from high issuance costs and from excessive arbitrage. Title IX addresses these problems by adopting several requirements designed to increase the amount of the subsidy to an eligible home purchaser and improve the efficiency of the bonds.

(a) Arbitrage limitations

Present arbitrage rules permit relatively large amounts of arbitrage to be earned on the investments in mortgages, on reserves, and during a temporary period until the mortgage loans are made. Moreover, the availability of large arbitrage profits have permitted the issuance costs to be higher than they might otherwise be.

In order to reduce these inefficiencies, Title IX contains three rules designed to limit the amount of arbitrage. First, it requires that the net cost of borrowing to the mortgagor cannot exceed the yield on the bonds by more than one percentage point. Second, Title IX requires that the arbitrage on reserves and other nonmortgage investments decrease as the mortgages are repaid. Third, Title IX requires that the net arbitrage from the reserves, and other nonmortgage investments, and temporary period investments be passed on to the mortgagors.

(b) Loan-to-value requirements

One of the largest barriers that a first time purchaser must face is saving for a sufficient down payment. The Committee believes there is a tendency for mortgage originators to select the safest loans and, consequently, originate loans with those persons who are able to make the largest down payments. Yet, the individuals with the most need [450] are those individuals able to make the smallest down payments. Accordingly, Title IX requires that at least 75 percent of the lendable proceeds must be used for mortgages where the loan to value ratio is at least 95 percent. A slightly less restrictive rule is allowed for graduated payment mortgages because of the negative amortization that exists with graduated payment mortgages.

(3) Restrictions designed to limit revenue loss

The Committee also is concerned with the relatively large revenue expenditure that would have occurred if the use of tax-exempt bonds to pro-

vide mortgage financing were not curtailed substantially. The Committee believes that the use of tax-exempt mortgage financing should not be allowed to increase to such a degree that it becomes a substantial percentage of all mortgage financings. Moreover, limiting the amount of tax-exempt financing allows the conventional suppliers of mortgage financing to continue without completing with governmental units who have the competitive advantage of being able to issue tax-exempt debt.

Title IX contains a restriction that the maximum amount of tax-exempt mortgage financing that a governmental unit can issue in a calendar year is 5 percent of the average agregate principal amount of mortgages originated within the jurisdiction of the issuing governmental unit during the previous three years.

Moreover, Title IX provides a $50,000,000 minimum amount that can be issued by all governmental units within a State where the aggregate limitations of all governmental units within the State under the 5-percent limitation is less than $50,-000,000.

Finally, the Committee believes it is appropriate to prohibit the advance refunding of tax-exempt mortgage bonds after the date of enactment of any existing or future mortgage subsidy bond.

(4) Registered bonds

The Committee is aware that most tax-exempt bonds are issued in bearer form. This creates an opportunity for evasion of both estate and gift taxes since there is no record of ownership maintained by the issuer. Moreover, enforcement of the restrictions of Title IX related to owner-occupied housing requires that the owner of the bonds be identifiable in the event that any bonds cease being qualified mortgage bonds where the requirements of Title IX are not met. In order to address these problems, Title IX requires that all housing bonds issued after date of enactment be issued in registered form.

(5) Veterans' programs

The Committee believes that programs using tax-exempt bond proceeds for mortgage funds for veterans should be permitted to continue. Title IX provides an exception for these programs from the limitations otherwise imposed on the use of tax-exempt bonds to finance owner-occupied housing but does provide that such bonds be general obligation bonds issued in registered form.

(6) Sunset

The Committee recognizes that it is creating an untried program to implement housing policy. Moreover, the need for the subsidy may change over time. Consequently, the Committee has decided to termi-[451]nate the program in two years. At the end of the two-year period, no tax-exempt bonds for owner-occupied housing will be permitted except for veterans' programs. This sunset of the program will permit the Committee to reexamine the results of the need for the program within a relatively short period of time.

Multi-Family Rental Housing

Present law allows the use of industrial development bonds for residential real property for family units. While most of the financing that has been done under this rule has been for low or moderate income persons, there have been instances where the rule has been used to finance apartment buildings all of whose units were at market rate rentals. Moreover, there is nothing in present law that would prohibit the use of tax-exempt bonds for the financing of luxury apartment buildings.

The Committee believes that tax-exempt industrial development bonds should be available only where they benefit low or moderate income persons. However, the Committee recognizes that there is a valid housing policy in encouraging mixed income projects. As a result, Title IX restricts the exception for tax-exempt industrial development bonds to bonds whose proceeds are used to finance projects where at least 20 percent of the units are rented to low or moderate income individuals.

Explanation Of Provisions

a. Owner-Occupied Single-Family Housing (Sec. 902 of Title IX and new sec. 103A of the Code)

(1) Structure of provision

Title IX adds a new section to the Code (sec. 103A) which deals with the treatment of tax-exempt bonds for financing of owner-occupied residences. Under this section, interest on an obligation will not be exempt from Federal income tax if a significant portion of the bond proceeds are to be used directly or indirectly for mortgages (or other financing) of owner-occupied residences.[1] For this purpose, a significant portion is normally considered to be 5 percent.

Under Title IX, there are two exceptions to the rule that interest on mortgage subsidy bonds is not exempt from Federal income tax. These two exceptions are for qualified mortgage bonds and qualified veterans' mortgage bonds. However, in order for interest on a qualified mortgage bond or a qualified veterans' mortgage bond to be exempt from income tax, it must meet the general requirements for exemption under Code section 103 in addition to the requirements for a qualified mortgage bond or a qualified veterans' mortgage bond.

(2) Qualified mortgage bond

Under Title IX, a qualified mortgage bond is an obligation which is issued as part of a qualified mortgage issue. A qualified mortgage [452] issue means an issue by a State or a possession of the United States or political subdivision thereof or the District of Columbia if all of the proceeds (other

[1] Under Title IX, it is irrelevant whether the obligation is a general obligation of the issuing unit or whether the security for the bonds, or for the payment of debt service on the bonds, is from the mortgages financed with the bond proceeds.

than issuance costs [2] and a reasonably required reserve [3]) are to be used to finance owner-occupied residences and if the issue meets all of the requirements discussed below. Under Title IX, qualified mortgage bonds may not be issued after a 2-year period following the date of enactment.

Under Title IX, the requirements are divided into two groups. As to one group of requirements, the issue meets the requirements only if the issuer in good faith attempted to satisfy all such requirements before the mortgages were executed. Where such good faith has been exercised, 95 percent or more of the proceeds that are devoted to financing of owner-occupied residences (referred to as lendable proceeds) must have been invested in mortgages which meet all requirements in the group at the time of the execution of the mortgages. In addition, where the good faith and 95 percent requirements are met, all failures to meet the first group of requirements in every mortgage (i.e., the mortgage comprising 5 percent or less of the lendable proceeds) must be corrected within a reasonable period after such failure is first discovered. These requirements must be met for both mortgages that are originally financed with the bonds and for any mortgages which are financed with proceeds of principal payment and prepayments of original mortgages.

The good faith requirement can normally be met by having the trust indenture, participation agreements with loan originators, and other relevant instruments contain restrictions that permit the financing of mortgages only in accordance with the limitations of Title IX. In addition, good faith would normally require that the issuer take reasonable steps to insure that loan originators are complying with the restrictions placed in the applicable instruments.

[2] Issuance costs include any accrued interest until the date of issuance of the bonds.

[3] A reasonable required reserve includes any reserve or reserves that are reasonably necessary to secure the payment of debt service on the bonds.

For purposes of meeting the 95-percent test, at least 95 percent of the total amount of the mortgages at the time of their origination must meet the requirements of Title IX. Where a particular mortgage fails to meet more than one of the requirements of Title IX, the amount of that mortgage will be taken into account only once in determining whether the 95-percent requirement is met. However, all of the defects in that mortgage must be corrected.

In order for a qualified mortgage bond issue to remain qualified, all of the failures to meet the requirements of Title IX with respect to every mortgage financed by the bond proceeds must be corrected within a reasonable period of time after the failure is first discovered by the issuer or mortgage originator. For example, where the income, three-year, or purchase price limitations are not met, the failure to meet those requirements can be corrected by calling the nonqualifying mortgage or by replacing the nonqualifying mortgage with a qualifying mortgage. Where the down payment requirement is not met, correction could be accomplished by increasing the amount of financing to an amount such that the requirement is met.

[453] The requirements that come within this group the requirements are the residence requirement (subsection (d)), the three-year requirement (subsection (e)), the purchase price requirement (subsection (f)), the down-payment requirement (subsection (g)), the income requirement (subsection (h)), the new mortgage requirement (subsection (l)(4)), and the assumption requirement (subsection (l)(5)).

With respect to the other group of requirements, the issue meets the requirements only if the issuer in good faith attempted to satisfy all of such requirements and any failure to meet such requirements is due to inadvertent error. The good faith requirement will be met if all reasonable steps are taken by the issuer to insure that the issue complies with these requirements. For example, if all reasonable steps are taken to determine accurately the size of the market share, but the requirement is not met because the amount of the mortgages originated in the area during the past three years is incorrectly determined as a result of a mathematical error, the issue will nonetheless qualify (provided the other requirements for qualification are met).

The requirements included in this group are the market share limitation (subsection (i)), the portion of loans in targeted areas requirement (subsection (j)), the arbitrage requirements (subsection (k)), the State approval requirement (subsection (l)(1)), the registration requirement (subsection (l)(2)), and the multiple originators requirement (subsection (l)(3)).

(a) Residence requirement

In order for an issue to be a qualified mortgage issue, all of the mortgages (or other financing) provided by the bond proceeds must be for single-family residences located within the jurisdiction of the issuing governmental unit. Moreover, all the residences must reasonably be expected to become the principal residence of the mortgagors within a reasonable time after the financing is provided.

In order to meet the principal residence requirement, the issuer and all mortgagors must reasonably expect, as of the execution of the mortgages, that the residences will become the principal residences of the mortgagors within a reasonable time after the execution of the mortgages. This requirement can normally be met by having the mortgagor execute an affidavit that he intends to make the residence his principal residence within a reasonable time after the purchase of the residence.

For this purpose, the term principal residence normally has the same meaning as that term does for purposes of section 1034 of the Code.

In order to meet the residence requirement, all of the mortgages financed by the issue must be for residences which are located within the

jurisdiction issuing the qualified mortgage bond. This requirement is necessary to insure that the market share limitation (discussed below) is met. Where two or more governmental units jointly issue a bond, the principal residence requirement will be met so long as the residence is located in any of the issuing jurisdictions.

In addition, to meet the residence requirement, all of the mortgages financed by the issue must be with respect to single-family residences. Thus, a mortgage used to finance the acquisition of a structure containing [454] the principal residence of the mortgagor plus one or more additional family units will not meet this requirement.

(b) The three-year requirement

In order for an issue to be a qualified mortgage issue, all of the mortgages financed from the bond proceeds must be provided to mortgagors each of whom did not have a present ownership interest in a principal residence at any time during the three-year period ending on the date that the mortgage is executed. Where there is more than one mortgagor with respect to a particular residence, all of the mortgagors must meet the three-year rule. However, it is not required that all persons which have any liability under the note secured by the mortgage meet the three-year test. For example, where a father of a home purchaser cosigns the note for his son but the father takes no interest in the residence, it is not necessary that the father meet the three-year requirement since the father is not a mortgagor of the residence.

The fact that the mortgagor had an interest in a residence which was not his principal residence during the previous three years will not cause him to fail the three-year requirement. Moreover, the mortgagor will not fail the three-year requirement merely because he owned a remainder interest during the previous three years in a rsidence which was his principal residence. However, a mortgagor will fail the three-year requirement where the present interest in the mortgagor's principal residence was held in trust during the previous three years (whether or not created by the purchaser). For the purpose of determining whether an interest is a present interest, the rules generally applicable in determining whether a gift of an interest qualifies for the $3,000 annual gift tax exclusion of Code section 2503 shall apply. A present interest does not include a mere expectancy to inherit an interest in his principal residence. Also, in determining whether the three-year requirement is met, the interest that a purchaser of a residence acquires upon the execution of a purchase contract is not treated as a present interest in a principal residence. (See below, however, for the requirement that a mortgage be a new mortgage.)

The three-year requirement does not apply with respect to mortgagors of residences in three situations. First, it does not apply to mortgagors of residences that are located in a targeted area. Second, it does not apply to mortgagors who receive qualified home improvement loans. Third, it does not apply to mortgagors who receive a qualified rehabilitation loan.

Targeted area residences

A targeted area residence is defined in Title IX to mean a residence located in either one of two areas: (1) a qualified census tract or (2) an area of chronic economic distress. This definition also is applicable for the purchase price limitation, the income limitation, the three-year requirement, and the targeted portion requirement.

A qualified census tract is a census tract in which 70 percent or more of the families have income which is 80 percent or less of the Statewide median family income. This determination is to be based on the most recent decennial census for which data are available.

[455] An area of chronic economic distress is defined as an area which has been designated as such by the State in accordance with its standards and which designated area has been approved by the Secretary of the Treasury and the Secretary of Housing and Urban Development as an area of chronic economic distress. The criteria to be used by the Secretary of the Treasury and the Secretary of Housing and Urban Development in approving an area as an area of chronic economic distress are: (1) the condition of the housing stock, including the age of the housing and the number of abandoned and substandard residential units; (2) the need of area residents for owner-financing through tax-exempt bonds, as indicated by low per capita income, a high percentage of families in poverty, a high number of welfare recipients, and high unemployment rates; (3) the potential for use of owner-financing through tax-exempt bonds to improve housing conditions in the area; and (4) the existence of a housing assistance plan which provides a displacement program and a public improvements and services program.

Qualified home improvement loan

A qualified home improvement loan is defined to mean financing (whether or not secured by a mortgage) in an amount which does not exceed $15,000 with respect to any residence for alterations, repairs and improvements on, or in connection with, an existing single-family, owner-occupied residence. The alterations, repairs and improvements must substantially protect or improve the basic livability of the property, such as the renovation of plumbing or electric systems, the installation of improved heating or air conditioning systems, the addition of additional living space, or the renovation of a kitchen area. Items that will not be considered to be items which substantially protect or improve the basic livability of the property include swimming pools, tennis courts, saunas, or other recreational or entertainment facilities. This definition of qualified home improvement loan is also applicable for the purchase price limitation and the down payment requirement.

Qualified rehabilitation loan

A qualified rehabilitation loan means any owner financing provided in connection with a qualified rehabilitation (or the acquisition of a resi-

dence with respect to which there has been a qualified rehabilitation) where the mortgagor is the first resident of the residence after the completion of the rehabilitation.[4]

Thus, under Title IX, a qualified rehabilitation loan includes a loan to an existing resident in order that a qualified rehabilitation can be performed on the residence. Moreover, a qualified rehabilitation loan includes a loan made to a mortgagor who buys a rehabilitated residence from a builder and then resides in it. However, a qualified rehabilitation loan cannot be made to a person who purchases the residence from a mortgagor who qualified for the qualified rehabilitation loan with respect to that residence.

[456] In order for the rehabilitation of a residence to be treated as a qualified rehabilitation, three requirements must be met. First, there must be a period of at least 20 years between the date on which the building was first used and the date that actual rehabilitation began. The date that the building was first used is the first date that the building was used for any purpose, including use in a trade or business or as a residence.

Second, 75 percent or more of the existing external walls of the building must be retained as external walls in the rehabilitation process. The rules applicable to the investment tax credit for qualified rehabilitated buildings (Code sec. 48(g)(1)(A)(iii)) are to apply for this purpose. (However, unlike Code section 48(g)(1)(B), once a building meets the 20-year test, more than one rehabilitation of that building within a 20-year period could qualify as a qualified rehabilitation.)

Third, expenditures for rehabilitation must amount to 25 percent or more of the mortgagor's adjusted basis in the residence (including the land on which the residence is located). Where an individual is already living in the building to be rehabilitated, the 25-percent test is determined by comparing amounts expended by the mortgagor on the qualified rehabilitation with the mortgagor's adjusted basis as of the completion of the rehabilitation. The amounts expended by the mortgagor for rehabilitation include all amounts expended for rehabilitation regardless of whether the amounts expended were financed from the proceeds of the loan or from other sources, and regardless of whether the expenditure is a capital expenditure, so long as the expenditure is made during the rehabilitation of the building and is reasonably related to the rehabilitation of the building. The adjusted basis of the building as of completion of rehabilitation includes any amounts expended for rehabilitation that are properly considered capital items. The value of services performed by the mortgagor or members of his family in rehabilitating the building will not be included in determining the rehabilitation expenditures for purposes of the 25 percent test. For this purpose, the adjusted basis to the mortgagor is his adjusted basis for purposes of determining gain.

Where a mortgagor purchases a building that has been substantially rehabilitated, the 25-percent test is determined by comparing the total expenditures made by the seller for the rehabilitation of the building with the purchase price of the building to the mortgagor. The total expenditures made by the seller for rehabilitation do not include the cost of acquiring the building or land, but do include all amounts directly expended by the seller in rehabilitating the building (excluding overhead and other indirect charges). The purchase price to the mortgagor does not include any closing costs. This definition of a qualified rehabilitation loan is also applicable to the downpayment requirement and the new mortgage requirement.

(c) Purchase price requirement

In order for an issue to be a qualified mortgage issue, all of the mortgages (or other financing) provided from the bond proceeds, except qualified home improvement loans, must be for the purchase of residences [457] where the acquisition cost of each residence does not exceed 80 percent (110 percent in targeted areas) of the average area purchase price applicable to that residence. The average area purchase price means the average purchase price of all single family residences in the statistical area in which the residence is located. The average is to be based on sales during the most recent 12-month period for which sufficient statistical information is available. Whether a particular residence meets the purchase price requirement is to be determined on the date that the mortgage originator makes a commitment to provide financing from the bond proceeds (or, if earlier, the date of the purchase of the residence). Separate determinations are to be made for new and used residences.

Statistical area

The term statistical area is defined to mean a standard metropolitan statistical area (SMSA) or any county (or portion of a county) which is not within a SMSA. Where a SMSA covers a portion of a county, the portion of the county that is not covered by the SMSA is treated as a separate statistical area. A SMSA is defined to mean those areas so designated by the Secretary of Commerce. Where a portion of a State is in neither a SMSA or a county (as occurs in the State of Alaska), the statistical area is to be the area designated by the Secretary of the Treasury as the equivalent of a county.

Sufficient statistical information with respect to a particular area is deemed to be available where there is sufficient information that a reasonable approximation of the average purchase price can be determined. Where there is not adequate statistical information for a particular area, the bill provides that the Secretary of the Treasury may substitute another area for the statistical area. For example, if there are several contiguous counties which have similar types of housing, but which have had so few sales within the 12-month period that the margin

[4] Where there are two or more mortgagors of a rehabilitation loan, the first residency requirement is met if any of the mortgagors meets the first residency requirement.

of error in determining the average purchase price in each individual county, but not all the counties combined, is unreasonably high, then the Secretary of the Treasury may designate all of those counties as the statistical area for purposes of the purchase price limitation.

Acquisition cost

The acquisition cost of a residence is the cost of acquiring the residence as a completed residential unit, excluding usual and reasonable settlement and financing costs, the values of services performed by the mortgagor and members of his family in completing the residence and the cost of any land which was acquired more than 2 years prior to construction of the residence. Where a residence is purchased subject to a ground rent, the acquisition cost of the residence includes the capitalized value of the ground rent.

The acquisition cost of an incomplete residence includes the reasonable cost of completing the residence, even though the cost of completing construction on an incomplete home is not to be financed with the proceeds of the bonds. For example, where a mortgagor purchases a building which is so incomplete that occupancy of the building is not permitted under applicable local law, the acquisition cost includes the [458] cost of completing the building so that occupancy of the building is permitted.

The acquistion cost of a residence does not include the value of services performed by the mortgagor or members of his family in building or completing the residence. For example, where the mortgagor builds his home by himself, or with the help of his family, the acquisition cost includes the cost of materials and the cost of work performed by subcontractors (whether or not related to the mortgagor), but it does not include the imputed cost of any labor actually performed by the mortgagor or a member of his family in constructing the residence. Similarly, where the mortgagor purchases an incomplete residence, the acquisition cost includes the cost of materials and labor paid by the mortgagor to complete the residence, but does not include the imputed value of the mortgagor's efforts or the efforts of his family in completing the residence.

Acquisition cost does not include usual and reasonable settlement or financing costs. Settlement fees include titling and transfer costs, title insurance, survey fees, or other similar costs. Financing costs include credit reference fees, points (paid by the buyer), or other costs of financing the residence. However, such amounts will be excluded in determining acquisition cost only to the extent that the amounts do not exceed the usual and reasonable costs which would be paid where financing is not provided through a qualified mortgage issue. For this purpose, financing costs do not include any points or other charges paid by the seller, even though they may be borne by the mortgagor through a higher purchase price.

In the case of rehabilitation loans, the purchase price limitation is met if the mortgagor's adjusted basis in the property as of the completion of the rehabilitation (including the cost of the rehabilitation) meets the 80 percent test (or 110 percent test where applicable). For this purpose, a rehabilitated residence is to be treated as a used residence.

(d) Down payment requirement

In order for an issue to be a qualified mortgage issue, at least 75 percent of the owner-occupied financing provided by the issue (excluding qualified home improvement loans and qualified rehabilitation loans) must be 95-percent financing. Under this requirement, 75 percent or more of the lendable proceeds of the issue must be used to provide owner-occupied financing that is 95-percent financing, regardless of the number of individual mortgages which qualify as 95-percent financing.

The owner occupied financing of a residence will satisfy the 95-percent requirement in two situations: first, where the amount of financing provided with respect to a residence by the issue is equal to 95 percent or more of the acquisition cost of a residence; and second, where a qualifying graduated payment mortgage is utilized with respect to a residence.

Graduated payment mortgages which are taken into account for purposes of the 75-percent test are mortgages where the amount of the financing provided by the bonds is equal to the greater of: (1) 90 percent of acquisition cost of the residence or (2) 95 percent of the [459] acquisition cost of the residence less the sum of the maximum amount of negative amortization under the graduated payment schedule and the amortization that would have occurred under a level payment 95-percent mortgage as of the time when the maximum negative amortization is reached under the graduated payment schedule (called the cross-over point). The effect of this rule is to require that any amount of down payment under a graduated payment mortgage in excess of 5 percent of the acquisition cost is returned to the mortgagor in the form of negative amortization so that the amount of financing outstanding under the graduated payment mortgage equals the amount of financing provided under a 95-percent mortgage at the cross-over point.

In addition, this requirement will also be satisfied in the case of a loan participation program which provides 95 percent financing. In general, a qualifying loan participation program is one which provides owner financing from the proceeds of an issue and from funds committed by private lending institutions. In the case of such a program, the 95 percent financing requirement will be satisfied where the owner financing provided from the proceeds of the issue and from funds committed by the participating lending institution is 95 percent financing. In other words, in the case of the first down-payment test, 95 percent of the acquisition costs of a residence would not have to be provided from the issue,

but rather, 95 percent of the acquisition cost of the residence must be provided by financing from a single loan part or all of which has to be provided from the issue.

In determining whether a mortgage meets either of the two down payment tests, the value of any property in which the mortgagee receives a security interest to secure the payment of the mortgage note shall be taken into account. For example, where the mortgagor is required to pledge a passbook savings account to secure payment of the mortgage note, the amount of the acquisition cost financed by the mortgage shall be reduced by the amount of the account at the time of the execution of the mortgage.

(e) Income requirements

In order for an issue to be a qualified mortgage issue, all of the mortgages provided by the lendable proceeds must be given to families that meet certain income limitations. Under these limitations, at least 50 percent of the lendable proceeds must be used for mortgages where the family income of the mortgagors of each mortgage is 90 percent or less of the median family income for the statistical area in which the residence is located.[5] In addition, any portion of the lendable proceeds not used for 90 percent income mortgagors must be used for mortgages where the family income of the mortgagors of each mortgage is 115 percent or less of the median family income for the statistical area in which the residence is located.

In the case of residences located in a targeted area, a higher series of income limitations apply. Under these rules, up to one-third of the [460] mortgages on residences located in targeted areas can be made to any mortgagor regardless of the family income of that mortgagor. All of the remaining two-thirds of the mortgages financed from the issue on residences located in a targeted area must be used for mortgages where the maximum income of the family purchasing the residences does not exceed 140 percent of the greater of the Statewide median family income or median family income in the statistical area in which the residence is located. However, the requirement that at least 50 percent of the lendable proceeds be used for mortgages where the family income of the mortgagors of each mortgage is 90 percent or less of the median family income for the statistical area in which the residence is located continues to apply.

The higher limitation in targeted areas is to be applied on a residence-by-residence basis. For example, the income limitation applicable to a residence in a targeted area in one statistical area may be based upon 140 percent of the Statewide median family income while the income limitation applicable to another residence in a targeted area in a different statistical area may be based upon the median family income of the statistical area even though both mortgages are financed from the same bond issue.

Under Title IX, the Secretary of the Treasury is to prescribe by regulation rules for determining the family income of the mortgagors and the median family income for the statistical area. These rules are to be consistent with the regulations prescribed under section 8 of the United States Housing Act of 1937 for determining family income.

The determination of whether the mortgagors meet the income limitations is to be made at the time of the execution of the mortgage. Subsequent changes in the income levels of the mortgagors are not to be taken into account under this test. Where it is determined after the execution of the mortgage that the income level of the mortgagor did not meet the income requirements as of the execution of the mortgage, the failure in that mortgage will be corrected if that mortgage is called within a reasonable period after the mortgage originator or the issuer learned that the mortgagor did not meet the income requirements.

(f) Market share limitation

In order for an issue to be a qualified mortgage issue, the aggregate amount of bonds to be issued plus the aggregate amount of qualified mortgage bonds previously issued by the issuing authority during the calendar year must not exceed the market share limit for that calendar year. Where the aggregate amount of bonds in an issue exceeds the market share limitation, the entire issue, and not just the excess of the principal amount of the issue over the market share limit, will be treated as a nonqualified mortgage issue. However, previous qualified mortgage issues which met the market share at the time of their issuance do not cease to be qualified mortgage issues just because a subsequent issue does not meet the market share limitation.

In general, the market share limit for a particular issuing authority for any calendar year is 5 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family owner-occupied residences [461] located within the jurisdiction of the issuing authority. The aggregate principal amount of mortgages includes all mortgages on single-family owner-occupied residences regardless of whether those mortgages are first or second mortgages or whether the mortgages are used to refinance an existing mortgage. However, only mortgages are included; workmen's liens, tax liens, liens relating to special assessments, or similar encumbrances are not included.

In determining the 5-percent amount, the best information available to the issuing authority must be used. For example, where the total amount of single-family mortgages is known, but not the amount of those mortgages which are represented by owner-occupied residences, the amount of mortgages on single-family, owner-occupied residences may be determined

[5] The statistical area used in connection with the income limitation need not be the same area that is used in connection with the purchase price limitation. This would usually occur where several counties are combined in determining average purchase price of residences.

by using a statistical average of single-family residences from a representative sample of the mortgages.

Where more than one governmental unit has the authority to issue mortgage subsidy bonds to finance mortgages on residences in the same geographical area, Title IX provides that the aggregate principal amount of the mortgages on residences is allocated to the governmental unit with jurisdiction over the smallest geographical area. For example, where both a county and a city located within the county have authority to issue mortgages subsidy bonds, the 5-percent limit of the city is determined by reference to the aggregate principal amount of mortgages on residences located within the city. The 5-percent limitation of the county is determined by reference to the aggregate principal amount of mortgages on residences that are located within the county but outside of the city. Similarly, in such a case, the 5-percent limit of the State would be determined by reference to the aggregate principal amount of mortgages on residences located outside of counties having authority to issue mortgage subsidy bonds.

Where two governmental units have authority to issue mortgage subsidy bonds and both governmental units have jurisdiction over the identical geographical area, the aggregate principal amount of mortgages on residences located within that area is to be allocated to the governmental unit having the broader sovereign powers. For example, where a city and a housing finance agency have jursdiction only within the city and both the city and housing finance agency have authority to issue mortgage subsidy bonds, then the aggregate principal amount of mortgages on residences is allocated to the city since the city has broader sovereign powers than the housing finance agency.

Title IX also provides that, where the aggregate amount of qualified mortgage bonds that could be issued by all governmental units within a State for a particular calendar year under the 5-percent limitation is less than $50,000,000, then the aggregate amount of qualified mortgage bonds that can be issued by the governmental units for the calendar year is increased to $50,000,000. The excess of the $50,000,000 over the aggregate of the 5-percent limitations for the State is allocated to each governmental unit in proportion to the ratio of the 5-percent limitation for that governmental unit to the aggregate of the 5-percent limitations of all governmental units within the State.

Title IX provides two exceptions to the rule that mortgages are allocated to the governmental unit representing the smallest geographical area for purposes of the 5-percent limitation. Under the first ex-[462]ception, a small governmental unit can enter into an agreement with the governmental unit having the next largest geographical area that includes the area of the smaller governmental unit to allocate all or a designated amount or portion of the mortgages on residences within the smaller governmental unit to the larger governmental unit for purposes of computing the market share limitations (under both the 5 percent or $50,000,000 limitations) for both governmental units. For example, where a city is located within a county and both the city and the county have the authority to issue mortgage subsidy bonds, the city could enter into an agreement with the county to allocate all or a designated amount or portion of the mortgages on residences within the 3 preceding calendar years to the county. If such an agreement were entered into, the market share limitation of the city would be reduced and the market share limitation of the county would be determined with regard to the mortgages allocated to the county from the city. Similarly, the county could enter into an agreement with the State (or State housing agency) to allocate any mortgages on residences within the county (including any residences allocated to the county under an agreement with the city) to the State (or State housing agency). However, the city could not enter into such an agreement with the State, since the State is not the next largest governmental unit.

Under the second exception, a State may enact a law (after the date of enactment of Title IX) which allocates the mortgages on residences within the State under any formula to any or all of the governmental units having authority to issue mortgage subsidy bonds. For example, a State could enact legislation allocating all or a designated amount or portion of the mortgages on residences within the State to a State housing finance agency. In such a case, there would be no requirement that the State housing finance agency use any of the bond proceeds to finance mortgages on residences in the geographical area represented by the local governmental units whose mortgages were allocated to the State housing finance agency. Such a State formula, however, would have to meet the portion of loans in targeted areas requirement discussed below.

Title IX also provides a transitional rule under which neither the 5-percent limitation nor the $50,000,000 minimum amount is reduced by bonds that were issued on or before April 24, 1979, or under the transitional rules of the bill. Thus, a State is entitled to a full $50,000,000 minimum amount for a calendar year even though the market share limitations of Title IX were in effect only for a portion of that year.

(g) *Portion of loans in targeted area requirement*

In order for an issue to be a qualified mortgage issue, a specified amount of the bond proceeds must be made available for mortgages on residences in targeted areas for at least one year after the date on which any financing of mortgages by the bonds first become available. Funds will be considered to be made available in targeted areas only if the issuer and the loan originators are reasonably diligent in trying to place mortgages in targeted areas (such as by advertising that mortgage funds are available for targeted areas). Due diligence is not shown by merely providing in the governing instruments that the required amount be set aside

for targeted areas. Moreover, the require-[463]ment that a designated amount of the bond proceeds be made available in targeted areas for a year does not abrogate the requirement of the arbitrage rules that due diligence be used in placing into mortgages those bond proceeds not required in targeted areas.

The specified amount of funds that must be made available in targeted areas is the lesser of 20 percent of the lendable proceeds or 40 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family, owner-occupied residences in targeted areas within the jurisdiction of the issuing authority. Thus, where there are no targeted areas located within the issuing jurisdiction during any of the preceding 3 calendar years, there is no requirement that any of the bond proceeds be made available in targeted areas since 40 percent of the aggregate mortgages in targeted areas would be zero.

The specified amount that must be made available in targeted areas is a minimum amount. More than the minimum amount may be (but need not be) made available in targeted areas even though that amount exceeds 40 percent of aggregate mortgages in the targeted area.

(h) Arbitrage

In order for an issue to be a qualified mortgage issue, the issue must meet certain requirements regarding arbitrage as to both mortgage loans and nonmortgage investments. A qualified mortgage issue must satisfy these requirements in addition to the requirements of section 103(c) of the Code.

Under Title IX, the effective rate of interest on mortgages provided under the issue cannot exceed the yield on the issue by more than 1 percentage point. This determination is to be made on a composite basis for all mortgages under the issue. Consequently, the effective interest rate on some mortgages may be greater than 1 percentage point above the yield of the issue if other mortgages have a lower effective interest rate.

In general, this requirement imposes a limitation on the amount of costs a mortgagor is required to pay. Under this provision, the total cost of issuing the bonds and providing mortgage financing which may be passed on to the mortgagors may not exceed the yield on the issue by more than 1 percentage point. This provision of Title IX differs from present law in that the effective rate of interest on the mortgages is determined under this provision without any adjustment for the cost of issuing the bond and providing mortgage financing.

In the case of a loan participation program (see section 2, d of Background on the Use of Tax-Exempt Bonds for Owner-Occupied Housing), the portion of the owner financing provided by the private lending institution will not be subject to this limitation since the amounts used to provide that portion of the financing are not the proceeds of a qualified mortgage issue. Thus, in the case of such a program, the portion of the owner financing provided from the proceeds of the qualified mortgage issue will be subject to the limitations of this provision, while the portion of the mortgage loan provided by the private lending institution would not be subject to those limitations where the interest rate with respect to the portion of the mortgage loan provided by the [464] private lending institution does not exceed the reasonable and customary rate of interest charged by such institutions. Where the charge exceeds the reasonable and customary rate, any excesses will be taken into account in computing the effective interest rate on the portion of the loan provided with the proceeds of the qualified mortgage issue.

Title IX provides three rules for determining the effective rate of interest on any mortgage. The first rule deals with the amount to be taken into account in determining the effective rate of interest on any mortgage. The second rule deals with prepayment assumptions and the third rule deals with actuarial assumptions.

The first rule provides that the effective rate of interest on any mortgage is determined by taking into account all amounts borne by the mortgagor which are attributable to the mortgage or to the bond issue. It is immaterial whether the amounts are paid by the mortgagor or by another person. These amounts are included whether they are designated as a "point," an origination fee, a program fee, or by any other designation. Similarly, it is immaterial whether the amounts are paid to the issuer, the originator or servicer of the mortgagor, or to some other person. Thus, an origination fee is included whether it is paid to the issuer directly or to the originator of the mortgage. Similarly, any mortgage prepayment penalty is to be treated as borne by the mortgagor and included in the determination of the effective rate of interest.

Title IX specifies certain items which are treated as borne by the mortgagor. This listing is not intended to be all inclusive, but merely provides examples of some of the amounts which are treated as borne by the mortgagor. The first item is all points or similar charges paid by the seller of the property. The second item is all amounts received from any person by any person in connection with the purchase or financing of the acquired property in excess of the usual and reasonable costs which would have been paid where financing is not provided through the use of qualified mortgage bonds.

Title IX also specifies two items which are treated as not borne by the mortgagor and, therefore, are not taken into account in determining the effective rate of interest on any mortgage. The first item is any expected rebate of arbitrage. Thus, if a mortgagor pays $100 of interest during a period and has an expected rebate of arbitrage of $5 with respect to that period, the amount taken into account in determining the effective rate of interest on the mortgage is $100. The second item is any application fee, survey fee,

credit report fee, insurance charge, or similar amount, paid in connection with the purchase or financing of the acquired property but only to the extent the amount paid does not exceed the usual and reasonable amount charged in the issuing jurisdiction in cases where owner-financing was not provided through the use of qualified mortgage bonds. However, this treatment of certain amounts as amounts not borne by the mortgagor does not apply to "points," origination fees, or similar amounts.

The second rule provides that, in determining the effective rate of interest on any mortgage, it shall be assumed that the mortgage prepayment rate will be the rate set forth in the most recent mortgage maturity experience table published by the Federal Housing Ad-[465]ministration for the State (or, if available, the area within the State) in which the residences are located. This rule addresses the problem of determining the effective rate of interest on a mortgage where prepayment occurs. Generally, where a point or fee is charged upon origination or prepayment of a mortgage, the effective rate of interest on the mortgage will vary depending on whether some or all of the mortgages are prepaid. In addition, the exact pattern of prepayments of the mortgages is not known at the time the bonds are issued. Title IX addresses the problem by providing that the FHA maturity experience tables shall be used to determine the mortgage prepayment rate in determining the effective interest rate. Thus, the mortgages are to be treated as prepaying on the basis of 100 percent of FHA tables.

The third rule provides that the effective rate of interest on the mortgages is to be determined on an actuarial basis. All amounts that are taken into account in determining the effective rate of interest are discounted, from the time the amount is received, to an amount equal to the "purchase price" of the mortgage. The discount rate which will discount all present and future receipts to the purchase price is the effective rate of interest on the mortgages.

The purchase price of the mortgage is the amount loaned to the mortgagor. Thus, if a mortgage loan is in the amount of $30,000 and the mortgagor is charged a one point origination fee, which is deducted from loan proceeds available to the mortgagor, the purchase price is $29,700.

Title IX also provides certain rules for determining the yield on the issue. The yield on the bond issue is also to be computed on an actuarial basis. In making the computation, the amounts payable as debt service are discounted to the issue price. The issue price is determined under the principles of section 1232(b)(2) of the Code and is the initial offering price to the public or private party (excluding bond houses and brokers) at which price a substantial amount of bonds were sold. This initial offering pirce to the public or private party could be at the face amount of the bonds (par) or at a discount or premium. Any discount at which the bonds are sold to an underwriter is disregarded in computing the yield of the bonds.

(i) Nonmortgage investments

Mortgage subsidy bonds issued prior to the effective date of Title IX usually have established a reserve of one and one-half times maximum annual scheduled debt service. This reserve amounts to about 12 percent of the original face amount of the bonds and generally has been invested in long-term Treasury obligations. Under section 103(c) of the Code, a reasonable reserve is permitted to be invested at an unrestricted yield.

However, in most mortgage subsidy bond issues, the reserve has been maintained at its original amount throughout the life of the bonds even though the scheduled debt service is rapidly decreased as a result of early redemption of some bonds because of prepayments of mortgages. Because the reserve is designed to provide a source for payment of debt service in the event funds are not otherwise available, Title IX provides that the reserve be reduced as future annual debt [466] service is reduced. More specifically, Title IX provides that the reserve amount is to be computed for each bond year on the basis of the debt service required for that year. The effect of this rule is to reduce the amount of the reserve that is invested at unrestricted yield.

Under section 103(c) of the Code, proceeds of a new issue may be invested at unrestricted yield either as a reserve or as less than a major portion of bond proceeds (the so-called minor portion). In addition to the rules under section 103(c) relating to reserves and the minor portion, the bill limits the amount that may be invested at unrestricted yield in nonmortgage investments to 150 percent of the debt service on the issue for the bond year. The amount subject to this 150 percent debt service rule includes the original bond proceeds, investment proceeds, and repayments of principal on the mortgages. A nonmortgage investment includes any investment other than qualified mortgages that are on owner-occupied residences. A mortgage-backed certificate or obligation is a nonmortgage investment.

An exception to the 150-percent debt service rule is provided, however, for proceeds invested for an initial temporary period until such proceeds are needed for mortgages. This rule is in addition to the temporary period rule provided under section 103(c). Consequently, the requirement that a designated amount of bond proceeds be made available in targeted areas does not abrogate the requirement that the issuer proceed with due diligence in placing the bond proceeds in mortgages. Although no time period is established under Title IX for the initial temporary period, it is anticipated that as a result of the 5-percent limitation and the due diligence requirement that mortgages will be placed within a short period of time.

A second exception to the 150-percent debt service rule is provided for amounts invested for a temporary period relating to payment of debt serv-

ice. Under this exception, the 13-month temporary period provided in the regulations under section 103(c) would be applicable to qualified mortgage bonds.

(j) Arbitrage to benefit mortgagors

Title IX requires that all arbitrage earned by the issuer on nonmortgage investments are to be paid or credited to the mortgagors. The amount of arbitrage earned is the excess of the nonmortgage earnings over the amount that would have been earned if the investments had been at the yield of the bonds. This amount will be the net amount of any negative arbitrage on investments. It is determined by taking into account any reinvestment of nonmortgage investment receipts and also includes any interest attributable to the excess whether or not such interest exceeds the yield of the bonds.

The amount paid or credited to the mortgagors must have a present value at least equal to the present value of the arbitrage profits. In determining these present value amounts, the yield of the bonds is to be used as the discount rate. The amounts must be paid or credited to the mortgagors as rapidly as practicable. For example, a bondholder's lien on these profits would violate this requirement because the profits would be paid to the mortgagors (if at all) only after the bonds had been retired.

[467] *(k) State opinion*

In order for an issue to be a qualified mortgage issue, the issuing authority must submit a preliminary official statement (or similar statement in the case of a private placement) relating to that issue to a State agency which has been designated by the State to receive such statements. Further, the agency has 30 days after submission to issue an opinion as to whether the issue meets the market share requirement and the portion of loans in targeted area requirement. If 30 days have elapsed and the agency has not issued an opinion, this requirement will be deemed to be satisfied. The opinion of the State agency does not bind the Internal Revenue Service. However, the opinion of the State agency within the 30-day period does bind the issuing governmental unit because a favorable opinion of the State agency is necessary in order for the issue to be a qualified mortgage issue.

(l) Registration

In order for an issue to be a qualified mortgage issue, all of the obligations which are part of the issue must be in registered form. A bond is in registered form if it is considered to be in registered form for purposes of reporting of original issue discount. (See section 6049 of the Code and section 1.6049-2(d) of the Income Tax Regulations.) This requirement is effective both for mortgage subsidy bonds issued after the date of enactment of Title IX and for those bonds issued after the date of enactment that would be mortgage subsidy bonds but for the transitional rules of Title IX.

(m) Multiple originator requirement

In order for an issue to be a qualified mortgage issue, there must be 2 or more persons that originate the mortgages financed from the issue. However, this rule does not apply where more than one mortgage originator has been offered an opportunity to participate in originating loans and only one person is willing and able to originate the mortgages or where a sound public policy is served by having only one person originate mortgages financed from the issue. In general, the offer to participate in originating loans from the issue must extend to all persons who are qualified and able to originate mortgages in the area in which the mortgages are to be made. Moreover, this requirement will not be met if insignificant amounts of bond proceeds are made available to mortgage originators other than one mortgage originator.

(n) New mortgage requirement

Generally, in order for an issue to be a qualified mortgage issue, no part of the bond proceeds from the issue can be used to acquire or replace existing mortgages. All of the lendable proceeds must be used to provide mortgage loans to persons who did not have a previous mortgage (whether or not paid off) on the residence securing the mortgage note at any time prior to execution of the mortgage.

There are three exceptions to the rule that all of the mortgages under the issue must be new mortgages. First, the rule does not apply to construction period loans. For example, where construction financing (whether or not from the bond proceeds) is made available to the [468] mortgagor so that he could build his residence, it is permissible to provide permanent financing to that mortgagor from the bond proceeds.

Second, the rule does not apply to bridge loans or similar temporary initial financing. For example, where the mortgagor purchases a residence in a targeted area and has not been able to sell his former residence prior to the closing on the new residence and obtains financing for the new residence until the former residence is sold, the providing of permanent financing from bond proceeds is permissible even though the permanent financing replaces the temporary financing.

Third, the rule does not apply to the replacement of an existing mortgage in the case of a qualified rehabilitation. For example, where a residence with an existing mortgage is rehabilitated and a rehabilitation loan is used to provide funds for the cost of rehabilitation and to retire (or "takeout") the existing mortgage, the mortgage will not violate the new mortgage requirement.

(o) Assumptions

In order for an issue to be a qualified mortgage issue, certain of the requirements for a qualified mortgage bond must be met by every mortgagor who assumes a mortgage that had been made from proceeds of a qualified mortgage issue. Those requirements are the residence requirements (subsection (d)), the 3-year requirement (subsection (e)), the purchase price requirement (subsection (f)), and the

income requirement (subsection (h)). These requirements are to be determined based upon the facts as they exist at the time of the assumption as if the loan were first being made at that time. For example, the average income of the statistical area is to be determined by the average income at the time of the assumption and not when the mortgage was originally made. Similarly, the purchase price requirement is determined with reference to the purchase price of the residence at the time of the assumption and not at the time the mortgage was originally made.

(3) Qualified veterans' mortgage bonds

Title IX also provides that qualified veterans' mortgage bonds shall not be treated as mortgage subsidy bonds. Under this provision, interest on a qualified veterans' mortgage bond will be exempt from Federal income taxation if the bond otherwise meets the general requirements of Code section 103.

In general, a bond is a qualified veterans' mortgage bond only if it meets certain specific requirements. First, the principal and interest on the bond must be secured by the general obligation of a State. Second, substantially all the proceeds of the bond must be used to provide residences for veterans.[6] For purposes of this provision, the term "veteran" has the same meaning as in section 101 of Chapter 1 of Title 38 of the United States Code (relating to veterans' benefits). Under that provision, the term veteran means a person who served in the active military, naval, or air service, and who was discharged or released therefrom under conditions other than dishonorable. Third, for bonds [469] issued after the date of enactment of Title IX, the bonds must be in registered form. (See above for a discussion of registration.) Fourth, in order to be a qualified veterans' mortgage bond, no part of the proceeds of the bond may be used for refinancing existing mortgages. The proceeds of a qualified veterans' mortgage bond are to be used solely for new mortgage loans.

(4) Advance refunding

Title IX prohibits the advance refunding of any bond if a significant portion of the proceeds are used for mortgages on owner-occupied housing. This provision applies to all bonds the proceeds of which are used for such purpose whether the bond was issued before, on, or after the date of enactment. Under this provision, no obligation may be issued for the advance refunding of any mortgage subsidy bonds, including qualified mortgage bonds and qualified veterans' mortgage bonds.

In general, an obligation issued for the refunding of a mortgage subsidy bond will be considered to be an advance refunding obligation if it is issued more than 180 days before the prior issue is redeemed.

b. Multi-Family Rental Housing (Sec: 903 of Title IX and sec. 103 (b) of the Code)

Under Title IX, interest on an industrial development bond substantially all the proceeds of which are used to provide a qualifying project for residential rental property will be exempt from Federal income taxation. A project will be treated as meeting the requirements of the provision only if 20 percent or more of the units in the project are to be occupied by individuals of low or moderate income.

The term "low or moderate income" has the same meaning as in section 169(k)(3)(B) of the Code. Under that section, low or moderate income is to be determined by the Secretary of theTreasury in a manner consistent with the Leased Housing Program under Section 8 of the United States Housing Act of 1937. The current Treasury regulations provide that occupants of a dwelling unit generally are considered families and individuals of low or moderate income only if their adjusted income does not exceed 80 percent of the median income for the area, as determined by the Secretary of Housing and Urban Development.

In order to qualify under this provision, 20 percent or more of the units in each project must be occupied by qualifying individuals on an ongoing basis. However, where an individual satisfies the low or moderate income test at the time he (or she) first occupies a unit in a project, that occupant will be treated as a qualifying individual as long as he or she continues to reside in the project, even though the occupant later ceases to be an individual of low or moderate income. Moreover, where a qualifying individual leaves the project, the unoccupied unit will continue as a qualifying unit until it is reoccupied by another tenant, at which time, the status of the new tenant as a qualifying individual is to be determined.

The 20-percent test generally must be met during the entire time that the bonds are outstanding. However, Title IX contains a special [470] rule for bonds issued before January 1, 1981 (and which do not come within the transitional rules) under which the 20-percent test need be met only for a period of 20 years. The 20-year period begins on the first date that the project is available for occupancy and that the tax-exempt obligations are outstanding. Under this special rule, the 20-percent test will be met where the developer of the project has entered into a contract with a Federal or State agency that requires that at least 20 percent of the units be maintained for persons of low or moderate income for a period of at least 20 years and provides rent subsidies for such persons for that period.

Only projects which provide units that contain complete living facilities which are to be used other than on a transient basis will qualify under this provision as an exempt facility. In general, a project is a building or structure which contains units having complete living facilities and facilities

[6] The term "substantially all" has the same meaning as under section 103(b)(4) of the Code.

which are functionally related and subordinate to the living facilities.

c. Effective Date and Transitional Rules (Sec. 904 of Title IX)

(1) General effective date

In general, the provisions of Title IX apply to all bonds issued after April 24, 1979. However, the provisions of Title IX terminate with respect to qualified mortgage bonds which are issued more than 2 years after the date of enactment. Finally, Title IX provides transitional rules under which certain obligations which do not meet the requirements of this bill may be issued after April 25, 1979. This was the date on which H.R. 3712, the predecessor of H.R. 5741 and H.R. 7652, was introduced.

(2) Transitional rules

(*a*) *General*

The transitional rules provide an official action rule, a rollover rule and a rule for projects under development. These rules apply to both obligations for owner-occupied residences (sec. 902 of the bill) and obligations for multi-family rental units (sec. 903 of the bill).

The transitional rules also provide an exception for State housing finance agencies, certain special rules, a rehabilitation program rule, and a $50 per capita exception for local governments. These rules apply to obligations for owner-occupied residences (sec. 902 of Title IX).

The official action rule in general addresses situations where a State or local government has made a determination to issue a particular tax-exempt bond issue for housing. Under this rule, if, prior to April 25, 1979, a State or local government had the authority to issue tax-exempt bonds for housing and had taken certain steps toward the issuance of a particular tax-exempt bond issue, then the general provisions of Title IX will not apply to the issue involved. The official action rule relates to official action with regard to a particular issue of bonds. Thus, under the official action rule, only one issue of bonds can be issued for any one official action. Similarly, the official action must relate to the bond issue, not to a housing project or program. (How-[471]ever, see below for a discussion of the rule for projects under development.)

The rollover rule addresses those situations in which a State or local government had issued obligations prior to April 25, 1979. Under this rule, if certain conditions are statisfied, the general provisions of Title IX will not apply where the State or local government refinances the obligation with another obligation.

The rules for projects under development address situations where plans and specifications for a particular project have been formulated before April 25, 1979. If certain conditions are satisfied with respect to such projects, the general provisions of Title IX will not apply to obligations issued to finance such projects.

The remaining transitional rules (i.e., exception for State housing finance agencies, the special rules, the rehabilitation program rule, and the $50 per capita exception for local governments) address those situations in which an obligation does not meet the requirements of the official action rule. More specifically, these rules generally address those situations where a State or local government did not have the authority to issue tax-exempt obligations for owner-occupied residences prior to April 25, 1979, or had not taken the required action toward the issuance of a particular tax-exempt bond issue for owner-occupied residences on such date. These rules reflect all the remaining instances with respect to which the Committee believed that the permanent requirements of Title IX should not apply.

(*b*) *Official action rule*

(*i*) *In general*

The official action rule provides that the provisions of Title IX shall not apply to an obligation if, prior to April 25, 1979, the governing body of the unit having authority to issue the obligations had taken official action with respect to that obligation indicating an intent to issue the obligation.

The official action rule imposes three conditions which must be satisfied for a particular action to be treated as a qualifying action. First, the action must be an official action. Second, the action must be a specific action with respect to a particular bond issue indicating an intent to actually issue that particular bond issue. Finally, the action must be taken by the governing body of a unit having authority to issue tax-exempt housing obligations.

Specific requirements

The first requirement that the action be an official action requires the adoption of a resolution, ordinance, or similar action prior to April 25, 1979. Under this rule, adoption of a resolution, ordinance, or similar action will qualify as an official action only if it conforms with State or local legal requirements and is a proper exercise of the powers of the governing body of the issuer. Thus, an action which is *ultra vires* will not constitute an official action. Moreover, the governing body must not have withdrawn its official action.[1] However, in the [472] case in which two governing bodies had taken joint official action prior to April 25, 1979, the fact that one governing body had withdrawn its official action will not cause the other governing body to be treated as having withdrawn its official action.

In addition, written evidence of the action must exist before April 25, 1979. Such written evidence includes the formal resolution or ordinance which was adopted, the recorded minutes of the governing body of the issuer, or a contract between the issuer and a party retained to prepare the documents necessary for the sale of the obligation.

[1] Where the official action is authorization to hire bond counsel or bond underwriters, a change in the bond counsel or bond underwriters is not considered a withdrawal of the official action of the governing body.

The second requirement is directed at the substance of the action taken. This requirement provides that the action must be a specific action with respect to a particular bond issue indicating an intent to actually issue that particular bond issue. More specifically, this rule requires that, prior to the time the action is taken, the issuing authority must have had formulated a specific bond issue proposal and the action be a step toward the sale of the bond issue. If the action does not relate to a particular bond issue or directs a party to formulate a proposal or to determine whether a State or local government should issue tax-exempt obligations for housing, it will not meet this requirement.

Generally, an official action would include the adoption of a resolution authorizing the hiring of bond counsel, bond underwriters, market analysts, or other persons to take steps (such as the preparation of documents) necessary for the issuance of a particular tax-exempt bond issue. In such instances, the second requirement would be satisfied since the authorization was with respect to a particular bond issue and the authorization indicated an intent to actually issue that particular bond issue.

In addition, the adoption of a resolution authorizing the issuance of a particular bond issue would meet this requirement since the authorization was a specific authorization with respect to a particular issue and the authorization to issue indicated an intent to actually issue that particular bond issue.

On the other hand, the adoption of a general authorization to hire bond counsel or other persons to represent a governmental unit or agency will not satisfy this requirement since the action does not relate to a particular bond issue and does not indicate an intent to actually issue a particular bond issue. Similarly, an authorization to conduct a market analysis to determine whether or not the governmental unit should issue housing bonds would not constitute a qualifying official action because the action did not indicate a decision by the governmental unit to issue the bonds.

In certain instances, the adoption of a resolution which authorizes the retention of a consultant to formulate a proposal for the redevelopment of the issuing jurisdiction and to take the appropriate steps necessary for the implementation of the proposal will satisfy this requirement. Such a resolution will meet this requirement if, pursuant to the authorization, the consultant had performed by April 25, 1979, more than an insubstantial amount of the same types of services that are provided by bond underwriters or bond counsel in preparation of the [473] issuance of the bond issue. The requirements would be satisfied in such a case since the services performed were with respect to a particular bond issue and indicate an intent to actually issue the particular bond issue. Furthermore, where the governing body of a governmental unit having authority to issue tax-exempt bonds had adopted a resolution authorizing the retention of bond counsel to represent the unit on the issuance of bonds generally, and bond counsel had in fact been hired pursuant to such resolution prior to April 25, 1979, written evidence of the fact that the bond counsel had performed before April 25, 1979, more than an insubstantial amount of work on the preparation of the issuance of a particular bond issue would be evidence that the first and second requirements of the official action rule are satisfied.

In addition, the creation of a bond issuing authority or the adoption of a resolution generally authorizing the issuance of tax-exempt obligations for housing will not satisfy either of these requirements since neither represents an official action with respect to a particular bond issue or indicates an intent to issue a particular bond issue. However, where a general authorization to issue tax-exempt obligations for housing exists and the governing body of the unit having authority to issue such obligation took further official action with respect to a particular issue prior to April 25, 1979, the requirements of this provision will be satisfied.

Thus, in the case in which an issuing authority adopts a resolution authorizing the issuance of bonds and the issuing authority had taken no further official action indicating an intent to actually issue a specific bond issue, the requirements of this provision will not be satisfied. On the other hand, if the issuing authority had adopted a resolution authorizing the hiring of bond counsel for the sale of a portion of the obligations authorized, such action will meet this requirement.

The third requirement of the official action rules is that the action be taken by the governing body of a unit having authority to issue tax-exempt obligations for housing. Under this requirement, the official action must, in fact, have been taken by the governing body of the issuing governmental unit. Thus, an action will not qualify if it was taken by a representative of the governing body. In general, this rule requires that the official action be taken by the governing body of the State or local government which will issue the obligations or by the governing body of an agency which will issue the obligations on behalf of a State or local government. In addition, this rule will be satisfied if the official action is taken by the governing body of a State or local government even though the obligation will be issued by an agency on behalf of the governmental unit. However, in order to satisfy the requirement, either the issuing State or local government or the agency which will issue obligations on behalf of a State or local government must, prior to April 25, 1979, have authority to issue tax-exempt obligations for housing. Such authority to issue tax-exempt obligations must be authority to issue obligations in the amount and for the same purpose as the proposed issue. Thus, a unit must have authority to issue mortgage subsidy bonds, in the case of an issuance of tax-exempt obligations for owner-occupied residences, and authority to issue industrial development bonds, in the case of an issuance of tax-exempt

obligations for multi-family rental facilities.

[474] A governmental unit will be considered to have authority to issue bonds as of April 24, 1979, where the governmental unit had the authority to create an agency which could issue the bonds on behalf of the governmental unit, even though the governmental unit had not created the agency as of April 24, 1979.

Staff action rule

The transitional rules also provide a rule which treats the actions of the staff of a housing authority as an official action of the governing body of the issuing authority.

Under this rule, if the permanent professional staff of a housing authority performed substantial work on a bond issue prior to April 25, 1979, and it was reasonable to expect that the bond issue, as developed by the staff, would be promptly approved by the governing body of the housing authority, then the work of the staff will be treated as the official action of the governing body. For purposes of this provision, any delay in approval caused by the introduction of this bill (or its predecessors) shall not be taken into account.

In general, this rule requires the existence of a housing authority or similar governmental unit or agency whose primary function is to develop or rehabilitate housing within its jurisdiction. This rule requires that the housing authority be staffed by a permanent professional staff and that the staff be compensated by the authority. In addition, the staff's sole responsibilities and duties must be performed for such housing authority.

Under this rule, the work of the staff will be treated as official action of the governing body of the issuing authority provided that, prior to April 25, 1979, the housing authority had the authority to issue tax-exempt obligations for housing. As a result, where such work has been performed, the first and third requirements of the official action rule will be satisfied. However, in order to satisfy the second requirement of that rule, the work of the staff must be with respect to a specific bond issue which indicates an intent to actually issue that bond issue. Therefore, the work performed by the staff must be of the same type as that which would be provided by a bond underwriter, bond counsel, or market analyst in preparation of the issuance of a bond issue. Thus, if the staff of a housing authority had prepared a bond indenture or had conducted a market analysis with respect to a specific bond issue, the second requirement of the official action rule will be satisfied. However, work done by a professional staff on a housing project, as opposed to work done on the issuance of bonds, would not qualify as official action under this provision.

Rules relating to size of issue

Title IX also provides a rule relating to the size of an issue where qualifying official action had been taken prior to April 25, 1979.

Under this rule, with one exception, an issue will not qualify under the official action rule if the issue size exceeds the intended issue size, or if the intended issue size cannot be determined. The issue size is defined as the aggregate face amount of obligations issued pursuant to the issue. The intended issue size means the aggregate face amount of obligations which a reasonable individual would reasonably con-[475]clude was the issue size which the governing body of the issuing authority on April 24, 1979, intended to issue. The determination of the intended issue size is to be made on the basis of the documentation which was in existence prior to April 25, 1979.

In the case where an issuing authority is uncertain of its intended issue size, it is anticipated that the issuer may submit a ruling request with the Internal Revenue Service to determine the intended issue size. However, where an intended issue size cannot be determined from such documentation or where no documentation exists, an issue will not qualify under the official action rule, unless the issue meets the requirements of the exception.

The determination of the intended issue size shall take into account all documents which relate to the issue. Thus, in the case of a bond issue which will be used to provide financing for a particular project to be constructed, the documentation which relates to the design and anticipated cost of the overall project or the cost of each unit within the project shall be taken into account in determining the intended issue size. Where such documents are the only documents which relate to the intended issue size, the intended issue size (exclusive of issuance costs and a reasonably required reserve) is an amount equal to the amount necessary to acquire or construct a unit or project substantially similar in cost and design to the units or project described in the documentation.

In the case where the only documentation which exists as of April 24, 1979, relates to the amount of mortgage money the issuing authority actually intended to make available, the intended issue size (exclusive of issuance costs and a reasonably required reserve) may not be in excess of the amount of mortgage money the issuing authority intended to provide.

An exception to the rule that an issue will not qualify under the official action rule is provided in the case of an issue for the owner financing on one- to four-family, owner-occupied residences where no documentation exists as of April 24, 1979, relating to the intended issue size. Under this exception, the issue size will not be treated as exceeding the intended issue size where two requirements are satisfied.

The first requirement is that all the lendable proceeds of the issue will be used to provide owner-financing for one- to four-family, owner-occupied residences. For purposes of this requirement, the lendable proceeds of an issue means the proceeds of the issue exclusive of issuance costs and a reasonably required reserve. An issue will not meet this requirement if any part of the proceeds are used to acquire or replace existing mortgages on one-

to four-family, owner-occupied residences. However, the replacement of construction period loans, temporary period financing, and an existing mortgage in the case of a qualified rehabilitation will not be treated as the acquisition or replacement of an existing mortgage.

The second requirement of the exception is that substantially all the proceeds of the issue be committed to the owner-financing of one- to four-family, owner-occupied residences within 9 months of the date of issuance. The commitment of the proceeds must be done by firm commitment letters issued during the 9-month period. This provision also [476] provides that a firm commitment letter be a document similar to the type a lender would ordinarily provide prospective home buyers where financing was not provided from the proceeds of a tax-exempt bond. In order to satisfy this requirement, a firm commitment letter must commit a stated amount of money to a specific individual for a stated period of time for the purchase of a particular residence at a stated interest rate.

Generally, an issue will not qualify under the exception unless both the one- to four-family and 9-month requirements are satisfied. However, in the case in which a bond issue has been issued and, at the time of issuance, it was reasonably expected that the 9-month rule would be satisfied, the bond issue will be tax-exempt if it otherwise satisfies the requirements of Code section 103 and if the proceeds for which commitments were not made within 9 months from the issuance date are used to redeem obligations. This rule will apply only if the uncommitted proceeds are used to redeem obligations within 15 months of the issuance date.

(*ii*) *Additional rules*

In general

The transitional rules provide two rules which address situations where the governing body of a local governmental unit took action with respect to the issuance of tax-exempt obligations for owner-occupied residences but did not have authority to issue such obligations at the time it took the action. Under these rules, the third specific requirement of the official action rule will be deemed to be satisfied. However, a dollar limit and a new mortgage requirement are imposed on obligations issued pursuant to these two rules. In addition, as is the case under the general official action rule (see section 2,a) only one issue of bonds can be issued for any one official action.

Local referendum rule

The first rule applies to situations where, prior to April 25, 1979, the governing body of a local governmental unit took a specific action with respect to the issuance of a particular issue of tax-exempt obligations for owner-occupied residences, and legislation authorizing the governmental unit to issue such obligations was enacted after April 24, 1979, but prior to June 7, 1979, and a local referendum authorizing the particular bond issue was held prior to June 7, 1979. In such cases where the action otherwise meets the requirements of the official action rule and the requirements set forth below are met, the legislation and referendum are treated as in effect at the time the action was taken.

In order to qualify under this rule, four conditions must be satisfied. First, on April 25, 1979, legislation must have been pending in a State legislature to authorize local governmental units to issue tax-exempt obligations for certain public purposes. Second, on April 27, 1979, the legislation must have been amended to authorize local governmental units to issue tax-exempt obligations for owner-occupied residences. Third, the legislation must have been enacted, and a referendum authorizing the issuance of tax-exempt obligations for owner-occupied residences must have been held, prior to June 7, 1979. Fourth, the governing body of the local governmental unit to which the legislation [477] applied must have taken action toward the issuance of tax-exempt obligations for owner-occupied residences prior to April 25, 1979. In addition, such action must be the type of action which would have satisfied the requirements of the official action rule had the legislation been enacted and the referendum been held at the time the action was taken. Thus, the action must satisfy the first two specific requirements of the official action rule.

In the case where these four conditions are satisfied, this rule provides that, for purposes of the official action rule, the legislation shall be treated as in effect, and the referendum shall be treated as having been held, at the time the action was taken. In such cases, the third specific requirement of the official action rule, that before April 24, 1979, the local governmental unit have authority to issue tax-exempt obligations for housing, will be satisfied.

This rule also provides a dollar limit on the amount of obligations which may be issued pursuant to this transitional rule and a new mortgage requirement. In general, a governmental unit may issue obligations under this rule in an amount equal to the intended issue size. In the case where no documentation exists as of April 24, 1979, with respect to the intended issue size, a local governmental unit may issue obligations in an amount equal to the amount allowed under the 9-month rule. In addition, the aggregate amount of obligations which may be issued by local governmental units with respect to any geographic area may not exceed $35 million. However in the case where a local governmental unit may issue obligations under the official action rule, the dollar limit is reduced by the aggregate amount of obligations issued after April 24, 1979, by local governmental units with respect to such geographic area under the official action rule.

The new mortgage requirement provides that substantially all the proceeds of the issue (exclusive of issuance costs and a reasonably required reserve) must be committed to the owner financing of one- to four-family unit residences. Under this limitation, all the lendable proceeds of the issue must be used to provide owner financing

(including "qualified loans" for home improvements (see section (e) of Explanation of Provisions) for one- to four-family unit residences, one unit of which is owner-occupied. An issue will not satisfy this requirement where any part of the proceeds of the issue are used to acquire or replace existing mortgages on owner-occupied residences. However, the replacement of construction period loans, temporary period financing, and an existing mortgage in the case of a qualified rehabilitation will not be treated as the acquisition or replacement of an existing mortgage.

September 29, 1979, rule

The second rule applies where the governing body of a local governmental unit had taken action with respect to the issuance of a particular tax-exempt bond issue for owner-occupied residences prior to April 25, 1979, and legislation granting the authority to issue such obligations was enacted after April 24, 1979, but prior to September 29, 1979. In such cases where the action would have qualified as official action had the legislation been in effect when the action was taken and the requirements set forth below are met, this rule treats the legislation as in effect at the time the action was taken.

[478] In order to qualify under this rule, three conditions must be satisfied. First, legislation authorizing local governmental units to issue tax-exempt obligations for owner-occupied residences must have been pending before a State legislature on April 25, 1979. Second, such legislation must have been enacted prior to September 29, 1979. Third, the governing body of a local governmental unit must have taken action toward the issuance of tax exempt obligations for owner-occupied residences prior to April 25, 1979. In addition, such action must be the type of action which would have satisfied the requirements of the official action rule had the legislation been enacted at the time the action was taken. Thus, the action must satisfy the first two specific requirements of the official action rule.

Under this rule, for purposes of applying the official action rule, the authorizing legislation is treated as in effect at the time the action is taken where the above three conditions are satisfied. As a consequence, the third specific requirement of the official action rule, i.e., that before April 25, 1979, the local governmental unit have authority to issue tax-exempt obligations for owner-occupied residences will be satisfied.

This rule also provides a dollar limit on the amount of obligations which may be issued and a new mortgage requirement. The new mortgage requirement is identical to the new mortgage requirement which is imposed under the local referendum rule. In general, the amount of obligations which may be issued by a governmental unit under this rule is an amount equal to the intended issue size or the amount allowed under the 9-month rule where no documentation with respect to the intended issue size is in existence as of April 24, 1979.

In addition, this rule provides a dollar limit which restricts the aggregate amount of obligations which may be issued by local governmental units with respect to a geographic area. The dollar limits for an area will equal the lesser of (1) the aggregate amount authorized in the legislation authorizing the issuance of tax-exempt obligations for owner-occupied residences or (2) $150 million.

(c) Exception for State housing finance agencies

The exception for State housing finance agencies provides, with limitations, that the provisions of sections 902 and 903 of the bill shall not apply to obligations issued by a State housing finance agency. The term "State housing finance agency" is intended to include a housing division (or agency) of a State regardless of whether the bonds are issued directly by the housing division (agency) or the State, or are issued by another entity on behalf of the housing division (agency) or the State. Two limitations are imposed under this provision. The first limitation is a dollar limitation. This limitation provides that the aggregate amount of obligations for owner-occupied residences which may be issued by State housing finance agencies in any State may not exceed $150 million reduced by the aggregate amount of obligations for owner-occupied residences issued by such agencies under the official action rule.

Under this rule, State housing finance agencies may issue tax-exempt obligations for owner-occupied residences without satisfying the requirements of sections 902 and 903 of Title IX. However, the total amount of such obligations which may be issued with respect to any State is reduced by the amount of obligations for owner-occupied residences [479] issued after April 24, 1979, under the official action rule, by all of the State housing finance agencies of a State. Thus, if after April 24, 1979, the State mortgage finance agency of a State issues $50 million of tax-exempt bonds for owner-occupied residences under the official action rule and the State housing finance agency of the same State issues $50 million of tax-exempt bonds for owner-occupied residences under the official action rule, the aggregate amount of obligations which may be issued under this exception is $50 million.

The second limitation provides that, in the case where tax-exempt obligations for owner-occupied residences are issued under this rule, substantially all the proceeds of the issue (exclusive of issuance costs and a reasonably required reserve) must be committed to the owner financing of one- to four-family unit residences before January 1, 1981. Under this limitation, all the lendable proceeds of the issue must be used to provide owner financing (including "qualified loans" for home improvements, see section (e) of the Explanation of Provisions) for one- to four-family unit residences one unit of which is owner-occupied. An issue will not satisfy these requirements where any part of the proceeds of the issue are used to acquire or replace existing mortgages on owner-occupied residences. However, the replacement of

construction period loans, temporary period financing, an existing mortgage in the case of a qualified rehabilitation will not be treated as the acquisition or replacement of an existing mortgage.

The commitment of the proceeds must be done by firm commitment letters issued prior to January 1, 1981. Under this provision, a firm commitment letter is a document similar to the type a lender would ordinarily provide prospective home buyers or borrowers where financing was not provided from the proceeds of a tax-exempt bond. In order to satisfy this requirement, a firm commitment letter must commit to an individual a stated amount of money for the purchase or improvement of a particular residence for a stated period of time at a stated interest rate.

Generally, an issue will not qualify under the second limitation unless both the owner-financing and January 1, 1981 requirements are satisfied. However, in the case in which a bond issue has been issued and, at the time of issuance, it was reasonably expected that the January 1, 1981, requirement would be satisfied, the bond issue will be tax-exempt if it otherwise satisfies the requirements of Code section 103 and if the proceeds for which commitments were not made by January 1, 1981, are used to redeem obligations. This rule will apply only if the uncommitted proceeds are used to redeem obligations by July 1, 1981.

An exception to the second limitation, the mortgage commitment requirement, is provided in certain cases. In general, the mortgage commitment requirement provides that no part of the proceeds of an issue may be used to acquire or replace existing mortgages on owner-occupied residences. This requirement is waived under the exception where certain conditions are satisfied.

The exception applies in the case of a program under which tax-exempt obligations are issued to finance the purchase of existing mortgages on owner-occupied residences from banks. A program will qualify [480] under this rule only if the program was established in 1970 by State legislation and the program is operated by a State housing agency.

In order for an obligation to qualify under this exception, the governing body of the State housing agency which administers the program must have a finding in August 1978 that there was a shortage of mortgage funds within the State. Further, the finding must have been made as a required step toward the issuance of such obligations. In addition, all the moneys received by a bank from the State housing agency for the purchase of existing mortgages must be reinvested within 90 days of receipt in new mortgages. The new mortgages provided by the issue must satisfy a down payment requirement and a targeted area requirement.

The down payment requirement provides that at least 75 percent of the financing provided by the issue be 95-percent financing. Under this requirement, 75 percent of the moneys received by banks for existing mortgages must be used to provide financing for residences in an amount equal to or greater than 95 percent of the acquisition cost of each such residence. Further, this requirement will be satisfied only where 75 percent of the money paid for existing mortgages is used to provide financing that is 95-percent financing, regardless of the number of individual mortgages which qualify as 95-percent financing.

The second requirement, the targeted area requirement, provides that at least 20 percent of the moneys paid for existing mortgages must be used to provide owner financing of targeted area residences. For purposes of this provision, a targeted area residence means a residence in an area which is a census tract in which 70 percent or more of the families have income which is 80 percent or less of the statewide median family income. This determination is to be based on the most recent decennial census for which data are available.

Finally, the aggregate amount of obligations (including issuance costs and a reasonably required reserve) which may be issued under this exception to the mortgage commitment requirement with respect to a qualifying program is $125 million.

(d) Special rules

(i) In general

Title IX also includes five special rules which provide if certain requirements are met, that the provisions of section 902 of the bill will not apply to certain obligations. Generally, these rules are intended to provide transitional relief for specific situations that have come to the attention of the Committee

Certain public trusts

The first special rule applies in the case of obligations issued by a public trust on behalf of certain counties. This rule applies only where four conditions are satisfied. First, prior to April 25, 1979, a State must have enacted a law under which counties were authorized to create public trusts to issue tax-exempt obligations for public purposes. Second, on April 25, 1979, the question of whether the State statute authorized the issuance of tax-exempt obligations to provide owner-occupied residences for moderate income families must have [481] been in litigation in a State court of competent jurisdiction. Third, prior to July 31, 1979, the Supreme Court of the State in which the litigation was pending must have held that providing low interest loans to moderate income families constituted a proper public function. Fourth, there is written evidence that the governing body of a county in the State in which the litigation was pending took action prior to April 25, 1979, indicating an intent to issue or to establish a program for issuing tax-exempt obligations for owner-occupied residences. Such written evidence would include, for example, a written resolution, written ordinance, or the recorded minutes of the governing body which took action.

The action must not have been withdrawn or resulted in the issuance of

tax-exempt obligations for owner-occupied residences prior to April 25, 1979. For example, if the governing body of a local governmental unit had taken action in 1978 indicating an intent to issue or to establish a program for issuing tax-exempt obligations for owner-occupied residences, and the governmental unit had issued such obligations prior to April 25, 1979, the previous action will not be treated as qualifying action under this provision.

Under this rule, the aggregate amount of obligations issued with respect to any county may not exceed $50 million.

Certain other local governmental units

The second special rule applies in the case of certain local governmental units which had established prior to April 25, 1979, income limitations for families eligible for owner financing under a tax-exempt housing bond program. In order to qualify under this rule, three conditions must be satisfied. First, legislation authorizing local governmental units to issue tax-exempt obligations for owner-occupied residences must have been pending before a State legislature on April 25, 1979. Second, the governing body of a local governmental unit in the State in which the legislation was pending must have taken certain qualifying action prior to April 25, 1979. Qualifying action for purposes of this provision means action indicating to the delegation of the State legislature which represents the area comprising the local governmental unit the income limitations which would be applied under the tax-exempt housing bond program, the local governmental unit intended to establish following enactment of the authorizing legislation. Further, an action will qualify under this provision only where there is written evidence (which was in existence prior to April 25, 1979) to establish that the action occurred. Third, the legislation authorizing local governmental units to issue tax-exempt obligations for owner-occupied residences must have been enacted before June 8, 1979.

Under this rule, the maximum amount of obligations which may be issued with respect to any local governmental area may not exceed $150 million.

Certain cities

The third special rule applies in the case of obligations issued by an urban residential finance authority on behalf of certain cities. In order to qualify under this rule, four conditions must be satisfied. [482] First, prior to April 25, 1979, two resolutions must have been submitted to the council of a city. The first such resolution must have provided for the creation of an urban residential finance authority. The second such resolution must have authorized the president of the city council to appoint the members of the authority. Second, a vote on the passage of the second resolution must have been postponed prior to April 25, 1979, because specific legislation authorizing that city to issue tax-exempt obligations for owner-occupied residences had not been enacted at the time the vote was to have been taken. Third, legislation authorizing the city to issue tax-exempt obligations for owner-occupied residences must have been enacted prior to April 25, 1979, by the State legislature of the State with respect to which the city was a political subdivision. Fourth, after April 24, 1979, and prior to May 17, 1979, the city council of the city authorized to issue such obligations must have passed the previously submitted motions creating an urban residential finance authority, and authorized the president of the city council to appoint the members of the authority.

Under this rule, the maximum amount of obligations which may be issued with respect to any city may not exceed $50 million.

Certain bond series

The fourth special rule applies in the case of a city which had postponed the issuance of one-half of a previously authorized bond issue series. In order to qualify under this rule, three conditions must be satisfied. First, on April 11, 1979, the council of a city must have adopted a resolution authorizing the issuance of a mortgage revenue bond series for owner-occupied residences in an aggregate principal amount not to exceed $30 million. Second, on or about August 1, 1979, approximately one-half of the obligations authorized in the April 11, 1979, resolution must have been issued. Third, the primary reason the remaining one-half of the authorized obligations were not issued on or about August 1, 1979, must have been to save interest payments on such obligations during the temporary period the proceeds of such obligations were not needed for home mortgage loans. In the case where these three conditions are satisfied, the requirements of section 902 of Title IX shall not apply to the remaining obligations which were authorized by the city on April 11, 1979.

Certain nonprofit corporations

The fifth special rule applies in the case of obligations issued by certain nonprofit corporations established pursuant to a State law for the purpose of issuing tax-exempt obligations for owner-occupied residences. In order to qualify under this rule, three conditions must be satisfied. First, a State law authorizing local governments to establish nonprofit corporations to issue tax-exempt obligations for owner-occupied residences must have been enacted after April 24, 1979, and before June 16, 1979. Second, a local government must establish such a nonprofit corporation and designate it as the nonprofit corporation with respect to which the rule applies. Third, on November 7 or November 14, 1979, an amount must have been specified by or for the local government as the maximum amount of obligations which the [483] local government expected the designated nonprofit corporation to issue with respect to a geographic area under any transitional authority provided by Title IX. For purposes of this provision, an amount will be treated as being specified for a local government if the amount was provided to the Committee on November 7 or November 14, 1979, by means of a letter to

the chairman of the Committee from a Member of Congress.

This rule also imposes a dollar limit on the aggregate amount of obligations which may be issued with respect to any geographic area. The maximum amount of obligations which may be issued under this rule is the amount specified on November 7 or November 14, 1979, by or for a local government as the maximum amount which the local government expected the designated nonprofit corporation to issue with respect to a specific geographic area under any transitional authority provided by Title IX.

(ii) Additional requirements

In general, in the cases described in the above special rules, the requirements of section 902 of Title IX shall not apply with respect to obligations prescribed in those rules which are issued by or on behalf of qualifying local governmental units. However, in order for an obligation to qualify under any one of the special rules of this provision, three additional conditions must be satisfied. Those conditions are a mortgage commitment requirement, an affidavit requirement, and a prior issue rule.

Mortgage commitment requirement

The mortgage commitment requirement provides that, in the case where tax-exempt obligations for owner-occupied residences are issued under any one of the special rules, substantially all the proceeds of the issue (exclusive of issuance costs and a reasonably required reserve) must be committed to the owner-financing of one to four family unit residences before January 1, 1981. The specific requirements of this provision are identical to those of the mortgage commitment requirement of the exception for State housing finance agencies (see section 2c).

Affidavit requirement

The affidavit requirement provides that, in general, no obligation may be issued under any one of the special rules with respect to a geographic area unless a majority of the members of the governing body of the local governmental unit file affidavits with the Secretary of the Treasury or his delegate under penalty of law that it was their specific intent on April 24, 1979, (1) that tax-exempt obligations be issued to provide financing for owner-occupied residences or (2) that a program be established to issue tax-exempt obligations to provide financing for owner-occupied residences.

This rule, in general, requires a majority of all the members of the governing body of the governmental unit described in the special rules to declare in their affidavits that, on April 24, 1979, the governing body intended to issue tax-exempt obligations to provide financing for owner-occupied residences or to establish a program for issuing such obligations. Affidavits must be filed by a majority of those members [484] that comprised the governing body at the time the action was taken. In the case of the fifth special rule, where the governing body of a local government is a commissioners' court, the required affidavit must be filed by the county judge who was on April 25, 1979, the presiding officer of such court.

Prior issues rule

The prior issues rule provides that the applicable dollar limit on the amount of obligations which may be issued under any provision of the special rules is reduced by the aggregate amount of obligations which are issued after April 24, 1979, under the official action rules by any local governmental unit with respect to the geographic area within the jurisdiction of the issuer.

Under this rule, the limit on the aggregate amount of obligations is reduced by the aggregate amount of obligations which are issued after April 24, 1979, under the official action rules. However, in the case of the fourth special rule which applies where a city had postponed the issuance of one-half of a previously authorized bond issue series, the limit on the aggregate amount of obligations which may be issued is not reduced by those obligations issued on August 1, 1979. The amount of obligations which are issued after April 24, 1979, under the official action rules includes any obligations issued under any provision of the official action rules with respect to a geographic area within the jurisdiction of a local governmental unit which is described in the special rules. Thus, the amount of obligations issued by or on behalf of a city under the official action rules would reduce the dollar limit under the special rules for obligations issued by the county within which the city is located. Similarly, the amount of obligations issued by the city would also reduce the amount of obligations which may be issued by a local housing authority within whose jurisdiction the city is located. In addition, in the case in which a larger governmental unit issues obligations under the official action rules, the amount of obligations which may be issued by a smaller local governmental unit is reduced by a portion of the obligations which are issued by the related larger local governmental unit after April 24, 1979, under the official action rules. The portion of the obligations issued by the larger local governmental unit which will reduce the applicable dollar limit for the small governmental unit will be computed by multiplying the amount of obligations issued by the larger governmental unit by a fraction, the numerator of which is the population with respect to the smaller governmental unit and the denominator of which is the population with respect to the larger governmental unit.

(e) Rehabilitation programs

The transitional rules also provide a rule for certain ongoing local governmental programs which provide rehabilitation loans. Under this rule, the provisions of Title IX shall not apply to certain obligations issued by local governmental units with respect to a rehabilitation program. This rule also provides a dollar limit and a commitment requirement.

In general, this rule applies to obligations used to provide "qualified loans" where a local governmental unit had established a "qualified rehabilitation loan program" prior to April 25, 1979. A "qualified [485] rehabilitation loan program" means a program for the financing of alterations, repairs, and improvements on, or in connection with, an existing residence by the owner of such residence. However, a program will qualify under the provision only where the alterations, repairs and improvements financed under the program substantially protect or improve the basic livability of the property. A "qualified loan" means the financing of alterations, repairs and improvements on, or in connection with, an existing one- to four-family residence (one unit of which is owner-occupied) by the owner thereof, where the alterations, repairs or improvements substantially protect or improve the basic livability of the property. However, a loan will not be treated as a qualified loan if the financing is in an amount which exceeds $20,000 plus $2,500 for each unit in excess of one.

The commitment requirement provides that substantially all the proceeds of an obligation (exclusive of issuance costs and a reasonably required reserve) meeting the requirements of this rule must be committed to qualified loans by January 1, 1981. The commitment of the proceeds must be done by firm commitment letters issued prior to January 1, 1981. The commitment letter must be a document similar to the type a lender would ordinarily provide prospective borrowers where financing was not provided from the proceeds of a tax-exempt bond. Thus, the commitment letter must commit to an individual a stated amount of money for the improvement of a particular residence for a stated period of time at a stated interest rate.

Generally, an issue will not qualify under this rule unless both the qualified loan and the January 1, 1981, requirements are satisfied. However, in the case in which a bond issue has been issued and, at the time of issuance, it was reasonably expected that the January 1, 1981, requirement would be satisfied, the bond issue will be tax-exempt if it otherwise satisfies the requirements of Code section 103 and if the proceeds for which commitments were not made by January 1, 1981, are used to redeem obligations. This rule will apply only if the uncommitted proceeds are used to redeem obligations by July 1, 1981.

This rule also provides a dollar limit which restricts the aggregate amount of obligations which may be issued by local governmental units with respect to any geographic area. The dollar limit for an area will, in general, equal the lesser of (1) $10 million or (2) the aggregate amount of loans made under a qualified rehabilitation loan program with respect to the area comprising the local governmental area during the period beginning January 1, 1977, and ending April 24, 1979. However, in any case in which a local governmental unit may issue obligations with respect to a qualified rehabilitation loan program under the official action rules, the dollar limit is reduced by the aggregate amount of such obligations issued after April 24, 1979, by the local governmental units with respect to such geographic area under the official action rules.

(f) $50 per capita exception for local governments

The $50 per capital exception provides that the provisions of section 902 of Title IX shall not apply to certain obligations issued by local governmental units. This rule applies where there is written evidence that the governing body of the local governmental unit which issues the [486] obligations had taken action prior to April 25, 1979, indicating an intent to issue (or to establish a program for issuing) tax-exempt obligations to finance owner-occupied residences. Such written evidence would include, for example, a written resolution, written ordinance, or the recorded minutes of the governing body which took the action.

Moreover, the action must not have been withdrawn or resulted in the issuance of tax-exempt obligations for owner-occupied residences prior to April 25, 1979. For example, if the governing body of a local governmental unit had taken action in 1978 indicating an intent to issue or to establish a program for issuing tax-exempt obligations for owner-occupied residences, and the governmental unit had issued such obligations prior to April 25, 1979, the previous action will not be treated as qualifying action under this provision.

For purposes of this rule, action taken by the governing body of a second local governmental unit with respect to a particular area is treated as action of the issuing governmental unit where both governmental units have authority with respect to the identical geographic area. Thus, action taken by the governing body of a municipality is treated as action taken by the governing body of the municipal housing authority which will issue the obligations, where both governmental units have jurisdiction over the same geographic area.

In addition to the above requirement, in order to qualify under this exception, two other conditions must be satisfied. First, on October 30, 1979, a local governmental unit must have had the authority to issue tax-exempt obligations to finance owner-occupied residences. Second, a majority of the members of the governing body of the local governmental unit must file affidavits with the Secretary of the Treasury or his delegate declaring under penalty of law that the governing body had taken action indicating an intent to issue (or to establish a program for issuing) tax-exempt obligations to finance owner-occupied residences. Under this rule, affidavits must be filed by a majority of those members that comprised the governing body at the time the action was taken.

This rule also provides a dollar limit on the amount of obligations issued by local governmental units. The aggregate amount of obligations issued with respect to any area under this rule, in general, may not exceed the amount equal to the product of $50 multiplied by the population of that area. How-

ever, this amount is reduced by the aggregate amount of obligations which are issued by local governmental units after April 24, 1979, with respect to an area under the official action rules, the special rules, and the rehabilitation program rules. For purposes of determining the aggregate amount of obligations which may be issued with respect to any area, the population of such area shall be the population as of July 1, 1976, as determined for purposes of revenue sharing under the State and Local Fiscal Assistance Act of 1972.

Thus, the amount of obligations issued by or on behalf of a city under the special rules would reduce the amount of obligations which may be issued by a county under this rule where the city is located within the county. Similarly, the amount of obligations issued by the city would also reduce the amount of obligations which may be [487] issued by a local housing authority within whose jurisdiction the city is located. In addition, in the case in which a larger governmental unit issues obligations under the official action rule, the amount of obligations which may be issued by a smaller local governmental unit is reduced by a portion of the obligations which are issued by the related larger local governmental unit after April 24, 1979, under the official action rules. The portion of the obligations issued by the larger local governmental unit which will reduce the applicable dollar limit for the smaller governmental unit will be computed by multiplying the amount of obligations issued by the larger governmental unit by a fraction, the numerator of which is the population with respect to the smaller governmental unit and the denominator of which is the population with respect to the larger governmental unit.

Where two or more governmental units meet the requirements of this rule and have the authority to issue mortgage subsidy bonds to finance mortgages on residences in the same geographic area, this provision provides that only the governmental unit with jurisdiction over the smallest geographic area shall be treated as having issuing authority within that geographic area. For example, where both a county and a city located within the county have authority to issue mortgage subsidy bonds and both meet the requirements of this rule, the dollar limit of the city is determined by reference to the population within the city. The dollar limit of the county is determined by reference to the population located within the county but outside of the city.

Where two governmental units have authority to issue mortgage subsidy bonds and both governmental units have jurisdiction over the identical geographic area, the population located within that area is to be allocated to the governmental unit having the broader sovereign powers. For example, where a city and a housing finance agency have jurisdiction only within the city and both the city and the housing finance agency have authority to issue mortgage subsidy bonds, then the population is allocated to the city since the city has broader sovereign powers than the housing finance agency.

Title IX provides an exception to the rule that where two or more local governmental units meet the requirements of the $50 per capita rule and have authority to issue mortgage subsidy bonds with respect to the same area, only the governmental unit representing the smallest geographic area is treated as having issuing authority with respect to such area. Under the exception, a small governmental unit can enter into an agreement with the governmental unit having the next largest geographic area that includes the area of the smaller governmental unit to allocate all or a designated amount or portion of the amount of obligations it is permitted to issue under this transitional rule to the larger governmental unit. For example, where a city is located within a county and both the city and the county meet the requirements of this rule and have the authority to issue mortgage subsidy bonds, the city could enter into an agreement with the county to allocate all or a designated amount or portion of the amount of obligations it is permitted to issue under this transitional rule to the county. If such an agreement were entered into, the dollar limit of the city would be reduced and the dollar limit of the county would be determined with regard to the obligations allocated to the county from the city.

[488] This rules also provides that substantially all the proceeds of an issue (exclusive of issuance costs and a reasonably required reserve) must be committed to the owner financing of one- to four-family residences before January 1, 1981. The requirements of this provision are identical to those of the mortgage commitment requirement of the exception for State housing finance agencies (see section 2c).

(g) Rollover rule

The rollover rule permits the refinancing of tax-exempt notes or obligations which were outstanding prior to April 25, 1979. This rule will apply, for example, where short-term, tax-exempt obligations were isued to provide financing for construction of a particular project with the intention that the short-term financing would be replaced with permanent long-term, tax-exempt financing following completion of construction, and where tax-exempt obligations were issued to provide financing for a multi-family rental facility or for single-family residences but, because of high tax-exempt interest rates, the period until maturity on the tax-exempt obligations was less than the period to maturity on the mortgage or other financing of the facility or family units.

The rollover rule allows the issuance of tax-exempt obligations after April 24, 1979, to refinance tax-exempt obligations which were outstanding on April 24, 1979, where certain conditions are satisfied. However, for refinancings after the date of enactment, see the discussion relating to advance refunding.

First, the proceeds of any obligation issued pursuant to this rule must be

used for the same purpose as the proceeds of the original obligation. Thus, if the proceeds of an obligation were used to provide construction period financing for the construction of a multi-family rental facility, the obligations issued pursuant to this rule must be used to provide financing for the same facility. Further, at the time the financing is issued, it must be reasonably anticipated that the facility will continue to be used for the same purpose.

This rule also requires that, as of April 24, 1979, there must have been an agreed-on period for the maturity of the mortgage or other permanent financing for the facility or units with respect to which obligations had been issued. The maturity date of a refinancing obligation issue pursuant to this provision must not exceed the agreed-on maturity period of the mortgage by more than two years. Under this rule, where more than one old obligation is to be replaced and the mortgages for the facilities financed with the old obligation have different agreed-on maturities, then a new bond issue will qualify under this rule if the maturity date of the new obligations corresponds with the differing agreed-on maturities of the mortgages.

The rollover rule also provides that the aggregate face amount of the refinancing obligation may not exceed the aggregate face amount of the refunded obligation by more than an amount which is reasonably necessary to cover construction period interest, reasonably required reserves, and the issuance costs of the refinancing obligations.

(h) Rules for projects under development

The transitional rules also include two rules for projects under development. The first rule applies to multi-family rental housing proj-[489]ects under development and the second rule applies to single-family, owner-occupied housing projects under development. These rules except from the general requirements of Title IX obligations the proceeds of which are to be used to finance the completion of certain projects which were in the development stage on April 24, 1979.

Multi-family rental housing

The multi-family housing rule provides two exceptions to the requirements of section 903 of Title IX. The first exception provides that the provisions of this bill which relate to tax-exempt obligations for multi-family rental housing shall not apply to tax-exempt obligations issued for certain projects which were in the development stage on April 24, 1979. This rule will only apply to a project if, prior to April 25, 1979, a plan specifying the number and location of rental units was approved by the governing body of a State or local government or by the governing body of a State or local housing agency or similar agency. In addition, substantial expenditures for site improvement for the project must have been incurred on or before April 24, 1979, for this rule to be applicable. Expenditures for the site improvement for the project can be incurred by any person regardless of whether or not they are otherwise involved in the project. Such expenditures would include expenditures for sewer and water facilities, and for roads. Such expenditures would not include costs for rezoning, costs of architects, environmental impact or similar studies, or any expenditures that relate to whether a particular site is to be used, as opposed to the development of a particular site. Finally, this rule will apply only with respect to obligations used to provide financing for the number and type of rental units specified in the approved plan and only if the units are constructed at the location specified in the approved plan. However, any number of issues of obligations can be issued to finance the project that qualifies under this rule.

The second exception provides that the provisions of Title IX which relate to tax-exempt obligations for multi-family rental housing shall not apply to tax-exempt obligations issued for certain projects which were in the development stage on April 24, 1979. This rule will only apply to a project if, prior to April 25, 1979, a plan specifying the number and location of rental units was preliminarily approved by the Secretary of HUD, pursuant to section 221(d)(4) or section 232 of the Housing Act. Such approval must be established by written evidence which was in existence prior to April 25, 1979. In addition, fees for processing the application for the project with HUD and other expenditures for the project must have been incurred on or before April 24, 1979.

Finally, this rule will apply only with respect to obligations used to provide financing for the number and type of rental units specified in the approved plan and only if the units are constructed at the location specified in the approved plan. However, any number of issues of obligations can be issued to finance the project that qualifies under this rule.

Owner-occupied housing

The second rule for projects under development provides that the provisions of Title IX which relate to tax-exempt obligations for [490] owner-occupied housing will not apply to tax-exempt obligations for certain projects in the development stage on April 24, 1979. In addition, the provisions of Title IX relating to industrial development bonds will not apply to the construction or other initial temporary financing of such a project if substantially all of the dwelling units in the project are to be owner-occupied residences.

In order to meet the requirements of this provision, a specific project must have been in the active development stage on or before April 24, 1979. Two other conditions must also be satisfied. First, on or before that date, substantial expenditures must have been made for detailed plans and specifications of the residences to be constructed. Such plans and specifications must include completed architectural and engineering designs which specify the number, size and

anticipated cost of the residences to be constructed.

Second, tax-exempt construction financing must have been issued with respect to the specific project or there must exist written evidence that a governmental unit intended to actually issue tax-exempt obligations to finance the acquisition of the units by individual home-buyers. Such construction financing must be outstanding on or before April 24, 1979, and such written evidence must have been in existence on or before such date.

Moreover, this exception shall apply only if the units constructed are substantially similar in design to the units specified in the plans and specifications which were in existence on or before April 24, 1979. The aggregate amount of the obligations issued with respect to a project in the development stage shall not exceed the reasonably anticipated cost of the project, where the obligations are to be used to provide construction period financing. In the case in which the obligations are to be used to finance the acquisition of the units by individual home-buyers, the aggregate amount of the obligations may not exceed the reasonably anticipated amount required to finance the acquisition of the units by individual home buyers, plus issuance costs and a reasonably required reserve. The proceeds of any obligations (exclusive of issuance costs and a reasonably required reserve) which are not used to finance the acquisition of units by home buyers must be used to redeem the obligations.

The second requirement of this rule will also be treated as being satisfied if certain actions had occurred prior to April 25, 1979. However, in the case in which a project qualifies under this special exception, the aggregate amount of obligations which may be issued by local governmental units with respect to the geographic area comprising a local governmental area may not exceed $20 million.

Generally, in order to qualify under this special exception, three actions must have occurred prior to April 25, 1979. First, the developer of a project must have acquired land on which the project was to be constructed. Second, the mayor's advisory committee of a city must have approved (subject to further revision) a written comprehensive proposal for such project submitted by the developer. In addition, the proposal must have requested that tax-exempt obligations be issued to finance the purchase of the units within the projects by individuals, and issuance of such obligations must have been authorized under a State law authorizing tax-exempt obligations for use only in [491] redevelopment areas. Third, a revised proposal must have been submitted to the redevelopment agency and the city council which had jurisdiction over the geographic area in which the project was to be located.

(i) Rule for local governments whose home rule powers were modified on April 26, 1979

The bill also provides a transitional rule under which section 902 of Title IX will not apply to obligations issued by certain local governments under modified home rule powers. This rule applies only where five conditions are satisfied. First, on April 1, 1979, legislation must have been pending in a State legislature limiting the authority of local governments within the State to issue tax-exempt obligations for owner-occupied housing under existing home rule authority. Second, such legislation must have been enacted on April 26, 1979. Third, the governing body of a local government in the State in which the legislation was pending must take action authorizing the undertaking of a demographic or related study of the mortgage market. Such study must have been intended to serve as a basis for the issuance of tax-exempt obligations for owner-occupied residences. Furthermore, such action must have been taken between June 1, 1978, and April 24, 1979. In addition, there must be written evidence which was in existence prior to April 25, 1979, which establishes that the action occurred. Fourth, on December 20, 1979, an amount must have been specified by or for the local government as the range of the amount of obligations which the local government expected to issue with respect to a geographic area under any transitional authority provided by Title IX. Fifth, the majority of the members of the governing body of the local government must certify that the local government was awaiting enactment of such legislation prior to determining to proceed toward the issuance of tax-exempt obligations for owner-occupied residences.

This rule also imposes a dollar limit on the aggregate amount of obligations which may be issued with respect to a geographic area. The maximum amount of obligations which may be issued under this rule is the amount specified on December 20, 1979, by or for the local governments.

Finally, this rule provides that substantially all the proceeds of an issue (exclusive of issuance costs and a reasonably required reserve) must be committed to owner financing before January 1, 1981.

(3) Effective date for registration requirement and advance refunding rule

The requirement that all tax-exempt obligations for housing be in registered form applies to any obligations issued after the date of enactment. This requirement shall apply whether an obligation is issued pursuant to the general provision of Title IX or pursuant to the transitional rules.

The prohibition of the advance refunding of tax-exempt obligations for owner-occupied residences is effective on the date of enactment. This rule will apply to the advance refunding after the date of enactment of any obligation issued, prior to April 25, 1979, or pursuant to the transitional rules of Title IX, to finance owner-occupied resi-[492]dences (whether the residences are single family or two to four family) and obligations issued under the requirements of Title IX for

owner-occupied residences. During the period beginning on April 25, 1979, and ending on the date of enactment, tax-exempt obligations for owner-occupied residences which were issued prior to April 25, 1979, may be advance refunded where the requirements for the rollover transitional rule are satisfied.

d. Revenue Effects

The increase in fiscal year receipts resulting from this provision was estimated at the time the Committee was considering Title IX to be $413 million in 1981, $1,718 million in 1982, $4,208 million in 1983, $7,754 million in 1984, and $12,203 million in 1985.

At the time these revenue estimates were prepared for the Committee, the revision of the estimates by the staff was not complete. Based upon more recent information, it is estimated that the increase in fiscal year receipts will be $497 million in fiscal year 1981, $1,801 million in 1982, $4,013 million in 1983, $7,104 million in 1984, and $10,801 million in 1985.

2. SUBTITLE B: ESTIMATED INCOME TAX PAYMENTS OF LARGE CORPORATIONS

(Sec. 911 of Title IX and sec. 6655 of the Code)

Present law

Under present law, a corporation must make estimated tax payments, if the estimated tax for the taxable year can reasonably be expected to be $40 or more (Code sec. 6154). In general, a corporation's estimated tax is the estimated income tax (other than the minimum tax) less any estimated credits against the tax. Any corporation required to make estimated tax payments must make such payments in installments. The number of installments, and the amount of each installment, is determined in accordance with the following table:

If the $40 threshold is first met—	The following percentages of the estimated tax shall be paid on the 15th day of the—			
	4th mo.	6th mo.	9th mo.	12th mo.
Before the 1st day of the 4th month of the taxable year	25	25	25	25
After the last day of the 3rd month and before the 1st day of the 6th month of the taxable year		33⅓	33⅓	33⅓
After the last day of the 5th month and before the 1st day of the 9th month of the taxable year			50	50
After the last day of the 8th month and before the 1st day of the 12th month of the taxable year				100

[493] A corporation that fails to pay the proper estimated tax when due may be subject to an underpayment penalty (Code sec. 6655). The penalty is figured for the period of underpayment, determined under section 6655 of the Code, at a rate determined under section 6621. (The penalty rate currently is 12 percent.) The amount of underpayment is, for purposes of this penalty, the excess of the amount of the installment which would be required to be paid if the estimated tax were equal to 80 percent of the tax shown on the return for the taxable year (or, if no return was filed, 80 percent of the tax for such year) over the amount, if any, of the installment paid on or before the last date prescribed for payment.

No penalty is charged with respect to underpayment of a corporation's estimated tax liability if the corporation made payments on or before the due date of the installment and the total payments up to the particular due date in question equal or exceed the amount which would have been due had the estimated tax been based on any of the following amounts: (1) the preceding year's liabilities, if a return showing a tax liability was filed by the corporation for the preceding taxable year and such preceding year was a taxable year of 12 months; (2) tax liabilities computed by using the current year's tax rates for the prior year's return and the law that applies to the prior year; or (3) 80 percent of the taxes which would have been due if the income which the corporation had already received during the current year had been placed on an annualized basis.

Reasons for change

The Committee believes that there are few, if any, reasons to permit very large corporations to escape paying estimated tax for the current year simply because they had little or no taxable income for their prior taxable year. Allowing these corporations to avoid paying estimated tax amounts to a large, interest-free loan to the corporations from the Government. Since large corporations should be able to estimate their income on a regular basis, the Committee feels that there is no need for them to base their estimated tax payments on the prior year's experience. Accordingly, the Committee has agreed that the use of the prior year exceptions to the general estimated tax penalty rules should be restricted in the case of large corporations. However, in the case of smaller business entities, which may lack the capability for projecting their annual income quarterly, no change in the prior year exceptions is made because the Committee feels that these corporations should continue to be able to rely on these exceptions.

Explanation of provision

Under Title IX, the estimated tax payments of a large corporation generally must equal at least 60 percent of tax shown on its income tax return

for the taxable year (or the actual tax if no return is filed).[1] Thus, a large corporation which had no taxable income for its preceding taxable year will no longer be able to avoid paying estimated tax for its current taxable year.

[494] Corporations subject to this new requirement will be those corporations which had taxable income of $1 million or more in any of the three taxable years immediately preceding the taxable year involved.

In the case of the component members of a controlled group of corporations (within the meaning of Code section 1563), the $1 million amount for any taxable year in the 3-year base period is to be divided among the members of the group in the same manner in which the benefits of the graduated tax rates are allocated for that year.

Effective date

The provision is effective for taxable years beginning after December 31, 1980.

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[508] 4. SUBTITLE D: TELEPHONE EXCISE TAX

(Sec. 951 of Title IX and sec. 4251 of the Code)

Present law

Under present law, the excise tax imposed on communication services (local telephone service, toll telephone service, and teletypewriter exchange service) for 1980 is 2 percent of amounts paid for such service (Code sec. 4251). The tax is scheduled to be reduced to 1 percent for 1981 and to expire on January 1, 1982. The communication services excise tax has been phasing out at the rate of one percentage point per year since 1973, when it declined from the prior rate of 10 percent to 9 percent.

[1] A large corporation could continue to rely on the present law exception where the estimated tax equals at least 80 percent of the tax computed on an annualized basis (Code sec. 6655(d)(3)).

Reason for change

The Committee believes that delaying the phasedown of the telephone excise tax will raise revenues to meet budget targets for fiscal year 1981 without having the adverse economic effects which might result from new taxes.

Explanation of provision

The provision delays by one year the remaining scheduled reductions in the communication services (telephone, etc.) excise tax. Thus, on amounts paid pursuant to bills first rendered during 1980 or 1981 the tax will be 2 percent. For 1982, the tax will be 1 percent, and the tax will expire on January 1, 1983.

Effective date

The provision is effective for amounts paid pursuant to bills first rendered after December 31, 1980.

Revenue effect

This provision is estimated to increase budget receipts by $358 million in fiscal year 1981, by $570 million in fiscal year 1982 and by $193 million in fiscal year 1983, and will have no revenue effect thereafter.

5. SUBTITLE E: FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT OF 1980

Present Law

General

Under the Code, nonresident aliens and foreign corporations engaged in a U.S. trade or business are generally taxed on the U.S. source income of that business in the same manner, and at the same rates, as U.S. persons. (However, their foreign source income not connected with that business is not taken into account in determining the applicable rates of U.S. tax.)

[509] In contrast, the U.S. source income of a nonresident alien or foreign corporation which is not effectively connected with a U.S. business is generally subject to a different tax regime. The Code provides that a foreign individual or corporation is ordinarily subject to a 30-percent withholding tax on the *gross* amount of certain passsive income such as rents, dividends, and interest, which is received from U.S. sources and is not effectively connected with a U.S. business. This withholding tax generally satisfies the taxpayer's U.S. income tax liability on the income. Capital gains not effectively connected with a U.S. business are not subject to any U.S. income tax, except in the limited situation of nonresident individuals who were present in the United States 183 days or more during the year, who are taxed at the flat rate of 30 percent on the gains.

Foreign investment in U.S. property

Whether a foreign investor in U.S. real property is engaged in a U.S. trade or business depends on all the facts and circumstances. For example, a foreign investor who enters into a single long-term net lease (under which the lessee is responsible for operation of the property and pays the expenses) probably would not be engaged in a U.S. trade or business whereas a taxpayer who owns and manages a number of commercial buildings would be so engaged.

If a foreign taxpayer is not actually engaged in a U.S. trade or business, he is permitted under the Code to elect to be treated as if he were so engaged with respect to all his real property held for the production of income. This election is provided because rental income, unlike other types of passive income, ordinarily has associated with it significant expenses. Therefore, a tax equal to 30 percent of the gross rentals could frequently exceed the entire economic income from the property. If the election is made, the taxpayer may reduce his gross income from the real property by the deductible expenses, such as depreciation, mortgage interest, and real property taxes. The taxpayer is then taxed on the net income at the graduated rates which generally apply to U.S. taxpayers rather than paying 30 percent on his gross rental income.

Often, as a result of the election, the investor will pay no tax on the current income because depreciation, mortgage interest, real property taxes and other expenses exceed gross income. (This result would be the same if a U.S. person owned the property.) However, by making the election, the taxpayer will also subject himself to U.S. tax on any capital gains from the sale or exchange of the property. The election, once made, is binding on the taxpayer in all subsequent years unless consent to revoke it is obtained from the Internal Revenue Service.

Apart from the Code election, a number of planning techniques exist whereby a foreign investor may obtain the advantages of being taxed on current income from real property on a net basis. However, unlike the Code election, these techniques also offer the opportunity to avoid tax on the capital gain which would result on the sale of the property. Also, unlike the Code election, they may be employed on a property-by-property basis. For example, a foreign investor who is actually engaged in a U.S. real estate business will be taxed on current income from the property on a net basis (which might result in no current tax because of the allowable deductions). He may sell the prop-[510]erty on the installment basis and receive most or all of the payments in years following the year of the sale. If he is not actually engaged in a U.S. trade or business in later years when the installment payments are received (and has not made the election to be treated as if he were), the gain would not be treated as effectively connected with a trade or business in the later years and would therefore go untaxed.

Secondly, a foreign investor could generally exchange his U.S. real property held for productive use or investment for other property of a like kind, whether within or without the U.S., without recognition of gain. If the property he acquired in the exchange were outside the U.S., the gain he would recognize on the ultimate sale of the property received in the exchange would not be subject to U.S. tax. This would be the case even if the investor were actually engaged in a U.S. trade or business or had made the election to be so treated.

A taxpayer may also obtain the benefits of current taxation on a net basis and exemption from tax on the gain by investing in U.S. real property indirectly through a foreign holding company which either is actually engaged in U.S. business or makes the election. The holding company would be subject to tax on the income it receives from the property but, as noted earlier, often there would be no taxable income on a current basis. Moreover, the corporation often could reduce or eliminate its taxable income by paying deductible interest to its investors. Ordinarily, dividends and interest paid by a foreign corporation deriving most of its income from U.S. sources are subject to U.S. withholding taxes. However, these taxes are sometimes waived on a reciprocal basis under tax treaties between the United States and other countries. If the corporation is entitled to such a treaty benefit, income paid currently by the corporation would escape that U.S. tax. (Foreign investors frequently utilize U.S. treaties applicable to the Netherlands Antilles and British Virgin Islands because these treaties contain the necessary waivers or reductions and because these jurisdictions impose low or no taxes on the income.)

The investors in the holding company could avoid U.S. tax on the gain from the sale of the property by either of two methods. First, if the corporation sells the property and follows a plan of liquidation meeting certain requirements, the corporation will not be taxable on the gain under a general rule of the Code which exempts liquidating corporations from tax on gains from the sale of property (sec. 337). Moreover, the shareholders and security holders will generally not be taxable when they exchange their stock and securities in liquidation for the proceeds of the sale of the real property because, as foreign investors, they generally are not subject to U.S. capital gains tax. Even though the corporation is engaged in a U.S. trade or business, that business is not imputed to its investors. Since mere ownership or sale of stock is genuerally not a trade or business, the gains ordinarily escape U.S. tax.

Second, if the investors instead sell their stock or securities, they would generally not be subject on the gain for the same reasons that they would generally not recognize gain in a liquidation. Assuming that the sales price reflected the appreciated value of the real property, the purchaser of the corporation, even if a U.S. person, could then [511] liquidate it without realizing a gain subject to U.S. tax because his basis in the stock for purposes of determining his gain on the liquidation would be his purchase price for the stock. He would also get a stepped-up basis for the real property equal to his purchase price for the stock.

Finally, some U.S. tax treaties (such as the treaties with the Netherlands Antilles and the British Virgin Islands) provide for a real property election similar to that in the Code, but the election may be made on a year-by-year basis. A foreign investor entitled to the benefits of such a treaty and not actually engaged in a U.S. business could use the treaty election to be taxed on a net basis in years prior to the year of sale. In the year of sale, the taxpayer would not make the treaty election and would not be taxed on the gain on the sale of the property because of the absence of a U.S. trade or business.

A number of U.S. tax treaties (not including, however, the protocols with the Netherlands Antilles or the British Virgin Islands) contain reciprocal provisions which prevent the United States from taxing certain types of U.S. source capital gains of foreign investors who are entitled to the treaty benefits. While these provisions reciprocally exempting capital gains generally do not apply with respect to real estate (that is, they do not restrict either country from taxing gains on sales of its real estate derived by resi-

dents of the other), they generally would apply with respect to stock in corporations formed or availed of to hold real estate. The Code provides that these treaty exemptions are to prevail if they require the exclusion from gross income of gains which the United States would otherwise tax (sec. 894(a); *cf.* also sec. 7852(d)).

Reasons for Change

The Committee believes that it is essential to establish equity of tax treatment in U.S. real property between foreign and domestic investors. The Committee does not intend by the provisions of Title IX to impose a penalty on foreign investors or to discourage foreign investors from investing in the United States. However, the Committee believes that the United States should not continue to provide an inducement through the tax laws for foreign investment in U.S. real property which affords the foreign investor a number of mechanisms to minimize or eliminate his tax on income from the property while at the same time effectively exempting himself from U.S. tax on the gain realized on disposition of the property.

In order to impose a tax on gains from the sale of U.S. real estate, it is also necessary to impose a similar tax on gain from the disposition of interests in entities which hold substantial U.S. real property. Otherwise, a foreign investor could, as under present law, avoid tax on the gain by holding the real estate through a corporation, partnership, or trust and disposing of his interest in that entity rather than having the entity itself sell the real estate.

Explanation of Provisions

General (sec. 962 of Title IX and new sec. 897 of the Code)

Under the provision, foreign investors are to be taxed on gains on the disposition of U.S. real property. Foreign investors are also to [512] be taxed on gains realized from the sale or exchange of an interest in a real property holding organization (RPHO). In general, an RPHO is a corporation, trust or partnership at least half of the assets of which are U.S. real property interests. An exception is made for portfolio stock investments in publicly-traded corporations. Reporting requirements are established to identify when taxable transactions have occurred. Title IX contains no withholding provisions—neither the purchaser of the property nor any U.S. agent is required to withhold any tax from the seller or to take any other action to ensure that the foreign seller pays the tax due on the sale.

Tax imposed on seller

Amount of tax

Title IX provides that gain or loss of a nonresident alien individual or a foreign corporation from the disposition of a United States real property interest is taken into account as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with that trade or business. Thus, gains are to be subject to tax at the same rates which apply to income received by U.S. persons. In the case of a foreign individual, a loss is to be taken into account under Title IX only to the extent the loss would be taken into account under Code section 165(c), which limits deductions for an individual's losses to business losses, losses on transactions entered into for profit, and losses for casualty or theft. Thus, for example, a loss on the sale of the taxpayer's personal residence would not be taken into account. If the foreign investor also has other effectively connected U.S. business activities, gains or losses from those activities during the taxable year are to be combined with gains or losses from U.S. real property interests in determining the investor's U.S. tax liability. However, losses from U.S. real property other than from its disposition could not be taken into account unless the property was actually effectively connected with a U.S. trade or business or the taxpayer had made the election to be so treated.

Although Title IX generally subjects to tax any sale, exchange, or other disposition of a U.S. real property interest, nonrecognition provisions of the Code will continue to apply in certain cases. Generally, pending the promulgation of regulations, the nonrecognition provisions are to apply to an exchange of a United States real property interest only where it is exchanged for another such interest the sale of which would be subject to U.S. income taxation. Gain on the sale of an interest is not to be considered subject to U.S. taxation for this purpose if the gain would be exempt under a treaty obligation of the United States and thus exempt from U.S. tax under Code section 894(a). However, the Treasury Department is directed to prescribe regulations which are necessary or appropriate to prevent the avoidance of Federal income taxes providing the extent to which nonrecognition provisions shall, and shall not, apply for purposes of the bill. These regulations may, under appropriate circumstances and conditions, provide for nonrecognition even where the taxpayer does not receive in the exchange a U.S. real property interest. Conversely, in appropriate cases, the regulations may provide for the recognition of [513] gain even where such an interest is received. For purposes of these provisions, the term "nonrecognition provision" means any provision of the Code for not recognizing gain or loss.

Direct interest in U.S. real property

The tax is imposed on gains from the disposition of interests in real property (including an interest in a mine, well, or other natural deposit) located in the United States. The term "interest in real property" includes fee ownership and co-ownership of land or improvements, easements, and options to acquire leaseholds of land or improvements. Such an interest would, for example, include a mineral royalty. Moreover, the term includes partial interests such as life

estates, remainders, reversions, and rights of refusal in real property. Movable walls, furnishings, and other similar personal property associated with the use of real property are considered real property for purposes of Title IX.

U.S. real property holding organizations

Also included in the definition of U.S. real property interests are certain holdings in a U.S. real property holding organization (RPHO). Thus, gain on the disposition of such holdings is subject to the tax. An exception is made to the general rule if the investment is in the form of portfolio stock holdings in a publicly-traded RPHO. Title IX provides that if any class of stock of a corporate RPHO is regularly traded on an established securities market, stock of that class is to be treated as a real property interest only in the case of a person who, at some time during the relevant time periods described below, held more than 5 percent of that class of stock.

An RHPO is a corporation, partnership, or trust, whether domestic or foreign, if at any time during the taxable year, the fair market value of its United States real property interests equals or exceeds 50 percent of the sum of (i) the fair market values of its United States real property interests, (ii) its interests in real property located outside the United States, plus (iii) any other of its assets which are used or held for use in a trade or business.

Generally, for purposes of this assets test, if an entity has an interest in another entity, that interest will be treated in its entirety as a U.S. real property interest if the second entity is an RPHO. However, if the second entity is not an RPHO (or, as described above, the interest is only a portfolio stock interest in a publicly traded RPHO), the interest generally will not be treated as a U.S. real property interest. As an exception to the general rules, if the first entity has a controlling interest in the second entity, special "look through" rules apply. The bill provides that in such a case, for purposes of the assets test, (i) the value of the controlling interest is not taken into account, (ii) the first entity is treated as holding a pro rata share of the assets of the second entity, and (iii) any assets used or held for use by the second entity in a trade or business shall be treated as so used or held by the first entity. A "controlling interest" is, in the case of a corporation, 50 percent or more of the total combined voting power of all classes of stock of the corporation, or 50 percent or more of the fair market value of all classes of stock of the corporation; in the case of a partnership, 50 percent or more of the capital or profits interest; or in [514] the case of a trust, 50 percent or more of the beneficial interests in the trust (actuarially determined).

Generally, the holdings subject to the tax are stock in a corporation (other than certain portfolio investments), or an interest (other than solely as a creditor) in a partnership or trust, which, during the shorter of the period (after June 18, 1980) during which the taxpayer held his interest or the 5 years preceding his sale of the interest, is or was an RPHO. However, the interest would not be a U.S. real property interest if the RPHO recognized gain on all its U.S. real property interests prior to sale of the interest in the RPHO. (Also, if the RPHO held an interest in another RPHO, this rule applies even if the interest in the second RPHO was not sold, as long as the second RPHO ceased to be an RPHO by operation of this rule.) Since convertible debt of an RPHO is an interest in an RPHO other than solely as a creditor, such convertible debt is a U.S. real property interest.

For purposes of determining whether the "look through" rules described above apply, and for purposes of applying the "portfolio investment" exception described above, constructive ownership rules are provided.

Reporting requirements (sec. 963 of Title IX and new secs. 6039(C) and 6039(D) of the Code)

Entities which may be RPHOs.— If, at any time during a calendar year, (i) a corporation, partnership, or trust beneficially owns real property interests which constitute more than 40 percent of the fair market value of the assets taken into consideration in determining whether or not it is an RPHO, and (ii) at least one foreign person has an interest (other than solely as a creditor) in the entity, the entity is required to file an information return for the year. The return is to set forth the following information: (i) the name and address of any foreign person who held an interest (other than solely as a creditor) in the entity at any time during the calendar year, (ii) any information regarding the composition of the assets of the entity at such time or times during the calendar year which the Treasury may prescribe by regulations, (iii) any information with respect to transfers during the calendar year of interests in the entity which the Treasury Department may prescribe by regulations, (iv) whether such entity is an RPHO at any time during the calendar year, and (v) any other information which the Treasury may prescribe by regulations. The entity must continue to file these returns for four years after the year in which the reporting requirement otherwise would cease to apply.

If a corporate RPHO would be required to file a return solely because a foreign person owns a class of its stock, and if the stock is regularly traded on an established securities market at all times during the calendar year, no return need be filed unless a foreign person owns more than 5 percent of that class of stock. For purposes of determining whether there is any foreign ownership or, where appropriate, more than 5 percent ownership, constructive ownership rules will apply.

In addition to the information return, the reporting entity is also re-

quired to furnish a written statement to every foreign person who held an interest (other than solely as a creditor) in the entity during the calendar year setting forth the name and address of the entity [515] making the return, whether the entity was a United States RPHO at any time during the calendar year and any other information that the Treasury may prescribe through regulations. The return is to be furnished to the person having the interest no later than January 31 of the year following the year for which the entity's return was made.

Other returns.—If a foreign person is not subject to the return requirements described above, that person is, except as provided below, required under Title IX to file a return if, at any time during the calendar year, that person beneficially owned a United States real property interest, or during that calendar year or a subsequent calendar year, the person received (or is to receive) an installment payment from an obligation acquired from the disposition of a United States real property interest. The return is to set forth (i) the name and address of the person, (ii) a description of all United States real property interests held by such person at any time during the calendar year and of all installment obligations from United States real property interests, and (iii) such other information as the Treasury may prescribe by regulations.

This return requirement does not apply, however, if the person was engaged in a U.S. trade or business during the year, because other return requirements apply under present law in that situation. The requirement also does not apply if the aggregate of the fair market value of the United States real property interests owned by the person at any time during the year, and the face amount of the U.S. real property interest installment obligations, is less than $5,000. The fair market value of United States real property interests is, for this purpose, determined as of the end of the calendar year (or, in the case of any property disposed of during the calendar year, as of the date of the disposition).

The return of a foreign person for a calendar year under this provision is to be filed by April 15 (March 15 in the case of a corporation) of the following calendar year, or at such other time as the Treasury may prescribe by regulations.

Failure to make a return or furnish a statement

A penalty for failure to file a tax return or to furnish a statement required under the rules described above will be imposed in an amount equal to $25 for each day during which such failure continues but not to exceed $25,000. Also, in the case of a failure by a foreign person to file a return required by the rules set forth in "Other returns," above, the penalty for any calendar year cannot exceed 5 percent of the aggregate of (i) the fair market value of the United States real property interests owned by that person at any time during the year, and (ii) the face amount of the United States real property interest installment obligations.

If it is shown that the failure to file a return or to furnish a notice is due to reasonable cause and not to willful neglect, no penalty will be imposed for that failure.

Miscellaneous amendments (sec. 964 of Title IX and secs. 861 and 7605 of the Code)

Source of income.—Income from the disposition of a United States real property interest will be United States source income.

[516] *Examination of taxpayer.*—Section 7605(b) will not apply to an inspection of a taxpayer's books of account for purposes of section 897.

Effective Date (sec. 965 of Title IX)

The amendments made by the provision will generally apply to dispositions after June 18, 1980. However, until January 1, 1985, gain will not be taxed to the extent required by treaty obligations of the United States. After that period for the renegotiation of conflicting treaty provisions (i.e., after December 31, 1984), the provision will prevail over any conflicting treaty provisions remaining in effect. Return requirements imposed for 1980 will not apply with respect to United States real property interests or installment obligations which were not held after June 18, 1980.

Revenue Effect

This provision is estimated to increase budget receipts by $40 million in fiscal year 1981, $88 million in fiscal year 1982, $97 million in fiscal year 1983, $106 million in fiscal year 1984, and $117 million in fiscal year 1985.

6. SUBTITLE F: INCLUSION IN WAGES OF EMPLOYEE SOCIAL SECURITY AND UNEMPLOYMENT TAXES PAID BY EMPLOYERS

(Sec. 971 of Title IX, secs. 3121 and 3306 of the Code and sec. 209 of the Social Security Act)

Present law

The Internal Revenue Code imposes separate social security (FICA) taxes on employers and employees. Traditionally, the employer deducts and withholds the employee's tax from his pay and remits both it and the employer's own tax payment to the Treasury. Section 209(f) of the Social Security Act and Code section 3121 (a)(6), however, exclude from the definition of wages for tax and benefit purposes any payment by an employer of the employee's social security or State unemployment compensation tax liability so long as the employer makes the payment without deduction from the remuneration of the employee. A similar exclusion applies to the definition of wages for the purposes of the Federal Unemployment Tax Act (FUTA) (Code sec. 3306 (b)(6)).

Ordinarily, the employee FICA tax is levied on the employee's earnings before deduction of the tax, and the

employee is credited for social security purposes with earnings equal to his or her earnings before deduction of FICA taxes. If an employer pays the employee FICA tax without deduction from the employee's remuneration, however, the procedure can be different. First, the amount of both the employer's and employee's payroll tax liability is, in effect, based on earnings after deducting the employee's FICA tax rather than earnings before the deduction. Second, the amount of earnings credited for social security benefit computation purposes is also in effect, earnings net of the FICA tax. An example of how such a salary reduction plan works under the alternative FICA tax computation is set out below:

[517]

	Before adoption of plan	After adoption of plan	Result
Employer:			
Pays salary of	$10,000	$9,387	
Pays employer FICA tax of	613	[1] 575	
Pays employee FICA tax of	0	[1] 575	
Total cost	10,613	10,538	Employer saves $75.
Employee:			
Receives salary of	10,000	9,387	
Pays employee FICA tax of	613	0	
Take Home Pay (before income tax)	9,387	9,387	
Income subject to income tax:			
Salary	10,000	9,387	
Employee tax paid by employer	0	575	
Total	10,000	9,962	Employee has $38 less subject to income tax.
Receives social security benefit credit of	10,000	9,387	Employee receives $613 less in social security benefit credit.
Social Security Trust Funds: Receives FICA taxes of	1,226	1,151	Trust funds lose $75 in revenues.

[1] Rounded to nearest dollar.

Reasons for change

The compensation plans which make use of the alternative FICA computation have an adverse effect on participating employees and on the financial condition of the social security trust funds.

First, reducing the amount of earnings subject to the FICA tax also reduces the amount of earnings credited for social security benefit computation purposes. Thus, while the employer and employee pay somewhat less in taxes, the employee receives more limited social [518] security protection. Moreover, the reduction in social security benefits may be only one by-product of such alternative tax computations. There might also be reductions in the benefits available under other employee benefit plans which are related to earnings, such as pensions, profit-sharing, other insurance, and unemployment compensation.

Second, the use of the alternative FICA computation leads to a reduction in total social security payroll tax receipts. While it also leads to a reduction in benefit payments, the reduction in benefit payments occurs in the future while the reduction in payroll tax revenue occurs immediately. Even the long-run use of the alternative computation will reduce receipts available to meet benefit payments. In a pay-as-you-go system such as social security, these results are particularly pernicious. If all employers adopted the alternative procedure, trust fund receipts would be reduced by more than $6 billion per year.

Third, the use of this alternative computation method has the effect of obscuring a fundamental characteristic of social security: it is a system to which individuals contribute and on the basis of which contributions, they draw benefits as an "earned" right. When the payroll tax is paid entirely by employers, it ceases to be a system to which individual workers feel they contribute.

Finally, the elimination of the alternative FICA tax computation has been recommended by the 1979 Quadrennial Advisory Council on Social Security. In its report, the Council noted its concern over the growing use of the "tax avoidance device". The Council emphasized that if enough employers began to use these plans, there would be a significant loss to the trust funds that would have to be made up by higher tax payments from all workers and employers.

Explanation of provision

The provision revises the Social Security Act (section 209(f)) and the Internal Revenue Code of 1954 (sections 3121(a)(6) and 3306(b)(6) to include within the definition of wages for tax and social security benefit computation purposes payments by an employer (without deduction from the remuneration of the employee) of social security and unemployment taxes imposed upon an employee. The provision does not apply to payments by an employer of the payroll taxes imposed upon an employee for wages paid for domestic service in the home of the employer.

The Committee has decided, however, to allow the continued use of the alternative computation procedure with respect to domestic labor. This is in recognition that this procedure has been much more common with regard to this type of employment and that requiring many small employers to change their methods of tax computation for what are often relatively informal employment arrangements could lead to problems of compliance.

Effective date

Except for certain State or local governmental employment, the provision applies with respect to remuneration paid after December 31, 1980.

[519] In the case of certain State, political subdivision, or other State or local coverage group employment under section 218 of the Social Security Act, the provision applies with respect to remuneration paid after December 31, 1983. This later effective date for governmental units is limited to remuneration for services in positions of a kind for which all or a substantial portion of the amounts equivalent to employee social security taxes were paid by such governmental unit (without deduction from the wages of the employee) under the practices of the governmental unit in effect on June 18, 1980.

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Conference Report No. 96-1479 2d Session

[Bracketed numerals indicate official report page numbers]

OMNIBUS RECONCILIATION ACT OF 1980

NOVEMBER 26, 1980.—Ordered to be printed

Mr. GIAIMO, from the committee of conference, submitted the following conference report to accompany H.R. 7765.[1]

* * * * *

[117] STUDENT LOAN PROGRAMS

(TITLE III)

* * * * *

4. The House bill, but not the Senate amendment, permits the Internal Revenue Service to provide the current mailing addresses of student loan defaulters to the holders of loans in default status.

The Senate recedes.

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[155] TITLE X—OTHER SOCIAL SECURITY ACT PROGRAMS; UNEMPLOYMENT COMPENSATION

* * * * *

[161] III. UNEMPLOYMENT COMPENSATION PROVISIONS

* * * * *

[162] 5. Waiting period for unemployment compensation benefits

House bill.—No provision.

Senate amendment.—The Senate amendment eliminates the Federal share (50 percent) of the cost of the first week of extended benefits in any State which does not have a "waiting week" for regular benefits, or which has a "waiting week" for which benefits are paid retroactively. This provision would be effective for extended benefits paid to individuals during eligibility periods beginning on or after October 1, 1980. However, in the case of a State in which State legislation is required in order to establish a "waiting week" or to eliminate retroactive payment for a "waiting week," this provision would first become effective for extended benefits payable for the period that begins after the end of the first regularly [163] scheduled session of the State legislature ending more than 30 days after enactment of this bill.

Under current law, twelve (12) States pay unemployment benefits starting with the first week of unemployment. The remaining States generally provide that benefits will become available only after the unemployed individual has served a "waiting week." Of these States, four (4) do not require "waiting week" under certain conditions. Nine (9) States that have a "waiting week" provision pay benefits retroactively for the "waiting week" after the individual has experienced a specific duration of unemployment.

Conference agreement.—The conference agreement follows the Senate amendment, with the October 1, 1980 effective date changed to date of enactment. The special effective date for States requiring legislation is retained.

* * * * *

[164] 8. Denial of extended benefits to individuals who fail to meet certain requirements related to work

Senate amendment. — The Senate amendment would:

(a) Deny extended benefits to an individual during a period of unemployment for which, under State law, he or she was disqualified from receiving State benefits because of voluntarily leaving employment, discharge for misconduct, or refusal of suitable employment, even though the disqualification was subsequently lifted prior to reemployment and the person received State benefits. However, the person could receive extended benefits if the disqualification is lifted because he or she became employed and met the work or earnings requirement specified in State law.

(b)(1) Deny extended benefits to any individual who fails to accept any work that is offered in writing or is listed with the State employment service, or fails to apply for any work to which he or she is referred by the State agency, if the work: is within the person's capabilities; pays wages equal to the highest of the Federal or any State or local minimum wage; pays a gross weekly wage that exceeds the person's average weekly unemployment compensation benefit plus any supplemental unemployment compensation payable to the individual; and is consistent with the State definition of "suitable" work with regard to provisions not specifically addressed in this amendment.

States would have to refer extended benefits claimants to any work meeting these requirements. If the State, based on information provided by the individual, determines that the individual's prospects for obtaining work in his or her customary occupation within a reasonably short period are good, the determination of whether any work is "suitable work" would be

[1] Public Law 96-499, page 509.

made in accordance with State law rather than the above.

(2) Extended benefits would be denied to any individual for so long as he or she fails to engage in a systematic and sustained effort to obtain work and fails to provide tangible evidence to the State agency that he or she has engaged in such an effort.

(3) Any individual who is denied extended benefits because of the requirements in (b)(1) or (b)(2) would continue to be ineligible to receive extended benefits until he or she had been employed for at least four weeks after the denial and earned wages equal to four times his or her average weekly unemployment compensation payment.

(c) Deny extended benefits to any individual with less than 20 weeks of qualifying employment in the base period.

Provisions (a), (b), and (c) would be effective for weeks of unemployment beginning on or after October 1, 1980.

Conference agreement.—The conference agreement follows part (a) and (b) of the Senate amendment, effective for weeks of unemployment beginning after March 31, 1981. The conference agreement does not include part (c).

[165] 9. Certification of State laws

House bill.—No provision.

Senate amendment. — The Senate amendment requires the Secretary of Labor, on October 31 of each taxable year beginning with taxable year 1980, to withhold certification of State unemployment compensation programs (for purposes of providing the credit against the Federal unemployment tax on employers in the State) for any State which has failed to amend its laws to comply with the preceding provisions, or which has, with respect to the 12-month period ending on such October 31, failed to comply substantially with such provisions.

Pursuant to the passage of previous Federal unemployment compensation requirements, the Secretary of Labor has been required to certify, on October 31 of each tax year, that a State has amended its laws to comply with current Federal unemployment compensation requirements. Failure of a State to receive from the Secretary such certification results in denial of the credit against Federal unemployment tax on employers in the State.

Conference agreement.—The conference agreement follows the Senate amendment, as it applies to those Senate provisions that were agreed to, beginning with taxable year 1981.

* * * * *

[171] TITLE XI—REVENUE MEASURES

A. Mortgage Subsidy Bonds

1. Single family owner-occupied residences

a. In general

House bill.—In general, the House bill is designed to direct the subsidy from the use of tax-exempt bonds for owner occupied housing to those individuals who have the greatest need for the subsidy, to increase the efficiency of the subsidy, and to restrict the overall revenue loss from the use of tax-exempt bonds for owner occupied housing. Under the house bill, interest on any bond generally is not tax-exempt if a significant portion of the proceeds are to be used for mortgages (or other financing) of owner-occupied residences. However, exceptions are provided in the case of qualified mortgage bonds and qualified veterans' mortgage bonds.

Senate amendment.—No provision.

Conference agreement.—The conference agreement adopts the House bill with various modifications. The conferees want to make it clear that it is not their intention to preempt States or localities from establishing limitations on the issuance of these bonds. However, no tax-exempt mortgage subsidy bonds can be issued which do not meet the requirements of the conference agreement. Further, the conference agreement is not intended to diminish in any way the authority of a State agency or commission charged with the protection of the State's credit pursuant to State law.

b. Qualified mortgage bonds

(1) Principal residence requirement

House bill.—All mortgages must be for single family residences which can reasonably be expected to become the principal residences of the mortgagors. The residences must be located within the jurisdiction of the issuing authority.

Senate amendment.—No provision.

Conference agreement.—The conference agreement generally follows the House bill but clarifies that mortgage subsidy bonds can be used to finance the mortgage of a building which contains up to four family units if at least one of the units is owner occupied and if the building had been used as a residence for at least 5 years before the mortgage is executed, subject to the other requirements of the conference agreement. Where a building that is financed by mortgage subsidy bonds contains more than one but less than five family units, the units which are not owner occupied may be leased by the owner occupier without meeting the multi-family provisions of the conference agreement so long as the bonds are not industrial development bonds. The special rule adopted by the conference agreement for buildings which contain not more than four family units does not limit the use of mortgage subsidy bonds to finance mortgages on an individual unit in a condominium or a share in a [172] cooperative housing corporation which are treated as single family residences under the conference agreement.

(2) Three-year requirement

House bill.—Each mortgagor must not have been a homeowner within the last 3 years. However, exceptions to the 3-year rule are provided for rehabilitation loans, for home improvement loans, and for mortgages or residences located in targeted areas.

A loan qualifies as a rehabilitation loan if the residence is at least 20 years

old at the time of the rehabilitation, 75 percent or more of the external walls of the residence are retained, and the rehabilitation costs are 25 percent or more of the mortgagor's basis in the residence (after the rehabilitation).

Home improvement loans are loans in an amount not in excess of $15,000 for certain alterations or repairs for existing single family residences.

For this purpose, the conference agreement makes clear that home improvement loans include loans made for energy conservation property and solar energy equipment. In addition, the conferees intend that the guidelines used for determining eligibility for insurance under Title I are to be used on an interim basis in determining what items qualify for home improvement loans until regulations are promulgated.

Senate amendment.—No provision.

Conference agreement.—The conference agreement follows the House bill.

(3) Income limitations

House bill.—The income of each mortgagor must not exceed 115 percent of the median family income in the Standard Metropolitan Statistical Area (SMSA), or county, if not in an SMSA, in which the residence is located. In the case of targeted areas, no more than one-third of the mortgagors can have incomes in excess of 140 percent of median family income for the State or the SMSA where the residence is located, whichever is higher. Both in targeted and non-targeted areas, 50 percent of the mortgage funds must go to families with incomes of 90 percent or less of the median family income in the SMSA.

Senate amendment.—No provision.

Conference agreement.—The conference agreement deletes all of the income limitations of the House bill. The conferees deleted these limitations because they believe that State and local governments should have sufficient flexibility in this area to design programs for their particular needs. However, the conferees expect that State and local governments will use mortgage subsidy bonds primarily for persons of low or moderate income.

(4) Targeted areas

House bill.—Targeted areas are defined as follows:

(*a*) census tracts in which 70 percent of the families have incomes of not more than 80 percent of statewide median income, or

(*b*) areas of chronic economic distress as defined by States, subject to the approval of the Secretaries of Treasury and Housing and Urban Development. Criteria used by Treasury and HUD to evaluate a proposed targeted area designation are: (1) the condition of [173] the housing stock, including age and number of abandoned and substandard units, (2) the need of area residents for owner-financing, as indicated by a high percentage of families in poverty, low per capita income, high numbers of welfare recipients, and high unemployment rates, (3) the potential for use of tax-exempt mortgage bonds for financing ownership to improve conditions in the area, and (4) the existence of a housing assistance plan which provides a displacement program and a public improvements and services program (similar to that required by HUD under its Community Development Block Grant program).

Senate amendment.—No provision.

Conference agreement.—The conference agreement follows the House bill.

The conferees want to clarify the requirement regarding the determination of targeted areas based upon the most recent decennial census for which data are available and upon the designation of areas of chronic economic distress. With respect to any particular bond issue, that determination may be made three months prior to the date of issuance.

(5) Purchase price limitation

House bill.—The purchase price of each residence must not exceed 80 percent of the average purchase price in the preceding year in the SMSA in which the mortgage is placed. In the case of targeted areas, the percentage would be 110 percent of the average purchase price in the SMSA. Average purchase price means average purchase price of a new home in the case of a purchase of a new home and average purchase price of an existing home in the case of the purchase of an existing home. In the case of home improvement loans, the purchase price limitation would not apply.

Senate amendment.—No provision.

Conference agreement.—The conference agreement generally follows the House bill except that the purchase price limitation in non-targeted areas is increased from 80 percent to 90 percent of the average purchase price in the preceding year in the SMSA in which the mortgage is placed.

In addition, the conference agreement adopts a special rule for determining the purchase price limitation in the case of mortgages on buildings (other than condominiums and cooperative housing corporations) that have more than one but less than 5 family units. In such a case, separate purchase price limitations are to be applied for one-family residences, two-family residences, three-family residences, and four-family residences.

(6) New mortgage requirement

House bill.—Except for construction period loans, bridge loans or similar temporary initial financing, and an existing mortgage in the case of a rehabilitation loan, none of the bond proceeds can be used to acquire or replace an existing mortgage.

Senate amendment.—No provision.

Conference agreement.—The conference agreement follows the House bill.

[174] *(7) Low downpayment requirement*

House bill.—At least 75 percent of the lendable proceeds (other than for rehabilitation loans and home improvement loans) must be used for mortgages which have a 95-percent loan to

value ratio. In addition, certain graduated payment mortgages with as low as a 90-percent loan to value ratio will qualify for purposes of the 75-percent requirement.

Senate amendment.—No provision.

Conference agreement.—The conference agreement deletes the low down payment requirement of the House bill.

(8) Assumptions of mortgages

House bill.—Individuals assuming a mortgage originally financed with tax-exempt bonds must meet the principal residence requirement, the three-year requirement, the purchase price limitation, and the income limitation.

Senate amendment.—No provision.

Conference agreement.—The conference agreement generally follows the House bill except it deletes the requirement that the person assuming the mortgage meet the income requirements of the House bill since income limits were deleted by the conference agreement.

(9) Market limitations

House bill.—The total amount of housing bonds that could be issued in a State each year would be limited to the greater of $50,000,000 or 5 percent of the average of all mortgages originated in that State in the preceding 3 years. The limit is to be allocated among governmental units within a State first on the basis of mortgages originated in the smallest jurisdiction having authority to issue housing bonds. This allocation can be changed by agreement among issuing subdivisions or by State statute.

Senate amendment.—No provision.

Conference agreement.—The conference agreement generally follows the House bill with two exceptions. First, it increases the market share limitation from the greater of $50,000,000 or 5 percent of the average of all mortgages originated in the State in the preceding 3 years to the greater of $200,000,000 or 9 percent of the average of all mortgages originated in the State in the preceding 3 years. In addition, the conference agreement modifies the way the limit is allocated among governmental units within the State.

The State ceiling is the greater of $200,000,000 or 9 percent of the average of all mortgages originated in the State in the preceding 3 years. The 9 percent State ceiling is to be computed in the same manner and using the same mortgages that were used in the House bill in computing the 5 percent limitation except the data are to be determined on a State-wide basis.

Thus, only mortgages on single family residences are to be used in determining the market limitation whether or not buildings with up to four family units are financed under the mortgage bond program. In the case of mortgages on buildings with more than one family unit, the full amount of the mortgage is counted toward the market limitation and not just the portion allocable to the owner-occupied unit.

[175] The State ceiling is then allocated among the various governmental units within the State that can issue mortgage subsidy bonds pursuant to a three-step rule.

Under the first step, the State ceiling is allocated equally between State housing agencies and localities until either the governor or the legislature makes a different allocation. One-half of the State ceiling is allocated to all State agencies that have authority to issue mortgage subsidy bonds. The other one-half of the State ceiling is allocated to localities that have authority to issue mortgage subsidy bonds in the same manner as provided for allocating the ceiling in the House bill. Thus, where more than one governmental unit has authority to issue mortgage subsidy bonds to finance mortgages on residences in the same geographical area, a portion of the State ceiling is allocated to the governmental unit with jurisdiction over the smallest geographic unit. The portion is determined by multiplying the State ceiling by a fraction the numerator of which is the average amount of mortgages placed in that governmental unit during the previous 3 years and the denominator of which is the total amount of all mortgages placed in the State during the same 3 previous calendar years. As under the House bill, a small governmental unit can enter into an agreement with the governmental unit having the next largest geographical area to allocate all or a designated amount or portion of the mortgages on residences within the smaller governmental unit to the larger governmental unit for purposes of computing the amount of the State ceiling allocated to both the small governmental unit and the next larger governmental unit.

Under the second step, the governor of the State is delegated the power to allocate the State ceiling among the governmental units having authority to issue mortgage subsidy bonds in any way he determines. Under this delegation of authority, the governor may allocate all or any amount or portion of the State ceiling to any governmental unit in the State that has authority to issue mortgage subsidy bonds. This power of the governor to allocate the State ceiling terminates at the earlier of the first day of the calendar year beginning after the first calendar year after 1980 during which the legislature of the State met in regular session or the effective date of any State legislation with respect to the allocation of the State ceiling enacted after the date of enactment of this bill.

Under the third step, the State legislature may enact a law providing for a different allocation than that provided in step one. Under this authority the State may allocate all or any amount or portion of the State ceiling to any governmental unit in the State that has authority to issue mortgage subsidy bonds.

The conference agreement provides a special allocation rule to certain political subdivisions with home rule powers. The home rule subdivisions to which the special allocation rule applies are those home rule subdivisions that are granted home rule pow-

ers by the beginning of the calendar year in which the bonds are issued pursuant to a State constitution that was adopted in 1970 and became effective on July 1, 1971 (Illinois). In that State, the full portion of the State ceiling is allocated to each home rule subdivision. The portion is determined by multiplying the State ceiling (i.e., the greater of $200,000,000 or 9 percent of average mortgages) by a fraction the numerator of which is the average amount of [176] mortgages placed in the home rule subdivision during the 3 previous calendar years and the denominator of which is the total amount of all mortgages placed in the State during the same 3 previous calendar years. The amount so allocated to home rule subdivisions cannot be altered by the power to provide a different allocation which the conference agreement grants to the governor or the State legislature described above. However, a home rule subdivision can agree to a different allocation.

The remaining portion of the State ceiling (i.e., the State ceiling reduced by the amount allocated to home rule subdivisions) is then allocated among the other governmental units in the State that have authority to issue mortgage subsidy bonds under essentially the same three steps described above.

Thus, under the first step, one half of the remaining State ceiling is allocated to all State agencies that have authority to issue mortgage subsidy bonds. The other one half of the remaining State ceiling is allocated to the localities outside of the home rule subdivisions. The amount of the remaining State ceiling that is allocated to each governmental unit that is not a home rule subdivision is determined by multiplying the remaining State ceiling by a fraction the numerator of which is the average amount of mortgages placed in that governmental unit during the 3 previous years and the denominator of which is the total amount of all mortgages placed in the State outside of the home rule subdivisions during the same 3 previous calendar years.

Under the second and third steps described above, the governor or State legislature can allocate the remaining State ceiling to any governmental units that have authority to issue mortgage subsidy bonds (including home rule subdivisions), but they cannot allocate the amount specially allocated to the home rule subdivisions.

(10) Required targeted portion

House bill.—If an issuing jurisdiction includes a targeted area, at least 20 percent of the lendable proceeds of a bond issue must be made available for at least one year for mortgage loans in the targeted areas in the issuing jurisdiction. This amount need not exceed 40 percent of the market share of the targeted areas.

Senate amendment.—No provision.

Conference agreement.—The conference agreement follows the House bill.

(11) Multiple originators' requirement

House bill.—There must be more than one person who originates mortgages from the bond proceeds, unless there is only one willing and able originator or there is a sound public purpose for using only one originator.

Senate amendment.—No provision.

Conference agreement.—The conference agreement deletes the multiple originators' requirement of the House bill.

(12) Bond issue approval

House bill.—All bonds must be submitted to a State agency for the agency's opinion as to whether or not the issue meets the market limitation and targeted portion requirement. The State agency must issue an opinion within 30 days after submission.

[177] *Senate amendment.*—No provision.

Conference agreement.—The conference agreement deletes the bond issue approval requirement of the House bill.

(13) Arbitrage restrictions

House bill.—The effective interest rate on mortgages to homeowners is limited to 1.0 percentage point above the yield to maturity to the purchasers of the bonds, calculated on the date of issuance. In addition, arbitrage is not permitted on reserves that exceed 150 percent of the annual debt service on the bonds. Finally, arbitrage earnings other than the 1.0 percentage point on home mortgages must be returned to the mortgagors.

Senate amendment.—No provision.

Conference agreement.—The conference agreement follows the House bill. However, the conferees wish to clarify several provisions of the conference agreement dealing with arbitrage. The first provision involves the determination of the effective rate of interest on the mortgages. The conference agreement requires that amounts that are taken into account in determining the effective rate of interest are to be discounted, from the time the amounts are received, to an amount equal to the "purchase price" of the mortgages. Because the yield on the bonds ordinarily is computed on a semi-annual basis, the conferees intend that the computation of the effective interest rate on mortgages should use the same semi-annual compounding interval as is used on the bonds. Under this method, monthly mortgage payments that are received before an interest payment date for the bonds are treated as received as of the next succeeding interest payment date.

The second point the conferees wish to clarify is that any losses on mortgage payments (after taking into account foreclosure proceedings and insurance) are taken into account in determining the effective interest rate. In determining the anticipated losses, the most recent experience of defaults for the area where the mortgages are to be placed is to be used.

The third provision the conferees desire to clarify involves the use of arbitrage on nonmortgage investments to compensate the issuer for any losses

on mortgages. If the actual losses (after foreclosure proceedings and insurance payments) exceed the anticipated losses taken into account in determining the effective interest rate, the issuer may use arbitrage from nonmortgage investments to recoup the excess losses. The amount of arbitrage so used would not have to be paid or credited to the mortgagors.

The conferees also want to clarify the requirement of the conference agreement that arbitrage on nonmortgage investments be paid or credited to the mortgagors as rapidly as practicable. The conferees understand that this requirement is satisfied if the arbitrage is paid or credited to such mortgagor at the time the mortgagor discharges his mortgage. Thus, at the time of any prepayment by the mortgagor of the entire principal amount of his mortgage (or at the last regular payment which discharges the mortgage), the mortgagor must be paid or credited with his allocable share of the cumulative amount of net arbitrage. In the case of prepayments, the cumulative amount of net arbitrage may be determined as of a date before the actual prepayment, but not more than one year earlier than the date of the prepayment.

[178] *(14) Termination ("sunset")*

House bill.—The issuance of qualified mortgage bonds would be permitted under the above rules only for 2 years from the date of enactment. After that time, the issuance of such bonds would be prohibited.

Senate amendment.—No provision.

Conference agreement.—The conference agreement provides that the issuance of qualified mortgage bonds would be permitted until December 31, 1983. After that date, the qualified mortgage bonds could not be issued.

(15) Registration

House bill.—All tax-exempt housing bonds issued after the date of enactment must be in registered form.

Senate amendment.—No provision.

Conference agreement.—The conference agreement generally follows the House bill except that it delays the effective date of the registration requirement from bonds issued after the date of enactment to bonds issued after December 31, 1981.

(16) Advance refunding

House bill.—No advance refunding of mortgage subsidy bonds will be permitted after the date of enactment.

Senate amendment.—No provision.

Conference agreement.—The conference agreement follows the House bill.

c. Qualified veterans' mortgage bonds

(1) Residences for veterans

House bill.—Substantially all of the proceeds from the bonds must be used to provide residences for veterans.

Senate amendment.—No provision.

Conference agreement.—The conference agreement follows the House bill.

(2) New mortgage requirement

House bill.—Except for construction period loans, bridge loans or similar temporary initial financing, and an existing mortgage where the residence is substantially rehabilitated, none of the proceeds of the bonds can be used to replace or acquire an existing mortgage.

Senate amendment.—No provision.

Conference agreement.—The conference agreement follows the House bill.

(3) General obligation requirement

House bill.—Both the principal and interest of the bond must be secured by the general obligation of a State.

Senate amendment.—No provision.

Conference agreement.—The conference agreement follows the House bill.

[179] *(4) Registration*

House bill.—All tax-exempt housing bonds issued after the date of enactment must be in registered form.

Senate amendment.—No provision.

Conference agreement.—The conference agreement generally follows the House bill, except that it delays the effective date of the registration requirement from bonds issued after the date of enactment to bonds issued after December 31, 1981.

(5) Advance refunding

House bill.—No advance refunding of mortgage subsidy bonds will be permitted after the date of enactment.

Senate amendment.—No provision.

Conference agreement.—The conference agreement follows the House bill.

d. Transitional rules

House bill.—The House bill applies to bonds issued after April 24, 1979, with three major exceptions and a number of exceptions for limited cases. The three major exceptions are as follows:

a. Official action

Tax-exempt housing bonds may be issued if, prior to April 25, 1979, the governing body of the unit having authority to issue the bonds had taken official action which indicated an intent to issue such bonds. A qualifying official action would include an authorization to hire bond counsel, an authorization to hire bond underwriters, or an authorization to make a market analysis with respect to a specified bond issue. Such authorization must be a specific authorization relating to a specified bond issue.

In the case of a sized or tentatively sized bond issue, only the amount of bonds the issuer reasonably intended to issue based on the documentation that existed before April 25, 1979, will qualify under this rule.

In case of an unsized bond issue, only an amount of bonds (exclusive of issuance costs and a reasonably required reserve) equal to the amount of mortgages for which the lenders had given firm commitments to home buyers within 9 months after the bonds are issued will qualify under this rule. Bond proceeds for which commitments

were not made within 9 months from the issuance date of the bonds must be used to redeem bonds.

b. Rollover rule

Tax-exempt indebtedness outstanding on April 24, 1979, may be rolled-over where the maturity date of the tax-exempt housing bonds is no longer than 2 years after the life of the initial mortgages on the properties.

c. Special rule for projects under development

Tax-exempt housing bonds for the financing of projects in the development stage may be issued where, prior to April 25, 1979,

(1) substantial expenditures had been made for detailed plans and specifications, and

(2) tax-exempt construction financing had been issued with respect to the project or there exists written evidence that a [180] governmental unit intended to issue tax-exempt bonds to finance the acquisition of the units by home buyers.

Senate amendment.—No provision. However, the Senate adopted an amendment to the supplemental appropriations bill that indicated the sense of the Senate that any bill restricting the use of mortgage subsidy bonds would not apply to bonds issued prior to January 1, 1981, so long as the proceeds of the bonds are committed to home purchasers within one year from the date of issue. The amendment was deleted from the bill in conference.

Conference agreement.—The conference agreement generally adopts the transitional rules in the House bill with several technical corrections. In addition, the conference agreement provides a general exception for bonds issued before January 1, 1981, and adds several additional special rules.

General rule

Under the conference agreement, the new rules that apply to the issuance of qualified mortgage bonds shall not apply to obligations issued before January 1, 1981, if these issues meet certain other criteria. Such obligations, if issued before January 1, 1981, will qualify, if they are part of an issue from which substantially all of the proceeds are committed by firm commitment letters within one year after the date of issue of the obligations. Commitment of substantially all of the proceeds allows use of a portion of the proceeds to meet issuance costs and provide for a reasonably required reserve. Firm commitment letters are identical to letters of firm commitment used when financing is provided from other sources than tax-exempt bonds.

Technical corrections

The technical corrections made by the conference agreement to the House transitional rule are as follows.

Section 904(b)(4) of the conference report relating to the date of a local referendum is modified to correct a technical error to show the correct date of the referendum as June 12, 1979.

Section 904(d)(3) of the conference report relating to the timing of resolutions before a city council and enactment of State authorizing legislation is modified to correct technical inaccuracies that do not affect the substance of the rule in the House-passed bill.

Section 904(d)(4) which relates to the date of a resolution that delayed completion of an issue because of interest charges is modified to insert the correct date of the resolution.

Section 904(h)(2) is modified by correcting the title of the National Housing Act.

Section 904(m)(3) is modified to extend the time limit for commitment letters to December 31, 1981.

Registration requirement

Section 904(i) relating to the requirement that all obligations issued as qualified mortgage bonds under the authority of this conference agreement must be in registered form is amended to require such registration for all obligations under this agreement issued after December 31, 1981. The registration requirement applies to obligations issued under the permanent rules and the transitional rules after the effective date.

[181] *Special transitional rule for loans to lenders*

The conference agreement includes a provision under which obligations may be issued during 1981 and 1982 as part of a loans to lender program. The amounts of the obligations issued under the loans to lender program will be included with the amount issued by the State housing finance agency under the limitation established by the conference agreement.

A qualified loans to lender program means any program, that has been established in accordance with legislation enacted by the State of New York in 1970, which finances the purchase of existing mortgages from financial institutions and requires that the financial institutions reinvest the proceeds in new mortgages within 90 days.

New mortgages made by financial institutions with the proceeds received from the sale of old mortgages to the State of New York Mortgage Agency (SONYMA) must meet the requirements established by the conference agreement with respect to new mortgages financed with mortgage revenue bonds. Because this is a special rule to accommodate a transitional problem, the requirements within the conference report with respect to low or moderate income rental housing and the arbitrage rules pertinent to mortgage revenue bonds will not apply during 1981 and 1982 to new mortgages by financial institutions using proceeds from the SONYMA loans to lender program. No inference is implied in this conference agreement dealing with mortgage revenue bonds with respect to the arbitrage rules which are in effect in section 103(c) of the Internal Revenue Code.

Certain additional transitional rules

The conference agreement adds transitional authority to issue tax-

exempt mortgage revenue bonds for seven specific projects in enumerated jurisdictions for specific purposes. In each case, the authority granted to a city or county may be used only by the appropriate issuing authority for that city. The amount specified in this subsection for a city shall be the maximum amount of obligations which may be issued by the appropriate issuing authority under the authority granted for the specific purpose of the issue. The obligations may be issued only for the purposes listed in this subsection of the conference agreement.

The ceiling amount for each area and the purpose of the issues are listed below.

2. Multi-family rental housing

a. General rule

House bill.—The present exception for tax-exempt industrial development bonds would be limited to obligations substantially all the proceeds of which are to be used for multi-family rental housing projects in which at least 20 percent of the units are to be occupied by individuals of low or moderate income, determined in a manner consistent with the Leased Housing Program under Section 8 of the United States Housing Act of 1937.

Senate amendment.—No provision.

Conference agreement.—The conference agreement generally follows the House bill except that, in projects located in a qualified [182] census tract or an area of chronic economic distress, at least 15 percent of the units are to be occupied by individuals of low or moderate income. For projects located in areas which are not in a qualified census tract or an area of chronic economic distress, the 20 percent requirement of the House bill is retained. The conferees want to clarify that the method for determining income in effect at the time of the bond issuance will be determinative for that issue even though they are subsequently changed.

The conference agreement adds a rule to the small issue exemption of Code section 103(b)(6) to insure that the small issue exemption is not used as a means of circumventing the multi-family rental provisions of the conference agreement. Under that rule, the small issue exemption would not apply to any obligation which is used as a part of an issue a significant portion of the proceeds of which are to be used directly or indirectly to provide residential real property for family units. In addition, the conferees want to clarify that interest on an industrial development bond a significant portion of which is used to provide residential real property for family units will be tax-exempt only if it meets the multi-family rental requirements of the conference agreement or the limited exception for the New York State Loan to Lenders Program regardless of whether the bond is a qualified mortgage bond or a qualified veterans' mortgage bond.

Also, the conference agreement provides a special rule similar to that in the House bill for bonds issued before January 1, 1984 (and which do not come within the transitional rules) under which the 20 percent requirement need be met only for a period of 20 years. The 20-year period begins on the first date that the project is available for occupancy and the tax-exempt obligations are outstanding. Under this rule, the 20 percent test will be met where the developer of the project has entered into a contract with a Federal or State agency that requires that at least 20 percent of the units be maintained for persons of low or moderate income for a period of at least 20 years and provides rent subsidies for such persons for that period.

b. Registration

House bill.—All tax-exempt bonds issued after the date of enactment must be in registered form.

Senate amendment.—No provision.

Conference agreement.—The conference agreement generally follows the House bill except that it delays the effective date of the registration requirements from bonds issued after the date of enactment to bonds issued after December 31, 1981.

City or county	Ceiling amount	Purpose of issue
Baltimore, Md.	$100,000,000	Financing owner-occupied residences.
Port Arthur, Tex.	175,000,000	For financing on new town in town project.
Minneapolis, Minn.	25,000,000	Financing owner-occupied residences.
Minneapolis-St. Paul, Minn.	235,000,000	Joint program for financing owner-occupied residences involving some UDAG grants and private financing.
Detroit, Mich.	50,000,000	To issue obligation maturing before 1986 for construction on the Riverfront West project.
Brevard County, Fla.	150,000,000	Financing owner-occupied residences.
Chicago, Ill.	235,000,000	For financing on the Presidential Towers project.

[183] *c. Transitional rules*

House bill.—The House bill applies to bonds issued after April 24, 1979, with three major exceptions and a number of exceptions for limited cases. The three major exceptions are as follows:

a. Official action

Tax-exempt housing bonds may be issued if, prior to April 25, 1979, the governing body of the unit having authority to issue the bonds had taken official action which indicated an intent to issue such bonds. A qualifying official action would include an authorization to hire bond counsel, an authorization to hire bond underwriters, or an authorization to make a market analysis with respect to a

specified bond issue. Such authorization must be a specific authorization relating to a specified bond issue.

In the case of a sized or tentatively sized bond issue, only the amount of bonds the issuer reasonably intended to issue based on the documentation that existed before April 25, 1979, will qualify under this rule.

In the case of an unsized bond issue, only the amount of bonds (exclusive of issuance costs and a reasonably required reserve) equal to the amount of mortgages for which the lenders had given firm commitments to developers for a specific project within 9 months after the bonds are issued will qualify under this rule. Bond proceeds for which commitments were not made within 9 months from the issuance date of the bonds must be used to redeem bonds.

b. Rollover rule

Tax-exempt indebtedness outstanding on April 24, 1979, may be rolled-over where the maturity date of the tax-exempt housing bonds is no longer than 2 years after the life of the initial mortgages on the properties.

c. Special rule for projects under development

Tax-exempt housing bonds for financing of projects in the development stage may be issued if:

(1) a plan specifying the number and location of rental units was approved on or before April 24, 1979, by a governing body, or a State or local housing agency or a similar agency, and

(2) substantial expenditures for site improvement for the project have been incurred on or before such date.

Senate amendment.—No provision.

Conference agreement.—The conference agreement adopts the transitional provisions of the House bill with certain technical amendments (described above). In addition, the conference agreement provides that the amendment made by sections 1102 and 1103 of the conference agreement shall not apply to obligations issued before January 1, 1981, where the construction of the project had begun, or the acquisition of the project occurs, before one year [184] after the date of issuance of the obligations. Finally, the conference agreement adopts additional special transitional rules for seven specific projects set forth above.

In addition, the conferees want to clarify the application of the House transitional rule for projects under development. The conferees intend that a project would qualify under this rule even though the project plans are modified to the extent of changing the specific location of structures within the project as long as the perimeter and the overall housing density of the project are not changed.

[185] B. Cash Management Provisions —Estimated Tax Payments

House bill.—Under present law, corporations generally are required to pay 80 percent of their current year's tax liability in quarterly estimated tax payments during the taxable year. However, corporations are exempt from the penalty for underpayment of estimated tax if their estimated tax payments equal 100 percent of their prior year's tax liability.

For both corporations and individuals, the minimum tax is not subject to the estimated tax requirements.

The House bill provides, in general, that corporations whose taxable income exceeded $1 million in any of the three preceding taxable years would be required to pay estimated tax of at least 60 percent of current year's tax liability regardless of their prior year's tax liability.

Senate amendment.—Under the Senate amendment, large corporations would be required to pay at least 50 percent of current year's tax liability on a current basis. Furthermore, the proportion of the tax shown on the return (or the actual tax if no return is filed) that is to be paid currently by any corporation not relying on the prior year exceptions would be increased from 80 percent to 85 percent. Finally, both the add-on minimum tax for corporations and individuals and the alternative minimum tax for individuals would be subject to the same estimated tax requirements as the regular income tax.

Conference agreement.—The conference agreement follows the House bill.

[186] C. Gains From Foreign Investment in U.S. Real Estate

1. General rule

House bill.—Nonresident aliens and foreign corporations ("foreign investors") would be subject to tax on the disposition of U.S. real property. Real property is intended to have the same meaning for this purpose that it has in the U.S. Treasury's model income tax treaty and thus it includes personal property associated with real property. Foreign investors would also be taxed on gain from the disposition of an interest in a U.S. real property holding organization (RPHO). The tax would be imposed regardless of whether or not the gain was effectively connected with a U.S. business or the seller was present in the United States.

Senate amendment.—Substantially the same as House bill.

Conference agreement.—The conference agreement follows the House bill and the Senate amendment.

2. Rate of tax

House bill.—All gains and losses from the disposition of U.S. real property interests would be treated as if they were effectively connected with a U.S. trade or business. Losses attributable to the U.S. real property from years prior to the year of sale would be allowed as deductions against the foreign investor's effectively connected U.S. gross income (including gains from real property sales) if the foreign investor elects under section 871(d) or 882(d) to be taxable on a net basis on its U.S. real property investment income.

Senate amendment. — Same as House bill, except that net gains from

disposition of U.S. real property interests would be subject to tax at a minimum rate of 28 percent if that tax would be higher than the tax under the general rule. No tax would be due if net gains during the taxable year from the sale of U.S. real property interests do not exceed $5,000.

Conference agreement.—The conference agreement generally follows the House bill. However, certain aspects of the Senate amendment were retained in modified form so that the tax on foreign investors would be more comparable to the tax imposed on U.S. investors in similar circumstances. The impact of the Senate amendment on foreign investors would have been greater than the tax imposed on similarly situated U.S. investors because the 28-percent minimum rate of the Senate amendment is higher than the capital gains rate imposed on long-term capital gains of U.S. investors who are not in the highest marginal tax brackets. In addition, the Senate amendment, in computing the tax, did not permit the use against U.S. real property gains or net losses which are effectively connected with another U.S. trade or business of the foreign investor or net losses from holding the U.S. real property interest which were attributable to prior years. The House bill, on the other hand, in many situations would have imposed a tax at rates lower than those imposed on similarly situated U.S. investors since the rate of tax would be determined with reference only to the foreign investor's income which was effectively connected with a U.S. trade or business. Since any other U.S. source investment income and all foreign source income of the foreign investor would not be taken into account, the rate of tax on the U.S. real estate gains of foreign investors (particularly if an installment sale were used to spread [187] the gain over several years) would generally be lower than that imposed on U.S. investors in similar circumstances. Consequently, the conferees decided, in the case of individuals, to impose the U.S. tax at a minimum rate of 20 percent of property gains (net of U.S. effectively connected losses) but otherwise to follow the approach of the House bill and generally to treat U.S. real property gains as gains effectively connected with a U.S. trade or business subject to the U.S. graduated capital gains rates and with full use of effectively connected losses against those gains.

3. Real property holding organizations (RPHOs)

House bills.—Corporation, partnership or trust would be an RPHO if, during the taxable year, the fair market value of its U.S. real property interests was at least 50 percent of the sum of the values of its (i) U.S. real property interests, (ii) interests in foreign real property, and (iii) other assets used in the trade or business "Look through" rules would apply where the entity had a controlling interest in another entity, and attribution rules would apply to determine whether a controlling interest existed.

In general, all gains from the disposition of an interest in an RPHO would be subject to tax. However, no tax would be imposed on sale of publicly traded stock in a corporation by a person who owned 5 percent or less.

Senate amendment.—Corporation, partnership or trust would be an RPHO if (a) at least a 50 percent interest in the entity is held by 10 or fewer persons, and (b) the fair market value of its U.S. real property interest is at least 50 percent of the value of all its assets (other than liquid assets).

U.S. tax treaties generally provide for a reduced rate of tax on dividends which might make it advantageous for a domestic corporation to distribute a U.S. real property interest to a shareholder in dividend form. To prevent this, the bill denies the recipient a basis step-up except to the extent that the corporation recognizes gain and the recipient pays U.S. income tax on the distribution. "Look-through" and attribution rules similar to the House bill would apply. All gains from disposition of an interest in an RPHO would be subject to tax.

Conference agreement.—The conference agreement generally follows the House bill with respect to domestic corporate RPHOs but adopts different rules for other entities as set forth below. Attribution rules similar to the House bill apply to determine whether there is a controlling interest in another entity but the "look through" rules apply to such an interest only with respect to assets actually held downward through the chain of ownership. U.S. corporations would be treated as RPHOs unless they elect to file returns establishing that less than 50 percent of their assets are U.S. real property interests.

(i) *Foreign corporations.*—Gain on the disposition of stock in a foreign corporation would not be subject to the tax imposed under the bill. Instead, the foreign corporation would be taxed on any distribution (whether or not in liquidation) of appreciated U.S. real property interests to its shareholders. Also, tax would be imposed if the property is sold in connection with a liquidation.

If the application of the provisions of section 897 or section 6039C to any foreign corporation would be barred by a treaty obligation of [188] the United States which provides that a permanent establishment of a foreign corporation in the United States may not be treated less favorably than a domestic corporation carrying on the same activities, then that foreign corporation may elect, subject to such terms and conditions as are specified by the IRS, to be treated as a U.S. corporation for purposes of sections 897 and 6039C. The election may be revoked only with the consent of the Secretary.

Conditions imposed by the IRS on the making of the election might, for example, include a requirement that the foreign corporation notify its shareholders that the election was being made or a requirement that the IRS be satisfied that treaty relief was applicable. Ordinarily, the election

would be made before the first disposition of stock in a foreign corporation which would be taxable if the election had been made before that first disposition. Where it deemed it to be appropriate, however, the IRS could permit the election to be made after the first disposition, provided satisfactory arrangements were made for the payment of an amount equal to the tax on any dispositions made prior to the election which would have been owing on the dispositions (if the election had been made prior to the first disposition) and an appropriate interest charge for the period since the time at which that tax would have been required to have been paid. In the case of dispositions of stock in foreign corporations made prior to the conference committee's action, it is contemplated that the election may be made retroactively, provided satisfactory arrangements are made for the payment of tax on the stock sale. (For example, if amounts were withheld by the buyer on the purchase of the foreign corporation's stock or were deposited in an escrow account for the satisfaction of the seller's tax liability on the stock sale, the election might be permitted if those funds were made available to satisfy the seller's tax liability.)

(ii) *Partnership, trusts, and estates.*—Gain on the disposition of an interest in these entities also would not be subject, in its entirety, to tax. Instead, a foreign investor in such an entity would be taxable on the disposition of his interest to the extent that the gain represented his pro rata share of appreciation in the value of U.S. real property interests on the entity.

(iii) *REITs.*—Distributions by a real estate investment trust (REIT) to foreign shareholders would be treated as gain on the sale of U.S. real property to the extent of the shareholders' pro rata share of the net capital gain of the REIT. In the case of REITs which are controlled by U.S. persons, sales of the REIT shares by foreign shareholders would not be subject to tax (other than in the case of distribution by the REIT).

4. Nonrecognition rules

House bill.—The Secretary would be authorized to prescribe regulations providing the extent to which nonrecognition rules would (or would not) apply under the bill. Pending the issuance of these regulations, nonrecognition provisions of the Code would apply, but only in the case of an exchange of a U.S. real property interest for an interest the disposition of which would be taxable under the Code (as modified by any treaty pursuant to sections 894 and 7852(d)).

Senate amendment.—Similar to the House bill, but without a rule prescribing treatment prior to the issuance of regulations.

[189] *Conference agreement.*—Follows the House bill, but also allows prescription of regulations determining the extent to which transfers of property in reorganizations are to be treated as sales at fair market value. Similar rules apply in the case of partnerships, trusts, and estates.

5. Withholding

House bill.—No provision.

Senate amendment.—The withholding requirement would apply only if the purchaser knows or has received a notice that the seller is a foreign person. The seller is required to notify the purchaser that the seller is a foreign person. The seller's agent is also required to notify the purchaser that the seller is a foreign person if the agent has reason to believe that the seller may be a foreign person. The amount to be withheld is the smallest of (i) 28 percent of the sales price, (ii) the "seller's maximum tax liability" (discussed below), or (iii) the fair market value of that portion of the sale proceeds which is within the withholder's control. The "seller's maximum tax liability" is the maximum amount which the Treasury determines that the seller could owe on his gain on the sale plus any unsatisfied prior withholding tax liabilities of prior foreign owners with respect to that property.

A purchaser would not be required to withhold if: (i) the property being sold is a single family residence which is to be used by the purchaser as his principal residence and the amount realized by the seller on the sale is $150,000 or less, (ii) the property being sold is stock of a corporation and the sales transaction takes place on an established securities market or (iii) the seller obtains a "qualifying statement" from the Treasury that he is exempt from tax or he has provided adequate security or has otherwise made arragnements with Treasury for the payment of the tax. The Treasury may prescribe a reduced amount to be withheld under similar procedures.

Conference agreement.—The conference agreement follows the House bill. The Senate conferees had proposed that the tax imposed under the conference agreement be enforced by the withholding provisions contained in the Senate bill, modified in several respects.[1] The House conferees refused to agree to the withholding provisions in the conference agreement. The conferees agreed it would be necessary to structure withholding provisions care-

[1] The withholding provisions of the Senate amendment would be modified to provide that neither the purchaser nor any settlement agent would be required to withhold unless he has actual knowledge that the seller is foreign or has received a notice from a seller's agent. The seller's agent would be relieved of any responsibility to give such a notice if he relies in good faith on a statement from the seller (or, in the case of a seller's agent retained by another seller's agent, from the seller's agent who retained him) that the seller is a U.S. person or, if the seller is foreign, that the seller notified the purchaser. A second modification proposed to the Senate bill withholding provisions was that if the purchaser assumes a debt of the seller or took the property subject to a debt of the seller, which was incurred within one year prior to the sale, that amount of the consideration would also be subject to withholding. A final modification would have set forth in greater detail the circumstances under which withholding might be reduced or waived. The taxpayer would be permitted to reduce (or eliminate) the amount of withholding by filing a return stating the basis for the property and the character of the contemplated gain. The IRS would be required to accept that basis and character for withholding purposes unless the IRS responded within 30 days specifying a lower (or zero) basis or different character if the IRS were not satisfied that the amount to be withheld would be sufficient to cover the taxpayer's underlying liability.

fully to ensure that they would not inadvertently disrupt the U.S. real estate market or expose U.S. buyers or U.S. agents of foreign sellers [190] of U.S. real estate to liability where such liability would not be appropriate. Given this potential, the House conferees took the position that withholding provisions should not be adopted until they could be more fully considered by the committees and the public had adequate opportunity to consider and comment on the proposed withholding mechanism. The conferees agreed that, until and unless withholding provisions were adopted by a subsequent Congress, the tax should be enforced through information reporting as discussed below.

6. Reporting

a. Returns to identify whether an entity is an RPHO

House bill.—If, at any time during a calendar year, (i) an entity beneficially owns U.S. real property interests which constitute more than 40 percent of the fair market value of the assets taken into consideration in determining whether or not it is an RPHO and (ii) at least one foreign person has an interest (other than a portfolio interest in publicly-traded stock) in the entity, the entity is required to file an information return for the year. The return is to set forth the name and address of any foreign person who held an interest, whether the entity is an RPHO at any time during the calendar year, and other information which the Treasury may prescribe by regulations.

Senate amendment.—If, at any time during a calendar year, (i) an entity has U.S. real property interests which constitute more than 40 percent of the fair market value of its assets, (ii) 10 or fewer persons have a controlling interest in the entity, and (iii) at least one foreign person has an interest in the entity, the entity is required to file an information return for the year. The information required is similar to the information required under the House bill.

Conference agreement.—The conference agreement deletes the requirement that entities file returns establishing whether or not they are RPHOs. Under the conference agreement, an entity (or a person owning an interest in the entity) may on a voluntary basis file a return, containing such information as may be required by the IRS, establishing that the entity is not an RPHO.

b. Returns to identify foreign owners

House bill.—Foreign owners of U.S. real estate who are not subject to the return requirements described above are generally required to file returns showing (i) the name and address of the person, (ii) a description of all U.S. real property interests held by such person, and (iii) such other information as the Treasury may prescribe by regulations.

Senate amendment.—No provision.

Conference agreement.—The conference agreement generally follows the House bill with several modifications.

U.S. corporations which are U.S. real property holding corporations or which were U.S. real property holding corporations at any time during the preceding 4 years will be required to file annual returns setting forth the name and the address (if known by the corporation) of each foreign shareholder (other than shareholders owning stock which is publicly traded, any information required by [191] the Secretary with respect to transfers of stock in the corporation by such foreign shareholders and any other information which the Secretary may prescribe by regulations. Any nominee holding stock in a U.S. corporation on behalf of a foreign person is required to file a return in the same manner as the corporation is required. No requirement for reporting with respect to publicly traded stock is imposed because information with respect to foreign shareholders holding more than 5 percent of any publicly traded class of stock in a U.S. corporation (less than 5 percent shareholders are not taxable on the disposition of their stock) should be readily available from the SEC.

Foreign corporations and partnerships, trusts, or estates (whether foreign or domestic) are required to file annual returns setting forth the name and address of each foreign person who has a substantial indirect investment in U.S. real property through the entity, such information with respect to the assets of the entity, and such other information as the Secretary may prescribe by regulations. For this purpose, a foreign person having a substantial indirect investment through the entity would include any foreign person whose pro rata share of the U.S. property interests held by the entity exceeded $50,000 at any time during the calendar year. Any entity required to make such a return is also required to furnish each of the foreign persons holding a substantial investment in U.S. real property through that entity a statement showing the name and address of the entity, the substantial investor's pro rata share of the U.S. real property held by the entity and such other information as is required by regulations. In determining whether the pro rata share of any foreign person's beneficial interest in the real property held by the entity exceeds $50,000, the entity's pro rata share of any real property interest held by any other such entity in which the first entity holds a beneficial interest, and interests in the first entity held by the person's family, shall also be taken into account.

These reporting requirements will not apply to any entity for any calendar year where the entity furnishes the IRS with such security as the IRS determines to be necessary to ensure that any U.S. tax with respect to U.S. real property interests held by such entity will be paid. It is expected that the security which the IRS would consider to be satisfactory for this purpose would depend upon the circumstances. Thus, for example, in the case of a foreign corporation the only asset of which is a tract of undeveloped U.S. real estate, the IRS might require a recorded security interest in the real

estate, a guarantee by a person from whom the IRS would be reasonably certain it could collect the unpaid tax, or some similar type of security. On the other hand, in the case of a foreign corporation engaged in a U.S. trade or business with a variety of U.S. assets and where the circumstances indicated that it was improbable that the foreign corporation would attempt to liquidate and remove its assets from the United States without satisfying its U.S. tax liability, the IRS might only require an undertaking by the foreign corporation to pay the tax in a closing agreement or some similar security. Where an arrangement is reached with the IRS, the entity is not required to report the identity of the foreign persons holding interests in the entity and, in addition, the foreign person is not required to take its pro rata interest in the entity into ac-[192]count in determining its own reporting requirements. Where the foreign corporation was unable to supply the necessary information to the IRS as to the identity of its shareholders because, for example, its stock is in bearer form or was held by nominees unwilling to disclose the identity of the beneficial owner, it would be required to provide security satisfactory to the IRS.

A separate reporting requirement applies to foreign persons owning U.S. real property who are not required to file a return under section 6039C(b) for the year. Where such a foreign person did not engage in a trade or business in the United States at any time during the calendar year and the fair market value of the U.S. real property interests held by the foreign person at any time during the year equals or exceeds $50,000, the foreign person is required to file a return setting forth his (or its) name and address, a description of all U.S. real property interests held at any time during the calendar year and such other information as is required by regulations. "Look through" and family attribution rules apply to determine whether a person is a substantial investor.

c. Failure to make a return or furnish a statement

House bill.—A penalty for failure to file a tax return or to furnish a statement required under the rules described above will be imposed in an amount equal to $25 for each day during which such failure continues but not to exceed $25,000. Also, in the case of a failure by a foreign person to file a return required by the rules set forth in (b) above, the penalty for any calendar year cannot exceed 5 percent of the aggregate of (i) the fair market value of the U.S. real property interests owned by that person at any time during the year and (ii) the face amount of the U.S. real property interest installment obligations.

Senate amendment.—A penalty for failure to file a tax return or to furnish a statement will be imposed in an amount equal to the greater of (i) $25 a day during which the failure continues, but not to exceed $25,000, or (ii) the amount of the tax under the bill which is not paid and which is attributable to transfers (other than those made in an established securities market) occurring during the calendar year for which the return or statement was required.

Conference agreement.—The conference agreement generally follows the House bill.

In the case of each failure to file a return containing the information required by these information reporting requirements or to furnish the statement to a beneficial owner of an interest of its pro rata share of the U.S. real property assets held by the entity, a penalty is imposed of $25 for each day during which the failure continues (but not to exceed $25,000 for the calendar year) unless it is shown that the failure is due to reasonable cause and not to willful neglect. A further limitation to the penalty applies in the case of a failure of a foreign person to disclose his U.S. real property interests (sec. 6039C(c)). In the case of such a failure, the penalty is not to exceed 5 percent of the aggregate fair market value of the U.S. real property interests held by the person at any time during the year.

[193] 7. Effective date

a. General rule

House bill.—The bill would apply to dispositions after June 18, 1980.

Senate amendment.—The Senate amendment would apply to dispositions after December 31, 1979, except those made pursuant to a contract binding at all times after December 6, 1979.

Conference agreement.—The conference agreement generally follows the House bill and would apply to dispositions after June 18, 1980. However, no step-up in basis would be allowed with respect to a disposition made to a related party (within the meaning of Code section 453(f)(1)) in a nontaxed transaction after December 31, 1979.

b. Tax treaties

House bill.—Until January 1, 1985, gain would not be taxed to the extent required by treaty obligations of the U.S. On and after that date, the provision would prevail over any conflicting treaty provisions remaining in effect.

Senate amendment. — Same as House bill.

Conference agreement.—The conference agreement generally follows the House bill and the Senate amendment, but no step-up in basis would be allowed with respect to a disposition made to a related party which is exempt from the tax imposed by the bill solely because of delays of the effective date attributable to conflicting treaty obligations. In situations where a treaty is renegotiated to resolve conflicts between the treaty and the conference agreement, the delay in the effective date of the conference agreement can be extended in the revised treaty or an accompanying exchange of notes for a period of up to two years after the signing of the revised treaty in order to permit the Senate adequate time to consider the revised treaty.

[194] D. Windfall Profit Tax

1. Royalty owners credit

House bill.—No provision.

Senate amendment.—The Senate amendment provides royalty owners with a credit (or refund) of up to $1,000 against the windfall profit tax imposed on the removal of their royalty oil during calendar year 1980. The credit is available only to individuals, estates, and family farm corporations and not to other corporations or to trusts. In the case of a family, the husband and wife and their minor children are treated as one taxpayer for purposes of the $1,000 limit on the credit. A qualified family farm corporation that is eligible for the credit is one which (1) was in existence on June 25, 1980, (2) all of the outstanding stock of which was held by members of the same family at all times between July 24, 1980, and January 1, 1981, and (3) 80 percent of the assets of which was used for farming purposes.

The Senate amendment also requires that in calculating the amount of income tax deduction for the windfall profit tax, net income for percentage depletion purposes, and oil related income for the minimum tax on intangible drilling costs, a taxpayer must reduce the gross amount of windfall profit tax paid or withheld during the taxable year by the amount of the credit allowable against that tax. This reduction of the income tax deduction must be made regardless of whether the taxpayer actually claims the allowable credit.

Conference agreement.—The conference agreement follows the Senate amendment.

2. Stripper oil exemption

House bill.—No provision.

Senate amendment. — The Senate amendment provides for an exemption from the windfall profit tax for up to 2 barrels a day of stripper well production for each stripper well from which the producer receives production. This exemption applies to oil removed in the four quarters of fiscal year 1981.

Conference agreement. — The conference agreement follows the House bill.

3. Modification of inflation adjustment

House bill.—No provision.

Senate amendment.—Under present law, the windfall profit tax is imposed on the difference between the selling price of each barrel of domestic crude oil and its adjusted base price for the calendar quarter during which it is removed. The adjusted base price is determined by increasing the base price to take account of inflation between the second quarter of 1979 and the second quarter prior to the quarter for which the adjusted base price is being determined. In the case of newly discovered oil, heavy oil and incremental tertiary oil, the adjusted base price is determined by using the rate of inflation plus 2 percent per year.

The Senate amendment would adjust the otherwise applicable adjusted base price for each calendar quarter in fiscal year 1981 by subtracting an amount equal to 10.9 percent of that adjusted base price.

Conference agreement. — The conference agreement follows the House bill.

[195] E. Inclusion in Wages of Social Security and Unemployment Taxes Paid by Employers

House bill.—Under present law, employer payment of an employee's liability for social security taxes or State unemployment compensation taxes (without deduction from the remuneration of the employee) is specifically exempted from wages for purposes of social security taxes (FICA), Federal unemployment taxes (FUTA), and social security benefits.

The House bill provides that the payment by an employer of an employee's liability for social security taxes or State unemployment compensation taxes would be included in the definition of wages for purposes of FICA, FUTA, and social security benefits. However, this provision would not apply with respect to payments for domestic service in the employer's home.

The provision generally would be effective with respect to remuneration paid after December 31, 1980. However, in the case of certain State, political subdivision, or other State or local coverage group employment under section 218 of the Social Security Act, the provision would apply with respect to remuneration paid after December 31, 1983. This later effective date would apply only to remuneration for services in positions of a kind for which all, or a substantial portion of the amounts equivalent to employee social security taxes were paid (without deduction from the wages of the employee) under the practices in effect on June 18, 1980.

Senate amendment. — The Senate amendment is similar to the House bill except that it does not apply to: (1) employer payment of employee State unemployment compensation taxes or (2) agricultural labor. In addition, the December 31, 1983, effective date for certain State and local governmental units would apply to payments of amounts equivalent to employee social security taxes if these amounts were paid (without deduction from remuneration of the employee) under practices that were in effect on July 26, 1980.

Conference agreement. — The conference agreement follows the House bill with two modifications. Under the conference agreement, agricultural labor would be excluded from the application of the provision. In addition, the later effective date with respect to certain State and local governmental units would apply to payments of amounts equivalent to employee social security taxes if these amounts were paid (without deduction from remuneration of the employee) under practices that were in effect on October 1, 1980.

Concerning the application of these amendments to State and local governments, the conferees wish to empha-

size that the general rule with respect to social security taxation is that all forms of remuneration constitute wages for social security tax purposes unless specifically exempted by statute. Payments by State and local governments of the equivalent of employee social security taxes for their employees, since these payments represent a benefit to the employees from their employer, constitute "remuneration" within the meaning of the Act and the Code but for the exception which is being eliminated by this provision.

[196] F. Telephone Excise Tax

House bill.—Present law imposes an excise tax on amounts paid for communications services (local telephone service, toll telephone service and teletypewriter service). The tax is 2 percent for 1980 and 1 percent for 1981. The tax is to expire on January 1, 1982.

The House bill delays the reduction and expiration of the tax by one year. Under the House bill, the tax is 2 percent for 1980 and 1981 and 1 percent for 1982. The tax is to expire on January 1, 1983.

Senate amendment. — The Senate amendment is the same as the House bill.

Conference agreement. — The conference agreement follows the House bill and the Senate amendment.

Public Law 96-510 96th Congress, H.R. 7020 [1] December 11, 1980

An Act to provide for liability, compensation, cleanup, and emergency response for hazardous substances released into the environment and the cleanup of inactive hazardous waste disposal sites.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Comprehensive Environmental Response, Compensation, and Liability Act of 1980".

* * * * *

TITLE II—HAZARDOUS SUBSTANCE RESPONSE REVENUE ACT OF 1980

SEC. 201. SHORT TITLE; AMENDMENT OF 1954 CODE

(a) SHORT TITLE.—This title may be cited as the "Hazardous Substance Response Revenue Act of 1980".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this title an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

Subtitle A—Imposition of Taxes on Petroleum and Certain Chemicals

SEC. 211. IMPOSITION OF TAXES

(a) GENERAL RULE.—Subtitle D (relating to miscellaneous excise taxes) is amended by inserting after chapter 37 the following new chapter:

"CHAPTER 38—
ENVIRONMENTAL TAXES

"SUBCHAPTER A. Tax on petroleum.
"SUBCHAPTER B. Tax on certain chemicals.

"Subchapter A—Tax on Petroleum

"Sec. 4611. Imposition of tax.
"Sec. 4612. Definitions and special rules.

"SEC. 4611. IMPOSITION OF TAX

"(a) GENERAL RULE.—There is hereby imposed a tax of 0.79 cent a barrel on—

"(1) crude oil received at a United States refinery, and

"(2) petroleum products entered into the United States for consumption, use, or warehousing.

"(b) TAX ON CERTAIN USES AND EXPORTATION.—

"(1) IN GENERAL.—If—

"(A) any domestic crude oil is used in or exported from the United States, and

"(B) before such use or exportation, no tax was imposed on such crude oil under subsection (a),

then a tax of 0.79 cent a barrel is hereby imposed on such crude oil.

"(2) EXCEPTION FOR USE ON PREMISES WHERE PRODUCED.—Paragraph (1) shall not apply to any use of crude oil for extracting oil or natural gas on the premises where such crude oil was produced.

"(c) PERSONS LIABLE FOR TAX.—

"(1) CRUDE OIL RECEIVED AT REFINERY.—The tax imposed by subsection (a)(1) shall be paid by the operator of the United States refinery.

"(2) IMPORTED PETROLEUM PRODUCT.—The tax imposed by subsection (a)(2) shall be paid by the person entering the product for consumption, use, or warehousing.

"(3) TAX ON CERTAIN USES OR EXPORTS.—The tax imposed by subsection (b) shall be paid by the person using or exporting the crude oil, as the case may be.

"(d) TERMINATION. — The taxes imposed by this section shall not apply after September 30, 1985, except that if on September 30, 1983, or September 30, 1984—

"(1) the unobligated balance in the Hazardous Substance Response Trust Fund as of such date exceeds $900,000,000, and

"(2) the Secretary, after consultation with the Administrator of the Environmental Protection Agency, determines that such unobligated balance will exceed $500,000,000 on September 30 of the following year if no tax is imposed under section 4611 or 4661 during the calendar year following the date referred to above, then no tax shall be imposed by this section during the first calendar year beginning after the date referred to in paragraph (1).

[1] The publication of the law and House Report No. 96-1016 Part II, page 593, this Bulletin, is restricted to excerpts involving tax matters. House Report No. 1016 Part I and Senate Report No. 96-848 are not published.

"SEC. 4612. DEFINITIONS AND SPECIAL RULES

"(a) DEFINITIONS.—For purposes of this subchapter—

"(1) CRUDE OIL.—The term 'crude oil' includes crude oil condensates and natural gasoline.

"(2) DOMESTIC CRUDE OIL.—The term 'domestic crude oil' means any crude oil produced from a well located in the United States.

"(3) PETROLEUM PRODUCT.—The term 'petroleum product' includes crude oil.

"(4) UNITED STATES.—

"(A) IN GENERAL.—The term 'United States' means the 50 States, the District of Columbia, the Commonwealth of Puerto Rico, any possession of the United States, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands.

"(B) UNITED STATES INCLUDES CONTINENTAL SHELF AREAS.—The principles of section 638 shall apply for purposes of the term 'United States'.

"(C) UNITED STATES INCLUDES FOREIGN TRADE ZONES.—The term 'United States' includes any foreign trade zone of the United States.

"(5) UNITED STATES REFINERY.—The term 'United States refinery' means any facility in the United States at which crude oil is refined.

"(6) REFINERIES WHICH PRODUCE NATURAL GASOLINE.—In the case of any United States refinery which produces natural gasoline from natural gas, the gasoline so produced shall be treated as received at such refinery at the time so produced.

"(7) PREMISES.—The term 'premises' has the same meaning as when used for purposes of determining gross incomes from the property under section 613.

"(8) BARREL.—The term 'barrel' means 42 United States gallons.

"(9) FRACTIONAL PART OF BARREL.—In the case of a fraction of a barrel, the tax imposed by section 4611 shall be the same fraction of the amount of such tax imposed on a whole barrel.

"(b) ONLY 1 TAX IMPOSED WITH RESPECT TO ANY PRODUCT.—No tax shall be imposed by section 4611 with respect to any petroleum product if the person who would be liable for such tax establishes that a prior tax imposed by such section has been imposed with respect to such product.

"(c) DISPOSITION OF REVENUES FROM PUERTO RICO AND THE VIRGIN ISLANDS.—The provisions of subsections (a)(3) and (b)(3) of section 7652 shall not apply to tax imposed by section 4611.

"Subchapter B—Tax on Certain Chemicals

"Sec. 4661. Imposition of tax.
"Sec. 4662. Definitions and special rules.

"SEC. 4661. IMPOSITION OF TAX

"(a) GENERAL RULE.—There is hereby imposed a tax on any taxable chemical sold by the manufacturer, producer, or importer thereof.

"(b) AMOUNT OF TAX.—The amount of the tax imposed by subsection (a) shall be determined in accordance with the following table:

"In the case of:	The tax is the following amount per ton
Acetylene	$4.87
Benzene	4.87
Butane	4.87
Butylene	4.87
Butadiene	4.87
Ethylene	4.87
Methane	3.44
Naphthalene	4.87
Propylene	4.87
Toluene	4.87
Xylene	4.87
Ammonia	2.64
Antimony	4.45
Antimony trioxide	3.75
Arsenic	4.45
Arsenic trioxide	3.41
Barium sulfide	2.30
Bromine	4.45
Cadmium	4.45
Chlorine	2.70
Chromium	4.45
Chromite	1.52
Potassium dichromate	1.69
Sodium dichromate	1.87
Cobalt	4.45
Cupric sulfate	1.87
Cupric oxide	3.59
Cuprous oxide	3.97
Hydrochloric acid	0.29
Hydrogen fluoride	4.23
Lead oxide	4.14
Mercury	4.45
Nickel	4.45
Phosphorus	4.45
Stannous chloride	2.85
Stannic chloride	2.12
Zinc chloride	2.22
Zinc sulfate	1.90
Potassium hydroxide	0.22
Sodium hydroxide	0.28
Sulfuric acid	0.26
Nitric acid	0.24

"(c) TERMINATION.—No tax shall be imposed under this section during any period during which no tax is imposed under section 4611(a).

"SEC. 4662. DEFINITIONS AND SPECIAL RULES

"(a) DEFINITIONS.—For purposes of this subchapter—

"(1) TAXABLE CHEMICAL.—Except as provided in subsection (b), the term 'taxable chemical' means any substance—

"(A) which is listed in the table under section 4661(b), and

"(B) which is manufactured or produced in the United States or entered into the United States for consumption, use, or warehousing.

"(2) UNITED STATES.—The term 'United States' has the meaning given such term by section 4612(a)(4).

"(3) IMPORTER.—The term 'importer' means the person entering the

taxable chemical for consumption, use, or warehousing.

"(4) TON.—The term 'ton' means 2,000 pounds. In the case of any taxable chemical which is a gas, the term 'ton' means the amount of such gas in cubic feet which is the equivalent of 2,000 pounds on a molecular weight basis.

"(5) FRACTIONAL PART OF TON.—In the case of a fraction of a ton, the tax imposed by section 4661 shall be the same fraction of the amount of such tax imposed on a whole ton.

"b) EXCEPTIONS; OTHER SPECIAL RULES.—For puropses of this subchapter—

"(1) METHANE OR BUTANE USED AS A FUEL.—Under regulations prescribed by the Secretary, methane or butane shall be treated as a taxable chemical only if it is used otherwise than as a fuel (and, for purposes of section 4661(a), the person so using it shall be treated as the manufacturer thereof).

"(2) SUBSTANCES USED IN THE PRODUCTION OF FERTILIZER.—

"(A) IN GENERAL.—In the case of nitric acid, sulfuric acid, ammonia, or methane used to produce ammonia which is a qualified substance, no tax shall be imposed under section 4661 (a).

"(B) QUALIFIED SUBSTANCE.—For purposes of this section, the term 'qualified substance' means any substance—

"(i) used in a qualified use by the manufacturer, producer, or importer,

"(ii) sold for use by the purchaser in a qualified use, or

"(iii) sold for resale by the purchaser to a second purchaser for use by such second purchaser in a qualified use.

"(C) QUALIFIED USE.—For purposes of this subsection, the term 'qualified use' means any use in the manufacture or production of a fertilizer.

"(3) SULFURIC ACID PRODUCED AS A BYPRODUCT OF AIR POLLUTION CONTROL.—In the case of sulfuric acid produced solely as a byproduct of and on the same site as air pollution control equipment, no tax shall be imposed under section 4661.

"(4) SUBSTANCES DERIVED FROM COAL.—For purposes of this subchapter, the term 'taxable chemical' shall not include any substance to the extent derived from coal.

"(c) USE BY MANUFACTURER, ETC., CONSIDERED SALE.—If any person manufactures, produces, or imports a taxable chemical and uses such chemical, then such person shall be liable for tax under section 4661 in the same manner as if such chemical were sold by such person.

"(d) REFUND OR CREDIT FOR CERTAIN USES.—

"(1) IN GENERAL.—Under regulations prescribed by the Secretary, if—

"(A) a tax under section 4661 was paid with respect to any taxable chemical, and

"(B) such chemical was used by any person in the manufacture or production of any other substance the sale of which by such person would be taxable under such section,

then an amount equal to the tax so paid shall be allowed as a credit or refund (without interest) to such person in the same manner as if it were an overpayment of tax imposed by such section. In any case to which this paragraph applies, the amount of any such credit or refund shall not exceed the amount of tax imposed by such section on the other substance manufactured or produced.

"(2) USE AS FERTILIZER.—Under regulations prescribed by the Secretary, if—

"(A) a tax under section 4661 was paid with respect to nitric acid, sulfuric acid, ammonia, or methane used to make ammonia without regard to subsection (b)(2), and

"(B) any person uses such substance, or sells such substance for use, as a qualified substance,

then an amount equal to the excess of the tax so paid over the tax determined with regard to subsection (b)(2) shall be allowed as a credit or refund (without interest) to such person in the same manner as if it were an overpayment of tax imposed by this section.

"(e) DISPOSITION OF REVENUES FROM PUERTO RICO AND THE VIRGIN ISLANDS.—The provisions of subsections (a)(3) and (b)(3) of section 7652 shall not apply to any tax imposed by section 4661.".

(b) CLERICAL AMENDMENT.—The table of chapters for subtitle D is amended by inserting after the item relating to chapter 37 the following new item:

"CHAPTER 38. Environmental taxes.".

(c) EFFECTIVE DATE.—The amendment made by this section shall take effect on April 1, 1981.

* * * * *

Subtitle C—Post-Closure Tax and Trust Fund

SEC. 231. IMPOSITION OF TAX

(a) IN GENERAL.—Chapter 38, as added by section 211, is amended by adding at the end thereof the following new subchapter:

"Subchapter C—Tax on Hazardous Wastes

"Sec. 4681. Imposition of tax.

"Sec. 4682. Definitions and special rules.

"SEC. 4681. IMPOSITION OF TAX

"(a) GENERAL RULE.—There is hereby imposed a tax on the receipt of hazardous waste at a qualified hazardous waste disposal facility.

"(b) AMOUNT OF TAX. — The amount of the tax imposed by subsection (a) shall be equal to $2.13 per dry weight ton of hazardous waste.

"SEC. 4682. DEFINITIONS AND SPECIAL RULES

"(a) DEFINITIONS.—For purposes of this subchapter—

"(1) HAZARDOUS WASTE. — The

term 'hazardous waste' means any waste—

"(A) having the characteristics identified under section 3001 of the Solid Waste Disposal Act, as in effect on the date of the enactment of this Act (other than waste the regulation of which under such Act has been suspended by Act of Congress on that date), or

"(B) subject to the reporting or recordkeeping requirements of sections 3002 and 3004 of such Act, as so in effect.

"(2) QUALIFIED HAZARDOUS WASTE DISPOSAL FACILITY.—The term 'qualified hazardous waste disposal facility' means any facility which has received a permit or is accorded interim status under section 3005 of the Solid Waste Disposal Act.

"(b) TAX IMPOSED ON OWNER OR OPERATOR.—The tax imposed by section 4681 shall be imposed on the owner or operator of the qualified hazardous waste disposal facility.

"(c) TAX NOT TO APPLY TO CERTAIN WASTES.—The tax imposed by section 4681 shall not apply to any hazardous waste which will not remain at the qualified hazardous waste disposal facility after the facility is closed.

"(d) APPLICABILITY OF SECTION.—The tax imposed by section 4681 shall apply to the receipt of hazardous waste after September 30, 1983, except that if, as of September 30 of any subsequent calendar year, the unobligated balance of the Post-closure Liability Trust Fund exceeds $200,000,000, no tax shall be imposed under such section during the following calendar year.".

(b) CONFORMING AMENDMENT.—The table of subchapters for chapter 38 is amended by adding at the end thereof the following new item:

"SUBCHAPTER C—Tax on Hazardous Wastes.".

SEC. 232. POST-CLOSURE LIABILITY TRUST FUND

(a) CREATION OF TRUST FUND.—There is established in the Treasury of the United States a trust fund to be known as the "Post-closure Liability Trust Fund", consisting of such amounts as may be appropriated, credited, or transferred to such Trust Fund.

(b) EXPENDITURES FROM POST-CLOSURE LIABILITY TRUST FUND.—Amounts in the Post-closure Liability Trust Fund shall be available only for the purposes described in sections 107(k) and 111(j) of this Act (as in effect on the date of the enactment of this Act).

(c) ADMINISTRATIVE PROVISIONS.—The provisions of sections 222 and 223 of this Act shall apply with respect to the Trust Fund established under this section, except that the amount of any repayable advances outstanding at any one time shall not exceed $200,000,000.

TITLE III—MISCELLANEOUS PROVISIONS

* * * * *

EFFECTIVE DATES, SAVINGS PROVISION

SEC. 302. (a) Unless otherwise provided, all provisions of this Act shall be effective on the date of enactment of this Act.

(b) Any regulation issued pursuant to any provisions of section 311 of the Clean Water Act which is repealed or superseded by this Act and which is in effect on the date immediately preceding the effective date of this Act shall be deemed to be a regulation issued pursuant to the authority of this Act and shall remain in full force and effect unless or until superseded by new regulations issued thereunder.

(c) Any regulation—

(1) respecting financial responsibility,

(2) issued pursuant to any provision of law repealed or superseded by this Act, and

(3) in effect on the date immediately preceding the effective date of this Act shall be deemed to be a regulation issued pursuant to the authority of this Act and shall remain in full force and effect unless or until superseded by new regulations issued thereunder.

(d) Nothing in this Act shall affect or modify in any way the obligations or liabilities of any person under other Federal or State law, including common law, with respect to releases of hazardous substances or other pollutants or contaminants. The provisions of this Act shall not be considered, interpreted, or construed in any way as reflecting a determination, in part or whole, of policy regarding the inapplicability of strict liability, or strict liability doctrines, to activities relating to hazardous substances, pollutants, or contaminants or other such activities.

EXPIRATION, SUNSET PROVISION

SEC. 303. Unless reauthorized by the Congress, the authority to collect taxes conferred by this Act shall terminate on September 30, 1985, or when the sum of the amounts received in the Treasury under section 4611 and under 4661 of the Internal Revenue Code of 1954 total $1,380,000,000, whichever occurs first. The Secretary of the Treasury shall estimate when this level of $1,380,000,000 will be reached and shall by regulation, provide procedures for the termination of the tax authorized by this Act and imposed under sections 4611 and 4661 of the Internal Revenue Code of 1954.

* * * * *

LEGISLATIVE VETO

SEC. 305. (a) Notwithstanding any other provision of law, simultaneously with promulgation or repromulgation of any rule or regulation under authority of title I of this Act, the head of the department, agency, or instrumentality promulgating such rule or regulation shall transmit a copy thereof to the Secretary of the Senate and the Clerk of the House of Representatives. Except as provided in subsection (b) of this section, the rule or regulation shall not become effective, if—

(1) within ninety calendar days of continuous session of Congress after the date of promulgation, both Houses of Congress adopt a concurrent resolution, the matter after the resolving clause of which is as follows: "That Congress disapproves the rule or regulation promulgated by the dealing with the matter of , which rule or regulation was transmitted to Congress on .", the blank spaces therein being appropriately filled; or

(2) within sixty calendar days of continuous session of Congress after the date of promulgation, one House of Congress adopts such a concurrent resolution and transmits such resolution to the other House, and such resolution is not disapproved by such other House within thirty calendar days of continuous session of Congress after such transmittal.

(b) If, at the end of sixty calendar days of continuous session of Congress after the date of promulgation of a rule or regulation, no committee of either House of Congress has reported or been discharged from further consideration of a concurrent resolution disapproving the rule or regulation and neither House has adopted such a resolution, the rule or regulation may go into effect immediately. If, within such sixty calendar days, such a committee has reported or been discharged from further consideration of such a resolution, or either House has adopted such a resolution, the rule or regulation may go into effect not sooner than ninety calendar days of continuous session of Congress after such rule is prescribed unless disapproved as provided in subsection (a) of this section.

(c) For purposes of subsections (a) and (b) of this section—

(1) continuity of session is broken only by an adjournment of Congress sine die; and

(2) the days on which either House is not in session because of an adjournment of more than three days to a day certain are excluded in the computation of thirty, sixty, and ninety calendar days of continuous session of Congress.

d) Congressional inaction on, or rejection of, a resolution of disapproval shall not be deemed an expression of approval of such rule or regulation.

* * * * *

SEC. 308. If any provision of this Act, or the application of any provision of this Act to any person or circumstance, is held invalid, the application of such provision to other persons or circumstances and the remainder of this Act shall not be affected thereby.

Approved December 11, 1981

House Report No. 96-1016 Part II 2d Session

[Bracketed numerals indicate official report page numbers]

HAZARDOUS WASTE CONTAINMENT ACT OF 1980

JUNE 20, 1980.

Mr. ULLMAN, from the Committee on Ways and Means, submitted the following report to accompany H.R. 7020.[1]

The Committee on Ways and Means, to whom was referred the bill (H.R. 7020) to amend the Solid Waste Disposal Act to provide authorities to respond to releases of hazardous waste from inactive hazardous waste sites which endanger public health and the environment, to establish a Hazardous Waste Response Fund to be funded by a system of fees, to establish prohibitions and requirements concerning inactive hazardous waste sites, to provide for liability of persons responsible for releases of hazardous waste at such sites, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment is a new title to be added at the end of the amendment in the nature of a substitute recommended by the Committee on Interstate and Foreign Commerce, and appears in the reported bill in boldface roman type.

[1] Public Law 96-510, page 589.

WAYS AND MEANS COMMITTEE AMENDMENT TO H.R. 7020, THE HAZARDOUS WASTE CONTAINMENT ACT

H.R. 7020, the Hazardous Waste Containment Act, has been considered and reported favorably by the Committee on Interstate and Foreign Commerce (H. Rept. 96-1016, part I). H.R. 7020 then was referred sequentially to the Committee on Ways and Means for consideration of the revenue aspects of this legislation, which properly fall within the jurisdiction of the Committee on Ways and Means. Specifically, the Committee on Ways and Means considered the revenue issues related to the establishment of taxes on crude oil, petrochemical feedstocks, and certain specified inorganic chemicals for use to provide revenues to clean up discharges of oil and hazardous substances in inactive waste sites. As a result of this consideration, the Committee on Ways and Means favorably reports H.R. 7020 with a committee amendment in the form of a new title.

[2] I. SUMMARY

The Ways and Means Committee amendment to H.R. 7020 imposes excise taxes on crude oil, specified petrochemical feedstocks, and specified inorganic substances. These excise taxes are expected to raise $35 million a year from oil, $108 million a year from petrochemical feedstocks, and $36 million a year from inorganic substances. Revenues from these taxes are to be deposited into a "Hazardous Waste Response Trust Fund," the proceeds of which can be used to finance the costs of containing or cleaning up waste from inactive hazardous waste sites which are causing or threatening to cause harm to the public health and environment.

These excise taxes are to be imposed for the period October 1, 1980 through September 30, 1985. Payments out of the Trust Fund are prohibited after September 30, 1985, unless further action is taken by the Congress.

In addition, the committee amendment provides for a study by the Secretary of the Treasury, in consultation with the Environmental Protection Agency, the Department of Commerce and the Office of the United States Trade Representative, on various aspects of the taxes imposed under the amendment. The Secretary of the Treasury is to report to the Congress by January 1, 1985.

[3] II. EXPLANATION OF WAYS AND MEANS COMMITTEE AMENDMENT TO H.R. 7020

A. Present Law

Excise taxes

Under present law, excise taxes are imposed upon the manufacture, production, removal, sale, supply, or use of various items or services. In some instances, revenues from these taxes are deposited into specially designated trust funds. Examples of such earmarked excise taxes and designated trust funds include the Black-lung coal tax (Code sec. 4121), which is deposited into the Black Lung Disability Trust Fund, aviation-related taxes (e.g., Code secs. 4261, 4271), which are deposited into the Airport and Airway Trust Fund, highway-related taxes (e.g., Code secs. 4041 and 4081 (fuels), 4071 (tires, etc.)) which are deposited into the Highway Trust Fund and inland waterway taxes (Code sec. 4042) which are deposited into the Inland Waterways Trust Fund.

Under present law, there is no general excise tax imposed with respect to substances, such as crude oil, petrochemical feedstocks, and inorganic chemicals, which may cause environmental pollution or other damage. However, charges (fees) are imposed under present law on oil produced on the Outer Continental Shelf and on Alaskan North Slope oil transported through the Trans-Alaska Pipeline System (TAPS).

Funds

Present law contains no specially designated trust fund, supported by taxes and appropriations, which is intended to provide monies for cleanup of all types of environmentally hazardous releases from inactive waste sites. However, there are various Federal and State funds designed to accomplish these purposes as to specific locations, damages or losses, and certain types of releases, spills, discharges and pollution. Some of these funds, and related provisions, are described below.

Federal Water Pollution Control Act ("Clean Water Act"), Section 311.

Section 311 of the Federal Water Pollution Control Act (33 U.S.C. 1331) establishes a $35 million revolving fund maintained by fines, penalties and appropriations of general revenue. The fund may be used for cleanup of releases of oil and designated hazardous substances into navigable waters and restoration of accompanying natural resources. The Act also establishes certain rules pertaining to responsibility for cleanup expenses, and authorizes the fund to seek reimbursement from parties who release oil or designated hazardous substances into navigable waters.

Resource Conservation and Recovery Act.

The Resource Conservation and Recovery Act provides for the regulation and control of the generation, treatment and disposal of hazardous wastes. Permits are required for treatment or storage facilities. [4] The Environmental Protection Agency may sue to require cleanup of an inactive disposal site if the site is posing an imminent and substantial hazard to public health. However, this provision does not provide funds for cleanup of inactive sites when the owner is unknown, is not responsible, or is financially unable to pay for these costs.

[5] B. Reasons for Change

The Committee on Ways and Means believes that it is important to establish a readily available source of funds to respond to releases of hazardous waste from inactive waste sites which endanger public health and the environment. The committee recognizes that the United States Government must bear some of the costs incurred for this purpose. However, it also believes that these costs generally should be borne by the party responsible for the waste, and alternatively by the industries which create the items most frequently located in inactive waste sites.

To accomplish these goals, the commitee has decided that is is appropriate to impose excise taxes on certain items which may result in environmentally hazardous pollution from inactive waste sites or which are used to produce hazardous material. The committee also has decided that revenues from these taxes should be earmarked for inclusion in a newly constituted trust fund for payment of cleanup costs for hazardous waste sites. Because the precise scope of the hazardous waste site problem and the financial cost of the remedy are not readily ascertainable, the committee has decided to terminate the taxes and spending from the trust fund at the end of September 1985 (fiscal year 1985) so that Congress may reexamine the situation.

[6] C. Explanation of Provisions

1. Environmental excise taxes

a. Petroleum tax (Sec. 211 of the amendment and new secs. 4611-4612 of the Code)

The committee amendment imposes a specific excise tax (the "petroleum tax") of 0.6 cents a barrel on domestic crude oil and on petroleum products (including crude oil) entering the United States. The tax on domestic crude oil is imposed on the operator of any United States refinery receiving such crude oil. For this purpose, as under existing Treasury regulations, refining is defined as any operation by

which the physical or chemical characteristics of crude oil or its products are changed, exclusive of such operations as passing crude oil through separators or placing crude oil in settling tanks.

If crude oil is used in, or exported from, the United States before imposition of the petroleum tax, then the user or exporter of the oil is subject to that tax to the same extent as it would have been imposed had a United States refiner received the oil. The committee amendment defines oil subject to tax as crude oil, including crude oil condensate and natural gasoline, but not other natural gas liquids. Thus, the term crude oil also does not include butane, ethane, or propane recovered from a natural gas stream; butane, however, is taxed as a specified petrochemical feedstock under the chemical tax described below. Moreover, taxable crude oil does not include oil used for extraction purposes on the premises where it was produced, such as for powerhouse fuel or for reinjection as part of a tertiary recovery process. In addition, the term crude oil does not include synthetic petroleum, e.g., shale oil, liquids from coal, tar sands, or biomass, or refined oil.

Petroleum products entered into the United States for consumption, use or warehousing, are subject to a tax of 0.6 cents a barrel. This tax is imposed upon the person who enters such products. Generally, the term petroleum products include crude oil, crude oil condensate, natural and refined gasoline, refined and residual oil, and any other hydrocarbon product derived from crude oil or natural gasoline which enters the United States in liquid form. For puroses of determining whether crude oil or petroleum products have been produced in, entered into, or exported from the United States, the term United States means the 50 States, the District of Columbia, Puerto Rico, the Northern Mariana Islands, the Trust Territory of the Pacific Islands, and any possession of the United States. The United States also includes the Outer Continental Shelf areas and foreign trade zones located within the United States. There is no exception for bonded petroleum products.

In the case of areas which are not subject to the general United States customs laws, an "entry" has occurred at any time that such an event would have occurred if the customs laws were applicable to [7] that area. However, an "entry" is deemed to have occurred in the case of fuel stores on a ship or the casual use of items such as fuel in an automobile's gas tank.

In the case of refiners that recover natural gasoline, the gasoline so recovered is treated as received by that refiner at the time it is recovered. If natural gasoline is recovered in a gas separation plant rather than at a refinery, the tax is imposed when the gasoline is received at a refinery or when it is used or exported without passing through a refinery. Thus, a refiner must pay the same tax whether it purchases natural gasoline or wet gas from which it recovers natural gasoline.

The committee amendment also provides that the petroleum tax is imposed only once (under new Code section 4611) with respect to any petroleum product. Anyone who otherwise is liable for the tax may establish that it already has been imposed with respect to that product.

The committee amendment contains no special administrative or compliance provisions relating to the petroleum tax. Instead, the existing rules relating to excise taxes apply. Thus, the Internal Revenue Service has its full range of administrative and compliance powers available in administering and collecting the tax. Similarly, the penalties contained in existing law apply, as apropriate, to the petroleum tax.

Effective date

The petroleum excise tax imposed by the committee amendment applies for the period October 1, 1980, through September 30, 1985.

b. Chemical tax (Sec. 211 of the amendment and new secs. 4661-4662 of the Code)

The commitee amendment imposes specific excise taxes (the "chemical tax") on specied petrochemical feedstocks and on specified inorganic substances. The tax, which is similar to existing excise taxes, is imposed on any taxable chemical sold by the taxpayer, i.e., the manufacturer, producer, or importer of the chemical. If the taxpayer uses a taxable chemical prior to its sale the tax is imposed as if the chemical had been sold.

The chemical tax on specified petrochemical feedstocks is $2.54 a ton. The feedstocks subject to tax are: ethylene, propylene, butylene, butadiene, butane, benzene, toluene, xylene, naphthalene, and methane. These feedstocks are subject to the chemical tax regardless of the source from which the feedstock is derived. As a result feedstocks derived from synthetic petroleum are subject to the chemical tax.

There is no exemption from the chemical tax for petrochemical feedstocks used as fuel. Because petroleum fuels typically pass through the hands of numerous persons before they are burned by the ultimate consumer, it is unclear how such an exemption could be effectively administered. The cost of documenting ultimate fuel use under such circumstances might well cost more than the taxes saved. The committee amendment does require the Secretary of the Treasury to study the feasibility of providing an exemption for petrochemical feedstocks which are used as fuel.

[8] The tax on specified inorganic substances subject to the tax are:

(A) arsenic and the equivalent weight of arsenic in arsenic trioxide;

(B) cadmium;

(C) chromium and the equivalent weight of chromium in chromite, sodium dichromate, and potassium dichromate;

(D) lead and the equivalent weight of lead in lead oxide;

(E) mercury;

(F) the equivalent weight of barium in barium sulfide;

(G) antimony and the equivalent weight of antimony in antimony trioxide and antimony sulfide;

(H) cobalt;

(I) nickel;

(J) the equivalent weight of tin in stannic chloride and stannous chloride;

(K). chlorine;

(L) the equivalent weight of fluorine in hydrofluoric acid;

(M) bromine;

(N) the equivalent weight of hydrogen in phosphoric acid, sulfuric acid, hydrochloric acid, or nitric acid; and

(O) elemental phosphorus.

In the case of a taxable chemical which is a gas (e.g., methane), the tax is imposed on the number of cubic feet of such gas which is equivalent to 2000 lbs. on the basis of molecular weight.

The commitee amendment provides an exemption from the tax for chemicals which are used in producing fertilizer if the use occurs with the taxpayer or with the first or second purchaser of the chemical from the taxpayer. Subsequent purchasers of taxpaid chemicals used in producing fertilizer may obtain refunds of the tax paid on the item used.

The committee amendment also provides that the Secretary of the Treasury is to promulgate regulations necessary to avoid imposition of the chemical tax imposed by this Act more than once upon the same substances. Specifically, a system would be provided that if a taxable chemical is used to manufacture or produce a second taxable chemical, then a credit against the amount of tax on the second chemical would be permitted for the amount of tax imposed on the first substance.

For purposes of the chemical tax, an importer is anyone who enters taxable chemicals into the United States for consumption, use, or warehousing. For purposes of the chemical tax, the term United States means the 50 States, the District of Columbia, Puerto Rico, the Northern Mariana Islands, the Trust Territory of the Pacific, and any possession of the United States, as well as the Outer Continental Shelf and any foreign trade zones of the United States. There are no exceptions for bonded items.

In the case of areas which are not subject to the general United States customs laws, an "entry" has occurred at any time that such an event would have occurred if the customs laws were applicable to that area. However, an "entry" is deemed not to have occurred in the case of fuel stores on a ship or the casual use of items such as fuel in an automobile's gas tank.

[9] The committee amendment contains no special administrative or compliance provisions relating to the chemical tax. Instead, the existing rules relating to excise taxes apply. Thus, the Internal Revenue Service has its full range of administrative and compliance powers available in administering and collecting the tax. Similarly, the penalties contained in existing law would apply, as appropriate, to the chemical tax.

Effective date

The chemical excise tax imposed by the committee amendment applies for the period October 1, 1980, through September 30, 1985.

Public Law 96-536
96th Congress, H.J. Res. 644 [1]
December 16, 1980

JOINT RESOLUTION

Making further continuing appropriations for the fiscal year 1981, and for other purposes.

* * * * *

SEC. 116. None of the funds appropriated by this joint resolution may be used to disqualify, pursuant to section 411(d)(1)(B) of the Internal Revenue Code of 1954, any plan which has vesting requirements or provides for nonforfeitable rights to benefits, equal to or more stringent than 4/40.

None of the funds appropriated by this joint resolution may be used to issue an unfavorable advance determination letter, pursuant to section 411(d)(1)(B) of the Internal Revenue Code of 1954, with respect to any plan which has vesting requirements or provides for nonforfeitable rights to benefits, equal to or more stringent than 4/40.

* * * * *

Approved December 16, 1980.

[1] This publication of the law is restricted to excerpts involving tax matters.

Public Law 96-541
96th Congress, H.R. 6975 [1]
December 17, 1980

An Act to extend certain temporary tax provisions, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. 18-MONTH EXTENSION OF PROVISIONS RELATING TO EMPLOYMENT TAXES.

(a) IN GENERAL.—Subsection (a) of section 530 of the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1, 119] (relating to termination of certain employment tax liability for periods before 1981) is amended—

(1) by striking out "January 1, 1981" in paragraphs (1)(A) and (3) and inserting in lieu thereof "July 1, 1982",

(2) by striking out "1981" in the subsection heading and inserting in lieu thereof "July 1, 1982", and

(3) by striking out "1979 and 1980" in the heading for paragraph (3) and inserting in lieu thereof "prior".

(b) PROHIBITION AGAINST REGULATIONS AND RULINGS ON EMPLOYMENT STATUS.—Subsection (b) of section

[1] Senate Report No. 96-1007, page 599. House Report No. 96-1108 is not published.

530 of the Revenue Act of 1978 [*supra* at 119] is amended by striking out "January 1, 1981" and inserting in lieu thereof "July 1, 1982".

SEC. 2. THREE-YEAR EXTENSION OF PROVISIONS RELATING TO HISTORIC PRESERVATION.

(a) AMORTIZATION OF CERTAIN REHABILITATION EXPENDITURES. — Section 191 of the Internal Revenue Code of 1954 (relating to amortization of certain rehabilitation expenditures for certified historic structures) is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

"(g) APPLICATION OF SECTION.— This section shall apply with respect to additions to capital account made after June 14, 1976, and before January 1, 1984.".

(b) DENIAL OF DEDUCTIONS FOR CERTAIN DEMOLITIONS.—Section 280B of such Code (relating to denial of deduction for demolition of certain historic structures) is amended by adding at the end thereof the following new subsection:

"(c) APPLICATION OF SECTION.— This section shall apply with respect to demolitions commencing after June 30, 1976, and before January 1, 1984.".

(c) DEPRECIATION OF IMPROVEMENTS.—Subsection (n) of section 167 of such Code (relating to depreciation of improvements) is amended by adding at the end thereof the following new paragraph:

"(4) APPLICATION OF SUBSECTION. —This subsection shall apply to that portion of the basis which is attributable to construction, reconstruction, or erection after December 31, 1975, and before January 1, 1984.".

(d) DEPRECIATION OF CERTAIN SUBSTANTIALLY REHABILITATED HISTORIC PROPERTY.—Subsection (o) of section 167 of such Code (relating to depreciation of substantially rehabilitated historic property) is amended by adding at the end thereof the following new paragraph:

"(3) APPLICATION OF SUBSECTION. —This subsection shall apply with respect to additions to capital account occurring after June 30, 1976, and before January 1, 1984.".

(e) CONFORMING AMENDMENT.— The following provisions of section 2124 of the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1, 392] are hereby repealed:

(1) paragraph (4) of subsection (a),

(2) paragraph (3) of subsection (b),

(3) paragraph (2) of subsection (c), and

(4) paragraph (2) of subsection (d).

SEC. 3. TWO-YEAR EXTENSION OF PROVISION FOR 60-MONTH DEPRECIATION OF EXPENDITURES TO REHABILITATE LOW-INCOME RENTAL HOUSING.

Subsection (k) of section 167 of the Internal Revenue Code of 1954 (relating to depreciation of expenditures to rehabilitate low-income rental housing) is amended by striking out "January 1, 1984".

SEC. 4. TWO-YEAR EXTENSION OF CREDIT OR REFUND OF TAX ON FUELS USED IN CERTAIN TAXICABS.

Paragraph (3) of section 6427(e) of the Internal Revenue Code of 1954 (relating to termination of credit or refund of tax on fuels used in certain taxicabs) is amended by striking out "1980" and inserting in lieu thereof "1982".

SEC. 5. EXTENSION OF CERTAIN PROVISIONS RELATING TO EXCLUSION OF SCHOLARSHIP INCOME.

(a) FEDERAL GRANTS NOT INCLUDABLE IN GROSS INCOME MERELY BECAUSE THE RECIPIENT IS REQUIRED TO RENDER FUTURE SERVICE AS A FEDERAL EMPLOYEE.—

(1) IN GENERAL.—Section 117 of the Internal Revenue Code of 1954 (relating to scholarships and fellowship grants) is amended by adding at the end thereof the following new subsection:

"(c) FEDERAL GRANTS FOR TUITION AND RELATED EXPENSES NOT INCLUDABLE MERELY BECAUSE THERE IS REQUIREMENT OF FUTURE SERVICE AS FEDERAL EMPLOYEE.—

"(1) IN GENERAL.—If—

"(A) an amount received by an individual under a Federal program would be excludable under subsections (a) and (b) as a scholarship or fellowship grant but for the fact that the individual is required to perform future service as a Federal employee, and

"(B) the individual establishes that, in accordance with the terms of the grant, such amount was used for qualified tuition and related expenses,

gross income shall not include such amount.

"(2) QUALIFIED TUITION AND RELATED EXPENSES DEFINED.—For purposes of this subsection—

"(A) IN GENERAL. — The term 'qualified tuition and related expenses' means—

"(i) tuition and fees required for the enrollment or attendance of a student at an institution of higher education, and

"(ii) fees, books, supplies, and equipment required for courses of instruction at an institution of higher education.

"(B) INSTITUTION OF HIGHER EDUCATION.—The term 'institution of higher education' means an educational institution in any State which—

"(i) admits as regular students only individuals having a certificate of graduation from a high school, or the recognized equivalent of such a certificate,

"(ii) is legally authorized within such State to provide a program of education beyond high school,

"(iii) provides an educational program for which it awards a bachelor's or higher degree, provides a program which is acceptable for full credit toward such a degree, or offers a program of training to prepare students for gainful employment in a recognized health profession, and

"(iv) is a public or other nonprofit institution.

"(3) SERVICE AS FEDERAL EM-

PLOYEE.—For purposes of this subsection, service in a health manpower shortage area shall be treated as service as a Federal employee.".

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to taxable years beginning after December 31, 1980.

(b) NATIONAL RESEARCH SERVICE AWARDS.—Paragraph (2) of section 161(b) of the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1, 44] (relating to national research service awards) is amended by striking out "1980" and inserting in lieu thereof "1981".

SEC. 6. REVISING AND MAKING PERMANENT RULES ALLOWING DEDUCTION FOR CONTRIBUTIONS FOR CONSERVATION PURPOSES.

(a) IN GENERAL.—Paragraph (3) of section 170(f) of the Internal Revenue Code of 1954 (relating to denial of deduction in case of certain contributions of partial interests in property) is amended by striking out subparagraphs (B) and (C) thereof and inserting in lieu thereof the following new subparagraph:

"(B) EXCEPTIONS.—Subparagraph (A) shall not apply to—

"(i) a contribution of a remainder interest in a personal residence or farm,

"(ii) a contribution of an undivided portion of the taxpayer's entire interest in property, and

"(iii) a qualified conservation contribution.".

(b) QUALIFIED CONSERVATION CONTRIBUTION DEFINED.—Section 170 of such Code is amended by redesignating subsections (h) and (i) as subsections (i) and (j), respectively, and by inserting after subsection (g) the following new subsection:

"(h) QUALIFIED CONSERVATION CONTRIBUTION.—

"(1) IN GENERAL.—For purposes of subsection (f)(3)(B)(iii), the term 'qualified conservation contribution' means a contribution—

"(A) of a qualified real property interest,

"(B) to a qualified organization,

"(C) exclusively for conservation purposes.

"(2) QUALIFIED REAL PROPERTY INTEREST.—For purposes of this subsection, the term 'qualified real property interest' means any of the following interests in real property:

"(A) the entire interest of the donor other than a qualified mineral interest,

"(B) a remainder interest, and

"(C) a restriction (granted in perpetuity) on the use which may be made of the real property.

"(3) QUALIFIED ORGANIZATION.—For purposes of paragraph (1), the term 'qualified organization' means an organization which—

"(A) is described in clause (v) or (vi) of subsection (b)(1)(A), or

"(B) is described in section 501(c)(3) and—

"(i) meets the requirements of section 509(a)(2), or

"(ii) meets the requirements of section 509(a)(3) and is controlled by an organization described in subparagraph (A) or in clause (i) of this subparagraph.

"(4) CONSERVATION PURPOSE DEFINED.—

"(A) IN GENERAL.—For purposes of this subsection, the term 'conservation purpose' means—

"(i) the preservation of land areas for outdoor recreation by, or the education of, the general public,

"(ii) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem,

"(iii) the preservation of open space (including farmland and forest land) where such preservation is—

"(I) for the scenic enjoyment of the general public, or

"(II) pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit, or

"(iv) the preservation of an historically important land area or a certified historic structure.

"(B) CERTIFIED HISTORIC STRUCTURE.—For purposes of subparagraph (A)(iv), the term 'certified historic structure' means any building, structure, or land area which—

"(i) is listed in the National Register, or

"(ii) is located in a registered historic district (as defined in section 191(d)(2)) and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district.

A building, structure, or land area satisfies the preceding sentence if it satisfies such sentence either at the time of the transfer or on the due date (including extensions) for filing the transferor's return under this chapter for the taxable year in which the transfer is made.

"(5) EXCLUSIVELY FOR CONSERVATION PURPOSES.—For purposes of this subsection—

"(A) CONSERVATION PURPOSE MUST BE PROTECTED.—A contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity.

"(B) NO SURFACE MINING PERMITTED.—In the case of a contribution of any interest where there is a retention of a qualified mineral interest, subparagraph (A) shall not be treated as met if at any time there may be extraction or removal of minerals by any surface mining method.

"(6) QUALIFIED MINERAL INTEREST.—For purposes of this subsection, the term 'qualified mineral interest' means—

"(A) subsurface oil, gas, or other minerals, and

"(B) the right to access to such minerals.".

(c) DEDUCTION FOR CONTRIBUTIONS FOR CONSERVATION PURPOSES MADE PERMANENT.—Section 309(b)(1) of the Tax Reduction and Simplification Act of 1977 [Pub. L. 95-30, 1977-1 C.B. 451, 468] and section 2124(e)(4) of the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1, 396] are each amended by striking out, "and before June 14, 1981".

(d) EFFECTIVE DATE.—The amendments made by subsection (a) and (b) shall apply to transfers made after the date of the enactment of this Act in taxable years ending after such date.

Approved December 17, 1980.

Senate Report No. 96-1007 2d Session

[Bracketed numerals indicate official report page numbers]

TAX TREATMENT EXTENSION ACT OF 1980

SEPTEMBER 30 (legislative day, JUNE 12), 1980.

Mr. LONG, from the Committee on Finance, submitted the following report to accompany H.R. 6975.[1]

The Committee on Finance, to which was referred the bill (H.R. 6975) for the elimination of duties on wood veneers, having considered the same, reports favorably thereon with an amendment and recommends that the bill as amended do pass.

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

House bill.—H.R. 6975, as it passed the House, would eliminate the duties on wood veneers.

Committee bill.—The committee amendment deletes the provision relating to the elimination of duties on wood veneers, and adds provisions extending the expiration dates of certain tax provisions, dealing with the tax treatment of certain Federal scholarship grants, and revising the rules allowing deductions for contributions made for conservation purposes.

I. SUMMARY

As passed by the House, this bill would eliminate the duties on wood veneers. In lieu of this provision (the substance of which was added by the committee to H.R. 5047), the committee added as an admendment in the nature of a substitute the following tax provisions.

SECTION 1. EMPLOYMENT TAX STATUS OF INDEPENDENT CONTRACTORS

In general, under present law, taxpayers who had a reasonable basis for not treating workers as employees in prior years may continue to do so for periods ending before January 1, 1981, without incurring employment tax liabilities. The bill would extend present law through June 30, 1982.

[2] SEC. 2. EXTENSION OF PROVISIONS RELATING TO HISTORIC PRESERVATION

Under present law, taxpayers may amortize over a 60-month period the capital expenditures incurred in a certified rehabilitation of a certified historic structure. Alternatively, taxpayers may use accelerated depreciation methods to depreciate substantially rehabilitated historic structures. In general, taxpayers may not deduct the costs of any loss sustained in the demolition of a certified historic structure or a structure located in a registered historic district. Present law also provides that accelerated depreciation methods may not be used with respect to real property constructed on a site that has been occupied by a certified historic structure (or by any structure in a registered historic district, except in limited circumstances) that has been demolished or substantially altered (other than by virtue of a certified rehabilitation). The bill would extend these provisions through December 31, 1983.

SEC. 3. 60-MONTH AMORTIZATION FOR EXPENDITURES TO REHABILITATE LOW-INCOME RENTAL HOUSING

Under present law, certain expenditures made to rehabilitate low-income rental housing may, at the election of the taxpayer, be depreciated over a 60-month period. Rehabilitation expenditures made pursuant to a binding contract entered into before January 1, 1982 qualify for this special treatment. The bill would extend this provision to any qualifying rehabilitation expenditures made through December 31, 1983 (including rehabilitations which had begun before that date and are still in process after that date).

SEC. 4. EXTENSION OF CREDIT OR REFUND OF TAX ON FUELS USED IN CERTAIN TAXICABS

Under present law, certain taxicab use of motor fuels is exempt (through refund or credit) from the 4-cents per gallon excise taxes on gasoline and other motor fuels. This exemption currently applies for calendar years 1979 and 1980. The bill would extend the present fuels tax exemption for qualified taxicab services through December 31, 1982.

SEC. 5. CERTAIN FEDERAL SCHOLARSHIP GRANTS AND NATIONAL RESEARCH SERVICE AWARDS

Present law generally excludes from gross income amounts received as scholarship or fellowship grants unless, as a condition to receiving such amounts, the recipient must agree to perform services for the grantor. In addition, temporary legislation provides tax-exempt treatment as scholarships or fellowships for National Research Service Awards made through 1980.

The bill, in general, would exclude from gross income scholarships received under Federal programs which require future Federal service by the recipients. In addition, the bill would extend the tax-exempt treatment of National Research Service Awards as scholarships or fellowships through 1981.

SEC. 6. DEDUCTIONS FOR CONTRIBUTIONS FOR CONSERVATION PURPOSES

This provision revises the provisions of current law allowing deductions for charitable contributions of easements and other partial interest in real estate contributed for conservation purposes. The provision would expand the types of partial interests which qualify to [3] include the entire interest of the donor in real property other than the rights to subsurface minerals. It also

[1] Public Law 96-541, page 596. This publication of the Senate Report is restricted to excerpts involving tax matters.

would limit contributions eligible for the deduction to those contributed to a governmental unit, publicly supported charitable organization, or an entity controlled by one of these two kinds of organizations. Conservation purposes, as amended by this provision, would be defined as: (1) the preservation of land areas for outdoor recreation by, or the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or of a similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation is for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State or local governmental policy and will yield a significant public benefit; or (4) the preservation of a historically important land area or a certified historic structure. Finally, the bill would make these provisions permanent.

II. EXPLANATION OF THE BILL

A. 18-Month Extension of Provisions Relating to Employment Status for Employment Taxes: Independent Contractor Interim Relief (sec. 1 of the bill)

Present law

The Revenue Act of 1978 provided interim relief for certain taxpayers involved in controversies with the IRS concerning the proper classification of workers for employment tax purposes. In general, the Act terminated taxpayers' potential liabilities for Federal income tax withholding, social security and FUTA taxes in cases where taxpayers have a reasonable basis for treating workers other than as employees. In addition, the Act prohibited the issuance of Treasury regulations and revenue rulings on common law employment status before 1980.

The temporary prohibition on reclassifications and the issuance of new rulings or regulations by the Internal Revenue Service was extended through December 31, 1980, by Public Law 96-167 [1980-1 C.B. 483].

Reasons for change

Because of the complexity of developing a permanent, substantive solution to the controversy about employment tax status rules, the committee believes the temporary, interim relief legislation should be extended to protect taxpayers until the Congress adopts new classification rules.

Explanation of provision

The bill extends the temporary interim relief legislation and the prohibition on the issuance of new rulings or regulations by the Internal Revenue Service for 18 months, through June 30, 1982.

Effective date

The bill will be effective upon enactment and will extend the present law relief provisions through June 30, 1982.

Revenue effect

The revenue effect of this provision cannot be estimated because the provisions affect IRS asserted employment tax liabilities which were [4] contested by taxpayers in both administrative and judicial proceedings.

B. Extension of Historic Structures Provisions (sec. 2 of the bill and secs. 167(n), 167(o), 191 and 280B of the Code)

Present law

In 1976, rules were enacted to create tax incentives for the preservation of historic structures and reduce the tax advantages of the demolition of historic structures and construction of replacement structures. These provisions expire in 1981.

Under one of the provisions, taxpayers may amortize over a 60-month period the capital expenditures incurred in a certified rehabilitation of a certified historic structure (Code sec. 191). This provision applies with respect to additions to capital account made after June 14, 1976, and before June 15, 1981. Alternatively, taxpayers may use accelerated depreciation methods to depreciate substantially rehabilitated historic structures (Code sec. 167(o)). This provision applies with respect to additions to capital account occurring after June 30, 1976, and before July 1, 1981.

In addition, taxpayers may not deduct (except under limited circumstances) the costs of or any loss sustained in the demolition of a certified historic structure or, except in limited circumstances, a structure located in a registered historic district (Code sec. 280B). This provision applies to demolitions commencing after June 30, 1976, and before January 1, 1981. Present law also provides that accelerated depreciation methods may not be used with respect to real property constructed on a site that has been occupied by a certified historic structure (or by any structure in a registered historic district, except in limited circumstances) that has been demolished or substantially altered (other than by virtue of a certified rehabilitation) (Code sec. 167(n)). This provision applies to that portion of the basis attributable to construction, reconstruction, or erection after December 31, 1975, and before January 1, 1981.

Reasons for change

The committee believes the preservation of historic structures is important, and preliminary data indicates that these provisions have encouraged the preservation of historic structures throughout the country. Therefore, the committee agreed to extend the provisions for three years, which will allow the Departments of Interior and Treasury to complete a study of the provisions currently in progress.

Explanation of bill

The bill extends through December 31, 1983, the sunset dates for provisions enacted in 1976 that encourage the preservation of historic structures (Code secs. 167(n), 167(o), 191, and 280B).

Effective date

The provisions in the bill will be effective upon enactment.

Revenue estimate

This provision is expected to reduce fiscal year budget receipts by $2 million in 1981, $21 million in 1982, $66 million in 1983, $111 million in 1984, and $131 million in 1985.

[5] *C. Five-Year Amortization for Low-Income Rental Housing (sec. 3 of the bill and sec. 167(k) of the Code)*

Present law

Under the Code, special depreciation rules are provided for expenditures to rehabilitate low-income rental housing (sec. 167(k)). Low-income rental housing includes buildings or other structures that are used to provide living accommodations for families and individuals of low or moderate income. Occupants of a dwelling unit are considered families and individuals of low or moderate income only if their income does not exceed certain limits, as determined by the Secretary of Treasury in a manner consistent with the limits established for the Leased Housing Program under section 8 of the United States Housing Act of 1937, as amended.

Under the special depreciation rules for low-income rental property, taxpayers can elect to compute depreciation on certain rehabilitation expenditures under a straight-line method over a period of 60 months if the additions or improvements have a useful life of 5 years or more. Under present law, only the aggregate rehabilitation expenditures for any housing which do not exceed $20,000 per dwelling unit qualify for the 60-month depreciation. In addition, for the 60-month depreciation to be available, the sum of the rehabilitation expenditures for 2 consecutive taxable years—including the taxable year—must exceed $3,000 per dwelling unit.

Reasons for change

The special tax incentive for rehabilitation expenditures for low- and moderate-income rental housing under present law expires on December 31, 1981. In order to avoid discouraging this rehabilitation, the committee believes that the special depreciation provision for low-income rental housing should be extended for an additional two years.

Explanation of provision

The bill provides a two-year extension of the special 5-year depreciation rule for expenditures to rehabilitate low-income rental housing. Under the bill, rehabilitation expenditures that are made pursuant to a binding contract entered into before January 1, 1984, will qualify for the 5-year depreciation rule even though the expenditures actually are made after December 31, 1983.

Effective date

The two-year extension applies to expenditures paid or incurred with respect to low- and moderate-income rental housing after December 31, 1981, and before January 1, 1984 (including expenditures made pursuant to a binding contract entered into before January 1, 1984).

Revenue effect

This provision will have no effect on budget receipts in fiscal year 1981 but will reduce them by $1 million in fiscal year 1982, $8 million in 1983, $18 million in 1984, and $26 million in 1985.

[6] *D. Two-Year Extension of Fuels Tax Exemption for Certain Taxicabs (sec. 4 of the bill and sec. 6427(e) of the Code)*

Present law

Under present law (enacted in the Highway Revenue Act of 1978 [Pub. L. 95-599, 1978-2 C.B. 403]), certain taxicab use of motor fuels is exempt (through refund or credit) from the 4 cents a gallon excise tax on gasoline and other motor fuels. The fuel is exempt if (1) taxicabs are not prohibited from ride sharing (under company policy or the rules of a Federal, State or local authority having jurisdiction over a substantial portion of the transportation) and (2) for 1978 and later model taxicabs acquired after 1978, the fuel economy of the model type of vehicle must exceed the fleet average fuel economy standard applicable under the Motor Vehicle Information and Cost Savings Act, as amended. However, the latter requirement does not apply to vehicles manufactured by certain small manufacturers (that is, those that produce less than 10,000 vehicles per year and which have been granted an exemption under section 502(c) of that Act).

A purchaser who uses the fuel for qualified taxicab services may file for a refund for the first three quarters of his taxable year if the refund of tax due is $50 or more as of the end of a quarter. Any amounts not otherwise refunded may be claimed as a credit on the purchaser's tax return.

The exemption applies for calendar years 1979 and 1980. Under the conference report for the Highway Revenue Act of 1978, a Treasury report is to be submitted concerning the effectiveness of the exemption in encouraging more energy-efficient taxicabs and in removing barriers to ride sharing.

Reasons for change

Due to time lags necessary to collect and evaluate data, the Treasury Department has not yet submitted its report on the effectiveness of this provision. Accordingly, the committee decided to extend this exemption for two years so that ample time would be available for the Treasury Department to collect data and for the Congress to evaluate thoroughly the effectiveness of this exemption.

Explanation of provision

The bill will extend the present fuels tax exemption for qualified taxicab services for two years, or through December 31, 1982.

Effective date

The bill applies to fuels used after December 31, 1980, and before January 1, 1983.

Revenue effect

It is estimated that this bill will reduce budget receipts by $10 million in fiscal year 1981, $30 million in fiscal year 1982, $20 million in fiscal year 1983, and a negligible amount thereafter. These receipts otherwise would remain in the Highway Trust Fund.

[7] *E. Extension of Certain Provisions Relating to Exclusion of Scholarship Income (sec. 5 of the bill and sec. 117 of the Code)*

Present law

Section 117 provides that amounts received as scholarships at educational institutions and up to $300 per month for 36 months of any amounts received as fellowship grants generally are excluded from gross income. This exclusion also applies to incidental amounts received to cover expenses for travel, research, clerical help, and equipment. However, the exclusion for scholarship and fellowship grants is restricted to educational grants by relatively disinterested grantors who do not require any significant consideration from the recipient. Educational grants are not excludable from gross income if they represent compensation for past, present, or future services, or if the studies or research are primarily for the benefit of the grantor or are under the supervision of the grantor (Treas. Reg. § 1.117.4(c)).

Special legislation provides that members of a uniformed service participating in the Armed Forces Health Professions Scholarship Program, the Public Health Services Program, and similar programs may exclude from gross income amounts received as scholarships under these programs. Participants in these programs must agree to work for their funding service after completion of their studies. This temporary exclusion will not apply to scholarships awarded students entering these programs after December 31, 1980.

Under a separate provision applicable to National Research Service Awards made through 1980, the recipients of such awards may treat them as excludable scholarships or fellowships.

Reasons for change

The committee believes that Federal awards granted in return for future services generally should be excludable to the extent they are used for direct educational expenses. The committee believes that the temporary special tax rules governing National Research Service awards should be extended for another year so that appropriate permanent rules for their treatment can be developed.

Explanation of the bill

General rule.—The bill provides that an amount which is received by an individual as a grant under a Federal program and which would be excludable from gross income as a scholarship or fellowship grant, but for the fact that the recipient must perform future service as a Federal employee, is not includable in gross income if the individual establishes that the amount was used for qualified tuition and related expenses.

The excludable qualified tuition and related expenses are the amount used for tuition and fees required for the enrollment or attendance of the student at an institution of higher education and for fees, books, supplies, and equipment required for courses of instruction at that institution.

[8] The bill defines an "institution of higher education" as a public or other nonprofit educational institution in any State which: (1) admits as regular students only individuals who have a certificate of graduation from a high school (or the recognized equivalent of such a certificate); (2) is legally authorized within the State to provide a program of education beyond high school; and (3) provides an educational program for which it awards a bachelor's or higher degree, provides a program which is acceptable for full credit toward such a degree, or offers a program of training to prepare students for gainful employment in a recognized health profession.

National Research Service Awards.—The bill extends for one year the temporary treatment of National Research Service Awards as excludable scholarships or fellowships.

Effective date

The exclusion provided for Federal grants requiring future services applies to taxable years beginning after December 31, 1980.

The extension of the special provision for National Research Service Awards applies to awards made during calendar year 1981.

Revenue effect

The exclusion from gross income for amounts received as scholarships under the Armed Forces Health Professions Scholarship Program, the Public Health Services Program and similar programs will reduce budget receipts by $3 million in fiscal year 1981, $8 million in fiscal year 1982, $14 million in fiscal year 1983, $20 million in fiscal year 1984, and $24 million in fiscal year 1985.

It is estimated that the one-year extension for National Research Service Awards will reduce budget receipts by less than $1 million in fiscal year 1981, $8 million in fiscal year 1982, $8 million in fiscal year 1983, and less than $5 million in fiscal year 1984.

F. Charitable Deduction for Certain Contributions of Real Property for Conservation Purposes (sec. 6 of the bill and sec. 170 of the Code)

Present law

As a general rule, a deduction is not allowed for income, estate, or gift tax purposes for contributions to charity of less than the taxpayer's entire interest in the contributed property. This restriction was enacted by Congress in the Tax Reform Act of 1969 [Pub. L. 91-172, 1969-3 C.B. 10] to prevent certain tax-avoidance transactions in which the taxpayer could obtain a deduction for a gift to a charity of the use of part of his property. Exceptions allowing deductions for charitable

contributions of partial interests in property were provided in the 1969 Act for the contribution of (1) a remainder interest in a personal residence or farm; (2) an undivided portion of the taxpayer's entire interest in the property; (3) certain interests in trust; and (4) interests not transferred in trust that would be deductible if made in trust (Code secs. 170(f), 2055(e)(2), and 2522(c)(2)).

The Conference Report on the Tax Reform Act of 1969 [Conf. Rept. 91-782, 1969-3 C.B. 644] states that a gift of an open space easement in gross is to be considered a gift of an undivided interest in property if the easement is in perpetuity. On the basis of that Conference Report language, the Internal Revenue Service issued Regulations providing that a deduction would be al-[9]lowed for the value of a restrictive easement gratuitously conveyed to a charitable organization in perpetuity whereby the donor agrees to restrictions on the use of his property, such as restrictions on the type and height of buildings that may be erected, the removal of trees, the erection of utility lines, the dumping of trash, and the use of signs (Treas. Reg. § 1.170A-7(b)(1)(ii)). In addition, the IRS has issued public rulings allowing deductions, under the undivided interest exception, for contributions of certain kinds of perpetual easements, including open space, historical, and recreational easements.[1] The undivided interest exception did not, however, extend to situations where taxpayers transferred their fee interest in property to a charitable organization while retaining valuable mineral rights.[2]

Explicit statutory exceptions for charitable contributions made "exclusively for conservation purposes" were provided in the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1] (and modified by the Tax Reduction and Simplification Act of 1977 [Pub. L. 95-30, 1977-1 C.B. 451]). Under these exceptions, a deduction is permitted for the contribution to a charitable organization, exclusively for conservation purposes, of (a) lease on, option to purchase, or easement with respect to real property granted in perpetuity or (b) a remainder interest in real property.[3] (Code secs. 170(f)(3)(B)(iii) and (iv).) The exceptions for these partial interests contributed for conservation purposes only apply to contributions made before June 14, 1981.

Regulations have not yet been promulgated under the explicit deductions for conservation easements added to the Code by the 1976 and 1977 Acts, and the Regulations promulgated under the Tax Reform Act of 1969 and in accordance with the Conference Report language are still outstanding (Treas. Reg. § 1.170A-7(b)(1)(ii)). It is unclear whether Congress intended the statutory provisions enacted in 1976 and modified in 1977 to supersede the statements made in the 1969 Conference Report.

Reasons for change

The committee believes that the preservation of our country's natural resources and cultural heritage is important, and the committee recognizes that conservation easements now play an important role in preservation efforts. The committee also recognizes that it is not in the country's best interest to restrict or prohibit the development of all land areas and existing structures. Therefore, the committee believes that provisions allowing deductions for conservation easements should be directed at the preservation of unique or otherwise significant land areas or structures. Accordingly, the committee has agreed to extend the expiring provisions of present law on a permanent basis and modify those provisions in several respects.

In particular, the committee found it appropriate to expand the types of transfers which will qualify as deductible contributions in certain cases where the contributions are likely to further significant conservation goals without presenting significant potential for abuse. In [10] addition, the committee bill would restrict the qualifying contributions where there is no assurance that the public benefit, if any, furthered by the contribution would be substantial enough to justify the allowance of a deduction. In addition, the committee decided that the treatment of open space easements should be clarified.

Explanation of provision

Qualified real property interests

Under the bill, the types of partial interests which may qualify as a deductible conservation contribution are expanded to include the contribution of a taxpayer's entire interest in real property other than his interest in subsurface oil, gas, or other minerals and the right of access to such minerals. The committee intends that a contribution will not qualify under this new provision if the donor has reduced his "entire interest in real property" before the contribution is made by, for example, transferring part of his interest in the real property to a related person in order to retain control of more than a qualified mineral interest in the real property or reduce the real property interest donated.[4]

The types of partial interests which may qualify for a charitable deduction are also modified by replacing the present category covering a lease on option to purchase, or easement on real property granted in perpetuity with a general category covering "a restriction (granted in perpetuity) on the use which may be made of the real property." This new language would cover easements and other interests in real property that under State property laws have similar attributes (e.g., a restrictive covenant). The bill does not

[1] Rev. Rul. 74-583, 1974-2 C.B. 80; Rev. Rul. 75-358, 1975-2 C.B. 76; Rev. Rul. 75-373, 1975-2 C.B. 77.

[2] Compare Rev Rul. 76-331, 1976-2 C.B. 52 with Rev. Rul. 77-148, 1977-1 C.B. 63 and Rev. Rul. 75-373, 1975-2 C.B. 77.

[3] Prior to their modification by the 1977 Act, the provisions added by the 1976 Act also allowed deductions for term easements having a duration of at least 30 years.

[4] See e.g., Treas. Reg. § 1.170A-7(a)(2)(i).

modify the other category of partial interests, remainder interests in real property, which may qualify for a deductible conservation contribution.

Conservation purpose

The bill revises in several respects the present definition of conservation purposes. The bill defines the term "conservation purpose" to include four objectives. Although many contributions may satisfy more than one of these objectives (it is possible, for example, that the protection of a wild and scenic river could further more than one of the objectives), it is only necessary for a contribution to further one of the four.

First, conservation purpose includes the preservation of land areas for outdoor recreation by the general public or for the education of the general public. Thus, conservation purposes would include, for example, the preservation of a water area for the use of the public for boating or fishing, or a nature or hiking trail for the use of the public.

Second, conservation purpose includes the protection of a relatively natural fish, wildlife or plant habitat, or similar ecosystem. Under this provision, a contribution would be considered to be made for conservation purposes if it will operate to protect or enhance the viability of an area or environment in which a fish, wildlife, or plant community normally lives or occurs. It would include the preservation of a habitat or environment which to some extent had been altered by human activity if the fish, wildlife, or plants exist there in a relatively natural state; for example, the preservation of a lake formed by a man-made [11] dam or a salt pond formed by a man-made dike if the lake or pond is a natural feeding area for a wildlife community that includes rare, endangered or threatened native species. The committee intends that contributions for this purpose will protect and preserve significant natural habitats and ecosystems, in the United States. Examples include habitats for rare, endangered, or threatened native species of animals, fish or plants; natural areas that represent high quality examples of a native ecosystem terrestrial community, or aquatic community; and natural areas which are included in, or which contribute to the ecological viability of a local, state, or national park, nature preserve, wildlife refuge, wilderness area or other similar conservation area. These natural habitats and ecosystems might be protected by easements or other restrictions regarding, for example, the development or use of property that would affect the habitat or ecosystem to be protected.

Third, conservation purposes would include the preservation of open space (including farmland and forest land) where such preservation (1) is for the scenic enjoyment of the general public and will yield a significant public benefit or (2) is pursuant to a clearly delineated Federal, State, or local governmental conservation policy and will yield a significant public benefit. The requirements of this conservation purpose are intended to insure that deductions are permitted only for open space easements that provide significant benefits to the public. The bill permits a deduction for an open space easement only if it meets the requirements imposed by this provision. Thus, a deduction for an open space easement in gross is not allowable under the undivided portion exception in Code section 170(f)(3)(B)(ii).

To satisfy the requirement of scenic enjoyment by the general public, visual, not physical, access by the general public to the property is sufficient. Thus, preservation of land may be for the scenic enjoyment of the general public if development of the property would interfere with a scenic panorama that can be enjoyed from a park, nature preserve, road, waterbody, trail, historic structure or land area, and such area or transportation way is open to, or utilized by, the public.

Open space easements also may qualify even if the property has no significant scenic value as long as the preservation or conservation of the property is pursuant to a clearly delineated Federal, State, or local governmental preservation or conservation policy. This provision is intended to protect the types of property identified by representatives of the general public as worthy of preservation or conservation. For example, this requirement would be satisfied by a Federal executive order pursuant to a Federal statute establishing a conservation program or a state statute or local ordinance establishing a funded conservation program for a scenic river or other identified conservation project. A program need not be funded to satisfy this requirement, but the program must involve a significant commitment by the government with respect to the conservation project. A broad declaration by a single official, (for example, a county executive) or a legislative body, for example (a state legislature), that land should be conserved is not sufficient, but the governmental conservation policy need not be a certification program that identifies particular lots or small parcels of individually owned property.

[12] All contributions made for the preservation of open space must yield a significant public benefit. Public benefit will be evaluated by considering all information germane to the contribution; factors germane to the evaluation of public benefit from one contribution may be irrelevant in determining public benefit from another contribution. Factors that may be considered include (but are not limited to) the following:

(1) the uniqueness of the property;

(2) the intensity of land development in the vicinity of the property (both existing development and foreseeable trends of development);

(3) the consistency of the proposed open space use with public programs (whether Federal, State, or local) for conservation in the region, including programs for water supply protection, water quality maintenance or enhancement, flood prevention and control, erosion control, shoreline protection, and protection of land areas included in, or related to, a government approved master plan or land management area; and

(4) the opportunity for the general public to enjoy the use of the property or to appreciate its scenic values.

The preservation of an ordinary tract of land would not, in and of itself, yield a significant public benefit, but the preservation of ordinary land areas in conjunction with other factors that demonstrate significant public benefit or the preservation of a unique land area for public enjoyment would yield a significant public benefit. For example, the preservation of a vacant downtown lot would not by itself yield a significant public benefit, but the preservation of the downtown lot as a public garden would, absent countervailing factors, yield a significant public benefit. The following are other examples of contributions which would, absent countervailing factors, yield a significant public benefit: (1) the preservation of farmland pursuant to a State program for flood prevention and control; (2) the preservation of a unique natural land formation for the enjoyment of the general public; (3) the preservation of woodland along a Federal highway pursuant to a government program to preserve the appearance of the area so as to maintain the scenic view from the highway; and (4) the preservation of a stretch of undeveloped oceanfront property located between a public highway and the ocean so as to maintain the scenic ocean view from the highway.

Finally, conservation purpose also includes the preservation of an historically important land area or a certified historic structure. The term "historically important land area" is intended to include independently significant land areas (for example, a civil war battlefield) and historic sites and related land areas, the physical or environmental features of which contribute to the historic or cultural importance and continuing integrity of certified historic structures such as Mount Vernon, or historic districts, such as Waterford, Virginia, or Harper's Ferry, West Virginia. For example, the integrity of a certified historic structure may be protected under this provision by perpetual restrictions on the development of such a related land area. The term "certified historic structure" for purposes of this charitable contribution deduction generally has the same meaning as in present Code section 191(d)(1) (dealing with 5-year amortization of expenditures incurred in the rehabilitation of certified historic structures). However, [13] a "structure" for this purpose means any structure whether or not it is depreciable. Thus, for example, easements on private residences may qualify under this provision. In addition, a structure would be considered to be a certified historic structure if it satisfied the certification requirements either at the time the transfer was made or at the due date (including extensions) for filing the donor's return for the year in which the contribution was made.

In view of the need of potential donors to be secure in their knowledge that a contemplated contribution will qualify for a deduction, the committee expects that taxpayers may obtain a prior administrative determination as to whether the contemplated contribution will be considered to have been made for a qualifying conservation purpose. In addition, the committee expects that regulations under this section will be classified among those regulation projects having the highest priority, and that, to the extent possible, issues that may arise in the interpretation of the statute will be resolved before publication of regulations by the issuance of administrative determinations.

Exclusively for conservation purposes

The bill retains the present law requirement that contributions be made "exclusively for conservation purposes." Moreover, the bill explicitly provides that this requirement is not satisfied unless the conservation purpose is protected in perpetuity. The contribution must involve legally enforceable restrictions on the interest in the property retained by the donor that would prevent uses of the retained interest inconsistent with the conservation purposes. In the case of a contribution of a remainder interest, the contribution will not qualify if the tenants, whether they are tenants for life or a term of years, can use the property in a manner that diminishes the conservation values which are intended to be protected by the contribution.

In addition, this requirement is not met if the contribution would accomplish one of the enumerated conservation purposes, but would allow uses of the property that would be destructive of other significant conservation interests. For example, the preservation of farmland would not qualify under the open space purpose if a natural ecosystem has been or, under the terms of the contribution, can be significantly injured or destroyed by the use of pesticides in the operation of the farm. This requirement is not intended to prohibit uses of the property, such as the selective cutting of timber or farming, if under the circumstances they are not destructive of significant conservation interests.

In the case of a qualified mineral interest gift, the requirement that the conservation purpose be protected in perpetuity is not satisfied if any method of mining, removal, or extraction that is inconsistent with the particular conservation purposes of a contribution is permitted at any time. Some methods of mining, removal, or extraction may have temporary, localized impact on the real property contributed that is not destructive of significant conservation interests, and this requirement may be satisfied even though such methods are permitted. In addition, the bill specifically states that this requirement is not met if at any time the minerals may be removed or extracted by any surface mining method.

[14] By requiring that the conservation purpose be protected in perpetuity, the committee intends that the perpetual restrictions must be enforceable by the donee organization (and successors in interest) against all other parties in interest (including successors in interest). Generally, the committee contemplates that the restrictions would be recorded. The committee does not, by the requirement that the conservation purpose

be protected in perpetuity, intend that a recipient of a conservation contribution must set aside funds for the enforcement of the contribution.

The committee does intend, however, to limit the deduction only to those cases where the conservation purposes will in practice be carried out. The committee contemplates that the contributions will be made to organizations which have the commitment and the resources to enforce the perpetual restrictions and to protect the conservation purposes. The requirement that the conservation purpose be protected in perpetuity also is intended to limit deductible contributions to those transfers which require that the donee (or successor in interest) hold the conservation easement (or other restriction) or other property interests exclusively for conservation purposes (i.e., that they not be transferable by the donee except to other qualified organizations that also will hold the perpetual restriction or property exclusively for conservation purposes).

Qualified organizations

In general, the bill restricts eligible recipients of contributions of partial interests for conservation purposes to governments and publicly supported charities. Thus, a governmental unit (described in Code sec. 170(b)(1)(A)(v)) would be an eligible recipient, as would a charitable organization (described in Code sec. 501(c)(3)) that is publicly supported within the meaning of either Code section 170(b)(1)(A)(vi) or Code section 509(a)(2). In addition, an organization that is not itself publicly supported but nevertheless is qualified as a "public charity" (under Code sec. 509(a)(3)) would be eligible if it is controlled by a government or publicly supported organization. Thus, for example, an organization created as a title-holding subsidiary of a public supported charitable organization would be an eligible recipient if it is controlled by the parent organization.

Valuation

In general, a deduction is allowed for a charitable contribution in the amount of the fair market value of the contributed property, defined as the price at which the property would change hands between a willing buyer and a willing seller. Thus, the amount of the deduction for the contribution of a conservation easement or other restriction is the fair market value of the interest conveyed to the recipient. However, because markets generally are not well established for easements or similar restrictions, the willing buyer/willing seller test may be difficult to apply (although it may become increasingly possible to determine the value of conservation easements by reference to amounts paid for such interests in easement acquisition programs as such programs increase). As a consequence, conservation easements are typically (but not necessarily) valued indirectly as the difference [15] between the fair market value of the property involved before and after the grant of the easement. (See Rev. Rul. 73-339, 1973-2 C.B. 68 and Rev. Rul. 76-376, 1976-2 C.B. 53). Where this test is used, however, the committee believes it should not be applied mechanically.

For example, where before and after valuation is used, the fair market value of the property before contribution of the easement should take into account not only the current use of the property but also an objective assessment of how immediate or remote the likelihood is that the property, absent the restriction, would be developed. Where applicable, valuation of the property before contribution should take into account zoning, conservation, or historic preservation laws that would restrict development of the property. Valuation of the transfer should take into account the impact of the transfer on the property, as in the case where restrictions on one parcel of property serve to increase the value of adjacent property. Also, there may be instances in which the grant of an easement may serve to enhance, rather than reduce, the value of property, and in such instances no deduction would be allowable; for example, where there is a premium in value on property of a historic nature. Similarly, in a case where the owners of a high-rise oceanfront condominium make a contribution of an open space easement that prohibits further development of the property between the high-rise structure and the shoreline but does not allow the public access to the beach and does not diminish the value of the property overall, there would be no deductible amount. (In this example, it is questionable, absent other considerations, whether the gift of such a beach easement with limited public scenic value and without public access to the beach would qualify under the requirements of the open space provision.) The committee also intends that, as the use of conservation easements increases, valuation would increasingly take into account the selling price value, in arm's-length transactions, of other properties burdened with comparable restrictions.

Study by Treasury

The committee found that it was hindered to some extent in its analysis of the present provisions relating to conservation contributions and its consideration of the proposed legislation by the absence of a comprehensive data base concerning the nature and scope of conservation easements and remainder interests. To permit Congress to evaluate more precisely the effectiveness of the conservation contribution provisions and the need, if any, to modify them at some future date, the committee requests that the Administration undertake a study on conservation easements and remainders to be submitted to Congress by 1985. The committee contemplates that, if possible, the Internal Revenue Service will devise a method by which to collect information on the number and characteristics of interests for which deductions are claimed under this section, possibly through the use of forms required to be submitted with the

tax return on which a deduction is claimed.

Effective date

The provisions of the bill apply to transfers made after the date of enactment in taxable years ending after such date.

* * * * *

Public Law 96-589
96th Congress, H.R. 5043 [1]
December 24, 1980

An Act to amend the Internal Revenue Code of 1954 to provide for the tax treatment of bankruptcy, insolvency, and similar proceedings, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; TABLE OF CONTENTS; AMENDMENT OF 1954 CODE.

(a) SHORT TITLE.—This Act may be cited as the "Bankruptcy Tax Act of 1980".

(b) TABLE OF CONTENTS.—

Sec. 1. Short title; table of contents; amendment of 1954 Code.
Sec. 2. Tax treatment of discharge of indebtedness.
Sec. 3. Rules relating to title 11 cases for individuals.
Sec. 4. Corporate reorganization provisions.
Sec. 5. Miscellaneous corporate amendments.
Sec. 6. Changes in tax procedures.
Sec. 7. Effective dates.

(c) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. TAX TREATMENT OF DISCHARGE OF INDEBTEDNESS.

(a) AMENDMENT OF SECTION 108.—Section 108 (relating to discharge of indebtedness) is amended to read as follows:

"SEC. 108. INCOME FROM DISCHARGE OF INDEBTEDNESS.

"(a) EXCLUSION FROM GROSS INCOME.—

"(1) IN GENERAL.—Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

"(A) the discharge occurs in a title 11 case,

"(B) the discharge occurs when the taxpayer is insolvent, or

"(C) the indebtedness discharged is qualified business indebtedness.

"(2) COORDINATION OF EXCLUSIONS.—

"(A) TITLE 11 EXCLUSION TAKES PRECEDENCE. — Subparagraphs (B) and (C) of paragraph (1) shall not apply to a discharge which occurs in a title 11 case.

"(B) INSOLVENCY EXCLUSION TAKES PRECEDENCE over QUALIFIED BUSINESS EXCLUSION.—Subparagraph (C) of paragraph (1) shall not apply to a discharge to the extent that the taxpayer is insolvent.

"(3) INSOLVENCY EXCLUSION LIMITED TO AMOUNT OF INSOLVENCY.—In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent.

"(b) REDUCTION OF TAX ATTRIBUTES IN TITLE 11 CASE OR INSOLVENCY.—

"(1) IN GENERAL.—The amount excluded from gross income under subparagraph (A) or (B) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2).

"(2) TAX ATTRIBUTES AFFECTED; ORDER OF REDUCTION.—Except as provided in paragraph (5), the reduction referred to in paragraph (1) shall be made in the following tax attributes in the following order:

"(A) NOL.—Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

"(B) CERTAIN CREDIT CARRYOVERS.—Any carryover to or from the taxable year of the discharge of an amount for purposes of determining the amount of a credit allowable under—

"(i) section 38 (relating to investment in certain depreciable property),

"(ii) section 40 (relating to expenses of work incentive programs),

"(iii) section 44B (relating to credit for employment of certain new employees), or

"(iv) section 44E (relating to alcohol used as a fuel).

For purposes of clause (i), there shall not be taken into account any portion of a carryover which is attributable to the employee plan credit (within the meaning of section 48(o)(3)).

"(C) CAPITAL LOSS CARRYOVERS.—Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.

"(D) BASIS REDUCTION.—

"(i) IN GENERAL.—The basis of the property of the taxpayer.

"(ii) CROSS REFERENCE.—

"For provisions for making the reduction described in clause (i), see section 1017.

"(E) FOREIGN TAX CREDIT CARRYOVERS.—Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 33.

"(3) AMOUNT OF REDUCTION.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the reductions described in paragraph (2) shall be one dollar for each dollar excluded by subsection (a).

"(B) CREDIT CARRYOVER REDUCTION.—The reductions described in

[1] Pertinent excerpts from Senate Report No. 96-1035, page 620. House Report No. 96-833 is not published.

subparagraphs (B) and (E) of paragraph (2) shall be 50 cents for each dollar excluded by subsection (a).

"(4) ORDERING RULES.—

"(A) REDUCTIONS MADE AFTER DETERMINATION OF TAX FOR YEAR.—The reduction described in paragraph (2) shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge.

"(B) REDUCTIONS UNDER SUBPARAGRAPH (A) OR (C) OF PARAGRAPH (2).—The reductions described in subparagraph (A) or (C) of paragraph (2) (as the case may be) shall be made first in the loss for the taxable year of the discharge and then in the carryovers to such taxable year in the order of the taxable years from which each such carryover arose.

"(C) REDUCTIONS UNDER SUBPARAGRAPHS (B) AND (E) OF PARAGRAPH (2).—The reductions described in subparagraphs (B) and (E) of paragraph (2) shall be made in the order in which carryovers are taken into account under this chapter for the taxable year of the discharge.

"(5) ELECTION TO APPLY REDUCTION FIRST AGAINST DEPRECIABLE PROPERTY.—

"(A) IN GENERAL.—The taxpayer may elect to apply any portion of the reduction referred to in paragraph (1) to the reduction under section 1017 of the basis of the depreciable property of the taxpayer.

"(B) LIMITATION.—The amount to which an election under subparagraph (A) applies shall not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.

"(C) OTHER TAX ATTRIBUTES NOT REDUCED.—Paragraph (2) shall not apply to any amount to which an election under this paragraph applies.

"(c) TAX TREATMENT OF DISCHARGE OF QUALIFIED BUSINESS INDEBTEDNESS.—In the case of a discharge of qualified business indebtedness—

"(1) BASIS REDUCTION.—

"(A) IN GENERAL.—The amount excluded from gross income under subparagraph (C) of subsection (a)(1) shall be applied to reduce the basis of the depreciable property of the taxpayer.

"(B) CROSS REFERENCE.—

"For provisions for making the reduction described in subparagraph (A), see section 1017.

"(2) LIMITATION.—The amount excluded under subparagraph (C) of subsection (a)(1) shall not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs (determined after any reductions under subsection (b)).

"(d) MEANING OF TERMS; SPECIAL RULES RELATING TO SUBSECTIONS (a), (b), and (c).—

"(1) INDEBTEDNESS OF TAXPAYER.—For purposes of this section, the term 'indebtedness of the taxpayer' means any indebtedness—

"(A) for which the taxpayer is liable, or

"(B) subject to which the taxpayer holds property.

"(2) TITLE 11 CASE.—For purposes of this section, the term 'title 11 case' means a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

"(3) INSOLVENT.—For purposes of this section, the term 'insolvent' means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

"(4) QUALIFIED BUSINESS INDEBTEDNESS.—Indebtedness of the taxpayer shall be treated as qualified business indebtedness if (and only if)—

"(A) the indebtedness was incurred or assumed—

"(i) by a corporation, or

"(ii) by an individual in connection with property used in his trade or business, and

"(B) such taxpayer makes an election under this paragraph with respect to such indebtedness.

"(5) DEPRECIABLE PROPERTY.—The term 'depreciable property' has the same meaning as when used in section 1017.

"(6) SUBSECTIONS (a), (b), AND (c) TO BE APPLIED AT PARTNER LEVEL.—In the case of a partnership, subsections (a), (b), and (c) shall be applied at the partner level.

"(7) REDUCTIONS OF TAX ATTRIBUTES IN TITLE 11 CASES OF INDIVIDUALS TO BE MADE BY ESTATE.—In any case under chapter 7 or 11 of title 11 of the United States Code to which section 1398 applies, for purposes of paragraphs (1) and (5) of susection (b) the estate (and not the individual) shall be treated as the taxpayer. The preceding sentence shall not apply for purposes of applying section 1017 to property transferred by the estate to the individual.

"(8) TIME FOR MAKING ELECTION, ETC.—

"(A) TIME.—An election under paragraph (4) of this subsection or under paragraph (5) of subsection (b) shall be made on the taxpayer's return for the taxable year in which the discharge occurs or at such other time as may be permitted in regulations prescribed by the Secretary.

"(B) REVOCATION ONLY WITH CONSENT.—An election referred to in subparagraph (A), once made, may be revoked only with the consent of the Secretary.

"(C) MANNER.—An election referred to in subparagraph (A) shall be made in such manner as the Secretary may by regulations prescribe.

"(9) CROSS REFERENCE.—

"For provision that no reduction is to be made in the basis of exempt property of an individual debtor, see section 1017(c)(1).

"(e) GENERAL RULES FOR DISCHARGE OF INDEBTEDNESS (INCLUDING DISCHARGES NOT IN TITLE 11 CASES OR INSOLVENCY).—For purposes of this title—

"(1) NO OTHER INSOLVENCY EXCEPTION.—Except as otherwise provided in this section, there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness.

"(2) INCOME NOT REALIZED TO EXTENT OF LOST DEDUCTIONS.—No income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.

"(3) ADJUSTMENTS FOR UNAMORTIZED PREMIUM AND DISCOUNT.—The amount taken into account with respect to any discharge shall be properly adjusted for unamortized premium and unamortized discount with respect to the indebtedness discharged.

"(4) ACQUISITION OF INDEBTEDNESS BY PERSON RELATED TO DEBTOR.—

"(A) TREATED AS ACQUISITION BY DEBTOR.—For purposes of determining income of the debtor from discharge of indebtedness, to the extent provided in regulations prescribed by the Secretary, the acquisition of outstanding indebtedness by a person bearing a relationship to the debtor specified in section 267(b) or 707(b)(1) from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness by the debtor. Such regulations shall provide for such adjustments in the treatment of any subsequent transactions involving the indebtedness as may be appropriate by reason of the application of the preceding sentence.

"(B) MEMBERS OF FAMILY.—For purposes of this paragraph, sections 267(b) and 707(b)(1) shall be applied as if section 267(c)(4) provided that the family of an individual consists of the individual's spouse, the individual's children, grandchildren, and parents, and any spouse of the individual's children or grandchildren.

"(C) ENTITIES UNDER COMMON CONTROL TREATED AS RELATED.—For purposes of this paragraph, two entities which are treated as a single employer under subsection (b) or (c) of section 414 shall be treated as bearing a relationship to each other which is described in section 267(b).

"(5) PURCHASE-MONEY DEBT REDUCTION FOR SOLVENT DEBTOR TREATED AS PRICE REDUCTION.—If—

"(A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced,

"(B) such reduction does not occur—

"(i) in a title 11 case, or

"(ii) when the purchaser is insolvent, and

"(C) but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness,

then such reduction shall be treated as a purchase price adjustment.

"(6) INDEBTEDNESS CONTRIBUTED TO CAPITAL.—For purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtednes from a shareholder as a contribution to capital—

"(A) section 118 shall not apply, but

"(B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.

"(7) RECAPTURE OF GAIN ON SUBSEQUENT SALE OF STOCK.—

"(A) IN GENERAL.—If a creditor acquires stock of a debtor corporation in satisfaction of such corporation's indebtedness, for purposes of section 1245—

"(i) such stock (and any other property the basis of which is determined in whole or in part by reference to the adjusted basis of such stock) shall be treated as section 1245 property, and

"(ii) the aggregate amount allowed to the creditor—

"(I) as deductions under subsection (a), (b), or (c) of section 166 (by reason of the worthlessness or partial worthlessness of the indebtedness), or

"(II) as an ordinary loss on the exchange,

shall be treated as an amount allowed as a deduction for depreciation.

The amount determined under clause (ii) shall be reduced by the amount (if any) included in the creditor's gross income on the exchange.

"(B) TAXPAYERS ON RESERVE METHOD.—In the case of a taxpayer to whom subsection (c) of section 166 (relating to reserve for bad debts) applies, the amount determined under clause (ii) of subaparagraph (A) shall be the aggregate charges to the reserve resulting from the worthlessness or partial worthlessness of the indebtedness.

"(C) SPECIAL RULE FOR CASH BASIS TAXPAYERS.—In the case of any creditor who computes his taxable income under the cash receipts and disbursements method, proper adjustment shall be made in the amount taken into account under clause (ii) of subparagraph (A) for any amount which was not included in the creditor's gross income but which would have been included in such gross income if such indebtedness had been satisfied in full.

"(D) STOCK OF PARENT CORPORATION.—For purposes of this paragraph, stock of a corporation in control (within the meaning of section 368(c)) of the debtor corporation shall be treated as stock of the debtor corporation.

"(E) TREATMENT OF SUCCESSOR CORPORATION.—For purposes of this paragraph, the term 'debtor corporation' includes a successor corporation.

"(F) PARTNERSHIP RULE.—Under regulations prescribed by the Secretary, rules similar to the rules of subparagraphs (A), (B), (C), (D), and (E) of this paragraph shall apply with respect to the indebtedness of a partnership.

"(8) STOCK FOR DEBT EXCEPTION NOT TO APPLY IN DE MINIMIS CASES.—For purposes of determining income of the debtor from discharge of indebt-

edness, the stock for debt exception shall not apply—

"(A) to the issuance of nominal or token shares, or

"(B) with respect to an unsecured creditor, where the ratio of the value of the stock received by such unsecured creditor to the amount of his indebtedness cancelled or exchanged for stock in the workout is less than 50 percent of a similar ratio computed for all unsecured creditors participating in the workout.

"(9) DISCHARGE OF INDEBTEDNESS INCOME NOT TAKEN INTO ACCOUNT IN DETERMINING WHETHER ENTITY MEETS REIT QUALIFICATION.—Any amount included in gross income by reason of the discharge of indebtedness shall not be taken into account for purposes of paragraphs (2) and (3) of section 856(c)."

(b) AMENDMENT OF SECTION 1017.—Section 1017 (relating to discharge of indebtedness) is amended to read as follows:

"SEC. 1017. DISCHARGE OF INDEBTEDNESS.

"(a) GENERAL RULE.—If—

"(1) an amount is excluded from gross income under subsection (a) of section 108 (relating to discharge of indebtedness), and

"(2) under subsection (b)(2)(D), (b)(5), or (c)(1)(A) of section 108, any portion of such amount is to be applied to reduce basis,

then such portion shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs.

"(b) AMOUNT AND PROPERTIES DETERMINED UNDER REGULATIONS.—

"(1) IN GENERAL.—The amount of reduction to be applied under subsection (a) (not in excess of the portion referred to in subsection (a)), and the particular properties the bases of which are to be reduced, shall be determined under regulations prescribed by the Secretary.

"(2) LIMITATION IN TITLE 11 CASE OR INSOLVENCY.—In the case of a discharge to which subparagraph (A) or (B) of section 108(a)(1) applies, the reduction in basis under subsection (a) of this section shall not exceed the excess of—

"(A) the aggregate of the bases of the property held by the taxpayer immediately after the discharge, over

"(B) the aggregate of the liabilities of the taxpayer immediately after the discharge.

The preceding sentence shall not apply to any reduction in basis by reason of an election under section 108(b)(5).

"(3) CERTAIN REDUCTIONS MAY ONLY BE MADE IN THE BASIS OF DEPRECIABLE PROPERTY.—

"(A) IN GENERAL.—Any amount which under subsection (b)(5) or (c)(1)(A) of section 108 is to be applied to reduce basis shall be applied only to reduce the basis of depreciable property held by the taxpayer.

"(B) DEPRECIABLE PROPERTY.—For purposes of this section, the term 'depreciable property' means any property of a character subject to the allowance for depreciation, but only if a basis reduction under subsection (a) will reduce the amount of depreciation or amortization which otherwise would be allowable for the period immediately following such reduction.

"(C) SPECIAL RULE FOR PARTNERSHIP INTERESTS.—For purposes of this section, any interest of a partner in a partnership shall be treated as depreciable property to the extent of such partner's proportionate interest in the depreciable property held by such partnership. The preceding sentence shall apply only if there is a corresponding reduction in the partnership's basis in depreciable property with respect to such partner.

"(D) SPECIAL RULE IN CASE OF AFFILIATED GROUP.—For purposes of this section, if—

"(i) a corporation holds stock in another corporation (hereinafter in this subparagraph referred to as the 'subsidiary'), and

"(ii) such corporations are members of the same affiliated group which file a consolidated return under section 1501 for the taxable year in which the discharge occurs,

then such stock shall be treated as depreciable property to the extent that such subsidiary consents to a corresponding reduction in the basis of its depreciable property.

"(E) ELECTION TO TREAT CERTAIN INVENTORY AS DEPRECIABLE PROPERTY.—

"(i) IN GENERAL.—At the election of the taxpayer, for purposes of this section, the term 'depreciable property' includes any real property which is described in section 1221(1).

"(ii) ELECTION.—An election under clause (i) shall be made on the taxpayer's return for the taxable year in which the discharge occurs or at such other time as may be permitted in regulations prescribed by the Secretary. Such an election, once made, may be revoked only with the consent of the Secretary.

"(c) SPECIAL RULES.—

"(1) REDUCTION NOT TO BE MADE IN EXEMPT PROPERTY.—In the case of an amount excluded from gross income under section 108(a)(1)(A), no reduction in basis shall be made under this section in the basis of property which the debtor treats as exempt property under section 522 of title 11 of the United States Code.

"(2) REDUCTIONS IN BASIS NOT TREATED AS DISPOSITIONS.—For purposes of this title, a reduction in basis under this section shall not be treated as a disposition.

"(d) RECAPTURE OF REDUCTIONS.—

"(1) IN GENERAL.—For purposes of sections 1245 and 1250—

"(A) any property the basis of which is reduced under this section and which is neither section 1245 property nor section 1250 property shall be treated as section 1245 property, and

"(B) any reduction under this section shall be treated as a deduction allowed for depreciation.

"(2) SPECIAL RULE FOR SECTION 1250.—For purposes of section 1250(b), the determination of what would

have been the depreciation adjustments under the straight line method shall be made as if there had been no reduction under this section."

(c) AMENDMENT OF SECTION 111.—Section 111 (relating to recovery of bad debts, prior taxes, and delinquency amounts) is amended by adding at the end thereof the following new subsection:

"(d) INCREASE IN CARRYOVER TREATED AS YIELDING TAX BENEFIT.—For purposes of paragraph (4) of subsection (b), an increase in a carryover which has not expired shall be treated as a reduction in tax."

(d) AMENDMENT OF SECTION 382 (b).—Subsection (b) of section 382 (relating to special limitations on net operating loss carryover), as in effect before its amendment by section 806 of the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-2 C.B. (Vol. 1) 1, 74] is amended by adding at the end thereof the following new paragraph:

(7) SPECIAL RULE FOR REORGANIZATIONS IN TITLE 11 OR SIMILAR CASES.—For purposes of this subsection, a creditor who receives stock in a reorganization in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) shall be treated as a stockholder immediately before the organization."

(e) TECHNICAL AMENDMENTS.—

(1) Subsection (b) of section 703 (relating to elections of the partnership) is amended to read as follows:

"(b) ELECTIONS OF THE PARTNERSHIP.—Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership, except that any election under—

"(1) section 57(c) (defining net lease),

"(2) subsection (b)(5) or (d)4) of section 108 (relating to income from discharge of indebtedness),

"(3) section 163(d) (relating to limitation of interest on investment indebtedness),

"(4) section 617 (relating to deduction and recapture of certain mining exploration expenditures), or

"(5) section 901 (relating to taxes of foreign countries and possessions of the United States),

shall be made by each partner separately."

(2) Subsection (c) of section 118 (relating to cross references) is amended to read as follows:

"(c) CROSS REFERENCES.—

"(1) For basis of property acquired by a corporation through a contribution to its capital, see section 362.

"(2) For special rules in the case of contributions of indebtedness, see section 108(e)(6)."

SEC. 3. RULES RELATING TO TITLE 11 CASES FOR INDIVIDUALS.

(a) IN GENERAL.—

(1) ADDITION OF RULES.—Chapter 1 (relating to normal taxes and surtaxes) is amended by adding at the end thereof the following new subchapter:

"SUBCHAPTER V—TITLE 11 CASES

"Sec. 1398. Rules relating to individual's title 11 cases.

"Sec. 1399. No separate taxable entities for partnerships, corporations, etc.

"SEC. 1398. RULES RELATING TO INDIVIDUALS' TITLE 11 CASES.

"(a) CASES TO WHICH SECTION APPLIES.—Except as provided in subsection (b), this section shall apply to any case under chapter 7 (relating to liquidations) or chapter 11 (relating to reorganizations) of title 11 of the United States Code in which the debtor is an individual.

"(b) EXCEPTIONS WHERE CASE IS DISMISSED, ETC.—

"(1) SECTION DOES NOT APPLY WHERE CASE IS DISMISSED.—This section shall not apply if the case under chapter 7 or 11 of title 11 of the United States Code is dismissed.

"(2) SECTION DOES NOT APPLY AT PARTNERSHIP LEVEL.—For purposes of subsection (a), a partnership shall not be treated as an individual, but the interest in a partnership of a debtor who is an individual shall be taken into account under this section in the same manner as any other interest of the debtor.

"(c) COMPUTATION AND PAYMENT OF TAX; ZERO BRACKET AMOUNT.—

"(1) COMPUTATION AND PAYMENT OF TAX.—Except as otherwise provided in this section, the taxable income of the estate shall be computed in the same manner as for an individual. The tax shall be computed on such taxable income and shall be paid by the trustee.

"(2) TAX RATES.—The tax on the taxable income of the estate shall be determined under subsection (d) of section 1.

"(3) AMOUNT OF ZERO BRACKET AMOUNT.—The amount of the estate's zero bracket amount for the taxable year shall be the same as for a married individual filing a separate return for such year.

"(d) TAXABLE YEAR OF DEBTORS.—

"(1) GENERAL RULE.—Except as provided in paragraph (2), the taxable year of the debtor shall be determined without regard to the case under title 11 of the United States Code to which this section applies.

"(2) ELECTION TO TERMINATE DEBTOR'S YEAR WHEN CASE COMMENCES.—

"(A) IN GENERAL.—Notwithstanding section 442, the debtor may (without the approval of the Secretary) elect to treat the debtor's taxable year which includes the commencement date as 2 taxable years—

"(i) the first of which ends on the day before the commencement date, and

"(ii) the second of which begins on the commencement date.

"(B) SPOUSE MAY JOIN IN ELECTION.—In the case of a married individual (within the meaning of section 143), the spouse may elect to have the debtor's election under subparagraph (A) also apply to the spouse, but only if the debtor and the spouse file a joint return for the taxable year referred to in subparagraph (A)(i).

"(C) NO ELECTION WHERE DEBTOR HAS NO ASSETS.—No election may be

made under subparagraph (A) by a debtor who has no assets other than property which the debtor may treat as exempt property under section 522 of title 11 of the United States Code.

"(D) TIME FOR MAKING ELECTION.—An election under subparagraph (A) or (B) may be made only on or before the due date for filing the return for the taxable year referred to in subparagraph (A)(i). Any such election, once made, shall be irrevocable.

"(E) RETURNS.—A return shall be made for each of the taxable years specified in subparagraph (A).

"(F) ANNUALIZATION.—For purpurposes of subsections (b), (c), and (d) of section 443, a return filed for either of the taxable years referred to in subparagraph (A) shall be treated as a return made under paragraph (1) of subsection (a) of section 443.

"(3) COMMENCEMENT DATE DEFINED.—For purposes of this subsection, the term 'commencement date' means the day on which the case under title 11 of the United States Code to which this section applies commences.

"(e) TREATMENT OF INCOME, DEDUCTIONS, AND CREDITS.—

"(1) ESTATE'S SHARE OF DEBTOR'S INCOME.—The gross income of the estate for each taxable year shall include the gross income of the debtor to which the estate is entitled under title 11 of the United States Code. The preceding sentence shall not apply to any amount received or accrued by the debtor before the commencement date (as defined in subsection (d)(3)).

"(2) DEBTOR'S SHARE OF DEBTOR'S INCOME.—The gross income of the debtor for any taxable year shall not include any item to the extent that such item is included in the gross income of the estate by reason of paragraph (1).

"(3) RULE FOR MAKING DETERMINATIONS WITH RESPECT TO DEDUCTIONS, CREDITS, AND EMPLOYMENT TAXES.—Except as otherwise provided in this section, the determination of whether or not any amount paid or incurred by the estate—

"(A) is allowable as a deduction or credit under this chapter, or

"(B) is wages for purposes of subtitle C,

shall be made as if the amount were paid or incurred by the debtor and as if the debtor were still engaged in the trades and businesses and in the activities, the debtor was engaged in before the commencement of the case.

"(f) TREATMENT OF TRANSFERS BETWEEN DEBTOR AND ESTATE.—

"(1) TRANSFER TO ESTATE NOT TREATED AS DISPOSITION.—A transfer (other than by sale or exchange) of an asset from the debtor to the estate shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition, and the estate shall be treated as the debtor would be treated with respect to such asset.

"(2) TRANSFER FROM ESTATE TO DEBTOR NOT TREATED AS DISPOSITION.—In the case of a termination of the estate, a transfer (other than by sale or exchange) of an asset from the estate to the debtor shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition, and the debtor shall be treated as the estate would be treated with respect to such asset.

"(g) ESTATE SUCCEEDS TO TAX ATTRIBUTES OF DEBTOR.—The estate shall succeed to and take into account the following items (determined as of the first day of the debtor's taxable year in which the case commences) of the debtor—

"(1) NET OPERATING LOSS CARRYOVERS.—The net operating loss carryovers determined under section 172.

"(2) CHARITABLE CONTRIBUTIONS CARRYOVERS.—The carryover of excess charitable contributions determined under section 170(d)(1).

"(3) RECOVERY EXCLUSION.—Any recovery exclusion under section 111 (relating to recovery of bad debts, prior taxes, and delinquency amounts).

"(4) CREDIT CARRYOVERS, ETC.—The carryovers of any credit, and all other items which, but for the commencement of the case, would be required to be taken into account by the debtor with respect to any credit.

"(5) CAPITAL LOSS CARRYOVERS.—The capital loss carryover determined under section 1212.

"(6) BASIS, HOLDING PERIOD, AND CHARACTER OF ASSETS.—In the case of any assets acquired (other than by sale or exchange) by the estate from the debtor, the basis, holding period, and character it had in the hands of the debtor.

"(7) METHOD OF ACCOUNTING.—The method of accounting used by the debtor.

"(8) OTHER ATTRIBUTES.—Other tax attributes of the debtor, to the extent provided in regulations prescribed by the Secretary as necessary or appropriate to carry out the purposes of this section.

"(h) ADMINISTRATION, LIQUIDATION, AND REORGANIZATION EXPENSES; CARRYOVERS AND CARRYBACKS OF CERTAIN EXCESS EXPENSES.—

"(1) ADMINISTRATION, LIQUIDATION, AND REORGANIZATION EXPENSES.—Any administrative expense allowed under section 503 of title 11 of the United States Code, and any fee or charge assessed against the estate under chapter 123 of title 28 of the United States Code, to the extent not disallowed under any other provision of this title, shall be allowed as a deduction.

"(2) CARRYBACK AND CARRYOVER OF EXCESS ADMINISTRATIVE COSTS, ETC., TO ESTATE TAXABLE YEARS.—

"(A) DEDUCTION ALLOWED.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (i) the administrative expense carryovers to such year, plus (ii) the administrative expense carrybacks to such year.

"(B) ADMINISTRATIVE EXPENSE LOSS, ETC.—If a net operating loss would be created or increased for any estate taxable year if section 172(c) were applied without the modification contained in paragraph (4) of section 172(d), then the amount of the net operating loss so created (or the

amount of the increase in the net operating loss) shall be an administrative expense loss for such taxable year which shall be an administrative expense carryback to each of the 3 preceding taxable years and an administrative expense carryover to each of the 7 succeeding taxable years.

"(C) DETERMINATION OF AMOUNT CARRIED TO EACH TAXABLE YEAR.—The portion of any administrative expense loss which may be carried to any other taxable year shall be determined under section 172(b)(2), except that for each taxable year the computation under section 172(b)(2) with respect to the net operating loss shall be made before the computation under this paragraph.

"(D) ADMINISTRATIVE EXPENSE DEDUCTIONS ALLOWED ONLY TO ESTATE.—The deductions allowable under this chapter solely by reason of paragraph (1), and the deduction provided by subparagraph (A) of this paragraph, shall be allowable only to the estate.

"(i) DEBTOR SUCCEEDS TO TAX ATTRIBUTES OF ESTATE.—In the case of a termination of an estate, the debtor shall succeed to and take into account the items referred to in paragraphs (1), (2), (3), (4), (5), and (6) of subsection (g) in a manner similar to that provided in such paragraphs (but taking into account that the transfer is from the estate to the debtor instead of from the debtor to the estate). In addition, the debtor shall succeed to and take into account the other tax attributes of the estate, to the extent provided in regulations prescribed by the Secretary as necessary or appropriate to carry out the purposes of this section.

"(j) OTHER SPECIAL RULES.—

"(1) CHANGE OF ACCOUNTING PERIOD WITHOUT APPROVAL.—Notwithstanding section 442, the estate may change its annual accounting period one time without the approval of the Secretary.

"(2) TREATMENT OF CERTAIN CARRYBACKS.—

"(A) CARRYBACKS FROM ESTATE.—If any carryback year of the estate is a taxable year before the estate's first taxable year, the carryback to such carryback year shall be taken into account for the debtor's taxable year corresponding to the carryback year.

"(B) CARRYBACKS FROM DEBTOR'S ACTIVITIES.—The debtor may not carry back to a taxable year before the debtor's taxable year in which the case commences any carryback from a taxable year ending after the case commences.

"(C) CARRYBACK AND CARRYBACK YEAR DEFINED.—For purposes of this paragraph—

"(i) CARRYBACK.—The term 'carryback' means a net operating loss carryback under section 172 or a carryback of any credit provided by part IV of subchapter A.

"(ii) CARRYBACK YEAR.—The term 'carryback year' means the taxable year to which a carryback is carried.

"SEC. 1399. NO SEPARATE TAXABLE ENTITIES FOR PARTNERSHIPS, CORPORATIONS, ETC.

"Except in any case to which section 1398 applies, no separate taxable entity shall result from the commencement of a case under title 11 of the United States Code."

(2) CLERICAL AMENDMENT.—The table of subchapters for chapter 1 is amended by adding at the end thereof the following new item:

"SUBCHAPTER V. Title 11 cases."

(b) RETURN REQUIREMENTS.—

(1) Subsection (a) of section 6012 (relating to persons required to make returns of income) is amended by adding at the end thereof the following new paragraph:

"(9) Every estate of an individual under chapter 7 or 11 of title 11 of the United States Code (relating to bankruptcy) the gross income of which for the taxable year is $2,700 or more."

(2) Paragraph (4) of section 6012(b) (relating to returns of estates and trusts) is amended by striking out "an estate or a trust" and inserting in lieu thereof "an estate, a trust, or an estate of an individual under chapter 7 or 11 of title 11 of the United States Code".

(c) DISCLOSURE OF RETURNS.—

(1) Subsection (e) of section 6103 (relating to confidentiality and disclosure of returns and return information) is amended by striking out paragraph (4), by redesignating paragraphs (5) and (6) as paragraphs (6) and (7), respectively, and by inserting after paragraph (3) the following new paragraphs:

"(4) TITLE 11 CASES AND RECEIVERSHIP PROCEEDINGS.—If—

"(A) there is a trustee in a title 11 case in which the debtor is the person with respect to whom the return is filed, or

"(B) substantially all of the property of the person with respect to whom the return is filed is in the hands of a receiver,

such return or returns for prior years of such person shall, upon written request, be open to inspection by or disclosure to such trustee or receiver, but only if the Secretary finds that such trustee or receiver, in his fiduciary capacity, has a material interest which will be affected by information contained therein.

"(5) INDIVIDUAL'S TITLE 11 CASE.—

"(A) IN GENERAL.—In any case to which section 1398 applies (determined without regard to section 1398(b)(1)), any return of the debtor for the taxable year in which the case commenced or any preceding taxable year shall, upon written request, be open to inspection by or disclosure to the trustee in such case.

"(B) RETURN OF ESTATE AVAILABLE TO DEBTOR.—Any return of an estate in a case to which section 1398 applies shall, upon written request, be open to inspection by or disclosure to the debtor in such case.

"(C) SPECIAL RULE FOR INVOLUNTARY CASES.—In an involuntary case, no disclosure shall be made under subparagraph (A) until the order for relief has been entered by the court having jurisdiction of such case unless such court finds that such disclosure is appropriate for purposes of determining whether an order for relief should be entered."

(2) Paragraph (6) of section 6103 (e) (as redesignated by paragraph (1)) is amended by striking out "or (4)" and inserting in lieu thereof "(4), or (5)".

(d) TECHNICAL AMENDMENT.—Subsection (e) of section 443 (relating to cross references) is amended by adding at the end thereof the following new sentence:

"For returns for a period of less than 12 months in the case of a debtor's election to terminate a taxable year, see section 1398(d)(3)(E)."

SEC. 4. CORPORATE REORGANIZATION PROVISIONS.

(a) CERTAIN TRANSFERS IN TITLE 11 OR SIMILAR CASES TO BE INCLUDED IN DEFINITION OF REORGANIZATION.—Paragraph (1) of section 368(a) (defining reorganization) is amended by adding at the end thereof the following new subparagraph:

"(G) a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356."

(b) ADDITIONAL RULES FOR COORDINATING TITLE 11 AND SIMILAR CASES WITH THE GENERAL REORGANIZATION RULES.—Section 368(a) is amended by adding at the end thereof the following new paragraph:

"(3) ADDITIONAL RULES RELATING TO TITLE 11 AND SIMILAR CASES.—

"(A) TITLE 11 OR SIMILAR CASE DEFINED.—For purposes of this part, the term 'title 11 or similar case' means—

"(i) a case under title 11 of the United States Code, or

"(ii) a receivership, foreclosure, or similar proceeding in a Federal or State court.

"(B) TRANSFER OF ASSETS IN A TITLE 11 OR SIMILAR CASE.—In applying paragraph (1)(G), a transfer of the assets of a corporation shall be treated as made in a title 11 or similar case if and only if—

"(i) such corporation is under the jurisdiction of the court in such case, and

"(ii) the transfer is pursuant to a plan of reorganization approved by the court.

"(C) REORGANIZATION QUALIFYING UNDER PARAGRAPH (1)(G) AND ANOTHER PROVISION.—If a transaction would (but for this subparagraph) qualify both—

"(i) under subparagraph (G) of paragraph (1), and

"(ii) under any other subparagraph of paragraph (1) or under section 332 or 351,

then, for purposes of this subchapter (other than section 357(c)(1)), such transaction shall be treated as qualifying only under subparagraph (G) of paragraph (1).

"(D) AGENCY RECEIVERSHIP PROCEEDINGS WHICH INVOLVE FINANCIAL INSTITUTIONS.—For purposes of subparagraphs (A) and (B), in the case of a receivership, foreclosure, or similar proceeding before a Federal or State agency involving a financial institution to which section 585 or 593 applies, the agency shall be treated as a court.

"(E) APPLICATION OF PARAGRAPH (2)(E)(ii).—In the case of a title 11 or similar case, the requirement of clause (ii) of paragraph (2)(E) shall be treated as met if—

"(i) no former shareholder of the surviving corporation received any consideration for his stock, and

"(ii) the former creditors of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, debt of the surviving corporation which had a fair market value equal to 80 percent or more of the total fair market value of the debt of the surviving corporation."

(c) TRANSFERS OF ASSETS TO SUBSIDIARIES.—Subparagraph (C) of section 368(a)(2) (relating to transfers of assets or stock of subsidiaries in certain paragraph (1)(A), (1)(B), and (1)(C) cases) is amended to read as follows:

"(C) TRANSFERS OF ASSETS OR STOCK TO SUBSIDIARIES IN CERTAIN PARAGRAPH (1)(A), (1)(B), (1)(C), AND (1)(G) CASES.—A transaction otherwise qualifying under paragraph (1)(A), (1)(B), or (1)(C) shall not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets or stock. A similar rule shall apply to a transaction otherwise qualifying under paragraph (1)(G) where the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met with respect to the acquisition of the assets or stock."

(d) USE OF STOCK OF CONTROLLING CORPORATION.—Subparagraph (D) of section 368(a)(2) (relating to use of stock of controlling corporation in paragraph (1)(A) cases) is amended to read as follows:

"(D) USE OF STOCK OF CONTROLLING CORPORATION IN PARAGRAPH (1)(A) AND (1)(G) CASES.—The acquisition by one corporation, in exchange for stock of a corporation (referred to in this subparagraph as 'controlling corporation') which is in control of the acquiring corporation, of substantially all of the properties of another corporation shall not disqualify a transaction under paragraph (1)(A) or (1)(G) if—

"(i) no stock of the acquiring corporation is used in the transaction, and

"(ii) in the case of a transaction under paragraph (1)(A), such transaction would have qualified under paragraph (1)(A) had the merger been into the controlling corporation."

(e) TREATMENT OF PROPERTY ATTRIBUTABLE TO ACCRUED INTEREST.—

(1) AMENDMENT OF SECTION 354.—Subsection (a) of section 354 (relating to exchanges of stocks and securities in certain reorganizations) is amended by striking out paragraphs (2) and (3) and inserting in lieu thereof the following:

"(3) LIMITATIONS.—

"(A) EXCESS PRINCIPAL AMOUNT.—Paragraph (1) shall not apply if—

"(i) the principal amount of any such securities received exceeds the

principal amount of any such securities surrendered, or

"(ii) any such securities are received and no such securities are surrendered.

"(B) PROPERTY ATTRIBUTABLE TO ACCRUED INTEREST.—Neither paragraph (1) nor so much of section 356 as relates to paragraph (1) shall apply to the extent that any stock, securities, or other property received is attributable to interest which has accrued on securities on or after the beginning of the holder's holding period.

"(3) CROSS REFERENCES.—

"(A) For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered, but not including property to which paragraph (2)(B) applies), see section 356.

"(B) For treatment of accrued interest in the case of an exchange described in paragraph (2)(B), see section 61."

(2) AMENDMENT OF SECTION 355.—Subsection (a) of section 355 (relating to distribution of stock and securities of a controlled corporation) is amended by striking out paragraphs (3) and (4) and inserting in lieu thereof the following:

"(3) LIMITATIONS.—

"(A) EXCESS PRINCIPAL AMOUNT.—Paragraph (1) shall not apply if—

"(i) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

"(ii) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

"(B) STOCK ACQUIRED IN TAXABLE TRANSACTIONS WITHIN 5 YEARS TREATED AS BOOT.—For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction—

"(i) which occurs within 5 years of the distribution of such stock, and

"(ii) in which gain or loss was recognized in whole or in part,

shall not be treated as stock of such controlled corporation, but as other property.

"(C) PROPERTY ATTRIBUTABLE TO ACCRUED INTEREST.—Neither paragraph (1) nor so much of section 356 as relates to paragraph (1) shall apply to the extent that any stock, securities, or other property received is attributable to interest which has accrued on securities on or after the beginning of the holder's holding period.

"(4) CROSS REFERENCES.—

"(A) For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered, but not including property to which paragraph (3)(C) applies), see section 356.

"(B) For treatment of accrued interest in the case of an exchange described in paragraph (3)(C), see section 61."

(f) TERMINATION OF EXISTING PROVISIONS RELATING TO INSOLVENCY REORGANIZATIONS.—Part IV of subchapter C of chapter 1 (relating to insolvency reorganizations) is amended by inserting before section 371 the following new section:

"SEC. 370. TERMINATION OF PART.

"(a) GENERAL RULE.—Except as provided in subsection (b), this part shall not apply to any proceeding which is begun after September 30, 1979.

"(b) EXCEPTIONS.—Subsection (a) shall not apply to subsections (c) and (e) of section 374."

(g) CARRYOVER OF SECTION 381 ITEMS IN SECTION 368(a)(1)(G) REORGANIZATIONS.—Subsection (a) of section 381 (relating to carryovers in certain corporate acquisitions) is amended—

(1) by striking out "subparagraph (A), (C), (D) (but only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met), or (F) of section 368(a)(1)" in paragraph (2) and inserting in lieu thereof "subparagraph (A), (C), (D), (F), or (G) of section 368(a)(1)", and

(2) by adding at the end thereof the following new sentence: "For purposes of the preceding sentence, a reorganization shall be treated as meeting the requirements of subparagraph (D) or (G) of section 368(a)(1) only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met."

(h) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Paragraphs (1) and (2) of section 354(b) (relating to exception to general rule on exchanges of stock and securities in certain reorganizations) are each amended by striking out "section 368(a)(1)(D)" and inserting in lieu thereof "subparagraph (D) or (G) of section 368(a)(1)".

(2) Paragraph (2) of section 357(c) (relating to liabilities in excess of basis) is amended to read as follows:

"(2) EXCEPTIONS.—Paragraph (1) shall not apply to any exchange—

"(A) to which subsection (b)(1) of this section applies,

"(B) to which section 371 or 374 applies, or

"(C) which is pursuant to a plan of reorganization within the meaning of section 368(a)(1)(G) where no former shareholder of the transferor corporation receives any consideration for his stock."

(3) Paragraph (1) of section 368(a) (defining reorganization) is amended—

(A) by striking out "or" at the end of subparagraph (E), and

(B) by striking out the period at the end of subparagraph (F) and inserting in lieu thereof "; or".

(4) Subsection (b) of section 368 (defining party to reorganization) is amended—

(A) by striking out "or (1)(C)" in the third sentence and inserting in lieu thereof "(1)(C), or (1)(G)", and

(B) by striking out "paragraph (1)(A)" in the fourth sentence and in-

serting in lieu thereof "paragraph (1)(A) or (1)(G)".

(5) The table of sections for part IV of subchapter C of chapter 1 is amended by inserting before the item relating to section 371 the following new item:

"Sec. 370. Termination of part."

SEC. 5. MISCELLANEOUS CORPORATE AMENDMENTS.

(a) EXCEPTION FROM PERSONAL HOLDING COMPANY TAX FOR CORPORATIONS IN TITLE 11 OR SIMILAR CASES.—Subsection (c) of section 542 (relating to exceptions from definition of personal holding company) is amended by striking out the period at the end of paragraph (8) and inserting in lieu thereof "; and" and by adding at the end thereof the following new paragraph:

"(9) a corporation which is subject to the jurisdiction of the court in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) unless a major purpose of instituting or continuing such case is the avoidance of the tax imposed by section 541."

(b) REDEMPTION OF STOCK ISSUED IN RAILROAD REORGANIZATIONS.—

(1) IN GENERAL.—Subsection (b) of section 302 (relating to redemptions treated as exchanges) is amended by striking out paragraph (4) and by redesignation paragraph (5) as paragraph (4).

(2) CONFORMING AMENDMENTS.—

(A) Subsection (a) of section 302 is amended by striking out "(2), (3), or (4)" and inserting in lieu thereof "(2), or (3)".

(B) Paragraph (4) of section 302 (b) (as redesignated by paragraph (1)) is amended—

(i) by striking out "(2), (3), or (4)" and inserting in lieu thereof "(2) or (3)", and

(ii) by striking out "(1), (2), or (4)" and inserting in lieu thereof "(1) or (2)".

(c) SECTION 337 TO APPLY WHERE LIQUIDATING CORPORATION IS INSOLVENT.—Section 337 (relating to gain or loss on sales or exchanges in connection with certain liquidations) is amended by adding at the end thereof the following new subsection:

"(g) TITLE 11 OR SIMILAR CASES.—If a corporation completely liquidates pursuant to a plan of complete liquidation adopted in a title 11 or similar case (within the meaning of section 368(a)(3)(A))—

"(1) for purposes of subsection (a), the term 'property' shall not include any item acquired on or after the date of the adoption of the plan of liquidation if such item is not property within the meaning of subsection (b)(2), and

"(2) subsection (a) shall apply to sales and exchanges by the corporation of property within the period beginning on the date of the adoption of the plan and ending on the date of the termination of the case."

(d) ESTATE OF INDIVIDUAL IN TITLE 11 CASE PERMITTED TO BE SHAREHOLDER OF SUBCHAPTER S CORPORATION.—Section 1371 (defining small business corporation) is amended by adding at the end thereof the following new subsection:

"(f) ESTATE OF INDIVIDUAL IN TITLE 11 CASE MAY BE SHAREHOLDER.—For purposes of subsection (a)(2), the term 'estate' includes the estate of an individual in a case under title 11 of the United States Code."

(e) AMENDMENTS OF SECTION 351.—

(1) Section 351 (relating to transfer to corporation controlled by transferor) is amended by redesignating subsection (e) as subsection (f) and by striking out subsection (d) and inserting in lieu thereof the following new subsections:

"(d) SERVICES, CERTAIN INDEBTEDNESS, AND ACCRUED INTEREST NOT TREATED AS PROPERTY.—For purposes of this section, stock or securities issued for—

"(1) services,

"(2) indebtedness of the transferee corporation which is not evidenced by a security, or

"(3) interest on indebtedness of the transferee corporation which accrued on or after the beginning of the transferor's holding period for the debt,

shall not be considered as issued in return for property.

"(e) EXCEPTIONS. — This section shall not apply to—

"(1) TRANSFER OF PROPERTY TO AN INVESTMENT COMPANY.—A transfer of property to an investment company.

"(2) TITLE 11 OR SIMILAR CASE.—A transfer of property of a debtor pursuant to a plan while the debtor is under the jurisdiction of a court in a title 11 or similar case (within the meaning of section 368(a)(3)(A)), to the extent that the stock or securities received in the exchange are used to satisfy the indebtedness of such debtor."

(2) Subsection (a) of section 351 is amended by striking out the last sentence.

(f) EFFECT ON EARNINGS AND PROFITS.—Section 312 (relating to effect on earnings and profits) is amended by adding at the end thereof the following new subsection:

"(l) DISCHARGE OF INDEBTEDNESS INCOME.—

"(1) DOES NOT INCREASE EARNINGS AND PROFITS IF APPLIED TO REDUCE BASIS.—The earnings and profits of a corporation shall not include income from the discharge of indebtedness to the extent of the amount applied to reduce basis under section 1017.

"(2) REDUCTION OF DEFICIT IN EARNINGS AND PROFITS IN CERTAIN CASES.—If—

"(A) the interest of any shareholder of a corporation is terminated or extinguished in a title 11 or similar case (within the meaning of section 368(a)(3)(A)), and

"(B) there is a deficit in the earnings and profits of the corporation,

then such deficit shall be reduced by an amount equal to the paid-in capital which is allocable to the interest of the shareholder which is so terminated or extinguished."

SEC. 6. CHANGES IN TAX PROCEDURES.

(a) SUSPENSION OF RUNNING OF PERIOD OF LIMITATIONS DURING TITLE 11 CASES.—Section 6503 (relating to suspension of running of period of lim-

itation) is amended by redesignating subsection (i) as subsection (j) and by inserting after subsection (h) the following new subsection:

"(i) CASES UNDER TITLE 11 OF THE UNITED STATES CODE.—The running of the period of limitations provided in section 6501 or 6502 on the making of assessments or collection shall, in a case under title 11 of the United States Code, be suspended for the period during which the Secretary is prohibited by reason of such care from making the assessment or from collecting and—

"(1) for assessment, 60 days thereafter, and

"(2) for collection, 6 months thereafter."

(b) COORDINATION OF DEFICIENCY PROCEDURES WITH TITLE 11 CASES.—

(1) IN GENERAL.—Section 6213 (relating to restrictions applicable to deficiencies; petition to Tax Court) is amended by redesignating subsections (f) and (g) as subsections (g) and (h), respectively, and by inserting after subsection (e) the folllowing new subsection:

"(f) COORDINATION WITH TITLE 11.—

"(1) SUSPENSION OF RUNNING OF PERIOD FOR FILING PETITION IN TITLE 11 CASES.—In any case under title 11 of the United States Code, the running of the time prescribed by subsection (a) for filing a petition in the Tax Court with respect to any deficiency shall be suspended for the period during which the debtor is prohibited by reason of such case from filing a petition in the Tax Court with respect to such deficiency, and for 60 days thereafter.

"(2) CERTAIN ACTION NOT TAKEN INTO ACCOUNT.—For purposes of the second and third sentences of subsection (a), the filing of a proof of claim or request for payment (or the taking of any other action) in a case under title 11 of the United States Code shall not be treated as action prohibited by such second sentence."

(2) CLERICAL AMENDMENT.—Subsection (d) of section 6404 (relating to abatements) is amended by striking out "section 6213(f)(2)(A)" and inserting in lieu thereof "section 6213(g)(2)(A)".

(c) TRUSTEE OF DEBTOR'S ESTATE MAY INTERVENE IN TAX COURT PROCEEDING.—

(1) IN GENERAL.—Part II of subchapter C of chapter 76 (relating to Tax Court procedure) is amended by redesignating section 7464 as section 7465 and by inserting after section 7463 the following new section:

"SEC. 7464. INTERVENTION BY TRUSTEE OF DEBTOR'S ESTATE.

"The trustee of the debtor's estate in any case under title 11 of the United States Code may intervene, on behalf of the debtor's estate, in any proceeding before the Tax Court to which the debtor is a party."

(2) CLERICAL AMENDMENT.—The table of sections for part II of subchapter C of chapter 76 is amended by striking out the item relating to section 7464 and by inserting in lieu thereof the following:

"Sec. 7464. Intervention by trustee of debtor's estate.

"Sec. 7465. Provisions of special application to transferees."

(d) CROSS REFERENCES TO TAX DETERMINATIONS IN TITLE 11 CASES.—

(1) AMENDMENT OF SECTION 7430.—Section 7430 (relating to cross references) is amended by striking out paragraphs (1), (2), (3), and (4) and inserting in lieu thereof the following new paragraph:

"(1) For determination of amount of any tax, additions to tax, etc., in title 11 cases, see section 505 of title 11 of the United States Code."

(2) AMENDMENT OF SECTION 6212.—Paragraph (2) of section 6212(c) (relating to cross references) is amended by adding at the end thereof the following new sentence:

"For provisions allowing determination of tax in title 11 cases, see section 505(a) of title 11 of the United States Code."

(3) AMENDMENT OF SECTION 6512.—Section 6512 (relating to limitations in case of petition to Tax Court) is amended by adding at the end thereof the following new subsection:

(c) CROSS REFERENCE.—

"For provisions allowing determination of tax in title 11 cases, see section 505(a) of title 11 of the United States Code."

(4) AMENDMENT OF SECTION 6532.—Subsection (a) of section 6532 (relating to periods of limitations on suits) is amended by adding at the end thereof the following new paragraph:

"(5) CROSS REFERENCE.—

"For substitution of 120-day period for the 6-month period contained in paragraph (1) in a title 11 case, see section 505(a)(2) of title 11 of the United States Code."

(e) RELIEF FROM CERTAIN PENALTIES IN TITLE 11 CASES.—

(1) IN GENERAL.—Subchapter A of chapter 68 (relating to additions to the tax and additional amounts) is amended by inserting after section 6657 the following new section:

"SEC. 6658. COORDINATION WITH TITLE 11.

(a) CERTAIN FAILURES TO PAY TAX.—No addition to the tax shall be made under section 6651, 6654, or 6655 for failure to make timely payment of tax with respect to a period during which a case is pending under title 11 of the United States Code—

"(1) if such tax was incurred by the estate and the failure occurred pursuant to an order of the court finding probable insufficiency of funds of the estate to pay administrative expenses, or

"(2) if—

"(A) such tax was incurred by the debtor before the earlier of the order for relief or (in the involuntary case) the appointment of a trustee, and

"(B)(i) the petition was filed before the due date prescribed by law (including extensions) for filing a return of such tax, or

"(ii) the date for making the addition to the tax occurs on or after the day on which the petition was filed.

"(b) EXCEPTION FOR COLLECTED TAXES.—Subsection (a) shall not

apply to any liability for an addition to the tax which arises from the failure to pay or deposit a tax withheld or collected from others and required to be paid to the United States."

(2) CLERICAL AMENDMENT.—The table of sections for subchapter A of chapter 68 is amended by inserting after the item relating to section 6657 the following:

"Sec. 6658. Coordination with title 11."

(f) CREDIT AGAINST FEDERAL UNEMPLOYMENT TAX NOT REDUCED IN CERTAIN CASES.—Subsection (a) of section 3302 (relating to credits against unemployment tax) is amended by adding at the end thereof the following new paragraph:

"(5) In the case of wages paid by the trustee of an estate under title 11 of the United States Code, if the failure to pay contributions on time was without fault by the trustee, paragraph (3) shall be applied by substituting '100 percent' for '90 percent'."

(g) REMOVAL OF PROVISION FOR IMMEDIATE ASSESSMENT IN CERTAIN TITLE 11 CASES.—

(1) IN GENERAL.—Section 6871 (relating to claims for income, estate, and gift taxes in bankruptcy and receivership proceedings) is amended to read as follows:

"SEC. 6871. CLAIMS FOR INCOME, ESTATE, GIFT, AND CERTAIN EXCISE TAXES IN RECEIVERSHIP PROCEEDINGS, ETC.

"(a) IMMEDIATE ASSESSMENT IN RECEIVERSHIP PROCEEDINGS.—On the appointment of a receiver for the taxpayer in any receivership proceeding before any court of the United States or any State or of the District of Columbia, any deficiency (together with all interest, additional amounts, and additions to the tax provided by law) determined by the Secretary in respect of a tax imposed by subtitle A or B or by chapter 41, 42, 43, 44, or 45 on such taxpayer may, despite the restrictions imposed by section 6213 (a) on assessments, be immediately assessed if such deficiency has not theretofore been assessed in accordance with law.

"(b) IMMEDIATE ASSESSMENT WITH RESPECT TO CERTAIN TITLE 11 CASES.—Any deficiency (together with all interest, additional amounts, and additions to the tax provided by law) determined by the Secretary in respect of a tax imposed by subtitle A or B or by chapter 41, 42, 43, 44, or 45 on—

"(1) the debtor's estate in a case under title 11 of the United States Code, or

"(2) the debtor, but only if liability for such tax has become res judicata pursuant to a determination in a case under title 11 of the United States Code,

may, despite the restrictions imposed by section 6213(a) on assessments, be immediately assessed if such deficiency has not theretofore been assessed in accordance with law.

"(c) CLAIM FILED DESPITE PENDENCY OF TAX COURT PROCEEDINGS.—In the case of a tax imposed by subtitle A or B or by chapter 41, 42, 43, 44, or 45—

"(1) claims for the deficiency and for interest, additional amounts, and additions to the tax may be presented, for adjudication in accordance with law, to the court before which the receivership proceeding (or the case under title 11 of the United States Code) is pending, despite the pendency of proceedings for the redetermination of the deficiency pursuant to a petition to the Tax Court; but

"(2) in the case of a receivership proceeding, no petition for any such redetermination shall be filed with the Tax Court after the appointment of the receiver."

(2) AMENDMENT OF SECTION 6873.—Subsection (a) of section 6783 (relating to unpaid claims) is amended by striking out "or any proceeding under the Bankruptcy Act".

(3) CLERICAL AMENDMENTS.—

(A) The table of sections for subchapter B of chapter 70 is amended by striking out the item relating to section 6871 and inserting in lieu thereof the following:

"Sec. 6871. Claims for income, estate, gift, and certain excise taxes in receivership proceedings, etc."

(B) The heading of subchapter B of chapter 70 is amended to read as follows:

"Subchapter B—Receiverships, Etc."

(C) The item relating to subchapter B in the table of subchapters for chapter 70 is amended to read as follows:

"SUBCHAPTER B. Receiverships, etc."

(D) The heading of chapter 70 is amended to read as follows:

"CHAPTER 70—JEOPARDY, RECEIVERSHIPS, ETC."

(E) The item relating to chapter 70 in the table of chapters for subtitle F is amended to read as follows:

"CHAPTER 70. Jeopardy, receiverships, etc."

(h) REPEAL OF SECTION 1018.—

(1) IN GENERAL.—Section 1018 (relating to adjustment of capital structure before September 22, 1938) is hereby repealed.

(2) CLERICAL AMENDMENT.—The table of sections for part II of subchapter O of chapter 1 is amended by striking out the item relating to section 1018.

(i) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Subsection (a) of section 128 (relating to cross references) is amended by striking out paragraph (1) and by redesignating paragraphs (2) through (9) as paragraphs (1) through (8), respectively.

(2) Subsection (c) of section 354 (relating to certain railroad reorganizations) is amended by striking out "approved by the Interstate Commerce Commission under section 77 of the Bankruptcy Act, or" and inserting in lieu thereof "confirmed under section 1173 of title 11 of the United States Code, or approved by the Interstate Commerce Commission".

(3) Paragraph (5) of section 422 (c) (relating to certain transfers by insolvent individuals) is amended by

striking out "under the Bankruptcy Act" and inserting in lieu thereof "under title 11 of the United States Code".

(4) Section 1023 (relating to cross references) is amended by striking out paragraph (2) and by redesignating paragraph (3) as paragraph (2).

(5) Paragraph (3) of section 6012 (b) (relating to receivers, trustees, and assignees for corporations) is amended by striking out "trustee in bankruptcy" and inserting in lieu thereof "trustee in a case under title 11 of the United States Code".

(6) Section 6036 (relating to notice of qualification as executor or receiver) is amended by striking out "trustee in bankruptcy" and inserting in lieu thereof "trustee in a case under title 11 of the United States Code".

(7) Paragraph (2) of section 6155 (b) (relating to cross references) is amended by striking out "bankruptcy or".

(8) Subsection (c) of section 6161 (relating to claims in bankruptcy or receivership proceedings) is amended—

(A) by striking out "in bankruptcy or receivership proceedings" and inserting in lieu thereof "in cases under title 11 of the United States Code or in receivership proceedings", and

(B) by striking out "BANKRUPTCY OR RECEIVERSHIP PROCEEDINGS" in the subsection heading and inserting in lieu thereof "CASES UNDER TITLE 11 OF THE UNITED STATES CODE OR IN RECEIVERSHIP PROCEEDINGS".

(9) Paragraph (1) of section 6216 (relating to cross references) is amended to read as follows:

"(1) For procedures relating to receivership proceedings, see subchapter B of chapter 70."

(10)(A) Section 6326 (relating to cross references) is amended by striking out paragraphs (2), (3), (4), and (5) and inserting in lieu thereof the following:

"(2) For exclusion of tax liability from discharge in cases under title 11 of the United States Code, see section 523 of such title 11.

"(3) For recognition of tax liens in cases under title 11 of the United States Code, see sections 545 and 724 of such title 11.

"(4) For collection of taxes in connection with plans for individuals with regular income in cases under title 11 of the United States Code, see section 1328 of such title 11."

(B) Section 6326 is amended by redesignating paragraphs (6) and (7) as paragraphs (5) and (6), respectively.

(11) Paragraph (2) of section 6503(i) (relating to cross references) is amended to read as follows:

"(2) Receiverships, see subchapter B of chapter 70."

(12) Section 6872 (relating to suspension period on assessment) is amended by striking out "any proceeding under the Bankruptcy Act" and by inserting in lieu thereof "any cases under title 11 of the United States Code".

(13) Section 7430 (as amended by this Act) is amended by inserting after paragraph (1) the following new paragraphs:

"(2) For exclusion of tax liability from discharge in cases under title 11 of the United States Code, see section 523 of such title 11.

"(3) For recognition of tax liens in cases under title 11 of the United States Code, see sections 545 and 724 of such title 11.

"(4) For collection of taxes in connection with plans for individuals with regular income in cases under title 11 of the United States Code, see section 1328 of such title 11."

(14) Paragraph (1) of section 7508(d) is amended by striking out "BANKRUPTCY AND RECEIVERSHIPS" in the paragraph heading and inserting in lieu thereof "CASES UNDER TITLE 11 OF THE UNITED STATES CODE AND RECEIVERSHIPS".

SEC. 7. EFFECTIVE DATES.

(a) For section 2 (Relating to Tax Treatment of Discharge of Indebtedness).—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by section 2 shall apply to any transaction which occurs after December 31, 1980, other than a transaction which occurs in a proceeding in a bankruptcy case or similar judicial proceeding (or in a proceeding under the Bankruptcy Act) commencing on or before December 31, 1980.

(2) TRANSITIONAL RULE.—In the case of any discharge of indebtedness to which subparagraph (A) or (B) of section 108(a)(1) of the Internal Revenue Code of 1954 (relating to exclusion from gross income), as amended by section 2, applies and which occurs before January 1, 1982, or which occurs in a proceeding in a bankruptcy case or similar judicial proceedings commencing before January 1, 1982, then—

(A) section 108(b)(2) of such Code (relating to reduction of tax attributes), as so amended, shall be applied without regard to subparagraphs (A), (B), (C), and (E) thereof, and (B) the basis of any property shall not be reduced under section 1017 of such Code (relating to reduction in basis in connection with discharges of indebtedness), as so amended, below the fair market value of such property on the date the debt is discharged.

(b) FOR SECTION 3 (RELATING TO RULES RELATING TO TITLE 11 CASES FOR INDIVIDUALS).—The amendments made by section 3 shall apply to any bankruptcy case commencing more than 90 days after the date of the enactment of this Act.

(c) FOR SECTION 4 (RELATING TO CORPORATE REORGANIZATION PROVISIONS).—

(1) IN GENERAL.—The amendments made by section 4 shall apply to any bankruptcy case or similar judicial proceeding commencing after December 31, 1980.

(2) EXCHANGES OF PROPERTY FOR ACCRUED INTEREST.—The amendments made by subsection (e) of section 4 (relating to treatment of property attributable to accrued interest) shall also apply to any exchange—

(A) which occurs after December 31, 1980, and

(B) which does not occur in a

bankruptcy case or similar judicial proceeding (or in a proceeding under the Bankruptcy Act) commenced on or before December 31, 1980.

(d) FOR SECTION 5 (RELATING TO MISCELLANEOUS CORPORATE AMENDMENTS).—

(1) FOR SUBSECTION (a) (RELATING TO EXEMPTION FROM PERSONAL HOLDING COMPANY TAX). — The amendments made by subsection (a) of section 5 shall apply to any bankruptcy case or similar judicial proceeding commenced after December 31, 1980.

(2) FOR SUBSECTION (b) (RELATING TO REPEAL OF SPECIAL TREATMENT FOR CERTAIN RAILROAD REDEMPTIONS). —The amendments made by subsection (b) of section 5 shall apply to stock which is issued after December 31, 1980 (other than stock issued pursuant to a plan of reorganization approved on or before that date).

(3) FOR SUBSECTION (c) (RELATING TO APPLICATION OF 12-MONTH LIQUIDATION RULE).—The amendment made by subsection (c) of section 5 shall apply to any bankruptcy case or similar judicial proceeding commenced after December 31, 1980.

(4) FOR SUBSECTION (d) (RELATING TO PERMITTING BANKRUPTCY ESTATE TO BE SUBCHAPTER S SHAREHOLDER).—The amendment made by subsection (d) of section 5 shall apply to any bankruptcy case commenced on or after October 1, 1979.

(5) FOR SUBSECTION (e) (RELATING TO CERTAIN TRANSFERS TO CONTROLLED CORPORATIONS). — The amendments in subsection (a) of this section.

(6) FOR SUBSECTION (f) (RELATING TO EFFECT OF DEBT DISCHARGE ON EARNINGS AND PROFITS). — The amendment made by subsection (f) of section 5 shall apply as provided in subsection (a) of this section.

(e) FOR SECTION 6 (RELATING TO CHANGES IN TAX PROCEDURES).— The amendments made by section 6 shall take effect on October 1, 1979, but shall not apply to any proceeding under the Bankruptcy Act commenced before October 1, 1979.

(f) ELECTION TO SUBSTITUTE SEPTEMBER 30, 1979, FOR DECEMBER 31, 1980.—

(1) IN GENERAL.—The debtor (or debtors) in a bankruptcy case or similar judicial proceeding may (with the approval of the court) elect to apply subsections (a), (c), and (d) by substituting "September 30, 1979" for "December 31, 1980" each place it appears in such subsections.

(2) EFFECT OF ELECTION.—Any election made under paragraph (1) with respect to any proceeding shall apply to all parties to the proceeding.

(3) REVOCATION ONLY WITH CONSENT.—Any election under this subsection may be revoked only with the consent of the Secretary of the Treasury or his delegate.

(4) TIME AND MANNER OF ELECTION.—Any election under this subsection shall be made at such time, and in such manner, as the Secretary of the Treasury or his delegate may by regulations prescribe.

(g) DEFINITIONS.—For purposes of this section—

(1) BANKRUPTCY CASE.—The term "bankruptcy case" means any case under title 11 of the United States Code (as recodified by Public Law 95-598).

(2) SIMILAR JUDICIAL PROCEEDING. —The term "similar judicial proceeding" means a receivership, foreclosure, or similar proceeding in a Federal or State court (as modified by section 368(a)(3)(D) of the Internal Revenue Code of 1954).

Approved December 24, 1980

Senate Report No. 96-1035 2d Session

[Bracketed numerals indicate official report page numbers]

BANKRUPTCY TAX ACT OF 1980

NOVEMBER 25 (legislative day, NOVEMBER 20), 1980.

Mr. LONG, from the Committee on Finance, submitted the following report to accompany H.R. 5043.[1]

The Committee on Finance, to which was referred the act (H.R. 5043) to amend the Internal Revenue Code of 1954 to provide for the tax treatment of bankruptcy, insolvency, and similar proceedings, and for other purposes, having considered the same, reports favorably thereon with amendments and recommends that the act as amended do pass.

The amendments are shown in the text of the bill in linetype and italic.

[2] I. SUMMARY

A. Tax Treatment of Discharge of Indebtedness

In Public Law 95-598, Congress repealed provisions of the Bankruptcy Act governing Federal income tax treatment of a discharge of indebtedness in bankruptcy, effective for cases instituted on or after October 1, 1979. The bill provides tax rules in the Internal Revenue Code applicable to debt discharge in the case of bankrupt or insolvent debtors, and makes related changes to existing Code provisions applicable to debt discharge in the case of solvent debtors outside bankruptcy.

Bankruptcy or insolvency

Under the bill, no amount is to be included in income for Federal income tax purposes by reason of a discharge of indebtedness in a bankruptcy case, or outside bankruptcy if the debtor is insolvent. Instead, the amount of discharged debt which is excluded from gross income by virtue of the bill's provisions (the "debt discharge amount") is applied to reduce certain tax attributes.

Unless the taxpayer elects first to reduce basis in depreciable assets (or in real property held primarily for sale customers in the ordinary course of a trade or business), the debt discharge amount is applied to reduce the taxpayer's net operating losses and then

[1] Public Law 96-589, page 607.

certain tax credits and capital loss carryovers. Any excess of the debt discharge amount over the amount of reduction in these attributes is applied to reduce asset basis (but not below the amount of the taxpayer's remaining undischarged liabilities) and then to reduce carryovers of the foreign tax credit. Any further remaining debt discharge amount is disregarded, i.e., does not result in income or have other tax consequences.

The bill provides that the taxpayer can elect to apply the debt discharge amount first to reduce basis in depreciable property (or in realty held as inventory), before applying any remaining amount to reduce net operating losses and then other tax attributes in the order stated in the bill. A debtor making this election can elect to reduce basis in depreciable property (or in realty held as inventory) below the amount of remaining liabilities (i.e., where the debtor would rather so reduce asset basis than reduce carryovers).

To the extent the debtor makes an election to reduce basis in depreciable assets, or reduces basis in assets after reduction in other tax attributes, it is anticipated that Treasury regulations prescribing the order of basis reduction among assets will generally accord with present Treasury regulations which apply in the case of basis reduction under section 270 of the (now repealed) Bankruptcy Act. If the debtor elects to reduce basis in realty held as inventory, the particular real properties the bases of which are to be reduced will be determined pursuant to Treasury regulations.

To insure that ordinary income treatment eventually will be given to the full amount of basis reduction in depreciable or nondepreciable [3] assets, the bill provides that any gain on a subsequent disposition of reduced-basis assets is subject to "recapture" under sections 1245 or 1250 of the Internal Revenue Code.

Outside bankruptcy—solvent taxpayers

The bill modifies the existing Federal income tax election (Code secs. 108 and 1017) under which a solvent taxpayer outside bankruptcy can elect to reduce basis of assets instead of recognizing current income from debt cancellation. As with the rules of the bill applicable to bankrupt or insolvent debtors, the bill provides that the election to reduce basis allowed to solvent debtors outside bankruptcy requires reduction in basis of depreciable assets (or in realty held as inventory).

To the extent that the debtor makes an election to reduce basis, it is anticipated that Treasury regulations prescribing the order of basis reduction among the taxpayer's depreciable assets will generally accord with present Treasury regulations under section 1017 of the Code. If the debtor elects to reduce basis in realty held as inventory, the particular real properties the bases of which are to be reduced will be determined pursuant to Treasury regulations. As in the case of bankrupt or insolvent debtors, the bill provides that any gain on a subsequent disposition of reduced-basis assets is subject to "recapture" under Code sections 1245 or 1250.

The bill also provides that in the case of a solvent taxpayer outside bankruptcy, a reduction to the purchaser in the amount of a purchase-money debt, by the seller of the property, is treated for Federal income tax purposes as a purchase price reduction and not as a discharge of indebtedness.

Equity-for-debt rules

The committee bill generally does not change the present law rule developed by the courts governing whether income is recognized if a corporation issues its own stock to its creditor for oustanding debt (whether or not the debt constitutes a security for tax purposes). Therefore, no attribute reduction generally will be required where such stock is issued to discharge the debt, except where only a *de minimis* amount of stock is issued.

By contrast, the bill as passed by the House would have provided that if a corporate debtor issues stock in cancellation of short-term debt or trade credit, the debt discharge rules of the bill would apply to the extent the indebtedness exceeds the value of the stock. It is anticipated that by providing for favorable tax treatment if stock is issued to creditors in discharge of debt, the committee bill will encourage reorganization, rather than liquidation, of financially distressed companies that have a potential for surviving as operating concerns.

Because the committee bill generally retains the present law rules governing the tax treatment of debt discharge when a corporation's indebtedness is satisfied with its own stock, the committee bill also retains the present rules of Code section 382(a) relating to special limitations on net operating loss carryover on certain acquisitions of stock of a corporation. Under the House bill, the section 382(a) limitations generally would not have applied to the extent creditors received stock in exchange for their claims.

[4] A creditor who receives stock in cancellation of debt can take a bad debt reduction to the same extent as under present law. In order properly to match the character of the gain derived on sale of such stock with its origin, the committee bill provides that any gain on a later sale of the stock by the former creditor will be "recaptured" as ordinary income up to the amount of the creditor's prior deductions against ordinary income.

The bill also provides that the debt discharge rules apply to the extent that the amount of debt transferred by a shareholder to a corporation as a contribution to capital exceeds the shareholder's basis in the debt.

Other rules concerning debt discharge

In addition, other rules in the bill concerning debt discharge relate to debt acquired by a related party, discharge of liabilities payment of which would have given rise to deductions, the tax benefit rule under Code section 111, and discharge of a partnership debt. Also, the bill provides (overturning a contrary position of the Internal Revenue Service) that if the basis of investment credit property is reduced by a debt discharge amount,

no investment credit recapture will occur by reason of the reduction.

Effective date

The provisions of the bill relating to tax treatment of debt discharge apply for bankruptcy cases (or receivership, foreclosure, or similar judicial proceedings) commenced after December 31, 1980. In the case of discharge of indebtedness outside bankruptcy cases (or receivership, etc. proceedings), the debt discharge rules of the bill apply to any discharge of indebtedness occurring after December 31, 1980.

The bill also provides an effective date election for debtors in bankruptcy cases commenced on or after October 1, 1979 (but prior to January 1, 1981), and for debtors in receivership, foreclosure, or similar judicial proceedings commenced on or after October 1, 1979 (but prior to January 1, 1981). The debtor is such a case or proceeding can elect to have all the following provisions of the bill apply to all transactions in the case or proceeding; section 2 (tax treatment of discharge of indebtedness); section 4 (corporate reorganization provisions); and sections 5(a), 5(b), 5(c), 5(e), and 5(f) (miscellaneous corporate amendments). If the election is made, all provisions of sections 2 and 4 and all the above-listed provisions of section 5 of the bill are applicable to all transactions in the case or proceeding and to all parties involved in the case or proceeding.

B. Bankruptcy Estate of an Individual

In general

The bill treats the bankruptcy estate of an individual in a liquidation or reorganization case under the new bankruptcy statute as a separate taxable entity for Federal income tax purposes. Also, the bill provides that no separate taxable entity is created by commencement of a bankruptcy case in which the debtor is an individual in a case under chapter 13 of the new bankruptcy law (adjustment of debts of an individual with regular income), a partnership, or a corporation.

[5] The Federal income tax rules set forth in the bill with respect to a bankruptcy estate of an individual which is treated as a separate taxable entity include rules for allocation of income and deductions between the debtor and the estate, computation of the estate's taxable income, accounting methods and periods of the estate, the treatment of the estate's administrative costs as deductible expenses, carryover of tax attributes between the debtor and the estate, and requirements for filing and disclosure of returns.

Debtor's election to close taxable year

Also, the bill generally gives an individual debtor an election to close his or her taxable year as of the day the bankruptcy case commences. If the election is made, the debtor's Federal income tax liability for the "short" taxable year ending on commencement of the case becomes an allowable claim against the bankruptcy estate. If the election is not made, the commencement of the bankruptcy case does not terminate the taxable year of an individual debtor.

Effective date

These provisions of the bill apply to bankruptcy cases commencing more than 90 days after the date of enactment of the bill.

C. Corporate Reorganizations in Bankruptcy

Expansion of reorganization provisions

The bill expands the categories of tax-free corporate reorganizations defined in section 368 of the Code to include a new category of "G" reorganizations. This category includes certain transfers of assets pursuant to a court-approved reorganization plan in a bankruptcy case (or in a receivership, foreclosure, or similar proceeding). Accordingly, the bill terminates the applicability of special rules of current law relating to insolvency reorganizations (Code secs. 371-374).

The bill permits a "G" reorganization to take the form of a triangular reorganization, including a "reverse merger." Also, the bill allows the acquiring corporation in a "G" reorganization to transfer the acquired assets to a controlled subsidiary. The statutory rule generally governing carryover of tax attributes in corporate reorganizations (Code sec. 381) will apply in the case of a "G" reorganization.

Since "G" reorganizations are subject to the rules governing the tax treatment of exchanging shareholders and security holders which apply generally to corporate reorganizations, a shareholder or security holder who receives securities in a "G" reorganization with a principal amount exceeding the principal amount of securities surrendered is taxed on the excess. Also, money or other "boot" property received in a "G" reorganization is subject to the dividend-equivalence tests which apply to reorganizations generally.

Property attributable to accrued interest

Under the bill, a creditor exchanging securities in any corporate reorganization described in section 368 of the Code (including a "G" reorganization) will be treated as receiving interest income on the exchange to the extent the creditor receives new securities, stock, or other property attributable to accrued but unpaid interest on the securities surrendered.

[6] *Effective date*

These provisions apply to bankruptcy cases commencing after December 31, 1980, and to receivership, foreclosure, or similar judicial proceedings commencing after that date. Also, these provisions will apply to a bankruptcy case or a receivership, etc. proceeding commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election (described above) is made.

In the case of transactions outside bankruptcy cases and receivership, etc. proceedings, the amendments relating to exchanges of property for accrued

interest apply to transactions occurring after December 31, 1980.

D. Miscellaneous Corporate Amendments

The bill makes a number of miscellaneous amendments to the Internal Revenue Code relating to corporate tax issues, including the following.

1. Personal holding company status.—Under the bill, a corporate debtor generally is not to be considered a personal holding company, subject to additional taxes on certain passive income, while in a bankruptcy case (or receivership, foreclosure, or similar proceeding). This provision applies to bankruptcy cases commencing after December 31, 1980, and to receivership, etc. proceedings commencing after that date. Also, this provision will apply to a bankruptcy case or a receivership, etc. proceeding commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election (as described above) is made.

2. Liquidation rule.—The corporate nonrecognition tax rules applicable to 12-month liquidations are extended by the bill to cover sales by a corporation in a bankruptcy case (or a receivership, etc. proceeding) of assets, other than assets acquired after commencement of the bankruptcy case, during the entire period after adoption (after commencement of the case) of the plan of liquidation through conclusion of the case. This provision applies to bankruptcy cases (or receivership, etc. proceedings) commencing after December 31, 1980. Also, this provision will apply to a bankruptcy case or a receivership, etc. proceeding commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election (described above) is made.

3. Subchapter S shareholder.—The bill provides for bankruptcy cases commencing on or after October 1, 1979, the bankruptcy estate of an individual debtor can be an eligible shareholder in a subchapter S corporation.

4. Section 351 applicability.—Under the bill, transfers to a controlled corporation which is not evidenced by a security, or of claims against the corporation for accrued but unpaid interest on indebtedness, are not covered by the nonrecognition rule of section 351 of the Code. Also, the nonrecognition rule does not apply in the case of a transfer to a controlled corporation of the assets of a debtor in a bankruptcy or similar case to the extent the stock or securities received in exchange for the assets are used to satisfy the indebtedness of the debtor. The effective date for these provisions is the same as for the provisions of the bill relating to tax treatment of discharge of indebtedness.

[7] *5. Earnings and profits.*—The bill provides that to the extent the amount of discharged indebtedness is applied to reduce basis under section 1017 of the Code, such basis-reduction amount does not affect the debtor corporation's earnings and profits. Also, the bill provides that any deficit in earnings and profits is reduced by the paid-in capital of any shareholder whose interest is eliminated in a bankruptcy case. The effective date for this provision is the same as for the provisions of the bill relating to tax treatment of discharge of indebtedness.

E. Changes in Tax Procedures

The bill coordinates certain provisions of the Internal Revenue Code with the bankruptcy court procedures enacted in Public Law 95-598.[1] These procedures include the automatic stay on assessment or collection of certain tax claims against the debtor, the automatic stay on institution or continuation by the debtor of deficiency litigation in the U.S. Tax Court, and the authority of the bankruptcy court to lift the stay and permit the debtor's tax liability to be determined by the Tax Court.

[8] II. EXPLANATION OF THE BILL

A. Tax Treatment of Discharge of Indebtedness (sec. 2 of the bill and secs. 108, 111, 382(b) and 1017 of the Code)

Present Law

In general

Under present law, income is realized when indebtedness is forgiven or in other ways cancelled (sec. 61(a)(12) of the Internal Revenue Code). For example, if a corporation has issued a $1,000 bond at par which it later repurchases for only $900, thereby increasing its net worth by $100, the corporation realizes $100 of income in the year of repurchase (*United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931)).

There are several exceptions to the general rule of income realization. Under a judicially developed "insolvency exception," no income arises from discharge of indebtedness if the debtor is insolvent both before and after the transaction;[1] and if the transaction leaves the debtor with assets whose value exceeds remaining liabilities, income is realized only to the extent of the excess.[2] Treasury regulations provide that the gratuitous cancellation of

[1] In 1978, the Congress enacted legislation (Public Law 95-598) which significantly revised and modernized the substantive law of bankruptcy as well as bankruptcy court procedures. Public Law 95-598 repealed the Bankruptcy Act and substituted a new title 11 in the U.S. Code, completely replacing the former provisions. The new law generally was effective for bankruptcy cases commencing on or after October 1, 1979.

The 1978 statute did not include a "short title" (although it has been designated by some commentators as the "Bankruptcy Reform of 1978"). This report refers to the 1978 bankruptcy statute as "P.L. 95-598." The substantive bankruptcy law which was superseded by P.L. 95-598 is referred to as the "Bankruptcy Act."

In this report, the provisions of title 11 of the U.S. Code which were enacted by P.L. 95-598 are cited as "new 11 U.S. Code sec. —." References to the "Code" are to the Internal Revenue Code of 1954, as amended.

In the bill (H.R. 5043), bankruptcy cases to which the substantive provisions of P.L. 95-598 apply—generally, cases commenced on or after October 1, 1979—are referred to as "title 11 cases."

[1] Treas. Regs. § 161-12(b)(1); *Dallas Transfer & Terminal Warehouse Co.* v. *Comm'r*, 70 F.2d 95 (5th Cir. 1934).

[2] *Lakeland Grocery Co.*, 36 B.T.A. 289 (1937).

a corporation's indebtedness by a shareholder-creditor does not give rise to debt discharge income to the extent of the principal of the debt, since the cancellation amounts to a contribution to capital of the corporation.[3] Some courts have applied this exception even if the corporation had previously deducted the amount owed to the shareholder-creditor.[4] Under a related exception, cases have held that no income arises from discharge of indebtedness if stock is issued to a creditor in satisfaction of the debt, even if the creditor was previously a shareholder, and even if the stock is worth less than the face amount of the obligation satisfied.[5] Further, cancellation of a previously accrued and deducted expense does not give rise to income if the deduction did not result in a reduction of tax (Code sec. 111). A debt cancellation which constitutes a gift or bequest is not treated as income to the donee debtor (Code sec. 102).[6]

A debtor which otherwise would be required to report current income from debt cancellation under the preceding rules instead may elect to reduce the basis of its assets in accordance with Treasury regulations (Code secs. 108 and 1017). This income exclusion is available if the discharged indebtedness was incurred by a corporation or [9] by an individual in connection with property used in his trade or business. These provisions were intended to allow the tax on the debt discharge income to be deferred and collected through lower depreciation reductions for the reduced-basis assets, or greater taxable gains on sale of the assets.

The Internal Revenue Service takes the position that a reduction in the basis of qualified investment credit property resulting from an income-exclusion election under sections 108 and 1017 of the Code is *pro tanto* a disposition of the property the basis of which was reduced, resulting in partial recapture of the investment credit allowed upon its purchase (Rev. Rul. 74-184, 1974-1 C.B. 8).

Bankruptcy proceedings

The Bankruptcy Act contains certain rules relating to the Federal income tax treatment of discharge of indebtedness in bankruptcy proceedings. However, these rules have been repealed by P.L. 95-598 effective for bankruptcy cases instituted on or after October 1, 1979.

Under the Bankruptcy Act provisions, no income is recognized on cancellation of indebtedness in an insolvency reorganization (under chapter X). The Act requires the debtor corporation to reduce the basis of its assets by the amount of indebtedness discharged, but not below the fair market value of such assets as of the date the bankruptcy court confirms the reorganization plan.[7] However, under section 372 of the Internal Revenue Code, no basis reduction is required if the corporation's property is transfered to a successor corporation as part of the bankruptcy reorganization.[8]

Similar rules apply in the case of an "arangement" (under chapter XI), a "real property arrangement" (under chapter XII), and a wage earner's plan (under chapter XIII), except that no basis reduction is required under a wage earner's plan.[9] In addition, in the case of a Bankruptcy Act discharge other than under an insolvency reorganization or an arrangement described above, income is not realized to the extent the general "insolvency exception" applies.[10]

Reasons for Change

Overview

In P.L. 95-598, Congress repealed provisions of the Bankruptcy Act governing Federal income tax treatment of debt discharge in bankruptcy, effective for cases instituted on or after October 1, 1979. The committee's bill provides tax rules in the Internal Revenue Code applicable to debt discharge in the case of bankrupt or insolvent debtors, and makes related changes to existing Code provisions applicable to debt discharge in the case of solvent debtors outside bankruptcy.

The rules of the bill concerning income tax treatment of debt discharge in bankruptcy are intended to accommodate bankruptcy policy [10] and tax policy. To preserve the debtor's "fresh start" after bankruptcy, the bill provides that no income is recognized by reason of debt discharge in bankruptcy, so that a debtor coming out of bankruptcy (or an insolvent debtor outside bankruptcy) is not burdened with an immediate tax liability. The bill provides that the debt discharge amount thus excluded from income is applied to reduce the taxpayer's net operating losses and certain other tax attributes, unless the taxpayer elects to apply the debt discharge amount first to reduce basis in depreciable assets (or in realty held as inventory).

In the case of solvent debtors outside bankruptcy, the bill modifies the election (under Code secs. 108 and 1017) permitting such debtors to reduce asset basis in lieu of reporting ordinary income from debt cancellation, as on repurchase of bonds at a discount. Under the bill, a solvent taxpayer can elect to reduce basis only in depreciable assets (or in realty held as inventory).

[3] Treas. Regs. § 1.61-12(a).

[4] *Putoma Corp.* v. *Comm'r*, 66 T.C. 652 (1978), *aff'd*, 604 F.2d 734 (5th Cir. 1979).

[5] *Comm'r* v. *Motor Mart Trust*, 156 F.2d 122 (1st Cir. 1946).

[6] Debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment rather than under the debt discharge rules. Treas. Regs. § 1.61-12(a).

[7] Secs. 268 and 270 of the Bankruptcy Act.

[8] While under present law no basis reduction is required if a successor corporation is used in the insolvency reorganization, the Code under present law does not permit the carryover of tax attributes, such as net operating losses, from the debtor to the successor corporation (except possibly in certain situations where the reorganization meets the requirements of secs. 368 and 381 of the Code, in which case net operating losses may be limited by section 382 of the Code).

[9] Secs. 395, 396, 520, 522, and 679 of the Bankruptcy Act.

[10] Treas. Regs. § 1.61-12(b). See text accompanying notes 1 and 2.

Debtors given flexibility

The committee believes that these attribute-reduction provisions of the bill give flexibility to the debtor to account for a debt discharge amount in a manner most favorable to the debtor's tax situation. For example, a bankrupt or insolvent debtor which wishes to retain net operating losses and other carryovers will be able to elect to reduce asset basis in depreciable property (or in realty held as inventory). On the other hand, a debtor having an expiring net operating loss which otherwise would be "wasted" will be able (by not making the election) to apply the debt discharge amount first against the net operating loss. Similarly, a solvent debtor can continue to defer recognition of income by electing to reduce basis of depreciable assets (or in realty held as inventory), or (by not electing) can include all or part of the debt discharge amount in income (for example, in order to offset an expiring net operating loss).

At the same time, in developing the rules of the bill, the committee recognized that the basis-reduction mechanism of present law fails to effectuate the Congressional intent of deferring, but eventually collecting tax on, ordinary income realized from debt discharge.

Thus present law permits both solvent and insolvent taxpayers to apply the amount of their discharged debts to reduce the basis of nondepreciable assets which may never be sold, such as stock in a subsidiary corporation or the land on which the company operates its business, thereby avoiding completely, rather than deferring, the tax consequences of debt discharge. Also under present law, a related party (such as the parent corporation of a debtor) can acquire the taxpayer's debt at a discount and effectively eliminate it as a real liability to outside interests, but the debtor thereby avoids the tax treatment which would apply if the debtor had directly retired the debt by repurchasing it. In other cases, the debtor may be able to convert ordinary income from discharge of indebtedness into capital gain, as where the debtor reduces basis in a nondepreciable capital asset.

Deferal of ordinary income on debt discharge

Accordingly, the rules of the bill are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge. Thus in the case of a bankrupt or insolvent debtor, the debt discharge [11] amount is applied to reduce the taxpayer's net operating losses and certain other tax attributes, unless the taxpayer elects to apply the amount first to reduce basis in depreciable assets. In the case of a solvent debtor outside bankruptcy, the debtor can defer recognition of income, but only by reducing basis in depreciable assets. Similarly, the debtor can defer immediate tax consequences of debt discharge by reducing basis in real property held as inventory. A subsequent disposition of such reduced-basis realty will result in recognition of a larger amount of ordinary income, just as reduction in basis of depreciable assets results in lower depreciation deductions to offset ordinary income.

To insure that the debt discharge amount eventually will result in ordinary income (and cannot be converted to capital gain), the bill provides that any gain on a subsequent disposition of the reduced-basis property will be subject to a "recapture" under rules similar to those now applicable with respect to depreciation recapture. Also, the bill contains rules relating to discharge of indebtedness as a capital contribution, acquisition of debt by a related party, discharge of partnership debt, and other income tax aspects of discharge of indebtedness.

Stock-for-debt rules to encourage reorganizations

The committee bill generally does not change the present law rule developed by the courts governing whether income is recognized if a corporation issues its own stock to its creditor for outstanding debt (whether or not the debt constitutes a security for tax purposes). Therefore, no attribute reduction generally will be required where such stock is issued to discharge the debt. The bill as passed by the House would have provided that if a corporate debtor issues stock in cancellation of short-term debt or trade credit, the debt discharge rules of the bill would have applied to the extent the indebtedness exceeded the value of the stock.

The commitee believes that by providing for favorable tax treatment if stock is issued to creditors in discharge of debt, the committee bill encourages reorganization, rather than liquidation, of financially distressed companies that have a potential for surviving as operating concerns. However, the committee does not believe that these rules should apply if only a *de minimis* amount of stock is issued for the outstanding debt, so that the general rules on debt forgiveness cannot thereby be circumvented.

The deduction available under present law for certain creditors receiving stock in cancellation of a debt remains unchanged. However, the committee bill provides that any gain on a later sale of the stock by the former creditor will be "recaptured" as ordinary income up to the amount of the creditor's prior deductions against ordinary income.

Because the committee bill generally retains the present law rules governing the tax treatment of debt discharge when a corporation's indebtedness is satisfied with its own stock, the committee bill also retains the present rules of Code section 382(a) relating to special limitations on net operating loss carryover on certain acquisitions of stock of a corporation. Under the House bill, the section 382(a) limitations generally would not have applied to the extent creditors received stock in exchange for their claims.

[12] *Postponement of effective dates for bankruptcy cases*

Under the bill as introduced and passed by the House, the provisions

relating to tax treatment of debt discharge (section 2), corporate reorganizations in bankruptcy (section 4), and certain miscellaneous corporate amendments (section 5) would have applied for bankruptcy cases (or receivership, foreclosure, or similar judicial proceedings) commenced on or after October 1, 1979. In light of the time that has elapsed since introduction of the bill, the committee believes that the provisions of sections 2, 4, and 5 of the bill should apply to bankruptcy cases (or receivership, etc. proceedings) commenced after December 31, 1980.

However, some taxpayers may have entered into bankruptcy reorganizations with the expectation that the bill would be enacted with the original retroactive effective dates. Accordingly, the committee bill allows a bankrupt or insolvent debtor, in the case of proceedings commenced on or after October 1, 1979, to elect to have all the debt discharge and related provisions of the bill (sections 2, 4, and 5), apply retroactively as under the original effective date. No change would be made in the effective date for rules applicable to debt discharge, etc. outside bankruptcy (i.e., transactions occurring after December 31, 1980).

Explanation of Provisions

Debt discharge in bankruptcy

In general

Under the bill, no amount is to be included in income for Federal income tax purposes by reason of a discharge of indebtedness in a bankruptcy case.[11] Instead, the amount of discharged debt which is excluded from gross income by virtue of the bill's provisions (the "debt discharge amount") is to be applied to reduce certain tax attributes.

Unless the taxpayer elects first to reduce basis in depreciable assets (or in real property held primarily for sale to customers in the ordinary course of a trade or business), the debt discharge amount is applied to reduce the taxpayer's tax attributes in the following order:

(1) net operating losses and carryovers;

(2) carryovers of the investment tax credit (other than the ESOP credit), the WIN credit, the new jobs credit, and the credit for alcohol used as a fuel;

(3) capital losses and carryovers;

(4) the basis of the taxpayer's assets (both depreciable and nondepreciable); and

(5) carryovers of the foreign tax credit.[12]

[13] The reduction in each category of carryovers is made in the order of taxable years in which the items would be used, with the order determined as if the debt discharge amount were not excluded from income.[13] For this purpose, any limitations on the use of credits that are based on the income of the taxpayer are disregarded.

After reduction of the attributes specified in categories (1), (2), and (3) above, any remaining debt discharge amount is applied to reduce asset basis, but not below the amount of the taxpayer's remaining undischarged liabilities. (Thus, a sale of all the taxpayer's assets immediately after the discharge generally will not result in income tax liability unless the sale proceeds and cash on hand exceed the amount needed to pay off the remaining liabilities.) Any amount of debt discharge which remains after such reduction in asset basis, including any debt discharge amount which remains unapplied solely by virtue of the limitation just described with respect to undischarged liabilities, is applied to reduce carryovers of the foreign tax credit.

Any amount of debt discharge which is left after attribute reduction under these rules is disregarded, i.e., does not result in income or have other tax consequences.

Election to reduce basis in certain property

The bill provides that the taxpayer can elect, in accordance with Treasury regulations, to apply all or a portion of the debt discharge amount first to reduce basis (but not below zero) in depreciable property[14] or in real property held primarily for sale to customers in the ordinary course of a trade or business (within the meaning of Code sec. 1221(1)). Any remaining amount is then applied to reduce net operating losses and other tax attributes in the order described above. A debtor making this election can elect to reduce basis (but not below zero) in depreciable proerty or in realty held as inventory below the amount of remaining liabilities (i.e., where the debtor would rather reduce basis in such assets than reduce carryovers).

[11] For purposes of these rules, the term "bankruptcy case" (referred to in the bill as a "title 11 case") means a case under new title 11 of the U.S. Code, but only if the taxpayer is under the jurisdiction of the court in the case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

[12] For purposes of the attribute reduction rules, credits are reduced at the rate of 50 cents for each dollar of debt discharge amount. This flat-rate reduction avoids the complexity of determining a tax on the debt discharge amount and determining how much of the amount would be used up by the credits for purposes of determining other reductions. Except for reductions in credit carryovers, the specified tax attributes are reduced one dollar for each dollar of debt discharge amount.

[13] Thus in the case of net operating losses or capital losses, the debt discharge amount first reduces the current year's loss and then reduces the loss carryovers in the order in which they arose. The investment credit carryovers are reduced on a FIFO basis, and the other credit carryovers also are reduced in the order they would be used against taxable income. These reductions are made after the computation of the current year's tax.

[14] For this purpose, the term "depreciable property" means any property of a character subject to the allowance for depreciation, but only if the basis reduction would reduce the amount of depreciation or amortization which otherwise would be allowable for the period immediately following such reduction. Thus, for example, a lessor could not reduce the basis of leased property where the lessee's obligation in respect of the property will restore to the lessor the loss due to depreciation during the term of the lease, since the lessor cannot take depreciation in respect of that property. See *Harry H. Kem, Jr.*, 51 T.C. 455 (1968), *aff'd*, 432 F.2d 961 (9th Cir. 1970).

In addition, the bill provides that, for purposes of this election, stock held by a parent corporation in a subsidiary is treated as depreciable property (or as realty held as inventory) if the parent and subsidiary file a consolidated return for the taxable year in which the discharge occurs, and if the subsidiary agrees to reduce its basis in depreciable property (or in real property held as inventory) which the subsidiary holds.[15] Thus, if the debtor is a parent corporation which files [14] a consolidated return with a subsidiary, the debtor can elect to apply the debt discharge amount, in accordance with Treasury regulations, to reduce the basis of stock it holds in the subsidiary to the extent the subsidiary consents to reduce the basis of depreciable property which it holds (or realty which it holds as inventory).

An election first to reduce basis in depreciable property in realty held as inventory must be made on the taxpayer's return for the year in which the discharge occurs, or at such time as permitted by Treasury regulations. Once made, the election can be revoked by the taxpayer only with the consent of the Internal Revenue Service.

Recapture rule

If the basis of property is reduced pursuant to the attribute reduction rules in the bill, any gain on a subsequent disposition of the property is subject to "recapture" under section 1245 of the Code or, in the case of depreciable realty, under section 1250. (This recapture rule applies to any reduced-basis asset, whether depreciable or non-depreciable, and whether or not a disposition of such asset otherwise would be subject to recapture under Code sections 1245 or 1250.) The computation of the amount of straight-line depreciation (under sec. 1250(b)) is determined as if there had been no reduction of basis under section 1017.

[15] This rule can be applied successively through a chain of corporations so long as the lowest tier subsidiary reduces its basis in actual depreciable property (or realty which it holds as inventory).

Basis reduction—general rule

To the extent a debtor makes an election to reduce basis in depreciable property, or reduces basis in assets after reduction of other attributes, the particular properties the bases of which are to be reduced will be determined pursuant to Treasury regulations. It is anticipated that the order of reduction prescribed in such regulations will generally accord with present Treasury regulations which apply in the case of basis reduction under section 270 of the (now repealed) Bankruptcy Act (Treas. Regs. §§ 1.1016-7 and 1.1016-8). If the debtor elects to reduce basis in realty held as inventory, the particular real properties the bases of which are to be reduced will be determined pursuant to Treasury regulations.

In order to avoid interaction between basis reduction and reduction of other attributes, the bill provides that the basis reduction takes effect on the first day of the taxable year following the year in which the discharge took place. If basis reduction is required in respect of a discharge of indebtedness in the final year of a bankruptcy estate, the reduction is to be made in the basis of assets acquired by the debtor from the estate at the time so acquired.

In a bankruptcy case involving an individual debtor to which new section 1398 of the Code (as added by the bill) applies, any attribute reduction required under the bill applies to the attributes of the bankruptcy estate (except for purposes of applying the basis-reduction rules of section 1017 to property transferred by the estate to the individual) and not to those attributes of the individual which arise after commencement of the case. Also, the bill provides that in a bankruptcy case involving an individual debtor, no reduction in basis is to be made in the basis of property which the debtor treats as exempt property under new 11 U.S. Code section 522.

[15] *Debt discharge outside bankruptcy—insolvent debtors*

The bill provides that if a discharge of indebtedness occurs when the taxpayer is insolvent (but is not in a bankruptcy case), the amount of debt discharge is excluded from gross income up to the amount by which the taxpayer is insolvent.[16] The excluded amount is applied to reduce tax attributes in the same manner as if the discharge had occurred in a bankruptcy case. Any balance of the debt discharged which is not excluded from gross income (because it exceeds the insolvency amount) is treated in the same manner as debt cancellation in the case of a wholly solvent taxpayer.

Debt discharge outside bankruptcy—solvent debtors

In the case of a solvent taxpayer outside bankruptcy, the bill modifies the present rule (secs. 108 and 1017 of the Code) permitting an election to reduce the basis of assets in lieu of reporting income from discharge of indebtedness. Under the election as modified, income from debt discharge will not currently be recognized by a solvent debtor outside bankruptcy to the extent the debtor elects to reduce basis in depreciable property or in real property held primarily for sale to customers in the ordinary course of a trade or business (within the meaning of Code sec. 1221(1)).[17]

[16] The bill defines "insolvent" as the excess of liabilities over the fair market value of assets, determined with respect to the taxpayer's assets and liabilities immediately before the debt discharge. The bill provides that except pursuant to section 108(a)(1)(B) of the Code (as added by the bill), there is to be no insolvency exception from the general rule that gross income includes income from discharge of indebtedness.

[17] The exclusion from gross income under section 108(a) of the Code (as amended by the bill) applies, in the case of a discharge which does not occur in a title 11 case and which does not occur when the taxpayer is insolvent, where the indebtedness discharged is "qualified business indebtedness." The latter term means indebtedness of the taxpayer if both (1) the indebtedness was incurred or assumed by a corporation, or by an individual in connection with property used in his trade or business, and also (2) the taxpayer makes an election to reduce the basis of depreciable or realty held as inventory.

For this purpose, the term "depreciable property" is defined the same way as in the case of the election by a bankrupt or insolvent taxpayer to reduce the basis of depreciable property (see note 14, *supra*).

If the debtor elects to reduce basis in depreciable property, the particular depreciable assets the bases of which are to be reduced (but not below zero) will be determined pursuant to Treasury regulations. It is anticipated that the order of reduction among depreciable assets of the taxpayer will generally accord with present Treasury regulations (Treas. Regs. §§ 1.1017-1 and 1.1017-2). If the debtor elects to reduce basis in realty held as inventory, the particular real properties the bases of which are to be reduced (but not below zero) will be determined pursuant to Treasury regulations. The bill provides that the basis reduction takes effect on the first day of the taxable year following the year in which the discharge takes place.

In addition, the bill provides that, for purposes of this election, stock held by a parent corporation in a subsidiary is treated as depreciable property (or as realty held as inventory) if the parent and subsidiary file a consolidated return for the taxable year in which the discharge occurs, and if the subsidiary agrees to reduce its basis in depreciable property (or in real property held as inventory) which the [16] subsidiary holds.[18] Thus, if the debtor is a parent corporation which files a consolidated return with a subsidiary, the debtor can elect to apply the debt discharge amount, in accordance with Treasury regulations, to reduce the basis of stock it holds in the subsidiary to the extent the subsidiary consents to reduce the basis of depreciable property which it holds (or realty which it holds as inventory).

An election first to reduce basis in depreciable property or in realty held as inventory must be made on the taxpayer's return for the year in which the discharge occurs, or at such time as permitted by Treasury regulations. Once made, the election can be revoked by the taxpayer only with the consent of the Internal Revenue Service.

To the extent a solvent taxpayer outside bankruptcy does not make an election to reduce basis in depreciable property (or in realty held as inventory) in lieu of reporting income from debt discharge, or to the extent the debt discharge amount exceeds the maximum reduction which can be made through an election, the excess constitutes income from discharge of indebtedness which constitutes gross income for Federal income tax purposes (sec. 61(a)(12) of the Code).

Recapture rule

To ensure that ordinary income treatment eventually will be given to the full amount of basis reduction, the bill provides that any gain on a subsequent disposition of reduced-basis property is subject to "recapture" under section 1245 of the Code or, in the case of depreciable realty, under section 1250. (This recapture rule applies to any reduced-basis property, whether or not a disposition of such property otherwise would be subject to recapture under Code sections 1245 or 1250.) The computation of the amount of straight-line depreciation (under sec. 1250(b)) is determined as if there had been no reduction of basis under section 1017.

Certain reductions as purchase price adjustments

The bill provides that if the seller of specific property reduces the debt of the purchaser which arose out of the purchase, and the reduction to the purchaser does not occur in a bankruptcy case or when the purchaser is insolvent, then the reduction to the purchaser of the purchase-money is to be treated (for both the seller and the buyer) as a purchase price adjustment on that property. This rule applies only if but for this provision the amount of the reduction would be treated as income from discharge of indebtedness.

This provision is intended to eliminate disagreements between the Internal Revenue Service and the debtor as to whether, in a particular case to which the provision applies, the debt reductions should be treated as discharge income or a true price adjustment. If the debt has been transferred by the seller to a third party (whether or not related to the seller), or if the property has been transferred by the buyer to a third party (whether or not related to the buyer), this provision does not apply to determine whether a reduction in the amount of purchase-money debt should be treated as discharge income or a true price adjustment. Also, this provision does not apply when the debt is reduced [17] because of factors not involving direct agreements between the buyer and the seller, such as the running of the statue of limitations on enforcement of the obligation.

Equity-for-debt rules

Issuance of stock

The committee bill generally does not change the present law rule developed by the courts governing whether income is recognized if a corporation issues its own stock to its creditor for outstanding debt (whether or not the debt constitutes a security for tax purposes). Therefore, no attribute reduction generally will be required where such stock is issued to discharge the debt.

However, the general "stock-for-debt exception" will not apply if only a nominal or token amount of stock is issued for the debt, to be determined according to all the facts and circumstances, so that the forgiveness rules may not be circumvented by the issuance of nominal or token shares to a creditor who had no real equity interest in the corporation.

Also, the general "stock-for-debt exception" will not apply to the debt of an unsecured creditor[19] in a work-

[18] This rule can be applied successively through a chain of corporations so long as the lowest tier subsidiary reduces its basis in actual depreciable property (or realty which it holds as inventory).

[19] For this purpose, a claim is considered as secured by a lien on property only to the extent of the fair market value of the creditor's interest in such property. Any claim in excess of such value is treated as a separate claim of an unsecured creditor. This is consistent with the approach taken in new 11 U.S. Code sec. 506.

out[20] if that creditor receives an amount of stock (by value) which is less than one-half the amount of stock that such creditor would receive if all the corporation's unsecured creditors, to the extent their debts are either cancelled or satisfied with the debtor's stock in the workout, received a pro-rata amount of the stock issued.

Thus, for example, if creditor A held $1,000 of unsecured debt against a debtor corporation and if, in a workout, the debtor corporation fully satisfied $10,000 of its unsecured debt (including the debt to A) by the transfer of $6,000 of its stock, A must receive at least $300 of stock in satisfaction of its claim (assuming no other property is transferred) in order for the debtor to rely, with respect to the stock issued to A, on the general rule of present law that no debt discharge income is recognized and no attribute reduction is required when a corporation's debt is satisfied by the issuance of its own stock. If creditor A receives only $100 of stock for his $1,000 debt under these facts, then the debtor corporation will have a debt discharge amount of $900 with respect to issuance of stock to creditor A. If creditor A receives $300 or more of stock for his $1,000 debt under these facts, then the debtor corporation will not have any debt discharge amount with respect to issuance of stock to creditor A.

If a corporate debtor issues a package of stock and other property in cancellation of debt, the cash and other property are to be treated as satisfying an amount of debt equal to the amount of cash and the value of other property, and the stock is to be treated as satisfying the remainder of the debt. Consequently, there will be no debt discharge amount recognized by the debtor (unless the *de minimis* exception applies) on issuance of stock and other property for debt.

[18] Because the committee bill generally retains the present law rules governing the tax treatment of debt discharge when a corporation's indebtedness is satisfied with its own stock, the committee bill also retains the present rules of Code section 382 (a) relating to special limitations on net operating loss carryover on certain acquisitions of stock of a corporation. Under the House bill, the section 382 (a) limitations generally would not have applied to the extent creditors received stock in exchange for their claims.

Recapture on disposition of stock

The committee bill provides that if a creditor acquires stock of the debtor corporation in exchange for the corporation's indebtedness, then upon subsequent disposition of the stock, any deduction taken with respect to the debt either as a bad debt deduction (under Code secs. 166(a) or (c)), reduced by any gain on the exchange, or as an ordinary loss on the exchange shall be subject to "recapture" under the rules of Code section 1245.[20a]

Thus, for example, assume that corporation A made a $1,000 short-term loan to corporation B on July 1, 1980, and that corporation A, for its taxable year 1982, takes an $800 deduction for partially worthless bad debt under Code section 166(a). Assume further that on March 1, 1983, B satisfies the principal of the debt with B stock worth $500, resulting in a gain to A of $300. If A later disposes of the B stock for $1,500, $500 of A's gain will be treated as ordinary income ($800 bad debt deduction less $300 gain on receipt of the stock). In addition, if the stock is disposed of in a tax-free transaction (for example, by reason of secs. 354 or 1306), the potential recapture will carry over to the stock received.

In the case of a cash-basis creditor, any amount not taken into account by reason of his method of accounting shall be treated the same as a deduction allowed with respect to the debt. A special rule is provided in the bill for taxpayers on the reserve method for bad debts under Code section 166(c).

Capital contributions

The bill provides that the discharge of indebtedness rules apply to the extent that the amount of debt transferred to a corporation as a contribution to capital exceeds the shareholder's basis in the debt.[21] [19] Thus, the discharge of indebtedness rules apply when a cash-basis taxpayer contributes to the capital of an accrual-basis corporation a debt representing an accrued expense previously deducted by the corporation.[22]

[20] A "workout" includes a title 11 case (within the meaning of Code sec. 368(a)(3)(A)) or other transaction or series of transactions involving a significant restructuring of the debt of a corporation in financial difficulty.

[20a] For purposes of these recapture rules, the bill provides that the term "debtor corporation" includes a successor corporation, and that stock of a corporation in control of the debtor corporation is treated as stock of the debtor. Also, the bill provides that similar recapture rules apply in the case of discharge of partnership indebtedness.

[21] For example, assume a corporation accrues and deducts (but does not actually pay) a $1,000 liability to a shareholder-employee as salary, and the cash-basis employee does not include the $1,000 in income. In a later year, the shareholder-employee forgives the debt.

Under the bill, the corporation must account for a debt discharge amount of $1,000. If the corporation is insolvent or in bankruptcy, it must apply the $1,000 debt discharge amount to reduce tax attributes pursuant to the rules discussed in the text above. If the debtor is a solvent corporation outside bankruptcy, it can elect to reduce basis of depreciable assets (or of realty held as inventory) by $1,000 in lieu of recognizing $1,000 of income in the year of discharge.

On the other hand, if the shareholder-employee were on the accrual basis, had included the salary in income, and his or her basis in the debt was still $1,000 at the time of the contribution, there would be no debt discharge amount, and no attribute reduction would be required.

[22] This contribution-to-capital rule reverses the result reached in *Putoma Corp. v. Comm'r*, 66 T.C. 652 (1976), *aff'd*, 601 F.2d (5th Cir. 1979). Moreover, it is intended that the result reached in *Putoma* could not alternatively be sustained on the ground that the shareholder has made a "gift" to the corporation, since it is intended that there will not be any gift exception in a commercial context (such as a shareholder-corporation relationship) to the general rule that income is realized on discharge of indebtedness.

Whether a cancellation of indebtedness by a shareholder-creditor is a contribution

Debt acquired by related party

The bill provides that, for purposes of determining income of the debtor from discharge of indebtedness, an outstanding debt acquired from an unrelated party by a party related to the debtor is treated as having been acquired by the debtor to the extent provided in regulations issued by the Treasury Department.

For purposes of this rule, a person is treated as related to the debtor if the person is (1) a member of a controlled group of corporations (as defined for purposes of Code sec. 414(b)) of which group the debtor is a member; (2) a trade or business treated as under common control with respect to the debtor (within the meaning of Code secs. 414(b) or 414(c)); (3) either a partner in a partnership treated as controlled by the debtor or a controlled partnership with respect to the debtor (within the meaning of Code sec. 707(b)(1); or (4) a member of the debtor's family or other person bearing a relationship to the debtor specified in Code section 267(b). The definition of "family" for this purpose also includes a spouse of the debtor's child or grandchild.

This rule is intended to treat a debtor as having its debt discharged if a party related to the debtor purchases the debt at a discount (for example, where a parent corporation purchases at a discount debt issued by its subsidiary).[23]

[20] *Other rules concerning debt discharge*

No disposition on basis reduction.—If the basis of qualified investment credit property is reduced by a debt discharge amount under the rules of the bill, no investment credit recapture tax is incurred, because the reduction would not be considered a disposition. This rule overturns the position taken by the Internal Revenue Service in Rev. Rul. 74-184, *supra,* in the case of a solvent debtor making an election under sections 108 and 1017 of the Code (as amended by the bill), and precludes extension of that position to bankrupt or insolvent debtors.[24]

Indebtedness of taxpayer.—The debt discharge rules of the bill apply with respect to discharge of any indebtedness for which the taxpayer is liable or subject to which the taxpayer holds property.

Unamortized premium and discount.—The bill provides that the amount taken into account with respect to any discharge of indebtedness is to be properly adjusted for unamortized premium and unamortized discount with respect to the indebtedness discharged.[25]

"Lost" deductions.—The bill provides that if the payment of a liability would have given rise to a deduction, the discharge of that liability does not give rise to income or require reduction of tax attributes. For example, assume a cash-basis taxpayer owes $1,000 to its cash-basis employee as salary and has not actually paid such amount. If later the employee forgives the debt (whether or not as a contribution to capital), then the discharge does not give rise to income or require any reduction of tax attributes.

Tax benefit rule.—The bill clarifies present law by providing that in applying the tax benefit rule of Code section 111 in order to determine if the recovery of an item is taxable, a deduction is treated as having produced a reduction in tax if the deduction increased a carryover that had not expired at the end of the taxable year in which the recovery occurs. Thus, if an accrual-basis taxpayer incurs a deductible obligation to pay rent in 1980, and that obligation is forgiven in 1981, the rent deduction is treated as having produced a reduction in tax even if it had entered into the calculation of a net [21] operating loss that had not expired at the end of 1981 but had not been used as of that time.

Real estate investment trusts.—To qualify as a real estate investment trust (REIT) an organization must satisfy,

to capital depends upon the facts of the particular case. In order for the contribution to capital rule to apply, the shareholder's action in cancelling the debt must be related to his status as a shareholder. If the shareholder-creditor acts merely as a creditor attempting to maximize the satisfaction of a claim, such as where the stock and bonds are publicly held and the creditor simply happens also to be a shareholder, the cancellation of the indebtedness on exchange of the bonds for stock is not to be treated as a contribution to capital by a shareholder for purposes of this rule.

[23] It is intended that the Treasury Department has authority to and will issue regulations providing for the following income tax consequences on repayment or capital contribution of debt which had been acquired bv a related party subject to the rule of the bill treating the debtor as having acquired the debt.

If the debtor subsequently pays the debt to the related party, the entire transaction is to be treated generally the same as if the debtor had originally acquired the debt. For example, assume a parent corporation purchases for $900 on the open market a $1,000 bond issued at par by its wholly owned subsidiary. Under the bill, the debtor (the subsidiary) must account for a debt discharge amount of $100 for its taxable year during which the debt was so acquired. In the following year when the debt matures, assume the subsidiary pays its parent the full principal amount ($1,000). The Treasury regulations are to provide that the debtor is treated as having paid a dividend of $100 ($1,000 payment to the parent less the $900 paid by the parent to acquire the debt) to its parent corporation.

If a related party transfers to a corporation as a contribution to capital debt issued by the corporation and the debtor corporation thereby would otherwise have a debt discharge amount pursuant to the rules of the bill, the bill provides that no such income shall arise a second time. For example, assume a parent corporation purchases for $900 on the open market a $1,000 bond issued at par account for a debt discharge amount of $100 for its taxable year during which debt to its subsidiary as a contribution to capital (i.e., forgives the debt). The amount under the debt). The amount under the capital contribution rules of the bill ($100 in the example given, assuming the parent's basis in the bond is still $900) is to be reduced by the debt discharge amount previously taken into account by the subsidiary ($100) and thus no additional amount is to be taken into income.

[24] No inference is intended, by virtue of adoption of the non-disposition rule of the bill as described in the text above, as to whether the position taken by the Internal Revenue Service in Rev. Rul. 74-184, *supra,* represents a correct interpretation of Federal income tax law prior to the effective date of the bill's no-disposition rule.

A purchase price adjustment (whether or not described in new sec. 108(e)(5) of the Code, as added by this bill) continues to constitute an adjustment for purposes of the investment credit rules of the Code.

[25] This provision of the bill is not intended to be a change from the rules of current law as to adjustments for unamortized premium and discount.

among other requirements, source-of-income tests establishing that it has primarily passive income from real estate investments (Code sec. 856). The bill provides that income from cancellation of indebtedness is not to be taken into account for these source-of-income tests. For example, if a solvent REIT investing primarily in mortgages has debt cancellation on redemption of bonds, and such amount would be includible in gross income under the rules of the bill (absent an election to apply such amount to reduce the basis of depreciable assets or realty held as inventory), the amount of such income is not to be taken into account for purposes of Code section 856.

Amendment to Code section 382 (b).—The committee bill provides that creditors of a debtor corporation are to be treated as shareholders in applying the continuity rules of Code section 382(b) in a title 11 or similar case (within the meaning of Code sec. 368(a)(3)(A), as added by the bill). The House bill would have limited this rule to reorganizations under Code section 368(a)(1)(G), as added by the bill.

Partnerships

The bill provides that the rules of exclusion from gross income and reduction of tax attributes in section 108 of the Code (as amended by the bill) are to be applied at the partner level and not at the partnership level.[26] Accordingly, income from discharge of a partnership debt is not excludable at the partnership level under amended section 108. Instead, such income is treated as an item of income which is allocated separately to each partner pursuant to section 702(a) of the Code.

This allocation of an amount of debt discharge income to a partner results in that partner's basis in the partnership being increased by such amount (sec. 705). At the same time, the reduction in the partner's share of partnership liabilities caused by the debt discharge results in a deemed distribution (under sec. 752), in turn resulting in a reduction (under sec. 733) of the partner's basis in the partnership. The section 733 basis reduction, which offsets the section 705 basis increase, is separate from any basis reduction pursuant to the attribute-reduction rules of the bill.

The tax treatment of the amount of discharged partnership debt which is allocated as an income item to a particular partner depends on whether that partner is in a bankruptcy case, is insolvent (but not in a bankruptcy case), or is solvent (and not in a bankruptcy case). For example, if the particular partner is bankrupt, the debt discharge amount is excluded from gross income pursuant to amended section 108 and is applied to reduce the partner's net operating losses and other tax attributes, unless the partner elects to apply the amount first to reduce basis in depreciable property.[27] If the particular partner is [22] solvent (and not in a bankruptcy case), the amount allocated to that partner is included in that partner's gross income except to the extent the partner elects to reduce basis of depreciable assets.

The bill provides that, in connection with these attribute-reduction rules, a partner's interest in a partnership is to be treated as depreciable property to the extent of such partner's proportionate interest in the depreciable property held by the partnership if the partnership agrees to make a corresponding reduction in the basis of the partnership property with respect to such partner (in a manner similar to that which would be required if the partnership had made an election under Code section 754 to adjust basis in the case of a transfer of a partnership interest).[28]

Technical amendments

The bill amends section 703(b) of the Code, relating to elections of a partnership, to provide that any election under sections 108(b)(5) or 108(d)(4) of the Code (as amended by the bill) with respect to income from discharge of indebtedness is to be made by each partner separately and not by the partnership. Section 118(c) of the Code, relating to cross references, is amended to add a reference to the rules of the bill on capital contributions of indebtedness.

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[26] The effect of these provisions of the bill is to overturn the decision in *Stackhouse* v. *U.S.*, 441 F.2d 465 (5th Cir. 1971).

[27] For purposes of this explanation of the partnership rules, the term "depreciable property" also refers to real property held for sale to customers in the ordinary course of business.

[28] For example, assume that a partnership is the debtor in a bankruptcy case which begins March 1, 1981, and that in the bankruptcy case a partnership liability in the amount of $30,000 is discharged. The partnership has three partners. The three partners have equal distributive shares of partnership income and loss items under section 702(a) of the Code. Partner A is the debtor in a bankruptcy case; partner B is insolvent (by more than $10,000), but is not a debtor in a bankruptcy case; and partner C is solvent, and is not a debtor in a bankruptcy case.

Under section 705 of the Code, each partner's basis in the partnership is increased by $10,000, i.e., his distributive share of the income of the partnership (The $30,000 debt discharge amount constitutes income of the partnership for this purpose, inasmuch as the income exclusion rules of amended sec. 108 do not apply at the partnership level.) However, also by virtue of present law, each partner's basis in the partnership is decreased by the same amount (Code secs. 752 and 733). Thus, there is no net change in each indebtedness except by operation at the partner level of the rules of sections 108 and 1017 of the Code (as amended by the bill).

In the case of bankrupt partner A, the $10,000 debt discharge amount must be applied to reduce net operating losses and other tax attributes as specified in the bill, unless A elects first to reduce the basis of depreciable assets. The same tax treatment applies in the case of insolvent partner B. In the case of solvent partner C, such partner can elect to reduce basis in depreciable assets in lieu of recognizing $10,000 of income from discharge of indebtedness.

If A, B, or C elects to reduce basis in depreciable assets, such partner may be permitted, under the Treasury regulations, to reduce his basis in his partnership interest (to the extent of his share of partnership depreciable property), because the bill treats that interest as depreciable property. However, a partner may reduce basis in his interest in the partnership only if the partnership makes a corresponding reduction in the basis of the partnership property with respect to such partner (in a manner similar to that which would be required if the partnership had made an election under section 754 to adjust basis in the case of a transfer of a partnership interest).

Effective Date

General rule

The amendments to the Internal Revenue Code made by section 2 of the bill apply to transactions in a bankruptcy case if the case com-[23] mences after December 31, 1980; to transactions in a receivership, foreclosure, or similar proceeding if the proceeding commences after December 31, 1980; and to other transactions which occur after December 31, 1980 (except that the provisions of section 2 do not apply to any transaction in a bankruptcy case which began prior to January 1, 1981 or in a receivership, foreclosure, or similar proceeding which proceeding began before January 1, 1981, even if such transaction occurs after December 31, 1980).[29]

Special effective date election

The bill also provides an effective date election for debtors in bankruptcy cases commenced on or after October 1, 1979 (but prior to January 1, 1981), and for debtors in receivership, foreclosure, or similar judicial proceedings commenced on or after October 1, 1979 (but prior to January 1, 1981).

The debtor (or debtors, if there is more than one debtor in the case) in such a case or proceeding can elect, with the approval of the court, to have the following provisions of the bill apply to transactions in the case or proceeding, notwithstanding the general effective date of the bill:

section 2 (tax treatment of discharge of indebtedness);

section 4 (corporate reorganization provisions; and

sections 5(a), 5(b), 5(c), 5(e), and 5(f) (miscellaneous corporate amendments).

If the election is made, all provisions of sections 2 and 4 and all the above-listed provisions of section 5 of the bill are applicable to all transactions in the case or proceeding and to all parties involved in the case or proceeding. Thus, the debtor may not elect to have only certain of these provisions apply to transactions in the case or proceeding, and may not elect to have the provisions apply only to certain transactions in the case or proceeding.

An effective date election is to be made at such time and in such manner as prescribed by Treasury regulations, taking into account the need for all parties involved in the case or proceeding to be aware of the election. The election, once made, is irrevocable.

[24] B. Rules Relating to Title 11 Cases for Individuals (sec. 3 of the bill; new secs. 1398 and 1399 and secs. 6012 and 6103 of the Code)

Effect of Bankruptcy Law

Under bankruptcy law, the commencement of a liquidation or reorganization case involving an individual debtor creates an "estate" which consists of property formerly belonging to the debtor. The bankruptcy estate generally is administered by a trustee for the benefit of creditors, and it may derive its own income and incur expenditures. At the same time, the individual is given a "fresh start"—that is, wages earned by the individual after commencement of the case and after-acquired property do not become part of the bankruptcy estate, but belong to the individual, and certain property may be set aside as exempt.

Reasons for Change

At present, there are no rules in the Internal Revenue Code specifying whether the bankruptcy estate constitutes a taxable entity apart from the individual debtor; and, if so, how tax attributes are to be allocated between the estate and the debtor. This has resulted in uncertainty and litigation concerning the Federal income tax liability of the bankruptcy estate and the debtor. The provisions of section 3 of the bill, adding new sections 1398 and 1399 to the Internal Revenue Code, provide the first comprehensive statutory treatment of these issues.

In addition, the committee has concluded that an individual debtor in a bankruptcy case generally should be given an election to close his or her taxable year at the date of bankruptcy. If a debtor makes such an election, the debtor's Federal income tax liability for the "short" taxable year ending with commencement of the bankruptcy case becomes collectible out of the bankruptcy estate as a liability incurred before bankruptcy, to the extent the estate has assets with which to pay debts of that priority. Since income items (or benefits of prebankruptcy transactions that gave rise to tax liability) may have passed to the bankruptcy trustee, it is appropriate that the tax liability be collectible out of estate assets as a prebankruptcy liability. To the extent that assets of the bankruptcy estate are not sufficient to pay any tax due for that year, the bankruptcy statute provides that the remaining liability is not dischargeable in the bankruptcy case and hence can be collected from the individual debtor after the case.

Explanation of Provisions

1. Debtor and bankruptcy estate as separate entities

Present law

For Federal income tax purposes, the estate created on commencement of a bankruptcy proceeding with respect to an individual debtor [25] is treated as a new taxable entity, separate from the individual (Rev. Rul. 72-387, 1972-2 C.B. 632). Accordingly, the trustee must file a tax return (Form 1041) for the bankruptcy estate if the gross income of the estate, for the period beginning with filing of the petition or for any subsequent taxable year, is $600 or more.

The taxable year of the individual debtor is not terminated on commencement of the bankruptcy proceeding. On the individual's return (Form 1040 or 1040A) for the year in which the bankruptcy proceeding commenced, the individual reports all income earned by him or her during the en-

[29] Where the new recapture rules for stock apply (generally, to stock acquired after December 31, 1980) those rules apply without regard to when the deductions to be recaptured were allowed.

tire year (including income earned by the individual before commencement of the preceding year, even though any assets derived from such income pass to the bankruptcy estate), but does not report any income earned by the bankruptcy estate.

General provisions of bill

The bill, like present law, treats the bankruptcy estate of an individual as a separate taxable entity for Federal income tax purposes. The separate entity rules under the bill (new Code sec. 1398)[1] apply if a bankruptcy case involving an individual debtor is brought under chapter 7 (liquidation) or chapter 11 (reorganization) of title 11 of the U.S. Code, as amended by P.L. 95-598. No separate taxable entity is created on commencement of a case under chapter 13 of new 11 U.S. Code (adjustment of debts of an individual with regular income).[2]

Exception

If a bankruptcy case involving an individual is commenced but subsequently dismissed by the bankruptcy court, the estate is not treated as a separate entity (new Code sec. 1398 (b)(1)). In this situation, where the bankruptcy case does not run to completion, it is appropriate to treat the debtor's tax status as if no proceeding had been brought.[3]

Partnerships, corporations

The bill provides that no taxable entity results from commencement of a bankruptcy case involving a partnership or corporation. This rule [26] (new Code sec. 1399) reverses current Internal Revenue Service practice as to partnerships, under which the estate of a partnership in bankruptcy is treated as a taxable entity (Rev. Rul. 68-48, 1968-1 C.B. 301), but is the same as present law with respect to commencement of a bankruptcy case involving a corporation (Treas. Reg. § 1.641(b)-2(b)).

Accordingly, the bankruptcy trustee of a partnership in a bankruptcy case is required to file annual information returns (under section 6031 of the Code) for the partnership. Also, the bankruptcy trustee of a corporation in a bankruptcy case, as under present law, is required to file annual income tax returns and pay corporate income tax for the corporation (sec. 6012(b)(3) of the Code; Rev. Rul. 79-120, 1979-1 C.B. 382).

2. Debtor's election to close taxable year

In general

The bill gives an individual debtor an election to close his or her taxable year as of the day before the date on which the bankruptcy case commences (the "commencement date"). If the election were made, the debtor's taxable year which otherwise would include the commencement date is divided into two "short" taxable years of less than 12 months. The first such year ends on the day before the commencement date; the second such year begins on the commencement date (new Code sec. 1398(d)(3)(A)). If the election were not made, the commencement of the bankruptcy case does not affect the taxable year of an individual debtor (new Code sec. 1398 (d)(2)).

As a result of the debtor's making the election, his or her Federal income tax liability for the first short taxable year becomes (under bankruptcy law) an allowable claim against the bankruptcy estate as a claim arising before bankruptcy. Accordingly, any tax liability for that year is collectible from the estate, depending on the availability of estate assets to pay debts of that priority. Inasmuch as any such tax liability for an electing debtor's first short taxable year is not dischargeable, the individual debtor remains liable for any amount not collected out of the bankruptcy estate (new 11 U.S. Code sec. 523(a)(1)). If the debtor does not make the election, no part of the debtor's tax liability from the year in which the bankruptcy case commences is collectible from the estate, but is collectible directly from the individual debtor.

If the election is made, the debtor is required to annualize his or her taxable income for each short taxable year in the same manner as if a change of annual accounting period had been made (new Code sec. 1398(d)(3)(F)).

Availability of election

The election provided under the bill is available in cases to which new section 1398 of the Code applies. Accordingly, the election is available to an individual debtor in a bankruptcy case under chapter 7 (liquidation) or chapter 11 (reorganization) of title 11 of the U.S. Code, as amended by P.L. 95-598, except where such case is commenced but subsequently dismissed by the bankruptcy court. Also, the bill provides that the election is not available to a debtor who has no assets other than property which he or she may treat as exempt [27] property under new 11 U.S. Code section 522

[1] In this report, provisions of the Internal Revenue Code which are added by section 3 of the bill are cited as "new Code sec. —".

[2] The rationale for generally treating the individual debtor and the bankruptcy estate as separate entities is that the individual may obtain new assets or earn wages after transfer of the pre-bankruptcy property to the trustee and thus derive income independent of that derived by the trustee from the transferred assets of the individual debtor and assets of the bankruptcy estate as in chapter 7 and exempt property may be used to make payments to creditors, and hence the bankruptcy law does not create the same dichotomy between after-acquired assets of the individual debtor and assets of the bankruptcy estate as in chapter 7 or chapter 11 cases.

For purposes of the separate entity rules under new Code section 1398, a partnership is not treated as an individual. The interest in a partnership of a debtor who is an individual is taken into account under new Code section 1398 in the same manner as any other interest of the debtor (new Code sec. 1398(b)(2)).

[3] If the estate is not treated as a separate entity because the bankruptcy case was dismissed, the debtor includes on his or her return(s), for the year(s) the estate was in existence, any gross income, deductions, or credits which otherwise would be tax items of the estate. The estate, although temporarily in existence under bankruptcy law prior to dismissal of the case, does not constitute a taxable entity for Federal income tax purposes.

(new Code sec. 1398(d)(3)(C)). In the latter instance, since there would be no assets in the bankruptcy estate out of which the debtor's tax liability for the commencement date could be collected, there is no reason to authorize termination of the taxable year.

Due date, manner of election

The election must be made on or before the 15th day of the fourth month following the commencement date—i.e., by the date on which a return would be due for the first short taxable year if the election were made, determined without regard to any extension for filing such return. For example, if the bankruptcy case commences on March 10, the election must be made by July 15 of that year. The election is to be made in such manner as prescribed by Treasury regulations, but an election is not conditioned on approval of the Internal Revenue Service, as under section 442 of the Code. The election, once made, is irrevocable (new Code sec. 1398(d)(3)(D)).

Spousal election

If the debtor making the election was married on the date the bankruptcy case involving him or her commenced, the debtor's spouse can join in the election to close the taxable year, but only if the debtor and the spouse file a joint return for the first short taxable year (new Code sec. 1398(d)(3)(B)). The filing of a joint return for the first short taxable year does not require the debtor and the spouse to file a joint return for the second short taxable year.

If during the same year a bankruptcy case involving the debtor's spouse were commenced, the spouse can elect to terminate his or her then taxable year as of the day before the commencement date, whether or not the spouse previously had joined in the debtor's election. If the spouse previously had joined in the debtor's election, or if the debtor had not made an election, the debtor can join in the spouse's election. But if the debtor had made an election and the spouse had not joined in the debtor's election, the debtor cannot join in the spouse's election, inasmuch as the debtor and the spouse, having different taxable years, could not file a joint return for a year ending with the spouse's commencement date (sec. 6013 of the Code).

Illustrative example

The rules relating to spousal elections under the bill are illustrated by the following example.

Assume that husband and wife are calendar-year taxpayers, that a bankruptcy case involving only the husband commences on March 1, 1982, and that a bankruptcy case involving only the wife commences on October 1, 1982.

If the husband does not make an election, his taxable year would not be affected; i.e., it does not terminate on February 28. If the husband does make an election, his first short taxable year would be January 1 through February 28; his second short taxable year would begin March 1. The wife could join in the husband's election, but only if they file a joint return for the taxable year January 1 through February 28.

The wife could elect to terminate her then taxable year on September 30. If the husband had not made an election, or if the wife [28] had not joined in the husband's election, she would have (if she made the election) two taxable years in 1982—the first from January 1 through September 30, and the second from October 1 through December 31. If the husband had not made an election to terminate his taxable year on February 28, the husband could join in an election by his wife, but only if they file a joint return for the taxable year January 1 through September 30. If the husband had made an election but the wife had not joined in the husband's election, the husband could not join in an election by the wife to terminate her taxable year on September 30, since they could not file a joint return for such year.

If the husband had made the election and the wife had joined in it, she would have two additional taxable years with respect to her 1982 income and deductions (if she makes the election relating to her own bankruptcy case)—the second short taxable year would be March 1 through September 30, and the third short taxable year would be October 1 through December 31. The husband could join in the wife's election if they file a joint return for the second short taxable year. If the husband does so join in the wife's election, they could file joint returns for the short taxable year ending December 31, but would not be required to do so.

3. Computation of bankruptcy estate's tax liability

Gross income

Under the bill, the gross income of the bankruptcy estate of an individual consists of (1) any gross income of the individual debtor, other than any amount received or accrued as income by the debtor before the commencement of the case, which under bankruptcy law (new 11 U.S. Code) constitutes property of the bankruptcy estate, and (2) the gross income of the estate beginning on and after the date the case commenced (new Code sec. 1398(e)(1)).

Attribute carryover

The estate succeeds to the following income tax attributes of the debtor (determined as of the first day of the debtor's taxable year in which the case commences):

(*a*) net operating loss carryovers;

(*b*) capital loss carryovers;

(*c*) credit carryovers;

(*d*) charitable contribution carryovers;

(*e*) recovery exclusions (under sec. 111 of the Code);

(*f*) the debtor's basis in and holding period for, and the character in the debtor's hands of, any asset acquired (other than by sale or exchange) from the debtor;

(*g*) the debtor's method of accounting; and

(*h*) other tax attributes, to the extent provided by Treasury regulations (new Code sec. 1398(g)). For example, the regulations could allow the estate the benefit of section 1341 of the Code if the estate repays income which the debtor received under claim of right.

Character of expenditures

Under present law, it is not clear whether certain expenses or debts paid by the trustee are deductible if the trustee does not actually operate the debtor's trade or business (and if such expenses are not [29] incurred in a new trade or business of the estate). To alleviate this problem, the bill provides that an amount paid or incurred by the bankruptcy estate is deductible or creditable by the estate to the same extent as that item would be deductible or creditable by the debtor had the debtor remained in the same trades, businesses, or activities after the case commenced as before and had the debtor paid or incurred such amount. The same test is applied to determine whether amounts paid by the estate constitute wages for purposes of Federal employment taxes (new Code sec. 1398(e)(4)).

Administrative expenses

Under present law, it is unclear in certain circumstances whether administrative and related expenses of the bankruptcy estate are deductible by the estate (see Rev. Rul. 68-48, 1968-1 C.B. 301). The bill provides (new Code sec. 1398(h)(1) that the estate can deduct (a) any administrative expense allowed under new 11 U.S. Code sec. 503 and (b) any fee or charge assessed against the estate under 28 U.S. Code, ch. 123 (court fees and costs). Such deductions are available whether or not considered trade or business expenses or investment expenses, but are subject to disallowance under other provisions of the Internal Revenue Code, such as section 263 (capital expenditures), 265 (expenses relating to tax-exempt interest), or 275 (certain taxes).

Under present law, any deduction otherwise available for administrative or related expenses may be lost, since no carryover deduction is permitted for expenses not incurred in a trade or business. The trustee often cannot pay administrative expenses until the end of the bankruptcy proceeding; unless considered trade or business expenses, the unused amount cannot be carried back and deducted against income of the bankruptcy estate received in earlier years.

To alleviate this problem, the bill provides that any amount of the new deduction for administrative, etc. expenses not used in the current year can be carried back by the estate three years (but only to a taxable year of the estate) and forward seven years (new Code sec. 1398(h)(2)). These carryovers are "stacked" after the net operating loss deductions (allowed by sec. 172 of the Code) for the particular year. An administrative, etc. expense which is deductible solely under new Code sec. 1398(h)(1), or a carryover deduction for such expense, is allowable only to the estate (new Code sec. 1398(h)(2)(D)).

Carryback of estate's net operating losses

If the bankruptcy estate itself incurs a net operating loss (apart from losses passing to the estate from the individual debtor), the bill provides that the bankruptcy estate can carry back its net operating losses not only to previous taxable years of the estate, but also to taxable years of the individual prior to the year in which the case commenced (new Code sec. 1398(j)(2)). Similarly, the bill allows the bankruptcy estate to carry back excess credits, such as the investment tax credit, to pre-bankruptcy taxable years of the individual debtor.

Tax rate schedule, etc.

Except as otherwise provided in new Code section 1398, the taxable income of the bankruptcy estate is computed in the same manner as [30] in the case of an individual. The estate is allowed a deduction of $1,000 under section 151 of the Code as its personal exemption. Under the bill, the zero bracket amount for the estate and the tax rate schedule applicable to the estate are the same as for married individuals filing separate returns (new Code sec. 1398(c)). The estate is not eligible for income averaging.

Returns of estate

Under the bill, the trustee is required to file a Federal income tax return on behalf of the bankruptcy estate for any year in which the estate's gross income is $2,700 or more (sec. 3(b) of the bill and new sec. 6012(a)(9) of the Code), and to pay the estate's tax liability due for that year (new Code sec. 1398(c)(1)). No return need be filed and no income tax would be due if gross income for the year is less than $2,700.

Change of accounting period

The estate is permitted to change its annual accounting period (taxable year) one time without obtaining approval of the Internal Revenue Service as otherwise required under section 442 of the Code (new Code sec. 1398(j)(1). This rule permits the trustee to effect an early closing of the estate's taxable year prior to the expected termination of the estate, and then to submit a return for such "short year" for an expedited determination of tax liability pursuant to new 11 U.S. Code sec. 505.

Disclosure of returns

The bill provides that the estate's Federal income tax return is open (upon written request) to inspection by or disclosure to the individual debtor (sec. 3(c) of the bill and amended sec. 6103(e) of the Code). Such disclosure is necessary so that the debtor can properly determine any amount of tax attributes to which the debtor would succeed on termination of the bankruptcy estate.

No-disposition rule

Under the bill, a transfer (other

than by sale or exchange) of an asset from the bankruptcy estate to the individual debtor on termination of the estate would not be treated as a disposition giving rise to recognition of gain or loss, recapture of deductions or credits, or acceleration of income or deductions (new Code sec. 1398(f)(2)).

4. Computation of individual's tax liability

Gross income, deductions, credits

If any item of gross income of the debtor realized after commencement of the bankruptcy case is treated under new Code section 1398(e)(1) as gross income of the bankruptcy estate (because under bankruptcy law such income constitutes property of the estate), that item is not included by the debtor as gross income on his or her return or a joint return with the debtor's spouse (new Code sec. 1398(e)(2)).

This provision of the bill, treating such income items as gross income of the estate rather than of the individual, is intended to override otherwise applicable "assignment of income" principles of tax law. For example, if the estate were entitled under bankruptcy law to a salary payment earned by the debtor before the case commences but paid after that date, the amount of the payment is included in the [31] estate's gross income and is not to be included in the debtor's gross income.

If any item of deduction or credit of the debtor is treated under new Code section 1398(e)(3) as a deduction or credit of the bankruptcy estate that item is not allowable to the debtor as a deduction or credit on his or her return or a joint return with the debtor's spouse (new Code section 1398(e)(3)). This rule is intended to insure that no particular item of deduction or credit can be allowable to both the debtor and the estate.

No-disposition rule

Under the bill, a transfer (other than by sale or exchange) of an asset from the individual debtor to the bankruptcy estate is not treated as a disposition giving rise to recognition of gain or loss, recapture of deductions or credits, or acceleration of income or deductions (new Code sec. 1398(f)(1)). For example, such a transfer of an installment obligation is not treated as a disposition giving rise to acceleration of gain under section 453(d) of the Code.

Carryback of net operating loss

The bill provides that an individual debtor cannot carry back, to a year that preceded the year in which the case was commenced, any net operating loss or credit carryback from a taxable year ending after commencement of the bankruptcy case (new Code sec. 1398(j)(2)(B)). As noted above, the bill would permit the bankruptcy estate to carry back its net operating loss deduction to offset the pre-bankruptcy income of the individual debtor.

Attribute carryover

On termination of the bankruptcy estate, the debtor would succeed to the following tax attributes of the estate (including such attributes which first arose during administration of the estate):

(*a*) net operating loss carryovers;

(*b*) capital loss carryovers;

(*c*) credit carryovers;

(*d*) charitable contribution carryovers;

(*e*) recovery exclusions (under sec. 111 of the Code);

(*f*) the estate's basis in and holding period for, and the character in the estate's hands of, any asset acquired (other than by sale or exchange) from the estate; [4] and

(*g*) other tax attributes, to the extent provided by Treasury regulations (new Code sec. 1398(i)).

Disclosure of returns

In a bankruptcy case to which new Code section 1398 applies (determined without regard to whether the case is dismissed), the Federal [32] income tax returns of the debtor for the taxable year in which the bankruptcy case commenced and preceding years are open (upon written request) to inspection by or disclosure to the trustee of the bankruptcy estate. (This disclosure is necessary so that the trustee properly may determine attribute carryovers to the estate and may carry back deductions to preceding years of the debtor.) In an involuntary case, however, no such disclosure of the trustee could be made prior to the time the bankruptcy court has entered an order for relief unless that court finds that such disclosure is appropriate for purposes of determining whether an order for relief should be entered (sec. 3(c) of the bill and amended sec. 6103(e) of the Code).

Also under the bill, prior year returns of the debtor in a bankruptcy case, or of a person whose property is in the hands of a receiver, are open (upon written request) to inspection by or disclosure to the trustee or receiver, but only if the Internal Revenue Service finds that such trustee or receiver, in his fiduciary capacity, has a material interest which would be affected by information contained in the return.

5. Technical amendment

Section 443(c) of the Code, relating to cross references, is amended by adding a cross reference to new Code section 1398(d)(3)(E), with respect to returns for a period of less than 12 months in the case of a debtor's election to terminate a taxable year.

[4] In a bankruptcy case to which new Code sec. 1398 applies, any attribute reduction under section 2 of the bill applies to tax attributes of the bankruptcy estate (except for purposes of applying the basis-reduction rules of section 1017 to property transferred by the estate to the individual) and not to those attributes of the individual which arose after commencement of the case. Also, the bill provides that in a bankruptcy case involving an individual debtor, no reduction in basis is to be made in the basis of property which the debtor treats as exempt property under new 11 U.S. Code section 522. The tax attributes to the estate, as so reduced, carry over (to the extent unused on termination of the estate) to the individual debtor pursuant to new Code sec. 1398(i).

6. Effective date

The amendments made by section 3 of the bill apply to bankruptcy cases commencing more than 90 days after the date of enactment of the bill.

[33] C. Corporate Reorganization Provisions (sec. 4 of the bill and secs. 354, 355, 357, 368, and 381 of the Code)

Present Law

Definition of reorganization

A transfer of all or part of a corporation's assets, pursuant to a court order in a proceeding under chapter X of the Bankruptcy Act (or in a receivership, foreclosure, or similar proceeding), to another corporation organized or utilized to effectuate a court-approved plan may qualify for tax-free reorganization treatment under special rules relating to "insolvency reorganizations" (secs. 371-374 of the Internal Revenue Code).

These special rules for insolvency reorganizations generally allow less flexibility in structuring tax-free transactions than the rules applicable to corporate reorganizations as defined in section 368 of the Code. Also, the special rules for insolvency reorganizations do not permit carryover of tax attributes to the transferee corporation, and otherwise differ in important respects from the general reorganization rules.[1] While some reorganizations under chapter X of the Bankruptcy Act may be able to qualify for nonrecognition treatment under Code section 368, other chapter X reorganizations may be able to qualify only under the special rules of sections 371-374 and not under the general reorganization rules of section 368.

Triangular reorganizations

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of Code sections 371-374, the stock or securities used to acquire the assets of the corporation in bankruptcy must be the acquiring corporation's own stock or securities. This limitation generally precludes corporations in bankruptcy from engaging in so-called triangular reorganizations, where the acquired corporation is acquired for stock of the parent of the acquiring corporation. By contrast, tax-free triangular reorganizations generally are permitted under the general rules of Code section 368.

Transfer to controlled subsidiary

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of Code sections [34] 371-374, it is not clear under present law whether and to what extent the acquiring corporation may transfer assets received into a controlled subsidiary. In the case of other corporate reorganizations, the statute expressly defines the situations where transfers to subsidiaries are permitted (Code sec. 368(a)(2)(C)).

Carryover of tax attributes

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of Code sections 371-374, court cases have held that attributes (such as net operating losses) of the corporation in bankruptcy do not carry over to the new corporation. In the case of other corporate reorganizations, however, specific statutory rules permit carryover of tax attributes to the surviving corporation (Code sec. 381).

"Principal amount" rule; "boot" test

In a corporate reorganization, generally the exchange of stock or securities of one corporation for those of another corporation is not tax-free to the extent the principal amount of the securities received exceeds the principal amount of the securities surrendered, or to the extent of the principal amount of the securities received if no securities are surrendered (Code secs. 354(a)(2)(B) and 356(d)(2)). Also, "boot" (money or property other than stock and securities permitted to be received without recognition of gain) received in a corporate reorganization is subject to the dividend-equivalence test of Code section 356. These rules do not apply under present law to insolvency reorganizations qualifying only under Code sections 371-374.

Treatment of accrued interest

Under present law, a claim for unpaid interest is treated as an integral part of the security to which it relates, so that the surrender of the security together with the claim for unpaid interest is treated only at the surrender of a security. Thus, the nonrecognition provisions apply to an exchange of a security with accrued but unpaid interest although the unpaid interest would have been taxable as ordinary income if paid separately.[2]

Reasons for Change

The committee believes that the provisions of existing Federal income tax law which are generally applicable to tax-free corporate reorganizations should also apply to reorganizations of corporations in bankruptcy or similar proceedings, in order to facilitate the rehabilitation of financially troubled businesses.

Also, the committee believes that a creditor who exchanges securities in a corporate reorganization (including an insolvency reorganization) should be treated as receiving interest income on

[1] Under present law, it is not clear to what extent creditors of an insolvent corporation who receive stock in exchange for their claims may be considered to have "stepped into the shoes" of former shareholders for purposes of satisfying the nonstatutory "continuity of interest" rule, under which the owners of the acquired corporation must continue to have a proprietary interest in the acquiring corporation. Generally, the courts have found the "continuity of interest" test satisfied if the creditors' interests were transformed into proprietary interests prior to the reorganization (e.g., *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942); Treas Reg. § 1.371-1(a)(4)). It is unclear whether affirmative steps by the creditors are required or whether mere receipt of stock is sufficient.

[2] *Carman* v. *Comm'r*, 189 F. 2d 363 (2nd Cir. 1951); Rev. Rul. 59-98, 1959-1 C.B. 76.

the exchange to the extent the creditor receives new securities, stock, or any other property for accrued but unpaid interest on the securities surrendered.

Explanation of Provisions

Section 4 of the bill generally conforms the tax rules governing insolvency reorganizations with the existing rules applicable to other [35] corporate reorganizations. These provisions are the same as section 4 of the House bill.

Definition of reorganization

In general

The bill adds a new category—"G" reorganizations—to the general Code definition of tax-free reorganizations (sec. 368(a)(1)). The new category includes certain transfers of assets pursuant to a court-approved reorganization plan in a bankruptcy case under new title 11 of the U.S. Code, or in a receivership, foreclosure, or similar proceeding [3] in a Federal or State court.[4]

The special tax rules (Code secs. 371-374) now applicable to insolvency reorganizations continue to apply only to bankruptcy proceedings commenced prior to October 1, 1979, except that the bill does not terminate the applicability of the rules in sections 374(c) and 374(e) of the Code governing tax-free exchanges under the final system plan for ConRail.

In order to facilitate the rehabilitation of corporate debtors in bankruptcy, etc., these provisions are designed to eliminate many requirements which have effectively precluded financially troubled companies from utilizing the generally applicable tax-free reorganization provisions of present law. To achieve this purpose, the new "G" reorganization provision does not require compliance with State merger laws (as in category "A" reorganizations), does not require that the financially distressed corporation receive solely stock of the acquiring corporation in exchange for its assets (category "C"), and does not require that the former shareholders of the financially distressed corporation control the corporation which receives the assets (category "D").

The "G" reorganization provision added by the bill requires the transfer of assets by a corporation in a bankruptcy or similar case, and the distribution (in pursuance of the court-approved reorganization plan) of stock or securities of the acquiring corporation in a transaction which qualifies under sections 354, 355, or 356 of the Code. This distribution requirement is designed to assure that either substantially all of the assets of the financially troubled corporation, or assets which consist of an active business under the tests of section 355, are transferred to the acquiring corporation.

"Substantially all" test

The "substantially all" test in the "G" reorganization provision is to be interpreted in light of the underlying intent in adding the new "G" category, namely, to facilitate the reorganization of companies in bankruptcy or similar cases for rehabilitative purposes. Accordingly, it is intended that facts and circumstances relevant to this intent, such as the insolvent corporation's need to pay off creditors or to sell [36] assets or divisions to raise cash, are to be taken into account in determining whether a transaction qualifies as a "G" reorganization. For example, a transaction is not precluded from satisfying the "substantially all" test for purposes of the new "G" category merely because, prior to a transfer to the acquiring corporation, payments to creditors and asset sales were made in order to leave the debtor with more manageable operating assets to continue in business.[5]

Relation to other provisions

A transaction which qualifies as a "G" reorganization is not to be treated as also qualifying as a liquidation under section 332, an incorporation under section 351, or a reorganization under another category of section 368(a)(1) of the Code.[6]

A transaction in a bankruptcy or similar case which does not satisfy the requirements of new category "G" is not thereby precluded from qualifying as a tax-free reorganization under one of the other categories of section 368(a)(1). For example, an acquisition of the stock of a company in bankruptcy, or a recapitalization of such a company, which transactions are not covered by the new "G" category, can qualify for nonrecognition treatment under sections 368(a)(1)(B) or (E), respectively.

Continuity of interest rules

The "continuity of interest" requirement which the courts and the Treasury have long imposed as a prerequisite for nonrecognition treatment for a corporate reorganization must be met in order to satisfy the requirements of new category "G". Only reorganizations—as distinguished from liquida-

[3] For this purpose, the definition of a receivership, foreclosure, or similar proceeding is the same as under present section 371 of the Code.

[4] Under the bill, asset transfers in a receivership, foreclosure, or similar proceeding involving a financial institution (to which section 585 or 593 of the Code applies) before a Federal or State agency are treated in the same manner as transfers in such a proceeding before a court. Thus, for example, asset transfers in a proceeding under 12 U.S.C. sec. 1729 involving a savings and loan association can qualify as a "G" reorganization.

[5] Because the stated intent for adding the new "G" category is not relevant to interpreting the "subtantially all" test in the case of other reorganization categories, the comments in the text as to the appropriate interpretation of the "subtantially all" test in the context of a "G" reorganization are not intended to apply to, or in any way to affect interpretations under present law of, the "subtantially all" test for other reorganization categories.

[6] However, if a transfer qualifying as a "G" reorganization also meets the requirements of section 351 or qualifies as a reorganization under section 368(a)(1)(D) of the Code, the "excess liability" rule of section 357(c) applies if any former shareholder of the transferor corporation receives consideration for his stock, but does not apply if no former shareholder of the transferor corporation receives any consideration for his stock (i.e., if the corporation is insolvent). This rule parallels present law, under which insolvency reorganizations under sections 371 or 374 are excluded from the application of section 357(c).

tions in bankruptcy and sales of property to either new or old interests supplying new capital and discharging the obligations of the debtor corporation—can qualify for tax-free treatment.

It is expected that the courts and the Treasury will apply to "G" reorganizations continuity-of-interest rules which take into account the modification by P.L. 95-598 of the "absolute priority" rule. As a result of that modification, shareholders or junior creditors, who might previously have been excluded, may now retain an interest in the reorganized corporation.

For example, if an insolvent corporation's assets are transferred to a second corporation in a bankruptcy case, the most senior class of creditor to receive stock, together with all equal and junior classes (including shareholders who receive any consideration for their stock), [37] should generally be considered the proprietors of the insolvent corporation for "continuity" purposes. However, if the shareholders receive consideration other than stock of the acquiring corporation, the transaction should be examined to determine if it represents a purchase rather than a reorganization.

Thus, short-term creditors who receive stock for their claims may be counted toward satisfying the continuity of interest rule, although any gain or loss realized by such creditors will be recognized for income tax purposes.

Triangular reorganizations

The bill permits a corporation to acquire a debtor corporation in a "G" reorganization in exchange for stock of the parent of the acquiring corporation rather than for its own stock.

In addition, the bill permits an acquisition in the form of a "reverse merger" of an insolvent corporation (i.e., where no former shareholder of the surviving corporation receives any consideration for his stock) in a bankruptcy or similar case if the former creditors of the surviving corporation exchange their claims for voting stock of the controlling corporation which has a value equal to at least 80 percent of the value of the debt of the surviving corporation.[7]

Transfer to controlled subsidiary

The bill permits a corporation which acquires substantially all the assets of a debtor corporation in a "G" reorganization to transfer the acquired assets to a controlled subsidiary without endangering the tax-free status of the reorganization. This provision places "G" reorganizations on a similar footing with other categories of reorganizations.

Carryover of tax attributes

Under the bill, the statutory rule generally governing carryover of tax attributes in corporate reorganizations (Code sec. 381) also applies in the case of a "G" reorganization. This eliminates the so-called "clean slate" doctrine.[8]

"Principal amount" rule; "boot" test

Under the bill, "G" reorganizations are subject to the rules governing the tax treatment of exchanging shareholders and security holders which apply to other corporate reorganizations.

Accordingly, an exchanging shareholder or security holder of the debtor company who receives securities with a principal amount exceeding the principal amount of securities surrendered is taxable on the excess, and an exchanging shareholder or security holder who surrenders no securities is taxed on the principal amount of any securities received. Also, any "boot" received is subject to the general dividend-equivalence test of Code section 356.

Treatment of accrued interest

Under the bill, a creditor exchanging securities in any corporate reorganization described in section 368 of the Code (including a "G" [38] reorganization) is treated as receiving interest income on the exchange to the extent the security holder receives new securities, stock, or any other property attributable to accrued but unpaid interest (including accrued original issue discount) on the securities surrendered. This provision, which reverses the so-called *Carman* rule,[9] applies whether or not the exchanging security holder realizes gain on the exchange overall. Under this provision, a security holder which had previously accrued the interest (including original issue discount) as income recognizes a loss to the extent the interest is not paid in the exchange.

Example

The reorganization provisions of the bill are illustrated in part by the following example.

Assume that Corporation A is in a bankruptcy case commenced after December 31, 1980. Immediately prior to a transfer under a plan of reorganization, A's assets have an adjusted basis of $75,000 and a fair market value of $100,000. A has a net operating loss carryover of $200,000. A has outstanding bonds of $100,000 (on which there is no accrued but unpaid interest) and trade debts of $100,000.

Under the plan of reorganization, A is to transfer all its assets to Corporation B in exchange for $100,000 of B stock. Corporation A will distribute the stock, in exchange for their claims against A, one-half to the security holders and one-half to the trade creditors. A's shareholders will receive nothing.

The transaction qualifies as a reorganization under new section 368(a)(1)(G) of the Code, since all the creditors are here treated as proprietors for continuity of interested purposes. Thus, A recognizes no gain or loss on the transfer of its assets to B (Code sec. 361). B's basis in the assets is $75,000 (sec. 362), and B succeeds

[7] Priority claims described in new 11 U.S. Code section 1129(a)(9) which are paid in cash may be excluded from this determination.

[8] The bill also provides that creditors of a debtor corporation in a title 11 or similar case are to be treated as shareholders in applying the continuity rules of Code sec. 382(b).

[9] See note 2, *supra*.

to A's net operating loss carryover (sec. 381).

Under the bill, the pro-rata distribution of B stock to A's creditors does not result in income from discharge of indebtedness or require attribute reduction.

Assume the same facts as above except that B also transfers $10,000 in cash, which is distributed by A to its creditors. Although A would otherwise recognize gain on the receipt of boot in an exchange involving appreciated property, the distribution by A of the $10,000 cash to those creditors having a proprietary interest in the corporation's assets for continuity of interest purposes prevents A from recognizing any gain (Code sec. 361(b)(1)(A)).[10]

Technical and conforming amendments

Section 4(h) of the bill makes technical and conforming amendments to the Internal Revenue Code.

1. Amendment of section 354(b).—Paragraphs (1) and (2) of Code section 354(b), relating to exception to general rule on exchanges of stock and securities in certain reorganizations, are amended by adding references to new subparagraph "G" of section 368(a)(1).

[39] *2. Amendment of section 357(c)(2).*—Code section 357(c)(2), providing exceptions to the general rule with respect to liabilities in excess of basis on transfers to controlled corporations, is amended to add an exception for any exchange pursuant to a plan of reorganization under new category "G" of section 368(a)(1) if no former shareholder of the transferor corporation receives any consideration for his stock.[11]

3. Amendment of section 368(a)(1).—A conforming amendment is made to Code section 368(a)(1) to take into account the addition of new category "G" reorganizations.

4. Amendment of section 368(b).—Code section 368(b), defining "party to a reorganization", is amended to include references to new category "G" reorganizations.

5. Technical change.—A change is made in the table of sections for part IV of subchapter C of chapter 1 of the Code.

Effective Date

The amendments made by section 4 of the bill apply to bankruptcy cases commencing after December 31, 1980 and to receivership, foreclosure, or similar judicial proceedings commencing after that date. Also, these amendments will apply to a bankruptcy case or a receivership, etc. proceeding commenced on or after October 1, 1979 (but prior to January 1, 1981), if the special effective date election provided by the bill is made (see explanation of effective date election under part II-A of the report).

In the case of transactions outside bankruptcy cases and receivership, etc. proceedings, the amendments made by section 4(e) of the bill, relating to exchanges of property for accrued interest, apply to transactions occurring after December 31, 1980.

[40] D. Miscellaneous Corporate Amendments (sec. 5 of the bill)

1. Exception from personal holding company status (sec. 5(a) of the bill and sec. 542 of the Code)

Present Law

Under present law, a corporation in a bankruptcy or insolvency proceeding may become subject to the personal holding company tax on certain passive income (sec. 541 of the Internal Revenue Code) if its assets are converted to investments which produce passive income before the corporation is liquidated.

Reasons for Change

The committee believes that the personal holding company tax generally should not apply to corporations in bankruptcy or insolvency proceedings, since financially troubled corporations under court supervision generally are not used to avoid income tax on their shareholders.

Explanation of Provision

Under this provision, a corporation subject to court jurisdiction in a bankruptcy or similar case[1] is not to be considered a personal holding company. This exception is not available, however, if a major purpose in commencing or continuing the case is avoidance of the personal holding company tax. This provision is the same as section 5(a) of the House bill.

Effective Date

The amendment made by this provision applies to bankruptcy cases commencing after December 31, 1980 and to similar cases commenced after that date. Also, the amendment will apply to a bankruptcy or similar case commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election provided by the bill is made (see explanation of effective date election under part II-A of this report).

2. Repeal of special treatment for certain railroad stock redemptions (sec. 5(b) of the bill and sec. 302 of the Code)

Present Law

Present law provides that any distribution in redemption of stock issued by a railroad corporation pursuant to a reorganization plan under section 77 of the Bankruptcy Act gives rise to capital gain, even if under the general redemption distribution tests the stockholder would realize ordinary income (sec. 302(b)(4) of the Code).

[41] *Reasons for Change*

The committee believes that the Federal income tax treatment of re-

[10] See Code sec. 371(a)(2)(A) and Treas. Reg. § 1.371-1(b) for a similar rule relating to distribution of boot to creditors in an insolvency reorganization under present law.

[11] See note 6, *supra*.

[1] The terms "bankruptcy case" and "similar case" refer, respectively, to (1) cases under new 11 U.S. Code and (2) receivership, foreclosure, or similar proceedings in a Federal or State court (or, in the case of a financial instiution, a Federal or State agency).

demption of certain railroad corporation stock should be the same as applies in the case of redemption of all other stock.

Explanation of Provision

This provision repeals the special rule giving automatic capital gain treatment in the case of redemptions of certain stock issued by railroad corporations in bankruptcy. This provision is the same as section 5(b) of the House bill.

Effective Date

The amendment made by this provision applies to a redemption of stock issued after December 31, 1980 (other than stock issued pursuant to a plan of reorganization approved on or before that date). Also, the amendment will apply to a bankruptcy or similar case commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election provided by the bill is made (see explanation of effective date election under part II-A of this report).

3. Application of section 337 liquidation rule to corporations in bankruptcy (sec. 5(c) of the bill and sec. 337 of the Code)

Present Law

Under present law, a corporation which adopts a plan of liquidation and within 12 months thereafter liquidates in a distribution to shareholders generally does not recognize gain or loss on sales within that period (sec. 337 of the Code). The Internal Revenue Service has ruled that this provision does not apply if, as in the case of an insolvency proceeding, the assets are transferred on liquidation to creditors rather than to shareholders (Rev. Rul. 56-387, 1956-2 C.B. 189).

Reasons for Change

The committee believes that nonrecognition treatment should be extended to sales of certain assets by liquidating corporations in bankruptcy or similar cases. In addition, inasmuch as insolvency proceedings may last longer than 12 months, the committee believes that the nonrecognition period should likewise be extended to the termination of the case. Because the nonrecognition period thus would extend to termination of the case, the committee believes that, in order to preclude tax-free "churning" of assets, nonrecognition treatment should not be available on sales of property (other than bulk sales of inventory) acquired after adoption of the liquidation plan.

Explanation of Provision

This provision allows a corporation in a bankruptcy or similar case [2] to sell certain of its assets tax-free where the corporation, after the case commences, adopts a plan of complete liquidation and completes the liquidation before the termination of the case.

The period of nonrecognition begins on the date of adoption (after commencement of the case) of a plan of liquidation and ends on the date the case terminates. It is intended that under the provision, the [42] liquidating corporation could retain sufficient assets to pay administrative claims following the close of the case. This provision does not apply to assets acquired on or after the date of adopting the liquidation plan, other than to inventory sold in bulk.[3]

Effective Date

The amendment made by this provision applies to bankruptcy cases commencing after that date. Also, the amendment will apply to a bankruptcy or similar case commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election provided by the bill is made (see explanation of effective date election under part II-A of this report).

4. Estate of individual in bankruptcy as subchapter S shareholder (sec. 5(d) of the bill and sec. 1371 of the Code)

Present Law

Under present law, only individuals, estates, and certain trusts are permitted to be shareholders of subchapter S corporations (sec. 1371 of the Code). Failure to satisfy this rule disqualifies the election of the corporation under subchapter S.

The Internal Revenue Service has ruled that an "estate" for subchapter S purposes includes only the estate of a decedent and not the estate of an individual in bankruptcy (Rev. Rul. 66-266, 1966-2 C.B. 356). Accordingly, the Revenue Service also has ruled that the filing of a voluntary petition in bankruptcy by a shareholder terminates the subchapter S election as of the beginning of the taxable year in which the petition is filed (Rev. Rul. 74-9, 1974-1 C.B. 241). However, the U.S. Tax Court has held that the filing of a petition seeking financial rehabilitation of a debtor under the debt arrangement provisions of the Bankruptcy Act does not create a new entity apart from the debtor and does not cause the termination of a subchapter S election.[4]

Reasons for Change

The committee is concerned that if bankruptcy of an individual shareholder causes termination of a subchapter S election, other shareholders may be adversely affected by an event over which they had no control. The committee believes that the estate of an individual in a bankruptcy case should be permitted to be an eligible shareholder for purposes of the provisions of subchapter S.

Explanation of Provision

Under the bill, the bankruptcy estate of an individual is permitted to be an eligible shareholder in a subchapter S corporation. Thus, a corporation's subchapter S election is not terminated because of commencement

[2] See note 1, *supra*.
[3] Only one bulk sale in any case can qualify for this treatment.

[4] *CHM Company*, 68 T.C. 31 (1977).

of a bankruptcy case involving an individual who is a shareholder in the corporation. In addition, the bankruptcy estate of an individual which owns stock in a corporation can consent to an election under subchapter S made by the corporation after commencement of the bankruptcy case. This provision is the same as section 5(d) in the House bill.

[43] *Effective Date*

The amendment made by this provision applies to bankruptcy cases commenced on or after October 1, 1979.

5. Certain transfers to controlled corporations (sec. 5(e) of the bill and sec. 351 of the Code)

Present Law

Under present law, if property is transferred to a corporation controlled by the transferor, no gain or loss is recognized on the transfer (sec. 351 of the Code). For this purpose, property includes (1) indebtedness of the transferee corporation not evidenced by a security [5] and (2) a claim for accrued interest on indebtedness of the transferee corporation.[6]

Reason for Change

The committee believes that creditors holding debt not evidenced by a security who exchange their claims against a debtor corporation for stock of the corporation should recognize gain or loss on the exchange. This treatment will accord with the treatment of these creditors on an exchange under a plan of reorganization.

In addition, the committee believes that a transfer of assets to a corporation by a debtor in a bankruptcy or insolvency proceeding where the stock received is transferred to creditors should be treated in the same manner as if the property had been transferred to the creditors, who then transferred the property to a controlled corporation. This rule is designed to prevent the incorporation by a debtor of high-basis, low-value assets where a transfer by the creditors to a controlled corporation would result in a fair market value basis to the corporation.

Explanation of Provision

Under the provision, transfers to a controlled corporation of indebtedness of the corporation which is not evidenced by a security, or of claims against the corporation for accrued but unpaid interest on indebtedness, are not covered by the nonrecognition rule of section 351 of the Code.

Also, the nonrecognition rule does not apply in the case of a transfer to a controlled corporation of the assets of a debtor in a bankruptcy or similar case [7] to the extent the stock or securities received in exchange for the assets are used to satisfy the indebtedness of the debtor. Accordingly, gain or loss is recognized to the debtor upon the debtor's transfer of assets to the controlled corporation if the stock is then transferred to creditors pursuant to a plan approved in a bankruptcy or similar case. (If less than all the stock is transferred to creditors, a proportionate share of gain or loss is recognized.) Since the basis of the stock received is adjusted for any gain or loss recognized, the amount recognized on the transfer of the stock to the creditors reflects any amount recognized on the incorporation transfer.

[44] Thus, the sum total of income or loss to the debtor in the two transfers is the same as if the assets had been transferred directly to the creditors. However, the basis of the assets in the hands of the corporation also is adjusted by any gain or loss recognized on the transfer to the corporation, thus reducing any "built-in" loss on assets which had depreciated in value.[8]

This provision is the same as section 5(e) of the House bill.

Effective Date

The effective date for this provision is the same as for section 2 of the bill, relating to income from discharge of indebtedness.

6. Effect of discharge of indebtedness on earnings and profits (sec. 5(f) of the bill and sec. 312 of the Code)

Present Law

Under present law, the effect of discharge of indebtedness on the earnings and profits of a corporation in a bankruptcy proceeding is unclear.[9]

Reason for Change

The committee believes that income from discharge of indebtedness should increase earnings and profits whether or not current tax is imposed on that income. The bankruptcy considerations underlying deferral of recognition of such income by a debtor in a bankruptcy case do not justify extending tax foregiveness to shareholders receiving nonliquidating distributions from the corporation. Also, the committee believes that a corporation's deficit in earnings and profits should be reduced by the amount of the paid-in capital of any stockholder whose interest is extinguished in a bankruptcy or similar case, since it represents no part of the stock of the creditors who become the owners of the corporation.

Explanation of Provision

The bill provides that to the extent that income from discharge of indebtedness (including an amount excluded from gross income pursuant to section 108 of the Code, as amended by this

[5] *Alexander F. Duncan,* 9 T.C. 468 (1947), acq. 1948-2 C.B. 2; Rev. Rul. 77-81, 1977-1 C.B. 97.

[6] See *Carman* v. *Comm'r.,* 189 F.2d 363 (2d Cir. 1951).

[7] See note 1, *supra.*

[8] This rule does not apply to a transfer under a plan of reorganization, since no gain or loss is recognized by reason of section 361 of the Code.

[9] In the case of *Meyer* v. *Comm'r,* 383 F.2d 883 (8th Cir. 1967), the Eighth Circuit held that earnings and profits did not arise where indebtedness was discharged under the Bankruptcy Act. The Internal Revenue Service has announced that it will not follow the *Meyer* decision to the extent that the amount of debt discharged exceeds the reduction in basis of the taxpayer's assets (Rev. Rul. 75-515, 1975-2 C.B. 117).

bill) is applied to reduce basis under section 1017 of the Code, such basis-reduction amount does not affect the debtor corporation's earnings and profits (although reduced depreciation deductions or increased gains on sales of reduced-basis assets would affect earnings and profits in the years such deductions are taken or sales made). Otherwise, discharge of indebtedness income, including amounts excluded from gross income (pursuant to section 108 of the Code, as amended by this bill), increases the earnings and profits of the corporation (or reduces a deficit).

[45] In addition, the committee bill provides that any deficit in earnings and profits is reduced (but positive earnings and profits will not be created) by the paid-in capital of any shareholder whose interest is eliminated in a bankruptcy or similar case.

Effective Date

The effective date for this provision is the same as for section 2 of the bill, relating to income from discharge of indebtedness.

[46] E. Changes in Tax Procedures (sec. 6 of the bill)

1. Coordination with bankruptcy court procedures (secs. 6(a), (b), (c), (d), and (g) of the bill and secs. 6213, 6503, 6871, and 7464 of the Code)

Procedures Under Bankruptcy Act

Bankruptcy court jurisdiction

In the case of an individual debtor, the commencement of a bankruptcy proceeding creates an estate. This estate, which is under control of the bankruptcy court, consists of all assets of the individual other than exempt property and certain assets acquired after the proceeding begins. The assets of the bankruptcy estate are not subject to levy by the Internal Revenue Service for the debtor's prepetition income tax liabilities, and generally can be reached only through the Service's filing of a proof of claim in the bankruptcy court.

The bankruptcy court has jurisdiction to determine the debtor's liability for any unpaid tax, whether or not assessed, unless the liability was adjudicated prior to bankruptcy by a court of competent jurisdiction (sec. 2a(2A) of the Bankruptcy Act). In proceedings under the Bankruptcy Act,[1] a determination by the bankruptcy court of a prepetition tax liability of an individual debtor is binding on the Internal Revenue Service and on the trustee of the bankruptcy estate. However, the determination might not settle the personal liability of an individual debtor for the amount, if any, of prepetition nondischargeable tax claims which are not satisfied out of the assets of the bankruptcy estate. Accordingly, if the bankruptcy court rules in favor of the Revenue Service with respect to a nondischargeable tax claim, the debtor may be able to force the Service to relitigate the issue if the claim cannot be fully paid out of estate assets.

Effect on Tax Court jurisdiction

Under present Federal income tax law (sec. 6871 of the Code) as applicable to Bankruptcy Act proceedings, the Internal Revenue Service is authorized, on institution of a bankruptcy proceeding, immediately to assess any income tax liabilities against the debtor. The Service is not required to follow the normal procedure under which a deficiency notice is issued to the taxpayer and the taxpayer may challenge an asserted income tax liability in the U.S. Tax Court without payment of the tax.

Even if a statutory deficiency notice had been issued and the time for filing a Tax Court petition had not expired before commencement of the bankruptcy proceeding, the debtor still is barred from contest- [47] ing the asserted liability in the Tax Court (i.e., from litigating without first paying the disputed amount) if the Revenue Service exercises its immediate assessment authority. Present income tax law likewise provides that any portion of a claim for nondischargeable taxes allowed in a bankruptcy proceeding but not satisfied out of assets in the estate shall be paid by the taxpayer after termination of the bankruptcy proceeding (sec. 6873 of the Code).

Under the law applicable to Bankruptcy Act proceedings, the U.S. Tax Court thus loses jurisdiction to determine the debtor's personal liability for prepetition taxes unless a Tax Court case had been filed prior to the bankruptcy proceeding. Accordingly, unless the debtor can invoke the jurisdiction of the bankruptcy court and that court makes a determination, the debtor is precluded from prepayment review of an asserted income tax liability. The debtor's only recourse is to pay the tax and then contest the issue through the refund claim procedure of the Internal Revenue Service and subsequent refund litigation in the U.S. District Court or U.S. Court of Claims.

If a notice of deficiency had been issued and a Tax Court case filed prior to institution of the bankruptcy proceeding, but the Tax Court had not reached a decision as to the debtor's income tax liability, both the bankruptcy court and the Tax Court have jurisdiction to determine the tax liability issue. A decision by the Tax Court would not necessarily bind the estate of the bankrupt, unless the trustee had intervened in the Tax Court litigation. A decision by the bankruptcy court might not necessarily bind the individual debtor, unless the debtor individually had invoked the bankruptcy court's jurisdiction.

Thus, under the law applicable to Bankruptcy Act proceedings, in certain circumstances there may be duplicative litigation concerning the debtor's tax liability. In other circumstances, the debtor may be precluded from obtaining prepayment review of prepetition tax liabilities.

New Bankruptcy Status (P.L. 95-598)

New 11 U.S. Code section 505(a) continues the jurisdiction of the bank-

[1] The Bankruptcy Act was repealed by P.L. 95-598, effective for bankruptcy cases commencing on or after October 1, 1979, but remains in effect for bankruptcy proceedings commenced prior to that date.

ruptcy court to determine liability for a tax deficiency, regardless of whether it has been assessed, unless it has been adjudicated by a court of competent jurisdiction prior to filing of the bankruptcy petition.[2] The new law, effective for bankruptcy cases commenced on or after October 1, 1979, also seeks to resolve the problems mentioned above by giving the bankruptcy court, in effect, the authority to determine whether the tax liability issue should be decided in the bankruptcy court or in the U.S. Tax Court.

[48] Under new 11 U.S. Code section 362(a)(8, commencement of a bankruptcy case triggers an automatic stay of institution or continuation of any U.S. Tax Court proceedings to challenge an asserted tax deficiency of the debtor. Also under the new law, in order to maintain orderly judicial proceedings in any situation where a controversy might arise between a taxpayer and the Internal Revenue Service, assessment or collection of a prepetition tax claim against the debtor is automatically stayed by commencement of the bankruptcy case (sec. 362(a)(6).[3] Unless the stay is lifted by the bankruptcy court, or a discharge is granted or denied, the stay continues until termination of the bankruptcy case (sec. 362(c)).

The new statute authorizes the bankruptcy judge to lift the stay and permit the debtor to institute a Tax Court case (if a notice of deficiency has been issued and the period for filing such case has not expired) or to continue a pending Tax Court case involving the debtor's tax liability (new 11 U.S. Code sec. 362(d)). The bankruptcy court, for example, could lift the stay if the debtor seeks to litigate in the Tax Court and the trustee wishes to intervene in that proceeding. In such a case, the merits of the tax controversy will be determined by the Tax Court, and the Tax Court's decision will bind both the individual debtor as to any taxes which are nondischargeable and the intervenor trustee as to the tax claim against the estate.

However, if the bankruptcy court does not lift the automatic stay, but instead itself decides the tax issue and (at the request of the Revenue Service or of the debtor) determines the debtor's personal liability for a nondischargeable tax, then the bankruptcy court's decision will bind both the individual debtor and the estate as well as the government.[4]

Reasons for Change

The committee believes that the provisions of the Internal Revenue Code relating to assessment and collection procedures should be coordinated with rules enacted in the new bankruptcy statute (P.L. 95-598) for determination of tax liabilities in bankruptcy cases.

Explanation of Provisions

Section 6(a), 6(b), 6(c), 6(d), and 6(g) of the bill coordinate certain provisions of the Internal Revenue Code with the bankruptcy court procedures enacted in P.L. 95-598, as described above. These procedures include the automatic stay on assessment or collection of [49] certain tax claims against the debtor, the automatic stay on institution or continuation by the debtor of deficiency litigation in the U.S. Tax Court, and the authority of the bankruptcy court to lift the stay and permit the debtor's tax liability to be determined by the Tax Court. These provisions are the same as the corresponding sections of the House bill.

Immediate assessment

General rule

Section 6(g) of the bill generally repeals the present rule (in sec. 6871(a) of the Code) authorizing the Internal Revenue Service to assess certain prepetition tax deficiencies of the debtor immediately on institution of bankruptcy proceedings. Accordingly, if the bankruptcy court lifts the automatic stay under new 11 U.S. Code section 362(a)(8), the debtor is not precluded from filing a petition (if timely) in the Tax Court to challenge an asserted prebankruptcy tax deficiency.

Exceptions

The bill authorizes the Revenue Service to make an immediate assessment (1) of tax imposed on the bankruptcy estate of an individual debtor, or (2) of tax imposed on a debtor if liability for such tax has become res judicata against the debtor pursuant to a bankruptcy court determination.

These two exceptions reflect bankruptcy situations in which there is no need to require the Revenue Service to follow the normal deficiency notice

[2] Under the law applicable to Bankruptcy Act proceedings, the trustee of a bankruptcy estate must proceed in courts other than the bankruptcy court to seek a refund of Federal taxes paid by the debtor. While the trustee succeeds to any right to refund for tax overpayments, the bankruptcy court has jurisdiction only to allow claims against the bankruptcy estate, and not to enforce claims against third parties.

New 11 U.S. Code sec. 505(a) expands the jurisdiction of the bankruptcy court to include determination of refund claims. To invoke the bankruptcy court's jurisdiction, the trustee must file an administrative claim for refund with the Internal Revenue Service (if the debtor had not done so prior to commencement of the bankruptcy case). If a claim filed by the trustee is denied or if 120 days elapse without action by the Internal Revenue Service, the court has jurisdiction to determine the refund issue.

[3] The stay does not preclude the Internal Revenue Service from issuing a deficiency notice during the bankruptcy case (new 11 U.S. Code sec. 362(b)(8)).

[4] 124 Cong. Rec. H-11,111 (daily ed. Sept. 28, 1978) (remarks of Mr. Edwards); 124 Cong. Rec. S-17,427 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini). In the case of a corporate debtor, the commencement of a bankruptcy proceeding does not create a separate taxable entity, and (unlike in the case of an individual debtor) the debtor corporation is considered to be personally before the bankruptcy court. Accordingly, a decision by the bankruptcy court as to the corporate debtor's prepetition income tax liability is binding on the corporation, which cannot thereafter institute a Tax Court case to relitigate the issue. However, under P.L. 95-598, the bankruptcy judge is authorized to lift the automatic stay under new 11 U.S. Code sec. 362 and permit the tax issue to be determined in the U.S. Tax Court (if a case involving the issue is already pending in that Court, or if a deficiency notice has been issued and the period for filing such case has not expired).

procedure. In the case of taxes imposed on the bankruptcy estate of an individual (i.e., where the estate is treated as a separate taxable entity), the estate's own tax liability is determined by the bankruptcy court and cannot be litigated in the Tax Court. In the case where an individual debtor's personal liability for nondischargeable tax claims has been litigated in the bankruptcy court, and under the doctrine of res judicata the debtor would be precluded from relitigating the issue in any court, no purpose would be served by requiring issuance of a deficiency notice prior to assessment. For the same reason, the bill permits immediate assessment of a corporate debtor's tax liabilities once the bankruptcy court has made a determination which is res judicata.

Conforming rules

The bill also amends section 6871 of the Code to delete the prohibition in current law on filing a Tax Court petition after commencement of a bankruptcy proceeding. This change likewise conforms to the provisions of P.L. 95-598 which stay the debtor, on commencement of a bankruptcy case, from instituting a Tax Court proceeding to challenge an asserted tax deficiency, but authorize the bankruptcy judge to lift the stay and permit the debtor to institute a Tax Court case (if a notice of deficiency has been issued and the period for filing such case has not expired). Also, the bill restates the rule of present law that claims for certain tax deficiencies, etc. may be presented for adjudication before the bankruptcy court, notwithstanding the pendency of any Tax Court proceedings for redetermination of the deficiency.

[50] *Receiverships*

The bill does not modify the present law rules in section 6871 of the Code relating to receivership proceedings. To the extent immediate assessment authority is retained for receivership proceedings, and for the two bankruptcy situations described above, the bill expands the category of taxes which could be so assessed to include taxes under Internal Revenue Code chapters 41 (public charities), 42 (private foundations and black lung benefit trusts), 43 (qualified pension, etc., plans), 44 (real estate investment trusts), and 45 (windfall profit tax).

Collection

Section 6(g) of the bill amends section 6873(a) of the Code to delete the rule that any portion of a claim for nondischargeable taxes allowed in a bankruptcy case but not satisfied out of assets in the estate must be paid by the taxpayer upon notice and demand by the Internal Revenue Service after termination of the bankruptcy case. (No change is made in section 6873 with respect to payment of claims for taxes allowed in a receivership proceeding.) As described above, if the bankruptcy court has made a determination of the debtor's tax liability which (under the doctrine of res judicata) precludes the debtor from relitigating the issue in any other court, the Revenue Service can make an immediate assessment of such liability without isuing a deficiency notice. Thereafter, the provisions of the Code relating to collection of assessed taxes apply.

Tax Court petition

Section 6(b) of the bill provides that if the stay under new 11 U.S. Code section 362(a)(8) precludes a debtor from filing a petition in the U.S. Tax Court after receipt of a deficiency notice, the running of the normal 90-day period for filing the petition is suspended during the stay and for 60 days thereafter. Also, the bill clarifies that the filing of a proof of claim, the filing of request for payment, or other action taken by the Internal Revenue Service in the bankruptcy case (such as a request that the court determine the personal liability of an individual debtor for a nondischargeable tax) is not to be treated as prohibited under section 6213(a) of the Code (relating to certain restrictions generally applicable to assessment of a tax deficiency).

Tax Court intervention

Section 6(c) of the bill provides that the trustee of the bankruptcy estate of a debtor may intervene, as a matter of right, on behalf of the estate in any proceeding before the U.S. Tax Court to which the debtor is a party. This provision applies where the bankruptcy judge lifts the automatic stay under new 11 U.S. Code section 362 so that the debtor's prepetition tax liability can be determined in the Tax Court.

Assessment and collection limitations

Section 6(a) of the bill provides that if the automatic stay under the Internal Revenue Service is prohibited for a period of time by reason of a bankruptcy case from assessment or collection of tax (for example, because of the automatic stay under new 11 U.S. Code sec. 362(a)(6)), the running of the period of limitations is suspended, [51] for assessment, for the prohibition period and for 60 days thereafter; and for collection, for the prohibition period and for six months thereafter.

Cross references

Section 6(d) of the bill adds cross references in sections 6212, 6512, 6532, and 7430 of the Code to new 11 U.S. Code section 505 (relating to jurisdiction of the bankruptcy court).

2. Relief from certain failures to pay tax when due (sec 6(e) of the bill and new sec. 6658 of the Code)

Present Law

The Internal Revenue Code (secs. 6651, 6654, and 6655) imposes penalties for failure timely to pay certain taxes, unless the taxpayer can establish that the failure was due to reasonable cause and not due to willful neglect. Under bankruptcy rules, a debtor or the trustee of a bankruptcy estate may be precluded from timely paying certain taxes after commencement of the bankruptcy proceedings.

Reasons for Change

The committee believes that penalties should not be imposed for failure timely to pay certain taxes to the extent that bankruptcy proceedings preclude payment of such taxes when due.

Explanation of Provision

Section 6(e) of the bill relieves the debtor or the trustee from penalties which otherwise might be applicable under sections 6651, 6654, or 6655 of the Code for failure timely to pay certain taxes, with respect to a period during which a bankruptcy case is pending, to the extent that the bankruptcy case precludes payment of such taxes when due.[5] This provision is the same as section 6(e) of the House bill.

In the case of a tax incurred by the estate, the relief is granted if the failure occurs pursuant to a court order finding probable insufficiency of funds to pay such taxes. In the case of a tax incurred by the debtor before commencement of the bankruptcy case, the relief provision of the bill applies if either the bankruptcy petition is filed before the tax return due date, or the date for imposing the penalty occurs after commencement of the bankruptcy case.

These relief rules do not, however, apply with respect to liability for penalties for failure timely to pay or deposit any employment tax required to be withheld by the debtor or trustee.

3. Preservation of FUTA credit (sec. 6(f) of the bill and sec. 3302 of the Code)

Present Law

Present law provides a credit against the Federal unemployment tax imposed on an employer for amounts paid by the employer into a State unemployment compensation fund (sec. 3302 of the Internal Revenue Code). A reduction in the otherwise allowable credit is re- [52] quired in the case of late contributions to a State fund (sec. 3302(a)(3) of the Code).

Reasons for Change

The committee believes that if because of the pendency of bankruptcy proceedings, the trustee of a bankruptcy estate is precluded from making timely payment of contributions to a State unemployment compensation fund, it is not appropriate to require a reduction in the credit against the Federal unemployment tax.

Explanation of Provision

Section 6(f) of the bill amends section 3302(a) of the Code to provide that there is no reduction in the credit against the FUTA tax if the failure to make timely contributions to a State unemployment compensation fund, with respect to wages paid by the trustee of a bankruptcy estate, is without fault of the trustee on account of the bankruptcy case. This provision is the same as section 6(f) of the House bill.

4. Repeal of deadwood provision (sec. 6(h) of the bill and sec. 1018 of the Code)

Present Law

Section 1018 of the Internal Revenue Code provides certain basis adjustment rules which apply if, in a bankruptcy proceeding under section 77B of the Bankruptcy Act which concluded before September 22, 1938, indebtedness was cancelled in pursuance of a plan of reorganization consummated by adjustment of the capital or debt structure of the insolvent corporation.

Reasons for Change

The committee believes that inasmuch as section 1018 of the Code applies only with respect to certain bankruptcy proceedings concluded before September 22, 1938, that provision should be deleted from the statute as deadwood.

Explanation of Provision

Section 6(h) of the bill repeals section 1018 of the Internal Revenue Code. This provision is the same as section 6(h) of the House bill.

5. Technical and conforming amendments (sec. 6(i) of the bill)

Section 6(i) of the bill makes technical and conforming amendments to the Internal Revenue Code, principally to substitute references to bankruptcy cases under new title 11 of the U.S. Code for references to bankruptcy proceedings under the now-repealed Bankruptcy Act.

1. Amendment of section 128(a).—In section 128(a) of the Code, relating to cross references to other Acts, the reference to the Bankruptcy Act is deleted.

2. Amendment of section 354(c).—Section 354(c) of the Code, relating to exchanges of stock and securities in certain railroad reorganizations, is amended to substitute a reference to plans of reorganization confirmed under new 11 U.S. Code section 1173, for a reference to plans approved by the Interstate Commerce Commission under section 77 of the Bankruptcy Act.

3. Amendment of section 422(c).—Section 422(c)(5) of the Code, relating to certain transfers by insolvent individuals of stock acquired [53] pursuant to exercise of a qualified stock option, is amended by substituting a reference to new 11 U.S. Code for a reference to the Bankruptcy Act.

4. Amendment of section 1023.—Section 1023 of the Code, relating to cross references, is amended by deleting a cross reference to the Bankruptcy Act.

5. Amendment of section 6012(b).—Section 6012(b)(3) of the Code, relating to returns made by receivers, trustees, and assignees for corporations, is amended by substituting a reference to a trustee in a bankruptcy case under new 11 U.S. Code for a reference to a trustee in a bankruptcy proceeding (under the Bankruptcy Act).

[5] No inference is intended, by virtue of adoption of the rules in section 6(e) of the bill, that under present law such penalties should be imposed where a debtor or the trustee of a bankruptcy estate is precluded from timely paying such taxes by virtue of bankruptcy proceedings.

6. Amendment of section 6036.—Section 6036 of the Code, relating to notice of qualification as executor or receiver, is amended by substituting a reference to a trustee in a bankruptcy case under new 11 U.S. Code for a reference to a trustee in a bankruptcy proceeding (under the Bankruptcy Act).

7. Amendment of section 6155(b).—Section 6155(b)(2) of the Code, relating to cross references, is amended by deleting the reference to section 6873 of the Code with respect to bankruptcy proceedings (under the Bankruptcy Act).

8. Amendment of section 6161(c).—Section 6161(c) of the Code, relating to extension of time for payment of tax claims in bankruptcy or receivership proceedings, is amended by substituting references to bankruptcy cases under new 11 U.S. Code for references to bankruptcy proceedings (under the Bankruptcy Act).

9. Amendment of section 6216(1).—Section 6216(1), relating to cross references, is amended by deleting a reference to subchapter B of chapter 70 of the Code with respect to bankruptcy proceedures.

10. Amendment of section 6326.—Section 6326 of the Code, relating to cross references, is amended by deleting references to the Bankruptcy Act and adding references to new 11 U.S. Code.

11. Amendment of section 6503(i).—Section 6503(i)(2), relating to cross references, is amended by deleting a reference to subchapter C of chapter 70 of the Code with respect to suspension of running of period of limitation in a bankruptcy proceeding (under the Bankruptcy Act).

12. Amendment of section 6872.—Section 6872 of the Code, relating to suspension of period on assessment, is amended by substituting a reference to a bankruptcy case under new 11 U.S. Code for a reference to a bankruptcy proceeding under the Bankruptcy Act.

13. Amendment of section 7430.—Section 7430 of the Code, relating to cross references, is amended by deleting references to the Bankruptcy Act and adding references to new 11 U.S. Code.

14. Amendment of section 7508(d).—Section 7508(d)(1) of the Code, relating to time for performing certain acts postponed by reason of service in combat zone, is amended by substituting a reference to bankruptcy cases under new 11 U.S. Code for a reference to bankruptcy proceedings (under the Bankruptcy Act).

6. Effective date for provisions of section 6 of the bill

The provisions of section 6 of the bill (relating to changes in tax procedures) are effective October 1, 1979, except that such provisions do not apply to any Bankruptcy Act proceeding commenced before October 1, 1979.

* * * * *

Public Law 96-595
96th Congress, H.R. 4968 [1]
December 24, 1980

An Act to amend the Internal Revenue Code of 1954 with respect to net operating loss carryovers of taxpayers who cease to be real estate investment trusts, to increase interest rates on certain United States retirement bonds, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. NET OPERATING LOSS CARRYOVER FOR CERTAIN REITS.

(a) IN GENERAL.—Subparagraph (E) of section 172(b)(1) of the Internal Revenue Code of 1954 (relating to net operating loss deduction) is amended to read as follows:

"(E)(i) A net operating loss for a REIT year—

"(I) shall not be a net operating loss carryback to any taxable year preceding the taxable year of such loss, and

"(II) shall be a net operating loss carryover to each of the 8 taxable years following the taxable year of such loss.

"(ii) In the case of any net operating loss for a taxable year which is not a REIT year—

"(I) such loss shall not be carried back to any taxable year which is a REIT year, and

"(II) the number of taxable years to which such loss may be a net operating loss carryover under subparagraph (B) shall be increased (to a number not greater than 8) by the number of taxable years to which such loss may not be a net operating loss carryback by reason of subclause (I).

"(iii) For purposes of this subparagraph, the term 'REIT year' means any taxable year for which the provisions of part II of subchapter M (relating to real estate investment trusts) apply to the taxpayer.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to the determination of the net operating loss deduction for taxable years ending after October 4, 1976. For purposes of applying the preceding sentence to any net operating loss for a taxable year which is not a REIT year and which ends on or before October 4, 1976, subclause (II) of section 172(b)(1)(E)(ii) of the Internal Revenue Code of 1954 shall be applied by substituting "the number of REIT years to which such loss was a net operating loss carryback" for "the number of taxable years to which such loss may not be a net operating loss carryback by reason of subclause (I)". In the case of a net operating loss for a taxable year described in the preceding sentence, subclause (II) of section 172(b)(1)(E)(ii) of such Code shall not apply to any taxpayer which acted so as to cause it to cease to qualify as a "real estate investment trust" within the meaning of section 856 of such Code if the principal purpose for such action was to secure the benefit of the allowance of a net operating loss carryover under section 172(b)(1)(B) of such Code.

[1] Senate Report No. 96-1037, page 649; House Report No. 96-1045 is not published.

SEC. 2. INCREASES IN INTEREST RATES PAYABLE ON UNITED STATES RETIREMENT PLAN AND INDIVIDUAL RETIREMENT BONDS.

(a) IN GENERAL.—The first section of the Second Liberty Bond Act (31 U.S.C. 752) is amended by adding at the end thereof the following new paragraph:

"The Secretary of the Treasury, with the approval of the President, may provide by regulations that the investment yield on any offerings of bonds issued under this Act which are described in section 405(b) or 409(a) of the Internal Revenue Code of 1954 (relating to retirement plan bonds and individual retirement bonds, respectively) be increased for the interest accrual periods specified in such regulations so that the investment yield on such bonds for such periods is consistent with the investment yield on new offerings of such bonds.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to the investment yield on bonds issued before, on, or after the date of the enactment of this Act, but only for purposes of increasing the investment yield on such bonds for interest accrual periods beginning after the date of enactment of this Act.

SEC. 3. GENERAL STOCK OWNERSHIP CORPORATIONS.

(a) IN GENERAL.—Subchapter U of the Internal Revenue Code of 1954 (relating to general stock ownership corporations) is amended—

(1) by inserting "or the estate of a deceased shareholder" after "State" in section 1391(a)(4)(D)(ii);

(2) by striking out "Individuals" in the caption of section 1391(c) and inserting in lieu thereof "Individual";

(3) by striking out "1393" in section 1392(a) and inserting in lieu thereof "1396(b)";

(4) by striking out "and all succeeding years" in section 1392(b)(1);

(5) by striking out "section, the term 'taxable income' " in section 1393(a)(2) and inserting in lieu thereof "subchapter, the taxable income";

(6) by striking out "a GSOC" in sections 1393(a)(2), 1393(b)(3), 1394(c), and 1396(b) and inserting in lieu thereof "an electing GSOC";

(7) by striking out "GSOC's" in the heading for section 1394 and inserting in lieu thereof "GSOC";

(8) by striking out "the GSOC" in sections 1393(b)(3) and 1394(d) and inserting in lieu thereof "an electing GSOC";

(9) by striking out "A GSOC" in section 1396(a) and inserting in lieu thereof "An electing GSOC";

(10) by adding at the end of section 1396(b) the following: "Such tax shall be deductible as an ordinary and necessary expense of the corporation under section 162."; and

(11) by amending the table of sections for such subchapter to read as follows:

"Subchapter U—General Stock Ownership Corporations

"Sec. 1391. Definitions.

"Sec. 1392. Election by GSOC.

"Sec. 1393. GSOC taxable income taxed to shareholders.

"Sec. 1394. Rules aplicable to distributions of an electing GSOC.

"Sec. 1395. Adjustment to basis of stock of shareholders.

"Sec. 1396. Minimum distributions.

"Sec. 1397. Special rules applicable to an electing GSOC.".

(b) CONFORMING AMENDMENT.—The last sentence of section 6039B of such Code (relating to return of general stock ownership corporations) is amended by inserting "electing" after "Every".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to corporations chartered after December 31, 1978, and before January 1, 1984.

SEC. 4. CHARITABLE SERVICES PERFORMED ABROAD.

(a) IN GENERAL.—Subsection (a) of section 911 of the Internal Revenue Code of 1954 (relating to income earned by individuals in certain camps) is amended by inserting "or who performs qualified charitable services in a lesser developed country," after "hardship area,".

(b) DOLLAR LIMITATIONS.—

(1) IN GENERAL.—Subparagraph (A) of subsection (c)(1) of such section 911 of such Code is amended to read as follows:

"(A) DOLLAR LIMITATIONS.—

"(i) CAMP RESIDENTS.—In the case of an individual who resides in a camp located in a hardship area, the amount excluded from the gross income of the individual under subsection (a) for any taxable year shall not exceed an amount which shall be computed on a daily basis at an annual rate of $20,000 for days during which he resides in a camp.

"(ii) EMPLOYEES OF CHARITABLE ORGANIZATIONS.—If any individual performs qualified charitable services in a lesser developed country during any taxable year, the amount of the earned income attributable to such services excluded from the gross income of the individual under subsection (a) for the taxable year shall not exceed an amount which shall be computed on a daily basis at an annual rate of $20,000.

"(iii) SPECIAL RULE.—If any individual performs qualified charitable services in a lesser developed country and performs other services while residing in a camp located in a hardship area during any taxable year, the amount of the earned income attributable to such other services excluded from the gross income of the individual under subsection (a) for the taxable year shall not (after the application of clause (i) with respect to such earned income) exceed $20,000 reduced by the amount of the earned income attributable to qualified charitable services excluded from gross income under subsection (a) for the taxable year.".

(2) DEFINITIONS. — Subsection (1)(1) of such section 911 of such Code is amended by adding at the end thereof the following:

"(D) QUALIFIED CHARITABLE SERVICES.—For purposes of this subsection, the term 'qualified charitable services'

means services performed by an employee for an employer which—

"(i) meets the requirements of section 501(c)(3), and

"(ii) is not a private foundation (within the meaning of section 509(a)).

"(E) LESSER DEVELOPED COUNTRY.—The term 'lesser developed country' means any foreign country other than—

"(i) a country listed in the first sentence of section 502(b) of the Trade Act of 1974 (19 U.S.C. 2462), or

"(ii) a country designated by the President as not being a lesser developed country.".

(c) TECHNICAL AMENDMENTS.—

(1) The heading for such section 911 of such Code is amended by inserting "OR FROM CHARITABLE SERVICES" after "CAMPS".

(2) The item relating to section 911 in the table of sections for subpart B of part III of subchapter N of chapter 1 of such Code is amended by inserting "or from charitable services" after "camps".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1978.

SEC. 5. ARBITRAGE REQUIREMENTS FOR MORTGAGE SUBSIDY BONDS.

(a) GENERAL RULE.—Paragraph (4) of section 103A(i) of the Internal Revenue Code of 1954 (relating to requirements related to arbitrage) is amended by adding at the end thereof the following new subparagraphs:

"(C) REDUCTION WHERE ISSUER DOES NOT USE FULL 1 PERCENTAGE POINT UNDER PARAGRAPH (2).—

"(i) IN GENERAL.—The amount required to be paid or credited to mortgagors under subparagraph (A) (determined under this paragraph without regard to this subparagraph) shall be reduced by the unused paragraph (2) amount.

"(ii) UNUSED PARAGRAPH (2) AMOUNT.—For purposes of clause (i), the unused paragraph (2) amount is the amount which (if it were treated as an interest payment made by mortgagors) would result in the excess referred to in paragraph (2)(A) being equal to 1 percentage point. Such amount shall be fixed and determined as of the yield determination date.

"(D) ELECTION TO PAY UNITED STATES.—Subparagraph (A) shall be satisfied with respect to any issue if the issuer elects before issuing the obligations to pay over to the United States—

"(i) not less frequently than once each 5 years after the date of issue, an amount equal to 90 percent of the aggregate amount which would be required to be paid or credited to mortgagors under subparagraph (A) (and not theretofore paid to the United States), and

"(ii) not later than 30 days after the redemption of the last obligation, 100 percent of such aggregate amount not theretofore paid to the United States.

"(E) SIMPLIFIED ACCOUNTING.—The Secretary shall permit any simplified system of accounting for purposes of this paragraph which the issuer establishes to the satisfaction of the Secretary will assure that the purposes of this paragraph are carried out.".

(b) TECHNICAL AMENDMENT.—Paragraph (8) of section 103A(1) of such Code is amended by inserting "or paid to the United States" after "credited to mortgagors".

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect as if included in the amendments made by section 1102 of the Mortgage Subsidy Bond Tax Act of 1980 [Pub. L. 96-499, page , this Bulletin].

Approved December 24, 1980.

Senate Report No. 96-1037 2d Session

[Bracketed numerals indicate official report page numbers]

NET OPERATING LOSS CARRYOVERS OF REAL ESTATE INVESTMENT TRUSTS

NOVEMBER 25 (legislative day, NOVEMBER 20), 1980.

Mr. LONG, from the Committee on Finance, submitted the following report to accompany H.R. 4968.[1]

The Committee on Finance, to which was referred the act (H.R. 4968) to amend the Internal Revenue Code of 1954 to provide that in certain cases the net operating loss carryover period for a taxpayer who ceases to be a real estate investment trust shall be the same as the net operating loss carryover period for a taxpayer who continues to be a real estate investment trust, having considered the same, reports favorably thereon with an amendment and an amendment to the title and recommends that the act as amended to pass.

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

House bill.—H.R. 4968, as it passed the House, provided certain former REITs an additional year of carryforward (with a maximum of eight years) of net operating losses for each year such former REITs are denied a NOL carryback because they had been REITs.

Committee bill.—The committee bill retains the House provision affecting REITs and adds provisions relating to (1) the rate of interest on U.S. retirement bonds (passed by the House as section 8 of H.R. 4746), (2) General Stock Ownership Corporations, and (3) the tax treatment of employees of charities working abroad (previously reported by the committee as section 201 of H.R. 1319).

[2] I. SUMMARY

SECTION 1. NET OPERATING LOSS CARRYOVERS OF REAL ESTATE INVESTMENT TRUSTS

The bill permits trusts which are former real estate investment trusts (REITS) an additional year to carry over operating losses for each year a carryback was not allowed because these entities were REITS in the carryback year. Under the bill, the maximum carryover period will be 8 years.

[1] Public Law 96-595, page 647.

SEC. 2. RATE OF INTEREST ON UNITED STATES RETIREMENT BONDS

Under present law, the interest rate on an individual retirement bond issued by the Treasury Department or a retirement plan bond issued by the Treasury Department remains the same from the date of issuance until the bond is redeemed (generally when the owner retires, becomes disabled, or dies).

This section of the bill authorizes the Treasury Department to make upward adjustments in the interest rate on outstanding retirement bonds, so that such a bond would earn interest at a rate consistent with the yield for new issues of such bonds.

SEC. 3. TECHNICAL AMENDMENTS RELATING TO GENERAL STOCK OWNERSHIP CORPORATIONS

Under present law, a State is authorized to establish a general stock ownership corporation (GSOC) for the benefit of all its citizens. It is anticipated that the GSOC will be permitted to borrow money to invest in business enterprises. The cash flow from the operation of the business would be used to service and repay the loan, and the remaining cash would be distributed to the GSOC shareholders (i.e., all the citizens of the State). A corporation must meet certain statutory tests in order to be treated as a GSOC. Generally, a GSOC is exempt from Federal income taxation. The shareholders of the GSOC, however, report their proportionate part of the GSOC's taxable income on their Federal individual income tax returns.

This section makes several technical changes in the tax law relating to GSOCs.

SEC. 4. TAX TREATMENT OF EMPLOYEES OF CHARITIES WORKING ABROAD

The Foreign Earned Income Act of 1978 [Pub. L. 95-615, 1978-2 C.B. 415, 416] generally replaced the prior $20,000 foreign earned income exclusion with a new system of itemized deductions for the excess costs of working overseas and an additional $5,000 deduction for employees working in hardship areas. As an exception to these new rules, the 1978 Act permits employees who reside in camps in hardship areas to elect to claim a $20,000 earned income exclusion in lieu of the new excess living cost and hardship area deductions.

The amendment allows individuals meeting the foreign residence or presence tests who perform "qualified charitable services" in less developed countries to elect, in lieu of the deduction for excess foreign living costs, an exclusion of $20,000 from gross income on the same basis as employees residing in camps in hardship areas. The amendment is effective for taxable years beginning after December 31, 1978.

[3] II. EXPLANATION OF THE BILL

A. Net Operating Loss Carryovers of Real Estate Investment Trusts (sec. 1 of the bill and sec. 172 of the Code)

Present law

Prior to the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1], real estate investment trusts (REITs) were not allowed a net operating loss deduction. Because of the effect that this rule had during the economic downturn in the early 1970's, many trusts [1] terminated their status as REITs so that they could carry over net operating losses incurred by them during those years. In such a case, a former REIT was allowed to carry over its losses for five years. However, it was not allowed a deduction for the carryback of the net operating loss to years during which it qualified as a REIT.

The Tax Reform Act of 1976 made two changes that affected the net operating loss carryovers of corporations and REITs. First, it lengthened the time that corporations could carry over their net operating loss deductions from five years to seven years. This change was effective for losses incurred in years ending after December 31, 1975. Because of this effective date, losses incurred before 1976 by trusts which had terminated their REIT status were subject to the five-year carryforward of losses instead of the seven-year carryforward.

The Tax Reform Act of 1976 also changed the treatment of net operating losses of REITs. Under the 1976 Act, a net operating loss incurred in a year that the trust is a REIT can be carried forward for eight years. However, no net operating loss carrybacks are permitted. This change in rules was effective for taxable years of a REIT ending after October 4, 1976. As a result of this effective date, losses incurred before 1976 by REITs were subject to an eight-year carryforward if they retained their REIT status during the entire eight-year carryforward period. However, under the 1976 Act rule, a net operating loss incurred before 1976 could not be carried over to the 6th, 7th, or 8th carryforward year unless the trust was a REIT for all years from the loss year through the carryover year. Thus, a former REIT which incurred a net operating loss in a taxable year ending before October 4, 1976, is permitted less than an eight-year carryover.

Reasons for change

The committee believes that a trust that terminates its status as a REIT should not have fewer years to which it can carry a net operating loss than it would have had if the trust had retained its REIT status.

[4] *Explanation of provision*

This provision allows a trust which was formerly a REIT an additional year of carryforward (with a maximum of eight years) of net operating losses for each year that it is denied a net operating loss carryback because it was a REIT. This change allows a former REIT to have a total of eight

[1] For this purpose, the term "trust" is used to describe the taxpayer even though corporations are permitted to be REITs under the Tax Reform Act of 1976.

carryover years. Thus, the treatment of these former REITs is similar to the treatment accorded to trusts which retain their REIT status throughout the carryover period.

In addition, the provision removes the restriction that allows a net operating loss incurred before 1976 to be carried forward to the 6th, 7th, or 8th year only if the trust claiming the loss qualified as a REIT for all years from the loss year through the carryover year.

The provision also provides a special anti-abuse rule under which losses arising in taxable years ending before October 5, 1976, may not be carried forward if the principal purpose of the trust in losing its REIT status was to obtain the benefit of a net operating loss carryover.

Effective date

The provision is effective for taxable years ending after October 4, 1976.

Revenue effect

It is estimated that this bill will reduce budget receipts by a negligible amount in fiscal years 1981 and 1982, $7 million in 1983, $15 million in 1984, and $20 million in 1985.

* * * * *

[7] C. Technical Amendments Relating to General Stock Ownership Corporations (sec. 3 of the bill and secs. 1391-1397 of the Code)

Present law

Under present law, a State is authorized to establish a general stock ownership corporation (GSOC) for the benefit of all its citizens. It is anticipated that the GSOC will be permitted to borrow money to invest in business enterprises. The cash flow from the operation of the business would be used to service and repay the loan, and the remaining cash would be distributed to the GSOC shareholders (i.e., all citizens of the State).

Present law provides that a corporation must meet certain statutory tests in order to be treated as a GSOC. The GSOC's corporate charter must provide for the issuance of only one class of stock, the issuance of shares only to eligible individuals, and the issuance of at least one share to each eligible individual if such eligible individual does not elect within one year after the date of issuance not to receive such share. Also, the charter must provide for certain restrictions on the transferability of the GSOC shares. The transfer restriction must provide that the share cannot be transferred until the earliest to occur of (1) the expiration of five years from issuance, (2) death, or (3) failure to meet the State's residency requirements. In no event may shares of stock of a GSOC be transfered to nonresidents. Also, no person may acquire more than 10 shares of the GSOC's stock.

An eligible individual is any individual who is a resident of the chartering State as of the date specified in the enabling legislation and who remains a resident between that date and the date of issuance of the stock.

A GSOC must make an election to obtain special tax treatment. The effect of the election is to exempt the corporation from Federal income taxation. The shareholders of the GSOC would report their proportionate part of the GSOC's taxable income on their Federal individual income tax returns.

The GSOC computes its taxable income in the same manner as a regular corporation, with certain modifications. A GSOC is required to distribute 90 percent of its taxable income for any taxable year to its shareholders by January 31 of the next succeeding year. To the extent a GSOC fails to meet this distribution requirement, a tax equal to 20 percent of the deficiency (i.e., the difference between the required distribution and the actual distribution) is imposed on the GSOC.

Reasons for change

The committee believes it appropriate to clarify provisions in present law affecting GSOC's in order to make their utilization and management easier.

[8] *Explanation of provision*

Under this provision, an estate can be a shareholder of stock in a GSOC. The amendment clarifies that the 20-percent tax on a deficiency (i.e., the difference between the required GSOC distribution and the actual GSOC distribution for the year) is deductible from the GSOC's taxable income for the year it is paid.

In addition, the bill makes several technical changes to the law governing GSOCs.

Effective date

The provisions apply with respect to corporations chartered after December 31, 1978, and before January 1, 1984.

Revenue effect

These provisions are not expected to have a direct effect on budget receipts.

[9] D. Tax Treatment of Employees of Charities Working Abroad (sec. 4 of the bill and sec. 911 of the Code)

Present law

General

United States citizens and residents are generally taxed by the United States on their worldwide income with the allowance of a foreign tax credit for foreign taxes paid. However, for years prior to 1978, U.S. citizens working abroad could exclude up to $20,000 of earned income a year if they were present in a foreign country for 17 out of 18 months or they were *bona fide* residents of a foreign country for a period which included an entire taxable year (Code sec. 911). In the case of individuals who had been *bona fide* residents of foreign countries for three years or more, the exclusion was increased to $25,000 of earned income. In addition, under the law prior to 1978, foreign taxes paid

on the excluded income were creditable against the U.S. tax on any foreign income above the $20,000 (or $25,000) limit.

The Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1] would generally have reduced the earned income exclusion for individuals working abroad to $15,000 per year. However, the Act would have retained a $20,000 exclusion for employees of domestic charitable organizations. (The term "charitable" as used in this explanation includes educational, religious, scientific, literary, etc., purposes for which an exemption is allowed under Code section 501(c)(3).) In addition, the Act would have made certain modifications in the computation of the exclusion.

These amendments made by the 1976 Act never went into general effect because the Foreign Earned Income Act of 1978 [Pub. L. 95-615, 1978-2 C.B. 415, 416] generally replaced the section 911 earned income exclusion for years begining after December 31, 1977, with a new system of itemized deductions for the excess costs of working overseas. (The basic eligibility requirements for the deduction are generally the same as for the prior earned income exclusion.) However, because the provisions of the 1978 Act were effective on January 1, 1978, and the Act did not become law until November 8, 1978, taxpayers were permitted to elect for 1978 to be taxed under the new provisions or under prior law (the exclusion as amended by the Tax Reform Act of 1976) so that the 1978 Act would not have any mandatory retroactive effect. It was anticipated that this election would be of particular interest to employees of domestic charitable organizations, since under the 1976 Act they would continue to be eligible for a $20,000 exclusion, even though it would be subject to the new computation rules of the 1976 Act.

Excess living cost deduction

The new excess living cost deduction (new Code sec. 913) provided by the 1978 Act consists of separate elements for the general cost of living, housing, education, and home leave costs. Employees of [10] charitable organizations are allowed these deductions on the same basis as other individuals. The cost-of-living element of the deduction is generally the amount by which the cost of living in the taxpayer's foreign tax home exceeds the cost of living in the highest cost metropolitan area in the continental United States (other than Alaska). The deduction is based on the spendable income of a person paid the salary of a Federal employee at grade level GS-14 step 1, regardless of the taxpayer's actual income. The housing element is the excess of the taxpayer's reasonable housing expenses over his base housing amount (generally one-sixth of his net income). The education deduction is generally the reasonable schooling expenses for the education of the taxpayer's dependents at the elementary and secondary levels. The deduction for annual home leave consists of the reasonable cost of coach fare transportation for the taxpayer, his spouse, and his dependents from his tax home outside the United States to his most recent place of residence within the United States.

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. For this purpose, hardship areas are generally those designated by the State Department as hardship posts where the hardship post allowance paid government employees is 15 percent or more of their base pay.

Exclusion for employees in hardship area camps

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. No foreign tax credit would be allowed for foreign taxes attributable to the excluded amount. Lodging is not a "camp" unless it is substandard lodging which is (i) provided by or on behalf of the employer for the convenience of the employer because the place at which the individual renders services is in a remote area where satisfactory housing is not available on the open market; (ii) located, as near as practicable, in the vicinity of the place at which the individual renders services; and (iii) furnished in a common area (or enclave) which is not available to the public and which normally accommodates 10 or more employees. The term "hardship area" has the same meaning for purposes of this provision as for the deduction for excess foreign living costs (sec. 913).

Reasons for change

Many charitable employees working abroad are eligible for a deduction for excess foreign living costs which is considerably less than $20,000 annually. Because these employees generally do not reside in camps, they may not elect the $20,000 annual exclusion. This change from prior law has resulted in a substantial increase in the tax liabilities of these individuals. For the most part, the committee believes that this increase is consistent with the intent of Congress in its refinement, through the Foreign Earned Income Act of 1978 [Pub. L. 95-615, 1978-2 C.B. 415, 416], of the tax relief afforded to Americans working abroad. However, the committee also believes that charitable employees in developing countries generally [11] are performing services which the United States has a special interest in supporting. Accordingly, these employees should be afforded an incentive along the lines of that provided for employees in hardship area camps under the 1978 Act.

Explanation of provision

The provision allows individuals meeting the foreign residence or presence tests in certain developing countries who perform "qualified charitable services" to elect, in lieu of the deduc-

tion for excess foreign living costs, an exclusion of $20,000 from gross income on the same basis as employees residing in camps in hardship areas. "Qualified charitable services" are defined to mean services performed by an employee for an employer which meets the requirements of Code section 501 (c)(3). The developing countries for which the provision applies are those countries other than (i) the countries listed in the first sentence of section 502(d) of the Trade Act of 1974 or (ii) countries designated by the President as not being lesser developed countries.

Effective date

The provision applies to taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce fiscal year receipts by $40 million in 1981, $18 million in 1982, $19 million in 1983, $21 million in 1984, and $22 million in 1985.

* * * * *

Public Law 96-596
96th Congress, H.R. 5391 [1]
December 24, 1980

An Act to amend the Internal Revenue Code of 1954 with respect to the determination of second tier taxes, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. AMENDMENT OF 1954 CODE.

Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. DETERMINATION OF SECOND TIER TAXES.

(a) DATE FOR DETERMINING AMOUNT OF SECOND TIER TAXES.—

(1) SUBSTITUTION OF TAXABLE PERIOD FOR CORRECTION PERIOD.—The following provisions are each amended by striking out "correction period" and inserting in lieu thereof "taxable period":

(A) Section 4941(b)(1) (relating to additional taxes on self-dealer).

(B) Section 4941(e)(2)(B) (defining amount involved).

(C) Section 4942(b) (relating to additional tax on failure to distribute income).

(D) Section 4943(b) (relating to additional tax on excess business holdings).

(E) Section 4944(b)(1) (relating to additional taxes on investment which jeopardizes charitable purpose).

(F) Section 4945(b)(1) (relating to additional taxes on taxable expenditures).

(G) Section 4951(b)(1) (relating to additional taxes on self-dealer).

(H) Section 4951(e)(2)(B) (defining amount involved).

(I) Section 4952(b)(1) (relating to additional taxes on taxable expenditures).

(J) Section 4971(b) (relating to additional tax on failure to meet minimum funding standards).

(K) Section 4975(b) (relating to additional taxes on disqualified persons).

(L) Section 4975(f)(4)(B) (defining amount involved).

(2) DEFINITION OF TAXABLE PERIOD.—

(A) Paragraph (1) of section 4941(e) (defining taxable period) is amended to read as follows:

"(1) TAXABLE PERIOD.—The term 'taxable period' means, with respect to any act of self-dealing, the period beginning with the date on which the act of self-dealing occurs and ending on the earliest of—

"(A) the date of mailing a notice of deficiency with respect to the tax imposed by subsection (a)(1) under section 6212,

"(B) the date on which the tax imposed by subsection (a)(1) is assessed, or

"(C) the date on which correction of the act of self-dealing is completed."

(B) Paragraph (1) of section 4942(j) is amended to read as follows:

"(1) TAXABLE PERIOD.—The term 'taxable period' means, with respect to the undistributed income for any taxable year, the period beginning with the first day of the taxable year and ending on the earlier of—

"(A) the date of mailing of a notice of deficiency with respect to the tax imposed by subsection (a) under section 6212, or

"(B) the date on which the tax imposed by subsection (a) is assessed."

(C) Paragraph (2) of section 4943(d) is amended to read as follows:

"(2) TAXABLE PERIOD.—The term 'taxable period' means, with respect to any excess business holdings of a private foundation in a business enterprise, the period beginning on the first day on which there are excess holdings and ending on the earlier of—

"(A) the date of mailing of a notice of deficiency with respect to the tax imposed by subsection (a) under section 6212 in respect of such holdings, or

"(B) the date on which the tax imposed by subsection (a) in respect of such holdings is assessed."

(D) Paragraph (1) of section 4944(e) is amended to read as follows:

"(1) TAXABLE PERIOD.—The term 'taxable period' means, with respect to any investment which jeopardizes the carrying out of exempt purposes, the period beginning with the date on which the amount is so invested and ending on the earliest of—

"(A) the date of mailing of a notice of deficiency with respect to the tax imposed by subsection (a)(1) under section 6212,

"(B) the date on which the tax imposed by subsection (a)(1) is assessed, or

[1] This publication of the law, House Report No. 96-912, page 657, and Senate Report No. 96-1034, page 658, are restricted to excerpts involving tax matters.

"(C) the date on which the amount so invested is removed from jeopardy."

(E) Paragraph (2) of section 4945 (i) is amended to read as follows:

"(2) TAXABLE PERIOD.—The term 'taxable period' means, with respect to any taxable expenditure, the period beginning with the date on which the taxable expenditure occurs and ending on the earlier of—

"(A) the date of mailing a notice of deficiency with respect to the tax imposed by subsection (a)(1) under section 6212, or

"(B) the date on which the tax imposed by subsection (a)(1) is assessed."

(F) Paragraph (1) of section 4951 (e) is amended to read as follows:

"(1) TAXABLE PERIOD.—The term 'taxable period' means, with respect to any act of self-dealing, the period beginning with the date on which the act of self-dealing occurs and ending on the earliest of—

"(A) the date of mailing a notice of deficiency with respect to the tax imposed by subsection (a)(1) under section 6212,

"(B) the date on which the tax imposed by subsection (a)(1) is assessed, or

"(C) the date on which correction of the act of self-dealing is completed."

(G) Paragraph (2) of section 4952 (e) is amended to read as follows:

"(2) TAXABLE PERIOD.—The term 'taxable period' means, with respect to any taxable expenditure, the period beginning with the date on which the taxable expenditure occurs and ending on the earlier of—

"(A) the date of mailing a notice of deficiency with respect to the tax imposed by subsection (a)(1) under section 6212, or

"(B) the date on which the tax imposed by subsection (a)(1) is assessed."

(H) Paragraph (3) of section 4971 (c) is amended to read as follows:

"(3) TAXABLE PERIOD.—The term 'taxable period' means, with respect to an accumulated funding deficiency, the period beginning with the end of the plan year in which there is an accumulated funding deficiency and ending on the earlier of—

"(A) the date of mailing of a notice of deficiency with respect to the tax imposed by subsection (a), or

"(B) the date on which the tax imposed by subsection (a) is assessed."

(I) Paragraph (2) of section 4975 (f) is amended to read as follows:

"(2) TAXABLE PERIOD.—The term 'taxable period' means, with respect to any prohibited transaction, the period beginning with the date on which the prohibited transaction occurs and ending on the earliest of—

"(A) the date of mailing a notice of deficiency with respect to the tax imposed by subsection (a) under section 6212,

"(B) the date on which the tax imposed by subsection (a) is assessed, or

"(C) the date on which correction of the prohibited transaction is completed."

(3) TECHNICAL AMENDMENTS.—

(A) Subsection (e) of section 4941 is amended by striking out paragraph (4).

(B) Subsection (j) of section 4942 is amended—

(i) by striking out paragraph (2),

(ii) by striking out "paragraph (5)" in paragraph (3)(B)(i) and inserting in lieu thereof "paragraph (4)",

(iii) by redesignating paragraph (4) as paragraph (2), and

(iv) by redesignating paragraphs (5) and (6) as paragraphs (4) and (5), respectively.

(C) Subsection (d) of section 4943 is amended by striking out paragraph (3) and by redesignating paragraph (4) as paragraph (3).

(D) Subsection (e) of section 4944 is amended by striking out paragraph (3).

(E) Subsection (e) of section 4951 is amended by striking out paragraph (4) and by redesignating paragraph (5) as paragraph (4).

(F) Subsection (f) of section 4975 is amended by striking out paragraph (6).

(4) CLERICAL AMENDMENTS.—

(A) Clause (ii) of section 4942(g)(2)(C) is amended by striking out "the initial correction period provided in subsection (j)(2)" and inserting in lieu thereof "the correction period (as defined in section 4962(e))".

(B) Subparagraph (A) of section 4943(d)(3) (as redesignated by paragraph (3)(c)) is amended by striking out "4942(j)(5)" and inserting in lieu thereof "4942(j)(4)".

(C) Subsection (e) of section 6213 (relating to suspension of filing period for certain excise taxes) is amended by striking out "section 4941(e)(4)" and all that follows through the end of such subsection and inserting in lieu thereof "section 4962(e)."

(D) Subsection (g) of section 6503 (relating to suspension of running of period of limitation pending correction) is amended by striking out "section 4941(e)(4)" and all that follows through the end of such subsection and inserting in lieu thereof "section 4962(e)."

(E) Section 6503 is amended by redesignating subsection (j) as subsection (i).

(F) The amendments made by sections 1203(h)(1) and 1601(f)(2) of the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1, 170, 222] and the amendment made by section 362(d)(5) of the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1, 86] shall be deemed to be amendments to section 6503(i) of the Internal Revenue Code of 1954 (as redesignated by subparagraph (E)).

(b) TAX COURT TO DETERMINE WHETHER TAXABLE EVENT HAS BEEN CORRECTED.—Subsection (c) of section 6214 (relating to determinations by Tax Court) is amended by adding at the end thereof the following new sentence: "The Tax Court, in redetermining a deficiency of any second tier tax (as defined in section 4962(b)), shall make a determination with respect to whether the taxable event has been corrected."

(c) ABATEMENT OF TAX WHERE THERE IS CORRECTION DURING CORRECTION PERIOD.—

(1) IN GENERAL.—Chapter 42 is amended by adding at the end thereof the following new subchapter:

"Subchapter C—Abatement of Second Tier Taxes Where There Is Correction During Correction Period

"Sec. 4961. Abatement of second tier taxes where there is correction.

"Sec. 4962. Definitions.

"SEC. 4961. ABATEMENT OF SECOND TIER TAXES WHERE THERE IS CORRECTION.

"(a) GENERAL RULE.—If any taxable event is corrected during the correction period for such event, then any second tier tax imposed with respect to such event (including interest, additions to the tax, and additional amounts) shall not be assessed, and if assessed the assessment shall be abated, and if collected shall be credited or refunded as an overpayment.

"(b) SUPPLEMENTAL PROCEEDING.—If the determination by a court that the taxpayer is liable for a second tier tax has become final, such court shall have jurisdiction to conduct any necessary supplemental proceeding to determine whether the taxable event was corrected during the correction period. Such a supplemental proceeding may be begun only during the period which ends on the 90th day after the last day of the correction period. Where such a supplemental proceeding has begun, the reference in the second sentence of section 6213(a) to a final decision of the Tax Court shall be treated as including a final decision in such supplemental proceeding.

"(c) SUSPENSION OF PERIOD OF COLLECTION FOR SECOND TIER TAX.—

"(1) PROCEEDING IN DISTRICT COURT OR COURT OF CLAIMS.—If, not later than 90 days after the day on which the second tier tax is assessed, the first tier tax is paid in full and a claim for refund of the amount so paid is filed, no levy or proceeding in court for the collection of the second tier tax shall be made, begun, or prosecuted until a final resolution of a proceeding begun as provided in paragraph (2) (and of any supplemental proceeding with respect thereto under subsection (b)). Notwithstanding section 7421(a), the collection by levy or proceeding may be enjoined during the time such prohibition is in force by a proceeding in the proper court.

"(2) SUIT MUST BE BROUGHT TO DETERMINE LIABILITY.—If, within 90 days after the day on which his claim for refund is denied, the person against whom the second tier tax was assessed fails to begin a proceeding described in section 7422 for the determination of his liability for such tax, paragraph (1) shall cease to apply with respect to such tax, effective on the day following the close of the 90-day period referred to in this paragraph.

"(3) SUSPENSION OF RUNNING OF PERIOD OF LIMITATIONS ON COLLECTION.—The running of the period of limitations provided in section 6502 on the collection by levy or by a proceeding in court with respect to any second tier tax described in paragraph (1) shall be suspended for the period during which the Secretary is prohibited from collecting by levy or a proceeding in court.

"(4) JEOPARDY COLLECTION. — If the Secretary makes a finding that the collection of the second tier tax is in jeopardy, nothing in this subsection shall prevent the immediate collection of such tax.

"SEC. 4962. DEFINITIONS.

"(a) FIRST TIER TAX.—For purposes of this subchapter, the term 'first tier tax' means any tax imposed by subsection (a) of section 4941, 4942, 4943, 4944, 4945, 4951, 4952, 4971, or 4975.

"(b) SECOND TIER TAX.—For purposes of this subchapter, the term 'second tier tax' means any tax imposed by subsection (b) of section 4941, 4942, 4943, 4944, 4945, 4951, 4952, 4971, or 4975.

"(c) TAXABLE EVENT.—For purposes of this subchapter, the term 'taxable event' means any act (or failure to act) giving rise to liability for tax under section 4941, 4942, 4943, 4944, 4945, 4951, 4952, 4971, or 4975.

"(d) CORRECT.—For purposes of this subchapter—

"(1) IN GENERAL.—Except as provided in paragraph (2), the term 'correct' has the same meaning as when used in the section which imposes the second tier tax.

"(2) SPECIAL RULES.—The term 'correct' means—

"(A) in the case of the second tier tax imposed by section 4942(b), reducing the amount of the undistributed income to zero,

"(B) in the case of the second tier tax imposed by section 4943(b), reducing the amount of the excess business holdings to zero, and

"(C) in the case of the second tier tax imposed by section 4944, removing the investment from jeopardy.

"(e) CORRECTION PERIOD. — For purposes of this subchapter—

"(1) IN GENERAL.—The term 'correction period' means, with respect to any taxable event, the period beginning on the date on which such event occurs and ending 90 days after the date of mailing under section 6212 of a notice of deficiency with respect to the second tier tax imposed on such taxable event, extended by—

"(A) any period in which a deficiency cannot be assessed under section 6213(a) determined without regard to the last sentence of section 4961(b)), and

"(B) any other period which the Secretary determines is reasonable and necessary to bring about correction of the taxable event.

"(2) SPECIAL RULES FOR WHEN TAXABLE EVENT OCCURS.—For purposes of paragraph (1), the taxable event shall be treated as occurring—

"(A) in the case of section 4942, on the first day of the taxable year for which there was a failure to distribute income,

"(B) in the case of section 4943, on the first day on which there are excess business holdings,

"(C) in the case of section 4971, on the last day of the plan year in which there is an accumulated funding deficiency, and

"(D) in any other case, the date on which such event occurred."

(2) CIVIL ACTIONS FOR REFUNDS.—Paragraph (1) of section 7422(g) (relating to special rules for certain excise taxes imposed by chapter 42 or 43) is amended to read as follows:

"(1) RIGHT TO BRING ACTIONS.—

"(A) IN GENERAL.—With respect to any taxable event, payment of the full amount of the first tier tax shall constitute sufficient payment in order to maintain an action under this section with respect to the second tier tax.

"(B) DEFINITIONS.—For purposes of subparagraph (A), the terms 'taxable event', 'first tier tax', and 'second tier tax' have the respective meanings given to such terms by section 4962."

(3) CLERICAL AMENDMENT.—The table of subchapters for chapter 42 is amended by adding at the end thereof the following new item:

"SUBCHAPTER C. Abatement of second tier taxes where there is correction during correction period."

(d) EFFECTIVE DATES.—

(1) FIRST TIER TAXES. The amendments made by this section with respect to any first tier tax shall take effect as if included in the Internal Revenue Code of 1954 when such tax was first imposed.

(2) SECOND TIER TAXES.—The amendments made by this section with respect to any second tier tax shall apply only with respect to taxes assessed after the date of the enactment of this Act. Nothing in the preceding sentence shall be construed to permit the assessment of a tax in a case to which, on the date of the enactment of this Act, the doctrine of res judicata applies.

(3) FIRST AND SECOND TIER TAX.—For purposes of this subsection, the terms "first tier tax" and "second tier tax" have the respective meanings given to such terms by section 4962 of the Internal Revenue Code of 1954.

SEC. 3. TREATMENT OF CERTAIN CHARITABLE TRUSTS FOR PURPOSES OF THE MINIMUM TAX.

(a) GENERAL RULE.—Subparagraph (C) of section 57(b)(2) (relating to treatment of certain charitable contributions of trusts for purposes of the minimum tax) is amended by redesignating clauses (iv) and (v) as clauses (v) and (vi), respectively, and by inserting after clause (iii) the following new clause:

"(iv) deductions allowable to a trust—

"(I) all the income interests in which are devoted to one or more of the purposes described in section 170(c) (determined without regard to section 170(c)(2)(A)),

"(II) all of the interests (other than income interests) which are held by a corporation, and

"(III) the grantor of which is a corporation."

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to taxable years beginning after December 31, 1975.

SEC. 4. EXCISE TAXES ON TIRES.

(a) REDUCTIONS IN RATE OF TAX.—

(1) IN GENERAL.—

(A) Section 4071(a)(1) is amended by striking out "10 cents" and inserting "9.75 cents".

(B) Section 4071(a)(2) is amended by striking out "5 cents" and inserting "4.875 cents".

(C) Section 4071(d)(1) is amended by striking out "5 cents" and inserting "4.875 cents".

(2) EFFECTIVE DATE.—The amendments made by this subsection shall apply on and after January 1, 1981.

(b) DETERMINATION OF OVERPAYMENT.—

(1) IN GENERAL.—The determination of the extent to which any overpayment of tax imposed by section 4071(a)(1) or (2) or section 4071(b) has arisen by reason of an adjustment of a tire after the original sale pursuant to a warranty or guarantee, and the allowance of a credit or refund of any such overpayment, shall be determined in accordance with the principles set forth in regulations and rulings relating thereto to the extent in effect on March 31, 1978.

(2) EFFECTIVE DATE.—This subsection shall apply to the adjustment of any tire after March 31, 1978, and prior to January 1, 1983.

(c) TIRES AND INNER TUBES.—

(1) IN GENERAL.—Paragraph (1) of section 6416(b) (relating to price readjustments) is amended to read as follows:

"(1) PRICE READJUSTMENTS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B) or (C), if the price of any article in respect of which a tax, based on such price, is imposed by chapter 32, is readjusted by reason of the return or repossession of the article or a covering or container, or by a bona fide discount, rebate, or allowance, including a readjustment for local advertising (but only to the extent provided in section 4216(e)(2) and (3)), the part of the tax proportionate to the part of the price repaid or credited to the purchaser shall be deemed to be an overpayment.

"(B) FURTHER MANUFACTURE.—Subparagraph (A) shall not apply in the case of an article in respect of which tax was computed under section 4223(b)(2); but if the price for which such article was sold is readjusted by reason of the return or repossession of the article, the part of the tax proportionate to the part of such price repaid or credited to the purchaser shall be deemed to be an overpayment.

"(C) ADJUSTMENT OF TIRE PRICE.—No credit or refund of any tax imposed by section 4071(a)(1) or (2) or section 4071(b) shall be allowed or made by reason of an adjustment of a tire pursuant to a warranty or guarantee."

(2) EFFECTIVE DATE.—The amendments made by this subsection shall apply to the adjustments of any tire after December 31, 1982.

SEC. 5. TAX TREATMENT OF PROCEEDS HELD IN TRUST FOR KLAMATH INDIAN TRIBE.

(a) IN GENERAL.—The first section of the Act [Pub. L. 94-81, 1975-2 C.B. 526] entitled "An Act to exclude from gross income gains from the condem-

nation of certain forest lands held in trust for the Klamath Indian Tribe", approved August 9, 1975, is amended by striking out "gain resulting from" and inserting in lieu thereof "all amounts realized by the trust from".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to all amounts whether received before, on, or after the date of the enactment of this Act.

Approved December 24, 1980.

House Report No. 96-912

2d Session

[Bracketed numerals indicate official report page numbers]

CHAPTER 42 SECOND TIER TAX CORRECTION ACT OF 1980

APRIL 29, 1980

Mr. ULLMAN, from the Committee on Ways and Means, submitted the following report to accompany H.R. 5391.[1]

The Committee on Ways and Means, to whom was referred the bill (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, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are shown in the reported bill, with the matter proposed to be stricken shown in linetype and the matter proposed to be inserted shown in italic type.

I. SUMMARY

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.

[2] II. EXPLANATION OF PROVISIONS

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 jurisdiction to enforce the second-tier taxes. In addition, the committee believes any changes to this system 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.

[3] *Explanation of the bill*

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 dificiency 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

[1] Public Law 96-596, page 653.

[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 [Pub. L. 91-172, 1969-3 C.B. 10, 14].

[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 [Pub. L. 93-406, 1974-3 C.B. 1, 89, 140].

[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 [Pub. L. 95-227, 1978-1 C.B. 494, 496].

[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).

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)).

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.[5]

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 that tax is final on that date).

[5] 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.

Senate Report No. 96-1034

2d Session

[Bracketed numerals indicate official report page numbers]

SECOND-TIER EXCISE TAXES

NOVEMBER 25, 1980

Mr. LONG, from the Committee on Finance, submitted the following report to accompany H.R. 5391.[1]

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.

[1] Public Law 96-596, page 653.

[2] I. SUMMARY

* * * * *

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.

* * * * *

[3] Section 6. Tax Treatment of Klamath Indian Judgments

Under present law, the income tax treatment of interest or damages for delay 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.

* * * * *

[6] 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.

[7] 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 prusuant 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

[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 [Pub.L. 94-455, 1976-3 C.B. (Vol. 1) 1].

[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 retreated "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.

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.

[8] 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 manufacturers 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).

* * * * *

[11] 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 [1975-2 C.B. 526], 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.

* * * * *

Public Law 96-598
96th Congress, H.R. 3317 [1]
December 24, 1980

An Act to amend the Internal Revenue Code of 1954 with respect to excise tax refunds in the case of certain uses of tread rubber, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. EXCISE TAX REFUNDS IN CASE OF CERTAIN USES OF TREAD RUBBER.

(a) REFUNDS FOR CERTAIN USES. —Subparagraph (G) of section 6416 (b) (2) of the Internal Revenue Code of 1954 (relating to special cases in which tax payments considered overpayments) is amended to read as follows:

"(G) in the case of tread rubber in respect of which tax was paid under section 4071(a) (4)—

"(i) used or sold for use otherwise than in the recapping or retreading of tires of the type used on highway vehicles (as defined in section 4072(c)),

"(ii) destroyed, scrapped, wasted, or rendered useless in the recapping or retreading process,

"(iii) used in the recapping or retreading of a tire the sale of which is later adjusted pursuant to a warranty or guarantee, in which case the overpayment shall be in proportion to the adjustment in the sales price of such tire, or

"(iv) used in the recapping or retreading of a tire, if such tire is by any person exported, used or sold for use as supplies for vessels or aircraft, sold to a State or local government for the exclusive use of a State or local government, or sold to a nonprofit educational organization for its exclusive use,

unless credit or refund of such tax is allowable under paragraph (3);".

(b) USE IN FURTHER MANUFACTURE, ETC.—

(1) IN GENERAL.—Paragraph (3) of section 6416(b) of such Code (relating to tax-paid articles used for further manufacture, etc.) is amended by inserting after subparagraph (C) the following new subparagraph:

"(D) in the case of tread rubber in respect of which tax was paid under section 4071(a) (4) used in the recapping or retreading of a tire, such tire is sold by the subsequent manufacturer or producer on or in connection with, or with the sale of, any other article manufactured or produced by him and such other article is by any person exported, sold to a State or local government for the exclusive use of a State or local government, sold to a nonprofit educational organization for its exclusive use, or used or sold for use as supplies for vessels or aircraft, unless credit or refund of such tax is allowable under subparagraph (C);".

(2) TECHNICAL AMENDMENTS.—

(A) Subparagraph (E) of section 6416(b) (2) of such Code is amended by inserting after "paragraph (3)" the following: "(or in the case of the tread rubber on a recapped or retreaded tire, resold for use as provided in subparagraph (D) of paragraph (3)),".

(B) Subparagraph (C) of section 6416(a) (1) of such Code is amended by striking out "(b) (3) (C)" and inserting in lieu thereof "(b) (3) (C) or (D)".

(C) Subparagraph (A) of section 6416(b) (3) of such Code is amended by inserting "(D)," after "(C),".

(D) Subparagraph (A) of section 6416(b) (4) of such Code is amended by striking out "section 4071" and inserting in lieu thereof "section 4071, or a recapped or retreaded tire in respect of which tax under section 4071 (a) (4) was paid on the tread rubber used in the recapping or retreading,".

(c) STATUTE OF LIMITATIONS.— Section 6511 of such Code (relating to limitations on credit or refund) is amended by redesignating subsection (i) as subsection (j) and by inserting after subsection (h) the following new subsection:

"(i) SPECIAL RULE FOR CERTAIN TREAD RUBBER TAX CREDITS OR REFUNDS.—The period for allowing a credit or making a refund of any overpayment of tax arising by reason of subparagraph (G) (iii) of section 6416 (b) (2) with respect to any adjustment of sales price of a tire pursuant to a warranty or guarantee shall not expire if claim therefor is filed before the date which is one year after the day on which such adjustment is made.".

(d) IMPORTED RECAPPED OR RETREADED UNITED STATES TIRES.— Section 4071 of such Code (relating to excise tax on tires and tubes) is amended by adding at the end thereof the following new subsection:

"(f) IMPORTED RECAPPED OR RETREADED UNITED STATES TIRES.—

"(1) IN GENERAL.—For purposes of subsection (a) (4), in the case of a tire which has been exported from the United States, recapped or retreaded (other than from bead to bead) outside the United States, and imported into the United States—

"(A) the person importing such tire shall be treated as importing the tread rubber used in such recapping or retreading (determined as of the completion of the recapping or retreading), and

[1] This publication of the law and Senate Report No. 96-898, page 663, are restricted to excerpts involving tax matters. House Report 96-560 is not published.

"(B) the sale of such tire by the importer thereof shall be treated as the sale of such tread rubber.

"(2) EXCEPTION FOR CERTAIN TAXABLE SALES.—Paragraph (1) shall not apply with respect to the sale of any tire if such tire is sold on or in connection with the sale of an article on which tax is imposed under section 4061.".

(e) EFFECTIVE DATE.—The amendments made by this section shall take effect on the first day of the first calendar month which begins more than 10 days after the date of the enactment of this Act.

SEC. 2. NONRECOGNITION OF GAIN ON SALE OF PRINCIPAL RESIDENCE.

(a) IN GENERAL.—In the case of an individual—

(1) who sold his principal residence (within the meaning of section 1034 of the Internal Revenue Code of 1954) in 1977,

(2) who purchased property on which to construct a new principal residence (within the meaning of such section)—

(A) the construction of which commenced during such year, and

(B) the construction of which was terminated before completion,

(3) who brought an action, and obtained a judgment, against the builder who commenced construction of the new residence but failed to complete it,

(4) who suspended construction of such residence so that the partially constructed residence could be used as evidence in connection with the prosecution of the builder (without regard to whether it was so used), and

(5) who failed to meet the requirements of such section with respect to occupancy of the new principal residence because of such suspension of construction,

the Secretary of the Treasury, in the administration of section 1034(c) of the Internal Revenue Code of 1954 (relating to rules for application of section 1034), shall apply paragraph (5) of such section as if "5 years" were substituted for "2 years" where it appears in the last sentence of such paragraph.

(b) EFFECTIVE DATE.—The provisions of the first section of this Act shall apply with respect to taxable years beginning after December 31, 1976, and before January 1, 1983.

SEC. 3. DISCLOSURE OF TAX RETURNS TO STATE AUDIT AGENCIES.

(a) GENERAL RULE.—Subsection (d) of section 6103 of the Internal Revenue Code of 1954 (relating to disclosure of return information to State tax officials) is amended to read as follows:

"(d) DISCLOSURE TO STATE TAX OFFICIALS.—

"(1) IN GENERAL.—Returns and return information with respect to taxes imposed by chapters 1, 2, 6, 11, 12, 21, 23, 24, 31, 32, 44, 51, and 52 and subchapter D of chapter 36 shall be open to inspection by, or disclosure to, any State agency, body, or commission, or its legal representative, which is charged under the laws of such State with responsibility for the administration of State tax laws for the purpose of, and only to the extent necessary in, the administration of such laws, including any procedures with respect to locating any person who may be entitled to a refund. Such inspection shall be permitted, or such disclosure made, only upon written request by the head of such agency, body, or commission, and only to the representatives of such agency, body, or commission designated in such written request as the individuals who are to inspect or to receive the returns or return information on behalf of such agency, body, or commission. Such representatives shall not include any individual who is the chief executive officer of such State or who is neither an employee or legal representative of such agency, body, or commission nor a person described in subsection (n). However, such return information shall not be disclosed to the extent that the Secretary determines that such disclosure would identify a confidential informant or seriously impair any civil or criminal tax investigation.

"(2) DISCLOSURE TO STATE AUDIT AGENCIES.—

"(A) IN GENERAL.—Any returns or return information obtained under paragraph (1) by any State agency, body, or commission may be open to inspection by, or disclosure to, officers and employees of the State audit agency for the purpose of, and only to the extent necessary in, making an audit of the State agency, body, or commission referred to in paragraph (1).

"(B) STATE AUDIT AGENCY.—For purposes of subparagraph (A), the term 'State audit agency' means any State agency, body, or commission which is charged under the laws of the State with the responsibility of auditing State revenues and programs.".

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect on the date of the enactment of this Act.

* * * * *

SEC. 5. TREATMENT OF CERTAIN EXPENSES INCLUDIBLE IN THE INCOME OF THE RECIPIENT.[2]

(a) IN GENERAL.—Subsection (e) of section 274 of the Internal Revenue Code of 1954 (relating to specific exceptions to application of disallowance of certain entertainment, etc., expenses) is amended by inserting after paragraph (9) the following new paragraph:

"(10) EXPENSES INCLUDIBLE IN INCOME OF PERSONS WHO ARE NOT EMPLOYEES.—Expenses paid or incurred by the taxpayer for goods, services, and facilities to the extent that the expenses are includible in the gross income of a recipient of the entertainment, amusement, or recreation who is not an employee of the taxpayer as compensation for services rendered or as a prize or award under section 74. The preceding sentence shall not apply to any amount paid or incurred by the taxpayer if such amount is re-

[2] See H.R. Rep. No. 96-1278, 96th Cong., 2d Sess. 32 (1980), with Pub. L. 96-605, page 702, this Bulletin.

quired to be included (or would be so required except that the amount is less than $600) in any information return filed by such taxpayer under part III of subchapter A of chapter 61 and is not so included."

(b) EFFECTIVE DATE.—The amendment by this section shall apply to any expenses paid or incurred after December 31, 1980, in taxable years ending after such date.

* * * * *

Approved December 24, 1980.

Senate Report No. 96-898

2d Session

[Bracketed numerals indicate official report page numbers]

OHIO WESLEYAN UNIVERSITY

AUGUST 18, 1980.

Mr LONG, from the Committee on Finance, submitted the following report to accompany H.R. 3317.[1]

The Committee on Finance, to which was referred the bill (H.R. 3317) to provide for duty-free entry of an organ for Ohio Wesleyan University, having considered the same, reports favorably thereon with an amendment to the text and an amendment to the title, and recommends that the bill as amended do pass.

The amendments are shown in the text of the bill in italic.

House bill.—H.R. 3317, as it passed the House, provided for the duty-free entry of an organ for Ohio Wesleyan University.

Committee bill.—The committee amendment deletes the provision relating to the duty-free entry of an organ for Ohio Wesleyan University, and adds provisions relating to (1) refund of the excise tax on tread rubber, (2) private relief relating to the replacement period for nonrecognition of gain on the sale of a personal residence, and (3) disclosure of tax returns to State audit agencies.

[1] Public Law 96-598, page 661.

[2] I. SUMMARY

As passed by the House, this bill provides for the duty-free entry of an organ for Ohio Wesleyan University. The committee approved the substance of the House-passed bill to be offered as an amendment to H.R. 3122, now pending on the Senate calendar.

In lieu of the House bill provision, the committee adopted an amendment to H.R. 3317 in the nature of a substitute with the following tax provisions.

SECTION 1. REFUNDS OF TREAD RUBBER EXCISE TAX

Under present law, a 5 cents-per-pound manufacturers excise tax is imposed on tread rubber used for recapping or retreading tires of the type used on highway vehicles. No credit or refund of the tread rubber tax is available if the tax-paid tread rubber is wasted in the recapping process, contained in a recapped tire the price of which is adjusted under a warranty, or sold in conjunction with certain otherwise tax-exempt sales. In some situations, the tread rubber tax can be avoided by exporting a tire to be recapped outside the United States and then importing the retreaded tire.

This section provides for a refund or credit of the manufacturers excise tax on tread rubber if the rubber is (1) wasted in the recapping process, (2) contained in a recapped tire which is adjusted under a warranty, or (3) sold in conjunction with certain otherwise tax-exempt sales.

The provision also imposes the tread rubber excise tax on the tread rubber in tires which are exported for recapping and subsequently imported into the United States.

SECTION 2. REPLACEMENT PERIOD FOR NONRECOGNITION OF GAIN ON SALE OF RESIDENCE

In general, gain on the sale of a taxpayer's principal residence will not be recognized for income tax purposes if a replacement residence is purchased or constructed and certain requirements are met within specified time periods.

This provision requires the Secretary of the Treasury, in limited circumstances, to extend to five years the present two-year period during which a taxpayer must occupy and use as a principal residence a newly constructed replacement residence. The provision is intended to benefit Mrs. Jane M. Cathcart of Virginia.

SECTION 3. DISCLOSURE OF TAX RETURNS TO STATE AUDIT AGENCIES

Under present law, returns and return information may be disclosed to State agencies which are charged under State law with responsibility for the administration of State tax laws for the purpose of, and only to the extent necessary in, the administration of such laws.

Under this provision, any returns or return information obtained by a State agency for tax administration purposes are made open to inspection by, or disclosure to, officers and employees of a State audit agency for the purpose of, and only to the extent necessary in, making an audit of the State agency which obtained the returns or return information.

[3] II. EXPLANATION OF THE BILL

A. Refunds of Tread Rubber Excise Tax (sec. 1 of the bill and secs. 4071, 6416, and 6511 of the Code)

Present law

Present law imposes a tax of 5 cents per pound on tread rubber used for recapping or retreading tires of the type used on highway vehicles (Code secs. 4071(a)(4), 4072(b), and 4073(c)).[1]

Tread rubber may be sold tax-free for use otherwise than in the recapping or retreading of tires of the type used on highway vehicles; or a credit or refund (without interest) of the

[1] The tax on tread rubber is scheduled to expire on October 1, 1984 (sec. 4071(d)(3)). (Revenues from this tax go into the Highway Trust Fund.)

tread rubber tax may be obtained if the tax-paid tread rubber is used or sold for use otherwise than in the recapping or retreading of tires of the type used on highway vehicles (Code sec. 6416(b)(2)(G)).

There are several instances under present law where a manufacturers excise tax is imposed on tread rubber when in a similar situation a manufacturers excise tax is not imposed (or a credit or refund of the tax is allowed) on new tires.

First, rubber wasted in manufacturing new tires is not subject to tax because the tax is imposed when the completed tire is sold and only upon the material actually contained in the completed tire (sec. 4071(a)(1)). The tax on tread rubber, on the other hand, is imposed before the recapping or retreading of a used tire. Waste of tread rubber in that process occurs after the tread rubber tax liability has been determined, and under present law no refund or credit is provided for any portion of the tax imposed on tread rubber which is so wasted.[2]

Second, if the sale price of a retreaded tire is adjusted by reason of a warranty or guarantee, no credit or refund of the tread rubber tax is provided.[3]

Third, no credit or refund is available for the tread rubber tax when a recapped or retreaded tire is exported, sold to a State or local government, sold to a nonprofit educational organization, or used or sold [4] for use as supplies for vessels or aircraft (Code secs. 4221 and 6416(b)). The credit or refund is not available where a retreaded tire is mounted on a new vehicle that then is disposed of in any of the above ways.

While used and recapped or retreaded tires ordinarily are subject to the tire tax when imported, a different situation exists when a used tire which has been taxed in the United States is exported, is retreaded (other than from bead to bead) abroad, and then is shipped back into the United States.[4] Then there is neither a tax on the imported retreaded tire nor on the tread rubber used in the retreading, because the tire already has been taxed and the tread rubber is considered to have lost its identity.

Under present law, the general time by which a claim for credit or refund of a tax must be filed is 3 years from the time the tax return was filed or, if later, 2 years from the time the tax was paid (Code sec. 6511).

Reasons for change

The committee believes that it is appropriate to make the application of the excise tax on tread rubber more nearly equivalent to the application of the tax on new tires. Also, the committee concluded that the tax law should not create a competitive advantage for tires which are exported for retreading and then imported for sale in the United States.

Explanation of provision

Credit or refund of tread rubber tax

This provision of the bill makes a credit or refund of the tread rubber tax available in three situations. These changes are intended to permit a credit or refund of the tax on the tread rubber used on a recapped or retreaded tire, under the same circumstances where a credit or refund would be available for the tax on a new tire.

First, the credit or refund is available where rubber is destroyed, scrapped, wasted, or rendered useless in the recapping or retreading process.

Second, the credit or refund is available where the tread rubber is used in the recapping or retreading of a tire if the sales price of the tire is later adjusted because of a warranty or guaranty. The overpayment (that is, the amount available for credit or refund) is the same proportion of the tax paid as the adjustment in the sales price of the retreaded tire to the immediate vendee by the tire retreader.

Third, a credit or refund of the tread rubber tax is provided to the manufacturer for the tread rubber on a recapped or retreaded tire if the tire is by any person (1) exported, (2) sold to a State or local government for its exclusive use, (3) sold to a nonprofit educational organization for its exclusive use, or (4) used or sold for use as supplies for a vessel or aircraft.

Finally, if a retreaded tire is sold by the retreader or by another manufacturer on or in conjunction with another article (for example, [5] a truck) manufactured by it, the bill provides that a credit or refund of the tread rubber tax is to be allowed to the further manufacturer if the article is exported or sold by any person for any of the above purposes.

Tax on imported recapped or retreaded tires

The bill also provides that used tires which are exported from the United States, recapped or retreaded abroad (other than from bead to bead), and then imported into the United States are to be subject to the tax on tread rubber. For this purpose, the amount of tread rubber to be taken into account is to be determined as of the completion of the recapping or re-

[2] In *Great Olympic Tire Co.* v. *U.S.*, 597 F. 2d 449, (5th Cir. 1979), the Fifth Circuit Court of Appeals held that tread rubber wasted in the recapping process is not subject to the section 4071(a)(4) manufacturers excise tax, and that highway-type tires returned under warranty after partial use are subject to the tax without allowance for a refund or credit of the tax previously imposed on the tread rubber remaining on the returned tire. In arriving at these conclusions, the court relied upon the fact that wasted rubber never became part of tires of the type used on highway vehicles and that rubber remaining in a returned tire had become part of a tire of the type used on highway vehicles. While the section 4071(a)(4) tread rubber tax does not refer to highway-type vehicle tires, as does the section 4071(a)(1) new tire tax, the court noted that the legislative history of the tread rubber tax clearly evidences an intention to limit the tax to such tires. *See* H. Rept. No. 10660, 84th Cong., 2d Sess., 1956-2 C.B. 1312; Rev. Rul. 65-223, 1965-2 C.B. 420. *See also Treadco Tires, Inc.* v. *U.S.*, 604 F. 2d 14 (5th Cir. 1979) (Rubber strip stock suppliers are not manufacturers within the meaning of section 4071(a)(4) when they furnish rubber strips to tire retreader for use in an Orbitread extrusion machine).

[3] *See* note 2, *supra*.

[4] Tires recapped from bead to bead are considered as having been newly manufactured and thus are taxable.

treading of the tire. The amount so determined is either the amount which is established as actually used in recapping or retreading the tire or an average amount which is generally used on comparable tires in the industry, as determined by the Treasury Department (Code sec. 4071(c)).

If a retreaded tire is imported on a vehicle which is not itself subject to a manufacturers excise tax (e.g., a passenger car or a light-duty truck), then the importer of the vehicle is under existing law treated as the importer of the tire (Code sec. 4071(e)). However, as noted, if the tire is not taxable because it was exported and recapped abroad (except from bead to bead), the importer is not liable for tax on the tread rubber on the imported tire. This provision carries the process a step further and treats the importer of the vehicle as the importer of the tread rubber on a retreaded tire even though the sale of the tire is not otherwise subject to tax.

Warranty or guaranty adjustments

The provision also modifies the statute of limitations in cases where a claim for credit or refund of the tread rubber tax is filed as a result of a warranty or guaranty adjustment. The provision provides that in such a case a claim for credit or refund may be filed at any time before the date on which the adjustment is made, if the period for filing the claim would otherwise expire before that later date.

In other words, under this provision, the manufacturer is assured that it will have one day less than a year after the time the adjustment is made (or deemed made) within which to file a claim for credit or refund of the relevant tax.

Effective date

The amendments made by this provision are effective on the first day of the first calendar month which begins more than 10 days after the date of the provision's enactment.

* * * * *

[6] B. Nonrecognition of Gain on Sale of Residence (Sec. 2 of the bill and sec. 1034 of the Code)

Present law

In general, the entire amount of gain realized on the sale of real property is recognized for income tax purposes. If certain requirements are met, however, gain on the sale of a taxpayer's principal residence will not be recognized, except to the extent the adjusted sales price of the old residence exceeds the cost of the new residence (Code sec. 1034).

To qualify for nonrecognition under section 1034, the taxpayer must purchase or construct, and use a replacement residence within certain time limits. The purchase of a new residence must occur within eighteen months before or after the sale of the old residence, and the taxpayer must use the new residence as a principal residence within eighteen months after the sale of the old residence (sec. 1034(a)). The construction of a new residence must begin no later than eighteen months after the sale of the old residence, and the taxpayer must occupy and use the new residence as his principal residence no later than two years after the sale of the old residence (sec. 1034(c)(5)).

Reasons for change

The committee believes that the time limits established under present law are adequate in most circumstances and greatly simplify the administration of the nonrecognition provisions under Code section 1034. The committee believes, however, that the exceptional circumstances presented in this specific case warrant a narrow exception to the time limit applicable to the occupation and use of a newly constructed residence.

Explanation of provision

This provision requires the Secretary of the Treasury to extend to five years the present two-year period during which a taxpayer must occupy and use as a principal residence a newly constructed replacement residence, if certain conditions exist. The period is extended only if a taxpayer: (1) sold his principal residence in 1977; (2) bought land for a new residence; (3) began construction of a replacement residence in 1977, and the construction was terminated by the builder before completion; (4) suspended construction to preserve evidence against the builder; (5) sued and obtained a judgment against the builder; and (6) did not occupy the new residence within two years of the sale of the old residence because of the suspension of construction.

This provision is intended to benefit Mrs. Jane M. Cathcart of Virginia.

Effective date

This provision applies to taxable years beginning after December 31, 1976, and before January 1, 1983.

* * * * *

[7] C. Disclosure of Tax Returns to State Audit Agencies (sec. 3 of the bill and sec. 6103(d) of the Code)

Present law

Under present law (Code sec. 6103(d)), returns and return information may be disclosed to State agencies which are charged under the laws of the State with responsibility for the administration of State tax laws for the purpose of, and only to the extent necessary in, the administration of such laws. Section 6103(d) sets forth specific rules with which a State agency must comply in order to receive Federal tax information. For example, the request for disclosure must be made by the head of the State tax agency in writing and the actual disclosure of the tax information may be made only to the representatives of the State tax agency who are designated in the written request to receive the information. Also, the law provides that the tax information cannot be disclosed to the Governor of a State. In addition, return information may not be disclosed to the extent that the Secretary of the Treasury determines such disclosure would identify

a confidential informant or seriously impair any civil or criminal tax investigation.

Return information disclosed to State agencies is subject to strict safeguard, recordkeeping, and reporting requirements (Code secs. 6103(p)(3) and 6103(p)(4)). These requirements provide assurances that Federal tax return information will be used only for the purposes authorized by law and provide a basis for determining when violations occur.

Present law allows State auditing agencies access to Federal tax return information only when the auditing agency actually is involved in the determination, assessment, collection, or refunding of taxes (that is, tax administration activities). Thus, a State auditing agency is not authorized access to Federal tax return information when the auditing agency's role is limited to general oversight of the taxing authority.

Reasons for change

The committee is concerned that present law, by denying State auditing agencies access to Federal return information, may seriously impede an audit agency's ability to exercise effectively its oversight responsibilities with respect to the State taxing authority. Accordingly, the committee believes that State taxing authorities should be permitted to disclose Federal tax returns and return information in their possession to State auditing agencies for the purpose of auditing the activities of the State taxing authority.

While the committee believes that State auditing agencies should be given access to tax returns and return information, the committee is concerned that safeguards required with respect to these disclosures be strictly maintained. Therefore, it is the intention of the committee that the Comptroller General report to the Congress both one and two years after implementation of this provision concerning the procedures established by State auditing agencies and State taxing authorities to protect taxpayer confidentiality.

[8] *Explanation of provision*

The bill provides that any returns or return information obtained by a State agency pursuant to the provisions of Code section 6103(d) may be open to inspection by, or disclosure to, officers and employees of the State audit agency for the purpose of, and only to the extent necessary in, making an audit of the State agency which obtained the returns or return information. Under the bill, a "State audit agency" is defined as any State agency, body, or commission which is charged under the laws of the State with the responsibility of auditing State revenues and programs.

In addition, a State audit agency which receives return information would be subject to the same safeguard, recordkeeping, and reporting requirements as apply to other State agencies which receive return information and would be subject to the confidentiality requirements imposed by section 6103(a) and the civil and criminal penalties applicable in the case of unauthorized disclosure of such return information.

Effective date

This provision becomes effective upon the date of enactment.

* * * * *

IV. REGULATORY IMPACT OF THE BILL

In compliance with paragraph 5 of Rule XXIX 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. 3317, 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 certain provisions of the tax law. Section 1 of the bill provides for a refund or credit of the manufacturers excise tax on tread rubber where the rubber is (1) wasted and in the recapping process, (2) contained in a recapped tire which is adjusted under a warranty, or (3) sold in conjunction with certain otherwise tax-exempt sales. Section 1 also imposes the tread rubber excise tax on the tread rubber in tires which are exported for recapping and subsequently imported into the United States. Section 2 of the bill provides private relief for a taxpayer in Virginia, and section 3 allows disclosure of tax returns to State audit agencies.

Impact on personal privacy.—The provision in section 3 of the bill will involve limited impact on the privacy of those whose returns are audited by a State audit agency in reviewing a State's tax administration. The other provisions of the bill will have minimal impact on personal privacy.

Determination of paperwork involved.—The provisions in section 1 of the bill will involve some additional paperwork with respect to the claiming of the refund or credit of the manufacturers excise tax on tread rubber and for returns involving the excise tax on tread rubber in tires which are exported for recapping and subsequently imported into the United States. The other provisions will have little, if any, net effect on paperwork for taxpayers.

* * * * *

Public Law 96-601
96th Congress, H.R. 5505[1]
December 24, 1980

An Act to simplify certain provisions of the Internal Revenue Code of 1954, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. AMENDMENT OF 1954 CODE.

Except as otherwise expressly provided, whenever in this Act an amend-

[1] This publication of the law, Senate Report No. 96-1033, page 668, and House Report No. 96-545, page 675, is restricted to excerpts involving tax matters.

ment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

* * * * *

SEC. 3. EXEMPT STATUS OF AUXILIARIES OF CERTAIN FRATERNAL BENEFICIARY SOCIETIES.

(a) GENERAL RULE.—Subsection (i) of section 501 is amended by adding at the end thereof the following new sentence: "The preceding sentence to the extent it relates to discrimination on the basis of religion shall not apply to—

"(1) an auxiliary of a fraternal beneficiary society if such society—

"(A) is described in subsection (c)(8) and exempt from tax under subsection (a), and

"(B) limits its membership to the members of a particular religion, or

"(2) a club which in good faith limits its membership to the members of a particular religion in order to further the teachings or principles of that religion, and not to exclude individuals of a particular race or color.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after October 20, 1976.

SEC. 4. EXTENSION OF WITHHOLDING TO PAYMENTS OF SICK PAY MADE BY THIRD PARTIES.

(a) GENERAL RULE.—Paragraph (1) of section 3402(o) (relating to extension of withholding to certain payments other than wages) is amended by striking out "and" at the end of subparagraph (A), by adding "and" at the end of subparagraph (B), and by inserting after subparagraph (B) the following new subparagraph:

"(C) any payment to an individual of sick pay which does not constitute wages (determined without regard to this subsection), if at the time the payment is made a request that such sick pay be subject to withholding under this chapter is in effect,".

(b) AMOUNT TO BE DEDUCTED AND WITHHELD.—Subsection (o) of section 3402 is amended by striking out paragraph (3) and inserting in lieu thereof the following new paragraphs:

"(3) AMOUNT WITHHELD FROM ANNUITY PAYMENTS OR SICK PAY.—If a payee makes a request that an annuity or any sick pay be subject to withholding under this chapter, the amount to be deducted and withheld under this chapter from any payment to which such request applies shall be an amount (not less than a minimum amount determined under regulations prescribed by the Secretary) specified by the payee in such request. The amount deducted and withheld with respect to a payment which is greater or less than a full payment shall bear the same relation to the specified amount as such payment bears to a full payment.

"(4) REQUEST FOR WITHHOLDING.—A request that an annuity or any sick pay be subject to withholding under this chapter—

"(A) shall be made by the payee in writing to the person making the payments and shall contain the social security number of the payee,

"(B) shall specify the amount to be deducted and withheld from each full payment, and

"(C) shall take effect—

"(i) in the case of sick pay, with respect to payments made more than 7 days after the date on which such request is furnished to the payor, or

"(ii) in the case of an annuity, at such time (after the date on which such request is furnished to the payor) as the Secretary shall by regulations prescribe.

Such a request may be changed or terminated by furnishing to the person making the payments a written statement of change or termination which shall take effect in the same manner as provided in subparagraph (C). At the election of the payor, any such request (or statement of change or revocation) may take effect earlier than as provided in subparagraph (C).

"(5) SPECIAL RULE FOR SICK PAY PAID PURSUANT TO CERTAIN COLLECTIVE-BARGAINING AGREEMENTS.—In the case of any sick pay paid pursuant to a collective-bargaining agreement between employee representatives and one or more employers which contains a provision specifying that this paragraph is to apply to sick pay paid pursuant to such agreement and contains a provision for determining the amount to be deducted and withheld from each payment of such sick pay—

"(A) the requirement of paragraph (1)(C) that a request for withholding be in effect shall not apply, and

"(B) except as provided in subsection (n), the amounts to be deducted and withheld under this chapter shall be determined in accordance with such agreement.

The preceding sentence shall not apply with respect to sick pay paid pursuant to any agreement to any individual unless the social security number of such individual is furnished to the payor and the payor is furnished with such information as is necessary to determine whether the payment is pursuant to the agreement and to determine the amount to be deducted and withheld.".

(c) DEFINITION OF SICK PAY.—Paragraph (2) of section 3402(o) (relating to definitions) is amended by adding at the end thereof the following new subparagraph:

"(C) SICK PAY.—For purposes of this subsection, the term 'sick pay' means any amount which—

"(i) is paid to an employee pursuant to a plan to which the employer is a party, and

"(ii) constitutes remuneration or a payment in lieu of remuneration for any period during which the employee is temporarily absent from work on account of sickness or personal injuries.".

(d) TECHNICAL AMENDMENT.—Subparagraph (B) of section 3402(o)(2) (defining annuity) is amended by striking out ", but only to the extent that the amount is includible in the gross income of such individual".

(e) REPORTING REQUIREMENTS.—Section 6051 (relating to receipts for employees) is amended by adding at the end thereof the following new subsection:

"(f) STATEMENTS REQUIRED IN CASE OF SICK PAY PAID BY THIRD PARTIES.—

"(1) STATEMENTS REQUIRED FROM PAYOR.—

"(A) IN GENERAL.—If, during any calendar year, any person makes a payment of third-party sick pay to an employee, such person shall, on or before January 15 of the succeeding year, furnish a written statement to the employer in respect of whom such payment was made showing—

"(i) the name and, if there is withholding under section 3402(o), the social security number of such employee,

"(ii) the total amount of the third-party sick pay paid to such employee during the calendar year, and

"(iii) the total amount (if any) deducted and withheld from sick pay under section 3402.

For purposes of the preceding sentence, the term 'third-party sick pay' means any sick pay (as defined in section 3402(o)(2)(C)) which does not constitute wages for purposes of chapter 24 (determined without regard to section 3402(o)(1)).

"(B) SPECIAL RULES.—

"(i) STATEMENTS ARE IN LIEU OF OTHER REPORTING REQUIREMENTS.—The reporting requirements of subparagraph (A) with respect to any payments shall, with respect to such payments, be in lieu of the requirements of subsection (a) and of section 6041.

"(ii) PENALTIES MADE APPLICABLE.—For purposes of sections 6674 and 7204, the statements required to be furnished by subparagraph (A) shall be treated as statements required under this section to be furnished to employees.

"(2) INFORMATION REQUIRED TO BE FURNISHED BY EMPLOYER.—Every employer who receives a statement under paragraph (1)(A) with respect to sick pay paid to any employee during any calendar year shall, on or before January 31 of the succeeding year, furnish a written statement to such employee showing—

"(A) the information shown on the statement furnished under paragraph (1)(A), and

"(B) if any portion of the sick pay is excludable from gross income under section 104(a)(3), the portion which is not so excludable and the portion which is so excludable.

To the extent practicable, the information required under the preceding sentence shall be furnished on or with the statement (if any) required under subsection (a).".

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to payments made on or after the first day of the first calendar month beginning more than 120 days after the date of the enactment of this Act.

SEC. 5. RHODE ISLAND INDIAN CLAIMS SETTLEMENT ACT.

(a) IN GENERAL.—The Rhode Island Indian Claims Settlement Act (Public Law 95-395) is amended by adding at the end thereof the following new title:

"TITLE II—TAX TREATMENT

"EXEMPTION FROM TAXATION

"SEC. 201. (a) Except as otherwise provided in subsections (b) and (c), the settlement lands received by the State Corporation shall not be subject to any form of Federal, State, or local taxation while held by the State Corporation.

"(b) The exemption provided in subsection (a) shall not apply to any income-producing activities occurring on the settlement lands.

"(c) Nothing in this Act shall prevent the making of payments in lieu of taxes by the State Corporation for services provided in connection with the settlement lands.

"DEFERRAL OF CAPITAL GAINS

"SEC. 202. For purposes of the Internal Revenue Code of 1954, any sale or disposition of private settlement lands pursuant to the terms and conditions of the settlement agreement shall be treated as an involuntary conversion within the meaning of section 1033 of the Internal Revenue Code of 1954.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on September 30, 1978.

Approved December 24, 1980.

Senate Report No. 96-1033 2d Session

[Bracketed numerals indicate official report page numbers]

TAX ADMINISTRATIVE PROVISIONS REVISIONS

NOVEMBER 25 (legislative day, NOVEMBER 20), 1980.

Mr. LONG, from the Committee on Finance, submitted the following report to accompany H.R. 5505.[1]

The Committee on Finance, to which was referred the act (H.R. 5505) to simplify certain provisions of the Internal Revenue Code of 1954, and for other purposes, having considered the same, reports favorably thereon with an amendment 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. 5505, as passed by the House, provided for revisions in certain administrative provisions of the Code and extended certain temporary tax provisions.

Committee bill.—The committee bill deletes the provisions of the House bill already enacted (secs. 2-6 and 12; H.R. 5224, P.L. 96-167 [1980-1 C.B. 483]); deletes the provision relating to time for payment of the excise tax on fishing equipment and the provision relating to the time in which certain members of the Armed Forces must replace a principal residence; retains the provision relating to the excise tax treatment of domestic wines for certain purposes, retains the provision re-

[1] Public Law 96-601, page 666.

lating to refunds of tread rubber excise tax (also included in H.R. 3317, as passed by the Senate); retains the provision relating to the exempt status of certain fraternal beneficiary societies, but extends its application to certain other social clubs, such as religious alumni clubs; and adds provisions relating to (1) extension of withholding to payments of sick pay made by third parties (sec. 4 of H.R. 4746, as passed by the House), (2) annual payment of the gift tax, and (3) tax treatment under the Rhode Island Indian Claims Settlement Act.

[2] I. SUMMARY

* * * * *

SEC. 3. REFUNDS OF TREAD RUBBER EXCISE TAX

Under present law, a 5-cents-per-pound manufacturers excise tax is imposed on tread rubber used for recapping or retreading tires of the type used on highway vehicles. No credit or refund of the tread rubber tax is available if the tax-paid tread rubber is wasted in the recapping process, contained in a recapped tire the price of which is adjusted under a warranty, or sold in conjunction with certain otherwise tax-exempt sales. In some situations, the tread rubber tax can be avoided by exporting a tire to be recapped outside the United States and then importing the retreaded tire.

This section provides for a refund or credit of the manufacturers excise tax on tread rubber where the rubber is (1) wasted in the recapping process, (2) contained in a recapped tire the price of which is adjusted under a warranty, or (3) sold in conjunction with certain otherwise tax-exempt sales.

The provision also imposes the tread rubber excise tax on the tread rubber in tires which are exported for recapping and subsequently imported into the United States.

SEC. 4. EXEMPT STATUS OF AUXILIARIES OF CERTAIN FRATERNAL BENEFICIARY SOCIETIES

In order to qualify for tax-exempt status under Code section 501(c)(7) after October 20, 1976, a social club cannot have any provision providing for discrimination against any person on the basis of race, color, or religion in the club's charter, bylaws, other governing instrument, or any written policy statement.

This section allows social clubs which are affiliated with fraternal beneficiary societies exempt under Code section 501(c)(8), such as those operated by the Knights of Columbus, to retain their exemption even though membership in the clubs is limited to members of a particular religion. In addition, this provision will allow certain alumni clubs which are limited to members of a particular religion to retain their exemption under Code section 501(c)(7).

[3] SEC. 5. EXTENSION OF WITHHOLDING TO PAYMENTS OF SICK PAY MADE BY THIRD PARTIES

Under present law, no tax is specifically required to be withheld upon payments of sick pay made to an employee by a person who is not the employer for whom the employee performs services. For example, no tax is withheld from payments of sick pay made on behalf of an employer by an insurance company under an accident or health policy.

In general, this section of the bill provides for voluntary withholding from payments of sick pay made by a third party. In addition, it contains a special provision relating to sick pay paid pursuant to certain collective-bargaining agreements and contains various reporting requirements.

SEC. 6. ANNUAL PAYMENT OF GIFT TAX

Under present law, a gift tax return generally is required to be filed, and any gift tax paid, on a calendar quarter basis if the sum of (1) the taxable gifts made during the calendar quarter plus (2) all other taxable gifts made during the calendar year (and for which a return has not yet been required to be filed) exceeds $25,000. However, if all transfers made in a calendar year that are subject to the gift tax filing requirements do not exceed $25,000 in taxable gifts, a return must be filed, and the gift tax paid, by April 15 of the following year.

The bill provides that gift tax returns are to be filed, and any gift tax paid, on an annual basis. The provision is effective with respect to gifts made after December 31, 1981.

SEC. 7. TAX TREATMENT UNDER THE RHODE ISLAND INDIAN CLAIMS SETTLEMENT ACT

Under present law, the tax status of land received by a corporation created under Rhode Island law to implement a settlement with the Narragansett Indian Tribe is unclear. In addition, present law is unclear with respect to various other aspects related to the Rhode Island Indian Claims Settlement Act.

The bill generally clarifies the tax treatment of transfers under the Rhode Island Indian Settlement Act.

[4] II. EXPLANATION OF THE BILL

* * * * *

[6] B. Refunds of Tread Rubber Excise Tax (sec. 3 of the bill and secs. 4071, 6416, and 6511 of the Code)

Present law

Present law imposes a tax of 5 cents per pound on tread rubber used for recapping or retreading tires of the type used on highway vehicles (Code secs. 4071(a)(4), 4072(b), and 4073(c)).[1]

Tread rubber may be sold tax-free for use otherwise than in the recapping or retreading of tires of the type used on highway vehicles, or a credit or refund (without interest) of the tread rubber tax may be obtained if the tax-paid tread rubber is used or sold for use otherwise than in the recapping or retreading of tires of the type used on highway vehicles (Code sec. 6416(b)(2)(G)).

[1] The tax on tread rubber is scheduled to expire on October 1, 1984 (Code sec. 4071(d)(3)). (Revenues from this tax go into the Highway Trust Fund.)

There are several instances under present law where a manufacturers excise tax is imposed on tread rubber when in a similar situation the manufacturers excise tax is not imposed (or a credit or refund of the tax is allowed) on new tires.

First, rubber wasted in manufacturing new tires is not subject to tax since the tax is imposed when the completed tire is sold and only upon the material actually contained in the completed tire. The tax on tread rubber, on the other hand, is imposed before the recapping or retreading of a used tire. Wastage of tread rubber in that process occurs after the tread rubber tax liability has been determined, and under present law no refund or credit is provided for any portion of the tax imposed on tread rubber which is so wasted.[2]

Second, if the sale price of a retreaded tire is adjusted by reason of a warranty or guarantee, no credit or refund of the tread rubber tax is provided.[3]

Third, no credit or refund is available for the tread rubber tax when a recapped or retreaded tire is exported, sold to a State or local government, sold to a nonprofit educational organization, or used or sold for use as supplies for vessels or aircraft (Code secs. 4221 and 6416(b)). [7] Neither is the credit or refund available when a retreaded tire is mounted on a new vehicle that then is disposed of in any of the above ways.

While used and recapped or retreaded tires ordinarily are subject to the tire tax when imported, a different situation exists when a used tire which has been taxed in the United States is exported, is retreaded (other than from bead to bead) abroad, and then is shipped back into the United States.[4] Then there is neither a tax on the imported retreaded tire nor on the tread rubber used in the retreading, because the tire already has been taxed and the tread rubber is considered to have lost its identity.

Under present law, the general time by which a claim for credit or refund of a tax must be filed is 3 years from the time the tax return was filed or, if later, 2 years from the time the tax was paid (Code sec. 6511).

Reasons for change

The committee believes that it is appropriate to make the application of the tread rubber tax more nearly equivalent to the application of the new tire tax. Also, the committee concluded that the tax law should not create a competitive advantage for tires which are exported for retreading and then imported for sale in the United States.

Explanation of provision

Credit or refund of tread rubber tax

This provision of the bill makes a credit or refund of the tread rubber tax available in three situations. These changes are intended to permit a credit or refund of the tax on the tread rubber used in a recapped or retreaded tire, under the same circumstances where similar treatment would be available for the tax on a new tire.

First, the credit or refund would be available where rubber is destroyed, scrapped, wasted, or rendered useless in the recapping or retreading process.

Second, the credit or refund would be available where the tread rubber is used in the recapping or retreading of a tire if the sales price of the tire is later adjusted because of a warranty or guaranty. The overpayment (that is, the amount available for credit or refund) would be the same proportion of the tax paid as the adjustment in the sales price of the retreaded tire to the immediate vendee by the tire retreader.

Third, a credit or refund of the tread rubber tax would be available to the manufacturer for the tread rubber on a recapped or retreaded tire if the tire is by any person (1) exported, (2) sold to a State or local government for its exclusive use, (3) sold to a nonprofit educational organization for its exclusive use, or (4) used or sold for use as supplies for a vessel or aircraft.

Finally, where a retreaded tire is sold by the retreader or by another manufacturer on or in conjunction with another article (for example, a truck) manufactured by it, the bill provides that a credit or refund of the tread rubber tax is to be allowed to the manufacturer of [8] the other article if the article is exported or sold by any person for any of the above purposes.

Tax on imported recapped or retreaded tires

The bill also provides that used tires which are exported from the United States, recapped or retreaded abroad (other than from bead to bead), and then imported into the United States are to be subject to the tax on tread rubber. For this purpose, the amount of tread rubber to be taken into account is to be determined as of the completion of the recapping or retreading of the tire. The amount so determined would be either the amount which is established as actually used in recapping or retreading the tire or an average amount which is generally used on comparable tires in the industry, as determined by the Treasury Department (Code sec. 4701(c)).

[2] In *Great Olympic Tire Co.* v. *U.S.*, 597 F.2d 449, 78-1 USTC ¶ 16,316 (5th Cir. 1979), the Fifth Circuit Court of Appeals held that tread rubber wasted in the recapping process is not subject to the section 4071(a)(4) manufacturers excise tax, and that highway-type tires returned under warranty after partial use are subject to the tax without allowance for a refund or credit of the tax previously imposed on the tread rubber remaining on the returned tire. In arriving at these conclusions, the court relied upon the fact that wasted rubber never became part of tires of the type used on highway vehicles and that rubber remaining in a returned tire had become part of a tire of the type used on highway vehicles. While the section 4071(a)(4) tread rubber tax does not refer to highway-type vehicles tires, as does the section 4071(a)(1) new tire tax, the court noted that the legislative history of the tread rubber tax clearly evidences an intention to limit the tax to such tires. *See* H. Rept. No. 10660, 84th Cong., 2d Sess., 1956-2 C.B. 1312; Rev. Rul. 65-223, 1965-2 C.B. 420.

[3] *See* note 2, *supra*.

[4] Tires recapped from bead to bead are considered as having been newly manufactured and thus are taxable.

If a retreated tire is imported on a vehicle which is not itself subject to a manufacturers excise tax (e.g., a passenger car or a light-duty truck), then the importer of the vehicle is under existing law (Code sec. 4071(a)) treated as the importer of the tire. However, as noted, if the tire is not taxable because it was exported and recapped abroad (except from bead to bead), the importer is not liable for tax on the tread rubber on the imported tire. This provision carries the process a step further and would treat the importer of the vehicle as the importer of the tread rubber that is on a retreaded tire which is not otherwise subject to tax on the complete tire.

Warranty or guarantee adjustments

The provision also modifies the statute of limitations in cases where a claim for credit or refund of the tread rubber tax is filed as a result of a warranty or guarantee adjustment. The amendment provides that in such a case a claim for credit or refund may be filed at any time before the date which is one year after the date on which the adjustment is made, if the period for filing the claim would otherwise expire before that later date.

In other words, under this provision, the manufacturer would be assured that it will have one day less than a year after the time the adjustment is made (or deemed made) within which to file a claim for credit or refund of the relevant tax.

Effective date

The amendments made by this provision will be effective on the first day of the first calendar month which begins more than 10 days after the date of enactment.

Revenue effect

This provision will reduce budget receipts by less than $100,000 in fiscal year 1981, and by less than $200,000 annually during each of the next four fiscal years. (These amounts would otherwise go into the Highway Trust Fund—through September 30, 1984.)

[9] C. Exempt Status of Auxiliaries of Certain Fraternal Beneficiary Socities (sec. 4 of the bill and sec. 501 of the Code)

Present law

Under present law, social clubs and similar nonprofit organizations, such as national organizations of college fraternities and sororities, are exempt organizations. Code section 501(c)(7) provides that these organizations must be organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes with no part of the net earnings inuring to the benefit of any private shareholder.

However, section 501(i) provides that an organization otherwise exempt from income tax as an organization described in section 501(c)(7) is to lose its exempt status for any taxable year, if at any time during that year the organization's charter, by-laws or other governing instrument, or any written policy statement, contains a provision which provides for discrimination against any person on the basis of race, color, or religion.

Exempt status is granted under section 501(c)(8) to fraternal beneficiary societies, orders, or associations which operate under the lodge system or which operate for the exclusive benefit of the members of a fraternity operating under the lodge system, and which provide for the payment of life, sick, accident, or other benefits to the members of the society, order, or association, or their dependents.

Reasons for change

Certain auxiliaries of a fraternal beneficiary society (which is an exempt organization described in section 501(c)(8) and which limits membership to members of a particular religion) are treated by the Internal Revenue Service as exempt social clubs. Certain alumni organizations which limit membership to a particular religion also enjoyed exempt status as social clubs prior to the enactment of section 501(i). The committee believes that these auxiliaries and alumni clubs should not be disqualified from treatment as exempt social clubs by reason of their failure to fulfill the nondiscrimination requirement with respect to religion in section 501(i).

Explanation of provision

This provision allows certain auxiliaries of fraternal beneficiary societies to qualify for tax-exempt status under section 501(c)(7) even though membership in the auxiliaries is limited to members of a particular religion. The bill provides that the restriction on religious discrimination in section 501(i) shall not apply to an auxiliary of a fraternal beneficiary society if the society is described in section 501(c)(8), is exempt from income tax under section 501(a), and limits its membership to the members of a particular religion.

The intended beneficiaries of this provision are the affiliated corporations of the unincorporated, subordinate lodges of the Knights of [10] Columbus, a fraternal society which claims tax-exempt status under section 501(c)(8). Generally, these affiliated corporations were formed to hold title to real property. Prior to the enactment of section 501(i) in 1976, some of the Knights' affiliated corporations have been treated as social clubs described in section 501(c)(7).

In addition, this provision also allows certain alumni clubs to retain their exemption under section 501(c)(7), even though they limit their membership to members of a particular religion. Such clubs will continue to be eligible for exemption provided the religious limitation on membership is designed in good faith, to further the teachings or principles of that religion, and not for the purpose of excluding individuals of a particular race or color. This provision is intended to benefit Catholic Alumni Clubs, but is not intended to authorize discrimination on the basis of race under the guise of religious affiliation. Nor is it intended to benefit primarily recreational entities such as country clubs where the membership limitation does not, in good faith, further a *bona fide* religious teaching.

Effective date

The provision will apply to taxable years beginning after October 20, 1976, the date on which section 501 (i) of the Code became effective.

Revenue effect

It is estimated that this provision will have a negligible effect upon budget receipts.

[11] D. Extension of Withholding to Payments of Sick Pay Made by Third Parties (sec. 5 of the bill and secs. 3402 and 6051 of the Code)

Present law

Under present law (Code sec. 105 (a)), amounts received by an employee through accident or health insurance for personal injuries or sickness (commonly referred to as wage continuation payments or "sick pay") generally must be included in gross income to the extent such amounts are attributable to contributions by the employer which were not includible in the gross income of the employee, or are paid by the employer.

Under section 342(a) of the Code, every employer who makes wage payments is required to deduct and withhold income taxes from these payments. Payments made by an employer to an employee under a wage continuation plan generally are treated as wages and subject to withholding (except to the extent that an employee receives back contributions he or she previously made to a wage continuation plan). However, no tax is specifically required to be withheld upon any wage continuation payment made by a person who is not the employer for whom the employee performs services. Thus, for example, no tax is specifically required to be withheld from wage continuation payments made on behalf of the employer by an insurance company under an accident or health policy, by a separate trust under an accident or health plan, or by a State agency from a sickness and disability fund maintained under State law (Treas. Reg. sec. 31.3401(a)-1(b)(8)(ii)(*d*) and Announcement 77-117, 1977-32 IRB 24 Aug. 8, 1977).)

Reasons for change

Because of the absence of withholding upon wage continuation payments made by third-party payors, employees who have received these payments during the year may experience an unexpected tax liability at the end of the year.[1] The committee believes that voluntary withholding upon such wage continuation payments should be provided so this result can be avoided by the current payment of tax. In addition, the committee believes that availability of withholding for these payments will facilitate compliance by taxpayers.

Explanation of provision

In general

The bill amends section 3402(o) of the Code to specifically require withholding from sick pay, if the payee so requests. For purposes of [12] this provision, sick pay would be defined as any amount which is paid to an employee pursuant to a plan to which the employer is a party, and which constitutes remuneration or a payment in lieu of renumeration for any period during which the employee is temporarily absent from work on account of sickness or personal injuries.

Under the bill, the amount of sick pay and annuity payments subject to withholding would be an amount specified by the payee in his or her request for withholding. However, in no case could this amount be less than a minimum amount to be set forth in regulations prescribed by the Secretary. In the case of a payment which is greater, or less, than a full payment, the amount withheld is to bear the same relation to the specified amount as such payment bears to a full payment.[2]

Requests for withholding

An individual who wishes to have his or her annuity or sick pay subject to withholding must make a written request to the person making the payments. This request must contain the individual's social security number and must specify the amount to be withheld from each full payment. In the case of sick pay, a request for withholding would be effective with respect to payments made more than 7 days after the date on which the request is furnished to the payor. In the case of an annuity, a request would be effective at such time (after the request is made) as the Secretary prescribes by regulations. A request for withholding may be changed or terminated by furnishing to the payor a written statement of change or termination.

Special rule for sick pay paid pursuant to collective-bargaining agreements

Under the bill, in the case of any sick pay paid pursuant to a collective-bargaining agreement between employee representatives and one or more employers, the amount of sick pay subject to withholding would be determined in accordance with such agreement if the agreement so provided. (That is, an employee who is a party to such an agreement would not be required to submit a written request for withholding to the payor.) However, there could be no withholding with respect to sick pay paid to an employee (who is party to a collective-bargaining agreement) who has in effect a withholding exemption certificate certifying that he incurred no tax liability for the preceding taxable year and anticipates that he will incur no tax liability for the current taxable year.

[1] Section 3402(o) of the Code authorizes withholding on certain pension and annuity payment if the payee so requests. However, this provision has no application to wage continuation payments made by third-party payors.

[2] For example, assume an individual receives sick pay of $100 per week and requests $25 per week to be withheld for taxes. After four full weeks of absence, the individual returns to work on a Wednesday. For the week he returns to work, he would be entitled to $40 of sick pay, $10 of which would be withheld for taxes.

The special treatment accorded to collective-bargaining agreements would not apply to sick pay paid pursuant to such an agreement to any individual unless the individual's social security number is furnished to the payor and the payor is furnished with the information necessary to determine whether the payment is pursuant to the agreement and to determine the amount to be withheld.

[13] *Reporting requirement*

The bill would require a person who makes a payment of third-party sick pay to an employee to furnish a written statement to the employer on behalf of whom the payment was made showing the name of the employee, the social security number of the employee (if there was withholding), the total amount of third-party sick pay paid to the employee during the calendar year, and the total amount (if any) withheld from sick pay. This statement would be due on or before January 15 of the year succeeding the year in which the payment of third-party sick pay was made. The bill defines "third-party sick pay" as any sick pay which does not constitute wages for purposes of withholding. This reporting requirement would be in lieu of the reporting requirements of section 6041(a) relating to certain payments of $600 or more. In addition, the bill would provide that a person required to furnish a statement to an employer who willfully furnishes a false or fraudulent statement, or who willfully fails to furnish a statement in the manner, at the time, and showing the information required, would, for each such failure, be subject to a penalty of $50, and, upon conviction of each such offense, could be fined not more than $1,000, or imprisoned not more than one year, or both.

Every employer who receives a statement from a person who made a third-party payment of sick pay to an employee would be required to furnish the information to the employee on another statement which shows which portion (if any) of the sick pay is excludable from gross income and which portion is not excludable. This statement must be furnished to the employee on or before January 31 of the year succeeding the year in which the payment of third-party sick pay was made.

Effective date

This provision of the bill will apply to payments made on or after the first day of the first calendar month beginning more than 120 days after the date of enactment.

Revenue effect

It is estimated that this provision will cause a one-time increase in budget receipts of less than $5 million in fiscal year 1981.

[14] E. Annual Payment of Gift Tax (sec. 6 of the bill and sec. 6019 of the Code)

Present law

Prior to 1971, gift tax returns were required to be filed, and any gift tax liability paid, on an annual basis.[1] For gifts between 1971 and 1976, gift tax returns were required to be filed, and any gift tax liability paid, on a calendar quarter basis. For gifts made after December 31, 1976, a gift tax return is required to be filed, and any gift tax paid, on a quarterly basis if the sum of (1) the taxable gifts made during the calendar quarter plus (2) all other taxable gifts made during the calendar year (and for which a return has not yet been required to be filed) exceeds $25,000.[2] If a gift tax return is required to be filed on a quarterly basis, the gift tax return is due, and any gift tax payable, on or before the 15th day of the second month following the close of the calendar quarter.

If all transfers made in a calendar year that are subject to the gift tax filing requirements do not exceed $25,000 in taxable gifts, a return must be filed, and any gift tax paid, by the filing date for gifts made during the fourth calendar quarter of the calendar year. In 1979 (P.L. 96-167 [1980-1 C.B. 483]), the due date for an annual return or a return for the fourth calendar quarter was conformed to the due date for filing individual income tax returns, i.e., April 15 of the following year.

Reasons for change

The committee believes that gift tax returns should be filed on an annual basis to reduce compliance problems for and confusion among affected taxpayers and administrative burdens for the Internal Revenue Service.

Explanation of provision

The bill provides that gift tax returns are to be filed, and any gift tax paid on an annual basis. In general, the due date for filing the annual gift tax return will be the 15th day of the fourth month following the close of the calendar year. However, for a calendar year in which the donor dies, the gift tax return for that year is required to be [15] filed no later than the due date for filing the donor's estate tax return (including extensions).

These changes will be effective with respect to gifts made after December 31, 1981.

Effective date

The provision applies with respect to gifts made after December 31, 1981.

Revenue effect

It is estimated that the provision will reduce budget receipts by $85 million in fiscal year 1982 and by less than $5 million each fiscal year thereafter.

[1] Prior to the enactment of the Excise, Estate and Gift Tax Adjustment Act of 1970 (Public Law 91-614 [1971-1 C.B. 533]), the due date for filing a gift tax return was April 15 following the calendar year in which a gift was made. In general, the 1970 Act enacted a requirement for the quarterly filing of gift returns (by the 15th day of the second month following the close of the calendar quarter) to provide for the more current payment of gift tax liabilities.

[2] In the case of nonresidents who are not citizens of the United States, the same rule applies except that $12,500 is substituted for $25,000.

[16] F. Tax Treatment Under the Rhode Island Indian Claims Settlement Act (sec. 7 of the bill)

Present law

In 1975, the Narragansett Indian Tribe brought suit against the State of Rhode Island and private landowners based on the Tribe's claims to certain land in Charlestown, Rhode Island. The Tribe argued that these lands had been alienated by it in 1880 in violation of the Trade and Intercourse Act of 1790. The Interior Department has held that the Tribe's claim is "credible." Prior to trial, the parties to the suit entered into a settlement agreement which required both State and Federal legislation for its implementation. Pursuant to the settlement and the implementing legislation, the Tribe's land claims have been extinguished. A public corporation (which is not a part of the State government) has been created under Rhode Island law with 5 directors to be appointed by the Tribe and 4 by State and local officials (the "Corporation"). The Corporation is to receive 1,060 acres of land now belonging to the State. Also pursuant to the settlement legislation, a fund of $3.5 million has been established in the U.S. Treasury for the purpose of purchasing 900 acres of privately held land in Charlestown at fair market value from its owners. Recently, 510 acres were acquired for $2.1 million. The land when acquired by the Secretary of the Interior with the proceeds of the fund is to be conveyed to the Corporation.

All land owned by the Corporation is to be held in trust for the benefit of the Tribe. All of the land contributed by the State, and at least 75 percent of the land acquired from private owners, is to be permanently dedicated to conservation purposes. It is anticipated that the Tribe may use the remaining land in other ways which reflect its heritage, or to provide housing for poor or aged members of the Tribe.

The settlement agreements further provided "That the parties to the Lawsuits will support efforts to obtain deferral of both State and Federal income taxes resulting from the conveyance of privately held portions of the Settlement Lands."

The Federal Government's participation in the settlement is under the authority of the Rhode Island Indian Claims Settlement Act, passed in 1978. That law provided for the extinguishment of aboriginal Indian title, creation of the fund for the purchase of the privately held land, and transfer of that land to the Corporation to be formed under the settlement agreement. It did not deal with any of the tax consequences of the settlement.[1]

[17] It is unclear whether, as the facts and circumstances develop, the Corporation could qualify for general exemption from Federal income tax (Code sec. 501). Also, the Corporation's receipt of land in settlement of the Tribe's damage claim might not be subject to income taxation.

Recognition of gain on the sale of property which is involuntarily converted (e.g., sold under the threat or imminence of condemnation) may generally be deferred if the taxpayer, for the purpose of replacing the property, purchases property similar or related in service or use to the converted property. Recognition of gain is limited to the amount by which the amount realized from the conversion exceeds the cost of the replacement property. (Code sec. 1033.) Generally, the replacement must occur within 2 years after the first year in which gain is realized. However, in the case of certain real property held for productive use in a trade or business or for investment, up to 3 years productive use in a trade or business or for investment, up to 3 years for replacement may be permitted.

Reasons for change

The committee believes that it is desirable to clarify the tax treatment with respect to land received by the Corporation. In addition, the committee believes that under the particular facts, and in the context of the overall settlement, treatment of the sales of the privately held property as an involuntary conversion would be appropriate. However, each disposition of Indian claims under the various lawsuits which have been brought will involve its own unique elements. Accordingly, the committee does not intend that this provision may be looked upon to any extent as a precedent for the apporpriate tax treatment of other dispositions of Indian claims.

Explanation of provision

The provision generally provides that the settlement land received by the Corporation shall not be subject to any form of Federal, State, or local taxation while held by the Corporation. Thus, for example, the Corporation would not realize income on receipt of the land and the land would be exempt from local property taxes. (An exemption from local property taxes is also provided in the Rhode Island legislation creating the Corporation.) However, the general exemption rule would not apply to any income-producing activities occurring on the settlement lands, and nothing in the bill would prevent the making of payments in lieu of taxes by the Corporation for services provided in connection with the settlement lands. The provision would not affect the question of whether the Corporation otherwise qualifies for exemption from Federal taxation.

The provision also provides that, for Federal income tax purposes, any sale

[1] As introduced, H.R. 12860, 95th Congress, contained tax provisions identical to this provision. It is understood that these tax provisions were eliminated from H.R. 12860 to expedite passage in the brief time which remained in the 95th Congress after consideration of the legislation in 1978.

While the Federal Government was not directly involved in drafting the settlement agreement itself, the Administration (through the White House, the Office of Management and Budget, and the Interior Department), the staffs of the House Interior and Insular Affairs Committee, the Senate Indian Affairs Committee, and the staffs of the Rhode Island Congressional delegation took part, along with the parties to the settlement agreement, in drafting the 1978 Settlement Act. Thus, these participants supported, with certain exceptions, the entire agreement of the parties, including the tax provisions.

or disposition of private settlement lands pursuant to the terms and conditions of the settlement agreement is to be treated as an involuntary conversion. This would permit the sellers to defer gain on the sale to the extent allowed by section 1033.

Effective date

The provision will be effective as of September 30, 1978, the date of the enactment of the Rhode Island Indian Claims Settlement Act.

Revenue effect

It is estimated that this provision will decrease budget receipts by less than $500,000 for the period 1980 through 1983.

* * * * *

House of Representatives Report No. 96-545

1st Session

[Bracketed numerals indicate official report page numbers]

TAX ADMINISTRATIVE PROVISIONS REVISION ACT OF 1979

OCTOBER 23, 1979.

Mr. ULLMAN, from the Committee on Ways and Means, submitted the following report to accompany H.R. 5505.[1]

The Committee on Ways and Means, to whom was referred the bill (H.R. 5505) to simplify certain provisions of the Internal Revenue Code of 1954, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment (stated in terms of the page and line numbers of the introduced bill) is as follows:

Page 18, after line 24, insert the following:

[1] Public Law 96-601, page 666.

SEC. 12. EXTENSION OF CERTAIN TEMPORARY TAX PROVISIONS

(a) GOVERNMENT HEALTH PROVISION SCHOLARSHIP PROGRAMS.—Subsection (c) of section 4 of Public Law 93-483 [1974-2 C.B. 447], as amended, is amended—

(1) by striking out "1980" and inserting in lieu thereof "1981", and

(2) by striking out "1984" and inserting in lieu thereof "1985".

(b) NATIONAL RESEARCH SERVICE AWARDS.—Paragraph (2) of section 161(b) of the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1, 44] (relating to national research service awards) is amended by striking out "1979" and inserting in lieu thereof "1980".

(c) DEDUCTION FOR ELIMINATING ARCHITECTURAL AND TRANSPORTATION BARRIERS TO THE HANDICAPPED.—Subsection (c) of section 2122 of the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1, 390] (relating to effective date for allowance of deduction for eliminating architectural and transportation barriers to the handicapped) is amended by striking out "January 1, 1980" and inserting in lieu thereof "January 1, 1981".

[2] (d) CONTROVERSIES INVOLVING WHETHER INDIVIDUALS ARE EMPLOYEES FOR PURPOSES OF THE EMPLOYMENT TAXES.—

(1) IN GENERAL.—Subsection (a) of section 530 of the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1, 119] (relating to termination of certain employment tax liability for periods before 1980) is amended—

(A) by striking out "January 1, 1980" in paragraphs (1)(A) and (3) and inserting in lieu thereof "January 1, 1981",

(B) by striking out "1980" in the subsection heading and inserting in lieu thereof "1981", and

(C) by striking out "1979" in the heading for paragraph (3) and inserting in lieu thereof "1979 and 1980".

(2) PROHIBITION AGAINST REGULATIONS AND RULINGS ON EMPLOYMENT STATUS.—Subsection (b) of section 530 of the Revenue Act of 1978 [*supra* at 119] is amended by striking out "January 1, 1980" and inserting in lieu thereof "January 1, 1981".

(e) ADDITIONAL 2-YEAR DELAY IN APPLICATION OF THE NET OPERATING LOSS RULES ADDED BY THE TAX REFORM ACT OF 1976.—Paragraphs (2) and (3) of section 806(g) of the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1, 81] (relating to effective dates for the amendments to sections 382 and 383 of the Internal Revenue Code of 1954) are amended by striking out "1980" each place it appears and inserting in lieu thereof "1982".

[3] I. SUMMARY

In general, H.R. 5505 contains changes in the Federal tax laws to simplify certain provisions, to extend other provisions which are about to expire, and to revise certain other provisions. The following is a section-by-section summary of the bill as reported by the committee.[1]

SEC. 2. PAYMENT OF INTEREST ON WRONGFUL LEVIES

This section provides for the payment of interest when the Internal Revenue Service administratively determines that a wrongful levy of property has been made and money is returned to the owner of the property.

SEC. 3. REPEAL OF REQUIREMENT THAT TRANSFERORS OF CERTAIN PROPERTY TO EXEMPT ORGANIZATIONS MUST FILE RETURNS

This section repeals the requirement that a person, who transfers income-producing property valued at more than $50,000 to an exempt organization, must file an information return if the organization is known to be subject to tax on unrelated business income.

[1] Sections 2-11 of the bill are as reported by the Subcommittee on Select Revenue Measures; the provisions of section 12 were contained in H.R. 5530 and were added as an amendment by the full committee.

SEC. 4. REPEAL OF ADDITION TO TAX IN THE CASE OF CERTAIN JEOPARDY ASSESSMENTS

This section repeals the 25-percent penalty imposed when a taxpayer violates or attempts to violate the special termination of taxable year jeopardy assessment provisions under present law.

SEC. 5. REPEAL OF REQUIREMENT THAT INFORMATION BE FURNISHED TO THE IRS IN CONNECTION WITH CERTAIN STOCK OPTIONS

This section repeals the requirement that information relating to certain qualified and restricted stock options be furnished to the Internal Revenue Service.

SEC. 6. TIME FOR FILING CERTAIN GIFT TAX RETURNS

This section provides that the due date for filing a gift tax return for the fourth calendar quarter of the calendar year is April 15 of the following year. Thus, the gift tax return due date would be consistent with the income tax due date for calendar year taxpayers. This section also provides that an extension for filing an income tax return will automatically extend the time for filing the fourth quarter or annual gift tax return.

SEC. 7. CHANGE OF TIME FOR PAYING EXCISE TAX ON FISHING EQUIPMENT

Present law imposes a 10-percent excise tax upon the sale of fishing rods, creels, reels, and artificial lures, baits, and flies by the manufac-[4]turer, producer or importer thereof. This tax generally is payable relatively soon after such fishing equipment is sold.

This section provides 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 will be due by the date specified by Treasury regulations.

* * * * *

SEC. 9. REFUNDS OF TREAD RUBBER EXCISE TAX

Under present law, a 5-cents-per-pound manufacturers excise tax is imposed on tread rubber used for recapping or retreading tires of the type used on highway vehicles. No credit or refund of the tread rubber tax is available if the tax-paid tread rubber is wasted in the recapping process, contained in a recapped tire the price of which is adjusted under a warranty, or sold in conjunction with certain otherwise tax-exempt sales. In some situations, the tread rubber tax can be avoided by exporting a tire to be recapped outside the United States and then importing the retreaded tire.

This section provides for a refund or credit of the manufacturers excise tax on tread rubber where the rubber is (1) wasted in the recapping process, (2) contained in a recapped tire the price of which is adjusted under a warranty, or (3) sold in conjunction with certain otherwise tax-exempt sales.

The provision also imposes the tread rubber excise tax on the tread rubber in tires which are exported for recapping and subsequently imported into the United States.

SEC. 10. NONRECOGNITION OF GAIN ON SALE OF RESIDENCE FOR CERTAIN MEMBERS OF THE ARMED FORCES

Under present law, a member of the Armed Forces serving on extended active duty generally is not required to recognize gain on the sale of a principal residence if he or she purchases and uses a new principal residence within four years after the date of the sale of the old residence.

This section extends the replacement period for members of the Armed Forces who are stationed outside of the United States or who are required to reside in Government-owned quarters to the later of: (1) four years after the date of the sale of the old residence, or (2) one year after the date on which the member no longer is stationed outside of the United States or required to reside in Government-owned quarters.

[5] SEC. 11. EXEMPT STATUS OF AUXILIARIES OF CERTAIN FRATERNAL BENEFICIARY SOCIETIES

In order to qualify for tax-exempt status under Code section 501(c)(7) after October 20, 1976, a social club cannot have any provision providing for discrimination against any person on the basis of race, color, or religion in the club's charter, bylaws, other governing instrument, or any written policy statement.

This section allows social clubs which are affiliated with fraternal beneficiary societies exempt under Code section 501(c)(8), such as those operated by the Knights of Columbus, to retain their exemption even though membership in the clubs is limited to members of a particular religion.

SEC. 12(a). UNIFORMED SERVICES HEALTH PROFESSIONS SCHOLARSHIPS

The section extends for one year the exclusion from gross income for amounts received by participants in the Uniformed Services Health Professions Scholarship program. As extended, the exclusion will be available to students entering the program in 1980 and to amounts received by them through 1984.

SEC. 12(b). NATIONAL RESEARCH SERVICE AWARDS

This section extends the scholarship exclusion for National Research Service Awards for one year to apply to 12(c) awards first made in 1980.

SEC. 12(c). EXPENDITURES TO REMOVE ARCHITECTURAL AND TRANSPORTATION BARRIERS TO THE HANDICAPPED AND ELDERLY

This section extends for 3 years, through December 31, 1982, the election to deduct annually up to $25,000 in capital costs incurred during the taxable year for the removal of architectural and transportation barriers to the handicapped and elderly.

SEC. 12(d). INTERIM RELIEF FOR INDEPENDENT CONTRACTOR STATUS CONTROVERSIES

This section extends for one year, through December 31, 1980, the in-

terim relief provided by the Revenue Act of 1978 with respect to independent contractor status controversies.

SEC. 12(e). POSTPONEMENT OF EFFECTIVE DATE FOR SPECIAL LIMITATIONS ON NET OPERATING LOSS CARRYOVERS

This section defers for 2 years the effective date for provisions under the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1] relating to special limitations on net operating loss carryovers. These provisions would be deferred until January 1, 1982, with respect to tax-free organizations and until June 30, 1982, with respect to taxable acquisitions.

[6] II. EXPLANATION OF THE BILL

A. Payment of Interest on Wrongful Levies (sec. 2 of the bill and sec. 6343(b) of the Code)

Present law

Under present law, two remedies are provided for third-party owners whose property is wrongfully seized by the Internal Revenue Service for the collection of a delinquent taxpayer's liability. In general, one remedy provides an administrative procedure for the return of the property wrongfully seized (sec. 6343(b)), and the other authorizes a civil action for an injunction, the return of the property wrongfully seized, or the proceeds from the sale of the property (sec. 7426).

Under the administrative procedure, the Internal Revenue Service is authorized to return property (or the proceeds from the sale of the property) to a person when it determines that the levy was wrongful (sec. 6343(b)). Where the Service returns the property or proceeds under the administrative procedure, a person whose property was wrongfully seized is not entitled to the payment of interest for the period the Government held the property or the proceeds therefrom.

On the other hand, the payment of interest is provided if the third party prevails under the judicial remedy (sec. 7426(g)).[1]

Under this provision, interest accrues from the date the Service receives money wrongfully levied upon (or the date of the sale of property wrongfully levied upon) until the date the judgment is paid. The interest is payable at the rate generally established to be paid on the overpayment of taxes (sec. 6621).[2]

Reasons for change

The committee believes that interest should be payable where it is administratively determined by the Internal Revenue Service that a wrongful levy of property has been made and money is returned to the owner of the property by the Service.

Explanation of provision

The bill provides for the payment of interest to a person under the administrative procedure for wrongful levies. Under rules similar to those in the interest provisions for the judicial remedy, interest is [7] to be paid if money is wrongfully seized or if the proceeds from a sale of the property are returned to the owner of the property. The rate of interest is to be determined under the general provision for the payment of interest on overpayments of tax. In the case of a seizure of money, the period for the payment of interest begins with the date the money is seized and ends on a date (to be determined by the Secretary) not more than 30 days prior to the date when the money is returned. In the case of a payment of the proceeds from the sale of property wrongfully seized, the period for the payment of interest begins with the date of sale of the property and ends on a date (to be determined by the Secretary) not more than 30 days prior to the date when the payment to the owner is made.[3]

Effective date

This provision applies to levies made after the date of enactment of the bill.

Revenue effect

This provision will reduce budget receipts by a negligible amount.

[8] B. Repeal of Requirement that Transferors of Certain Property to Exempt Organizations Must File Returns (sec. 3 of the bill and sec. 6050 of the Code)

Present law

Under present law, a person who transfers income-producing property valued at over $50,000 (without regard to any lien thereon) to an exempt organization must file a return (Form 4629) if the transferor knows the recipient is the type of organization subject to tax on its unrelated business income (sec. 6050). The regulations require that the return show a description of property transferred, the date of transfer, the fair market value of the property (without regard to any lien thereon) on that date, and the amount of any mortgage or similar lien on the property immediately after the transfer. This return requirement was added by the Tax Reform Act of 1969 [Pub. L. 91-172, 1969-3 C.B. 10].

Under persent law, the Internal Revenue Service can require an exempt organization to maintain records and furnish information with respect to transfers of income-producing property to it (secs. 6001 and 6033). Thus, the information now required to be furnished by the transferor may also be furnished by the transferee exempt organization.

Reasons for change

The committee believes that the re-

[1] The general provision for payment of interest on a judgment for the overpayment of taxes is sec. 2411 of title 28 of the United States Code. The rate of interest under this provision is determined by reference to section 6621 of the Internal Revenue Code of 1954.

[2] Currently, the rate of interest is 6 percent; however, under the present law provision, the IRS has determined that the rate will be 12 percent, effective on February 1, 1980 (Rev. Rul. 79-366, issued on October 12, 1979).

[3] The rule relating to the date on which interest is no longer payable is similar to the rule on interest on overpayment of tax (sec. 6611(b)(2)).

porting requirement for transferors of property to exempt organizations is unnecessary and should be repealed.

Explanation of provision

The bill repeals the requirement that transferors file an information return with respect to transfers to an exempt organization.

Effective date

The provision applies to transfers of property made after the date of enactment of the bill.

Revenue effect

This provision will have no direct effect on budget receipts.

[9] C. Repeal of Addition to Tax in the Case of Certain Jeopardy Assessments (sec. 4 of the bill and sec. 6658 of the Code)

Present law

Under present law, if the Internal Revenue Service determines that the collection of tax is in jeopardy, an assessment and collection of that tax may be made without resorting to the normal time-consuming assessment and collection procedures. For this purpose, there are two basic types of special assessments—termination assessments (sec. 6851) and jeopardy assessments (secs. 6861 and 6862). The termination assessment is limited to the assessment of income tax when the collection of income tax is in jeopardy before the end of the taxpayer's normal tax year or before the due date of the return. In other income tax cases and in all cases involving other taxes, the jeopardy assessment procedures are used.

The Code (sec. 6658) provides an addition to tax equal to 25 percent of the amount of tax when a taxpayer violates or attempts to violate the termination assessment provision. No similar penalty applies to jeopardy assessments.

Reasons for change

The committee believes that the addition to tax for a violation, or attempted violation, of the termination assessment provision is unnecessary and should be repealed.

Explanation of provision

The bill repeals the 25-percent addition to tax penalty with respect to termination assessments.

Effective date

This provision applies to violations (or attempted violations) occurring after the date of enactment of this bill.

Revenue effect

This provision will reduce budget receipts by a negligible amount.

[10] D. Repeal of Requirement that Information be Furnished to the Internal Revenue Service in Connection with Certain Stock Options (sec. 5 of the bill and sec. 6039 of the Code)

Present law

Under present law, an annual information return (Form 3921) is required to be filed with the Internal Revenue Service by a corporation which transfers a share of stock to any person pursuant to his exercise of a qualified stock option (described in sec. 422) or restricted stock option (sec. 424).[1] In addition, a return (Form 3922) is required to be filed by every corporation that records (or has its agent record) a transfer of stock which was acquired either through the exercise of an option granted under an employee stock purchase plan (sec. 423) at an exercise price between 85 percent and 100 percent of the stock's value as of the time of the grant of the option, or through the exercise of a restricted stock option (sec. 424) at an exercise price between 85 percent and 95 percent of the value of the stock as of the time of the grant of the option. (Under each of these sections, a portion of the sales price for the stock is treated as ordinary income.)

A written statement concerning information relating to these transfers must also be furnished to the person listed on the return prior to January 31 of the year following the calendar year covered by the return.

Reasons for change

The committee believes that the requirement that the information relating to certain stock options be furnished to the Service is unnecessary and should be repealed.

Explanation of provision

The bill repeals the requirement that information relating to certain qualified and restricted stock options be furnished to the Internal Revenue Service.

Effective date

This provision applies with respect to calendar years beginning after 1979.

Revenue effect

This provision will have no direct effect on budget receipts.

[11] E. Time for Filing Certain Gift Tax Returns (sec. 6 of the bill and sec. 6075(b) of the Code)

Present law

Under present law, a gift tax return, if required, is due on or before the 15th day of the second month following the close of the calendar quarter. Quarterly returns are required when taxable gifts made during a calendar year exceed $25,000. Where all transfers made in a calendar year which are subject to the gift tax filing requirements do not exceed $25,000 in taxable gifts, a return need be filed only by the filing date for gifts made during the fourth calendar quarter of the calendar year (i.e., February 15 of the following year).

On the other hand, an individual's income tax return is due on or before

[1] Under a provision added by section 603 of the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. I) 1, 50], options exercised after May 20, 1981, will no longer be treated as qualified or restricted stock options.

the 15th day of the fourth month following the close of the taxable year. For the calendar year taxpayer, a return is due on or before April 15. In addition, the Internal Revenue Service may grant an extension of time for filing a return. Presently, the Service grants an automatic 2-month extension for individuals upon timely application and payment of the estimated tax due.

Reasons for change

Because the filing date for the gift tax return is earlier than the due date of an individual's income tax return, a timely gift tax return cannot be filed for a taxable gift if the obligation to file a gift tax return is discovered during a review of the taxpayer's financial transactions in connection with the preparation of his income tax return. The committee believes that conformity of filing dates should be made in order to allow a taxpayer's advisors to review the taxpayer's annual transactions at one time to prepare both the gift and income tax returns.

Explanation of provision

The bill provides that the due date for the fourth calendar quarter or annual gift tax return is April 15. In addition, the bill provides that an extension for filing the income tax return of a calendar year taxpayer will automatically extend the time for filing the fourth quarter or annual gift tax return.

Effective date

The provision applies to gift tax returns for calendar years ending after the date of enactment of this bill.

Revenue effect

This provision will reduce budget receipts by a negligible amount.

[12] F. Change of Time for Paying Excise Tax on Fishing Equipment (sec. 7 of the bill and sec. 4161 (a) of the Code)

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 of 10 percent of the price for which the article is sold.

Treasury Department regulations prescribing the time for making deposits of manufacturers excise taxes are found 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 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 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 payment of the excise tax with respect to sales of taxable articles on credit except certain installment sales.

Reasons for change

Retail sale of sport fishing equipment is seasonable 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 sale proceeds not being collected for several months.

The committee is informed that this payment problem is unique to the fishing equipment industry, and has concluded that some extension of time for payment is appropriate in these circumstances to the extent it can be provided without incurring any fiscal year revenue loss.

[13] *Explanation of provision*

The bill provides that the manufacturers excise tax imposed on the sale of fishing equipment is payable according to the following schedule:

For articles sold during the quarter ending:	*Payment of the tax is due by:*
December 21	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 (until 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 such quarter, the bill does not require any change from the payment schedule presently in effect under Treasury regulations (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.

The committee intends that the postponement for the time for payment of the excise tax on fishing equipment shall not constitute a precedent for providing similar rules with respect to other excise taxes. The committee considers the payment problem of the fishing equipment industry to be unique.

Effective date

The provision applies to excise taxes payable on fishing equipment sold on or after the first day of the first calendar quarter beginning after the date of enactment of the bill.

Revenue effect

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

* * * * * *

[16] H. Refunds of Tread Rubber Excise Tax (sec. 9 of the bill and secs. 4071, 6416, and 6511 of the Code)

Present law

Present law imposes a tax of 5 cents per pound on tread rubber used for recapping or retreading tires of the type used on highway vehicles (secs. 4071(a)(4), 4072(b), and 4073(c).[1]

Tread rubber may be sold tax-free for use otherwise than in the recapping or retreading of tires of the type used on highway vehicles, or a credit or refund (without interest) of the tread rubber tax may be obtained if the tax-paid tread rubber is used or sold for use otherwise than in the recapping or retreading of tires of the type used on highway vehicles (sec. 6416(b)(2)(G)).

[1] The tax on tread rubber is scheduled to expire on October 1, 1984 (sec. 4071(d)(3)). (Revenues from this tax go into the Highway Trust Fund.)

There are several instances under present law where a manufacturers excise tax is imposed on tread rubber when in a similar situation the manufacturers excise tax is not imposed (or a credit or refund of the tax is allowed) on new tires.

First, rubber wasted in manufacturing new tires is not subject to tax since the tax is impsed when the completed tire is sold and only upon the material actually contained in the completed tire. The tax on tread rubber, on the other hand, is imposed before the recapping or retreading of a used tire. Wastage of tread rubber in that process occurs after the tread rubber tax liability has been determined, and under present law no refund or credit is provided for any portion of the tax imposed on tread rubber which is so wasted.[2]

Second, if the sale price of a retreaded tire is adjusted by reason of a warranty or guarantee, no credit or refund of the tread rubber tax is provided.[3]

Third, no credit or refund is available for the tread rubber tax when a recapped or retreaded tire is exported, sold to a State or local government, sold to a nonprofit educational organization, or used or sold for use as supplies for vessels or aircraft (secs. 4221 and 6146(b)). [17] Neither is the credit or refund available where a retreaded tire is mounted on a new vehicle that then is disposed of in any of the above ways.

[2] In *Great Olympic Tire Co.* v. *U.S.*, 597 F.2d 449, 78-1 USTC ¶ 16,316 (5th Cir. 1979), the Fifth Circuit Court of Appeals held that tread rubber wasted in the recapping process is not subject to the section 4071(a)(4) manufacturers excise tax, and that highway-type tires returned under warranty after partial use are subject to the tax without allowance for a refund or credit of the tax previously imposed on the tread rubber remaining on the returned tire. In arriving at these conclusions, the court relied upon the fact that wasted rubber never became part of tires of the type used on highway vehicles and that rubber remaining in a returned tire had become part of a tire of the type used on highway vehicles. While the section 4071(a)(4) tread rubber tax does not refer to highway-type vehicle tires, as does the section 4071(a)(1) new tire tax the court noted that the legislative history of the tread rubber tax clearly evidences an intention to limit the tax to such tires. *See* H. Rept. No. 10660, 84th Cong., 2d Sess., 1956-2 C.B. 1312; Rev. Rul. 65-223, 1965-2 C.B. 420.

[3] *See* note 2, *supra*.

While used and recapped or retreaded tires ordinarily are subject to the tire tax when imported, a different situation exists when a used tire which has been taxed in the United States is exported, is retreaded (other than from bead to bead) abroad, and then is shipped back into the United States.[4] Then there is neither a tax on the imported retreaded tire nor on the tread rubber used in the retreading, because the tire already has been taxed and the tread rubber is considered to have lost its identity.

Under present law, the general time by which a claim for credit or refund of a tax must be filed is 3 years from the time the tax return was filed or, if later, 2 years from the time the tax was paid (sec. 6511).

Reasons for change

The committee believes that it is appropriate to make the application of the tread rubber tax more nearly equivalent to the application of the new tire tax. Also, the committee concluded that the tax law should not create a competitive advantage for tires which are exported for retreading and then imported for sale in the United States.

Explanation of provision

Credit or refund of tread rubber tax

This provision of the bill makes a credit or refund of the tread rubber tax available in three situations. These changes are intended to permit a credit or refund of the tax on the tread rubber used on a recapped or retreaded tire, under the same circumstances where a credit or refund would be available for the tax on a new tire.

First, the credit or refund would be

[4] Tires recapped from bead to bead are considered as having been newly manufactured and thus are taxable.

available where rubber is destroyed, scrapped, wasted, or rendered useless in the recapping or retreading process.

Second, the credit or refund would be available where the tread rubber is used in the recapping or retreading of a tire if the sales price of the tire is later adjusted because of a warranty or guaranty. The overpayment (that is, the amount available for credit or refund) would be the same proportion of the tax paid as the adjustment in the sales price of the retreaded tire to the immediate vendee by the tire retreader.

Third, a credit or refund of the tread rubber tax would be available to the manufacturer for the tread rubber on a recapped or retreaded tire if the tire is by any person (1) exported, (2) sold to a State or local government for its exclusive use, (3) sold to a nonprofit educational organization for its exclusive use, or (4) used or sold for use as supplies for a vessel or aircraft.

Finally, where a retreaded tire is sold by the retreader or by another manufacturer on or in conjunction with another article (for example, a truck) manufactured by it, the bill would provide that a credit or refund of the tread rubber tax is to be allowed to the manufacturer of [18] the other article if the article is exported or sold by any person for any of the above purposes.

Tax on imported recapped or retreaded tires

The provision also would provide that used tires which are exported from the United States, recapped or retreaded abroad (other than from bead to bead), and then imported into the United States are to be subject to the tax on tread rubber. For this purpose, the amount of tread rubber to be taken into account is to be determined as of the completion of the recapping or retreading of the tire. The amount so determined would be either the amount which is established as actually used in recapping or retreading the tire or an average amount which is generally used on comparable tires in the industry, as determined by the Treasury Department (sec. 4701(c)).

If a retreaded tire is imported on a vehicle which is not itself subject to a manufacturers excise tax (e.g., a passenger car or a light-duty truck), then the importer of the vehicle is under existing law (Code sec. 4071(e)) treated as the importer of the tire. However, as noted, if the tire is not taxable because it was exported and recapped abroad (except from bead to bead), the importer is not liable for tax on the tread rubber on the imported tire. This provision carries the process a step further and would treat the importer of the vehicle as the importer of the tread rubber that is on a retreaded tire which is not otherwise subject to tax on the complete tire.

Warranty or guaranty adjustments

The provision also would modify the statute of limitations in cases where a claim for credit or refund of the tread rubber tax is filed as a result of a warranty or guaranty adjustment. The amendment provides that in such a case a claim for credit or refund may be filed at any time before the date which is one year after the date on which the adjustment is made, if the period for filing the claim would otherwise expire before that later date.

In other words, under this provision, the manufacturer would be assured that it will have one day less than a year after the time the adjustment is made (or deemed made) within which to file a claim for credit or refund of the relevant tax.

Effective date

The amendments made by this provision will be effective on the first day of the first calendar month which begins more than 10 days after the date of the provision's enactment.

Revenue effect

This provision will reduce budget receipts by less than $100,000 in fiscal year 1980, and by less than $200,000 annually during each of the next 4 fiscal years. (These amounts would otherwise go into the Highway Trust Fund—through September 30, 1984.)

[19] I. Nonrecognition of Gain on Sale of Residence for Certain Members of the Armed Forces (sec. 10 of the bill and sec. 1034 of the Code)

Present law

Under present law, the entire amount of gain or loss realized on the sale or exchange of property generally is recognized. However, under a "rollover" provision of the Code (sec. 1034), gain is not recognized on the sale or exchange of a taxpayer's principal residence if a new principal residence, at least equal in cost to the adjusted sales price of the old residence, is purchased and used by the taxpayer as his or her principal residence within a period beginning 18 months before and ending 18 months after the date of the sale of the old residence. The basis of the new residence then is reduced by the amount of gain not recognized on the sale of the old residence.

The replacement period is suspended during any time that the taxpayer (or the taxpayer's spouse) serves on extended active duty with the Armed Forces of the United States after the date of the sale of the old residence. Currently, this suspension may not extend more than four years beyond the date of the sale of the old residence. Thus, a member of the Armed Forces generally is not required to recognize gain on the sale of a principal residence if he or she purchases and uses a new principal residence within four years after the date of the sale of the old residence.

Reasons for change

The committee believes that the period for replacement of a residence should be extended for members of the Armed Forces who are stationed overseas or are required to reside in Government-owned quarters.

Explanation of provision

This provision extends the period of time in which a member of the Armed Forces who is stationed outside of the United States or is required to reside in Government-owned quarters must purchase a new principal residence in order to qualify for nonrecognition of gain on the sale of the old principal residence. Under this provision, a member of the Armed Forces who is stationed outside of the United States or is required to reside in Government-owned quarters after the date of the sale of the principal residence generally will not recognize gain on the sale of the residence if the taxpayer purchases and uses a new principal residence within the later of four years after the date of the sale of the old residence or one year after the date on which the taxpayer is no longer stationed outside of the United States or is no longer required to reside in Government-owned quarters.

[20] The benefits of this additional extension period will be available only if the taxpayer has timely filed, with the Internal Revenue Service, a notice of the taxpayer's intent to take advantage of the extension.

The committee intends that the extension of the period for replacement of a residence by a member of the Armed Forces shall not constitute a precedent for providing similar rules for other taxpayers. The committee considers the problem of replacing a principal residence beyond the usual 18-month period by a member of the Armed Forces to be a unique problem.

Effective date

The provision applies to sales of old residences after December 31, 1979 by eligible members of the Armed Forces.

Revenue effect

This section will have no effect on budget receipts through fiscal year 1985. Beginning with fiscal year 1986, it is estimated that this provision will reduce budget receipts by $10 million annually.

[21] J. Exempt Status of Auxiliaries of Certain Fraternal Beneficiary Societies (sec. 11 of the bill and sec. 501 of the Code)

Present law

Under present law, social clubs and similar nonprofit organizations, such as national organizations of college fraternities and sororities, are exempt organizations. Code section 501(c)(7) provides that these organizations must be organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes with no part of the net earnings inuring to the benefit of any private shareholder.

However, section 501(i) provides that an organization otherwise exempt from income tax as an organization described in section 501(c)(7) is to lose its exempt status for any taxable year, if at any time during that year the organization's charter, by-laws or other governing instrument, or any written policy statement, contains a provision which provides for discrimination against any person on the basis of race, color, or religion.

Exempt status is granted under section 501(c)(8) to fraternal beneficiary societies, orders, or associations which operate under the lodge system or for the exclusive benefit of the members of a fraternity operating under the lodge system, and which provide for the payment of life, sick, accident, or other benefits to the members of the society, order, or association, or their dependents.

Reasons for change

Certain auxiliaries of a fraternal beneficiary society (which is an exempt organization described in section 501(c)(8) and which limits membership to members of a particular religion) are treated by the Internal Revenue Service as exempt social clubs. The committee believes that these auxiliaries should not be disqualified from treatment as exempt social clubs by reason of their failure to fulfill the nondiscrimination requirement with respect to religion in section 501(i).

Explanation of provision

This provision allows certain auxiliaries of fraternal beneficiary societies to qualify for tax-exempt status under section 501(c)(7) even though membership in the auxiliaries is limited to members of a particular religion. The bill provides that the restriction on religious discrimination in section 501(i) shall not apply to an auxiliary of a fraternal beneficiary society if the society is described in section 501(c)(8), is exempt from income tax under section 501(a), and limits its membership to the members of a particular religion.

The intended beneficiaries of this provision are the affiliated corporations of the unincorporated, subordinate lodges of the Knights of Columbus, a fraternal society which claims tax-exempt status under section 501(c)(8). Generally, these affiliated corporations were formed to hold title to real property. Prior to the enactment of section 501(i) in 1976, some of the Knights' affiliated corporations have been treated as social clubs described in section 501(c)(7).

[22] *Effective date*

The provision will apply to taxable years beginning after October 20, 1976, the date on which section 501(i) of the Code became effective.

Revenue effect

It is estimated that this provision will result in a negligible reduction in budget receipts.

[23] K. Uniformed Services Health Professions Scholarships and National Research Service Awards (subsections (a) and (b) of sec. 12 of the bill)

Present law

Uniformed Services Health Professions Scholarships

The Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1] extended the exclusion provided under prior law for participants in the Uniformed Services Health Professions

Scholarship programs (including the Armed Forces and Public Health Professions Scholarship programs) so that students entering the programs in 1979 could exclude amounts received under these programs through 1983. This one-year extension generally covered program participants entering medical school in 1979 for their four years of training.

National Research Service Awards

In addition, the 1978 Act provided tax-exempt scholarship treatment for National Research Service Awards made through 1979 for the duration of such awards.

Reasons for change

The committee believes that, pending the completion of a comprehensive review of the tax treatment of scholarships, the excludable treatment of amounts received under the Uniformed Services Health Professions Scholarships programs and as a National Research Service Award should be continued.

Explanation of provision

The provision extends the tax exemption for participants in the Uniformed Services Health Professions Scholarship programs with respect to students entering programs in 1980, and applies to amounts received by them through 1984.

Also, the tax-exempt scholarship treatment for National Research Service Awards is extended to awards initially made during calendar year 1980.

Revenue effect

The one-year extension of tax exemption for Uniformed Services Health Professions Scholarship programs will reduce budget receipts by less than $5 million per year for fiscal years 1980-1984.

The one-year extension of tax exemption for 1980 National Research Service Awards will reduce budget receipts by $6 million in fiscal year 1981, $6 million in fiscal year 1982, and less than $5 million in fiscal year 1983.

[24] L. Deduction for Expenditures to Remove Architectural and Transportation Barriers to the Handicapped and Elderly (sec. 12(c) of the bill and sec. 190 of the Code)

Present law

The Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1] provided taxpayers with an elective tax deduction for the removal of architectural and transportation barriers to the handicapped and elderly (Code sec. 190). A taxpayer may treat certain expenses for the removal of such barriers as deductible expenses in the year paid or incurred instead of capitalizing them. Deductible expenses are those paid or incurred in order to make more accessible to and usable by the handicapped and elderly any facility or public transportation vehicle owned or leased by the taxpayer for use in his trade or business. The maximum deduction for a taxpayer, including a controlled group of corporations filing a consolidated return for any taxable year, is $25,000.

In order to qualify for the deduction, the expenses must be for barrier removal in business facilities which the taxpayer establishes to the satisfaction of the Secretary meets standards set by the Secretary of the Treasury with the concurrence of the Architectural and Transportation Barriers Compliance Board as established by 1968 legislation.

The deduction was limited to a three-year period ending before January 1, 1980, in order that the Congress could review its effectiveness.

Reasons for change

The committee believes that it is appropriate to extend this provision for an additional period of time so that the review of the effectiveness of the provision may be completed.

Explanation of provision

This provision extends the elective deduction for expenditures to remove architectural and transportation barriers to the handicapped and the elderly for three years, to taxable years beginning before January 1, 1983.

Revenue effect

This provision will result in a reduction in budget receipts of $4 million in fiscal 1980, $10 million per year in fiscal years 1981 and 1982, and $6 million in fiscal year 1983.

[25] M. Extension of Interim Relief in Independent Contractor Status Controversies (sec. 12(d) of the bill and sec. 530 of the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1, 119])

Present law

The Revenue Act of 1978 provided interim relief (until January 1, 1980) for certain taxpayers involved in controversies with the Internal Revenue Service over IRS-proposed reclassifications of workers, whom the taxpayers had considered independent contractors, as employees. In general, the Act terminated taxpayers' potential liabilities for Federal income tax withholding, social security and FUTA taxes in cases where taxpayers have a reasonable basis for treating workers other than as employees. In addition, the Act prohibited the issuance of Treasury regulations and Revenue Rulings on common law employment status before January 1, 1980, while the Congress considered legislative proposals for clarifying individuals' employment tax status.

Reasons for change

The committee believes that it is appropriate to extend the interim relief provision to permit the orderly consideration of pending legislation which will provide permanent rules in this area. Although the Subcommittee on Select Revenue Measures has held hearings on this subject and has commenced the markup of a bill (H.R. 5460) providing permanent rules, it may not be possible to complete Congressional action on proposed legislation for permanent rules before 1980

because of the press of other legislative business.

Explanation of provision

This provision extends the relief period, enacted in the Revenue Act of 1978, for one year until 1981, in order to allow the Congress to complete consideration of clarifying legislation.

Revenue effect

The revenue loss of this provision cannot be estimated because it generally affects individuals whose employment tax status under the present common law rules is the subject of dispute.

[26] N. Postponement of Effective Date for Special Limitations on Net Operating Loss Carryovers (sec. 12(e) of the bill and secs. 382 and 383 of the Code)

Present law

Prior to enactment of the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 (Vol. 1) 1], generally, if new owners purchased 50 percent or more of the stock of a loss corporation during a two-year period, the corporation's loss carryovers from prior years were allowed in full only if the corporation continued to conduct its prior trade or business or substantially the same kind of business. Generally, if the same business was not continued, however, loss carryovers were completely lost. This "purchase" rule applied where one or more of the 10 largest shareholders increased their stock ownership, within a two-year period, by 50 percentage points or more in a transaction in which the purchasers took a cost basis in their stock (except where the stock was acquired from "related" persons).

In the case of a tax-free reorganization, loss carryovers were allowed on a declining scale. If the former owners of the loss company received 20 percent or more of the fair market value of the stock of the acquiring company, the loss carryovers were allowed in full. For each percentage point less than 20 which the former owners received, the loss carryover was reduced by five percent. It was immaterial whether the business of the loss company was continued after the reorganization.

The 1976 Act extensively revised the Code provisions dealing with the carryover of net operating losses in cases of acquisitions of loss corporations. The limitations on loss carryover attributes were to apply to acquisitions made by purchase or through corporate reorganizations. The new provisions changed the basic concepts underlying the rules by deleting continuity of business requirements for purchases and establishing a new continuity of ownership test applicable to both purchases and reorganizations.

These new provisions were to apply to plans of reorganization adopted on or after January 1, 1978, and to sales or exchanges in taxable years beginning after June 30, 1978. However, the Revenue Act of 1978 extended these effective dates for two years, to January 1, 1980, and June 30, 1980.

Reasons for change

A number of technical problems concerning the 1976 revisions have been brought to the committee's attention. The committee believes that an additional period of time is necessary to complete a review of the provision.

Explanation of provision

This provision delays the effective date of the 1976 Act change for an additional two years, until January 1, 1982, with respect to plans [27] of reorganization adopted on or after that date, or until June 30, 1982, with respect to sales or exchanges occurring in taxable years beginning after that date.

Revenue effect

The provision will reduce budget receipts by less than $5 million annually during the postponement period.

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Public Law 96-603
96th Congress, H.R. 4155 [1]
December 28, 1980

An Act to amend the Internal Revenue Code of 1954 to simplify private foundation return and reporting requirements, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SIMPLIFICATION OF PRIVATE FOUNDATION RETURN AND REPORTING REQUIREMENTS.

(a) AMENDMENT OF SECTION 6033.—Section 6033 of the Internal Revenue Code of 1954 (relating to returns by exempt organizations) is amended by redesignating subsection (c) as subsection (e) and by inserting after subsection (b) the following new subsections:

"(c) ADDITIONAL PROVISIONS RELATING TO PRIVATE FOUNDATIONS.—In the case of an organization which is a private foundation (within the meaning of section 509(a))—

"(1) the Secretary shall by regulations provide that the private foundation shall include in its annual return under this section such information (not required to be furnished by subsection (b) or the forms or regulations prescribed thereunder) as would have been required to be furnished under section 6056 (relating to annual reports by private foundations) as such section 6056 was in effect on January 1, 1979,

"(2) a copy of the notice required by section 6104(d) (relating to public inspection of private foundations' annual returns), together with proof of publication thereof, shall be filed by the foundation together with the annual return under this section, and

"(3) the foundation managers shall furnish copies of the annual return under this section to such State officials, at such times, and under such conditions, as the Secretary may by regulations prescribe.

[1] Senate Report No. 96-1039, page 691; House Report No. 96-1044 is not published.

Nothing in paragraph (1) shall require the inclusion of the name and address of any recipient (other than a disqualified person within the meaning of section 4946) of 1 or more charitable gifts or grants made by the foundation to such recipient as an indigent or needy person if the aggregate of such gifts or grants made by the foundation to such recipient during the year does not exceed $1,000.

"(d) SECTION TO APPLY TO NONEXEMPT CHARITABLE TRUSTS AND NONEXEMPT PRIVATE FOUNDATIONS.—The following organizations shall comply with the requirements of this section in the same manner as organizations described in section 501(c)(3) which are exempt from tax under section 501(a):

"(1) NONEXEMPT CHARITABLE TRUSTS.—A trust described in section 4947(a)(1) (relating to nonexempt charitable trusts).

"(2) NONEXEMPT PRIVATE FOUNDATIONS.—A private foundation which is not exempt from tax under section 501(a)."

(b) PUBLIC INSPECTION OF PRIVATE FOUNDATIONS' ANNUAL RETURNS.—

(1) IN GENERAL.—The first sentence of subsection (d) of section 6104 of such Code (relating to public inspection of private foundations' annual reports) is amended to read as follows: "The annual return required to be filed under section 6033 (relating to returns by exempt organizations) by any organization which is a private foundation within the meaning of section 509(a) shall be made available by the foundation managers for inspection at the principal office of the foundation during regular business hours by any citizen on request made within 180 days after the date of the publication of notice of its availability."

(2) CONFORMING AMENDMENTS.—Such subsection (d) is amended—

(A) by striking out "ANNUAL REPORTS" in the heading and inserting in lieu thereof "ANNUAL RETURNS"; and

(B) by striking out "annual report" each place it appears in the second and third sentences and inserting in lieu thereof "annual return".

(c) REPEAL OF PRIVATE FOUNDATION ANNUAL REPORTING REQUIREMENTS.—Subpart D of part III of subchapter A of chapter 61 of such Code (relating to information concerning private foundations) is hereby repealed.

(d) TECHNICAL AMENDMENTS.—

(1) Section 6034 of such Code (relating to returns by trust described in section 4947(a) or claiming charitable deductions under section 642(c)) is amended—

(A) by striking out "section 4947(a)" in subsection (a) and inserting in lieu thereof "section 4947(a)(2)";

(B) by adding at the end of subsection (b) the following new sentence: "This section shall not apply in the case of a trust described in section 4947(a)(1).";

(C) by striking out "EXCEPTION" in the heading of subsection (b) and inserting in lieu thereof "EXCEPTIONS"; and

(D) by striking out "SECTION 4947(a)" in the section heading and inserting in lieu thereof "SECTION 4947(a)(2)".

(2)(A) The first sentence of section 6652(d)(3) of such Code (relating to annual reports) is amended to read as follows: "In the case of a failure to comply with the requirements of section 6104(d) (relating to public inspection of private foundations' annual returns), on the date and in the manner prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause, there shall be paid (on notice and demand by the Secretary and in the same manner as tax) by the person failing to meet such requirement, $10 for each day during which such failure continues, but the total amount imposed hereunder on all such persons for such failure with respect to any one annual return shall not exceed $5,000."

(B) The heading of paragraph (3) of section 6652(d) of such Code is amended by striking out "REPORTS" and inserting in lieu thereof "RETURNS".

(3) Subsection (b) of section 6104 of such Code (relating to inspection of annual information returns) is amended by striking out "6056,".

(4) Section 6685 of such Code (relating to assessable penalties with respect to private foundation annual reports) is amended to read as follows:

"SEC. 6685. ASSESSABLE PENALTIES WITH RESPECT TO PRIVATE FOUNDATION ANNUAL RETURNS.

"In addition to the penalty imposed by section 7207 (relating to fraudulent returns, statements, or other documents), any person who is required to comply with the requirements of section 6104(d) (relating to private foundations' annual returns) and who fails to so comply with respect to any return, if such failure is willful, shall pay a penalty of $1,000 with respect to each such return."

(5) Section 7207 of such Code (relating to fraudulent returns, statements, or other documents) is amended by striking out "sections 6047(b) or (c), 6056, or 6104(d)" and inserting in lieu thereof "subsection (b) or (c) of section 6047 or pursuant to subsection (d) of section 6104".

(e) CLERICAL AMENDMENTS.—

(1) The table of sections for subpart A of part III of subchapter A of chapter 61 of such Code is amended by striking out "4947(a)" in the item relating to section 6034 and inserting in lieu thereof "4947(a)(2)".

(2) The table of subparts for part III of subchapter A of chapter 61 of such Code is amended by striking out the item relating to subpart D.

(3) The table of sections for subchapter B of chapter 68 of such Code is amended by striking out "reports" in the item relating to section 6685 and inserting in lieu thereof "returns".

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1980.

SEC. 2. ALLOWANCE OF DEDUCTION FOR CERTAIN FOREIGN DEFERRED COMPENSATION PLANS.

(a) ALLOWANCE.—Part I of subchapter D of chapter 1 of the Internal Revenue Code of 1954 (relating to pension, profit sharing, stock bonus plans, etc.) is amended by inserting after section 404 the following new section:

"SEC. 404A. DEDUCTION FOR CERTAIN FOREIGN DEFERRED COMPENSATION PLANS.

"(a) GENERAL RULE.—Amounts paid or accrued by an employer under a qualified foreign plan—

"(1) shall not be allowable as a deduction under section 162, 212, or 404, but

"(2) if they satisfy the conditions of section 162, shall be allowed as a deduction under this section for the taxable year for which such amounts are properly taken into account under this section.

"(b) RULES FOR QUALIFIED FUNDED PLANS.—For purposes of this section—

"(1) IN GENERAL.—Except as otherwise provided in this section, in the case of a qualified funded plan contributions are properly taken into account for the taxable year in which paid.

"(2) PAYMENT AFTER CLOSE OF TAXABLE YEAR.—For purposes of paragraph (1), a payment made after the close of a taxable year shall be treated as made on the last day of such year if the payment is made—

"(A) on account of such year, and

"(B) not later than the time prescribed by law for filing the return for such year (including extensions thereof).

"(3) LIMITATIONS.—In the case of a qualified funded plan, the amount allowable as a deduction for the taxable year shall be subject to—

"(A) in the case of—

"(i) a plan under which the benefits are fixed or determinable, limitations similar to those contained in clauses (ii) and (iii) of subparagraph (A) of section 404(a)(1) (determined without regard to the last sentence of such paragraph (A)), or

"(ii) any other plan, limitations similar to the limitations contained in paragraph (3) of section 404(a), and

"(B) limitations similar to those contained in paragraph (7) of section 404(a).

"(4) CARRYOVER.—If—

"(A) the aggregate of the contributions paid during the taxable year reduced by any contributions not allowable as a deduction under paragraphs (1) and (2) of subsection (g), exceeds

"(B) the amount allowable as a deduction under subsection (a) (determined without regard to subsection (d)),

such excess shall be treated as an amount paid in the succeeding taxable year.

"(5) AMOUNTS MUST BE PAID TO QUALIFIED TRUST, ETC.—In the case of a qualified funded plan, a contribution shall be taken into account only if it is paid—

"(A) to a trust (or the equivalent of a trust) which meets the requirements of section 401(a)(2),

"(B) for a retirement annuity, or

"(C) to a participant or beneficiary.

"(c) RULES RELATING TO QUALIFIED RESERVE PLANS.—For purposes of this section—

"(1) IN GENERAL.—In the case of a qualified reserve plan, the amount properly taken into account for the taxable year is the reasonable addition for such year to a reserve for the taxpayer's liability under the plan. Unless otherwise required or permitted in regulations prescribed by the Secretary, the reserve for the taxpayer's liability shall be determined under the unit credit method modified to reflect the requirements of paragraphs (3) and (4). All benefits paid under the plan shall be charged to the reserve.

"(2) INCOME ITEM.—In the case of a plan which is or has been a qualified reserve plan, an amount equal to that portion of any decrease for the taxable year in the reserve which is not attributable to the payment of benefits shall be included in gross income.

"(3) RIGHTS MUST BE NONFORFEITABLE, ETC.—In the case of a qualified reserve plan, an item shall be taken into account for a taxable year only if—

"(A) there is no substantial risk that the rights of the employee will be forfeited, and

"(B) such item meets such additional requirements as the Secretary may by regulations prescribe as necessary or appropriate to ensure that the liability will be satisfied.

"(4) SPREADING OF CERTAIN INCREASES AND DECREASES IN RESERVES.—There shall be amortized over a 10-year period any increase or decrease to the reserve on account of—

"(A) the adoption of the plan or a plan amendment,

"(B) experience gains and losses, and

"(C) any change in actuarial assumptions,

"(D) changes in the interest rate under subsection (g)(3)(B), and

"(E) such other factors as may be prescribed by regulations.

"(d) AMOUNTS TAKEN INTO ACCOUNT MUST BE CONSISTENT WITH AMOUNTS ALLOWED UNDER FOREIGN LAW.—

"(1) GENERAL RULE.—In the case of any plan, the amount allowed as a deduction under subsection (a) for any taxable year shall equal—

"(A) the lesser of—

"(i) the cumulative United States amount, or

"(ii) the cumulative foreign amount, reduced by

"(B) the aggregate amount determined under this section for all prior taxable years.

"(2) CUMULATIVE AMOUNTS DEFINED.—For purposes of paragraph (1)—

"(A) CUMULATIVE UNITED STATES AMOUNT.—The term 'cumulative United States amount' means the aggregate amount determined with respect to the plan under this section for the taxable year and for all prior taxable years to which this section applies. Such determination shall be made for

each taxable year without regard to the application of paragraph (1).

"(B) CUMULATIVE FOREIGN AMOUNT.—The term 'cumulative foreign amount' means the aggregate amount allowed as a deduction under the appropriate foreign tax laws for the taxable year and all prior taxable years to which this section applies.

"(3) EFFECT ON EARNINGS AND PROFITS, ETC.—In determining the earnings and profits and accumulated profits of any foreign corporation with respect to a qualified foreign plan, the amount determined under paragraph (1) with respect to any plan for any taxable year shall in no event exceed the amount allowed as a deduction under the appropriate foreign tax laws for such taxable year.

"(e) QUALIFIED FOREIGN PLAN.—For purposes of this section, the term 'qualified foreign plan' means any written plan of an employer for deferring the receipt of compensation but only if—

"(1) such plan is for the exclusive benefit of the employer's employees or their beneficiaries,

"(2) 90 percent or more of the amounts taken into account for the taxable year under the plan are attributable to services—

"(A) performed by nonresident aliens, and

"(B) the compensation for which is not subject to tax under this chapter, and

"(3) the employer elects (at such time and in such manner as the Secretary shall by regulations prescribe) to have this section apply to such plan.

"(f) FUNDED AND RESERVE PLANS.—For purposes of this section—

"(1) QUALIFIED FUNDED PLAN.—The term 'qualified funded plan' means a qualified foreign plan which is not a qualified reserve plan.

"(2) QUALIFIED RESERVE PLAN.—The term 'qualified reserve plan' means a qualified foreign plan with respect to which an election made by the taxpayer is in effect for the taxable year. An election under the preceding sentence shall be made in such manner and form as the Secretary may by regulations prescribe and, once made, may be revoked only with the consent of the Secretary.

"(g) OTHER SPECIAL RULES.—

"(1) NO DEDUCTION FOR CERTAIN AMOUNTS.—Except as provided in section 404(a)(5), no deduction shall be allowed under this section for any item to the extent such item is attributable to services—

"(A) performed by a citizen or resident of the United States who is an officer, shareholder, or highly compensated, or

"(B) performed in the United States the compensation for which is subject to tax under this chapter.

"(2) TAXPAYER MUST FURNISH INFORMATION.—

"(A) IN GENERAL.—No deduction shall be allowed under this section with respect to any plan for any taxable year unless the taxpayer furnishes to the Secretary with respect to such plan (at such time as the Secretary may by regulations prescribe)—

"(i) a statement from the foreign tax authorities specifying the amount of the deduction allowed in computing taxable income under foreign law for such year with respect to such plan,

"(ii) if the return under foreign tax law shows the deduction for plan contributions or reserves as a separate, identifiable item, a copy of the foreign tax return for the taxable year, or

"(iii) such other statement, return, or other evidence as the Secretary prescribes by regulation as being sufficient to establish the amount of the deduction under foreign law.

"(B) REDETERMINATION WHERE FOREIGN TAX DEDUCTION IS ADJUSTED.—If the deduction under foreign tax law is adjusted, the taxpayer shall notify the Secretary of such adjustment on or before the date prescribed by regulations, and the Secretary shall redetermine the amount of the tax for the year or years affected. In any case described in the preceding sentence, rules similar to the rules of subsection (c) of section 905 shall apply.

"(3) ACTUARIAL ASSUMPTIONS MUST BE REASONABLE; FULL FUNDING.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), principles similar to those set forth in paragraphs (3) and (7) of section 412(c) shall apply for purposes of this section.

"(B) INTEREST RATE FOR RESERVE PLAN.—

"(i) IN GENERAL.—In the case of a qualified reserve plan, in lieu of taking rates of interest into account under subparagraph (A), the rate of interest for the plan shall be the rate selected by the taxpayer which is within the permissible range.

"(ii) RATE REMAINS IN EFFECT SO LONG AS IT FALLS WITHIN PERMISSIBLE RANGE.—Any rate selected by the taxpayer for the plan under this subparagraph shall remain in effect for such plan until the first taxable year for which such rate is no longer within the permissible range. At such time, the taxpayer shall select a new rate of interest which is within the permissible range applicable at such time.

"(iii) PERMISSIBLE RANGE.—For purposes of this subparagraph, the term 'permissible range' means a rate of interest which is not more than 20 percent above, and not more than 20 percent below, the average rate of interest for long-term corporate bonds in the appropriate country for the 15-year period ending on the last day before the beginning of the taxable year.

"(4) ACCOUNTING METHOD.—Any change in the method (but not the actuarial assumptions) used to determine the amount allowed as a deduction under subsection (a) shall be treated as a change in accounting method under section 446(e).

"(5) SECTION 481 APPLIES TO ELECTION.—For purposes of section 481, any election under this section shall be treated as a change in the taxpayer's method of accounting. In applying section 481 with respect to any such election, the period for taking into account any increase or decrease in accumulated profits, earnings and profits or taxable income resulting from the application of section 481(a)(2) shall be the year for which the

election is made and the fourteen succeeding years.

"(h) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section (including regulations providing for the coordination of the provisions of this section with section 404 in the case of a plan which has been subject to both of such sections)."

(b) AMENDMENTS OF SECTION 679 (a).—Subsection (a)(1) of section 679 of such Code (relating to foreign trusts having one or more United States beneficiaries) is amended by adding the phrase "Or section 404A" immediately after the phrase "section 404(a)(4)".

(c) TAXPAYER MUST NOTIFY SECRETARY WHERE THERE IS A REDETERMINATION OF TAX, ETC., UNDER FOREIGN LAW.—

(1) AMENDMENT OF SECTION 905 (c).—Subsection (c) of section 905 of such Code (relating to adjustments on payment of accrued taxes) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall not apply (with respect to any period after the refund or adjustment in the foreign taxes) if the taxpayer fails to notify the Secretary (on or before the date prescribed by regulations for giving such notice) unless it is shown that such failure is due to reasonable cause and not due to willful neglect."

(2) CIVIL PENALTY FOR FAILURE TO NOTIFY.—Subchapter B of chapter 68 of such Code (relating to assessable penalties) is amended by inserting after section 6688 the following new section:

"SEC. 6689. FAILURE TO FILE NOTICE OF REDETERMINATION OF FOREIGN TAX.

"(a) CIVIL PENALTY.—If the taxpayer fails to notify the Secretary (on or before the date prescribed by regulations for giving such notice) of a foreign tax redetermination, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the deficiency attributable to such redetermination an amount (not in excess of 25 percent of the deficiency) determined as follows—

"(1) 5 percent of the deficiency if the failure is for not more than 1 month, with

"(2) an additional 5 percent of the deficiency for each month (or fraction thereof) during which the failure continues.

"(b) FOREIGN TAX REDETERMINATION DEFINED.—For purposes of this section, the term 'foreign tax redetermination' means any redetermination for which a notice is required under subsection (c) of section 905 or paragraph (2) of section 404A(g)."

(d) CLERICAL AMENDMENTS.—

(1) The table of sections for part I of subchapter D of chapter 1 of such Code is amended by inserting after the item relating to section 404 the following new item:

"SEC. 404A. DEDUCTION FOR CERTAIN FOREIGN DEFERRED COMPENSATION PLANS."

(2) The table of sections for subchapter B of chapter 68 of such Code is amended by inserting after the item relating to section 6688 the following new item:

"SEC. 6689. FAILURE TO FILE NOTICE OF REDETERMINATION OF FOREIGN TAX."

(e) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply with respect to employer contributions or accruals for taxable years beginning after December 31, 1979.

(2) ELECTION TO APPLY AMENDMENTS RETROACTIVELY WITH RESPECT TO FOREIGN SUBSIDIARIES.—

(A) IN GENERAL.—The taxpayer may elect to have the amendments made by this section apply retroactively with respect to its foreign subsidiaries.

(B) SCOPE OF RETROACTIVE APPLICATION.—Any election made under this paragraph shall apply with respect to all foreign subsidiaries of the taxpayer for the taxpayer's open period.

(C) DISTRIBUTION BY FOREIGN SUBSIDIARY MUST BE OUT OF POST-1971 EARNINGS AND PROFITS.—The election under this paragraph shall apply to distributions made by a foreign subsidiary only if made out of accumulated profits (or earnings and profits) earned after December 31, 1970.

(D) REVOCATION ONLY WITH CONSENT.—An election under this paragraph may be revoked only with the consent of the Secretary of the Treasury or his delegate.

(E) OPEN PERIOD.—For purposes of this subsection, the term "open period" means, with respect to any taxpayer, all taxable years which begin before January 1, 1980, and which begin after December 31, 1971, and for which, on December 31, 1980, the making of a refund, or the assessment of a deficiency, was barred by any law or rule of law.

(3) ALLOWANCE OF PRIOR DEDUCTIONS IN CASE OF CERTAIN FUNDED BRANCH PLANS.—

(A) IN GENERAL.—If—

(i) the taxpayer elects to have this paragraph apply, and

(ii) the taxpayer agrees to the assessment of all deficiencies (including interest thereon) arising from all erroneous deductions,

then an amount equal to 1/15th of the aggregate of the prior deductions which would have been allowable if the amendments made by this section applied to taxable years beginning before January 1, 1980, shall be allowed as a deduction for the taxpayer's first taxable year beginning in 1980, and an equal amount shall be allowed for each of the succeeding 14 taxable years.

(B) PRIOR DEDUCTION.—For purposes of subparagraph (A), the term "prior deduction" means a deduction with respect to a qualified funded plan (within the meaning of section 404A(f)(1) of the Internal Revenue Code of 1954) of the taxpayer—

(i) which the taxpayer claimed for a taxable year (or could have claimed if the amendments made by this section applied to taxable years beginning

before January 1, 1980) beginning before January 1, 1980,

(ii) which was not allowable, and

(iii) with respect to which, on December 1, 1980, the assessment of a deficiency was not barred by any law or rule of law.

(4) TIME AND MANNER FOR MAKING ELECTIONS.—

(A) TIME.—An election under paragraph (2) or (3) may be made only on or before the due date (including extensions) for filing the taxpayer's return of tax under chapter 1 of the Internal Revenue Code of 1954 for its first taxable year ending on or after December 31, 1980.

(B) MANNER.—An election under paragraph (2) may be made only by a statement attached to the taxpayer's return for its first taxable year ending on or after December 31, 1980. An election under paragraph (3) may be made only if the taxpayer, on or before the last day for making the election, files with the Secretary of the Treasury or his delegate such amended return and such other information as the Secretary of the Treasury or his delegate may require, and agrees to the assessment of a deficiency for any closed year falling within the open period, to the extent such deficiency is attributable to the operation of such election.

SEC. 3. TREATMENT OF TRANSFERS OF PROVEN OIL OR GAS PROPERTIES BY INDIVIDUALS TO CORPORATIONS.

(a) IN GENERAL.—Subsection (c) of section 613A of the Internal Revenue Code of 1954 (relating to exemption for independent producers and royalty owners) is amended by redesignating paragraphs (10) and (11) as paragraphs (11) and (12), respectively, and by inserting after paragraph (9) the following new paragraph:

"(10) TRANSFERS BY INDIVIDUALS TO CORPORATIONS.—

"(A) IN GENERAL.—Paragraph (9)(A) shall not apply to a transfer by an individual of qualified property to a qualified transferee corporation solely in exchange for stock in such corporation.

"(B) 1,000-BARREL LIMIT FOR CORPORATION.—A tentative quantity shall be determined for the qualified transferee corporation under this subsection.

"(C) TRANSFEROR'S TENTATIVE QUANTITY REDUCED.—

"(i) IN GENERAL.—The tentative quantity for the transferor (and his family) for any period shall be reduced by the transferor's pro rata share of the corporation's depletable quantity for such period.

"(ii) PRO RATA SHARE.—For purposes of clause (i), a transferor's pro rata share for any period shall be—

"(I) in the case of production from property to which subparagraph (A) applies, that portion of the corporation's depletable quantity which is allocable to production from such property, and

"(II) in the case of production from all other property, that portion of the corporation's depletable quantity which is allocable to the production from such property, multiplied by a fraction the numerator of which is the fair market value of the transferor's stock in the corporation, and the denominator of which is the fair market value of all stock in the corporation.

"(iii) DEPLETABLE QUANTITY.—For purposes of this paragraph, a corporation's depletable quantity for any period is the lesser of—

"(I) such corporation's tentative quantity for such period (determined under paragraphs (3) and (8)), or

"(II) such corporation's average daily production for such period.

"(D) QUALIFIED TRANSFEREE CORPORATION DEFINED.—For purposes of this paragraph, the term 'qualified transferee corporation' means a corporation all of the outstanding stock of which has been issued to individuals solely in exchange for qualified property held by such individuals.

"(E) QUALIFIED PROPERTY DEFINED.—For purposes of this paragraph, the term 'qualified property' means oil or gas property with respect to which—

"(i) there has been no prior transfer to which paragraph (9)(A) applied, and

"(ii) the transferor has made an election to have this paragraph apply.

The term also includes cash (not to exceed $1,000 in the aggregate) which one or more individuals transfer to the corporation.

"(F) TRANSFEROR MUST RETAIN STOCK DURING LIFETIME.—If at any time during his lifetime any transferor disposes of stock in the corporation (other than to a member of his family), then the depletable quantity of the corporation (determined without regard to this subparagraph) shall be reduced (for all periods on or after the date of the disposition) by an amount which bears the same ratio to such quantity as the fair market value of the stock so disposed of bears to the aggregate fair market value of all stock of the corporation on such date of disposition.

"(G) SPECIAL RULES RELATING TO FAMILY OF TRANSFEROR.—

"(i) IN GENERAL.—For purposes of this paragraph—

"(I) the issuance of stock to a member of the family of the transferor shall be treated as issuance of stock to the transferor, and

"(II) during the lifetime of the transferor, stock transferred to a member of the family of the transferor shall be treated as held by the transferor.

If stock described in the preceding sentence ceases to be held by a member of the family of the transferor, the transferor shall be treated as having disposed of such stock at the time of such cessation.

"(ii) FAMILY DEFINED.—For purposes of this paragraph, the members of the family of an individual include only his spouse and minor children.

"(H) PROPERTY SUBJECT TO LIABILITIES.—For purposes of this paragraph, section 357 shall be applied as if—

"(i) references to section 351 include references to subparagraph (A) of this paragraph, and

"(ii) the reference in subsection (a)(1) of section 357 to the nonrecog-

nition of gain includes a reference to the nonapplication of paragraph (9)(A) of this subsection.

"(I) ELECTION.—A transferor may make an election under this paragraph only in such manner as the Secretary may by regulations prescribe and only on or before the due date (including extensions) for filing the return of the corporation of the taxes imposed by this chapter for the corporation's first taxable year ending after the date of the transfer (or, if later, after the date of the enactment of this paragraph).

"(J) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this paragraph."

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to transfers in taxable years ending after December 31, 1974, but only for purposes of applying section 613A of the Internal Revenue Code of 1954 to periods after December 31, 1979.

SEC. 4. CREDITS ALLOWABLE AGAINST MINIMUM TAX.

(a) ALLOWANCE OF CREDIT.—

(1) IN GENERAL.—Paragraph (1) of section 55(c) (relating to credits allowable against alternative minimum tax) is amended to read as follows:

"(1) IN GENERAL.—For purposes of—

"(A) determining the amount of any credit allowable under subpart A of part IV of this subchapter (other than the foreign tax credit allowable under section 33(a)) against the tax imposed by subsection (a), the tax imposed by subsection (a) shall be treated as a tax imposed by this chapter only to the extent of the amount which would be determined under subsection (a)(1) if the alternative minimum taxable income was reduced by the sum of—

"(i) the net capital gain, and

"(ii) the adjusted itemized deductions, and

"(B) determining the amount of any such credit (including the credit allowable under section 33(a)) against the tax imposed by this chapter (other than the tax imposed by this section) for the current taxable year, this section shall be disregarded.

(2) METHOD OF DETERMINING CREDITS TAKEN INTO ACCOUNT.—Section 55(c) is amended by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively, and by inserting after paragraph (1) the following new paragraph:

"(2) RULES FOR DETERMINING AMOUNT OF CREDIT ALLOWABLE.—For purposes of determining the amount of any credit under subpart A of part IV of this subchapter (other than the credits imposed by sections 31, 39, and 43) which can be taken against the tax imposed by subsection (a)—

"(A) the amount of such credit shall be increased by an amount equal to the lesser of—

"(i) the amount of such credit allowable in computing the regular tax for the current taxable year, or

"(ii) the excess of—

"(I) the amount of the tax imposed by subsection (a), over

"(II) the sum of the amounts determined under this subparagraph with respect to credits allowed under a section of such subpart having a higher number designation than such credit (other than the credits allowable by sections 31, 39, and 43), and

"(B) in the case of any credit under section 38, 40, or 44B, such credit shall be reduced, under regulations prescribed by the Secretary, by that portion of such credit which is not attributable to an active trade or business of the taxpayer."

(3) Paragraph (4) of section 55(c) (relating to carryover and carryback of certain credits), as redesignated by paragraph (2), is amended to read as follows:

"(4) CARRYOVER AND CARRYBACK OF CERTAIN CREDITS.—

"(A) IN GENERAL.—For purposes of determining the amount of any carryover or carryback to any other taxable year of any credit allowable under subpart A of part IV of this subchapter (other than section 33), the amount of the limitation under section 44E(e)(1), 44C(b)(1) and (2), 53(b), 50A(a)(2), or 46(a)(3) to the extent such limitation does not exceed the amount of the credit allowable in computing the regular tax for the current taxable year shall be increased for the current taxable year by the amount determined under subparagraph (A) of paragraph (1) of this subsection, and decreased by—

"(i) the sum of the credits allowed under a section having a lower number designation than the section allowing such credit (other than the credits allowable by sections 31, 33, 39, and 43) against the tax imposed by subsection (a), and

"(ii) the amount determined with respect to such credit under paragraph (2)(B) for the current taxable year.

"(B) AMOUNT OF CREDIT.—Any increase under paragraph (2)(A) shall be taken into account in determining the amount of any carryover or carryback from the current taxable year."

(b) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Paragraph (2) of section 55(b) (defining regular tax) is amended by striking out "credit allowable under section 33" and inserting in lieu thereof "credits allowable under such subpart".

(2) Paragraph (3) of section 55(c) (relating to foreign tax credit), as redesignated by subsection (a)(2), is amended—

(A) by striking out subparagraph (B) and redesignating subparagraphs (C), (D), and (E) as subparagraphs (B), (C), and (D), respectively;

(B) by striking out "subparagraph (C)" in subparagraphs (C) and (D)(i), as so redesignated, and inserting in lieu thereof "subparagraph (B)"; and

(C) by striking out clause (ii) of subparagraph (D), as so redesignated, and inserting in lieu thereof the following:

"(ii) any increase under paragraph (2)(A) shall be taken into account."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1979.

Approved December 28, 1980.

Senate Report No. 96-1039
2d Session

[Bracketed numerals indicate official report page numbers]

DISCLOSURE OF MAILING ADDRESSES OF INDIVIDUALS WHO HAVE DEFAULTED ON CERTAIN STUDENT LOANS

NOVEMBER 25 (legislative day, NOVEMBER 20), 1980.

Mr. LONG, from the Committee on Finance, submitted the following report to accompany H.R. 4155.[1]

* * * * *

[2] I. SUMMARY

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SEC. 2. SIMPLIFICATION OF PRIVATE FOUNDATION RETURN AND REPORTING REQUIREMENTS

This section combines information reporting requirements for private foundations so that only one return would have to be filed to furnish information now required on two separate returns. It also provides that nonexempt wholly charitable trusts would be required to report the same information and be subject to the same disclosure requirements as exempt charitable organizations. Finally, it provides that disclosure of the name and address of an indigent or needy person receiving a grant of less than $1,000 in any year need not be made.

SEC. 3. NONQUALIFIED DEFERRED COMPENSATION PLANS FOR NONRESIDENT ALIENS

Under present law the Code provides special rules for deductions of amounts under pension and other deferred compensation plans. Separate rules apply with respect to qualified and nonqualified deferred compensation plans.

The IRS has held that if a foreign branch's plan for the benefit of nonresident alien employees did not meet all of the requirements for qualification under the Code, no deduction would be allowable under the rules for qualified plans, but amounts would be deductible, if at all, only under the rules which apply to nonqualified plans.

The bill provides that in the case of a nonqualified deferred compensation plan which is maintained for the benefit of persons substantially all of whom are nonresident aliens, the general rules regarding the timing and allowability of deductions for contributions will not apply (unless the taxpayer elects to have those rules apply to the plan). Instead, special rules for deductibility are prescribed.

Subject to limitations, the bill permits a deduction for amounts paid to a trust even though the trust did not meet all the requirements for qualification. Deductions would generally be limited to the lesser [3] amount deductible under foreign law or the amount allowable under standards comparable to those applied in the case of plans in the United States (but eliminating those limitations applicable to further U.S. social policy rather than U.S. tax policy). In the case of unfunded reserve plans, the deductible addition to the reserve would be the present discounted value of the current liability of the foreign subsidiary or branch, using a discount rate intended to put employers electing to use unfunded reserve plans in a position equivalent to employers electing to use funded plans.

SEC. 4. TRANSFERS OF PROVEN OIL AND GAS PROPERTIES TO A CONTROLLED CORPORATION BY INDIVIDUALS

Under present law, independent producers and royalty owners are permitted to claim a deduction for percentage depletion with respect to a limited amount of oil or gas production. Generally, the otherwise allowable percentage depletion deduction is denied with respect to production from proven oil and gas properties which have been transferred after 1974. Such a transfer, however, generally does not preclude the deduction if the transferee and transferor must allocate one depletable quantity. Existing law contains no provision whereby an individual and his or her controlled corporation must allocate one depletable quantity in order to come within this exception.

The bill provides a limited exception to the generally applicable rules of present law which prohibit oil and gas production from being eligible for percentage depletion if the production is from a proven oil or gas property which has been transferred by an individual after December 31, 1974. Under this elective exception (which generally would not allow an increase in the aggregate amount of oil or gas production subject to percentage depletion), individuals would be allowed to transfer oil or gas properties to a controlled corporation without the loss of percentage depletion if several conditions are satisfied. Only oil or gas properties could be transferred to the corporation, and all of the corporation's outstanding stock (and no debt securities or similar obligations) would have to be issued directly to the individual transferors of the oil or gas properties solely in exchange for those properties. The corporation and the shareholders would be required to allocate one 1,000 barrel amount eligible for depletion subsequent to the transfer.

In the absence of satisfying these new rules or of an election under this provision, the rules of present law would continue to apply. Thus, production from a proven oil or gas property which has been transferred by an individual in an exchange to which section 351 applies would not be eligible for percentage depletion.

The provision applies to qualifying transfers made by individuals in taxable years ending after December 31, 1974, but only as to percentage depletion for production in periods after December 31, 1979. Therefore, the provision does not apply to oil or gas production in periods before January 1, 1980.

SEC. 5. TAX CREDITS ALLOWABLE AGAINST ALTERNATIVE MINIMUM TAX

In general, this section of the bill

[1] Public Law 96-603, page 684.

allows each nonrefundable tax credit to be used to offset the alternative minimum tax, except to the extent attributable to net capital gains and adjusted itemized deductions, if the credit is attributable to the active conduct of a trade or business by the taxpayer.

* * * * *

[6] B. Simplification of Private Foundation Return and Reporting Requirements (sec. 2 of the bill and secs. 6033, 6034, and 6056 of the Code)

Present law

Present law requires the foundation managers of private foundations having at least $5,000 of assets to file an annual report (sec. 6056). The report (Form 990-AR) is to contain the foundation's gross income, expenses, disbursements, balance sheet, total amount of contributions and gifts received by it during the year, an itemized list of all grants or contributions made or approved, the names and addresses of the foundation managers, and a list of those foundation managers who are substantial contributors or own certain interests in businesses in which the foundation owns an interest. This report must be made available for public inspection at the principal office of the foundation (sec. 6104(d)) and is open to public inspection at the offices of the Internal Revenue Service (sec. 6104(b)). In addition, the report must be furnished to the appropriate State officials (sec. 6056(d)).

Under present law, most exempt organizations described in section 501(c)(3) of the Code (including exempt private foundations) must file an annual information return (sec. 6033). Under this provision, the return for foundations, Form 990-PF, must state items of gross income, etc., and such other information as may be required by the forms and regulations. At present, this return contains most of the information required in the annual report of the foundation managers. This annual information return also is open to public inspection at the offices of the Internal Revenue Service (sec. 6104(b)). In addition, a copy of this return must be attached to the annual report of a private foundation when the report is furnished to the appropriate State officials (Treas. Reg. sec. 1.6056-1(b)(3)). Thus, information furnished on a foundation manager's report (Form 990-AR) substantially duplicates or overlaps the return filed by the foundation (Form 990-PF) in content and availability for public inspection.

Under present law, trusts which have solely charitable beneficiaries but which are not exempt from taxation (sec. 4947(a)(1) trusts) are subject to different return and disclosure requirements from those applicable to exempt charitable trusts and organizations. A nonexempt charitable trust is not required to file an annual information return open to public inspection. Instead, this type of trust is required to file an income tax return (Form 1041) under section 6012 if its gross income for the year is at least $600 or if it has any taxable income. (Form 1041 need not be filed by a nonexempt charitable trust which is a private foundation and which has no taxable income for the year.) These tax returns are not open to public inspection. In addition, a nonexempt charitable trust, other than one which is required to distribute all its net income currently, must file an annual [7] information return (Form 1041-A), open to public inspection, setting forth certain information concerning its charitable contributions, income and expenses, and balance sheet items, but not containing all of the information required of exempt charitable trusts (sec. 6034). If a nonexempt charitable trust is a private foundation, it also must file a return (pursuant to the regulations under sec. 6011) setting forth much of the information contained on an exempt organization's information return, but this return (Form 5227) is not open to public inspection. In addition, a nonexempt charitable trust which is a private foundation must file the annual report (Form 990-AR or an equivalent report), which is open to inspection and must be furnished to the appropriate State officials as in the case of exempt private foundations, if the trust has at least $5,000 of assets.

Reasons for change

The committee believes that the private foundation reporting requirements should be simplified by combining the annual return (Form 990-PF) and annual report (Form 990-AR) into a single return containing the information presently required on each of the two separate documents. This will reduce administrative costs for foundations. Also, combining the two forms into one will increase the amount of information about the foundation available for inspection at the foundation's office and available to State officials.

Also, the committee believes that nonexempt charitable trusts described in section 4947(a)(1) of the Code should be required to report the same information and be subject to the same disclosure requirements as exempt charitable organizations.

Finally, the committee believes that the disclosure of the name and address of indigent or needy persons receiving grants of less than $1,000 in any year should not be required.

Explanation of provision

The bill eliminates the requirement (under sec. 6056) for the managers of any private foundation with assets of $5,000 or more to file an annual report. Instead, the bill requires that all information currently required to be furnished on the annual report (Form 990-AR) but not on the information return (Form 990-PF) be furnished instead on the foundation's annual information return (under sec. 6033). The combined annual information return will be subject to public inspection at the foundation's office and must be furnished to the appropriate State officials under the same conditions now applicable to the annual report.

In the case of a foundation which has no principal office or whose principal office is in a personal residence,

it is anticipated that the Treasury will by regulation allow the annual inspection requirement to be met by having the return available for public inspection at an appropriate substitute location or by making copies of the return available by mail free of any charge (including postage and copying) upon request.

The bill also provides that the return not be required to contain the name and address of a needy or indigent recipient (other than a disqualified person) of a gift or grant made by the foundation where [8] the total of the gifts or grants received by the person during the year from the foundation does not exceed $1,000.

The section 6033 information reporting requirements under the bill will apply to nonexempt charitable trusts described in section 4947(a)(1) as well as to exempt charities. If a nonexempt charitable trust is a private foundation, the trust's information return must contain all the information required of an exempt private foundation. In addition, nonexempt trusts described in Code section 4947(a)(1) will no longer be required to file a Form 1041-A (under section 6034). In the case of a nonexempt charitable trust which has no taxable income, the Treasury may prescribe regulations to treat the filing of the information return as satisfying the income tax return filing requirements (under sec. 6012). The filing by a trust of the annual information return under section 6033, in good faith, showing sufficient facts upon which to determine income tax liability will commence the period of limitations on any income tax liability if it is later determined that the trust in fact had taxable income.[1]

[1] This rule is consistent with the principles of the decision in *California Thoroughbred Breeders Association* v. *Commissioner,* 47 T.C. 335 (1966), acquiesced in by the Commissioner in Rev. Rul. 69-247, 1969-1 CB 303, in which it was held that the filing of a Form 990 information return by an exempt organization disclosing sufficient facts to apprise the Service of potential unrelated business taxable income commenced the statute of limitations although a tax return (900-T) was not filed.

Effective date

This provision applies to taxable years beginning after December 31, 1980.

Revenue effect

This provision will not have any direct effect on budget receipts.

[9] C. Nonqualified Deferred Compensation Plans for Nonresident Aliens (sec. 3 of the bill and secs. 404A, 905, and 6689 of the Code)

Present law

United States businesses operating abroad often provide deferred compensation for their foreign employees. In many cases, plans are established which cover almost exclusively nonresident alien employees, rather than U.S. citizens working abroad. The foreign operations of the U.S. business may be conducted through a branch of a U.S. corporation or through a foreign subsidiary of a U.S. parent corporation.

General rules relating to deductibility of deferred compensation

In general, the year in which a taxpayer is allowed to deduct expenses, such as compensation, is determined by its method of accounting. Generally, cash basis taxpayers deduct expenses in the year they are paid, while accrual basis taxpayers deduct the expenses in the year in which all events have occurred which determine the fact of the liability and the amount of the liability can be estimated with reasonable accuracy.

However, the Code provides special rules (sec. 404) for deductions of amounts under pension and other deferred compensation plans, which must be met in addition to the usual requirements for deduction of the amounts as business expenses (secs. 162 and 212). Separate rules apply with respect to qualified and nonqualified deferred compensation plans.

Qualified plans.—In order for a deferred compensation plan to be "qualified" under the Code, contributions under it must be paid into a trust to protect them from the employer's creditors. A number of other requirements must also be met. In particular, the plan must be administered for the sole benefit of employees and their beneficiaries, eligibility to participate must be nondiscriminatory, contributions or benefits must be nondiscriminatory, and benefits must be paid no later than specified dates. Additional requirements must be met if the plan covers self-employed individuals, such as partners. The Employee Retirement Income Security Act of 1974 (ERISA) [Pub. L. 93-406, 1974-3 C.B. 1] added a number of additional requirements, including, for example, new eligibility rules, minimum standards for vesting and accrual of benefits, minimum funding standards, maximum limitations on contributions and benefits, a requirement that benefits be paid in certain cases in the form of joint and survivor annuities, and prohibitions on certain dealings between the plan and related parties.

If a plan is qualified, a deduction is allowed at the time a contribution is paid into the plan's trust. The amount of the contribution allowable as a deduction is no less than the amount necessary to satisfy the minimum funding standard prescribed by ERISA. A maximum limitation is also placed on the amount of the contribution which may be deducted. Generally, this may not exceed the "normal cost" of the [10] plan for the year plus an amount which would amortize plan benefit liabilities attributable to past service of employees (if not already included in normal cost under the funding method used by the taxpayer) over a period of no less than 10 years. (The "normal cost" is a measure intended to reflect the ratable share of the increase in plan liabilities to participants resulting from service performed that year. Under some allowable funding methods, a ratable portion of liability for past service of the employees is also included in the year's normal cost.) No deduction is allowed for contributions in excess of the "full funding limitation," the amount by which the accrued liability for benefits of the plan

exceeds the value of its assets. Other limitations on deductions also apply if the employer maintains qualified profit sharing or stock bonus plans for his employees. An unlimited carryforward is allowed for contributions in excess of the limitations.

Nonqualified plans.—If a plan of deferred compensation does not meet the requirements for qualification under the Code, a separate rule applies to the deductibility of contributions. The deduction is taken in the taxable year in which an amount attributable to the contribution is includible in the income of the employee. A similar rule applies to deferred compensation arrangements with independent contractors. However, if the plan covers more than one employee, the deduction may be taken only if separate accounts are maintained for each employee. (Section 1022(j) of ERISA [Pub. L. 93-406, 1974-3 C.B. 1, 111] waives this requirement for certain plans to provide severance pay required by foreign law.) Otherwise, the IRS takes the position that the contribution is never deductible, except in the case of unfunded plans where payment is made directly to the former employees.

Separate accounts are established only for defined contribution plans, which generally require that an amount established pursuant to a formula, which may vary from employee to employee, be contributed to the accounts of the participants. Each employee bears the risk of fluctuations in the value of the investments in his account. Separate accounts are not maintained, however, for defined benefit plans. These plans specify by formula the benefits which participants are to receive on retirement. Contributions to them are based on actuarial calculations of the amounts which will be required to be paid out, generally based in the aggregate on the ages and life expectancies of members of the workforce, likely turnover of participants, and expected investment performance of amounts contributed. The employer bears the risk of investment gain or loss. Because the actuarial assumptions are based on aggregate data, no separate accounts are maintained. Hence, in situations where this rule applies, no deduction is allowed for contributions to a nonqualified defined benefit plan.

Foreign deferred compensation plans

Foreign branch operations.—The Code permits the trust of a qualified plan to be organized under foreign law and waives certain nondiscrimination rules with respect to nonresident aliens but does not otherwise expressly waive any of the requirements for qualification. In Letter Ruling 7904042, the Internal Revenue Service held that if a plan for the benefit of nonresident alien employees did not meet all of [11] the requirements for qualification under the Code (including the provisions added by ERISA), no deduction would be allowable under the rules for qualified plans described above. Instead, the Service held that amounts would be deductible, if at all, only under the rules which apply to nonqualified plans. Since the plans in question were defined benefit plans which did not maintain separate accounts for participants, the Service denied deductions for contributions made to the plans.

Foreign subsidiary operations.—Foreign subsidiaries of U.S. corporations generally do not have U.S. operations which would subject them to U.S. tax, and since their income is thus not subject to U.S. tax, the question of whether a deduction is allowed for contributions to a plan for nonresident aliens does not have the same direct effect on their U.S. tax liability as in the case of a foreign branch of a U.S. corporation. However, the treatment of the contribution in computing the foreign subsidiary's accumulated profits has important consequences in determining the indirect foreign tax credit which the U.S. parent corporation is allowed with respect to dividends received from the foreign subsidiary.[1]

Generally, if a U.S. corporation owns at least 10 percent of the voting stock of a foreign corporation from which it receives a dividend, the U.S. corporation is deemed to pay the amount of foreign income taxes paid by the foreign subsidiary on the accumulated earnings from which the dividend was paid. The U.S. corporation may then, within limitations, claim a credit against its U.S. tax liability in the amount of the foreign income taxes deemed paid by it. Under regulations, the determination of foreign taxes paid on accumulated earnings is made on a year-by-year basis, starting with the most recent year. If only part of the accumulated earnings of that year are paid out, only a proportionate part of the foreign income taxes paid with respect to the earnings for that year are deemed paid. Thus, if a dividend of a given size is paid, more of the foreign income taxes paid by the foreign subsidiary will be deemed to have been paid by (and thus would be creditable by) the U.S. parent if the accumulated earnings of the subsidiary are smaller than if they are larger—because a proportionately larger share of the accumulated earnings would be paid out in the dividend, resulting in a greater proportion of the foreign taxes being deemed paid.

The deduction issue discussed in connection with foreign branches can also be relevant in the case of a foreign subsidiary if it conducts a U.S. business, the taxable income from which must be determined, or if it is a controlled foreign corporation (CFC).[2]

In the case of a CFC, subpart F (secs. 951-964 of the Code) provides that, in general, the United States shareholders must currently include in their income certain types of tax haven income of the corporation and certain types of passive investment income.

[1] Section 406 of the Code permits, in limited instances, a U.S. parent corporation with a qualified plan to make contributions on behalf of employees of a foreign subsidiary who are U.S. citizens. In such cases, a deduction is allowed to the foreign subsidiary.

[2] Generally, a foreign corporation is a CFC if more than 50 percent of the voting power is held by "United States shareholders," that is, U.S. persons each of whom holds 10 percent or more of the voting power.

Generally, the amount [12] of this income to be taken into account is reduced by deductions properly allocable to that income, so if foreign pension costs are so allocable, it is necessary to determine whether and when they are deductible. Moreover, an indirect foreign tax credit similar to that described above may be allowed to the U.S. shareholder with respect to the amount which the shareholder must include in income. The credit is equal to the proportionate part of the foreign income taxes paid on the earnings and profits of the CFC from which the distribution is deemed to be made. Thus, questions similar to those described above arise as to the size of the earnings and profits.

In Letter Ruling 7839005, the Internal Revenue Service considered an accrual basis CFC which established an irrevocable balance sheet reserve for pension expenses. The taxpayer contended that the CFC's earnings and profits should be reduced by the amount of its pension liability which had properly been accrued. The Service held, however, that earnings and profits could be reduced only to the extent of pension payments actually made. The Service did not view as controlling the taxpayer's argument that this result would distort (generally by reducing) its allowable indirect foreign tax credit with respect to dividend distributions from the CFC.

Foreign trusts with U.S. beneficiaries.—The Code provides that if a U.S. person transfers property to a foreign trust, and a U.S. person is the beneficiary of any part of the trust, then the transferor is treated as the owner of the transferred trust property and therefore is taxable on the income earned on that part. Moreover, if the trust does not have a U.S. beneficiary at the time of the transfer but later acquires one, the transferor is subject to tax on all the undistributed net income on amounts it previously transferred to the trust. The Code expressly provides that these rules do not apply to foreign trusts established under qualified plans. However, there is no similar exception for foreign trusts under nonqualified plans. Thus, if a U.S. corporation makes a contribution to a foreign trust of a nonqualified plan, it is possible that the corporation would be taxable on the income earned on the contribution, either immediately if the trust has a U.S. person as a beneficiary, or subsequently if one of the plan participants or his beneficiary becomes a U.S. citizen or resident.

Reasons for change

The committee believes that the provisions of present law generally applicable to deferred compensation plans are ill-suited to plans maintained for the benefit of foreign employees. These plans must frequently comply with provisions of foreign law which are either inconsistent with U.S. law or can be made consistent only through the surrender of major tax benefits under the foreign system. The committee believes that U.S. employers should be able to obtain deductions (and adjustments to earnings and profits) which take into account their obligations under these plans. It is unnecessary to burden qualification for these tax benefits with many of the provisions intended to protect employees and their beneficiaries applicable to domestic plans. However, in order to prevent distortions of income or of the allowable foreign tax credit, the bill includes certain limitations on the allowable amount of deductions.

[13] *Explanation of provision*

In general

The bill permits employers to elect a special set of provisions relating to deductions (and adjustments to earnings and profits) for qualified foreign plans. A "qualified foreign plan" means any written plan of an employer for deferring the receipt of compensation with respect to which the election has been made, but only if two requirements are met. First, the plan must be for the exclusive benefit of the employer's employees or their beneficiaries. Second, 90 percent or more of the amounts taken into account for the taxable year under the plan must be attributable to services (i) performed by nonresident aliens, (ii) the compensation for which is not subject to Federal income tax under the Code (as modified by applicable treaties). A plan is written to the extent it is defined by plan instruments, an applicable statute, or both. The bill does not apply to plans for independent contractors.

Under the bill, amounts paid or accrued by an employer under such a plan are not allowable as a deduction under Code sections 162, 212, or 404, but if they satisfy the conditions of Code section 162, they are allowable as a deduction under the bill for the taxable year for which the amounts are properly taken into account under the bill.

Certain provisions of the bill apply only to funded plans, while others apply only to reserve plans. Other provisions apply to both types. A qualified foreign plan is subject under the bill to the provisions relating to funded plans unless the taxpayer elects to be subject to the provisions for reserve plans.

The Committee intends that, for taxable years beginning after December 31, 1980 (and prior years to the extent that taxpayer elects retroactive effectiveness of the provisions), the taxpayer may claim a deduction for deferred compensation only pursuant to the terms of the bill, to the extent permitted for contributions to qualified plans, or to the extent permitted under section 404(a)(5). However, the Committee also intends that, for prior years, no inference should be drawn from the enactment of the legislation as to the deductibility of contributions to foreign deferred compensation plans.

Funded plans

Generally, in the case of a funded plan contributions are properly taken into account for the taxable year in which paid. However, a provision similar to that available to domestic plans permits in some cases delay in payment of the contribution up to the time the return for the year is filed.

A contribution will be taken into account only if it is paid to a trust (or the equivalent of a trust) for the exclusive benefit of employees or their beneficiaries, for a retirement annuity, or directly to a participant or beneficiary.

In the case of a defined benefit plan, limitations to prevent distortion of income or the allowable foreign tax credit are placed on the amount deductible in any year which are similar to the limits imposed on domestic plans, except that aspects of the domestic limitations which relate to the minimum funding requirements are omitted because the funding rules do not apply to qualified foreign plans. Deductions to profit sharing plans are also subject to [14] limitations similar to those imposed on domestic plans. Where more than one type of deferred compensation plan is maintained, the general rule limiting deductions for contributions to 25 percent of other compensation is also applicable. If the contributions paid in any year (reduced by certain amounts not allowable as deductions under the bill) exceed the foregoing limitations, a carryforward of the excess is permitted.

Reserve plans

In the case of an unfunded reserve plan, the amount properly taken into account for the taxable year is the reasonable addition for that year to a reserve for the taxpayer's liability under the plan. All benefits paid under the plan are to be charged to the reserve. In the case of a plan which is or has been a qualified reserve plan, an amount equal to the portion of any decrease for the taxable year in the reserve which is not attributable to the payment of benefits is to be included in gross income. The reserve must be decreased to the extent that it exceeds the taxpayer's liability properly taken into account.

The addition to the reserve is computed by discounting the accrued vested liabilities of the employer under the plan by an interest rate which is intended to approximate the amount which the employer could reasonably be expected to earn on funds invested in its business. The bill prescribes a formula for determining the permissible interest rate to be used in discounting the employer's liabilities under the plan in order to compute the amount allowable as an addition to the reserve for the year. The taxpayer may select a discount rate which is no more than 20 percent above, and not more than 20 percent below, the average rate of interest for long term corporate bonds in the appropriate foreign country for a 15-year period prior to the year of the adjustment to the reserve. Once a discount rate within this permissible rate has been selected by the taxpayer for the plan, that rate shall remain in effect for the plan until the first year for which the rate is no longer within the permissible range. If in any year the rate selected by the taxpayer ceases to fall within the permissible range, the taxpayer shall select a new rate of interest which is within the permissible range applicable for that year.

Unless otherwise required or permitted by the Treasury, the reserve for the taxpayer's liability is to be determined under the unit credit method modified to reflect the following requirements. First, an item shall be taken into account for a taxable year only if there is no substantial risk that the rights of the employee will be forfeited, and the item meets such additional requirements as the Treasury may be regulations prescribe as necessary or appropriate to ensure that the liability will be satisfied. Second, any increase or decrease to the reserve on account of the adoption of the plan or a plan amendment, experience gains and losses, any change in plan assumptions, and changes in the interest rate is to be amortized over a 10-year period. Other factors prescribed by regulations must also be amortized over the 10-year period. These could include, for example, adjustments in the reserve resulting from changes in levels of compensation on which benefits depend, or the vesting in one year of a benefit which was accrued in a prior year.

[15] *Consistency with foreign law*

In the case of any qualified foreign plan, whether funded or reserve, the amount allowed as a deduction under the bill for any taxable year is equal to the lesser of (i) the cumulative U.S. amount, or (ii) the cumulative foreign amount, reduced in either case by the aggregate amount determined under the bill for all prior taxable years. "Cumulative U.S. amount" means the aggregate amount determined with respect to the plan under this provision for the taxable year and for all prior taxable years to which the bill applies. (The determination is to be made, however, for each taxable year without regard to the limitation imposed by this provision.) "Cumulative foreign amount" means the aggregate amount allowed as a deduction under the appropriate foreign tax laws for the taxable year and all prior taxable years to which this provision applies. If the deduction under the foreign tax law is later adjusted, the taxpayer is to notify the Treasury of the adjustment on or before the date prescribed by regulations, and the Treasury will redetermine the amount of the U.S. tax for the year or years affected. (In any such case, rules similar to the rules of Code section 905(c) will apply. See the discussion below under the heading "Foreign tax credit redeterminations.")

In determining the earnings and profits and accumulated profits of any corporation with respect to a qualified foreign plan, the principles of this limitation are generally to apply. However, the deduction allowed in computing the earnings and profits or the accumulated profits of any foreign corporation with respect to a qualified foreign plan is not in any event to exceed the amount allowed as a deduction under the appropriate tax laws for such taxable year. This additional limitation is imposed in response to the possibilities for distortion of a taxpayer's indirect foreign tax credit which are presented by the present

annual system for determining the amount of the foreign taxes paid by a subsidiary which are attributable to dividends paid to its U.S. shareholders. The effective rate of foreign tax paid by a foreign subsidiary determined with reference to U.S. accounting rules may fluctuate significantly from year to year for a variety of reasons, including, in particular, differences between the U.S. accounting rules for computing the foreign subsidiary's earnings and profits or accumulated profits and the accounting rules used by the foreign government in imposing the tax. The interaction of these foreign rate fluctuations and the annual rules for computing the indirect foreign tax credit permit substantial distortions of the taxpayer's deemed paid foreign tax credit as compared with the effective tax rate of the subsidiary over a period of years. For example, dividends might be repatriated only in high effective tax rate years of the subsidiary (measured under U.S. accounting rules), yielding a deemed paid credit higher than the long term effective rate of the subsidiary. Conversely, dividends might be repatriated through years in which the subsidiary has no accumulated profits according to U.S. accounting rules, with the result that the taxes paid by the subsidiary for the year are lost. This potential for distortion might be eliminated if the indirect credit were computed with reference to the subsidiary's accumulated foreign taxes and undistributed accumulated profits for all years. Until and unless such a change was so made, however, it was determined that no carryforward of [16] any amount which is disallowed for a year because the foreign deduction of the subsidiary for the year exceeded the U.S. deduction for the year will be permitted to a future year where it would increase the amount allowable under U.S. rules over the amount of the foreign deduction for the later year. (The impact of this limitation is that such an excess is permanently lost.)

Other limitations

The bill further provides that, except as provided in Code section 404(a)(5), no deduction will be allowed under the bill for any item to the extent it is attributable to services (i) performed by a citizen or resident of the United States who is an officer, shareholder, or highly compensated, or (ii) performed in the United States the compensation for which is subject to Federal income tax under the Code (as modified by applicable treaties).

No deduction is allowed under the bill with respect to any plan for any taxable year unless the taxpayer furnishes to the Treasury (i) a statement from the foreign tax authorities specifying the amount of the deduction allowed in computing taxable income under foreign law for the year with respect to the plan, (ii) if the return under foreign tax law shows the deduction for plan contributions or reserves as a separate, identifiable item, a copy of the foreign tax return for the taxable year, or (iii) such other statement, return, or other evidence as the Treasury prescribed by regulation as being sufficient to establish the amount of the deduction under foreign law.

Actuarial assumptions must be reasonable in the aggregate. Also, in the case of a reserve plan, rates of interest used for actuarial computations are to be the appropriate market interest rates for borrowing money in the appropriate country, as determined under regulations prescribed by the Treasury. No deduction is allowable for any amount to the extent that it would cause the fair market value of the plan's assets to exceed the accrued liability (including normal cost) under the plan. Any change in the method (but not the actuarial assumptions) used to determine the amount allowed as a deduction is to be treated as a change in accounting method under Code section 446(e). Thus, such a change would require the permission of the Treasury and could give rise to an adjustment to income (Code section 481). In applying section 481 with respect to any such election, the period for taking into account any increase or decrease in accumulated profits, earnings and profits or taxable income resulting from the application of section 481(a)(2) shall be the year for which the election is made and the nine succeeding years.

Foreign tax credit redeterminations

The allowance of deductions under the bill depends, in part, on the allowance of deductions under foreign law. The bill provides that when there is a change in deductions allowed under foreign law the taxpayer will be required to notify the Treasury of this change. This requirement parallels existing rules requiring notification if foreign taxes when paid differ from amounts claimed as credits by the taxpayer. The bill also clarifies enforcement of the provisions which require the taxpayer to notify the Treasury of changes in its foreign income tax liabilities.

[17] The bill provides that interest may be assessed and collected on the tax due resulting from a redetermination if the taxpayer has failed to notify the Treasury (on or before the date prescribed by regulations for giving such notice) of the foreign tax change, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The interest may be assessed and collected, however, only from the time of the refund of foreign income tax or any adjustments affecting deductions allowable under the bill or the time of any other adjustment to foreign income tax paid or accrued. Moreover, if the failure is not excusable, an additional penalty is to be assessed of 5 percent of the deficiency attributable to the redetermination for each month (or fraction of a month) during which the failure continues, not to exceed 25 percent.

Foreign trusts

The bill would make it clear that in the case of a contribution to a foreign trust subject to the special deduction rules, the corporation mak-

ing the contributions is not treated as the owner of part of the trust merely because the trust has or acquires U.S. beneficiaries.

Effective date

The amendments made by this provision are generally applicable to employer contributions or accruals by U.S. taxpayers and from subsidiaries of such taxpayers for taxable years after December 31, 1980. In addition, a taxpayer may elect to have the amendments apply retroactively. A retroactive election only applies to funded plans maintained by foreign branches of the taxpayer, but it applies to both funded plans or reserve plans maintained by foreign subsidiaries of the taxpayer. In the case of retroactive application to foreign subsidiaries, the legislation would apply to all dividends distributed out of accumulated profits and earnings and profits earned by such subsidiaries after December 31, 1971 and included in the taxpayer's income in its open period. Any retroactive election can only be revoked with the consent of the IRS. Any retroactive election shall apply to all open years of the taxpayer after December 31, 1971 (other than any open years which precede a closed year of the taxpayer).

Revenue effect

It is estimated that the provisions allowing a deduction for pension plans of foreign branches of U.S. corporations will reduce budget receipts by $20 million in fiscal 1981 and $10 million annually in 1982 through 1985. Although the tax liability involved in the case of unfunded accrual plans of foreign subsidiaries of U.S. companies is potentially far more substantial (possibly $500 million for the period prior to 1981 and $200 million a year thereafter), for several reasons the provisions involving foreign subsidiaries are estimated not to have any budget impact for the next few years. The affected taxpayers have contested the position of the IRS that accrual plans do not qualify for deductions in computing earnings and profits. Litigation resolving the issue is likely to take some time and thus, even if the IRS prevails, no U.S. tax on account thereof is likely to be paid for several years. Moreover, since taxpayers can avoid any U.S. tax liability with respect to the plans of the foreign subsidiaries if they fund those plans, it is not clear how much revenue, if any, would be raised if deductions are not allowed for foreign pension accruals.

[18] D. Transfers of Proven Oil or Gas Properties to a Controlled Corporation (sec. 4 of the bill and sec. 613A of the Code)

Present law

Under present law, oil and gas production generally is not entitled to percentage depletion. However, independent producers and royalty holders are permitted a percentage depletion deduction of 22 percent with respect to 1,000 barrels of oil (the "depletable quantity") per day. Between the end of 1980 and the beginning of 1984, the rate of percentage depletion phases down from 22 percent to 15 percent.

Generally, present law requires the depletable quantity of oil and gas to be allocated among all the properties owned directly by the taxpayer, and among all the properties owned by certain other persons with specified relationships to the taxpayer. For this purpose, the following persons are treated as one taxpayer, and must be aggregated in applying the depletable quantity: component members of the same group of corporations, businesses (including corporations, trusts, or estates) and members of the same family. Present law, however, does not require an allocation of the depletable quantity between a trust and a beneficiary of the trust, or between an individual and his or her controlled corporation. As a result, in these instances each taxpayer has a separate depletable quantity.

Under present law, production from a proven oil or gas property which has been transferred after December 31, 1974, generally is not eligible for percentage depletion. However, this rule generally does not apply to testamentary transfers, certain changes in trust interests, or to specified situations where the transferor and the transferee must allocate one depletable quantity following the transfer. If the allocation rule applies, this special exception to the general prohibition on the transfer of proven oil or gas properties applies to transfers covered by section 351, i.e., to transfers to a corporation which is controlled by the transferor(s) after the transfer. Since the depletable quantity is not allocable between an individual and his or her controlled corporation, this special exception is inapplicable to such transfers. As a result, percentage depletion is not available with respect to production from a proven oil or gas property which has been transferred after 1974 by an individual to his or her controlled corporation.

Reasons for change

The committee believes that the percentage depletion transfer rules may be unnecessarily complex and restrictive in the case of transfers of proven oil or gas properties by individuals to a controlled corporation. The committee believes that these rules, in some instances, may result in an unintended denial of percentage depletion where individuals transfer proven oil or gas properties without thorough consideration of the income tax consequences provided for under present law. Nevertheless, the committee also recognizes the importance of preventing a proliferation of the aggregate number of barrels of oil or gas pro-[19]duction with respect to which an individual may benefit from percentage depletion, and of preventing an increase in the overall number of percentage depletion exemptions.

The committee believes that the various important business, estate planning, and tax policy considerations involved in Congress' restriction

on eligibility for percentage depletion from oil and gas production can be reconciled in some situations not provided for currently in the Code. These instances are where only oil or gas properties are transferred by individuals to a controlled corporation solely in exchange for stock of that corporation, and where an election is made to share one depletable quantity. Therefore, the committee believes that it is appropriate to amend the rules of present law relating to transfers of proven oil or gas properties by individuals to a controlled corporation. To effectuate the reconciliation of the competing considerations involved, the committee has limited its action to transfers by individuals which involve only an exchange of stock for oil or gas properties.[1]

Explanation of provision

The bill provides a limited exception to the generally applicable rules of present law which prohibit oil and gas production from being eligible for percentage depletion if the production is from a proven oil or gas property which has been transferred by an individual to a controlled corporation after December 31, 1974. This limited exception applies only to transfers by individuals, and only where an irrevocable election is made to have the provision apply. There is no limit on the number of individuals who may make transfers of qualified property solely in exchange for stock of the transferee corporation. Similarly, there is no restriction on when such transfers may be made (other than those in the effective date of this provision) and, thus, qualifying transfers need not be made simultaneously.

If the requirements of the bill are satisfied, the provision would allow individuals to transfer oil or gas properties to a controlled corporation without the loss of percentage depletion.[2] The transferee corporation and the transferor(s), however, would have to share one 1,000-barrel amount for percentage depletion purposes.

The bill's exception to the percentage depletion transfer rule applies only to exchanges to which section 351 of the Code (relating to nonrecognition of gain on transfers to a controlled corporation) applies. In addition, the bill imposes other requirements (under new Code sec. 613A(c)(10)) which also must be satisfied. Specifically, the bill provides that the transfer rules of present law (sec. 613A(c)(9)(A)) [20] do not apply to a transfer of "qualified property" by individuals to a "qualified transferee corporation" solely in exchange for stock in such corporation. For this purpose, the term "qualified transferee corporation" means a corporation all of the outstanding stock of which has been issued directly to the individual transferors solely in exchange for "qualified property" held by such individuals. (Initial transfers of "qualified property" to such a corporation would meet the requirements of the provision even though the corporation may have no outstanding stock issued prior to the time of the initial transfer.) A "qualified transferee corporation" may issue stock only in exchange solely for "qualified property." No debt instruments or similar obligations may be issued in exchange for such property, and no stock may be issued for property which is not "qualified property" transferred to the corporation by individuals. As a result, stock of a "qualified transferee corporation" never may be issued for property which is not "qualified property" held by an individual. Similarly, a corporation which has issued any stock for property which is not "qualified property" cannot be a "qualified transferee corporation," even if that stock was issued prior to the effective date of the bill or before a transfer of oil or gas property to the corporation which otherwise might qualify under the amendment. Moreover, the corporation's stock would not be considered to be issued to individuals solely in exchange for a transfer of their "qualified property" if the transfer and stock issuance are part of an indirect sale arrangement between the transferors.

The term "qualified property" means only oil or gas property with respect to which there has been no prior transfer to which the general percentage depletion transfer rules (sec. 613A(c)(9)(A)) applied,[3] and with respect to which the transferor has made an election to have the bill's rules apply. Thus, the term "qualified property" includes both proven and unproven oil or gas property, but *no* other property. Notwithstanding this strict limitation of the term "qualified property," it also includes cash, but not in excess of $1,000 in the aggregate, transferred to the corporation by one or more individuals.

To determine whether the requirements of new paragraph (10) of section 613A(c) are satisfied, the amendment uses a variation of the generally applicable rules relating to assumption of liabilities in connection with a transfer to a controlled corporation (Code sec. 357). (This modification of the ordinarily applicable section 357 tests are *in addition to* the requirement that a transfer meet the terms of section 351 of the Code. In other words, a transaction must meet both the more general requirements of section 351 and the more restrictive tests of the amendment.) For purposes of applying the modified section 351 tests, section 357(a) is applied (subject to the limitations of section 357

[1] The committee previously has reported provisions which would apply to more situations than those covered by this bill. *See* H.R. 1212 (S. Rept. No. 96-532, 96th Cong., 1st Sess. (1979)) and H.R. 2492 (S. Rept. No. 96-684, 96th Cong., 2d Sess. (1980)).

[2] The term oil or gas property has the same meaning, for purposes of the amendment, as under section 613A(c)(9) (relating to transfers of proven oil or gas properties). Therefore, the term means an oil or gas mineral interest within the meaning of section 614 of the Code.

Only proven oil or gas properties are subject to the transfer restrictions of Code section 613A(c)(9). A property is treated as a proven oil or gas property if the principal value of the property has been demonstrated, at the time of the transfer, by prospecting, exploration, or discovery work.

[3] See note 2, *supra*. Code section 613A(c)(9)(B) lists the cases in which the general transfer rules of section 613A(c)(9)(A) do not apply.

(b) relating to tax avoidance and (c) relating to liabilities in excess of basis) as if its references to section 351 included references to the requirement of the amendment that qualified property be transferred solely in exchange for stock in a qualified transferee corporation. In addition, section 357(a)(1) is to be applied as if its reference [21] to nonrecognition of gain includes a reference to the inapplicability of the general percentage depletion transfer rules (sec. 613A(c)(9)(A)). Consequently, the amendment could apply if an individual transfers qualified property to a qualified transferee corporation solely in exchange for stock of that corporation, and in such a manner that the general, proven property, percentage depletion transfer rules (sec. 613A(c)(9)(A) of the Code) otherwise are inapplicable. Moreover, if such a qualified transferee corporation assumes a liability of the transferor (or acquires qualified property subject to a liability), then such an assumption or acquisition by the corporation is not treated as money or other property for purposes of disqualifying a transfer under new paragraph (10). Therefore, such a transfer involving liabilities would not prevent an otherwise qualifying exchange from being within the terms of the amendment.

In applying these modifications of section 357 it is intended that section 357 should be construed in view of the legislative purposes of section 613A and section 357 (including subsections (b) and (c)). As a result, the amendment's requirements that stock be issued directly by the qualified transferee corporation to the transferor solely in exchange for qualified property would not be satisfied if the transfer constituted, e.g., an indirect sale. For instance, a transfer would not qualify under new paragraph (10) if it were utilized to increase the proportionate ownership of one transferor in relation to another transferor.[4]

[4] The same result would occur (as under present law) if only the section 357 requirements applied. *See* Treas. regs. sec. 1.351-1(b)(1); S. Rept. No. 1622, 83d Cong., 2d Sess. 264 (1954).

Similarly, new paragraph (10) would not apply if one transferor receives stock from the transferee corporation and another (other than the transferee corporation) assumes, or becomes responsible for the satisfaction of, a liability of the transferor or to which the transferred property is subject.

The bill's exception to the general percentage depletion transfer rules applies only so long as the transferor retains the stock of the qualified transferee corporation. If any transferor makes a lifetime disposition of his or her stock in a qualified transferee corporation, then the corporation's depletable quantity (as determined without regard to the bill's exception) must be reduced for all periods on or after the date of that disposition. This reduction is equal to an amount which bears the same ratio to the corporation's depletable quantity (as determined without regard to the bill's exception) as the fair market value of the stock disposed of bears to the aggregate fair market value of all outstanding stock of the corporation on the date of the disposition.

Special rules, however, apply to certain interfamily transfers. A transferor may make a lifetime disposition of stock in a qualified transferee corporation to a member of his or her family without having the disposition result in a reduction in the corporation's depletable quantity. However, the corporation's depletable quantity would have to be reduced if stock transferred to such a family member ceased to be held by a member of the transferor's family. For this purpose, members of the transferor's family include only his or her spouse and minor children (and only so long as they retain that status). The bill provides similar special rules applicable to the issuance of stock in a [22] qualified transferee corporation to members of the transferor's family. Under these rules, stock issued to a member of the transferor's family is treated as having been issued directly to the transferor.

Transfers of stock in a qualified transferee corporation by reason of the death of a transferor do not result in a reduction of the corporation's depletable quantity. Similarly, upon the death of a transferor, the recipient (other than the transferor's spouse) of the transferor's stock in a qualified transferee corporation need not retain such stock. A disposition of stock by such a recipient will have no effect on the continued applicability of the exception contained in the committee bill.

The bill provides generally that a "tentative quantity" (within the meaning of sec. 613A(c)) is to be determined for the qualified transferee corporation under the new rules pertaining to transfers of qualified property by individuals to such a corporation. Similarly, the bill provides that the tentative quantity for the transferor (and the transferor's family) for any period is to be reduced by the transferor's pro rata share of the corporation's depletable quantity for that period. For purposes of computing the transferor's pro rata share of the corporation's depletable quantity for a period, a transferor's pro rata share is determined with regard to production from proven oil or gas properties plus production from all other property. In the case of production from a proven oil or gas property, the transferor's pro rata share for any period is that portion of the corporation's depletable quantity which is allocable to production from such property. In the case of production from an unproven oil or gas property, the transferor's pro rata share for any period is that portion of the corporation's depletable quantity which is allocable to production from such property. This amount is multiplied by a fraction, the numerator of which is the fair market value of the transferor's stock in the corporation and the denominator of which is the fair market value of all stock in the corporation. For purposes of the committee's bill, and for computing the reduction in the transferor's tentative quantity, a corporation's depletable quantity for any period is the lesser of (1) the corporation's tentative quantity for any period (determined under sec.

613A(c)(3) and (8)), or (2) the corporation's average daily production for the period.

Except to the extent provided in the provisions of the bill, the generally applicable rules of section 613A continue to apply, as do rules provided in other Code sections which are consistent with the terms, purpose, and policy of this amendment. To ensure this result, the bill specifically grants the Secretary broad authority to prescribe such regulations as may be necessary to accomplish the purposes of the amendment and to prevent a proliferation of the amount of oil or gas subject to percentage depletion.

The provisions of the bill are elective, and apply for only so long as an election is in effect and the terms of the provision otherwise are satisfied. An election under the bill must be made only in such manner as the Secretary may prescribe by regulations. It must be made or or before the due date, including extensions, for filing the corporation's income tax for the corporation's first taxable year ending after the date of the transfer (or if later, after the date of enactment).

The provisions of the bill will apply with respect to post-1979 oil or gas production from proven oil or gas properties transferred after [23] 1974 by individuals. However, for an election to be made under the bill, its requirements must have been satisfied at the time of the transfer and at all times thereafter. Therefore, the amendment will not apply to production from a proven oil or gas property which has been transferred after 1974 if the transfer would not have been allowable under the terms of the bill had the bill been effective on the date of the transfer.

Effective date

The provision will apply to production of oil and gas after December 31, 1979, from property transferred after December 31, 1974.

Revenue effect

It is estimated that this provision will reduce fiscal year budget receipts by $15 million in 1981, by $17 million in 1982, by $19 million in 1983, by $23 million in 1984, and by $26 million in 1985.

[24] E. Tax Credits Allowable Against Alternative Minimum Tax (sec. 5 of the bill and sec. 55 of the Code)

Present law

Under present law, an alternative minimum tax is payable by noncorporate taxpayers to the extent that the tax on the alternative minimum taxable income exceeds their regular income tax, including the "add-on" minimum tax (Code sec. 55).

In general, the alternative minimum taxable income is based on the sum of the taxpayer's gross income, reduced by allowed deductions, and increased by tax preference items, i.e., adjusted itemized deductions and the section 1202 capital gain deduction. The alternative minimum tax rate is 10 percent for amounts from $20,000 to $60,000; 20 percent for amounts from $60,000 to $100,000; and 25 percent for amounts over $100,000.

Present law provides several credits which ordinarily may be used to offset income tax liability. Some of these credits are intended to take into consideration previously paid taxes, and others are intended to encourage particular activities. The regular investment credit, for example, is equal to 10 percent of the cost of investments in certain tangible business property. (Code secs. 38, 46-48).

Tax credits generally are nonrefundable, but excess credits may be carried over to other years. For example, the regular investment credit may be used to offset the first $25,000 of tax liability plus a percentage of tax liability in excess of $25,000. This percentage is 70 percent in 1980 and will increase to 80 percent in 1981 and 90 percent for 1982 and later years. Excess investment credits from a taxable year may be carried over to apply against tax liability for the three preceding and seven succeeding years on a first-in, first-out basis.

As a general rule, only refundable tax credits may be claimed against the amount of the alternative minimum tax. The only nonrefundable tax credit that may offset this tax is the foreign tax credit. Refundable credits are allowed to reduce the alternative minimum tax because such credits would be available to taxpayers in any event. In addition, generally refundable credits and the foreign tax credit represent taxes actually paid.

If the alternative minimum tax applies, present law provides that nonrefundable credits may continue to offset so much of a taxpayer's overall tax liability as does not exceed the applicable percentage of the taxpayer's regular taxes. Nonrefundable credits, therefore, are not allowable against any tax in excess of the regular income tax. However, credit carryovers are restored to the extent they did not result in a reduction of tax by reason of the alternative minimum tax.

Reasons for change

The committee is concerned with the present law rule which provides that nonrefundable tax credits may not be claimed against the [25] alternative minimum tax. Because of this rule, a taxpayer may not currently be able to take full advantage of otherwise allowable tax credits for the current year even though the taxpayer has few or no tax preferences. Therefore, the committee bill allows the nonrefundable tax credits against the portion of alternative minimum tax which is not attributable to net capital gains and adjusted itemized deductions, if the credits are attributable to the active conduct of a trade or business by the taxpayer.

Explanation of provision

Under this provision of the bill, nonrefundable tax credits (other than the foreign tax credit) will be permitted to offset the alternative minimum tax except to the extent that the alternative minimum tax is attributable to net capital gains and adjusted itemized deductions. However, in the case of

the investment tax credit, WIN credit, and new jobs credit, this offset will be available only to the extent the credit is attributable to the active conduct of a trade or business by the taxpayer.[1]

[26] *Effective date*

The provision will apply with respect to taxable years beginning after December 31, 1979.

Revenue effect

It is estimated that this provision will reduce fiscal year budget receipts by $99 million in 1981, $72 million in 1982, by $57 million in 1983, by $39 million in 1984, and by $22 million in 1985. The fiscal year 1981 loss includes $70 million from calendar year 1980 liability.

* * * * *

Public Law 96-605
96th Congress, H.R. 7956 [1]
December 28, 1980

An Act to make various changes in the tax laws.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; AMENDMENT OF 1954 CODE.

(a) SHORT TITLE.—This Act may be cited as the "Miscellaneous Revenue Act of 1980".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

TITLE I—AMENDMENTS RELATING TO INCOME TAX GENERALLY

SEC. 101. TREATMENT OF COMMUNITY INCOME WHERE SPOUSES LIVE APART.

(a) GENERAL RULE.—Part I of subchapter B of chapter 1 (defining gross income, adjusted gross income, taxable income, etc.) is amended by adding at the end thereof the following new section:

"SEC. 66. TREATMENT OF COMMUNITY INCOME WHERE SPOUSES LIVE APART.

"(a) GENERAL RULE.—If—

"(1) 2 individuals are married to each other at any time during a calendar year;

"(2) such individuals—

"(A) live apart at all times during the calendar year, and

"(B) do not file a joint return under section 6013 with each other for a taxable year beginning or ending in the calendar year;

"(3) one or both of such individuals have earned income for the calendar year which is community income; and

"(4) no portion of such earned income is transferred (directly or indirectly) between such individuals before the close of the calendar year,

then, for purposes of this title, any community income of such individuals for the calendar year shall be treated in accordance with the rules provided by section 879(a).

"(b) DEFINITIONS.—For purposes of this section—

"(1) EARNED INCOME.—The term 'earned income' has the meaning given to such term by section 911(b).

"(2) COMMUNITY INCOME.—The term 'community income' means income which, under applicable community property laws, is treated as community income.

"(3) COMMUNITY PROPERTY LAWS.—The term 'community property laws' means the community property laws of

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[1] This provision may be illustrated by the following example. Assume that in 1981, an individual has a $60,000 income tax liability determined under section 1, and has an investment tax credit of $45,000 and a WIN credit of $5,000 (all attributable to his conduct of an active trade or business), thus resulting in a regular tax (as defined in Code section 55(b)(2)) of $10,000 ($60,000 tax less $50,000 credits). Further assume that the individual's alternative minimum tax is $12,000 ($22,000 amount computed under section 55(a)(1) less $10,000 regular tax) and that such minimum tax would be $2,000 ($12,000 less $10,000) if the alternative minimum taxable income were reduced by net capital gains and adjusted itemized deductions.

Under the bill, $2,000 of the alternative minimum tax may be reduced by the tax credits. For purposes of determining the amount of any credits which can be taken against the alternative minimum tax, the amount of the WIN credit is increased by $5,000 (the lesser of the $5,000 credit allowable against the section 1 tax or the $12,000 tax imposed by section 55(a)), and the amount of the investment tax credit is increased by $7,000 (the lesser of $45,000 credit allowable against the section 1 tax or the $12,000 section 55 tax reduced by the $5,000 WIN credit increase). These credits may be used to reduce the section 55 tax for 1981, but may not be used to reduce the 1981 section 1 tax (sec. 55(c)(1)(B)). Therefore, for 1981, the taxpayer's total tax liability will be $20,000 computed as follows: $60,000 (under section 1) plus $12,000 (under section 55) minus (i) investment credits of $47,000 ($45,000 plus $2,000) and (ii) WIN credits of $5,000.

The amount of the unused credits available for carrybacks and carryovers is to be $5,000 for the investment tax credit and $5,000 for the WIN credit, determined as follows:

For purposes of applying section 46(b), the tax liability determination (under section 46(a)(3)) is $47,000—the $45,000 investment tax credit allowable in computing the regular tax (since this amount is less than the actual amount determined under section 46(a)(3), plus the $2,000 amount determined under section 55(c)(1)(A)). For this purpose, the tax credits are $52,000 ($45,000 actual credits plus $7,000 increase under section 55(c)(2)(A)). Thus, the amount of excess credits is $5,000 ($52,000 less $47,000).

For purposes of applying section 50A(b), the tax liability determination (under section 50A(a)(2) is $5,000—the $5,000 WIN credit allowable in computing the regular tax (since this amount is less than the actual amount determined under section 50A(a)(2)), plus zero (the $2,000 amount determined under section 55(c)(1)(A) less the $2,000 investment tax credit allowable against the section 55 tax). For this purpose, the tax credits are $10,000 ($5,000 actual credit plus $5,000 increase under section 55(c)(2)(A)). Thus, the amount of the excess credits is $5,000 ($10,000 less $5,000).

The use of the carryovers of the excess credits is not limited to use against the section 55 tax.

[1] House Report No. 96-1278, page 709, and Senate Report No. 96-1036, page 723.

a State, a foreign country, or a possession of the United States."

(b) CLERICAL AMENDMENT.—The table of sections for part I of subchapter B of chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 66. Treatment of community income where spouses live apart."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to calendar years beginning after December 31, 1980.

SEC. 102. AMORTIZATION OF START-UP EXPENDITURES.

(a) IN GENERAL.—Part VI of subchapter B of chapter 1 (relating to itemized deductions for individuals and corporations) is amended by adding at the end thereof the following new section:

"SEC. 195. START-UP EXPENDITURES.

"(a) ELECTION TO AMORTIZE.—Start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the business begins).

"(b) START-UP EXPENDITURES.—For purposes of this section, the term 'start-up expenditure' means any amount—

"(1) paid or incurred in connection with—

"(A) investigating the creation or acquisition of an active trade or business, or

"(B) creating an active trade or business, and

"(2) which, if paid or incurred in connection wtih the expansion of an existing trade or business (in the same field as the trade or business referred to in paragraph (1)), would be allowable as a deduction for the taxable year in which paid or incurred.

"(c) ELECTION.—

"(1) TIME FOR MAKING ELECTION.—An election under subsection (a) shall be made not later than the time prescribed by law for filing the return for the taxable year in which the business begins (including extensions thereof).

"(2) SCOPE OF ELECTION.—The period selected under subsection (a) shall be adhered to in computing taxable income for the taxable year for which the election is made and all subsequent taxable years.

"(3) MANNER OF MAKING ELECTION.—An election under subsection (a) shall be made in such manner as the Secretary shall by regulations prescribe.

"(d) BUSINESS BEGINNING.—For purposes of this section, an acquired trade or business shall be treated as beginning when the taxpayer acquires it."

(b) CLERICAL AMENDMENT.—The table of sections for part VI of subchapter B of chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 195. Startup expenditures."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to amounts paid or incurred after July 29, 1980, in taxable years ending after such date.

SEC. 104. REVISION OF SOURCE RULES FOR INCOME FROM CERTAIN LEASED AIRCRAFT, VESSELS, AND SPACECRAFT.

(a) IN GENERAL.—Subsection (e) of section 861 (relating to election to treat income from certain aircraft and vessels as income from sources within the United States) is amended to read as follows:

"(e) INCOME FROM CERTAIN LEASED AIRCRAFT, VESSELS, AND SPACECRAFT TREATED AS INCOME FROM SOURCES WITHIN THE UNITED STATES.—

"(1) IN GENERAL.—For purposes of subsection (a) and section 862(a), if—

"(A) a taxpayer owning a craft which is section 38 property (or would be section 38 property but for section 48(a)(5)) leases such craft to a United States person, other than a member of the same controlled group of corporations (as defined in section 1563) as the taxpayer, and

"(B) such craft is manufactured or constructed in the United States,

then all amounts includible in gross income by the taxpayer with respect to such craft for any taxable year ending after the commencement of such lease (whether during or after the period of such lease), including gain from sale, exchange, or other disposition of such craft, shall be treated as income from sources within the United States.

"(2) CERTAIN TRANSFERS INVOLVING CARRYOVER BASIS.—If the taxpayer transfers or distributes a craft to which paragraph (1) applied and the basis of such craft in the hands of the transferee or distributee is determined by reference to its basis in the hands of the transferor or distributor, paragraph (1) shall continue to apply to such craft in the hands of the transferee or distributee.

"(3) CRAFT DEFINED.—For purposes of this subsection, the term 'craft' means a vessel, aircraft, or spacecraft.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to property first leased after the date of the enactment of this Act.

SEC. 105. TREATMENT OF HOMEOWNERS ASSOCIATIONS.

(a) GENERAL RULE.—Subsection (b) of section 528 (relating to tax imposed with respect to certain homeowners associations) is amended to read as follows:

"(b) TAX IMPOSED.—A tax is hereby imposed for each taxable year on the homeowners association taxable income of every homeowners association. Such tax shall be equal to 30 percent of the homeowners association taxable income.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1980.

SEC. 106. TREATMENT OF CERTAIN INCOME OF MUTUAL OR COOPERATIVE ELECTRIC AND TELEPHONE COMPANIES.

(a) TREATMENT OF CERTAIN IN-

COME FOR PURPOSES OF TAX EXEMPT STATUS.—Paragraph (12) of section 501(c) (relating to list of exempt organizations) is amended—

(1) by striking out "(12)" and inserting in lieu thereof "(12)(A)",

(2) by striking out the second sentence, and

(3) by adding at the end thereof the following new subparagraphs:

"(B) In the case of a mutual or cooperative telephone company, subparagraph (A) shall be applied without taking into account any income received or accrued—

"(i) from a nonmember telephone company for the performance of communication services which involve members of the mutual or cooperative telephone company,

"(ii) from qualified pole rentals, or

"(iii) from the sale of display listings in a directory furnished to the members of the mutual or cooperative telephone company.

"(C) In the case of a mutual or cooperative electric company, subparagraph (A) shall be applied without taking into account any income received or accrued from qualified pole rentals.

"(D) For purposes of this paragraph, the term 'qualified pole rental' means any rental of a pole (or other structure used to support wires) if such pole (or other structure)—

"(i) is used by the telephone or electric company to support one or more wires which are used by such company in providing telephone or electric services to its members, and

"(ii) is used pursuant to the rental to support one or more wires (in addition to the wires described in clause (i)) for use in connection with the transmission by wire of electricity or of telephone or other communications.

For purposes of the preceding sentence, the term 'rental' includes any sale of the right to use the pole (or other structure)."

(b) ENGAGING IN POLE RENTALS TREATED AS NOT ENGAGING IN UNRELATED TRADE OR BUSINESS.—Section 513 (defining unrelated trade or business) is amended by adding at the end thereof the following new subsection:

"(g) CERTAIN POLE RENTALS.—In the case of a mutual or cooperative telephone or electric company, the term 'unrelated trade or business' does not include engaging in qualified pole rentals (as defined in section 501(c)(12)(D))."

(c) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendments made by subsection (a) shall apply to all taxable years to which the Internal Revenue Code of 1954 applies.

(b) SUBSECTION (b).—The amendment made by subsection (b) shall apply to taxable years beginning after December 31, 1969.

SEC. 107. EXEMPTION FOR CERTAIN SUBSISTENCE ALLOWANCES RECEIVED BY CERTAIN POLICE OFFICERS BEFORE JANUARY 1, 1978.

(a) GENERAL RULE.—Subsection (b) of section 3 of the Act of October 7, 1978 [Pub. L. 95-427, 1978-2 C.B. 363, 364], entitled "An Act to prohibit the issuance of regulations on the taxation of fringe benefits, and for other purposes" is amended—

(1) by striking out "January 1, 1977" and inserting in lieu thereof "January 1, 1974", and

(2) by striking out "calendar year 1977" and inserting in lieu thereof "calendar year 1974, 1975, 1976, or 1977".

(b) STATUTE OF LIMITATIONS.—In the case of any allowance received during calendar year 1974, 1975, 1976, or 1977, subsections (a)(2) and (e) of such section 3 shall be applied by substituting the date one year after the date of the enactment of this Act for "April 15, 1979" each place it appears.

SEC. 108. TREATMENT OF CERTAIN EXPENSES INCLUDIBLE IN THE INCOME OF THE RECIPIENT.

(a) IN GENERAL.—Subsection (e) of section 274 (relating to specific exceptions to application of disallowance of certain entertainment, etc., expenses) is amended by inserting after paragraph (9) the following new paragraph:

"(10) EXPENSES INCLUDIBLE IN INCOME OF PERSONS WHO ARE NOT EMPLOYEES.—Expenses paid or incurred by the taypayer for goods, services, and facilities to the extent that the expenses are includible in the gross income of a recipient of the entertainment, amusement, or recreation who is not an employee of the taxpayer as compensation for services rendered or as a prize or award under section 74. The preceding sentence shall not apply to any amount paid or incurred by the taxpayer if such amount is required to be included (or would be so required except that the amount is less than $600) in any information return filed by such taxpayer under part III of subchapter A of chapter 61 and is not so included."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to any expenses paid or incurred after December 31, 1980, in taxable years ending after such date.

SEC. 109. INVESTMENT CREDIT FOR CERTAIN PROPERTY USED IN MARITIME SATELLITE COMMUNICATIONS.

(a) GENERAL RULE.—Paragraph (5) of section 48(a) (relating to property used by governmental units) is amended to read as follows:

"(5) PROPERTY USED BY GOVERNMENTAL UNITS.—Property used by the United States, any State or political subdivision thereof, any international organization, or any agency or instrumentality of any of the foregoing shall not be treated as section 38 property. For purposes of the preceding sentence, the International Telecommunications Satellite Consortium, the International Maritime Satellite Organization, and any successor organization of such Consortium or Organization shall not be treated as an international organization."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years begining after December 31, 1979.

SEC. 110. ACQUISITION INDEBTEDNESS.

(a) IN GENERAL.—Section 514(c) of the Internal Revenue Code of 1954 (defining acquisition indebtedness) is amended by adding at the end thereof the following new paragraph:

"(9) REAL PROPERTY ACQUIRED BY QUALIFIED TRUST.—For purposes of this section—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'acquisition indebtedness' does not include indebtedness incurred by a qualified trust in acquiring or improving any real property.

"(B) EXCEPTIONS.—The provisions of subparagraph (A) shall not apply in any case in which—

"(i) the acquisition price is not a fixed amount determined as of the date of acquisition;

"(ii) the amount of any indebtedness or any other amount payable with respect to such indebtedness, or the time for making any payment of any amount, is dependent, in whole or in part, upon any revenue, income, or profits derived from such real property;

"(iii) the real property is at any time after the acquisition leased by the qualified trust to the person selling such property to such trust or to any person who bears a relationship described in section 267(b) to such person;

"(iv) the real property is acquired from, or is at any time after the acquisition leased by the qualified trust to, any person who—

"(I) bears a relationship which is described in section 4975(e)(2)(C), (E), or (G) to any plan with respect to which such trust was formed, or

"(II) bears a relationship which is described in section 4975(e)(2)(F) or (H) to any person described in subclause (I); or

"(v) any person described in clause (iii) or (iv) provides the qualified trust with nonrecourse financing in connection with such transaction and such debt—

"(I) is subordinate to any other indebtedness on such property, or

"(II) bears interest at a rate which is significantly less than the rate available from any person not described in clause (iii) or (iv) at the time such indebtedness is incurred.

"(C) QUALIFIED TRUST.—For purposes of this paragraph, the term 'qualified trust' means any trust which constitutes a qualified trust under section 401."

(b) NO PRECEDENT.—The amendment made by subsection (a) shall not be considered a precedent with respect to extending such amendment (or similar rules) to any other person.

(c) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1980.

TITLE II—AMENDMENTS RELATING TO PENSION PLANS

SUBTITLE A—PREVENTION OF ABUSE OF CERTAIN PENSION PLAN PROVISIONS

SEC. 201. PREVENTION OF ABUSE OF CERTAIN PENSION PLAN PROVISIONS THROUGH THE USE OF SEPARATE CORPORATIONS OR OTHER ORGANIZATIONS.

(a) IN GENERAL.—Section 414 (relating to definitions and special rules relating to pension plan, etc.) is amended by adding at the end thereof the following new subsection:

"(m) EMPLOYEES OF AN AFFILIATED SERVICE GROUP.—

"(1) IN GENERAL.—For purposes of the employee benefit requirements listed in pargaraph (4), except to the extent otherwise provided in regulations, all employees of the members of an affiliated service group shall be treated as employed by a single employer.

"(2) AFFILIATED SERVICE GROUP.—For purposes of this subsection, the term 'affiliated service group' means a group consisting of a service organization (hereinafter in this paragraph referred to as the 'first organization') and one or more of the following:

"(A) any service organization which—

"(i) is a shareholder or partner in the first organization, and

"(ii) regularly performs services for the first organization or is regularly associated with the first organization in performing services for third persons, and

"(B) any other organization if—

"(i) a significant portion of the business of such organization is the performance of services (for the first organization, for organizations described in subparagraph (A), or for both) of a type historically performed in such service field by employees, and

"(ii) 10 percent or more of the interests in such organization is held by persons who are officers, highly compensated employees, or owners of the first organization or an organization described in subparagraph (A).

"(3) SERVICE ORGANIZATIONS.—For purposes of this subsection, the term 'service organization' means an organization the principal business of which is the performance of services.

"(4) EMPLOYEE BENEFIT REQUIREMENTS.—For purposes of this subsection, the employee benefit requirements listed in this paragraph are—

"(A) paragraphs (3), (4), (7), and (16) of section 401(a),

"(B) sections 408(k), 410, 411, and 415,

"(C) section 105(h), and

"(D) section 125.

"(5) OTHER DEFINITIONS. — For purposes of this subsection—

"(A) ORGANIZATION DEFINED.—The term 'organization' means a corporation, partnership, or other organization.

"(B) OWNERSHIP.—In determining ownership, the principles of section 267(c) shall apply.

"(6) PREVENTION OF AVOIDANCE.—The Secretary shall prescribe such regulations as may be necessary to prevent the avoidance with respect to service organizations, through the use of separate organizations, of any employee benefit requirement listed in paragraph (4)."

(b) TECHNICAL AMENDMENTS.—

(1) Paragraph (8) of section 105 (h) (relating to amount paid to highly compensated individuals under a discriminatory self-insured medical expense reimbursement plan) is amended—

(A) by striking out "subsection (b) or (c) of section 414" and inserting in lieu thereof "subsection (b), (c), or (m) of section 414", and

(B) by striking out "CONTROLLED GROUPS" in the paragraph heading and inserting in lieu thereof "CONTROLLED GROUPS, ETC.".

(2) Paragraph (4) of section 125 (g) (relating to special rules for cafeteria plans) is amended—

(A) by striking out "subsection (b) or (c) of section 414" and inserting in lieu thereof "subsection (b), (c), or (m) of section 414", and

(B) by striking out "CONTROLLED GROUPS" in the paragraph heading and inserting in lieu thereof "CONTROLLED GROUPS, ETC.".

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to plan years ending after November 30, 1980.

(2) PLANS IN EXISTENCE ON NOVEMBER 30, 1980.—In the case of a plan in existence on November 30, 1980, the amendments made by this section shall apply to plan years beginning after November 30, 1980.

SUBTITLE B—AMENDMENTS RELATING TO EMPLOYEE STOCK OWNERSHIP PLANS

SEC. 221. CASH DISTRIBUTION OPTION AND PUT OPTION FOR STOCK BONUS PLANS.

(a) IN GENERAL.—Subsection (a) of section 401 (relating to requirements for qualification) is amended by inserting immediately before the last sentence thereof the following new paragraph:

"(23) A stock bonus plan which otherwise meets the requirements of this section shall not be considered to fail to meet the requirements of this section because it provides a cash distribution option to participants if that option meets the requirements of section 409A(h)(2)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to plan years beginning after December 31, 1980.

SEC. 222. LIMITATION ON ANNUAL ADDITIONS TO PARTICIPANT ACCOUNTS UNDER EMPLOYEE STOCK OWNERSHIP PLANS.

(a) IN GENERAL.—Subparagraph (A) of section 415(c)(6) (relating to special limitation for employee stock ownership plan) is amended by inserting ", or purchased with cash contributed," after "contributed".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to years beginning after December 31, 1980.

SEC. 223. VALUATION OF EMPLOYER SECURITIES IN TAX CREDIT EMPLOYEE STOCK OWNERSHIP PLANS.

(a) IN GENERAL.—Clause (i) of section 48(n)(6)(B) (defining value for employer securities) is amended by striking out "the due date for filing the return for the taxable year determined with regard to extensions)" and inserting in lieu thereof "the date on which the securities are contributed to the plan".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply with respect to taxable years beginning after December 31, 1980.

SEC. 224. PARTICIPATION OF SUBSIDIARY CORPORATION IN TAX CREDIT EMPLOYEE STOCK OWNERSHIP PLAN.

(a) IN GENERAL.—Paragraph (4) of section 409A(1) (defining controlled group of corporations) is amended—

(1) by striking out the caption and inserting in lieu thereof "(4) APPLICATION TO CONTROLLED GROUP OF CORPORATIONS.—",

(2) by striking out "COMMON PARENT MAY OWN ONLY" in the caption of subparagraph (B) and inserting in lieu thereof "WHERE COMMON PARENT OWNS AT LEAST", and

(3) by adding at the end thereof the following new subparagraph:

"(C) WHERE COMMON PARENT OWNS 100 PERCENT OF FIRST-TIER SUBSIDIARY.—For purposes of subparagraph (A), if the common parent owns directly stock possessing all of the voting power of all classes of stock and all of the nonvoting stock, in a first-tier subsidiary, and if the first-tier subsidiary owns directly stock possessing at least 50 percent of the voting power of all classes of stock, and at least 50 percent of each class of nonvoting stock, in a second-tier subsidiary of the common parent, such second-tier subsidiary (and all other corporations below it in the chain which would meet the 80 percent test of section 1563(a) if the second-tier subsidiary were the common parent) shall be treated as includible corporations.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to qualified investment for taxable years beginning after December 31, 1978.

SEC. 225. PARTICIPATION RULES FOR TAX CREDIT EMPLOYEE STOCK OWNERSHIP PLAN WHICH IS ONLY EMPLOYER-PROVIDED ALTERNATIVE TO INDIVIDUAL RETIREMENT SAVINGS.

(a) IN GENERAL.—Subsection (b) of section 410 (relating to eligibility) is amended—

(1) by redesignating paragraph (2) as (3),

(2) by striking out "paragraph (1)" in paragraph (3) (as so redesignated) and inserting in lieu thereof "paragraphs (1) and (2)", and

(3) by inserting after paragraph (1) the following new paragraph:

"(2) SPECIAL RULE FOR CERTAIN PLANS.—A trust which is part of a tax credit employees stock ownership plan which is the only plan of an employer intended to qualify under section 401(a) shall not be treated as not a qualified trust under section 401(a) solely because it fails to meet the requirements of paragraph (1) if—

"(A) it benefits 50 percent or more of all the employees who are eligible under the plan (excluding employees

who have not satisfied the minimum age and service requirements, if any, prescribed by the plan as a condition of participation), and

"(B) the sum of the amounts allocated to each participant's account for the year does not exceed 2 percent of the compensation of that participant for the year."

(b) CONFORMING AMENDMENTS.—

(1) The last sentence of section 401(a)(4) is amended by striking out "section 410(b)(2)(A)" and inserting in lieu thereof "section 410(b)(3)(A)".

(2) Subparagraph (B) of section 401(d)(3) is amended—

(A) by striking out "section 410(b)(2)(A)" and inserting in lieu thereof "section 410(b)(3)(A)", and

(B) by striking out "section 410(b)2)(C)" and inserting in lieu thereof "section 410(b)(3)(C)".

(3) The last sentence of section 408(k)(2) is amended by striking out "section 410(b)(2)" and inserting in lieu thereof "section 410(b)(3)".

(4) Clause (i) of section 408(k)(3)(B) is amended by striking out "section 410(b)(2)" and inserting in lieu thereof "section 410(b)(3)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to plan years beginning after December 31, 1980.

SEC. 226. APPLICATION OF CASH OR DEFERRED ARRANGEMENT RULES TO CAFETERIA PLANS.

(a) IN GENERAL.—Paragraph (2) of section 125(d) (relating to deferred compensation plans excluded) is amended by adding at the end thereof the following: "The preceding sentence shall not apply in the case of a profit-sharing or stock bonus plan which includes a qualified cash or deferred arrangement (as defined in section 401(k)(2)) to the extent of amounts which a covered employee may elect to have the employer pay as contributions to a trust under such plan on behalf of the employee."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to taxable years beginning after December 31, 1980.

SEC. 227. ELIMINATION OF WITHHOLDING TAX ON PENSIONS PAID TO CERTAIN NONRESIDENT ALIENS.

(a) IN GENERAL.—Section 871(f) (relating to taxation of nonresident alien individuals) is amended to read as follows:

"(1) IN GENERAL.—For purposes of this section, gross income does not include any amount received as an annuity under a qualified annuity plan described in section 403(a)(1), or from a qualified trust described in section 401(a) which is exempt from tax under section 501(a), if—

"(A) all of the personal services by reason of which the annuity is payable were either—

"(i) personal services performed outside the United States by an individual who, at the time of performance of such personal services, was a nonresident alien, or

"(ii) personal services described in section 864(b)(1) performed within the United States by such individual, and

"(B) at the time the first amount is paid as an annuity under the annuity plan or by the trust, 90 percent or more of the employees for whom contributions or benefits are provided under such annuity plan, or under the plan or plans of which the trust is a part, are citizens or residents of the United States.

"(2) EXCLUSION.—Income received during the taxable year which would be excluded from gross income under this subsection but for the requirement of paragraph (1)(B) shall not be included in gross income if—

"(A) the recipient's country of residence grants a substantially equivalent exclusion to residents and citizens of the United States; or

"(B) the recipient's country of residence is a beneficiary developing country within the meaning of section 502 of the Trade Act of 1974 (19 U.S.C. 2462).".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to amounts received after July 1, 1979.

TITLE III—AMENDMENTS RELATING TO ESTATE TAX

SEC. 301. ADDITIONAL 3 YEARS ALLOWED TO AMEND GOVERNING INSTRUMENTS TO MEET REQUIREMENTS FOR GIFT OF SPLIT INTEREST TO CHARITY.—

(a) CHARITABLE LEAD TRUSTS AND CHARITABLE REMAINDER TRUSTS IN THE CASE OF ESTATE TAXES.—The first sentence of paragraph (3) of section 2055(e) (relating to disallowance of deductions in certain cases) is amended—

(1) by striking out "December 31, 1977" and inserting in lieu thereof "December 31, 1978"; and

(2) by striking out "December 31, 1978" each place it appears and inserting in lieu thereof "December 31, 1981".

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) shall apply in the case of decedents dying after December 31, 1969.

(2) CHARITABLE LEAD TRUSTS AND CHARITABLE REMAINDER TRUSTS IN THE CASE OF INCOME AND GIFT TAXES.—Section 514(b) (and section 514(c) insofar as it relates to section 514(b)) of the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1, 118] shall be applied as if the amendment made by subsection (a) had been included in the amendment made by section 514(a) of such Act.

TITLE IV—MISCELLANEOUS AMENDMENTS

SEC. 401. TREATMENT OF CERTAIN SOCIAL SECURITY TAX WAIVER EXEMPTIONS.

(a) WAIVER CERTIFICATE.—

(1) IN GENERAL.—Notwithstanding any other provision of law, any waiver certificate filed by a qualified corporation (hereafter in this section referred to as the "corporation") under section 3121(k)(1) of the Internal Revenue Code of 1954 (relating to waiver of

exemption from social security taxes by certain organizations) shall be deemed not to be effective, for purposes of the taxes imposed by section 3101 of such Code, with respect to any wages—

(A) paid by the Corporation to any employee thereof after December 31, 1972, and before April 1, 1975, if the Corporation furnishes to the Secretary of the Treasury or his delegate evidence reasonably satisfactory to him that the Corporation as refunded, prior to February 1, 1977, to such employee (or his survivors or estate) the full amount of the taxes imposed by section 3101 of such Code on such wages, or

(B) paid after March 31, 1975, and prior to July 1, 1977, by the Corporation to an individual as an employee of the Corporation, if the Corporation furnishes to the Secretary of the Treasury or his delegate evidence reasonably satisfactory to him that (i) such individual was not an employee of the Corporation on June 30, 1978, and (ii) no amount of the taxes imposed by section 3101 of such Code on such wages were withheld by the Corporation from such wages.

(2) APPLICATION OF PARAGRAPH (1).—

(A) EVIDENCE TO BE SUBMITTED TO SECRETARY.—The provisions of paragraph (1) shall not apply to wages described in subparagraph (A) or (B) of such paragraph unless, prior to the close of the one-year period which begins on the date of the enactment of this Act, the Corporation furnishes to the Secretary of the Treasury or his delegate the evidence referred to in either such subparagraph.

(B) TAX NOT IMPOSED.—If the provisions of paragraph (1) apply with respect to any wages paid by the Corporation to an employee thereof, no taxes imposed on such wages by section 3101 of the Internal Revenue Code of 1954 shall be payable, and no interest or penalty with respect to the imposition of taxes by such section on such wages (or with respect to the imposition of taxes by such section or section 3111 of such Code on any wages paid by the Corporation prior to January 1, 1978) shall be imposed or collected.

(C) CREDIT AGAINST TAX.—Under regulations prescribed by the Secretary, there shall be allowed as a one-time credit against the tax imposed on the Corporation under section 3101 or 3111 of the Internal Revenue Code of 1954 (and any interest or penalties imposed thereon) an amount equal to the sum of—

(i) all amounts of tax imposed by section 3101 of such Code which have been paid by the Corporation with respect to wages to which paragraph (1) applies, and

(ii) all amounts paid by such Corporation as a penalty or as interest with respect to the tax imposed by section 3101 or 3111 of such Code on such wages.

(b) TREATMENT FOR PURPOSES OF SOCIAL SECURITY ACT.—In the administration of titles II and XVIII of the Social Security Act, any wages paid to any individual to which the provisions of subsection (a) apply shall be treated as wages (within the meaning of section 209 of such Act) for purposes of determining—

(1) entitlement to, or amount of, any insurance benefit payable to such individual or any other person on the basis of the wages and self-employment income of such individual, or

(2) entitlement of such individual to benefits under title XVIII of such Act or entitlement of any other person to such benefits on the basis of the wages and self-employment income of such individual.

(c) QUALIFIED CORPORATION DEFINED.—For purposes of this section, the term "qualified corporation" means any corporation which—

(1) filed a waiver certificate under section 3121 of the Internal Revenue Code of 1954 during 1968;

(2) filed a second waiver certificate under such section during 1975 believing that no other waiver certificate had been filed;

(3) received a refund of the taxes imposed by sections 3101 and 3111 of such Code with respect to certain wages paid to more than 120 but less than 180 employees who did not concur in the filing of the second waiver certificate; and

(4) was notified during 1977 by the Internal Revenue Service that the certificate had been filed during 1968.

(d) LIABILITY FOR TAXES.—Except as provided in subsection (a)(2)(C)(ii), nothing in this section shall be construed to relieve the Corporation of any liability for the payment of the taxes imposed by section 3111 of the Internal Revenue Code of 1954 with respect to any wages paid by it to any individual for any period.

SEC. 402. TREATMENT OF AUTHORS AND ARTISTS AS EMPLOYEES.

(a) IN GENERAL.—An author or artist performing services under contract with a corporation shall be considered as an employee of the corporation for the purpose of applying the provisions specified in section 7701(a)(20) of the Internal Revenue Code of 1954, if, on December 31, 1977, such author or artist was a participant in one or more of the pension, profit-sharing or annuity plans of such corporation which are described in subsection (b)(2).

(b) DEFINITIONS.—For purposes of this section—

(1) CONTRACT.—The term "contract" means a contract which during its term—

(A) requires such author or artist to give the corporation first reading or first refusal on writings or drawings of specified types, and prohibits him from offering any such writing or drawing to any other publication unless it has been offered to and rejected by the corporation; or

(B) requires such author or artist to use his best efforts to produce work of specified types for the corporation.

(2) CORPORATION.—The term "corporation" means a corporation which for at least 15 years prior to January 1, 1978, had in effect one or more pension, profit-sharing and annuity plans, each of which—

(A) had contained from its inception a definition of the term "employee" that included the category of "authors and artists under contract", and

(B) had been determined by the Secretary of the Treasury (taking into account the definition described in subparagraph (A)) to be a qualified plan within part I of subchapter D of chapter 1 of subtitle A of the Internal Revenue Code of 1954 for all of such years.

(c) EFFECTIVE DATE.—The provisions of this section shall apply to taxable years ending after December 31, 1980.

Approved December 28, 1980.

House Report No. 96-1278 2d Session

[Bracketed numerals indicate official report page numbers]

MISCELLANEOUS REVENUE ACT OF 1980

SEPTEMBER 4, 1980.

Mr. ULLMAN, from the Committee on Ways and Means, submitted the following report together with additional views to accompany H.R. 7956.[1]

The Committee on Ways and Means, to whom was referred the bill (H.R. 7956) to make various changes in the tax laws, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments (stated in terms of page and line numbers of the introduced bill) are as follows:

Page 2, line 22, strike out "such individuals" and insert in lieu thereof "one or both of such individuals".

Page 8, line 6, strike out "natural".

Page 8, strike out lines 7 through 13 and insert the following:

"(iii) the preservation of open space (including farmland and forest land) where such preservation is—

"(I) for the scenic enjoyment of the general public, or

"(II) pursuant to a clearly delineated Federal, State, or local governmental conservation policy,

and will yield a significant public benefit, or

Page 15, strike out lines 18 through 20 and insert the following:

(c) EFFECTIVE DATES.—

(1) Subsection (a).—The amendments made by subsection (a) shall apply to all taxable years to which the Internal Revenue Code of 1954 applies.

[2] (b) Subsection (b).—The amendment made by subsection (b) shall apply to taxable years beginning after December 31, 1969.

Page 16, line 4, strike out "January 1, 1975" and insert in lieu thereof "January 1, 1974".

Page 16, line 6, strike out "calendar year 1975" and insert in lieu thereof "calendar year 1974, 1975".

Page 16, line 9, strike out "calendar year 1975" and insert in lieu thereof "calendar year 1974, 1975".

Page 27, after line 4, insert the following:

(b) CONFORMING AMENDMENTS.—

(1) The last sentence of section 401(a)(4) is amended by striking out "section 410(b)(2)(A)" and inserting in lieu thereof "section 410(b)(3)(A)".

(2) Subparagraph (B) of section 401(d)(3) is amended—

(A) by striking out "section 410(b)(2)(C)" and inserting in lieu thereof "section 410(b)(3)(A)", and

(B) by striking out "section 410(b)(2)(C)" and inserting in lieu thereof "section 410(b)(3)(C)".

(3) The last sentence of section 408(k)(2) is amended by striking out "section 410(b)(2)" and inserting in lieu thereof "section 410(b)(3)".

(4) Clause (i) of section 408(k)(3)(B) is amended by striking out "section 410(b)(2)" and inserting in lieu thereof "section 410(b)(3)".

Page 27, strike out lines 5 and 6, and insert the following:

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to plan years beginning

[3] I. SUMMARY

SECTION 101. TREATMENT OF CERTAIN COMMUNITY INCOME FOR SPOUSES LIVING APART

Under present law, income considered community property under State law is taxed in equal shares to a husband and wife. Generally, under this provision, community property laws are to be disregarded for income tax purposes when the spouses have lived apart for the entire year and no portion of the income earned by one spouse has been transferred to the other spouse. The provision is intended to provide relief for abandoned spouses who are presently taxed on a portion of the income earned by the other spouse.

SEC. 102. AMORTIZATION OF BUSINESS STARTUP COSTS

Under present law, costs incurred prior to the commencement of a business normally are nondeductible because they are not incurred in carrying on a trade or business. These startup or preopening costs must be capitalized and often cannot be depreciated or amortized because no ascertainable useful life can be established for these costs. However, the capitalized costs may be recovered for purposes of measuring gain or loss upon the disposition or cessation of the business.

Under this provision, qualifying business startup or investigatory expenses may, at the election of the taxpayer, be amortized over a period of not less than 60 months.

* * * * *

[4] SEC. 105. REVISION OF SOURCE RULES FOR INCOME FROM CERTAIN LEASED AIRCRAFT, VESSELS, AND SPACECRAFT

This provision would revise the rules for determining the source of income from the lease of certain vessels, aircraft, and spacecraft. The income or loss would generally be treated as from U.S. sources if the craft qualifies (or

[1] Public Law 96-605, page 702. This publication of the committee report is limited to pertinent excerpts.

would qualify except for governmental use) for the investment tax credit, is leased to a U.S. person, and is U.S. manufactured. This rule would treat income as from U.S. sources in later periods even if the craft is then leased to a foreign person.

SEC. 106. TAX RATES APPLICABLE TO NONEXEMPT INCOME OF HOMEOWNERS ASSOCIATIONS

Under present law, a qualified homeowners association is not taxed on its exempt function income. Other income, less certain deductions, is taxed at the highest corporate rate of 46 percent except for long-term capital gains, which are taxed at a rate of 28 percent. Under this provision of the bill, all income of a homeowners association (other than exempt function income) will be taxed at a rate of 30 percent.

SEC. 107. TAX TREATMENT OF CERTAIN INCOME OF MUTUAL OR COOPERATIVE TELEPHONE AND ELECTRIC COMPANIES

This section of the bill provides that, in determining whether a mutual or cooperative telephone or electric company meets the 85 percent member-income requirement for tax exemption (under Code sec. 501(c)(12)), any income from rental of poles (used in the cooperative's exempt activities) or from display listings in a directory is to be disregarded. The section also provides that income from the rental of such poles by mutual or cooperative telephone and electric companies is not subject to the tax on unrelated business taxable income.

SEC. 108. REFUND OF TAXES ON CERTAIN STATE POLICE OFFICER SUBSISTENCE ALLOWANCES

Under present law, cash meal allowances received by State police officers are includible in gross income. However, Public Law 95-427 [1978-2 C.B. 363] provided that certain cash meal allowances received by State police officers during the period after 1969 and before 1977 are not includible in income to the extent the allowances *were not reported* by the officers.

The provision will allow a refund or credit of taxes paid by a State police officer with respect to cash meal allowances which *were reported* in gross income in returns filed by the officer for calendar years 1974, 1975, and 1976.

[5] SEC. 109. CLARIFICATION OF LIMITATION ON DEDUCTIBILITY OF CERTAIN ENTERTAINMENT FACILITY EXPENSES INCLUDIBLE IN INCOME OF RECIPIENT

Under this provision, the general rule for the disallowance of deductions for entertainment, amusement, or recreation expenses (Code sec. 274(a)) does not apply to expenses which are includible in the gross income of the recipient of the entertainment, amusement, or recreation as compensation for services or as a prize or award under Code section 74. This provision will not apply if the taxpayer fails to include the amount in any information return (Form 1099) which is required to be filed with the Internal Revenue Service (or would be required except that the amount is less than $600).

SEC. 201.[1] PREVENTION OF ABUSE OF CERTAIN EMPLOYEE BENEFIT REQUIREMENTS

Under present law, individuals employed by certain separate but related entities are aggregated and treated as employed by a single employer for purposes of the rules relating to qualified retirement plans. To eliminate certain abuses resulting under present law, this provision expands the aggregation rules with respect to the treatment of certain service organizations and related organizations for purposes of satisfying requirements for qualified retirement plans, medical reimbursement plans, cafeteria plans, and simplified employee pensions.

SECS. 221-226. PROVISIONS RELATING TO EMPLOYEE STOCK OWNERSHIP AND CAFETERIA PLANS

1. Cash distribution option and put option for stock bonus plans (sec. 221 of the bill)

This provision will permit a tax-qualified stock bonus plan to distribute cash to a participant entitled to a distribution, subject to the participant's right to demand that benefits be distributed in the form of employer stock. If a stock bonus plan provides for cash distributions and if stock which is distributed is not readily tradable on an established market, the participant must have the right to require the employer to repurchase the stock.

2. Special limitation for tax credit employee stock ownership plans and employee stock ownership plans (sec. 222 of the bill)

Under this provision, the increase in the dollar limitation on annual additions with respect to a participant in a tax credit employee stock ownership plan or an employee stock ownership plan (provided certain requirements are met with respect to allocations under the plan) will be the lesser of (1) the usual dollar limitation on annual additions to a participant's account, or (2) the amount of employer securities (or cash used to acquire such securities) contributed to the plan.

3. Valuation of employer securities in tax credit employee stock ownership plans (sec. 223 of the bill)

Under this provision, the value of employer securities listed on a national exchange contributed to a tax credit employee stock ownership plan will be the average of the closing prices of such securities for the 20 consecutive trading days immediately preceding the date of contribution to the plan.

[6] *4. Participation of subsidiary corporation in a tax credit employee stock ownership plan (sec. 224 of the bill)*

Under this provision, if a parent corporation owns 100 percent of a first-tier subsidiary and the first-tier subsidiary owns 50 percent of a second-tier subsidiary, the second-tier subsidiary is allowed to contribute employer securities of the parent corporation to its tax credit employee stock ownership plan. In addition, parent stock could be contributed by 80-percent owned lower-tier subsidiaries in this chain.

5. Retirement savings by tax credit employee stock ownership plan participants (sec. 225 of the bill)

Under this provision, if employees

[1] 126 Cong. Rec. H12503-5 (daily ed. Dec. 13, 1980).

are permitted to elect out of a tax credit employee stock ownership plan for the purpose of establishing IRAs, the tax credit employee stock ownership plan does not fail to meet the minimum coverage requirements of the Code if the plan benefits at least 50 percent of all employees (excluding employees who have not satisfied the minimum age and service requirements or who are otherwise permitted to be excluded), and if the total allocations under the tax credit employee stock ownership plan are equal to no more than two percent of the compensation of participating employees.

6. Cafeteria plans permitted to provide deferred compensation under rules applicable to cash or deferred profit-sharing and stock bonus plans (sec. 226 of the bill)

Under this provision, benefits under a cafeteria plan could include amounts which an employee covered by a profit-sharing or stock bonus plan with a qualified cash or deferred arrangement can elect to have the employer pay as a contribution to a trust under a profit-sharing or stock bonus plan. Amounts contributed by the employer, pursuant to the employee's election, will be treated as nontaxable benefits for purposes of the "cafeteria" plan rules.

* * * * *

SEC. 302. EXTENSION OF TIME TO AMEND GOVERNING INSTRUMENTS OF CHARITABLE SPLIT-INTEREST TRUSTS

The Tax Reform Act of 1969 [Pub. L. 91-172, 1969-3 C.B. 10] imposed new requirements which must be satisfied by charitable lead and remainder trusts in order for an income, gift, or estate tax deduction to be allowed for the transfer of an income interest or a remainder interest to charity. However, certain exceptions were provided in the case of wills executed, or property transferred in trust, on or before October 9, 1969, in order to allow a reasonable period of time to take the new rules into account.

The provision extends for two years, until December 31, 1980, the time to amend, or commence judicial proceedings to amend, instruments of both charitable lead trusts or charitable remainder trusts which were executed before December 31, 1977, in order to conform such instruments to the 1969 Act requirements for a charitable deduction to be allowed for income, gift, or estate tax purposes.

[7] II. EXPLANATION OF THE BILL

A. Treatment of Certain Community Income for Spouses Living Apart (sec. 101 of the bill and new sec. 66 of the Code)

Present law

Under present income tax laws, income considered community property under State law generally is taxed in equal shares to a husband and wife. Consequently, if a husband and wife file separate returns, each is usually required to report one-half of the income considered community property.

Reasons for change

Under present law, an abandoned spouse may be liable for Federal income tax on one-half of the community income earned by the other spouse even though the abandoned spouse has not actually received or benefited from any of the income. The committee believes that in these circumstances a spouse should not be taxed on community income earned or received by the other spouse.

Explanation of provision

If certain requirements are met, State community property laws would be disregarded with respect to certain types of income for Federal income tax purposes. To qualify, a couple must be married at some time during the calendar year, but live apart during the entire calendar year and not file a joint return with respect to a taxable year beginning or ending in the calendar year. In addition, one or both of the spouses must have earned income for the calendar year that is community income, and no portion of that earned income must have been transferred directly or indirectly between the spouses during the calendar year. For purposes of the latter income transfer test, the committee intends that transfers of *de minimis* amounts or value are not to be taken into account. It is anticipated that definitive guidance concerning these amounts will be prescribed in Treasury regulations, revenue rulings, or revenue procedures, and periodically revised as circumstances may warrant. Further, a transfer or payment to, or for the benefit of, the couple's dependent child is not to treated as an indirect transfer to an abandoned spouse solely because the payment or transfer satisfies an obligation of support imposed on the abandoned spouse.

If the requirements are met, any community income of the spouses for the calendar year is allocated in accordance with Code section 879(a). Under that provision, earned income (other than trade or business income and a partner's distributive share of partnership income) is, for tax purposes, the income of the spouse who rendered the personal services. In the case of income derived from a trade or business (other than that carried on by a partnership), the income is [8] treated as the husband's income unless the wife exercises substantially all of the management and control of the trade or business. In the case of trade or business income of a partnership, the income is taxed to the spouse who has a distributive share of the partnership profits.

Effective date

The provision applies to calendar years beginning after December 31, 1979.

Revenue effect

It is estimated that this provision will have a negligible effect on budget receipts.

[9] B. Amortization of Business Start-up Costs (sec. 102 of the bill and new sec. 194 of the Code)

Present law

In general

Under present law, ordinary and

necessary expenses paid or incurred in carrying on a trade or business, or engaging in a profit-seeking activity, are deductible. Expenses incurred prior to the establishment of a business normally are not deductible currently since they are not incurred in carrying on a trade or business or while engaging in a profit-seeking activity.

Expenditures made in acquiring or creating an asset which has a useful life that extends beyond the taxable year normally must be capitalized. These costs ordinarily may be recovered through depreciation or amortization deductions over the useful life of the asset. However, costs which relate to an asset with either an unlimited or indeterminate useful life may be recovered only upon a disposition or cessation of the business.

Certain business organizational expenses for the formation of a corporation or partnership may be treated as deferred expenses, on an elective basis, and amortized over a period of not less than 60 months (Code secs. 248 and 709). Expenditures eligible for amortization only include expenditures which are directly incident to the creation of the corporation or business. Preopening or startup expenses, such as employee training expenses, are ineligible for amortization under the business organizational expense provisions.

Investigatory expenses

Investigatory expenses are costs of seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter any business. Business investigatory expenses may be of either a general or specific nature. The former are related either to businesses generally, or to a category of business; the latter are related to a particular business.

Business investigatory expenses generally are nondeductible regardless of whether they are incurred by an existing business in relation to another business or by a taxpayer who is not in any business. However, taxpayers may be able to deduct a loss for business investigatory expenses incurred in an unsuccessful attempt to acquire a specific business.[1] Nevertheless, business investigatory expenses of a general nature normally are viewed as being either nondeductible personal expenses, or as not being ordinary and necessary trade or business expenses, viz., because no business exists, within the meaning of section 162 of the Code.

[10] *Startup costs*

Startup or preopening expenses are costs which are incurred subsequent to a decision to acquire or establish a particular business and prior to its actual operation. Generally, the term "startup costs" refers to expenses which would be deductible currently if they were incurred after the commencement of the particular business operation to which they relate. Such costs may be incurred by a party who is not engaged in any existing business, or by a party with an existing business who begins a new one that is unrelated, or only tangentially related, to his or her existing business.

Startup costs may include expenses relating to advertising, employee training, lining-up distributors, suppliers, or potential customers, and professional services in setting up books and records. However, startup expenses also may refer to certain items related to the establishment and operation of a business which are nondeductible and nonamortizable even if they are incurred subsequent to commencement of business operations. These nondeductible and nonamortizable expenses either may be of a purely capital nature, or may be capitalizable simply because they relate to a business with an indeterminate life.

Reasons for change

The committee believes that the provision for the amortization of business startup and investigatory expenses will encourage formation of new businesses and decrease controversy and litigation arising under present law with respect to the proper income tax classification of startup expenditures.

[1] See *Harris W. Seed,* 52 T.C. 880 (1969), *acq.,* 1970-2 C.B. xxi; Rev. Rul. 77-254, 1977-2 C.B. 63.

Explanation of provision

In general

Under the provision, business startup expenditures may be amortized, at the election of the taxpayer, over a period of not less than 60 months.

Eligible expenditures

In general, expenditures eligible for amortization must satisfy two requirements. First, the expenditures must be paid or incurred in connection with creating, or investigating the creation or acquisition of, a trade or business entered into by the taxpayer. Second, the expenditure involved must be one which would be allowable as a deduction for the taxable year in which it is paid or incurred if it were paid or incurred in connection with the expansion of an existing trade or business in the same field as that entered into by the taxpayer.

Under the provision, eligible expenses consist of investigatory costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or to enter that business. These costs include expenses incurred for the analysis or survey of potential markets, products, labor supply, transportation facilities, etc. Eligible expenses also include startup costs which are incurred subsequent to a decision to establish a particular business and prior to the time when the business begins. For example, startup costs include advertising, salaries and wages paid to employees who are being trained and their instructors, travel and other expenses incurred in lining up prospective dis-[11]tributors, suppliers or customers, and salaries or fees paid or incurred for executives, consultants, and for similar professional services.

In the case of an existing business, eligible startup expenditures do not include deductible ordinary and necessary business expenses paid or incurred in connection with an expansion of the business. As under present law, these expenses will continue to be currrently deductible. The determination of whether there is an expansion of an

existing trade or business or a creation or acquisition of a new trade or business is to be based on the facts and circumstances of each case as under present law.

Startup expenditures eligible for amortization do not include any amount with respect to which a deduction would not be allowable to an existing trade or business for the taxable year in which the expenditure was paid or incurred. Thus, amounts paid or incurred in connection with the sale of stock, securities, or partnership interests are not within the definition of startup expenditures, e.g., securities registration expenses, underwriters' commissions, etc., are not startup expenditures. In addition, the amortization election for startup expenditures does not apply to amounts paid or incurred as part of the acquisition cost of a trade or business. Also, startup expenditures do not include amounts paid or incurred for the acquisition of property to be held for sale or property which may be depreciated or amortized based on its useful life, including expenses incident to a lease and leasehold improvements. Whether an amount is consideration paid to acquire a business (or an interest therein) depends upon the facts and circumstances of the situation. Corporate or partnership organizational expenditures which may be amortized under provisions of present law (Code sec. 248 or 709) are covered by those amortization provisions rather than this provision.

Trade or business requirement

Expenditures must relate to the investigation or creation of an active trade or business (within the meaning of Code sec. 162). Thus, expenditures attributable to an investment are not eligible for amortization under this provision. For this purpose, an activity with respect to which expenses are deductible only as itemized deductions for individuals (Code sec. 212) is not considered to be a trade or business. In addition, an activity is not considered to be a trade or business activity solely because the property used in the activity may be eligible for special capital gain or ordinary loss treatment under Code section 1231. Further, in the case of rental activities, there must be significant furnishing of services incident to the rentals to constitute an active business (within the meaning of Code sec. 162) rather than an investment. Thus, a rental activity is not considered to be an active trade or business solely because deductions attributable to it are allowable in computing adjusted gross income (Code sec. 62(5)).

Investigatory expenses for acquisition of existing businesses

In addition to the active business requirement applicable to the entity, in the case of investigatory expenditures incurred by a taxpayer with respect to the acquisition of an existing trade or business, the taxpayer will be considered to have entered into a trade or business only if the taxpayer has an equity interest in, and actively participates [12] in the management of, the trade or business. For this purpose, a taxpayer will not be considered to have a qualifying interest with respect to an investment represented by a bond or other debt instrument (even if convertible), preferred stock, or a limited partnership interest.

A sole proprietor would always be considered to have an operator equity interest in the trade or business. In the case of a taxpayer incurring investigatory expenses with respect to the acquisition of common stock, a taxpayer would usually be considered to have acquired an investment interest rather than a qualifying trade or business interest. Thus, investigatory expenses attributable to the acquisition of corporate stock generally will not be eligible for amortization. (As under present law, certain investment counseling and similar expenses paid or incurred with respect to investments held by an individual investor would be currently deductible as an itemized deduction for the production of income, etc., under Code section 212.) However, if in substance, a transaction is the acquisition of the assets of a trade or business, the investigatory expenses are eligible for amortization even though one of the steps of the transaction involved the acquisition of stock, e.g., the acquisition of a corporation which is then liquidated. Further, for example, a corporate taxpayer will be considered to have acquired the trade or business assets of an acquired corporation, rather than having made a portfolio investment in stock, if the acquired corporation becomes a member of an affiliated group which includes the taxpayer incurring the investigatory expenses and a consoliated income tax return is filed for that group.

In the case of the acquisition of a general partnership interest, the taxpayer could be considered to have acquired an active interest if the taxpayer actively participates in the management of the trade or business.

Taxpayer eligible for amortization

In general, the amortization deduction is allowable to the taxpayer who incurs the startup expenditures and enters the trade or business. In the case of startup expenditures incurred by a corporate taxpayer (including a subchapter S corporation), the amortization deduction is to be taken on the income tax return for that corporation and is not deductible as a special item to any shareholder. In the case of a sole proprietor, the amortization deduction is allowable as a deduction for the trade or business with respect to which the startup expenditures were paid or incurred. In the case of startup expenditures incurred by a partnership, the amortization deduction is to be taken into account in computing the taxable income of the partnership (except to the extent it may be required to be taken into account separately under regulations prescribed under Code sec. 702(a)(7)). In the case of qualifying investigatory expenses incurred in connection with the acquisition of a partnership interest, the amortization deduction is to be taken by the partner who incurred such expenses.

Amortization period

Under the provision, the trade or

business actually must be entered into (or "begin") before an amortization period can start. Therefore, no deduction is allowed under the provision with respect to items [13] incurred incident to a trade or business which actually is not commenced or acquired by the taxpayer.

The amortization period of not less than 60 months commences with the month in which a business begins. For purposes of this determination, an acquired trade or business is treated as beginning with the month in which a taxpayer acquires it. The month of acquisition is to be determined with regard to the economic substance of each situation. Generally, it is anticipated that the definition of when a business begins is to be made in reference to the existing provisions for the amortization of organizational expenditures (Code secs. 248 and 709). Since the minimum amortization period allowed by the provision is 60 months, the election is inapplicable to businesses which have an ascertainable useful life of less than 60 months. Expenditures related to such businesses remain subject to the provisions of existing law.

The generally applicable income tax rules apply in the case of any amount subject to an election which is unamortized upon a termination of the trade or business. Therefore, in an appropriate instance, a taxpayer may deduct any unamortized amount as a loss (Code sec. 165) or an unamortized amount might be carried over to the taxpayer's successor in interest (e.g., see Rev. Rul. 70-241, 1970-1 C.B. 84, relating to the treatment of unamortized organizational expenses in connection with a reorganization qualifying under Code section 368(a)(1)(F).

Scope and manner of election

Amortization elections generally must be made at the time, and in the manner, specified in Treasury regulations.[2] Elections, however, may not be made later than the time for filing the return (including extensions) for the taxable year in which the business begins. It is anticipated that election procedures will be similar to those used under sections 248 and 709 of the Code (relating to certain organization fees), and that elections may not be made on a conditional basis.

Once an amortization period is selected, it may not be changed. Thereafter, the selected period must be used in computing taxable income for the taxable year in which the election is made and for all subsequent taxable years.

The election applies to all eligible expenditures paid or incurred by the taxpayer in connection with a newly-created or acquired business.

Effective date

The provision applies to amounts paid or incurred after July 29, 1980.

Revenue effect

It is estimated that the provision would result in a reduction in budget receipts of $22 million in fiscal year 1981, $73 million in fiscal year 1982, $121 million in fiscal year 1983, $180 million in fiscal year 1984, and $254 million in fiscal year 1985.

* * * * *

[23] E. Revision of Source Rules for Income from Certain Leased Aircraft, Vessels, and Spacecraft (sec. 105 of the bill and sec. 861 of the Code)

Present law

The source of income or loss from the rental of personal property generally depends on whether the property is used inside or outside the United States. Under this rule, income from the lease of a vessel or aircraft would be treated as income from sources without the United States to the extent that the rental payments were attributable to use of the equipment outside the United States. Similarly, income from the lease of a spacecraft would be from sources outside the United States.

Typically, under a lease financing of equipment (i.e., the equipment is purchased by a financial institution and leased to the user), the lease produces a tax loss during its early years to the lessor (primarily as a result of accelerated depreciation or amortization deductions). Where the equipment is used outside the United States, the loss arising on the lease is considered to be a foreign source loss under the generally applicable source rules described above. The characterization of the loss as foreign source operates to reduce the lessor's foreign source taxable income and thus its foreign tax credit limitation. Under certain circumstances, this may cause the lessor to lose a foreign tax credit, to which it would otherwise be entitled, for foreign taxes paid with respect to its other foreign operations. As a result, this type of lease financing transaction could be less attractive than a lease-financing transaction involving equipment to be used exclusively in the United States.

In the case of ships and aircraft, which often are financed through long-term leases from financial institutions, lessors expressed concern about the loss of foreign tax credits. Under the Revenue Act of 1971 [Pub. L. 92-178, 1972-1 C.B. 443], lessors of certain ships and aircraft were given an election to treat all income and loss from the rental of the ships or aircraft as from sources within the United States (Code sec. 861(e)). Under this provision, if a taxpayer owns an aircraft or vessel which is eligible for the investment tax credit (or would be if not used by a government) and leases the aircraft or vessel to a United States person, other than a member of the same controlled group of corporations as the taxpayer, and if the aircraft or vessel is manufactured or constructed in the United States, then the taxpayer may elect, for any taxable year ending after the commencement of such lease, to treat all

[2] In the case of startup expenditures paid or incurred by a partnership in connection with the creation of a new, or acquisition of an existing, trade or business, an amortization election would have to be made by the partnership rather than the individual partners (sec. 703(b)).

amounts includible in gross income with respect to the aircraft or vessel (whether during or after the period of any such lease), including gain from sale, exchange, or other disposition of such aircraft or vessel, as income from sources within the United States. As a corollary to this rule, losses from the lease would also be treated as from U.S. sources. The election may not be revoked without the consent of the Treasury. Moreover, if the ship [24] or aircraft is transferred in certain transactions where gain is not fully recognized, the transferee is also bound by the election.

A similar problem also arose with respect to lease-financed U.S. railroad rolling stock used temporarily in Canada or Mexico. Under the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1], lessors generally are required, on a non-elective basis, to treat all income or loss from the rolling stock as from U.S. sources if it is expected that the leased rolling stock will be used predominantly within the United States.

Property which is used predominantly outside the United States, or which is used by a government or international organization, is generally not eligible for the investment tax credit. Exceptions are made to the requirement for use in the United States for U.S. documented ships or aircraft, rolling stock of domestic railroads, and certain other property. Under the Revenue Act of 1971 [Pub. L. 92-178, 1972-1 C.B. 443], this requirement is also waived for any communications satellite (as defined in section 103(3) of the Communications Satellite Act of 1962) or interest in such a satellite of a U.S. person. In addition, the 1971 Act waives the governmental use restriction for property used by the International Telecommunications Satellite Consortium (INTELSAT).

Reasons for change

The foreign tax credit rules are designed to prevent double taxation of the same income by the United States and foreign countries. The credit generally operates on the principle that the country in which income arises has the primary right to tax the income. Thus, where a U.S. taxpayer derives income from a foreign country, any taxes imposed by that country on the income are allowed as a credit against the U.S. tax on the income. In order to prevent the foreign tax credit from offsetting more than the U.S. tax on income which is potentially subject to double taxation, the credit is limited to the taxpayer's pre-credit tax on its foreign source income (computed on an overall basis). In view of the purpose to prevent double taxation (without allowing the credit to exceed the amount necessary to do so), the source rules used in computing the limitation are generally designed to identify as foreign source income that income which might reasonably be subject to foreign tax.

Where the lease property is a vessel, aircraft, or spacecraft used in international traffic, the present rules governing the source of income derived from the lease of personal property appear to produce results which by that standard are somewhat anomalous. The present source rules for rental income turn on the physical location of the property—the income is U.S. source if the property is physically located in the United States, foreign source if it is not. Where a U.S. taxpayer operates a ship, aircraft, or spacecraft in international traffic, the operating income occasionally is subject to tax by a country in which the operations are temporarily conducted; therefore, it is not unreasonable to treat operating income as foreign source where the craft is used outside the United States. However, where the craft is leased to the U.S. operator by another U.S. taxpayer, it evidently is very unlikely that any foreign government will attempt to tax the lease payments received by the U.S. lessor from the U.S. operator even if the craft is located outside the United States. (This is particularly true where the craft seldom, if ever, is located in a foreign country.)

[25] Accordingly, consistent with the objectives of the source rules outlined above, the committee decided that lease payments on vessels, aircraft, and spacecraft received by U.S. lessors from U.S. persons will be treated as U.S. source where the property qualifies for the investment credit.

Explanation of provision

In situations in which lessors of ships or aircraft may currently elect to have all income or loss from the equipment treated as from U.S. sources, such treatment will become mandatory. The rule is also extended to apply to spacecraft on the same terms as ships and aircraft. Thus, income (or loss) from the rental of a spacecraft, aircraft, or vessel (a "craft") will be treated as U.S. source if (1) the craft qualifies for the investment tax credit (or would so qualify but for the fact that it is leased to a governmental unit), (2) the craft is leased to a U.S. person (other than a member of the same affiliated group of corporations as the taxpayer), and (3) the craft is manufactured or constructed in the United States. Once this rule applies to a craft, it will apply in all subsequent years in which the taxpayer owns the craft, even if it is leased to a foreign person. Thus, all income or loss, including gains from the sale, exchange, or other disposition of the craft, will be U.S. source. Also, if the craft is transferred in certain transactions in which gain is not fully recognized, the transferee will also be subject to the special source rule with respect to the craft.

Effective date

The provision is effective with respect to equipment first leased after the date of enactment. Other equipment will continue to be subject to the rules of prior law and, if subject to an election under section 861(e), will remain subject to that election.

Revenue effect

It is estimated that this provision will reduce budget receipts by a negligible amount annually through fiscal year 1985.

[26] F. Tax Rates Applicable to Nonexempt Income of Homeowners Associations (sec. 106 of the bill and sec. 528(b) of the Code)

Present law

Homeowners associations

Under present law, a qualified homeowners association (a condominium management association or a residential real estate association) may elect to be treated as a tax-exempt organization (Code sec. 528). If an election is made, the association will not be taxed on "exempt function income." Exempt function income means membership dues, fees, and assessments received from persons who own residential units in the particular condominium or subdivision and who are members of the association.

The association will be taxed, however, on income which is not exempt function income. For example, any interest earned on amounts set aside in a sinking fund for future improvements is taxable. Similarly, any amount paid by persons who are not members of the association for use of the association's facilities, such as tennis courts, swimming pools, golf courses, etc., is taxable. Further, any amount paid by members for special use of the association's facilities, the use of which would not be available to all the members as a result of having paid the membership dues, fees, or assessments required to be paid by all members of the association, will be taxable. For example, if the membership dues, fees, or assessments do not entitle a member to use the association's party room or to use the swimming pool after a certain time period, then amounts paid for this use are taxable to the association.

Deductions from nonexempt income are allowed for expenses directly related to the production of such income, and a $100 deduction against taxable income is provided so that associations with only a minimal amount of taxable income will not be subject to tax. However, a net operating loss deduction is not allowed, and the special deductions for corporations (such as the dividends received deduction) are not allowed.

A homeowners association is taxed on its taxable income at the highest corporate rate (46 percent). If the association has net long-term capital gain, the tax rate is 28 percent for determining the association's alternative tax for capital gains.

Corporate tax rates

Under present law, a corporation is taxed at graduated rates on the first $100,000 of taxable income. The corporate rates are 17 percent on the first $25,000 of taxable income, 20 percent on the next $25,000, 30 percent on the next $25,000, 40 percent on the next $25,000, and 46 percent on all taxable income above $100,000. The alternative tax rate for capital gains is 28 percent.

[27] The Code contains rules to prevent abuse of the graduated rate structure. A controlled group of corporations is limited in the aggregate to a maximum of $25,000 of taxable income in each of the rate brackets below the 46 percent bracket (Code sec. 1561). These rules are used to prevent income splitting by such commonly controlled corporations.

Reasons for change

The basic rationale for the tax treatment of homeowners associations in the Code is that activities which would not be taxed if engaged in by homeowners individually (for example, maintenance of their property or the payment of utility bills) should not be subject to tax when the individuals band together in an association. An extension of this principle would appear to be that the rate of taxation on invested funds of the association should approximate the rate that would be imposed on the funds if they were invested by individual members of the association.

On the other hand, taxation of an association at the regular corporate rates would generally result in the taxation of this income at a rate of 17 percent. Members of homeowners associations are likely to be in higher tax brackets. In addition, there are apparently no rules which would prevent abuse of the graduated rate structure by commonly controlled or related homeowners associations. The tests for commonly controlled corporations would not appear to be effective for nonprofit corporations which do not normally have stock ownership. Also, there appear to be almost no barriers to prevent the multiplication of organizations in order to minimize the tax burden.

The committee believes that the taxable income of a homeowners association should not be subject to tax at higher rates than the rates which would normally apply to such income if it were taxable to the members of the association. However, it would be too complicated to require a pass through of ratable portions of an association's income to its members. Consequently, the committee believes that it is appropriate to tax the income of homeowners associations at a flat rate of 30 percent, which may reasonably approximate the average marginal income tax rate of the members of these associations.

Explanation of provisions

Under this provision, taxable income of a homeowners association will be taxed at a rate of 30 percent. This rate applies to both ordinary income and capital gains.

Effective date

This provision applies to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will reduce budget receipts by $1 million in fiscal year 1981, and $2 million annually in fiscal years 1982 through 1985.

[28] G. Tax Treatment of Certain Income of Mutual or Cooperative Telephone and Electric Companies (sec. 107 of the bill and secs. 501(c)(12) and 513 of the Code)

Present law

Rural cooperatives

Under present law (Code sec. 501(c)(12)), a mutual or cooperative telephone company qualifies for exemption from Federal income taxation only if at least 85 percent of its income consists of "amounts collected from members for the sole purpose of meeting losses and expenses." In determining whether this member-income test has been satisfied, amounts of credits accrued or received by a mutual or cooperative telephone company from another company for communications services on calls involving members of the telephone cooperative are not taken into account.

Similarly, a rural electric cooperative may qualify for exemption from Federal income taxation under Code section 501(c)(12) if it satisfies the 85-percent member-income test.[1]

Tax on unrelated business income

Under present law, most organizations which are generally tax exempt under the Internal Revenue Code are nonetheless subject to tax on unrelated business taxable income (Code sec. 511). Thus, unless a specific exception applies, an organization which is tax-exempt (under Code sec. 501(a))[2] is subject to tax with respect to income derived from any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds) to the exercise or performance of its exempt function.

Reasons for change

Recently, the Internal Revenue Service has indicated that income from the rental of poles (*e.g.*, payments by a rural electric cooperative for use of a rural telephone cooperative's poles) and display listings in "Yellow Page" directories may be included in nonmember income of rural cooperatives.

The committee believes that income from pole rentals and display listings should not be treated as nonmember income for purposes of the [29] 85-percent member-income test and that income from pole rentals should be exempt from the tax on unrelated business taxable income.

Explanation of provisions

The bill provides that, in applying the 85-percent member-income test to a mutual or cooperative telephone company, any income from qualified pole rentals or from display listings in a telephone directory is to be disregarded. Also, in applying the 85-percent non-member-income test to mutual or cooperative electric companies, any income from qualified pole rentals is to be disregarded. Income from qualified pole rentals generally means any income from the sale of the right to use any pole (or other structure) (1) which is used by the cooperative in providing telephone or electric services to its members, and (2) the use for which the pole is rented involved support of wires used for the transmission of electricity or of telephone or other communications.

The bill also provides that the engaging in activities which result in the receipt of qualified pole rentals is not an unrelated trade or business for a mutual or cooperative telephone or electric company. Thus, such rentals would not be subject to the tax on unrelated business taxable income.

Effective date

The provisions relating to the 85-percent member-income test apply to all taxable years to which the Internal Revenue Code of 1954 applies. The provisions relating to the treatment of qualified pole rentals for purposes of the unrelated business tax apply to taxable years beginning after December 31, 1969.

Revenue effect

It is estimated that this bill will reduce budget receipts by less than $5 million in fiscal year 1981 and by less than $2 million annually thereafter.

[30] H. Refund of Taxes on Certain State Police Officer Subsistence Allowances (sec. 108 of the bill)

Present law

Code section 119, which was enacted in 1954, excludes from an employee's gross income the value of employer-furnished meals if they are provided for the employer's convenience, on its business premises, and for substantially noncompensatory reasons. The legislative history of section 119 indicates that the exclusion applies only to the value of meals furnished in kind.[1]

Although in 1954 Congress provided for an exclusion of up to $5.00 per day of statutory subsistence allowances paid to police officers, this provision was repealed in 1958 "to bring the tax treatment of subsistence allowances for police officials into line with the treatment of such allowances in the case of other taxpayers. . . ." [2]

On November 29, 1977, the Supreme Court decided *Commissioner* v. *Kowalski*, 434 U.S. 77 [Ct. D. 1987, 1978-1 C.B. 15], which held that cash

[1] See Rev. Rul. 65-99, 1965-1 C.B. 242; Rev. Rul. 65-174, 1965-2 C.B. 169.

In addition, certain rural electric cooperatives in the Tennessee Valley Authority ("TVA") area are exempt from taxation under Code section 501(c)(4) even though, generally because of TVA requirements, they do not meet the 85-percent member-income test. See *U.S.* v. *Pickwick Electric Membership Corp.*, 158 F. 2d 272 (6th Cir. 1946).

[2] In this paragraph, references to "tax-exempt organizations" do not include social clubs (Code sec. 501(c)(7)) and employees' beneficiary associations (Code sec. 501(c)(9)), which are taxable on investment income of all types as well as unrelated business income. The term "tax-exempt organizations," as used in this paragraph also does not include political organizations (described in Code sec. 527) and homeowners associations (described in Code sec. 528).

[1] S. Rept. No. 1622, 83d Cong., 2d Sess. 190-191 (1954).

[2] H.R. Rep. No. 775, 85th Cong., 1st Sess. 7 (1957), 1958-3 C.B. 817.

meal allowances paid to a state trooper were includible in income since the section 119 exclusion applied only to meals furnished in kind. This decision resolved a conflict among the various appellate courts as to the taxability of cash meal allowances.

In response to the *Kowalski* decision, Congress enacted section 3 of Public Law 95–427 [1978-2 C.B. 363, 364]. Under that section, the Supreme Court's decision generally applies only prospectively. The Act allowed an exclusion from gross income for certain subsistence allowances received by an officer during the years 1970 through 1976 to the extent that the allowances were not included in income in the officer's income tax return. It also applied to all State police officer subsistence allowances received in 1977 without regard to an officer's treatment of those allowances on his or her return.

Public Law 95-427 did not authorize the refund of taxes paid prior to 1977 on such cash allowances if those payments had been included in income on the officer's income tax return. Thus, the Act was restricted to cases where officers might experience hardships in paying income tax deficiencies assessed with respect to cash meal allowances.

Reasons for change

After reviewing the income tax treatment of cash meal allowances received by State police officers during 1970 through 1976, the committee believes that it is appropriate to amend Public Law 95-427 to allow a credit or refund of taxes paid by such an officer with respect to those cash meal allowances which were included in gross income for calendar years 1974, 1975, and 1976.

Explanation of provision

The provision amends Public Law 95-427 to allow a credit or refund of taxes paid by State police officers with respect to cash meal allowances received during 1974, 1975, and 1976, whether or not the cash payments had been reported in gross income. As a result, the amended version of Public Law 95-427 will apply, on an elective basis, to all cash meal allowances received by all State police officers after 1973 and before 1978.

Effective date

The provision is effective upon enactment. The period of limitations for making refunds (or any other rule of law) will not operate to bar any claim for refund filed within one year of the date of enactment of the provision.

Revenue effect

It is estimated that the provision will result in a one-time decrease in budget receipts of $3 million in fiscal year 1981. This represents refunds or credits for taxes paid by State police officers with respect to cash meal allowances during 1974, 1975, and 1976 where the allowances were reported in income.

[32] I. Clarification of Limitation on Deductibility of Certain Entertainment Facility Expenses Includible in Income of Recipient (sec 109 of the bill and sec. 274 of the Code)

Present law

Prior to the enactment of the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1], expenses incurred with respect to entertainment facilities [1] 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.

In determining whether an entertainment facility was used primarily for business purposes, all the taxpayer's ordinary and necessary business use of the facility was taken into account. Once it was determined that the facility was used primarily for business, the portion of the expenses which were related directly to the active conduct of the taxpayer's business could be deducted.

The Revenue Act of 1978 provided generally that no deduction was allowable for any entertainment 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 (Code sec. 274 (e)(3)). Under this exception, expenses for goods, services, and facilities are not subject to the disallowance rules to the extent that the expenses are treated by the taxpayer, with respect to the recipient of the entertainment, as compensation to an employee on the taxpayer's return and as wages to the employee for purposes of income tax withholding. Thus, in the case of facility expenses which satisfy this exception, the Act retained the rules of prior law which formerly had applied to expenses treated as employee compensation.

The Technical Corrections Act of 1979 [Pub. L. 96-222, 1980-1 C.B. 499], provided that the provision disallowing expenses for entertainment facilities did not apply to expenses paid or incurred in 1979 or 1980 where the entertainment facilities are provided to a nonemployee of the payor, the amount of the expense is includible in the gross income of the recipient of the entertainment facilities as compensation for services or as a prize or award, and the payor complies with any required reporting of information [33] (i.e., an information return (Form 1099) is furnished to the In-

[1] 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.

ternal Revenue Service (but not the recipient) for amount in excess of $600).

Reasons for change

Present law already provides an exception to the disallowance rule for entertainment facilities in the case of facilities provided to employees. In such a case, the amount of the income is reported to the Internal Revenue Service regardless of the amount involved. The committee believes that a similar rule should apply to facilities provided to nonemployees so long as it is includible in the income of the recipient as a prize or award or for services rendered and information about the transaction is provided to the Internal Revenue Service (where required) regardless of the amount involved.

Explanation of provision

Under this provision, the general rule for the disallowance of expenses for entertainment, amusement, or recreation expenses (Code sec. 274(a)) does not apply to expenses which are includible in the gross income of the recipient of the entertainment, amusement, or recreation as compensation for services or as a prize or award under Code section 74. This provision will not apply if the taxpayer fails to include the amount in any information return (Form 1099) which is required to be filed with the Internal Revenue Service (or would be required except that the amount is less than $600).

Effective date

The provision is effective for expenses paid or incurred after December 31, 1980, in taxable years ending after that date.

Revenue effect

It is estimated that the provision will have no direct effect on budget receipts.

[34] J. Prevention of Abuse of Certain Employee Benefit Requirements (sec. 201 of the bill and sec. 414(m) of the Code)

Present law

Under present law, the tax qualification of a pension, profit-sharing, or stock bonus plan, the tax treatment of a participant in a cafeteria or medical reimbursement plan, and the tax treatment of a simplified employee pension depends, in part, upon whether there is discrimination in favor of employees who are officers, shareholders, or highly compensated.[1] The rules are intended to encourage employers to provide benefits to rank-and-file employees.

In applying the discrimination test and certain other rules, all employees of a controlled group of corporations and all employees of commonly controlled trades or businesses, whether or not incorporated, are treated as employed by a single employer. For purposes of this rule, the existence of a controlled group of corporations is determined generally by reference to the section 1563(a) definitions of parent-subsidiary controlled group and brother-sister controlled group. The commonly controlled trade or business determination is made under regulations which are "based on principles similar to the principles" which apply in the case of controlled groups of corporations. (Code sec. 414(b) and (c)).

Corporations in a brother-sister relationship are aggregated for plan purposes only if the same five or fewer persons who are individuals, estates or trusts own, among other things, *more* than 50 percent of the voting power (or value) of the stock in two or more corporations, and other conditions are satisfied. (Similar rules apply to unincorporated trades and businesses.)

These rules have been found to allow individuals to avoid the cost of providing benefits for rank-and-file employees by establishing individual corporations which then form a partnership of corporations. The partnership employs the rank-and-file employees. Because none of the corporations has *more* than a fifty percent interest in the partnership, the partnership is not a member of a group of commonly controlled trades or businesses. Therefore, the requirement of aggregation of employees for purposes of meeting the nondiscrimination and other rules does not apply and the plans established by the corporations need not provide coverage for the rank-and-file employees of the partnership. *Lloyd M. Garland, M.D., F.A.C.S., P.A.*, 73 T.C. 5 (1979).

[35] *Reasons for change*

The committee has determined that the use of separate entities should not permit the avoidance of employee benefit requirements designed to benefit rank-and-file employees under qualified pension, etc., plans, cafeteria and medical reimbursement plans, and simplified employee pensions.

Explanation of provision

The provision expands the classes of controlled groups of employers which are treated as a single employer in testing whether a pension, etc. plan, a cafeteria or medical reimbursement plan, or a simplified employee pension meets the nondiscrimination standards and other requirements of the tax law for favorable tax treatment.

In particular, under the provision, for purposes of the employee benefit requirements,[2] all employees of em-

[1] More favorable tax treatment is provided in the absence of such discrimination. In the case of qualified pension, etc. plans, this treatment includes current deductibility of employer contributions (within limits), deferral of tax on employee benefits, estate and gift tax exclusions, and special 10-year income averaging and tax-free rollovers for lump-sum distributions. In the case of cafeteria and medical reimbursement plans, certain amounts paid by employers to or on behalf of employees are excluded from income. In the case of simplified employee pensions, larger deductions are allowed for certain contributions to an individual retirement account.

[2] The employee benefit requirements consist of (1) in the case of qualified pension, etc., plans, the requirements of section 401 (a)(3), (4), (7), and (16), and sections 410, 411 and 415 (these provisions relate to employee participation and eligibility, discrimination, vesting, and limits on benefits and contributions) and, in the case of a plan adopted by more than one employer,

ployers who are members of an affiliated service group are treated as if they are employed by a single employer. Under the bill, an affiliated service group consists of a specified service organization and one or more adjunct service organizations which are related to the specified service organization.

Under the provision, an employer is a specified service organization if its principal business consists of the performance of specified services, that is, services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other field designated in Treasury regulations as a field in which separate organizations are used to avoid the employee benefit requirements. Under the provision, an employer is an adjunct service organization if a significant portion of its business consists of the performance of services for a specified service organization and if the services provided by the employer are of a kind historically performed by employees of that type of specified service organization.

Under the provision, an adjunct service organization is related to a specified service organization if (1) the specified service organization regularly uses the services of the adjunct service organization or is regularly associated with the adjunct service organization in performing specified services for third persons, and (2) 10 percent or more of the interests in the adjunct service organization is owned by persons who are (i) individuals performing specified services for the specified service organization or (ii) owners of the specified service organization.

In some cases, a specified service organization is owned by other specified service organizations or a combination of specified service organizations and individuals. Accordingly, in aggregating employers under the provision, all specified service organizations which are shareholders or partners in another specified service organization and which are regularly associated with the other specified organization in per-[36]forming specified services for third persons are treated (1) as part of the other specified service organization, and (2) as members of an affiliated service group which includes the other specified service organization.

Effective date

Generally, the provision applies for plan years ending after July 30, 1980. In the case of a plan in existence on July 30, 1980, the bill applies to plan years beginning after that date.

Revenue effect

It is estimated that the provision will increase budget receipts from the income tax by $50 million in fiscal year 1981, by $75 million in fiscal year 1982, and by $100 million annually in fiscal years 1983 through 1985.

[37] K. Provisions Relating to Employee Stock Ownership and Cafeteria Plans

1. Cash distribution option and put option for stock bonus plans (sec. 221 of the bill and new sec. 401(a)(23) of the Code)

Present law

Under present law, tax-qualified stock bonus plans must generally distribute stock to participants entitled to a distribution. However, a stock bonus plan which is either a tax credit employee stock ownership plan or an employee stock ownership plan may distribute cash, subject to a participant's right to demand that benefits be distributed in the form of employer securities.

Reasons for change

The committee has determined that a tax-qualified stock bonus plan generally should be eligible for the same rules with respect to cash and stock distributions to participants which govern tax credit employee stock ownership plans and employee stock ownership plans.

Explanation of provision

The provision would permit a tax-qualified stock bonus plan to distribute cash to a participant entitled to a distribution, subject to the participant's right to demand that benefits be distributed in the form of employer stock. If a stock bonus plan provides for cash distributions and if stock which is distributed is not readily tradable on an established market, the participant must have the right to require the employer to repurchase the stock.

Effective date

The provision is effective for plan years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will not have any revenue effect.

2. Special limitation for tax credit employee stock ownership plans and employee stock ownership plans (sec. 222 of the bill and sec. 415(c)(6)(A) of the Code)

Present law

Under present law, the dollar limitation on annual additions with respect to a participant in a tax credit employee stock ownership plan or an employee stock ownership plan may be increased, provided certain requirements with respect to allocations of employer contributions are met. The amount of such increase is the lesser of (1) the usual dol-[38]lar limitation on annual additions to a participant's account or (2) the amount of employer securities contributed to the plan.[1]

the requirements of section 412 relating to funding and the limitations of section 404(a) relating to employer deductions, (2) the requirements of section 105(h) for medical reimbursement plans, (3) the requirements of section 125 for cafeteria plans, and (4) the requirements of section 408(k) for simplified employee pensions.

[1] Under prop. reg. § 1.415-6(g)(4)(i) if a contribution of cash is used to purchase employer securities not later than 30 days after the time for filing the employer's tax return (including extensions), then generally the cash contribution is treated as a contribution of employer securities for purposes of the special dollar limitation.

Reasons for change

The committee has determined that it is necessary to make a clarifying change to the rule of present law which allows an increase in the limitation on contributions with respect to a participant in a tax credit employee stock ownership plan or an employee stock ownership plan. The change will make it clear that cash used to purchase employer securities is included for purposes of determining the increased limitation on annual additions to a participant's account.

Explanation of provision

Under the provision, the increase in the dollar limitation on annual additions with respect to a participant in a tax credit employee stock ownership plan or an employee stock ownership plan (provided certain requirements of present law are met with respect to allocations under the plan) would be the lesser of (1) the usual dollar limitation on annual additions to a participant's account, or (2) the amount of employer securities (or cash used to acquire such securities) contributed to the plan.

Effective date

The provision is effective for years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will not have any revenue effect.

3. Valuation of employer securities in tax credit employee stock ownership plans (sec. 223 of the bill and sec. 48(n)(B)(i) of the Code)

Present law

Under present law, the value of employer securities listed on a national exchange which are contributed to a tax credit employee stock ownership plan is the average of closing prices for such securities for the 20 consecutive trading days immediately preceding the due date for filing the employer's tax return for the year (including extensions).

Reasons for change

The committee has decided that the average closing price of employer securities during the 20 trading days preceding the date of contribution to a plan should be used to determine the value of those securities. The committee understands that the provision of present law for valuing readily tradable employer securities contributed to a tax credit employee stock ownership plan generally causes employers to postpone contributions of employer securities to a tax credit employee stock ownership plan until the due date for filing the employer's tax return.

[39] *Explanation of provision*

Under the provision, the value of employer securities listed on a national exchange contributed to a tax credit employee stock ownership plan is the average of the closing prices of such securities for the 20 consecutive trading days immediately preceding the date of contribution to the plan.

Effective date

The provision is effective for taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will not have any revenue effect.

4. Participation of subsidiary corporation in a tax credit employee stock ownership plan (sec. 224 of the bill and sec. 409(1)(4) of the Code)

Present law

The present-law rules governing tax credit employee stock ownership plans permit a 50-percent owned first-tier subsidiary of a parent corporation, and 80-percent owned second and lower-tier subsidiaries, to contribute employer securities of the parent corporation to a tax credit employee stock ownership plan.

Reasons for change

The committee believes that in the case where a first-tier subsidiary corporation owns 50 percent of a second-tier subsidiary and the first-tier subsidiary is 100-percent owned by a parent corporation, sufficient control of the second-tier subsidiary by the parent corporation exists to permit the second-tier subsidiary to contribute employer securities of the parent to a tax credit employee stock ownership plan maintained by the second-tier subsidiary.

Explanation of provision

Under the bill, if a parent corporation owns 100 percent of a first-tier subsidiary and the first-tier subsidiary owns 50 percent of a second-tier subsidiary, the second-tier subsidiary is allowed to contribute employer securities of the parent corporation to its tax credit employee stock ownership plan. In addition, parent stock could be contributed by 80-percent owned lower-tier subsidiaries in this chain.

Effective date

The provision is effective for taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will not have any revenue effect.

5. Retirement savings by tax credit employee stock ownership plan participants (sec. 225 of the bill and sec. 410(b)(1) of the Code)

Present law

Under present law, an employee who is an active participant in a tax-qualified plan during a year is not eligible to make deductible contributions to an IRA (individual retirement account, individual [40] retirement annuity, or retirement bond). Therefore, if an employee is an active participant in a tax-qualified tax credit employee stock ownership plan during a year such employee is ineligible for an IRA deduction. A plan can allow an employee to elect not to participate in a tax credit employee stock ownership plan in order to allow the employee to establish an IRA. However, the plan may be unable to satisfy certain minimum requirements

of the Code relating to employee eligibility for plan participation (sec. 410 (b)(1)) if substantial numbers of employees make such an election.

Reasons for change

The committee has determined that in the case where the only tax-qualified plan maintained by an employer is a tax credit employee stock ownership plan and if the value of employer securities allocated to employees' accounts under the tax credit employee stock ownership plan is relatively low, the minimum coverage requirements for tax-qualification of the tax credit employee stock ownership plan should be modified to permit employees to elect out of the plan, if the plan so provides, to establish IRAs.

Explanation of provision

Under the provision, the minimum coverage requirement for a tax credit employee stock ownership plan is changed, if a tax credit employee stock ownership plan is the only tax-qualified plan maintained by an employer. If employees are permitted to elect out of the tax credit employee stock ownership plan for the purpose of establishing IRAs, the tax credit employee stock ownership plan does not fail to meet the minimum coverage requirements of the Code if the plan benefits at least 50 percent of all employees (excluding employees who have not satisfied the minimum age and service requirements or who are otherwise permitted to be excluded), and if the total allocation under the tax credit employee stock ownership plan are equal to no more than two percent of the compensation of participating employees.

Effective date

The provision is effective for plan years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will decrease budget receipts by less than $5 million annually.

6. Cafeteria plans permitted to provide deferred compensation under rules applicable to cash or deferred profit-sharing and stock bonus plans (sec. 226 of the bill and secs. 125 and 401(k)(2) of the Code)

Present law

A cafeteria plan is an employee benefit plan under which a participant may choose between taxable benefits and one or more nontaxable fringe benefits. Under present law, cafeteria plans are not permitted to provide deferred compensation.

[41] *Reasons for change*

Both cafeteria plans and cash or deferred profit-sharing plans allow employees to choose between current compensation and other benefits. The committee believes that present law is too restrictive because it does not permit employees to choose among currently taxable compensation, deferred compensation, and fringe benefits under a single plan.

Explanation of provision

Under the provision, benefits under a cafeteria plan could include amounts which an employee covered by a profit-sharing or stock bonus plan with a qualified cash or deferred arrangement can elect to have the employer pay as a contribution to a trust under a profit-sharing or stock bonus plan. Amounts contributed by the employer, pursuant to the employee's election, will be treated as nontaxable benefits for purposes of the "cafeteria" plan rules.

Effective date

The provision is effective for taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will decrease budget receipts by less than $5 million annually.

* * * * *

[43] M. Extension of Time To Amend Instruments of Charitable Split-Interests Trusts (sec. 302 of the bill and secs. 170, 2055, 2522 of the Code)

Present law

The Tax Reform Act of 1969 [Pub. L. 91-172, 1969-3 C.B. 10] imposed new requirements that must be met in order for a charitable deduction to be allowed for income, gift, and estate tax purposes for the transfer of a split interest to charity (i.e., part charitable and part noncharitable). In the case of a remainder interest in trust, the interest passing to charity must be in either a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. In the case of an "income" interest passing to charity (i.e., a charitable lead trust), the "income" interest must be either a guaranteed annuity or a fixed percentage of the fair market value of the trust (determined annually). These rules generally apply for estate and gift tax purposes with respect to decedents dying or transfers made after December 31, 1969, and for income tax purposes to contributions and transfers in trust after July 31, 1969. However, certain exceptions were provided in the case of wills executed, or property transferred in trust, on or before October 9, 1969. In general, these exceptions did not apply the new rules to these wills and revocable trusts until October 9, 1972 (unless the will was modified in the meantime), to allow a reasonable period of time to take the new rules into account.

In 1970, the Internal Revenue Service issued proposed regulations with respect to the new requirements for a charitable remainder annuity trust or unitrust (under sec. 664 of the Code). These regulations provided additional transitional rules allowing trusts created after July 31, 1969 (which did not come within the statutory exceptions) to qualify for an income, estate, or gift tax deduction if the governing instrument was amended prior to January 1, 1971. Subsequently, the date by which the governing instrument had to be amended was further extended by the Internal Revenue Service. On August 22, 1972, the Internal Revenue Service issued final regulations which further extended the date to December

31, 1972. On September 5, 1972, the Internal Revenue Service published Rev. Rul. 72-395, 1972-2 C.B. 340, which provided sample provisions for inclusion in the governing instrument of a charitable remainder trust that could be used to satisfy the requirements under Code section 664.

In 1974, Congress extended the date by which the governing instrument of a trust created after July 31, 1969, and before September 21, 1974, or pursuant to a will executed before September 21, 1974, could be amended (P.L. 93-483) [1974-2 C.B. 447]. Under that Act, if the governing instrument was amended to conform by December 31, 1975, to meet the requirements of a charitable remainder annuity trust or unitrust or pooled income fund, an estate tax deduction was allowed for the chari-[44]table remainder interest which passed in trust from the decedent even though the interest failed to qualify at the time of the decedent's death.

The Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1] extended to December 31, 1977, the date by which the governing instrument of a charitable remainder trust created after July 31, 1969, and before December 31, 1977, must be amended in order to qualify as a charitable remainder annuity or unitrust or pooled income fund for purposes of the estate tax deduction. The Act also extended the date in the case of a trust created after July 31, 1969, pursuant to a will executed before December 31, 1977.

In the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1], Congress extended the amendment procedure to instruments establishing charitable lead trusts, and charitable remainder trusts in the case of income and gift taxes, which were created before December 31, 1977 (or created pursuant to a will executed before such date) which were amended (or judicial proceedings to amend were commenced) by December 31, 1978. As part of that provision, the Act extended until December 31, 1978, the time to amend (or to commence judicial proceedings to amend) instruments establishing charitable remainder trusts which were created before December 31, 1977 (or created pursuant to a will executed before such date) in order to conform such instruments to the requirements of the Tax Reform Act of 1969 for a charitable deduction to be allowed for estate tax purposes.

Reasons for change

Since the last extension enacted by Congress, a number of meritorious cases have come to the attention of the committee where amendment of the trust is the only method of preventing charity from bearing the additional estate taxes arising from the loss of the charitable deduction. In addition, the committee understands that the Treasury is studying the possibility of proposing a permanent rule on this issue. Consequently, the committee believes that an additional 2-year period, until December 31, 1980, is appropriate in order to permit the reformation of charitable split interest gifts.

Explanation of provision

The provision extends for 2 years (i.e., until December 31, 1980) the time to amend (or commence judicial proceedings to amend) instruments of both charitable lead trusts and charitable remainder trusts which were created before December 31, 1977 (or which were created pursuant to a will executed before such date) in order to conform such instruments to the requirements of the Tax Reform Act of 1969 for a charitable deduction to be allowed for income, gift, or estate tax purposes.

Effective date

The provision is effective, for estate and gift tax purposes, for decedents dying and transfers after December 31, 1969, and, for income tax purposes, for contributions and transfers in trust after July 31, 1969.

Revenue effect

It is estimated that the provision will decrease budget receipts by $8 million in fiscal year 1981, by $8 million in fiscal year 1982, and will not have any revenue effect thereafter.

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Senate Report No. 96-1036
2d Session

[Bracketed numerals indicate official report page numbers]

MISCELLANEOUS REVENUE ACT OF 1980

NOVEMBER 25, 1980

Mr. LONG, from the Committee on Finance, submitted the following report to accompany H.R. 7956.[1]

The Committee on Finance, to which was referred the act (H.R. 7956) to make various changes in the tax laws, having considered the same, reports favorably thereon with amendments and recommends that the act as amended do pass.

The amendments are shown in the text of the bill in italic.

House bill.—H.R. 7956, as it passed the House, contained provisions relating to (1) the treatment of certain community income for spouses living apart, (2) amortization of business startup costs, (3) charitable deductions for certain contributions of real property for conservation purposes, (4) investment tax credit for rehabilitated buildings leased to tax-exempt organizations or governmental units, (5) the revision of source rules for income from certain leased aircraft, vessels, and spacecraft, (6) tax rates applicable to nonexempt income of homeowners associations, (7) the tax treatment of certain income of mutual or cooperative telephone and electric companies, (8) the refund of taxes on certain State police officer subsistence allowances, (9) the clarification of the limitation on deductibility of certain entertainment facility expenses includible in income of the recipient, (10) prevention of abuse

[1] Public Law 96-605, page 702. This publication of the committee report is limited to pertinent excerpts.

of certain employee benefit requirements, (11) certain provisions relating to employee stock ownership and cafeteria plans, (12) the election of estate tax alternate valuation, and (13) a two-year extension of time to amend governing instruments of charitable split-interest trusts.

Committee bill.—The committee bill retains most of the provisions of the House bill but (1) postpones for one year (to taxable years beginning after 1980) the provisions relating to the treatment of certain community income for spouses living apart, (2) deletes the [2] provisions relating to contributions of real property for conservation purposes (similar provisions are contained in H.R. 6975 [Pub. L. 96-541, page 12, this Bulletin], as it passed the Senate), (3) deletes the provision relating to the investment tax credit for rehabilitated buildings leased to tax-exempt organizations or governmental units, (4) makes the provision relating to the participation of a subsidiary corporation in a tax credit employee stock ownership plan effective as if that provision had been included in the Revenue Act of 1978 [Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1] (rather than for taxable years beginning after December 31, 1980), (5) extends for three years (through 1981) the time for conforming governing instruments of charitable split-interest trusts, (6) adds a provision relating to the investment tax credit for maritime satellites (section 7 of H.R. 4746, as it passed the House), (7) adds a provision relating to the treatment of debt-financed real estate investments by qualified employees' trusts, and (8) adds a provision to repeal the withholding tax on pensions paid to nonresident aliens (previously reported by the committee as section 407 of H.R. 1212 and H.R. 2492).

* * * * *

[5] SEC. 109—EXEMPTION FROM UNRELATED BUSINESS INCOME TAX FOR CERTAIN REAL ESTATE INVESTMENTS OF QUALIFIED EMPLOYEES' TRUSTS

Under present law, a qualified employee trust does not pay tax on its investment income, unless the income is from property that was debt-financed. Income from such property is termed "unrelated business income" in the proportion that the property is debt-financed and is taxed.

The bill provides that, with certain exceptions, debt incurred by a tax-exempt employee trust with respect to real estate investments will not be considered acquisition indebtedness (and, consequently, none of the income from such investments would be subject to the tax on unrelated business income).

Debt does not qualify for this exception, where it is incurred with respect to real property if—

(1) the purchase price is not a fixed amount determined as of the date of acquisition,

(2) the purchase price (or the amount or timing of any payment) is dependent, in whole or in part, upon the future revenues, income, or profits derived from the property,

(3) the property is leased to the transferor (or to a party related to the transferor),

(4) the property is acquired from, or leased to, certain persons who are disqualified persons with respect to the trust, or

(5) the debt is nonrecourse debt owed to the transferor (or a related party) which either

(a) is subordinate to any other indebtedness secured by the property, or

(b) bears a rate of interest significantly less than that which would apply if the financing had been obtained from a third party.

* * * * *

[6] SEC. 207. ELIMINATION OF WITHHOLDING TAX ON PENSIONS PAID TO CERTAIN NONRESIDENT ALIENS

Under present law, a nonresident alien is not subject to U.S. tax on compensation for services performed outside the United States. A nonresident alien is, however, generally subject to a tax of 30 percent on investment income (interest, dividends, etc.) from U.S. sources. If a nonresident alien receives a pension in the form of an annuity from a qualified trust or under a qualified annuity plan, it would generally be subject to the 30-percent withholding tax on the portion [7] of the annuity attributable to U.S. source investment income earned on the contributions while they were held by the trust, unless a statutory or treaty exemption applies. Currently, there is a statutory exemption from tax on a pension paid to a nonresident alien for services performed outside the United States, if, at the time the annuity payments begin, 90 percent or more of the employees for whom contributions or benefits are provided by the plan are citizens or residents of the United States. Also, a number of U.S. tax treaties provide reciprocally that pensions and annuities received by a resident of one country from sources in the other are taxable only by the country of residence.

The committee amendment would expand the statutory exemption from tax for pensions and annuities by making it available to an individual if (1) the recipient's country of residence grants a substantially equivalent exclusion to citizens and residents of the United States or (2) the recipient's country of residence is a "beneficiary developing country" under section 502 of the Trade Act of 1974. This provision would apply to amounts received after July 1, 1979.

* * * * *

II. EXPLANATION OF THE BILL

A. Treatment of Certain Community Income for Spouses Living Apart (sec. 101 of the bill and new sec. 66 of the Code)

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Effective date

The provision applies to calendar years beginning after December 31, 1980.

* * * * *

[26] H. Investment Tax Credit for Certain Property Used in Maritime Satellite Communications (sec. 108 of the bill and sec. 48 of the Code)

Present law

Under present law, a credit against tax liability is provided with respect to a taxpayer's investment in certain types of depreciable business assets. Generally, the investment credit rate is 10 percent of qualified investment. Qualifying property for purposes of this investment tax credit includes tangible personal property and other tangible property used as an integral part of certain activities, including the furnishing of communications services. However, property which otherwise qualifies will generally be excluded from the credit if it is used predominantly outside of the United States or is used by a governmental unit or an international organization.

Under provisions enacted in the Revenue Act of 1971 [Pub. L. 92-178, 1972-1 C.B. 443] these exclusions are made inapplicable to any interest of a United States person in communications satellites and property used by the International Telecommunications Satellite Organization (INTELSAT), an international joint venture established to develop and operate the space segment of the global commercial communications satellite system. As a result, the Communications Satellite Corporation (COMSAT) is entitled to the credit for its investments in the INTELSAT system. COMSAT, a private, for-profit corporation created pursuant to the Communications Satellite Act of 1962, is the designated United States participant in INTELSAT.

During the 95th Congress, the International Maritime Satellite Telecommunications Act (P.L. 95-564) amended the Communications Satellite Act of 1962 to designate COMSAT as the United States participant in the International Maritime Satellite Organization (INMARSAT). INMARSAT is an international organization, similar in structure and operation to INTELSAT, which is being established to develop and operate a global maritime satellite telecommunications system.

Reasons for change

The committee believes that it is appropriate to extend the investment credit to interests of United States persons in property used by the International Maritime Satellite Organization.

Explanation of provision

This provision of the bill will make the international organization exclusion under the investment tax credit inapplicable to property used by the International Maritime Satellite Organization [27] (INMARSAT). As a result, the investment tax credit will be available for investments by COMSAT or other United States persons in property owned or used by INMARSAT. This is the same treatment as was provided in 1971 for investments in the INTELSAT system.

Effective date

This provision will apply to taxable years beginning after December 31, 1979.

Revenue effect

It is estimated that this provision will have an insignificant effect on budget receipts through fiscal year 1985.

[28] I. Exemption from Debt-Financed Income Rules for Certain Real Estate Investments of Tax-Exempt Employees' Trusts (sec. 109 of the bill and sec. 514(c) of the Code)

Present law

Generally, any organization which is exempt from Federal income tax under Code section 501(a) is taxed only on income from trades or businesses which are unrelated to the organization's exempt purposes; it is not taxed on passive investment income or income from any trade or business which is related to the organization's exempt purposes.[1]

This scheme of taxation applies to tax-exempt pension, etc. trusts described in Code section 401(a) ("qualified retirement plans") as well as most other tax-exempt organizations (described in the various paragraphs of Code sec. 501(c)).

Before 1969, some exempt organizations had used their tax-exempt status to acquire businesses using debt financing, with the purchase money obligations to be repaid out of tax-exempt profits, for example, as from leasing the assets of acquired businesses to the businesses' former owners.

The Tax Reform Act of 1969 [Pub. L. 91-172, 1969-3 C.B. 10] provided (in the so-called "Clay Brown provision") that an exempt organization's income from "debt-financed property," which is not used for its exempt function, is to be subject to tax in the proportion in which the property is financed by debt (Code secs. 512(b)(4) and 514). In general, debt-financed property is defined as any property which is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year or during the 12 months prior to disposition if the property is disposed of during the taxable year (Code sec. 514(b)(1)). A debt constitutes acquisition indebtedness with respect to property if the debt was incurred in acquiring or improving the property, or if the debt would not have been incurred "but for" the acquisition or improvement of the property.[2]

There appear to be situations in which the unrelated debt-financed in-

[1] There are some exceptions to the general rule that passive investment income is tax-exempt. For example, social clubs (Code sec. 501(c)(7)) and voluntary employees beneficiary associations (Code sec. 501(c)(9)) are generally taxed on such income. Also, private foundations are subject to an excise tax of 2 percent on their net investment income.

[2] There are several exceptions from the term "acquisition indebtedness." For instance, one exception is indebtedness on property which an exempt organization receives by devise, bequest, or under certain conditions, by gift. Also, the term "acquisition indebtedness" does not include indebtedness which was necessarily incurred in the performance or exercise of the purpose or function constituting the basis of the organization's exemption. Special exceptions are also provided for the sale of annuities and for debts insured by the Federal Housing Administration to finance low- and moderate-income housing.

come provisions may not apply to investments by retirement plans [29] (or other exempt organizations) which are made indirectly through a financial intermediary, for example, through an insurance company segregated asset account (Code sec. 801(g)), rather than made directly.

Reasons for change

The committee believes a limited exception should be made to the debt-financed income rules for certain debt-financed real estate investments by qualified retirement plans. While the "Clay Brown" provisions were designed in part to prevent uncontrolled growth of exempt organizations through investments financed with debt, the exemption for investment income of qualified retirement trusts is an essential tax incentive which is provided to tax-qualified plans in order to enable them to accumulate funds to satisfy their exempt purpose —the payment of employee benefits. Accordingly, the committee believes that it is inappropriate to continue the present law restrictions on debt-financed income to the extent that they discourage prudent debt-financed real estate investments by these trusts.

Trustees of these plans are desirous of investing in real estate for diversification and to offset inflation. Debt-financing is common in real estate investments. (For example, a debt-financed real estate acquisition by a trust may be economically advantageous if it can be made by assuming or taking subject to a favorable existing mortgage on the property.)[3] The committee also believes that, in order to alleviate a competitive problem, it is appropriate to allow qualified plans to make debt-financed investments directly.

The committee believes that specifically drawn prohibitions of debt-financed acquisitions with certain characteristics can eliminate the most egregious abuses addressed by the 1969 legislation while at the same time exempting from tax the income from debt-financed real estate received by qualified retirement plans.

The committee believes that it is appropriate to limit this change to real estate investments of qualified retirement trusts because, in addition to the considerations discussed above, the assets of such trusts will ultimately be used to pay taxable benefits to individual recipients whereas the investment assets of other organizations exempt under Code section 501(a) are not likely to be used for the purpose of providing benefits taxable at individual rates.[4]

[30] *Explanation of provision*

The bill provides that, with certain exceptions, indebtedness incurred by a qualified trust as a result of the acquisition or improvement of real property will not be considered "acquisition indebtedness." [5] Thus, income or gain received from or with respect to such debt-financed real property will not be treated as income from debt-financed property.

For these purposes, "real property" is intended to encompass interests in real property, including sole fee ownership, as well as interests in joint ventures and partnerships which acquire real estate for investment.

The bill provides that in five types of situations the new exception to the general definition of acquisition indebtedness will not apply.

The first situation is one in which the acquisition price is not a fixed amount determined as of the date of acquisition. However, the fact that the terms of a sales contract provide for price adjustments due to customary closing adjustments (such as proration of property taxes), as well as price adjustments, in an amount fixed in the contract, dependent upon subsequent resolution of limited, external contingencies such as zoning approvals, title clearances, and the removal of easements, will not cause the acquisition price to be treated as not being a fixed amount determined as of the date of acquisition.

The second situation is where either the amount of any indebtedness, the amount payable in respect of the indebtedness, or the time for making any payments, is dependent (in whole or in part) upon the future revenues, income, or profits derived from debt-financed real property. Accordingly, a trust's income or gain from the debt-financed "bootstrap" acquisitions will continue to be subject to tax.

The third type of situation is where the property is leased by the trust to the seller, or to a person related to the seller. The attribution rules of Code section 267(b) are applied to determine whether a person is related to the seller. Accordingly, a qualified trust's income or gain from "sale-leaseback" transactions will not be exempt from the tax on unrelated debt-financed income.

A fourth situation in which the exemption to the acquisition indebtedness rule will not apply is if the property is acquired by a qualified trust from a person related to the plan under which the trust is formed or if such property is leased to such a related person. For these purposes, related persons include (1) an employer any of whose employees are covered by the plan (Code sec. 4975(e)(2)(C)), (2) a person which has a 50 percent or more ownership interest in

[3] It may also be argued that if a qualified trust is subject to tax on a portion of the income from debt-financed real estate, it would be at a competitive disadvantage when compared to a taxable investor because the trust could use only straight line depreciation while other taxpayers can utilize accelerated depreciation under some circumstances. This argument overlooks the fact that, in many cases, component depreciation may be utilized to achieve a degree of acceleration which may be comparable to that achievable under accelerated methods of depreciation.

[4] Thus, exempting income of qualified trusts (much of which may be capital gains) will normally result only in deferral and, because of a change in character, may eventually be taxed at higher rates to the individuals than it would have been to the trust. By contrast, exempting debt-financed income of other tax-exempt organizations from unrelated business income tax is not likely to result in a later increase of taxable income of others.

[5] This provision is not intended to affect the definition of acquisition indebtedness in other circumstances, such as where the indebtedness relates to personal property. See *Elliott Knitwear Profit Sharing Plan* v. *Commissioner*, 614 F. 2d 347 (3rd Cir. 980) aff'g 17 T.C. 765 (1979).

such an employer or in which the employer has a 50 percent or more interest (Code secs. 4975(e)(2)(E) and (G)), (3) a member of the family of any individual described in (1) or (2) (Code sec. 4975(e)(2)(F)), or (4) an officer, director, 10 percent or more shareholder, or a highly compensated employee of a person described in (1) or (2) (Code sec. 4975(e)(2)(H)). This restriction is necessary because sales of prop- [31] erty at bargain rates to the trust (and certain types of leases) would permit an employer to make indirect contributions to the trust in excess of the amounts otherwise permitted by the Code and obtain the effect of allowance of a deduction (by reduction in purchase price) for excessive contributions. This also could result in discriminatory contributions in favor of employees who are officers, shareholders or highly compensated as well as avoidance of limitations on contributions and benefits.

The final situation where the new exception will not apply is where the seller, a person related to the seller (under Code sec. 267(b)), or a person related to the plan (under the rules described in the preceding paragraph) provides nonrecourse financing for the transaction, and either (1) the debt is subordinate to any other indebtedness on the property or (2) the debt bears interest at a rate which is significantly less than the rate available from unrelated parties at the time the indebtedness is incurred. This provision is intended to prevent the use of inflated purchase prices—with the seller providing financing at favorable rates while receiving increased income taxable as capital gains—and not to preclude a qualified trust from obtaining a favorable rate of interest. Accordingly, a rate of interest obtained from a seller that is not less than 90 percent of the rate of interest that could be obtained from an unrelated party for a comparable type of loan at the time the indebtedness was incurred will not be considered to be "significantly less."

In the case of real property investments made through joint ventures or partnerships, the debt of the venture or partnership is intended to be treated as debt of the venturers or partners in a manner similar to the provisions of Code section 752 and the regulations thereunder. After such attribution, the debt will be tested to determine whether the tests for the exception from the definition of acquisition indebtedness are satisfied.

Effective date

These provisions apply to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will reduce budget receipts by less than $10 million annually in fiscal years 1981 through 1985. It could cause significant revenue losses in later years.

* * * * *

[37] K. Elimination of Withholding Tax on Pensions Paid to Certain Nonresident Aliens

(Sec. 207 of the bill and sec. 871 of the Code)

Present law

Under present law, a nonresident alien is not subject to U.S. tax on compensation for services performed outside the United States (or certain *de minimis* services performed in the United States for a foreign employer). He is, however, generally subject to a tax of 30 percent on his investment income (interest, dividends, etc.) from U.S. sources.

If a nonresident alien receives a pension in the form of an annuity from a qualified trust or under a qualified annuity plan, and the pension is attributable to services performed outside the United States, he generally would not be subject to U.S. tax on the portion of the annuity which is attributable to his contributions or to his employer's contributions under the plan. However, he would generally be subject to the 30-percent withholding tax on the portion of the annuity attributable to investment income earned on the contributions while they were invested, unless a statutory or treaty exemption applies. Currently, there is a statutory exemption from tax on a pension paid to a nonresident alien for services performed outside the United States (or *de minimis* services within the United States for a foreign employer) if, at the time the annuity payments begin, 90 percent or more of the employees for whom contributions or benefits are provided by the plan are citizens or residents of the United States. (Sec. 871(f).) Also, a number of U.S. tax treaties provide reciprocally that pensions and annuities received by a resident of one country from sources in the other are taxable only by the country of residence.

Reasons for change

The committee believes that a pension paid to a nonresident alien should be exempt from withholding where his country of residence has unilaterally by its internal law enacted a provision granting the same relief to U.S. citizens and residents. Also, the committee believes that employers should be encouraged to provide pensions for their employees in certain developing countries.

Explanation of provision

The provision would expand the statutory exemption from tax for pension annuities by making it available to an individual if (a) the country of residence of the individual grants a substantially equivalent exclusion to citizens and residents of the United States or (b) the recipient's country of residence is a "beneficiary developing country" under section 502 of the Trade Act of 1974.[1]

[1] The following countries and territories are designated beneficiary developing countries for purposes of the Generalized System of Preferences, provided for in Title V of the Trade Act of 1974, 19 U.S.C. § 2461 *et seq.* (as designated in Executive Order No. 11888, November 24, 1975, as amended*):

Independent countries

Afghanistan, Angola, Argentina, Baha-

Effective date

The provision would apply to amounts received after July 1, 1979.

Revenue effect

It is estimated that this provision will decrease budget receipts by less than $5 million annually in fiscal years 1981 through 1985.

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mas, Bahrain, Bangladesh, Barbados, Bhutan, Bolivia, Botswana, Brazil, Burma, Burundi, Cameroon, Cape Verde, Central African Empire, Chad, Chile, Colombia, Comoros, Congo, Costa Rica, Cyprus, Dahomey, Djibouti, Dominican Republic, Egypt, El Salvador, Equatorial Guinea, Ethiopia, Fiji, Gambia, Ghana, Grenada, Guatemala, Guinea, Guinea Bissau, Guyana, Haiti, Honduras, India, Israel, Ivory Coast, Jamaica, Jordan, Kenya, Korea, Republic of, Laos, Lebanon, Lesotho, Liberia, Malagasy Republic, Malawi, Malaysia, Maldives, Mali, Malta, Mauritania, Mauritius, Mexico, Morocco, Mozambique, Nauru, Nepal, Nicaragua, Niger, Oman, Pakistan, Panama, Papua New Guinea, Paraguay, Peru, Philippines, Romania, Rwanda, Sao Tome and Principe, Senegal, Seychelles, Sierre Leona, Singapore, Somalia, Sri Lanka, Sudan, Surinam, Swaziland, Syria, Taiwan, Tanzania, Thailand, Togo, Tonga, Trinidad and Tobago, Tunisia, Turkey, Upper Volta, Uruguay, Western Samoa, Yemen Arab Republic, Yugoslavia, Zaire, and Zambia.

Non-independent countries and territories

Antigua, Belize, Bermuda, British Indian Ocean Territory, British Solomon Islands, Brunei, Cayman Islands, Christmas Island (Australia), Cocos (Keeling) Islands, Cook Islands, Dominica, Falkland Islands (Islas Malvinas), French Polynesia, Gibraltar, Gilbert and Ellice Islands, Heard Island and McDonald Islands, Hong Kong, Macao, Montserrat, Netherlands Antilles, New Caledonia, New Hebrides Condominium, Niue, Norfolk Island, Pitcairn Islands, Saint Christopher-Nevis-Anguilla, Saint Helena, Saint Lucia, Saint Vincent, Tokelau Islands, Trust Territory of the Pacific Islands, Turks and Caicos Islands, Virgin Islands, British, Wallis and Futuna Islands, and Western Sahara.

*Executive Order No. 11888, Nov. 24, 1975, 40 F.R. 55276, as amended by Ex. Ord. No. 11906, Feb. 26, 1976, 41 F.R. 8758; Ex. Ord. No. 11934, Aug. 30, 1976, 41 F.R. 37084; Ex. Ord. No. 11960, Jan. 19, 1977, 42 F.R. 4317; Ex. Ord. No. 11974, Feb. 25, 1977, 42 F.R. 11230A; Ex. Ord. No. 12032, Dec. 27, 1977, 42 F.R. 64851; Ex. Ord. No. 12041, Feb. 25, 1978, F.R. 8099; Proc. No. 4561, Apr. 7, 1978, 43 F.R. 15127; Ex. Ord. No. 12104, Dec. 15, 1978, 43 F.R. 59053; Ex. Ord. No. 12124, Feb. 28, 1979, 44 F.R. 11729.

Public Law 96-608
96th Congress, H.R. 5973 [1]
December 28, 1980

An Act to amend the Internal Revenue Code of 1954 to waive in certain cases the residency requirements for deductions or exclusions of individuals living abroad, to allow the tax-free rollover of certain distributions from money purchase pension plans, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. RESIDENCY REQUIREMENTS FOR DEDUCTIONS OR EXCLUSIONS OF INDIVIDUALS LIVING ABROAD.

(a) GENERAL RULE. — Subsection (j) of section 913 of the Internal Revenue Code of 1954 (relating to deduction for certain expenses of living abroad) is amended by adding at the end thereof the following new paragraph:

"(4) WAIVER OF PERIOD OF STAY IN FOREIGN COUNTRY.—For purposes of paragraphs (1) and (2) of subsection (a), an individual who—

"(A) for any period is a bona fide resident of or is present in a foreign country,

"(B) leaves such foreign country after August 31, 1978—

"(i) during any period during which the Secretary determines, after consultation with the Secretary of State or his delegate, that individuals were required to leave such foreign country because of war, civil unrest, or similar adverse conditions in such foreign country which precluded the normal conduct of business by such individuals, and

"(ii) before meeting the requirements of such paragraphs (1) and (2), and

"(C) establishes to the satisfaction of the Secretary that he could reasonably have been expected to have met such requirements but for the conditions referred to in clause (i) of subparagraph (B),

shall be treated as having met such requirements with respect to the period described in subparagraph (A) during which he was a bona fide resident or was present in the foreign country."

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1977.

(2) APPLICATION FOR PURPOSES OF SECTION 911.—In the case of an individual who leaves the foreign country after August 31, 1978, rules similar to the rules of section 913(j)(4) of the Internal Revenue Code of 1954 (as added by subsection (a)) shall apply for purposes of applying section 911 of such Code for taxable years beginning in 1977 or 1978.

SEC. 2. ROLLOVER TREATMENT FOR CERTAIN DISTRIBUTIONS FROM MONEY PURCHASE PENSION PLANS.

(a) GENERAL RULE. — Paragraph (6) of section 402(a) of the Internal Revenue Code of 1954 (relating to special rollover rules) is amended by adding at the end thereof the following new subparagraph:

"(E) SPECIAL RULE WHERE EMPLOYER MAINTAINS MONEY PURCHASE PLAN AND OTHER PENSION PLAN.—

"(i) IN GENERAL.—In the case of any distribution from a money purchase pension plan which is maintained by an employer, for purposes of paragraph (5)(D)(i)(II), subsection (e)(4)(C) shall be applied by not taking into account any pension plan maintained by such employer which is not a money purchase pension plan. The preceding sentence shall not apply to any distribution which is a qualifying rollover distribution without regard to this subparagraph.

"(ii) TREATMENT OF SUBSEQUENT DISTRIBUTIONS.—If—

"(I) any distribution of the balance to the credit of an employee from a money purchase pension plan main-

[1] Pertinent excerpts from Senate Report No. 96-1031, page 730, and House Report No. 96-689, page 736.

tained by an employer is treated as a qualifying rollover distribution by reason of clause (i), and

"(II) any portion of such distribution is transferred in a transfer to which paragraph (5)(A) applies,

then paragraph (2) of subsection (a), and paragraphs (1) and (3) of subsection (e), shall not apply to any distribution (after the taxable year in which the distribution described in subparagraph (A) of paragraph (5) is made) of the balance to the credit of such employee from any other pension plan maintained by such employer."

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendment made by subsection (a) shall apply to payments made in taxable years beginning after December 31, 1978.

(2) TRANSITIONAL RULE.—In the case of any payment made before January 1, 1982, in a taxable year beginning after December 31, 1978, which is treated as a qualifying rollover distribution (as defined in section 402(a)(5)(D)(i) of the Internal Revenue Code of 1954) by reason of the amendment made by subsection (a), the applicable period specified in section 402(a)(5)(C) of such Code shall not expire before the close of December 31, 1981.

SEC. 3. TREATMENT OF CERTAIN REPAYMENTS OF SUPPLEMENTAL UNEMPLOYMENT COMPENSATION BENEFITS.

(a) GENERAL RULE.—Section 62 of the Internal Revenue Code of 1954 (defining adjusted gross income) is amended by inserting after paragraph (15) the following new paragraph:

"(16) CERTAIN REQUIRED REPAYMENTS OF SUPPLEMENTAL UNEMPLOYMENT COMPENSATION BENEFITS.—The deduction allowed by section 165 for the repayment to a trust described in paragraph (9) or (17) of section 501(c) of supplemental unemployment compensation benefits received from such trust if such repayment is required because of the receipt of trade readjustment allowances under section 231 or 232 of the Trade Act of 1974 (19 U.S.C. 2291 and 2292) [Pub. L. 93-618, 1975-1 C.B. 501]."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to repayments made in taxable years beginning after the date of the enactment of this Act.

SEC. 4. TAX TREATMENT OF EXPENSES IN ATTENDING FOREIGN CONVENTIONS.

(a) IN GENERAL—Subsection (h) of section 274 of the Internal Revenue Code of 1954 (relating to attendance at foreign conventions, etc.) is amended to read as follows:

"(h) ATTENDANCE AT CONVENTIONS, ETC.—

"(1) IN GENERAL.—In the case of any individual who attends a convention, seminar, or similar meeting which is held outside the North American area, no deduction shall be allowed under section 162 or 212 for expenses allocable to such meeting unless the taxpayer establishes that the meeting is directly related to the active conduct of his trade or business or to an activity described in section 212 and that, after taking into account in the manner provided by regulations prescribed by the Secretary—

"(A) the purpose of such meeting and the activities taking place at such meeting,

"(B) the purposes and activities of the sponsoring organizations or groups,

"(C) the residences of the active members of the sponsoring organization and the places at which other meetings of the sponsoring organization or groups have been held or will be held, and

"(D) such other relevant factors as the taxpayer may present,

it is as reasonable for the meeting to be held outside the North American area as within the North American area.

"(2) CONVENTIONS ON CRUISE SHIPS.—In the case of any individual who attends a convention, seminar, or other meeting which is held on any cruise ship, no deduction shall be allowed under section 162 or 212 for expenses allocable to such meeting.

"(3) DEFINITIONS.—For purposes of this subsection—

"(A) NORTH AMERICAN AREA.—The term 'North American area' means the United States, its possessions, and the Trust Territory of the Pacific Islands, and Canada and Mexico.

"(B) CRUISE SHIP.—The term 'cruise ship' means any vessel sailing within or without the territorial waters of the United States.

"(4) SUBSECTION TO APPLY TO EMPLOYER AS WELL AS TO TRAVELER.—

"(A) Except as provided in subparagraph (B), this subsection shall apply to deductions otherwise allowable under section 162 or 212 to any person, whether or not such person is the individual attending the convention, seminar, or similar meeting.

"(B) This subsection shall not deny a deduction to any person other than the individual attending the convention, seminar, or similar meeting with respect to any amount paid by such person to or on behalf of such individual if includible in the gross income of such individual. The preceding sentence shall not apply if the amount is required to be included in any information return filed by such person under part III of subchapter A of chapter 61 and is not so included.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) of this section shall apply to conventions, seminars, and meetings beginning after December 31, 1980, except that in the case of any convention, seminar, or meeting beginning after such date which was scheduled on or before such date, a person, in such manner as the Secretary of the Treasury or his delegate may prescribe, may elect to have the provisions of section 274(h) of the Internal Revenue Code of 1954 be applied to such convention, seminar or meeting without regard to such amendment.

SEC. 5. TAXES ON SELF-DEALING IN THE CASE OF CERTAIN LEASES.

Section 4941(d)(2) of the Internal Revenue Code of 1954 (relating to

special rules in the case of self-dealing) is amended—

(1) by striking out "and" at the end of subparagraph (F);

(2) by striking out the period at the end of subparagraph (G) and inserting a semicolon and "and"; and

(3) by adding at the end thereof the following:

"(H) the leasing by a disqualified person to a private foundation of office space for use by the foundation in a building with other tenants who are not disqualified persons shall not be treated as an act of self-dealing if—

"(i) such leasing of office space is pursuant to a binding lease which was in effect on October 9, 1969, or pursuant to renewals of such a lease;

"(ii) the execution of such lease was not a prohibited transaction (within the meaning of section 503 (b) or any corresponding provision of prior law) at the time of such execution; and

"(iii) the terms of the lease (or any renewal) reflect an arm's-length transaction."

SEC. 6. TREATMENT OF CERTAIN INDEBTNESS INCURRED BEFORE 1965 FOR PURPOSES OF SECTION 514.

(a) GENERAL RULE. For purposes of applying section 514 of the Internal Revenue Code of 1954 with respect to any sale of real property during 1976, indebtedness incurred before January 1, 1965, by an organization to finance the construction of a building on such property shall not be treated as acquisition indebtedness if the parcel of real property on which such building was constructed—

(1) was acquired by such organization before January 1, 1952, and

(2) is contiguous to another parcel of real property which—

(A) was acquired by such organization before January 1, 1952, and

(B) was used by such organization, on January 1, 1952 and at all times thereafter before the date of the enactment of this Act, in a manner which meets the requirements of section 514(b)(1)(A) of such Code (relating to property used in carrying out exempt purpose).

(b) EFFECTIVE DATE.—The provisions of subsection (a) shall apply to sales during calendar year 1976.

Approved December 28, 1980.

Senate Report No. 96-1031 2d Session

[Bracketed numerals indicate official report page numbers]

TAX TREATMENT OF CERTAIN INDIVIDUALS LIVING ABROAD AND CERTAIN PENSION PLAN DISTRIBUTIONS

NOVEMBER 24 (legislative day, NOVEMBER 20), 1980

Mr. LONG, from the Committee on Finance, submited the following report to accompany H.R. 5973.[1]

The Committee on Finance, to which was referred the bill (H.R. 5973) to amend the Internal Revenue Code of 1954 to waive in certain cases the residency requirements for deductions or exclusions of individuals living abroad, to allow the tax-free rollover of certain distributions from money purchase pension plans, and for other purposes, having considered the same, report favorably thereon with amendments and recommend that the bill, as amended, do pass.

The amendments are shown in the text of the bill in italic.

House bill.—H.R. 5973, as passed by the House, dealt with (1) waiver of time limits in foreign residence or presence requirement for Americans working abroad, (2) treatment of certain distributions from money purchase pension plans, (3) application of targeted jobs credit to certain youth, and (4) treatment of certain indebtedness incurred by a tax-exempt organization for purposes of Code section 514.

Committee bill.—The committee bill retains the first two provisions of the House bill, deletes the third provision (previously enacted in H.R. 2797, P.L. 96-222 [1980-1 C.B. 499, 542]), and also deletes the fourth provision of the House bill. In addition, the committee bill includes tax provisions relating to the treatment of certain repayments of supplemental unemployment compensation benefits (sec. 5 of H.R. 4746, as passed the House), treatment of foreign convention expenses, and an exception to private foundation "self-dealing" rules for continuation of certain leasing arrangements (previously reported by the committee as sec. 202 of H.R. 2297).

[1] Public Law 96-608, page 728.

[2] I. SUMMARY

SECTION 1. WAIVER OF TIME LIMITS IN FOREIGN RESIDENCE OR PRESENCE REQUIREMENTS FOR AMERICANS WORKING ABROAD

This section 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.

SEC. 2. SPECIAL RULE FOR CERTAIN DISTRIBUTIONS FROM MONEY PURCHASE PENSION PLANS

Under present law, if an employer maintains a tax-qualified defined benefit pension plan and a tax-qualified money purchase pension plan, and if an employee is covered by both plans, a total distribution of the balance of the employee's interest in the money purchase plan to the employee (or the employee's spouse on account of the employee's death) is not eligible to be rolled over tax free to an individual retirement account or to another qualified plan unless a total

distribution is also made from the defined benefit plan in the same taxable year. This section would allow an employee (or a deceased employee's spouse) to make a tax-free rollover of a total distribution from a qualified money purchase plan where the employee is also covered by a qualified defined benefit plan maintained by the same employer even though a total distribution is not made from the defined benefit plan in the same taxable year.

SEC. 3. TREATMENT OF CERTAIN REPAYMENTS OF SUPPLEMENTAL UNEMPLOYMENT COMPENSATION BENEFITS

Under present law, if a worker who has been laid off is required to pay back supplemental unemployment compensation benefits because of the subsequent receipt of trade readjustment assistance, the worker may be entitled to tax relief in the year of repayment under a special tax computation for cases where the taxpayer restores a substantial amount held under a claim of right (Code sec. 1341). However, if the amount of supplemental unemployment compensation benefits required to be paid back by the worker is $3,000 or less, the worker may receive no tax relief for the repayment of previously taxed amounts unless itemized deductions are claimed.

This section of the bill would allow a deduction from gross income for the repayment of supplemental unemployment compensation benefits if the repayment is required because of the receipt of trade readjustment allowances.

[3] SEC. 4. TAX TREATMENT OF EXPENSES FOR ATTENDING FOREIGN CONVENTIONS

Present law provides specific rules (Code sec. 274(h)) limiting the deduction for expenses of attending conventions, seminars, or similar meetings held outside the United States, its possessions, and the Trust Territory of the Pacific. These rules apply not only to the individuals attending the convention, but also to an employer who pays the expenses.

Under this section of the bill, no deduction is to be allowed for expenses allocable to a convention, seminar, or similar meeting held outside the North American area unless, taking certain factors into account, it is "as reasonable" for the meeting to be held outside the North American area as within it. The two-convention rule of present law is repealed. Under the provision, a convention will not be treated as a foreign convention unless it is held outside the United States, its possessions, and the Trust Territory of the Pacific, and Canada and Mexico. The section also repeals the subsistence expense limitations, the coach fare limitations, and special reporting requirements [under] present law.

This provision is effective with respect to foreign conventions attended after December 31, 1980. Where a taxpayer has made plans to attend a foreign convention and such foreign convention was planned prior to December 31, 1980, such convention is grandfathered under the terms of this provision.

SEC. 5. EXCEPTION TO PRIVATE FOUNDATION "SELF-DEALING" RULES FOR CONTINUATION OF CERTAIN LEASING ARRANGEMENTS

Present law generally prohibits certain "self-dealing" transactions, including leasing arrangements, between a private foundation and a "disqualified person." There is a 10-year transitional rule that permits continuation of an otherwise prohibited leasing arrangement pursuant to a binding contract in effect on October 9, 1969 (or pursuant to renewals of such contract), if the leasing arrangement is at least as favorable to the foundation as an arm's length transaction with an unrelated party, and if the arrangement was not a prohibited transaction at its inception.

The provision would allow a permanent exception from the "self-dealing" rules under Code section 4941 in certain circumstances where a private foundation leases office space from a disqualified person, if (1) the lease is pursuant to a binding contract in effect on October 9, 1969 (or renewals thereof), (2) at the time of execution the lease was not a prohibited transaction, and (3) the space is leased to the foundation on a basis no less favorable than that on which such space would be made available in an arm's-length transaction. For the lease to qualify for this exception, the leased space must be in a building in which there are tenants who are not disqualified persons.

This provision would apply to the Moody Foundation of Galveston, Texas, and any other private foundation leasing arrangement meeting the specific requirements of the bill. The provision becomes effective for taxable years beginning after December 31, 1979.

[4] II. EXPLANATION OF THE BILL

A. Waiver of Time Limits in Foreign Residence or Presence Requirement for Americans Working Abroad (sec. 1 of the bill and sec. 913 of the Code)

Present law

Prior to enactment of the Foreign Earned Income Act of 1978 [Pub. L. 95-615, 1978-2 C.B. 415], 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 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 generally may 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, and has frequently been the subject of litigation. 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 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 [5] being temporarily away from home and not entitled to these deductions.[1] A number of items in the deduction for excess foreign living costs are measured with reference to the location of the individual's tax home.

Reasons for change

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. The committee believes that, 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 special circumstances involved. However, the committee does not intend that this provision be considered as a precedent for other legislative changes.

Explanation of provision

This provision 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 actually must have been a *bona fide* resident of, or present in, a foreign country. Second, he must leave the foreign country after August 31, 1978, 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. It is anticipated, for example, that such determinations ordinarily would be made in situations where the State Department issues a travel advisory recommending that U.S. citizens avoid travel to a country because of unsettled conditions there. Third, the individual must establish to the satisfaction of the Treasury that he could reasonably have been expected to meet the time limitation requirements, but for the war, civil unrest, or similar adverse conditions. An individual who could reasonably have been expected to be present in a foreign country for a period of 17 out of 18 months or a *bona fide* resident of that country for an entire taxable year would be considered to have his tax home in that country for purposes of the excess living cost deduction rather than being considered to be temporarily present in that country. 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.

[6] *Effective date*

With respect to the deduction for excess foreign living costs and the $20,000 annual exclusion as amended by the Foreign Earned Income Act of 1978, the provision would apply to taxable years beginning after December 31, 1977 (the general effective date for those provisions). Similar rules also are to be applied for taxable years beginning in 1977 or 1978 in the case of individuals who would otherwise be eligible for the exclusion of foreign earned income (sec. 911) as in effect prior to the 1978 Act, including taxpayers who, for 1978, elect the exclusion as amended by the Tax Reform Act of 1976 [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1].

Revenue effect

This provision will have no effect upon budget receipts. It forgives an unanticipated one-time tax increase of $10 million attributable to calendar 1979 tax liability.

[7] B. Special Rule for Certain Distributions From Money Purchase Pension Plans (sec. 2 of the bill and sec. 402 of the Code)

Present law

An employee who receives a lump sum distribution from a tax-qualified pension, profit-sharing, or stock bonus plan may defer tax on the distribution by rolling over the proceeds (net of any employee contributions) within 60 days of receipt (1) to an IRA (an individual retirement account, annuity, or bond), or (2) to another employer-

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

sponsored qualified pension, etc., plan.[1] The rollover rule also applies to the spouse of an employee who receives a lump sum distribution on account of the employee's death. A lump sum distribution from a qualified plan is eligible for favorable income tax treatment (e.g., 10-year income-averaging) if no portion of the distribution is rolled over.

A lump sum distribution must be a distribution of the balance to the credit of an employee under a qualified pension, etc., plan, made within one taxable year of the recipient. Generally, the distribution must have been made on account of death or separation from service, or after the employee attains age 59½. If an employer maintains more than one qualified plan of the same type, the plans are aggregated for the purpose of determining whether the balance to the credit of an employee has been distributed. Under the aggregation rules, all pension plans (defined benefit and money purchase) maintained by the employer are treated as a single plan, all profit-sharing plans maintained by the employer are treated as a single plan, and all stock bonus plans maintained by the employer are treated as a single plan.

Reasons for change

The committee believes that the present lump sum distribution rollover rules are too restrictive.

Explanation of provision

This provision would allow an employee who receives a total distribution from a money purchase pension plan (which is otherwise eligible for taxfree rollover treatment) to roll over the distribution to an IRA or to another qualified plan where the employer also maintains a defined benefit pension plan covering the employee even though a total distribution is not made from the defined benefit plan in the same taxable year. The provision also would apply to the spouse of an employee if the spouse receives such a total distribution on account of the employee's death.

[8] If the recipient rolls over a total distribution from a money purchase pension plan and, in a subsequent taxable year, receives a total distribution from a defined benefit pension plan maintained by the employer, the later plan distribution could be rolled over tax free (if it otherwise meets the requirements for a tax-free rollover) but otherwise would not be eligible for the favorable income tax treatment accorded lump sum distributions.

Effective date

Generally, this provision would apply to payments made in taxable years beginning after December 31, 1978. In the case of such payments made before January 1, 1981, the period for making a rollover would not expire before December 31, 1980.

Revenue effect

It is estimated that this provision would reduce budget receipts by less than $5 million annually.

[9] C. Treatment of Certain Repayments of Supplemental Unemployment Compensation Benefits (sec. 3 of the bill and sec. 62 of the Code)

Present law

Under present law, workers who are laid off may become entitled to taxable supplemental unemployment compensation benefits[1] during periods for which they are laid off. Subsequently, they may receive trade readjustment assistance,[2] which generally is nontaxable (except to the extent otherwise provided in section 85 of the Code). When this occurs, those workers may be required to pay back the supplemental unemployment benefits they previously received.

If repayment is made by a worker, a deduction is allowable (under section 165 of the Code) for the repayment. In addition, a special relief provision relating to the computation of tax where the taxpayer restores a substantial amount held under a claim of right may apply (Code sec. 1341).

Under the special relief provision, if the worker pays back more than $3,000 of supplemental unemployment compensation benefits, income tax for the taxable year of repayment may be computed by claiming an itemized deduction for the repayment or, if a greater benefit is derived, the tax for the current year may be reduced by the amount of tax for the prior taxable year which was attributable to the inclusion of such benefits in gross income. However, this special tax computation is not available if the repayment does not exceed $3,000. In this case, no relief is available for the repayment of amounts previously included in gross income unless the worker claims itemized deductions for the taxable year in which the repayment is made.

Reasons for change

The committee believes that relief should be available to all workers who are required to pay back supplemental unemployment compensation benefits because of the subsequent receipt of trade readjustment assistance.

[1] A rollover to a plan is not permitted if any part of the lump sum distribution represents contributions made while the employee was self-employed.

[1] These benefits generally are paid by trusts exempt from taxation under Code sec. 501(c)(17) or by voluntary employees' beneficiary associations exempt from taxation under Code sec. 501(c)(9).

[2] Under the Trade Act of 1974 [Pub. L. 93-618, 1975-1 C.B. 501], benefits are provided to workers who are separated from their jobs as a result of the adverse effect of increased imports. The worker's separation must be due to lack of work in adversely affected employment, and covered under a certification of eligibility. In the 52 weeks preceding his qualifying separation, he must have had at least 26 weeks of employment at wages of $30 or more a week in adversely affected employment with a single firm. Benefits under the Trade Act equal 70 percent of the worker's average weekly wage, but may not exceed the average weekly manufacturing wage. Benefits are reduced by 50 percent of any earnings during the week for which benefits are provided. These benefits generally are payable for up to 52 weeks, and also are provided in the form of training allowances, job search allowances, and relocation allowances.

[10] *Explanation of provision*

The bill amends section 62 of the Code to allow a deduction from gross income for the repayment of supplemental unemployment compensation benefits if the repayment is required because of the receipt of trade readjustment allowances under sections 231 or 232 of the Trade Act of 1974 [Pub. L. 93-618, 1975-1 C.B. 501]. Qualifying repayments would be those made to trusts exempt from taxation under section 501(c)(17) of the Code or to voluntary employees' beneficiary associations exempt from taxation under section 501(c)(9) of the Code.

In the case of a repayment of more than $3,000 of supplemental unemployment compensation benefits, the taxpayer will continue to have the option of computing tax for the current taxable year under existing provisions for restoration of amounts held under a claim of right (Code sec. 1341).

Effective date

The provision will apply to repayments made in taxable years beginning after the date of enactment.

Revenue effect

It is estimated that this provision will reduce budget receipts by $5 million annually.

[11] D. Tax Treatment of Expenses for Attending Foreign Conventions (sec. 4 of the bill and sec. 274 of the Code)

Present law

Present law provides specific rules (sec. 274(h)) limiting the deduction for expenses of attending conventions, seminars, or similar meetings held outside the United States, its possessions, and the Trust Territory of the Pacific. These rules apply not only to the individuals attending the convention, but also to an employer who pays the expenses. Under these rules:

(1) No deduction is allowed for expenses paid or incurred by an individual in attending more than two foreign conventions in any taxable year.

(2) With respect to the two conventions for which a deduction is allowable, the amount of expenses that can be deducted for transportation and subsistence are limited. A deduction for transportation expense outside the United States may not exceed the coach or economy rates charged by a commercial airline. The deduction for subsistence may not exceed the dollar per diem rate established for Federal employees at the location at which the convention is held.

(3) A deduction is allowed for subsistence expenses for all of the days, or half days, as the case may be, of the convention, if (a) a full day or half-day of business activities are scheduled on each day during the convention, and (b) the individual attends at least two-thirds of the total hours of scheduled business activities at the convention. Otherwise, a deduction is allowed for subsistence expenses only for those full or half days during which the individual attends at least two-thirds of the scheduled business activities for that day.

(4) A deduction for the full amount of expenses of transportation (subject to the coach or economy rate limitation) to and from the site of a foreign convention is allowable only if one-half or more of the total days of the trip are devoted to business-related activities, excluding travel days to and from the convention site. Otherwise, a deduction is allowable only for a prorated portion of the transportation expense (subject to the limit), based upon the percentage of the days devoted to business related activities. In determining whether a day is devoted to business-related activities, the same rules for counting full days and half days for purposes of subsistence expenses are applied.

(5) The taxpayer must comply with certain reporting requirements. For example, information must be furnished to indicate the total days of the trip (exclusive of the transportation days to and from the convention), the number of hours of each day devoted to business activities (in a brochure describing the convention, if available), and any other information required by regulations. In addition, the taxpayer must attach a statement to his or her income tax return, signed by [12] an appropriate officer of the sponsoring organization, which must include a schedule of the business activities of each convention day, the number of hours that the individual attended these activities each day, and any other information required by regulations.

Reasons for change

The committee believes that present law rules with respect to expenses incurred in connection with attending a foreign convention do not adequately disallow deductions for trips which are actually foreign vacations. However, the committee believes that certain requirements and limitations on deductions under present law are too complex and restrictive for legitimate foreign conventions for which business expenses should be allowed.

Explanation of provision

General test

Under the bill, no deduction is to be allowed for expenses allocable to a convention, seminar, or similar meeting held outside the North American area unless, taking certain factors into account, it is "as reasonable" for the meeting to be held outside the North American area as within it. The two-convention rule of present law would be repealed.

Under the proposed reasonableness standard, the factors to be taken into account are: (1) the purpose of the meeting and the activities taking place at the meeting; (2) the purposes and activities of the sponsoring organizations or groups; and (3) the residences of the active members of the sponsoring organization and the places at which other meetings of the sponsoring organizations or groups have been or will be held.

Under the bill, the reasonableness requirement would not be satisfied for a convention, seminar, or similar meeting which is conducted on board a cruise ship.

In addition, the bill makes clear that the foreign convention provisions do not apply to normal business meetings for employees of a company.

Foreign convention—North American area

Under the bill, a convention would not be treated as a foreign convention unless it were held outside the United States, its possessions, and the Trust Territory of the Pacific, and Canada and Mexico.

Subsistence expenses limitation

Under the bill, the special subsistence expense limitation under present law would be repealed. As for any other business expenses, expenditures for amounts which are lavish and extravagant would continue to be nondeductible.

Transportation expenses

Under the bill, the special coach fare limitation for transportation expenses would be repealed. As for any other travel expenses, the principal purpose for making the trip must be for business purposes for transportation expenses to be deductible.

[13] *Special reporting requirements*

Under the bill, the special reporting and substantiation requirements for foreign conventions would be repealed.

Amounts includible in recipient's income

The provision continues current law under which a deduction will not be denied to any person other than an individual attending a foreign convention under circumstances where the travel expenses paid by such person are includible in the income of the recipient, so long as such person paying for such expenses does not fail to comply with any applicable information reporting rules. The language of this provision is changed slightly as a matter of clarification, but the changes will not affect the result of cases currently governed by section 274(h)(6)(D)(ii) of the Internal Revenue Code.

(Under section 107 of H.R. 7956, which was also approved by the committee, the payor must comply with information reporting requirements even if the amount involved is less than $600 and reporting ordinarily would not be required.)

Effective date

This provision is effective with respect to foreign conventions attended after December 31, 1980. Where a taxpayer has made plans to attend a foreign convention and such foreign convention was planned prior to December 31, 1980, such convention would be grandfathered under the terms of this provision.

Revenue effect

It is estimated that this provision will have a negligible revenue effect.

[14] E. Exception to Private Foundation "Self-Dealing" Rules for Continuation of Certain Leasing Arrangements (sec. 5 of the bill and sec. 4941 of the Code)

Present law

The 1969 Tax Reform Act [Pub. L. 91-172, 1969-3 C.B. 10] in effect prohibited certain transactions between a private foundation and "disqualified persons" with respect to that foundation, such as substantial contributors to the foundation. These prohibited transactions include leasing arrangements between a private foundation and disqualified persons (Code sec. 4941(d)(1)(A)).

The 1969 Act also provided a transitional rule permitting continuation—until taxable years beginning after December 31, 1979—of otherwise prohibited leasing arrangements pursuant to binding contracts in effect on October 9, 1969 (or pursuant to renewals of such contracts). In order to qualify for this 10-year transitional protection, the leasing arrangement must be at least as favorable to the foundation as an arm's-length transaction with an unrelated party and must not have been a prohibited transaction at its inception (P.L. 91-172, sec. 101(1)(2)(C)) [*supra* at 35].

Reasons for change

The committee believes that where a private foundation has been leasing office space from a disqualified person pursuant to an arrangement protected by the 10-year transitional rule, the foundation should be able to continue such arrangement thereafter if the space is made available to the foundation on a basis no less favorable than that in an arm's-length transaction and if the leased space is in a building in which there are tenants who are not disqualified persons.

The committee believes that, although self-dealing arrangements between private foundations and disqualified persons generally should be prohibited, it is not appropriate, in the limited circumstances addressed by the provision, to force a private foundation to discontinue a leasing arrangement which antedates the 1969 Tax Reform Act and which has not been disadvantageous to the foundation. Inasmuch as continuation of the lease is excepted from the self-dealing excise taxes only if there are other tenants in the building who are not related to the foundation, the committee believes that the "arm's-length" standard is enforceable by the Internal Revenue Service.

Explanation of provision

The bill would provide a permanent exception from the self-dealing rules under Code section 4941 in certain circumstances where a private foundation leases office space from a disqualified person, if (1) the lease is pursuant to a binding contract in effect on October 9, 1969 (or renewals thereof), (2) at the time of execution the lease was not a prohibited transaction, and (3) the space is leased to the foundation on a [15] basis no less favorable than that on which such space would be made available in an arm's-length transaction. For the lease to qualify for this exception, the leased space must be in a building in which there are tenants who are not disqualified per-

sons.[1] Thus, this new provision will continue to protect certain of those leasing arrangements which were not acts of self-dealing for taxable years beginning before January 1, 1980, by reason of the 10-year transitional rule; the new provision is not intended to protect any leases (or renewals) which would not meet the standards (other than the 10-year time limitation) of the transitional rule (P.L. 91-172, sec. 101(*l*)(2)(C)) [*supra*].

The provision would apply to the Moody Foundation of Galveston, Texas, and any other private foundation which has been leasing space from a disqualified person pursuant to an arrangement covered by the 10-year transitional rule and which lease also meets the specific requirements of the provision.

Effective date

The provision applies to taxable years beginning after December 31, 1979.

Revenue effect

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

* * * * *

House Report No. 96-689
1st Session

[Bracketed numerals indicate official report page numbers]

TAX TREATMENT OF CERTAIN INDIVIDUALS LIVING ABROAD AND CERTAIN PENSION PLAN DISTRIBUTIONS

DECEMBER 5, 1979

Mr. ULLMAN, from the Committee on Ways and Means, submitted the following report to accompany H.R. 5973.[a]

* * * * *

[2] SECTION 4. SPECIAL RULE RELATING TO DEBT-FINANCED INCOME OF EXEMPT ORGANIZATIONS

Generally, under present law, passive investment income and gains from the sale of investments realized by an exempt organization are not subject to tax as unrelated business income. However, income and gains realized by an exempt organization from "debt-financed property" not used for its exempt function are subject to tax in the proportion in which the property is financed by acquisition indebtedness.

This section would provide a limited exception to the debt-financed income rules. This exception would allow certain sales of real property in 1976 to be made free of the unrelated business income tax if the property had been acquired prior to 1952 and the indebtedness was incurred before 1965. The intended beneficiary of the provision is the Tillamook County YMCA of Tillamook, Oregon.

* * * * *

[6] D. Special Rule Relating to Debt-Financed Income of Exempt Organizations (sec. 4 of the bill)

Present law

Generally, any organization which is exempt from Federal income tax (under sec. 501(a)) is taxed only on income from trades or businesses which are unrelated to the organization's exempt purposes; it is [7] not taxed on passive investment income or income from any trade or business which is related to the organization's exempt purposes.[1]

Before 1969, some exempt organizations had used their tax-exempt status to acquire businesses through debt financing, with purchase money obligations to be repaid out of tax-exempt profits, for example, as from leasing the assets of acquired businesses to the businesses' former owners.

The Tax Reform Act of 1969 [Pub. L. 91-172, 1969-3 C.B. 10] provided (in the so-called "Clay Brown provision") that an exempt organization's income from "debt-financed property," which is not used for its exempt function, is to be subject to tax in the proportion in which the property is financed by debt. In general, debt-financed property is defined as "any property which is held to produce income and with respect to which there is acquisition indebtedness" (sec. 514(b)(1)). A debt constitutes acquisition indebtedness with respect to property if the debt was incurred in acquiring or improving the property, or if the debt would not have been incurred "but for" the acquisition or improvement of the property.[2]

The provisions relating to unrelated debt-financed income generally applied to taxable years beginning after December 31, 1969.[3] The 1969 Act provided a transitional rule under which the Clay Brown rules were to apply only where indebtedness had been incurred after the date on which similar bills were introduced in the 89th Congress (June 27, 1966) until taxable years beginning after 1971.

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[1] The provision sets forth requirements which must be met as of the effective date in order for the permanent self-dealing exception provided by the bill to apply as of that date. The provision does not apply prior to the effective date.

[a] Public Law 96-608, page 728.

[1] There are some exceptions to the general rule that passive investment income is tax-exempt. For example, social clubs (sec. 501(c)(7)) and voluntary employees beneficiary associations (sec. 501(c)(9)) are generally taxed on such income. Also, private foundations are subject to an excise tax of 2 percent on their net investment income.

[2] There are several exceptions from the term "acquisition indebtedness." For instance, one exception is indebtedness on property which an exempt organization receives by devise, bequest, or under certain conditions, by gift. Also, the term "acquisition indebtedness" does not include indebtedness which was necessarily incurred in the performance or exercise of the purpose or function constituting the basis of the organization's exemption. Special exceptions are also provided for the sale of annuities and for debts insured by the Federal Housing Administration to finance low- and moderate-income housing.

[3] However, in extending the unrelated debt-financed income rule and other rules relating to the unrelated business income tax to churches, the 1969 Act provided that these provisions did not apply to churches for taxable years beginning before January 1, 1976.

After the transition period the new rules were applicable to all situations of investment borrowing by exempt organizations.

Reasons for change

The committee believes that, due to special circumstances, a limited exception to the debt-financed income rules should be provided for income derived from certain sales of real property during 1976 in situations where the indebtedness was incurred prior to 1965. However, the committee does not intend that this provision be considered as a precedent either in section 514 or with respect to other situations where a more favorable tax result could have been obtained by proper planning.

[8] *Explanation of provision*

The bill would provide a very limited exception to the debt-financed income rules. Under this exception, it is provided that, in applying the debt-financed income rules to any sale of real property during 1976, indebtedness incurred before January 1, 1965, by an organization to finance the construction of a building on such property shall not be treated as acquisition indebtedness if the parcel of real property on which the building was constructed (1) was acquired by the organization before January 1, 1952, and (2) is contiguous to another parcel of real property which (*a*) was acquired by the organization before January 1, 1952, and (*b*) was used by the organization for exempt purposes (for the entire period from January 1, 1952, until the date of enactment of the bill).

Although this provision may possibly benefit other taxpayers, it is primarily intended to provide tax-free treatment for a 1976 sale of real property by the Tillamook County Young Men's Christian Association (YMCA), Tillamook, Oregon. The real property sold by the Tillamook YMCA was property adjacent to property it used for carrying on its charitable and educational purposes.

Effective date

This provision would apply only to certain sales of real property during calendar year 1976.

Revenue effect

It is estimated that this provision would result in a one-time reduction in budget receipts of less than $50,000 in fiscal year 1980.

* * * * *

Public Law 96-611
96th Congress, H.R. 8406 [1]

An Act to amend title XVIII of the Social Security Act to provide for medicare coverage of pneumococcal vaccine and its administration.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

* * * * *

TECHNICAL AMENDMENTS AND AMENDMENTS RELATING TO CHILD SUPPORT AUDITS

SEC. 11. (a)(1) Section 127(a)(1) of the Food Stamp Act Amendments of 1980 (Public Law 96-249) [page 414, this Bulletin], is amended by striking out "Subsection (i) of section 6103" and inserting in lieu thereof "Subsection (1) of section 6103".

(2)(A) Section 408(a)(1) of the Social Security Disability Amendments of 1980 (Public Law 96-265) [page 418, this Bulletin], is amended by striking out (in the new paragraph added thereby to subsection (1) of section 6103 of the Internal Revenue Code of 1954) "(7) Disclosure" and inserting in lieu thereof "(8) Disclosure".

(B) Section 408(a)(2) of the Social Security Disability Amendments of 1980 is amended—

(i) in subparagraph (A), by—

(I) striking out "(l)(1) or (4)(B) or (5)" and insering in lieu thereof "(l)(1), (4)(B), (5), or (7)", and

(II) striking out "(l)(1), (4)(B), (5), or (7)" and inserting in lieu thereof "(l)(1), (4)(B), (5), (7), or (8)";

(ii) in subparagraph (B), by—

(I) striking out "(l)(3), or (6)", and

(II) striking out "(l)(3), (6), or (7)" and inserting in lieu thereof "(l)(3), (6), (7), or (8)";

(iii) in subparagraph (C), by—

(I) striking out "(l)(6)" and inserting in lieu thereof "(l)(6) or (7)", and

(II) striking out "(l)(6) or (7)" and inserting in lieu thereof "(l)(6), (7), or (8)"; and

(iv) in subparagraph (D), by—

(I) striking out "subsection (d), (l)(6) or (m)(4)(B)" and inserting in lieu thereof "subsection (d), (l)(6) or (7), or (m)(4)(P)", and

(II) striking out "subsection (d), (l)(6) or (7), or (m)(4)(E)" and inserting in lieu thereof "subsection (d), (l)(6), (7), or (8), or (m)(4)(B)".

(3) The amendment made by paragraph (1) shall take effect on May 26, 1980 and the amendments made by paragraph (2) shall take effect on June 9, 1980.

(4)(A) The first sentence of section 7213(a)(2) of the Internal Revenue Code of 1954 (relating to unauthorized disclosure of information by State and other employees) is amended by striking out "(l)(6) or (7)" and inserting in lieu thereof "(l)(6), (7), or (8)".

(B) The amendment made by subparagraph (A) shall take effect on December 5, 1980.

* * * * *

Approved December 28, 1980.

Public Law 96-613
96th Congress, H.R. 7171 [1]
December 28, 1980

An Act to make certain miscellaneous changes in the tax laws.

[1] The publication of the law is restricted to excerpts involving tax matters.

[1] Senate Report No. 96-1032, page 739; House of Representatives No. 96-1050 is not published.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. ANNUITY CONTRACTS PURCHASED BY THE UNIFORMED SERVICES UNIVERSITY OF THE HEALTH SCIENCES.

(a) IN GENERAL.—An annuity contract purchased by the Uniformed Services University of the Health Sciences for any employee who is a member of the civilian faculty or staff of such university shall, for purposes of section 403(b) of the Internal Revenue Code of 1954, be treated as an annuity contract purchased for an employee by an employer described in section 501(c)(3) of such Code which is exempt from tax under section 501 (a) of such Code.

(b) EFFECTIVE DATE.—Subsection (a) shall apply to service after December 31, 1979, in taxable years ending after such date.

SEC. 2. RETIREMENT-REPLACEMENT-BETTERMENT METHOD OF DEPRECIATION.

(a) IN GENERAL.—Section 167 of the Internal Revenue Code of 1954 (relating to allowance for depreciation) is amended by redesignating subsection (r) as subsection (s) and by inserting after subsection (q) the following new subsection:

"(r) RETIREMENT-REPLACEMENT-BETTERMENT METHOD.—In the case of railroad track used by a common carrier by railroad (including a railroad switching company or a terminal company), the term 'reasonable allowance' as used in subsection (a) includes an allowance for such track computed under the retirement-replacement-betterment method.".

(b) EFFCTIVE DATE.—The amendments made by subsection (a) shall apply with respect to taxable years ending after December 31, 1953.

SEC. 3. TREATMENT OF CERTAIN RAILROAD STOCK FOR PURPOSES OF CONSOLIDATED RETURN REGULATIONS.

(a) IN GENERAL.—For purposes of the consolidated return regulations prescribed under section 1502 of the Internal Revenue Code of 1954, if the determination of whether or not there has been a deemed disposition of stock in a transferor railroad (as defined in section 374(c)(5)(B) of such Code) depends on a determination of final value by the special court under the Regional Rail Reorganization Act of 1973 [Pub. L. 93-236, 1974-1 C.B. 383], that deemed disposition shall not be treated as occurring before the earlier of—

(1) the date on which such determination becomes final, or

(2) the first date on which there is an actual disposition of the stock or a deemed disposition not described above.

(b) EFFECTIVE DATE.—Subsection (a) shall apply to taxable years ending after March 31, 1976.

SEC. 4. RESTORATION OF CERTAIN NET OPERATING LOSS CARRYOVERS TO RAILROADS IN CONRAIL PROCEEDINGS WHERE OTHER MEMBERS OF CONSOLIDATED GROUP HAD INCOME BECAUSE OF STOCK DISPOSITION.

(a) IN GENERAL.—For purposes of subsection (e) of section 374 of the Internal Revenue Code of 1954 (relating to use of expired net operating loss carryovers to offset income arising from certain railroad reorganization proceedings), if—

(1) subparagraphs (A) and (B) of paragraph (1) of such subsection are satisfied with respect to a corporation,

(2) such corporation had a net operating loss for a taxable year which would have satisfied the requirements of clause (i) of subparagraph (C) of such paragraph (1) but for the fact that such net operating loss was used to reduce the income of an affiliated group of corporations which filed a consolidated return, and

(3) any portion of the amount so used was included in an excess loss account which was required to be restored to the income of a member or members of the affiliated group, (or would be required to be so restored but for an election under Regulation § 1.1502-19(a)(6)),

than an amount equal to the restoration amount shall be treated as meeting the requirements of subparagraph (C) of such paragraph (1).

(b) RESTORATION AMOUNT DEFINED.—

(1) IN GENERAL.—For purposes of subsection (a), the term "restoration amount" means, with respect to the net operating loss for any taxable year, an amount equal to the sum of—

(A) so much of the portion referred to in subsection (a)(3) as was required to be treated as ordinary income, and

(B) an amount equal to so much of such portion as was required to be treated as long-term capital gain, multiplied by the capital gain conversion fraction.

(2) CAPITAL GAIN CONVERSION FRACTION.—For purposes of paragraph (1), the capital gain conversion fraction is a fraction—

(A) the numerator of which is the rate of tax set forth in section 1201(a)(2) of such Code for the taxable year the portion was required to be included in income, and

(B) the denominator of which is the highest rate of tax set forth in section 11(b) of such Code for such taxable year.

(3) FIFO RULE FOR ADDITIONS TO EXCESS LOSS ACCOUNT.—For purposes of this subsection, the amount in any excess loss account at the time of restoration (and the ordinary income portion of the restoration) shall be treated as attributable to net operating losses in the order of the years in which the respective net operating losses arose.

(4) CAPITAL GAIN TREATMENT.—For purposes of paragraph (1), any amount to which an election under Regulation § 1.1502-19(a)(6) applies shall be treated as long-term capital gain.

(c) EFFECTIVE DATE.—This section shall apply to restorations occurring after March 31, 1976.

SEC. 5. PREVENTION OF ABUSE OF CERTAIN PENSION PLAN PROVISIONS THROUGH THE USE OF SEPARATE CORPORATIONS OR OTHER ORGANIZATIONS.

(a) IN GENERAL.—Section 414 (relating to definitions and special rules relating to pension plans, etc.) is amended by adding at the end thereof the following new subsection:

"(m) EMPLOYEES OF AN AFFILIATED SERVICE GROUP.—

"(1) IN GENERAL.—For purposes of the employee benefit requirements listed in paragraph (4), except to the extent otherwise provided in regulations, all employees of the members of an affiliated service group shall be treated as employed by a single employer.

"(2) AFFILIATED SERVICE GROUP.—For purposes of this subsection, the term 'affiliated service group' means a group consisting of a service organization (hereinafter in this paragraph referred to as the 'first organization') and one or more of the following:

"(A) any service organization which—

"(i) is a shareholder or partner in the first organization, and

"(ii) regularly performs services for the first organization or is regularly associated with the first organization in performing services for third persons, and

"(B) any other organization if—

"(i) a significant portion of the business of such organization is the performance of services (for the first organization, for organizations described in subparagraph (A), or for both) of a type historically performed in such service field by employees, and

"(ii) 10 percent or more of the interests in such organization is held by persons who are officers, highly compensated employees, or owners of the first organization or an organization described in subparagraph (A).

"(3) SERVICE ORGANIZATIONS.—For purposes of this subsection, the term 'service organization' means an organization the principal business of which is the performance of services.

"(4) EMPLOYEE BENEFIT REQUIREMENTS.—For purposes of this subsection, the employee benefit requirements listed in this paragraph are—

"(A) paragraphs (3), (4), (7), and (16) of section 401(a),

"(B) sections 408(k), 410, 411, and 415,

"(C) section 105(h), and

"(D) section 125.

"(5) OTHER DEFINITIONS. — For purposes of this subsection—

"(A) ORGANIZATION DEFINED.—The term 'organization' means a corporation, partnership, or other organization.

"(B) OWNERSHIP.—In determining ownership, the principles of section 267(c) shall apply.

"(6) PREVENTION OF AVOIDANCE.—The Secretary shall prescribe such regulations as may be necessary to prevent the avoidance with respect to service organizations, through the use of separate organizations, of any employee benefit requirement listed in paragraph (4)."

(b) TECHNICAL AMENDMENTS.—

(1) Paragraph (8) of section 105 (h) (relating to amount paid to highly compensated individuals under a discriminatory self-insured medical expense reimbursement plan) is amended—

(A) by striking out "subsection (b) or (c) of section 414" and inserting in lieu thereof "subsection (b), (c), or (m) of section 414", and

(B) by striking out "CONTROLLED GROUPS" in the paragraph heading and inserting in lieu thereof "CONTROLLED GROUPS, ETC.".

(2) Paragraph (4) of section 125 (g) (relating to special rules for cafeteria plans) is amended—

(A) by striking out "subsection (b) or (c) of section 414" and inserting in lieu thereof "subsection (b), (c), or (m) of section 414", and

(B) by striking out "CONTROLLED GROUPS" in the paragraph heading and inserting in lieu thereof "CONTROLLED GROUPS, ETC.".

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to plan years ending after November 30, 1980.

(2) PLANS IN EXISTENCE ON NOVEMBER 30, 1980.—In the case of a plan in existence on November 30, 1980, the amendments made by this section shall apply to plan years beginning after November 30, 1980.

Approved December 28, 1980.

Senate Report No. 96-1032
2d Session

[Bracketed numerals indicate official report page numbers]

CERTAIN MISCELLANEOUS CHANGES IN THE TAX LAWS

NOVEMBER 24 (legislative day, NOVEMBER 20, 1980)

Mr. LONG, from the Committee on Finance, submitted the following report to accompany H.R. 7171.[1]

The Committee on Finance, to which was referred the bill (H.R. 7171) to make certain miscellaneous changes in the tax laws, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

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

House bill.—H.R. 7171, as it passed the House, contains provisions relating to (1) an income tax exclusion for certain Federal scholarship grants, (2) the tax treatment of annuities purchased for employees of the Uniformed Services University of the Health Sciences, (3) the method of depreciation for railroad track assets, (4) the tax treatment of members of an affiliated group which included a transferor railroad in the ConRail reorganization, and (5) the excise tax treatment for wine and flavorings used in distilled spirits products.

Committee bill.—The committee bill (1) deletes the provision relating to Federal scholarship grants (similar provisions are included in H.R. 6975,

[1] Public Law 96-613, page 737.

as it passed the Senate), (2) retains the provision relating to the treatment of annuities purchased for employees of the Uniformed Services University of the Health Sciences, (3) deletes the provision relating to the depreciation of railroad track assets, (4) clarifies the provision relating to the treatment of certain net operating losses of a transferor railroad in the ConRail reorganization, (5) deletes the provision relating to wine and flavorings used in distilled spirits products (similar provisions are contained in H.R. 3317, as it passed the Senate), (6) adds a provision relating to the disclosure of tax returns to State audit agencies (section 6 of H.R. 4746, as it passed the House, and previously approved by the Senate, as section 3 of H.R. 3317), (7) adds a provision expanding the definition of lending or finance companies which are exempt from treatment as personal holding companies, and (8) adds a provision repealing the wagering excise taxes (previously reported by the committee in H.R. 3755).

[2] I. SUMMARY

Section 1.—Tax Treatment of Annuities Purchased for Employees of the Uniformed Services University of the Health Sciences

Present law provides that, if an annuity is purchased for an employee by an exempt organization described in Code section 501(c)(3) or by a public school system, the employer's contributions for the annuity contract are excludable, within certain limitations, from the employee's gross income and are not subject to tax until the employee receives payments under the annuity contract.

This provision of the bill extends the same rule to qualifying annuities purchased for the civilian staff and faculty of the Uniformed Services University of the Health Sciences, which was established by the Congress under the Department of Defense to train medical students for the uniformed services.

Secs. 2 and 3. Tax Treatment for Members of an Affiliated Group Which Included a Transferor Railroad in the ConRail Reorganization

Under present law, net operating losses of a member of an affiliated group of corporations controlled by a common parent corporation may be used to offset income reported by other members of the affiliated group where consolidated income tax returns are filed by the group. In order to reflect the reduction in tax liabilities derived by the other members of the affiliated group, the basis in the loss corporation's stock owned by other members of the group is reduced by these operating losses, and, where these losses exceed basis, a negative basis (called an excess loss account) is created. The excess loss account is restored to income when, for example, the loss corporation ceases to be a member of the affiliated group or the stock of the loss corporation becomes worthless.

The bill specifies that, for purposes of determining when an excess loss account is restored to income under the consolidated return rules, the determination of worthlessness of stock in a corporation which was a transferor railroad in the April 1, 1976, ConRail reorganization will not occur until after a final determination of the value of the transferred rail properties by a special court formed for this purpose. This provision is intended to benefit the Norfolk and Western Railway Company.

In addition, the bill provides that, to the extent an excess loss account arising from net operating losses of a ConRail transferor railroad from periods before or including the taxable year of the ConRail reorganization is restored as ordinary income (or its equivalent in capital gain income), the transferor's net operating losses will correspondingly be restored to the transferor railroad to apply solely against any income ultimately recognized by the transferor railroad [3] from the ConRail reorganization. This provision is intended to benefit the Erie Lackawanna Railway Company, and the Lehigh Valley Railroad Company.

Sec. 4. Disclosure of Tax Returns to State Audit Agencies

Present law authorizes the disclosure of returns and return information to State agencies which are charged under the laws of the State with responsibility for the administration of State tax laws for the purpose of, and only to the extent necessary in, the administration of such law.

This section of the bill will allow State taxing authorities to disclose Federal tax return information in their possession to State auditing agencies for the purpose of auditing the activities of the State taxing authority.

Sec. 5. Exemption of Certain Finance Companies From Personal Holding Company Treatment

Under present law, a tax is imposed on the undistributed personal holding company income of a personal holding company. Generally, personal holding company income includes interest. A corporation actively engaged in a lending or finance business is exempted from this tax if the corporation has qualifying business expenses equal to 15 percent of its ordinary gross income from its lending or finance business up to $500,000, plus five percent of such ordinary gross income from $500,000 to $1 million. The term "lending or finance business" does not include the business of making loans with remaining maturities of more than 60 months except in the case of certain secured obligations arising out of the borrower's or transferor's trade or business.

The bill increases the 60-month limitation of present law to 144 months, and amends the definition of a lending or finance business to include the business of making certain types of revolving credit loans. The bill also amends the business expense test of present law to require a lending or finance business to have qualifying business expenses equal to 15 percent of its ordinary gross income from the lending or finance business up to $500,000 plus five percent of such ordinary gross income

in excess of $500,000. In other words, the $1 million ordinary gross income ceiling would be eliminated for purposes of applying the qualifying business expense test.

SEC. 6. EXEMPTION FROM EXCISE TAX ON WAGERS AND OCCUPATIONAL TAX ON WAGERING

Under present law, a 2-percent excise tax is imposed on the amount of certain wagers. In addition, an annual $500 occupational tax is imposed on a person who is liable for the excise tax or who receives wages subject to the tax. These taxes do not apply with respect to parimutuel wagering, a wager placed in a coin-operated device, or a wager in a State-conducted lottery.

The bill repeals the 2-percent excise tax on certain wagering and the annual $500 occupational tax on persons engaged in the business of accepting wagers. The provisions are effective January 1, 1981.

[4] II. EXPLANATION OF BILL

A. Tax Treatment of Annuities Purchased for Employees of the Uniformed Services University of the Health Sciences (sec. 1 of the bill and sec. 403(b) of the Code)

Present law

If an annuity is purchased for an employee by an exempt organization described in Code section 501(c)(3) or by a public school system, the employer's contributions for the annuity contract are, within certain limitations, excludable from the employee's gross income and not subject to tax until the employee receives payments under the annuity contract (sec. 403(b)). Subject also to certain limitations generally applicable to tax-qualified retirement plans, the amount excludable in any year cannot exceed 20 percent of the employee's current annual compensation times the number of years of service, less amounts contributed tax-free in prior years.

In P.L. 92-426, Congress authorized establishment (under the Department of Defense) of the Uniformed Services University of the Health Sciences in order to train medical students for the uniformed services. This legislation authorizes hiring civilian faculty and staff members at salary schedules and with retirement benefits similar to those given to the faculty and staff of medical schools in the Washington, D.C. area. On July 15, 1975, the Secretary of Defense approved a tax-deferred annuity program for the faculty, similar to annuities available at certain medical schools in the Washington area and throughout the United States. However, because the University is a Federal instrumentality and is not an exempt organization described in section 501(c)(3), the annuities do not qualify under present law for tax deferral pursuant to section 403(b).

Reasons for change

The committee believes that annuities purchased for the civilian faculty and staff of the Uniformed Services University of the Health Sciences should qualify for income tax deferral in the same manner as annuities purchased for employees of exempt organizations described in section 501(c)(3) or of public school systems.

Explanation of provision

The provision treats otherwise qualified annuities purchased for the civilian staff and faculty of the Uniformed Services University of the Health Sciences in the same manner for income tax purposes (Code sec. 403(b)) as employee annuities purchased by section 501(c)(3) organizations or by public school systems. Any qualified annuity purchased by the University would be subject to the same limitations as other annuities described in section 403(b).

Effective date

The provisions apply to annuities purchased for service performed after December 31, 1979, in taxable years ending after that date.

Revenue effect

It is estimated that the provision will decrease budget receipts by less than $1 million per year.

[5] B. Tax Treatment for Members of an Affiliated Group Which Included a Transferor Railroad in the ConRail Reorganization (secs. 2 and 3 of the bill and sec. 374 of the Code)

Present law

On April 1, 1976, a number of insolvent midwestern and eastern railroads, along with many of their subsidiaries and affiliates, transferred their railroad properties to the Consolidated Rail Corporation (ConRail). These transfers were mandated and approved by the Congress[1] in order to provide financially self-sustaining rail services in areas served by these bankrupt railroads.

Under the legislation which established it, ConRail, a taxable corporation, was to acquire, rehabilitate, and operate the railroad properties. The transferor railroads (and their subsidiaries and affiliates) received ConRail stock and certificates of value issued by the United States Railway Association, a nonprofit Government corporation formed to oversee the ConRail reorganization. Valuation of the transferred railroad properties, and the corresponding value of the certificates of value received by the transferor railroads, is to be determined ultimately by a special court created for this purpose.

In 1976, the Congress also enacted legislation to deal with certain of the tax consequences of this reorganization to ConRail, the transferor railroads, and the shareholders and creditors of the transferor railroads. Under this legislation,[2] the transfer of rail properties to ConRail was treated like reorganizations in general (and other bankrupt railroad reorganizations in partic-

[1] The facilitating legislation for transfers was the Regional Rail Reorganization Act of 1973 (P.L. 93-236 [1974-1 C.B. 383], approved January 2, 1974) and the Railroad Revitalization and Regulatory Reform Act of 1976 (P.L. 94-210, approved February 5, 1976).

[2] P.L. 94-253 [1976-1 C.B. 520], approved March 31, 1976.

ular) so that the transferor companies and their shareholders and security holders did not recognize gain or loss on the transfer and ConRail received a carryover basis in the properties it acquired (Code sec. 374(c)). In addition, where the carryover period has expired for a transferor railroad's net operating losses which were incurred before and during the taxable year in which the ConRail reorganization took place, these losses generally may be revived to apply against any income eventually recognized from the ConRail transfer (Code sec. 374(e)).

The 1976 tax legislation did not deal with certain other aspects of the ConRail reorganization, such as investment credit recapture to the transferor railroads which arose from the mandated transfer of assets to ConRail. To deal with this aspect of the ConRail reorganization, the Revenue Act of 1978 (P.L. 95-600 [1978-3 C.B. (Vol. 1) 1], approved November 6, 1979) added an exception to the investment credit recapture rules so that a transferor railroad will not be subject to recapture of the investment credit because of its transfer of railroad properties to ConRail.

[6] Present law also provides rules which deal with the filing of consolidated returns by affiliated groups of corporations.[3] Under the section 1502 consolidated return regulations, income tax liability generally is based on the combined income of the corporations in the affiliated group. Where one or more members of the affiliated group have incurred net operating losses, these losses offset taxable income of other members of the affiliated group, and the tax basis of their investment in the stock of the loss corporation is reduced, generally by an allocated portion (based on stock ownership) of the losses reflected in the consolidated return. If the losses used on the consolidated returns exceed the basis of the stock owned by the other members of the group, the result is the creation of excess loss accounts which are the equivalent of negative basis in the stock of the loss corporation owned by the other members.

Where there is a disposition of the loss affiliate's stock or the stock ownership requirements for an affiliated group cease to be met, any excess loss accounts in existence at that time are "restored" by treating them as income.[4] The term disposition is broadly defined and includes the occurrence of worthlessness of the loss affiliate's stock. In these situations, ordinary income will result to the extent of "insolvency" of the loss affiliate and special rules are provided for determining insolvency in situations concerning excess loss accounts. Where an excess loss account is restored, a previously used net operating loss is not restored to the loss affiliate.

Reasons for change

The committee believes that the question of the worthlessness of a ConRail transferor railroad's stock cannot be accurately resolved, for purposes of determining whether to trigger an excess loss account under the consolidated return rules, until the value of the consideration for the ConRail certificates of value is ultimately decided at some time in the future. In addition, the committee considers that, to the extent an excess loss account is triggered in connection with the net operating losses of a transferor railroad in the ConRail reorganization, the losses should be restored to apply against income eventually recognized from the ConRail transfers to the same extent otherwise expired net operating losses may be generally revived by a transferor railroad. The committee's bill addresses these two aspects of the ConRail reorganization.

Explanation of provisions

Determination of worthlessness of capital stock of a transferor railroad (Sec. 2 of the bill)

Section 2 of the committee's bill provides a statutory rule, for purposes of applying the consolidated return regulations, under which the determination of worthlessness of the capital stock of a transferor [7] railroad in the ConRail reorganization is postponed until a determination of value by the special court becomes final. Under this rule, where the question of whether there have been certain types of dispositions (called "demeed dispositions") of a ConRail transferor railroad's stock under the consolidated return regulations depends upon the determination of value by the special court, a deemed disposition will not be considered as occurring until the earlier of either the date the special court's determination becomes final or the occurrence of another event which causes restoration of the excess loss account under the consolidated return regulations. The committee intends that the specific types of deemed dispositions which are addressed by this provision are: (1) worthlessness of the stock of the transferor railroad and, (2) where 10 percent or less of the face amount of an obligation of the transferor railroad will be recoverable at maturity by its creditors, as these two types of deemed dispositions are described in Income Tax Regulations § 1.1502-19(b)(2)(iii) and (iv), respectively. As a result, the excess loss account will be restored before the special court's determination becomes final if, for example, the transferor railroad ceases to be a member of the affiliated group, or if another member of the affiliated group transfers an obligation of the transferor railroad to a nonmember of the group for 25 percent or less of its face value.

Section 2 of the bill is intended to benefit the Norfolk and Western Railway Company.

Net operating losses of a transferor railroad (sec. 3 of the bill)

In addition, under section 3 of the

[3] These rules are primarily set forth in regulations promulgated under specific statutory authority (Code sec. 1502). An affiliated group of corporations is generally defined as a group of corporations connected with a common parent corporation through ownership of at least 80 percent of the voting power of all classes of voting stock and at least 80 percent of each class of nonvoting stock.

[4] These rules are necessary in order to reflect the reduction in tax liability which the other members of the affiliated group have derived through use of the losses.

bill, it is provided that if an excess loss account arising from the net operating losses of a transferor railroad is restored to income of the affiliated group which filed consolidated income tax returns with the transferor railroad, those losses which are subject to the revival provisions generally under the ConRail reorganization will be restored to the transferor railroad in an amount which corresponds to the ordinary income (or its equivalent in capital gain income adjusted to reflect the lower capital gains rate) recognized by the affiliated group through triggering the excess loss account. For this purpose, an excess loss account will be considered to have been restored to income by the affiliated group even if an election is made to reduce basis in investments in the transferor railroad under the consolidated return regulations (Treas. Reg. § 1.502-19(a)(6)). (However, if such an election to reduce basis is made, the amount restored to the transferor railroad will be adjusted to reflect the lower capital gains rate.)

Because existing law concerning the revival of net operating losses by ConRail transferor railroads applies only to those losses incurred before or during the taxable year which includes the April 1, 1976, ConRail transfer, the net operating losses which are eligible for restoration to the transferor railroad under this provision are limited to those of the transferor railroad which contributed to the excess loss account and which were incurred either in the first taxable year which ends after March 31, 1976, or in a prior taxable year, and which could be carried over to the first taxable year which ends after March 31, 1976.

A first-in-first-out rule is also provided for purposes of this provision so that the restoration of the excess loss account will be considered, [8] for purposes of restoring net operating losses to the transferor railroad under this provision, to result from the earliest of the losses which created the excess loss account. The net operating losses which are restored may only be applied against income which is eventually recognized from the March 31, 1976, transfer to ConRail. In addition, where losses eligible for restoration to the transferor railroad are attributable to capital gain income recognized by other members of the affiliated group (through restoration of the excess loss accounts) these losses will be restored to the transferor railroad only in amounts equal to the ordinary income equivalent of these capital gains. The ordinary income equivalent of the capital gain is the capital gain multiplied by a fraction, the numerator of which is the capital gain tax rate of corporations for the taxable year in which the loss accounts were restored, and the denominator of which is the maximum rate of tax on ordinary income of corporations for this taxable year.

The provisions of section 3 of the bill can be illustrated by the following example. Assume that the basis of a transferor railroad's stock owned by the other members of the affiliated group had been reduced to zero at the end of 1974, because of prior losses used by the group, that the transferor railroad incurred net operating losses of $10 million in calendar year 1975, $20 million in 1976, and $15 million in 1977, and that in 1978 it had $10 million of income. Assume further that in 1979 the transferor railroad ceased to be a member of the affiliated group, and the excess loss accounts of the other members of the group, $35 million in total, are restored as ordinary income to the group. Because of the ordering rule in the bill, the $10 million of the transferor railroad's income in 1978 is deemed to offset its post-1976 loss. Accordingly, the full $30 million of losses which were incurred in 1975 and 1976 (and which increased the excess loss account) will be restored under the rules of the bill. In addition, if the transferor railroad is insolvent to the extent of $20 million at the time of the restoration of the excess loss accounts, the amount of the restoration of losses to the transferor would be $20 million plus 28/46 times $10 million, or a total of $26,086,956. This reflects the second aspect of the ordering rule, which attributes the ordinary income portion of the restoration to the earliest losses of the transferor railroad.

Section 3 of the bill is intended to benefit the Erie Lackawanna Railway Company, a member of the affiliated group of corporations of which the Norfolk and Western Railway Corporation is the parent corporation and the Lehigh Valley Railroad Company, a member of the affiliated group of which the Penn Central Company is the parent company.

Effective date

The provisions apply to deemed dispositions of a ConRail transferor's stock for taxable years ending after March 31, 1976, and to restorations after March 31, 1976, of excess loss accounts attributable to net operating losses of a ConRail transferor.

Revenue effect

The revenue effects of sections 2 and 3 of the bill are indeterminate with respect to both the amount of tax involved and the timing of tax payment.

[9] If the excess loss account were restored to income for the 1976 tax year, the Norfolk and Western Railway Company would incur an additional tax liability of about $15 million. However, the amount of estimated tax liability, if any, may be adjusted after the determination of value by the special court. Because the taxpayer is expected to oppose assertion of a deficiency for its 1976 tax year, there would be an effect on budget receipts only if the taxpayer's position were not sustained and this occurred before the determination of the value by the special court became final or the Erie Lackawanna Railway Company ceased to be a member of the affiliated group of corporations of which the taxpayer is the parent corporation.

Restoration of the net operating losses to the Erie Lackawanna Railway Company could eventually decrease budget receipts by some amount of less than $15 million. However, these potential revenue losses are not expected to take place before fiscal year 1986.

The provision affecting the Lehigh Valley Railroad Company is estimated to reduce budget receipts by a total of less than $10 million. However, both the exact amount of the tax involved and the timing of the revenue losses are indeterminate.

[10] C. Disclosure of Tax Returns to State Audit Agencies (sec. 4 of the bill and sec. 6103(d) of the Code)

Present law

Under present law (Code sec. 6103 (d)), returns and return information may be disclosed to State agencies which are charged under the laws of the State with responsibility for the administration of State tax laws for the purpose of, and only to the extent necessary in, the administration of such laws. Section 6103(d) sets forth specific rules with which a State agency must comply in order to receive Federal tax information. For example, the request for disclosure must be made by the head of the State tax agency in writing and the actual disclosure of the tax information may be made only to the representatives of the State tax agency who are designated in the written request to receive the information. Also, the law provides that the tax information cannot be disclosed to the Governor of a State. In addition, return information may not be disclosed to the extent that the Secretary of the Treasury determines such disclosure would identify a confidential informant or seriously impair any civil or criminal tax investigation.

Return information disclosed to State agencies is subject to strict safeguard, recordkeeping, and reporting requirements (Code secs. 6103(p)(3) and 6103(p)(4)). These requirements provide assurances that Federal tax return information will be used only for the purposes authorized by law and provide a basis for determining when violations occur.

Reasons for change

The committee believes that a State taxing authority should be permitted to disclose Federal tax return information in its possession to a State audit agency for the purpose of auditing the State taxing authority.

Explanation of provision

The bill provides that any returns or return information obtained by a State agency pursuant to the provisions of section 6103(d) may be open to inspection by, or disclosure to, officers and employees of the State audit agency for the purpose of, and only to the extent necessary in, making an audit of the State agency which obtained the returns or return information. Under the bill, a "State audit agency" is defined as any State agency, body, or commission which is charged under the laws of the State with the responsibility of auditing State revenues and programs.

In addition, a State audit agency which receives return information would be subject to the same safeguard, recordkeeping, and reporting requirements as apply to other State agencies which receive return information and would be subject to the confidentiality requirements [11] imposed by section 6103(a) and the civil and criminal penalties applicable in the case of unauthorized disclosure of such return information.

Effective date

This provision is effective upon enactment.

Revenue effect

This provision will not have any impact on Federal revenues.

[12] D. Exemption of Certain Finance Companies from Personal Holding Company Treatment (sec. 5 of the bill and sec. 542 of the Code)

Present law

Code section 541 imposes a 70-percent tax on the undistributed personal holding company income of a personal holding company. This provision is intended to prevent individuals from avoiding the graduated individual tax rates (ranging up to 70 percent) by placing investments in corporations which are subject to a maximum tax rate of 46 percent.

A personal holding company is defined as a corporation 60 percent of whose adjusted ordinary gross income is personal holding company income and 50 percent of whose stock is owned by 5 or fewer shareholders at any time during the last half of the taxable year. Personal holding company income generally is defined as interest, dividends, royalties, rents and certain other types of passive investment income.

Certain types of corporations which are actively engaged in a trade or business which produces income which usually would be considered to be passive investment income are excluded from the personal holding company tax provisions. Among the corporations excluded from these provisions are lending or finance companies. A corporation qualifies as a lending or finance company if 60 percent of its ordinary gross income is derived from the active and regular conduct of a lending or finance business and certain other requirements are satisfied. The term lending or finance business is defined, in part, to mean a business of making loans, and purchasing or discounting accounts receivable, notes, or installment obligations which at the date of acquisition have a remaining maturity of no more than 60 months. One exception to the 60-month rule is provided for loans, notes, or obligations secured by a security interest in personal property where the security interest arose out of the sale of goods or services in the course of the borrower's or transferor's trade or business.

The personal holding company provisions also apply a business expense test in determining whether a corporation is engaged in the active and regular conduct of a lending or finance business. Under this requirement a corporation will not qualify as a lending or finance company exempt from the personal holding company provisions unless the sum of its business expenses directly allocable to its lending or finance business equals or ex-

ceeds 15 percent of the first $500,000 of its ordinary gross income derived from a lending or finance busi-[13]ness plus 5 percent of such ordinary gross income from $500,000 to $1,000,000.[1]

Reasons for change

Since 1964 (when the rules relating to lending or finance companies were last amended) the nature of the loans made by lending or finance companies has changed. First, these companies have been making loans of longer maturities—primarily second mortgages on real estate and also financing of mobile homes. Some of these loans have maturities of up to 144 months. Notwithstanding the length of the loans, the making of these loans by these companies is often done not as part of an investment activity, but rather as part of the active conduct of a trade or business. Second, these companies have made increasing use of revolving credit loans, which technically may have a maturity which does not meet the "no more than 60 months" requirement. Furthermore, due to the passage of time, the cap on the business expense test has become outdated.

The committee also notes that the recent case of *Omaha Aircraft Leasing Co.*, 74 T.C. No. 19 (1980), involved the issue of whether the taxpayer was engaged in the active and regular conduct of a lending or finance business. In addressing the issue of whether the "active and regular" requirement was met, the court considered (1) the number of loans outstanding, (2) the amount of effort and expense required to service the loans, (3) the extent of the taxpayer's activities involving attempts to make new loans, and (4) the duration of periods of inactivity by the taxpayer. The decision of the Tax Court in this case indicates that the "active and regular" requirement, coupled with the business expense test (as modified by the bill), should be sufficient to insure that the lending or finance company provisions will not apply to "incorporated pocketbooks" which are essentially passive investment entities even if loans with longer maturities are permitted.

Accordingly, the committee believes that the definition of the term lending or finance business should be modified to include the business of making revolving credit loans and loans with maximum maturities of 144 months and that the business expense test of present law should be modified by removing the cap.

Explanation of provision

The bill in general modifies the 60-month maturity limitation under the definition of a lending or finance business and the business expense requirement of the lending or finance company exception to the personal holding company provisions. Under the bill, the definition of a [14] lending or finance business is amended to include the business of making loans with maturities up to 144 months and to include the business of making certain types of revolving credit loans.

Revolving credit loans qualifying under the bill would be such loans made under an agreement which provides that the creditor will make loans or advances (not in excess of an agreed upon maximum amount) from time to time for the account of the debtor upon request and which provides that the debtor may repay the loan or advance in full or in installments.

The bill also removes the current cap on the amount of business expenses required in determining whether a corporation is a lending or finance company. Under the bill, a corporation would satisfy the business expense test only if its qualifying business expenses equal or exceed 15 percent of its ordinary gross income up to $500,000 derived from a lending or finance business, plus 5 percent of such ordinary gross income in excess of $500,000.

Effective date

The provision applies to taxable years beginning on or after the date of enactment.

Revenue effect

It is estimated that this provision will reduce fiscal year budget receipts by less than $5 million annually.

[15] E. Repeal of Excise Tax on Wagers and Occupational Tax on Wagering

(Sec. 6 of the bill and sec. 4402 and new secs. 4414 and 4415 of the Code)

Present law

Under present law, a 2-percent excise tax is imposed on the amount of certain wagers. For this purpose, a wager means (1) a wager placed with a person who is in the business of accepting wagers on the outcome of a sports event or contest, (2) a wager with respect to a sporting event or contest placed in a wagering pool conducted for profit, and (3) a wager placed in a lottery conducted for profit (including the numbers game, policy, and similar types of wagering). However, this excise tax is not imposed on (1) wagers placed with a parimutuel licensed under State law, (2) wagers placed in coin-operated gaming devices (e.g., slot machines) and (3) State-conducted wagering (e.g., State-conducted sweepstakes, off-track betting, and lotteries). Under present law, the 2-percent excise tax is imposed on so-called off-track betting authorized by State law but not conducted by the State.

Every person engaged in the business of accepting wagers is liable for the tax with respect to wagers on which the tax is imposed.

Under present law, a special occupational tax of $500 per year is imposed on each person who is liable for the 2-percent excise tax on wagers and on each person who is engaged in receiving wagers for such a person.

[1] Business expenses include only (1) deductions which are allowable only by reason of Code sections 162 or 404 and which do not represent compensation for personal services rendered by shareholders or members of their families and (2) deductions for depreciation and real property taxes to the extent that the property with respect to which such deductions are allowable is used directly in the active and regular conduct of the lending or finance business (Code sec. 542(d)(2)).

Reasons for change

The committee believes that the present law excise tax, which applies to certain types of wagering but not to others, discriminates unfairly among different types of legal wagering. The committee also believes that the imposition of taxes subjects legal wagering to an unnecessary economic burden not borne by illegal wagering for which such liabilities are generally evaded. Therefore, the bill eliminates the wagering excise and occupational taxes.

Explanation of provision

The provision repeals the 2-percent excise tax on wagers and the annual $500 occupational tax on persons engaged in the business of accepting wagers.

Effective date

The provision applies to any wager made, or any person engaged in receiving any wager, during taxable periods beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will reduce fiscal year budget receipts by $9 million in 1981, $14 million in 1982, $15 million in 1983 and 1984, and $16 million in 1985.

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SUPREME COURT OF THE UNITED STATES
NO. 78-1729

United States v. Payner
[447 U.S. 724]

On writ of certiorari to the United States Court of Appeals for the Sixth Circuit

[June 23, 1980]

Syllabus

At respondent's nonjury trial for falsifying a federal income tax return by denying that he maintained a foreign bank account, respondent moved to suppress a loan guarantee agreement in which he pledged the funds in the bank account as security. The District Court found respondent guilty on the basis of all the evidence, but then (1) found that the Government had discovered the guarantee agreement as the result of a flagrantly illegal search of a bank officer's briefcase, (2) suppressed all the Goverment's evidence except for respondent's tax return and related testimony, and (3) set aside the conviction for failure to demonstrate knowing falsification. The court held, *inter alia,* that, although the illegal search did not violate respondent's Fourth Amendment rights, the inherent supervisory power of the federal courts required it to exclude evidence tainted by the illegal search. The Court of Appeals affirmed.

Held:

1. Respondent lacks standing under the Fourth Amendment to suppress the documents illegally seized from the bank officer. A defendant's Fourth Amendment rights are violated only when the challenged conduct invaded *his* legitimate expectation of privacy rather than that of a third party, and respondent possessed no privacy interest in the documents seized in this case. Cf. *Rakas* v. *Illinois,* 439 U.S. 128; *United States* v. *Miller,* 425 U.S. 435 [Ct. D. 1978, 1976-1 C.B. 535].

2. The supervisory power of the federal courts does not authorize a court to suppress otherwise admissible evidence on the ground that it was seized unlawfully from a third party not before the court. Under the Fourth Amendment, the interest in deterring illegal searches does not justify the exclusion of tainted evidence at the instance of a party who was not the victim of the challenged practices. And the values assigned to the competing interests of deterring illegal searches and of furnishing the trier of fact with all relevant evidence do not change because a court has elected to analyze the question under the supervisory power instead of the Fourth Amendment. Such power does not extend so far as to confer on the judiciary discretionary power to disregard the considered limitations of the law it is charged with enforcing.

590 F. 2d 206, reversed.

POWELL, J., delivered the opinion of the Court, in which BURGER, C. J., and STEWART, WHITE, REHNQUIST, and STEVENS, JJ., joined. BURGER, C. J., filed a concurring opinion. MARSHALL, J., filed a dissenting opinion, in which BRENNAN and BLACKMUN, JJ., joined.

MR. JUSTICE POWELL delivered the opinion of the Court.

The question is whether the District Court properly suppressed the fruits of an unlawful search that did not invade the respondent's Fourth Amendment rights.

I

Respondent Jack Payner was indicted in September 1976 on a charge of falsifying his 1972 federal income tax return in violation of 18 U.S.C. § 1001.[1] The indictment alleged that respondent denied maintaining a foreign bank account at a time when he knew that he had such an account at the Castle Bank and Trust Company of Nassau, Bahama Islands. The Government's case rested heavily on a loan guarantee agreement dated April 28, 1972, in which respondent pledged the funds in his Castle Bank account as security for a $100,000 loan.

Respondent waived his right to jury trial and moved to suppress the guarantee agreement. With the consent of the parties, the United States District Court for the Northern District of Ohio took evidence on the motion at a hearing consolidated with the trial on the merits. The court found respondent guilty as charged on the basis of all the evidence. The court also found, however, that the Government discovered the guarantee agreement by exploiting a flagrantly illegal search that occurred on January 15, 1973. The court therefore suppressed "all evidence introduced in the case by the Government with the exception of Jack Payner's 1972 tax return . . . and the related testimony." *United States* v. *Payner,* 434 F. Supp. 113, 136 (1977). As the tax return alone was insufficient to demonstrate knowing falsification, the District Court set aside respondent's conviction.[2]

The events leading up to the 1973 search are not in dispute. In 1965, the Internal Revenue Service launched an investigation into the financial activities of American citizens in the Bahamas. The project, known as "Operation Trade Winds," was headquartered in Jacksonville, Fla. Suspicion focused on the Castle Bank in 1972, when investigators learned that a suspected narcotics trafficker had an account there. Special Agent Richard Jaffe of the Jacksonville office asked Norman Casper, a private investigator and occasional informant, to learn what he could about the Castle Bank and its depositors. To that end, Casper cultivated his friendship with Castle Bank vice-president Michael Wolstencroft. Casper introduced Wolstencroft to Sybol Kennedy, a private investigator and former employee. When Casper discovered that the banker intended to spend a few days in Miami in January of 1973, he devised a scheme to gain access to the bank records he knew Wolstencroft would be carrying in his briefcase. Agent

[1] 18 U. S. C. § 1001 provides in relevant part:
"Whoever, in any matter within the jurisdiction of any department or agency of the United States knowingly and willfully . . . makes any false, fictitious or fraudulent statements or representations, . . . shall be fined not more than $10,000 or imprisoned not more than five years, or both."

[2] The unusual sequence of rulings was a byproduct of the consolidated hearing conducted by the District Court. The court initially failed to enter judgment on the merits. At the close of the evidence, it simply granted respondent's motion to suppress. After the Court of Appeals for the Sixth Circuit dismissed the government's appeal for want of jurisdiction, the District Court vacated the order granting the motion to suppress and entered a verdict of guilty. The court then reinstated its suppression order and set aside the verdict. Respondent does not challenge these procedures.

Jaffe approved the basic outline of the plan.

Wolstencroft arrived in Miami on January 15 and went directly to Kennedy's apartment. At about 7:30 p.m., the two left for dinner at a Key Biscayne restaurant. Shortly thereafter, Casper entered the apartment using a key supplied by Kennedy. He removed the briefcase and delivered it to Jaffe. While the agent supervised the copying of approximately 400 documents taken from the briefcase, a "lookout" observed Kennedy and Wolstencroft at dinner. The observer notified Casper when the pair left the restaurant, and the briefcase was replaced. The documents photographed that evening included papers evidencing a close working relationship between the Castle Bank and the Bank of Perrine, Fla. Subpoenas issued to the Bank of Perrine ultimately uncovered the loan guarantee agreement at issue in this case.

The District Court found that the United States, acting through Jaffe, "knowingly and willfully participated in the unlawful seizure of Michael Wolstencroft's briefcase. . . ." 434 F. Supp, at 120. According to that court, "the Government affirmatively counsels its agents that the Fourth Amendment standing limitation permits them to purposefully conduct an unconstitutional search and seizure of one individual in order to obtain evidence against third parties. . . ." *Id.*, at 132-133. The District Court also found that the documents seized from Wolstencroft provided the leads that ultimately led to the discovery of the critical loan guarantee agreement. *Id.*, at 123.[3] Although the search did not impinge upon the respondent's Fourth Amendment rights, the District Court believed that the Due Process Clause of the Fifth Amendment and the inherent supervisory power of the federal courts required it to exclude evidence tainted by the Government's "knowing and purposeful *bad faith hostility* to any person's fundamental constitutional rights." *Id.*, at 129; see *id.*, at 133, 134-135.

The Court of Appeals for the Sixth Circuit affirmed in a brief order endorsing the District Court's use of its supervisory power. *United States* v. *Payner*, 590 F. 2d 206 (1979) (*per curiam*). The Court of Appeals did not decide the due process question.

We granted certiorari—U.S.—(1979), and we now reverse.

II

This Court discussed the doctrine of "standing to invoke the [Fourth Amendment] exclusionary rule" in some detail last term. *Rakas* v. *Illinois*, 439 U.S. 128, 138 (1978). We reaffirmed the established rule that a court may not exclude evidence under the Fourth Amendment unless it finds that an unlawful search or seizure violated the defendant's own constitutional rights. *Id.*, at 133-140. See, *e.g.*, *Brown* v. *United States*, 411 U.S. 223, 229-230 (1973); *Alderman* v. *United States*, 394 U.S. 165, 171-172 (1969); *Simmons* v. *United States*, 390 U.S. 377, 389 (1968). And the defendant's Fourth Amendment rights are violated only when the challenged conduct invaded *his* legitimate expectation of privacy rather than that of a third party. *Rakas* v. *Illinois*, *supra*, at 143; *id.*, at 149-152 (POWELL, J., concurring); *Combs* v. *United States*, 408 U.S. 224, 227 (1972); *Mancusi* v. *DeForte*, 392 U.S. 364, 368 (1968).

The foregoing authorities establish, as the District Court recognized, that respondent lacks standing under the Fourth Amendment to suppress the documents illegally seized from Wolstencroft. 434 F. Supp., at 126. The Court of Appeals did not disturb the District Court's conclusion that "Jack Payner possessed no privacy interest in the Castle Bank documents that were seized from Wolstencroft." 434 F. Supp., at 126; see 590 F. 2d, at 207. Nor do we. *United States* v. *Miller*, 425 U.S. 435 (1976), established that a depositor has no expectation of privacy and thus no "protectable Fourth Amendment interest" in copies of checks and deposit slips retained by his bank. *Id.*, at 437; see *id.*, at 442. Nothing in the record supports a contrary conclusion in this case.[4]

The District Court and the Court of Appeals believed, however, that a federal court should use its supervisory power to suppress evidence tainted by gross illegalities that did not infringe the defendant's constitutional rights. The United States contends that this approach—as applied in this case—upsets the careful balance of interests embodied in the Fourth Amendment decisions of this Court. In the Government's view, such an extension of the

[3] The United States argued in the District Court and the Court of Appeals that the guarantee agreement was discovered through an independent investigation untainted by the briefcase search. The Government also denied that its agents willfully encouraged Casper's illegal behavior. For purposes of this opinion, we need not question the District Court's contrary findings on either point.

[4] We are not persuaded by respondent's suggestion that the Bahamian law of bank secrecy creates an expectation of privacy not present in *United States* v. *Miller*, 425 U. S. 435 (1976). At the outset, it is not clear that secret information regarding this respondent's account played any role in the investigation that led to the discovery of the critical loan guarantee agreement. Even if the causal link were established, however, respondent's claim lacks merit. He cites a provision, Ch. 96.9 of the Statute Law of the Bahama Islands (1909), that is no longer in effect. Bank secrecy is now safeguarded by § 19 of the Banks Act, I Bah. Rev. Stat. ch. 96 (1965), as amended, 1965 Bah. Acts No. 65, which provides in relevant part:

"Except for the purpose of the performance of his duties or the exercise of his functions under this Act or when lawfully required to do so by any court of competent jurisdiction within the Colony or under the provisions of any law of the Colony, no person shall disclose any information relating to . . . the affairs of . . . any customer of a [bank] licensee which he has acquired in the performance of his duties or the exercise of his functions under this Act."

See also the Banks and Trust Companies Regulation Act, 1965 Bah. Acts No. 64, § 10, as amended, 1968 Bah. Acts No. 33, 1969 Bah. Acts No. 20, 1971 Bah. Acts No. 15. The statute is hardly a blanket guarantee of privacy. Its application is limited; it is hedged with exceptions; and we have been directed to no authority construing its terms. Moreover, American depositors know that their own country requires them to report relationships with foreign financial institutions. 31 U. S. C. § 1121; 31 CFR § 103.24. See generally *California Bankers Assn.* v. *Shultz*, 416 U. S. 21, 59-63, 71-76 (1974) [Ct. D. 1960, 1974-1 C.B. 393]. We conclude that respondent lacked a reasonable expectation of privacy in the Castle Bank records that documented his account.

supervisory power would enable federal courts to exercise a standardless discretion in their application of the exclusionary rule to enforce the Fourth Amendment. We agree with the Government.

III

We certainly can understand the District Court's commendable desire to deter deliberate intrusions into the privacy of persons who are unlikely to become defendants in a criminal prosecution. See 434 F. Supp., at 135. No court should condone the unconstitutional and possibly criminal behavior of those who planned and executed this "briefcase caper." [5] Indeed, the decisions of this Court are replete with denunciations of willfully lawless activities undertaken in the name of law enforcement. *E.g., Jackson* v. *Denno,* 378 U.S. 368, 386 (1964); see *Olmstead* v. *United States,* 277 U.S. 438, 485 (1928) (Brandeis, J., dissenting). But our cases also show that these unexceptional principles do not command the exclusion of evidence in every case of illegality. Instead, they must be weighed against the considerable harm that would flow from indiscriminate application of an exclusionary rule.

Thus, the exclusionary rule "has been restricted to those areas where its remedial objectives are most efficaciously served." *United States* v. *Calandra,* 414 U.S. 338, 348 (1974). The Court has acknowledged that the suppression of probative but tainted evidence exacts a costly toll upon the ability of courts to ascertain the truth in a criminal case. *E.g., Rakas* v. *Illinois, supra,* at 137-138; *United States* v. *Ceccolini,* 435 U.S. 268, 275-279 (1978); *Stone* v. *Powell,* 428 U.S. 464, 489-491 (1976); see *Michigan* v. *Tucker,* 417 U.S. 433, 450-451 (1974).[6] Our cases have consistently recognized that unbending application of the exclusionary sanction to enforce ideals of governmental rectitude would impede unacceptably the truth-finding functions of judge and jury. *E.g., Stone* v. *Powell, supra,* at 485-489; *United States* v. *Calandra, supra,* at 348. After all, it is the defendant, and not the constable, who stands trial.

The same societal interests are at risk when a criminal defendant invokes the supervisory power to suppress evidence seized in violation of a third party's constitutional rights. The supervisory power is applied with some caution even when the defendant asserts a violation of his own rights.[7] In *United States* v. *Caceres,* 440 U.S. 741, 754-757 (1979) [Ct. D. 1998, 1979-1 C.B. 465], we refused to exclude all evidence tainted by violations of an executive department's rules. And in *Elkins* v. *United States,* 364 U.S. 206, 216 (1960), the Court called for a restrained application of the supervisory power.

"[A]ny apparent limitation upon the process of discovering truth in a federal trial ought to be imposed only upon the basis of considerations which outweigh the general need for untrammeled disclosure of competent and relevant evidence in a court of justice." 364 U.S., at 216.
See also *Nardone* v. *United States,* 308 U.S. 338, 340 (1939).

We conclude that the supervisory power does not authorize a federal court to suppress otherwise admissible evidence on the ground that it was seized unlawfully from a third party not before the court. Our Fourth Amendment decisions have established beyond any doubt that the interest in deterring illegal searches does not justify the exclusion of tainted evidence at the instance of a party who was not the victim of the challenged practices. *Rakas* v. *Illinois, supra,* at 137; *Alderman* v. *United States, supra,* at 174-175.[8] The values assigned

[5] "The security of persons and property remains a fundamental value which law enforcement officers must respect. Nor should those who flout the rules escape unscathed." *Alderman* v. *United States,* 394 U. S. 165, 175 (1969). We note that in 1976 Congress investigated the improprieties revealed in this record. See Oversight Hearings into the Operations of the IRS before a Subcommittee of the House Committee on Government Operations (Operation Tradewinds, Project Haven, and Narcotics Traffickers Tax Program), 94th Cong., 1st Sess. As a result, the Commissioner of Internal Revenue "called off" Operation Trade Winds. Tr. of Oral Arg. 35. The Commissioner also adopted guidelines that require agents to instruct informants on the requirements of the law and to report known illegalities to a supervisory officer, who is in turn directed to notify appropriate state authorities. IRS Manual Supp. 9-21, §§ 9373.3(3), 9373.4 (Dec. 27, 1977). Although these measures appear on their face to be less positive than one might expect from an agency charged with upholding the law, they do indicate disapproval of the practices found to have been implemented in this case. We cannot assume that similar lawless conduct, if brought to the attention of responsible officials, would not be dealt with appropriately. To require in addition the suppression of highly probative evidence in a trial against a third party would penalize society unnecessarily.

[6] See also *Kaufman* v. *United States,* 394 U. S. 217, 237-238 (1969) (Black, J., dissenting); Oaks, Studying the Exclusionary Rule in Search and Seizure, 37 U. Chi. L. Rev. 665, 736-746, 755-756 (1970).

[7] Federal courts may use their supervisory power in some circumstances to exclude evidence taken from the *defendant* by "willful disobedience of law." *McNabb* v. *United States,* 318 U. S. 332, 345 (1943); see *Elkins* v. *United States,* 364 U. S. 206, 223 (1960); *Rea* v. *United States,* 350 U. S. 214, 216-217 (1956); cf. *Hampton* v. *United States,* 425 U. S. 484, 495 (POWELL, J., concurring in the judgment). This Court has never held, however, that the supervisory power authorizes suppression of evidence obtained from third parties in violation of Constitution, statute or rule. The supervisory power merely permits federal courts to supervise "the administration of criminal justice" among the parties before the bar. *McNabb* v. *United States, supra,* at 340.

[8] "The deterrent values of preventing the incrimination of those whose rights the police have violated have been considered sufficient to justify the suppression of probative evidence even though the case against the defendant is weakened or destroyed. We adhere to that judgment. But we are not convinced that the additional benefits of extending the exclusionary rule to other defendants would justify further encroachment upon the public interest in prosecuting those accused of crime and having them acquitted or convicted on the basis of all the evidence which exposes the truth." *Alderman* v. *United States, supra,* at 174-175. See also *Stone* v. *Powell,* 428 U. S. 464, 488-489 (1976); *United States* v. *Calandra,* 414 U. S. 338, 348 (1974).

The dissent urges that the balance of interests under the supervisory power differs from that considered in *Alderman* and like cases, because the supervisory power focuses upon the "need to protect the integrity of the federal courts." Although the District Court in this case relied upon a deterrent rationale, we agree that the supervisory power serves the "two-fold" purpose of deterring illegality and protecting judicial integrity. As the dissent recognizes, however, the Fourth Amendment exclusionary

to the competing interests do not change because a court has elected to analyze the question under the supervisory power instead of the Fourth Amendment. In either case, the need to deter the underlying conduct and the detrimental impact of excluding the evidence remain precisely the same.

The District Court erred, therefore, when it concluded that "society's interest in deterring [bad faith] conduct by exclusion outweigh[s] society's interest in furnishing the trier of fact with all relevant evidence." 434 F. Supp., at 135. This reasoning, which the Court of Appeals affirmed, amounts to a substitution of individual judgment for the controlling decisions of this Court.[9] Were we to accept this use of the supervisory power, we would confer on the judiciary discretionary power to disregard the considered limitations of the law it is charged with enforcing. We hold that the supervisory power does not extend so far.

The judgment of the Court of Appeals is *Reversed.*

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rule serves precisely the same purposes. *Ibid.*, citing, *inter alia, Dunaway* v. *New York,* 442 U. S. 200, 218 (1979), and *Mapp* v. *Ohio,* 367 U. S. 643, 659-660 (1961). Thus, the Fourth Amendment exclusionary rule, like the supervisory power, is applied in part "to protect the integrity of the *court* rather than to vindicate the constitutional rights of the defendant. . . ."; see generally *Stone* v. *Powell,* 428 U. S. 465, 486 (1976); *United States* v. *Calandra, supra,* at 486.

In this case, where the illegal conduct did not violate the respondent's rights, the interest in preserving judicial integrity and in deterring such conduct is outweighed by the societal interest in presenting probative evidence to the trier of fact. See *supra;* see also, *e.g., Stone* v. *Powell, supra,* at 485-486. None of the cases cited by the dissent supports a contrary view, since none of those cases involved criminal defendants who were not themselves the victims of the challenged practices. Thus, our decision today does not limit the traditional scope of the supervisory power in any way; nor des it render that power "superfluous." We merely reject its use as a substitute for established Fourth Amendment doctrine.

[9] The same difficulty attends respondent's claim to the protections of the Due Process Clause of the Fifth Amendment. The Court of Appeals expressly declined to consider the Due Process Clause. But even if we assume that the unlawful briefcase search was so outrageous as to offend fundamental " 'canons of decency and fairness,' " *Rochin* v. *California,* 342 U. S. 165, 169 (1952), quoting *Malinski* v. *New York,* 324 U. S. 401, 417 (1945) (opinion of Frankfurter, J.), the fact remains that "[t]he limitations of the Due Process Clause . . . come into play only when the Government activity in question violates some protected right of the *defendant,*" *Hampton* v. *United States, supra,* at 490 (plurality opinion).

Delegation Order No. 4 (Rev. 11) (Effective July 11, 1980)

Authority to Issue Summonses, to Administer Oaths and Certify, and to Perform Other Functions

1(a). The authorities granted to the Commissioner of Internal Revenue by 26 CFR 301.7602-1(b), 301.7603-1, 301.7604-1 and 301.7605-1(a) and the authorities contained in Section 7609 of the Internal Revenue Code of 1954 and vested in the Commissioner of Internal Revenue Service by Treasury Department Order No. 150-37, dated March 17, 1955, to issue summonses; to set the time and place for appearance; to serve summonses; to take testimony under oath of the person summoned; to receive and examine books, papers, records or other data produced in compliance with the summons; to enforce summonses; to apply for court orders approving the service of John Doe Summonses issued under Section 7609 (f) of the Internal Revenue Code; and to apply for court orders suspending the notice requirements in the case of summonses issued under Section 7609(g) of the Internal Revenue Code, are delegated to the officers and employees of the Internal Revenue Service specified in paragraphs 1(b), 1(c), and 1(d) of this Order and subject to the limitations stated in paragraphs 1(b), 1(c), 1(d), and 6 of this Order

(b) The authorities to issue summonses and to perform the other functions related thereto specified in paragraph 1(a) of this Order, are delegated to all District Directors, the Director of International Operations, and the following officers and employees, provided that the authority to issue a summons in which the proper name or names of the taxpayer or taxpayers is not identified because unknown or unidentifiable (hereinafter called a "John Doe" summons) may be exercised only by said officers and employees and by them only after obtaining preissuance legal review by Regional Counsel, Deputy Regional Counsel (General Litigation) or District Counsel, or the Director, General Litigation Division in the case of Inspection.

(1) Inspection: Assistant Commissioner and Director, Internal Security Division.

(2) District Criminal Investigation: Chief of Division, except this authority in streamlined districts is limited to the District Director.

(3) International Operations: Chiefs of Divisions.

(4) District Collection Activity: Chief of Division, except this authority in streamlined districts is limited to the District Director.

(5) District Examination: Chief of Division, except this authority in streamlined districts is limited to the District Director.

(6) District Employee Plans and Exempt Organizations: Chief of Division.

(c) The authorities to issue summonses except "John Doe" summonses, and to perform other functions related thereto specified in paragraph 1(a) of this Order, are delegated to the following officers and employees:

(1) Inspection: Regional Inspectors and Assistant Regional Inspectors (Internal Security) and Chief, Investigations Branch.

(2) District Criminal Investigation: Assistant Chief of Division; Chiefs of Branches; and Group Managers.

(3) International Operations: Assistant Director; Chiefs of Branches; Case Managers; and Group Managers.

(4) District Collection Activity: Assistant Chief of Division; Chiefs of Collection Section; Chiefs of Field Branches and Office Branches; Chiefs, Special Procedures Staffs; Chiefs of Technical and Office Compliance

Branches and Groups and Group Managers.

(5) District Examination: Chiefs of Branches, Case Managers, Group Managers and, in streamlined districts Chiefs, Examination Section.

(6) District Employee Plans and Exempt Organizations: Group Managers.

(d) The authority to issue summonses except "John Doe" summonses and to perform the other functions related thereto specified in paragraph 1(a) of this Order is delegated to the following officers and employees except that in the instance of a summons to a third party witness, the issuing officer's case manager, group manager, or supervisory official above that level, has in advance personally authorized the issuance of the summons. Such authorization shall be the original and all copies of the summons or by a statement on the face of the original and all copies of the summons, signed by the issuing officer, that he/she had prior authorization to issue said summons and stating the name and title of the authorizing official and the date of authorization.

(1) International Operations: Internal Revenue Agents; Attorneys, Estate Tax; Estate Tax Examiners; Special Agents; Revenue Service and Assistant Revenue Service Representatives; Tax Auditors; and Revenue Officers, GS-9 and above.

(2) District Criminal Investigation: Special Agents.

(3) District Collection: Revenue Officers, GS-9 and above.

(4) District Examination: Internal Revenue Agents; Tax Auditors; Attorneys, Estate Tax; and Estate Tax Examiners.

(5) District Employee Plans and Exempt Organizations: Internal Revenue Agents; Tax Law Specialists; and Tax Auditors.

(e) Each of the officers and employees referred to in paragraphs 1(b), 1(c) and 1(d) of this Order may serve a summons whether it is issued by him/her or another official.

(f) Revenue Representatives, GS-5 and above, and Revenue Officers, who are assigned to the District Collection Activity and to International Operations may serve any summons issued by the officers and employees referred to in paragraphs 1(b), 1(c) and 1(d) of this Order.

2. Each of the officers and employees referred to in paragraphs 1(b), 1(c), and 1(d) of this Order authorized to issue summonses, is delegated the authority under 26 CFR 301.7602-1(b) to designate any other officer or employee of the Internal Revenue Service referred to in paragraph 4(b) of this Order, as the individual before whom a person summoned pursuant to Section 7602 of the Internal Revenue Code shall appear. Any such other officer or employee of the Internal Revenue Service when so designated in a summons is authorized to take testimony under oath of the person summoned and to receive and examine books, papers, records or other data produced in compliance with the summons.

3. Internal Security Inspectors are delegated the authority under 26 CFR 301.7603-1 to serve summonses issued in accordance with this Order by any of the officers and employees of the Inspection Service referred to in paragraphs 1(b)(1) and 1(c)(1) of this Order even though Internal Security Inspectors do not have the authority to issue summonses.

4(a). The authorities granted to the Commissioner of Internal Revenue by 26 CFR 301.7602-1(a), and 301.7605-1(a) to examine books, papers, records or other data, to take testimony under oath and to set the time and place of examination are delegated to the officers and employees of the Internal Revenue Service specified in paragraphs 4(b), 4(c), and 4(d) of this Order and subject to the limitations stated in paragraphs 4(c) and 6 of this Order.

(b) General Designations

(1) Inspection: Assistant Commissioner; Director, Internal Security Division; Director, Internal Audit Division; Regional Inspectors; Internal Auditors; and Internal Security Inspectors.

(2) District Criminal Investigation: Chief and Assistant Chief of Division; Chiefs of Branches; Group Managers; and Special Agents.

(3) International Operations: Director, Assistant Director; Chief of Divisions and Branches; Special Agents; Case Managers; Group Managers, Internal Revenue Agents; Attorneys, Estate Tax; Estate Tax Examiners; Revenue Service and Assistant Revenue Service Representatives; Tax Auditors; and Revenue Officers.

(4) District Collection Activity: Chiefs and Assistant Chiefs of Division; Chiefs of Field Branches and Office Branches; Chiefs, Special Procedures Staffs; Chiefs, Technical and Office Compliance Branches; Chiefs, Collection Section; Chiefs, Technical and Office Compliance Branches and Groups; Group Managers and Revenue Officers.

(5) District Examination: Chiefs of Division; Chiefs of Examination Sections; Chiefs of Examination Branches; Case Managers; Group Managers; Internal Revenue Agents; Tax Auditors; Attorneys, Estate Tax; and Estate Tax Examiners.

(6) District Employee Plans and Exempt Organization: Chief of Division; Chief, Examination Branch;. Chief, Technical Staff; Group Managers; Internal Revenue Agents; Tax Law Specialists; and Tax Auditors.

(7) Service Center: Chief, Compliance Division; Chief, Examination Branch; Chief, Collection Branch; Chief, Criminal Investigation Branch; Revenue Agents; Tax Auditors; Tax Examiners in the correspondence examination functions; and Special Agents.

(c) District Directors, Service Center Directors, Regional Inspectors, the Chief of Investigation Branch, and the Director of International Operations may redelegate the authority under 4(a) of this Order to Law Clerks (Estate Tax), aides or trainees, respectively, for the positions of Revenue Agent, Tax Auditor, Tax Examiner in the Service Center Correspondence and Processing function, Tax Law

Specialists, Revenue Officer, Internal Auditor, Internal Security Inspector, Attorney (Estate Tax) and Special Agent, provided that each such Law Clerk (Estate Tax), aide or trainee shall exercise said authority only under the direct supervision, respectively, as applicable of a Revenue Agent, Tax Auditor, Tax Examiner in the Service Center Correspondence and Processing function, Tax Law Specialist, Revenue Officer, Social Agent, Internal Auditor or Internal Security Inspector or Attorney (Estate Tax).

(d) District Directors may redelegate the authority under 4(a) of this Order to Revenue Representatives and Office Collection Representatives.

5. Under the authority granted to the Commissioner of Internal Revenue by 26 CFR 301.7622-1, the officers and employees of the Internal Revenue Service referred to in paragraphs 1(b), 1(c), 1(d), and 4(b) and 4(c) of this Order are designated to administer oaths and affirmations and to certify to such papers as may be necessary under the internal revenue laws and regulations *except* that the authority to certify shall not be construed as applying to those papers or documents the certification of which is authorized by separate order or directive. Revenue Representatives and Office Collection Representatives referred to in paragraph 4(d) of this Order are not designated to administer oaths or to perform the other functions mentioned in this paragraph, except that Revenue Representatives, GS-5 and above, are authorized to certify the method and manner of service, and the method and manner of giving notice, when performing the functions and duties contained in paragraph 1(f) of this order.

6. The authority delegated herein may not be redelegated except as provided in paragraphs 4(c) and 4(d).

7. This Order supersedes Delegation Order No. 4 (Rev. 10) [1980-1 C.B. 569], issued February 1, 1980.

JEROME KURTZ,
Commissioner.

(Filed by the Office of the Federal Register on July 15, 1980, 8:45 a.m., and published in the issue of the Federal Register for July 16, 1980, 45 F.R. 47778)

Delegation Order No. 11 (Rev. 12) (Effective July 7, 1980)

Authority to Accept or Reject Offers in Compromise

The authority vested in the Commissioner of Internal Revenue by Treasury Department Order Nos. 150-25 and 150-36, 26 CFR 301.7122-1 and 26 CFR 301.7701-9, and Treasury Department Order No. 150-60, is hereby delegated as follows:

1. Regional Commissioners of Internal Revenue are delegated authority, under Section 7122 of the Internal Revenue Code, to accept offers in compromise in cases in which the unpaid liability (including any interest, penalty, additional amount or addition to tax) is $100,000 or more. This authority does not pertain to offers in compromise of liabilities arising under laws relating to alcohol, tobacco and firearms taxes. This authority may not be redelegated.

2. For the Office of International Operations, the Assistant Commissioner (Compliance) is delegated authority, under Section 7122 of the Internal Revenue Code, to accept offers in compromise of tax, based solely on doubt as to liability, in cases in which the unpaid liability (including any interest, penalty, additional amount or addition to tax) is $100,000 or more. This authority does not pertain to offers in compromise of liabilities arising under laws relating to alcohol, tobacco, and firearms taxes. This authority may not be redelegated.

3. For the Office of International Operations, the Director, Collection Division is delegated authority, under Section 7122 of the Internal Revenue Code, to accept offers in compromise based on doubt as to collectibility and those based on doubt as to both collectibility and liability in cases in which the unpaid liability (including any interest, penalty, additional amount or addition to tax) is $100,000 or more. This authority does not pertain to offers in compromise of liabilities arising under laws relating to alcohol, tobacco, and firearms taxes. This authority may not be redelegated.

4. District Directors, Assistant District Directors, the Director of International Operations and the Assistant Director of International Operations, Regional Directors of Appeals, Chiefs and Associate Chiefs, Appeals Offices, are delegated authority, under Section 7122 of the Internal Revenue Code, to accept offers in compromise in cases in which the liability sought to be compromised (including any interest, penalty, additional amount or addition to tax) is less than $100,000, to accept offers involving specific penalties, and to reject offers in compromise regardless of the amount of the liability sought to be compromised. This authority does not pertain to offers in compromise of liabilities arising under laws relating to alcohol, tobacco, and firearms taxes. The authority delegated to District Directors, Assistant District Directors and the Director of International Operations may not be redelegated, except that the authority to reject offers in compromise may be redelegated, but not lower than to Division Chief. The District Director in a streamlined district may not redelegate this authority. The Regional Director of Appeals, Chiefs and Associate Chiefs, Appeals Offices, may not redelegate this authority.

5. Service Center Directors and Assistant Service Center Directors are delegated authority, under Section 7122 of the Internal Revenue Code, to accept offers in compromise, limited to penalties based solely on doubt as to liability, in cases in which the unpaid liability is less than $100,000, and to reject offers in compromise, limited to penalties, regardless of the amount of the liability sought to be compromised. This authority does not pertain to offers in compromise of liabilities arising under laws relating to alcohol, tobacco, and firearms taxes. This authority may be redelegated, but not lower than to Division Chief.

6. This Order supersedes Delegation

Order No. 11 (Rev. 11) [1979-2 C.B. 481] issued August 23, 1979.

WILLIAM E. WILLIAMS,
Acting Commissioner.

(Filed by the Office of the Federal Register on July 10, 1980, 8:45 a.m., and published in the issue of the Federal Register for July 11, 1980, 45 F.R. 46956)

Delegation Order No. 51 (Rev. 5) (Effective September 29, 1980)

Proofs of Claim in Insolvency Proceedings

1. Pursuant to the authority vested in the Commissioner of Internal Revenue by 26 CFR 301.7701-9 and 26 CFR 301.6871, the authority to sign proofs of claim and other documents asserting the obligations incurred under the Internal Revenue laws (including taxes, penalties and interest), in order to claim and collect such obligations in any proceeding under the Bankruptcy Act, Bankruptcy Code and any receivership, decedent's estate, corporate dissolution, or other insolvency proceeding is hereby redelegated to the following officers:

Chief, Special Procedures Staff

Chief, Technical and Office Compliance Branch

Chief, Technical and Office Compliance Group in streamlined districts

2. The authority in Section 1 may be redelegated but no lower than the following:

Special Procedures Officers

Advisors no lower than grade 12

Advisor/Reviewers no lower than grade 12

This Order supersedes Delegation Order No. 51 (Rev. 4), issued March 21, 1979 [1979-1 C.B. 475].

JEROME KURTZ
Commissioner.

(Filed by the Office of the Federal Register on October 2, 1980, 8:45 a.m., and published in the issue of the Federal Register for October 3, 1980, 45 F.R. 65763)

Delegation Order No. 96 (Rev. 4) (Effective June 4, 1980)

Application of Rulings Without Retroactive Effect

1. Pursuant to authority granted to the Commissioner of Internal Revenue by 26 CFR 301.7805-1(b):

a. the Assistant Commissioner (Technical) and the Deputy Assistant Commissioner (Technical) are hereby authorized to prescribe the extent, if any, to which any ruling issued by or pursuant to authorization from the Assistant Commissioner relating to the internal revenue laws shall be applied without retroactive effect.

b. the Assistant Commissioner (Employee Plans and Exempt Organizations) and the Deputy Assistant Commissioner (Employee Plans and Exempt Organizations) are hereby authorized to prescribe the extent, if any, to which any ruling issued by or pursuant to authorization from the Assistant Commissioner relating to the internal revenue laws shall be applied without retroactive effect.

2. a. Pursuant to authority granted to the Commissioner of Internal Revenue by 26 CFR 301.7805-1(b), there is hereby delegated to the Director, Employee Plans Division and to the Director, Actuarial Division of the National Office, and to the Director of each EP/EO Key District, the authority to limit the retroactive effect of the revocation of any determination letter issued with respect to employee plans if the following conditions are met:

(1) The plan sponsor has received a favorable determination letter under the law in effect prior to the date that the Employee Retirement Income Security Act of 1974 [1974-3 C.B. 1] (ERISA) applied to the plan, but did not receive a favorable post-ERISA determination letter.

(2) The plan sponsor executed the necessary plan amendments to conform to ERISA retroactively to the first plan year that was subject to ERISA and such amendments are executed no later than 91 days after the issuance of a final determination letter or notice of amendments needed to effect compliance (which notice shall be issued at least 91 days period to the final examination report).

(3) Employees' and beneficiaries' rights and/or benefits under the plan are restored to levels they would have had to attain if the plan had never failed to qualify under ERISA.

(4) The requirements of section 2b relating to form are satisfied on June 4, 1980, and the requirements of section 2b relating to operation are met beginning with the ERISA effective date for the minimum participation standards determined with regard to each plan.

b. The requirements of this section are:

(1) The plan satisfies the age and service requirements for participation described in section 410(a) of the Code or fails to satisfy such requirements solely because the plan incorrectly credits service for eligibility purposes;

(2) The plan satisfies the requirements of section 411(a) or fails to satisfy such requirements solely because the plan incorrectly credits service for vesting purposes;

(3) In the case of a plan subject to the joint and survivor requirements of section 401(a)(11) such plan provides a joint and survivor annuity;

(4) The plan has not failed to satisfy the requirements of section 414(1);

(5) The plan has not, in operation, violated the limitations of section 415(c) by making excess allocations to individuals who are officers, shareholders or highly compensated; and

(6) The plan has not, in operation, been discriminatory in coverage or in contributions or benefits under sections 410(b) and 401(a)(4).

c. In the case of a plan that fails to satisfy section 2a solely as a result of not satisfying one or more of the requirements of section 2b, partial relief will be granted through section 7805(b). The employer's contributions will not be deductible as contributions to a qualified plan. However, section 7805(b) relief will be applied to the trust and all employees except to the

extent described in the next two sentences. In the case of a plan that does not satisfy section 2b(5), the 7805(b) relief described in the previous sentence will not apply to any officer, shareholder, or highly compensated individual who received annual additions that did not satisfy such section. In the case of a plan which does not satisfy section 2b(6), the 7805(b) relief will not apply to any officer, shareholder or highly compensated individual. Thus, any such officer, shareholder or highly compensated individual will not receive the tax treatment applicable with respect to qualified plans. In the case of a plan which fails to satisfy applicable requirements for any other reason relief can only be granted pursuant to section 1b.

d. The section 7805(b) relief detailed in sections 2a, 2c and 3 shall be effective for the period beginning with the ERISA effective date for the minimum participation standards determined with regard to each plan and ending on the date of final compliance which shall be no later than the date defined in section 2a(2) of this order.

e. In determining whether the requirements of this section are satisfied, proposed amendments received by the Service by June 4, 1980, will be taken into account.

3. a. In addition to the authority delegated in section 2 above, there is delegated to the Director of each EP/EO Key District, the Director, Employee Plans Division and the Director, Actuarial Division, the authority to limit the retroactive effect of the revocation, if any, of a favorable post-ERISA determination letter issued for a plan, except issues with respect to which an Alert Guidelines worksheet was completed. If a determination letter was issued erroneously with respect to issues covered by a completed Alert Guidelines worksheet, retroactive relief may only be granted pursuant to section 1b.

b. If a plan described in section 3a is amended in accordance with section 2a(2), restoration will be required and relief will be granted to the extent described below. If the defect did not exist at the time of the prior letter, the sponsor must restore any benefits and relief will be granted in accordance with the principles in section 2c for the period in which the defect existed. If the defect did exist at the time of the prior letter, the related benefits need only be restored for the period during which the plan was, without regard to the defect, not in compliance with Code section 401(a), and full section 7805(b) relief will be granted.

4. The delegation of authority granted pursuant to sections 2 and 3 above does not permit relief to be granted in any case if after September 30, 1982, amendments required for complete compliance have not been executed or a request for a determination letter with proposed ERISA amendments has not been filed. Notwithstanding the above, the Director of each EP/EO Key District is not delegated any section 7805(b) authority in the case of a plan which the Director of each EP/EO Key District determines to have been discriminatory for years before the effective date of section 410 for such plan. Cases described in this section must be referred to the National Office pursuant to procedures governing requests for technical advice.

5. Notwithstanding any of the above, section 7805(b) authority is not delegated to the Director, Employee Plans Division, the Director, Actuarial Division and the Director of each EP/EO Key District in the case of a plan which has been determined to have violated the exclusive benefit rule of section 401(a).

6. The section 7805(b) authority described in sections 2a, 2c or 3 will be exercised except in rare and unusual circumstances. Where rare and unusual circumstances exist, denial of section 7805(b) relief will be applied only if approved by the National Office.

7. The authority delegated in section 1 may not be redelegated.

8. The authority to grant 7805(b) relief in certain employee plan matters herein delegated to the Director, Employee Plans Division and to the Director of each EP/EO Key District may not be redelegated below the level of the Chief, Employee Plans Technical Branch and the Chief, EP/EO Division, respectively. The authority to grant 7805(b) relief delegated to the Director, Actuarial Division may not be redelegated.

9. This delegation order expires with respect to the Director of each EP/EO Key District on December 31, 1982.

10. This delegation order supersedes Delegation Order No. 96 (Rev. 3) [1976-2 C.B. 623] issued July 12, 1976.

JEROME KURTZ,
Commissioner.

(Filed by the Office of the Federal Register on June 5, 1980, 8:45 a.m., and published in the issue of the Federal Register for June 6, 1980, 45 F.R. 38198)

Delegation Order No. 112 (Rev. 6) (Effective June 2, 1980)

Authority to Issue Determination and Revocation Letters, to Grant Extensions of the Remedial Amendment Period and to Issue Examination Reports Relating to Employee Plans

Pursuant to authority vested in the Commissioner of Internal Revenue by Treasury Department Order No. 150-37, authority with respect to issuance of determination and revocation letters, to granting extensions of the remedial amendment period and to issuance of examination reports pertaining to employee plans and related matters is delegated as follows:

1. The District Director of each Employee Plans and Exempt Organizations key district is authorized, subject to paragraph 3, to:

(a) issue determination and revocation letters involving the provisions of sections 401, 403(a), 405, 409A, 501(a), and 4975(e)(7) of the Internal Revenue Code of 1954 with respect to:

(1) qualification of stock bonus, pension, profit sharing, employee stock ownership, annuity, and bond purchase plans, and cash or deferred arrangements;

(2) exemption from federal income tax under section 501(a) of trusts forming a part of such plans, provided that the determination does not involve application of section 502 (feeder organizations) or section 511 (unrelated business income), or the question of whether a proposed transaction will be a prohibited transaction under section 4975(c)(1) or section 503 with respect to plans described in 4975(g)(2) or (3);

(3) compliance with the applicable requirements of foreign situs trusts as to taxability of beneficiaries (section 402(c)) and deductions for employer contributions (section 404(a)(4)); and

(4) amendments, (including those relating to section 414(l) of the Code), partial terminations or terminations of such plans and trusts.

(b) issue examination reports with respect to:

(1) continued qualification under sections 401, 403(a), 405, 409A, and 4975(e)(7) of plans and continued exemption under section 501(a) of the related trust;

(2) imposition of tax under sections 1, 511 through 514, 641 and Chapter 43; and

(3) imposition of penalties under Chapter 68 of the Internal Revenue Code of 1954.

(c) issue determination letters with respect to whether a plan constitutes an employee stock ownership plan that is not intended to qualify under section 401 of the Internal Revenue Code of 1954 for taxable years beginning before January 1, 1979.

(d) issue modification or revocation of determination letters described above in accordance with currently applicable appeal procedures. If the revocation involves collectively-bargained plans, or plans for which the Internal Revenue Service is proposing to issue a revocation letter because certain fiduciary actions subject to Part 4, Subtitle B of Title I of the Employee Retirement Income Security Act (ERISA) [Pub. L. 93-406, 1974-3 C.B. 1, 43] have violated the exclusive benefit rule of section 401(a), the plan must have been submitted for technical advice and the Assistant Commissioner (E) must have concurred with the revocation.

(e) redelegate this authority as follows:

(1) with respect to issuance and modification of favorable determination letters or examination reports, other than a report issued with a proposed revocation letter, not below Internal Revenue Agent and Tax Law Specialist, GS-12, and then only if such individual is a person other than the initiator,

(2) with respect to issuance of proposed and final adverse determination letters or proposed revocation letters and related examination reports, not below Chief, EP/EO Division.

(3) with respect to issuance of final revocation letters, this authority may not be redelegated.

2. In each region, the Regional Director of Appeals, Chiefs and Associate Chiefs, Appeals Office, are authorized to:

(a) issue final determination or final revocation letters on appeals from proposed adverse determination and proposed revocation letters issued by key district offices under this delegation.

(b) issue letters as to the decision on appealed examination reports or statutory notices as provided in Delegation Order No. 77 [(Rev. 14), 1980-1 C.B. 573].

(c) This authority may not be redelegated.

3. The Assistant Commissioner (Employee Plans and Exempt Organizations), with concurrence of the Chief Counsel, is authorized to require preissuance review of final adverse determination and final revocation letters covered by section 7476(a) of the Internal Revenue Code of 1954.

4. The District Director of each Employee Plans and Exempt Organizations key district is authorized to:

(a) extend the remedial amendment period described in section 401(b) of the Internal Revenue Code of 1954 in accordance with currently applicable 401(b) procedures for individually designed plans and master and prototype plans not described in (b) below, but not in excess of eight months after the later of:

(1) the due date of the employer's income tax return without extension, for the year in which the remedial amendment period begins, or

(2) the end of the plan year within which the remedial amendment period begins;

(3) however, for a plan maintained by more than one employer, the remedial amendment period may not be extended in excess of two months after the last day of the tenth month after the end of the plan year.

(b) extend the remedial amendment period for a master or prototype plan whose sponsoring organization, after September 2, 1974, and on or before December 31, 1976, filed a request for an opinion letter with respect to the plan's qualification but not in excess of eight months after the later of:

(1) June 30, 1977, or

(2) the last day of the month that is six months after the month in which (i) the opinion or notification letter is issued, (ii) the request for the letter is withdrawn, or (iii) the request is otherwise disposed of by the Service.

(c) redelegate this authority but not below Chief, EP/EO Division.

Delegation Order No. 112 (Rev. 5) [1978-2 C.B. 481] issued October 1, 1978 is hereby superseded.

JEROME KURTZ,
Commissioner

(Filed by the Office of the Federal Register on June 5, 1980, 8:45 a.m., and published in the issue of the Federal Register for June 6, 1980, 45 F.R. 38200)

Delegation Order No. 114 (Rev. 2) (Effective August 28, 1980)

Designation to Act as "Competent or Taxation Authority" Under Tax Treaties

1. Pursuant to the authority delegated to me by Treasury Department Order No. 150-83 [1973-2 C.B. 508], there is hereby delegated to the Assist-

ant Commissioner (Compliance) the authority to act as "competent or taxation authority" under tax treaties of the United States. This authority includes the administration of the operating provisions of tax treaties as well as the interpretation or application of such treaties. With respect to the interpretation or application of tax treaties, the Assistant Commissioner (Compliance) shall act in all such matters only after the concurrence of the Assistant Commissioner (Technical).

2. The authority delegated herein to administer the operating provisions of tax treaties may be redelegated, but not lower than Division Director.

3. The authority delegated herein relating to the interpretation or application of tax treaties may not be redelegated.

4. Delegation Order No. 114 (Rev. 1) [1976-2 C.B. 623], issued November 3, 1976, is superseded.

JEROME KURTZ,
Commissioner.

Delegation Order No. 156 (Rev. 1), Amend. 1 (Effective June 1, 1980)

Authority to Disclose Returns and Return Information to Federal Officers or Employees for Administration on Nontax Federal Criminal Laws

Pursuant to the authority vested in the Commissioner of Internal Revenue by Treasury Department Order No. 150-37, dated March 17, 1955, authority is hereby delegated as follows:

1. The Deputy Commissioner; Assistant Commissioner (Taxpayer Service and Returns Processing); Deputy Assistant Commissioner (Taxpayer Service and Returns Processing); Director, Disclosure Operations Division; Regional Commissioners; District and Service Center Directors; Assistant District and Service Center Directors; Director of International Operations; and Assistant Director of International Operations are authorized:

a. To disclose or in specific instances, authorize the disclosure of returns or taxpayer return information to officers and employees of a Federal agency pursuant to an *ex parte* order by a Federal district court judge when needed for use in the enforcement of a Federal criminal statute (not involving tax administration), subject to the conditions prescribed in IRC 6103(i)(1) and the Treasury Regulations thereunder. This authority may not be redelegated.

b. To disclose or, in specific instances, authorize the disclosure of return information (other than taxpayer return information) to officers and employees of a Federal agency upon written request by the head of such agency, or in the case of the Department of Justice, the Attorney General, the Deputy Attorney General, or an Assistant Attorney General, when needed for use in the enforcement of a Federal criminal statute (not involving tax administration) subject to the conditions prescribed in IRC 6103(i)(2). This authority may not be redelegated.

2. The Deputy Commissioner; Assistant Commissioner (Taxpayer Service and Returns Processing); Deputy Assistant Commissioner (Taxpayer Service and Returns Processing); Director, Disclosure Operations Division; and Regional Commissioners are authorized:

a. To withhold any return or taxpayer return information pursuant to IRC 6103(i)(1) or (i)(4), upon a determination that such disclosure would identify a confidential informant or seriously impair any civil or criminal tax investigation. This authority may not be redelegated.

b. To withhold return information (other than taxpayer return information), pursuant to IRC 6103(i)(2) or (i)(4), upon a determination that such disclosure would identify a confidential informant or seriously impair any civil or criminal tax investigation. This authority may not be redelegated.

c. To disclose or, in specific instances, authorize the disclosure in writing of return information (other than taxpayer return information), which may constitute evidence of a violation of Federal criminal laws, to the extent necessary to apprise the head of the appropriate Federal agency enforcing such laws, subject to the conditions prescribed in IRC 6103(i)(3). The authority to withhhold return information (other than taxpayer return information), pursuant to IRC 6103(i)(4) upon a determination that such disclosure would identify a confidential informant or seriously impair a civil or criminal tax investigation is also delegated. The authority delegated in this paragraph may be redelegated to Assistant Regional Commissioners (Taxpayer Service and Returns Processing) and Regional Disclosure Officers, but such redelegation shall not extend to the authority to withhold return information (other than taxpayer return information). This authority is in addition to the authority previously delegated in paragraph (1)(g) of Delegation Order No. 156 (Rev. 1) [1979-2 C.B. 485].

3. This Amendment amends paragraphs (6)(b), (c), and (d) of Delegation Order No. 156 (Rev. 1). Delegation Order No. 156 (Rev. 1), issued July 30, 1979, is printed in the Federal Register dated August 1, 1979, Vol. 44, No. 149, Page 45275.

JEROME KURTZ,
Commissioner.

(Filed by the Office of the Federal Register on June 5, 1980, 8:45 a.m., and published in the issue of the Federal Register for June 6, 1980, 45 F.R. 38199)

Delegation Order No. 116 (Rev. 4) (Effective July 18, 1980)

Authority to Grant Extension of Time to File Income and Estate Tax Returns

The authority granted to the Commissioner of Internal Revenue by 26 CFR 1.6081-1, 26 CFR 20.6081-1 and 26 CFR 301.7701-9 to grant extensions of time to file income and estate tax returns, is hereby delegated to District Directors, Assistant District Directors, Director of International Op-

erations, Assistant Director of International Operations, Service Center Directors and Assistant Service Center Directors.

The authority delegated herein for estate tax returns may be redelegated, but not below:

Advisor/Reviewer, Advisor or Reviewer in the Special Procedures function in District Offices and Office of International Operations.

Senior Tax Examiners in Service Centers.

The authority delegated herein for income tax returns may be redelegated, but not below:

Chief, Special Procedures Staff or Chief, Technical and Office Compliance Branch/Group in District Offices and Office of International Operations; and full working level Tax Examiners in Service Centers.

Delegation Order No. 116 (Rev. 3) [1979-1 C.B. 476], issued January 29, 1979, is superseded.

JEROME KURTZ,
Commissioner.

(Filed by the Office of the Federal Register on July 22, 1980, 8:45 a.m., and published in the issue of the Federal Register on July 23, 1980, 45 F.R. 49204)

Delegation Order No. 183 (Effective June 23, 1980)

Extension of Time for Making Certain Elections

I. Pursuant to authority granted to the Commissioner of Internal Revenue by 26 CFR 1.9100-1, the Assistant Commissioner (Technical) and the Assistant Commissioner (Employee Plans and Exempt Organizations) are authorized to grant a reasonable extension of time fixed by regulations for making an election or application for relief in respect of tax under Subtitle A of the Code, subject to the requirements of 26 CFR 1.9100-1.

II. This authority may be redelegated to Division Directors and Branch Chiefs. In the case of granting extensions of time for filing applications for change in accounting method and accounting period not involving precedent issues this authority may be redelegated to the Chief of Ruling Section 1, Corporation Tax Branch.

JEROME KURTZ,
Commissioner.

(Filed by the Office of the Federal Register on July 3, 1980, 8:45 a.m., and published in the issue of the Federal Register for July 7, 1980, 45 F.R. 45751)

Executive Order 12238

Public International Organization Entitled to Enjoy Privileges, Exemptions, and Immunities

By the authority vested in me by Section 1 of the International Organizations Immunities Act (59 Stat. 669; 22 U.S.C. 288) [Pub. L. 291, 1946-1 C.B. 323], and having found that the United States participates in the International Maritime Satellite Organization pursuant to Title V of the Communications Satellite Act of 1962, as amended (47 U.S.C. 751 *et seq.*), the International Maritime Satellite Organization is hereby designated as a public international organization entitled to enjoy the privileges, exemptions, and immunities conferred by the International Organizations Immunities Act.

JIMMY CARTER

THE WHITE HOUSE
September 12, 1980.

(Filed by the Office of the Federal Register on September 12, 1980, 10:50 a.m., and published in the issue of the Federal Register on September 15, 1980, 45 F.R. 60877)

Notice 80-8

Inflation Adjustment for Computation of Windfall Profit Tax

Section 4989(b) of the Internal Revenue Code requires the determination of an inflation adjustment factor for use in computing the windfall profit tax.

The Service has determined that, for oil removed during the October-December quarter of 1980, the inflation adjustments are as follows:

Tier 1 or Tier 2 oil	0.0924
Tier 3 oil	0.1144

Worksheets for computation of the windfall profit tax are included in the Instructions for Form 6047, Windfall Profit Tax, and an explanation of the inflation adjustment may be found in the Specific Instructions for Line 4 of the worksheets.

Notice 80-9

Merchant Marine and Fisheries Capital Construction Funds—Applicable Rates of Interest on Nonqualified Withdrawals

Under the authority in section 607 (h)(4) of the Merchant Marine Act, 1936, (46 U.S.C. 1101), as amended by section 21 of the Merchant Marine Act of 1970 (84 Stat. 1031) [Pub. L. 91-469, 1970-2 C.B. 372], we hereby determine and announce that the applicable rate of interest on the amount of additional tax attributable to any nonqualified withdrawals from a capital construction fund established under section 607 of the Act shall be 10.36 percent, with respect to nonqualified withdrawals made in the taxable year beginning in 1980.

The determination of the applicable rate of interest with respect to nonqualified withdrawals was computed according to the joint regulations issued under the Act (46 CFR Part 391 § 391.7(e)(2)(ii)) by multiplying 8 percent by the ratio which (a) the average yield on 5-year Treasury securities for the calendar year immediately preceding the beginning of such taxable year, bears to (b) the average yield on 5-year Treasury securities for the calendar year 1970. The applicable rate so determined was computed to the nearest one-hundredth of 1 percent.

Dated: August 11, 1980.

SAMUEL B. NEMIROW,
Assistant Secretary for Maritime Affairs.

RICHARD A. FRANK,
Administrator, National Oceanic and Atmospheric Administration.

DONALD C. LUBICK,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 18, 1980, 8:45 a.m., and published in the issue of the Federal Register for August 19, 1980, 45 F.R. 55250)

Notice 80-10

Inflation Adjustment for Computation of Windfall Profit Tax

Section 4989(b) of the Internal Revenue Code requires the determination of an inflation adjustment factor for use in computing the windfall profit tax.

The Service has determined that, for oil removed during the January-March quarter of 1981, the inflation adjustments are as follows:

Tier 1 or Tier 2 oil ----- 0.1187
Tier 3 oil ----- 0.1469

Worksheets for computation of the windfall profit tax are included in the Instructions for Form 6047, Windfall Profit Tax, and an explanation of the inflation adjustment may be found in the Specific Instructions for Line 4 of the worksheets.

Notice 80-11 [1]

Certification of Unemployment Compensation Laws

Certification of State Unemployment Compensation Laws to the Secretary of the Treasury Pursuant to Section 3303(b)(1) of the Internal Revenue Code of 1954

In accordance with the provisions of paragraph (1) of Section 3303(b) of the Internal Revenue Code of 1954 (26 U.S.C. 3303(b)(1)), I hereby certify the unemployment compensation laws of the following named States, which heretofore have been certified pursuant to paragraph (3) of Section 3303(b) of the Code, to the Secretary of the Treasury for the 12-month period ending October 31, 1980.

Alabama
Alaska
Arizona
Arkansas
California
Colorado
Connecticut
Delaware
District of Columbia
Florida
Georgia
Hawaii
Idaho
Illinois
Indiana
Iowa
Kansas
Kentucky
Louisiana
Maine
Maryland
Massachusetts
Michigan
Minnesota
Mississippi
Missouri
Montana
Nebraska
Nevada
New Hampshire
New Jersey
New Mexico
New York
North Carolina
North Dakota
Ohio
Oklahoma
Oregon
Pennsylvania
Rhode Island
South Carolina
South Dakota
Tennessee
Texas
Utah
Vermont
Virginia
Washington
West Virginia
Wisconsin
Wyoming

Certification of States to the Secretary of the Treasury Pursuant to Section 3304 of the Internal Revenue Code of 1954

In accordance with the provisions of Section 3304(c) of the Internal Revenue Code of 1954 (26 U.S.C. 3304(c)), I hereby certify the following named States to the Secretary of the Treasury for the 12-month period ending October 31, 1980, in regard to the unemployment compensation laws of those States which heretofore have been approved under the Federal Unemployment Tax Act:

Alabama
Alaska
Arizona
Arkansas
California
Colorado
Connecticut
Delaware
District of Columbia
Florida
Georgia
Hawaii
Idaho
Illinois
Indiana
Iowa
Kansas
Kentucky
Louisiana
Massachusetts
Michigan
Minnesota
Mississippi
Missouri
Montana
Nebraksa
Nevada
New Hampshire
New Jersey
New Mexico
New York
North Carolina
North Dakota
Ohio
Oklahoma
Oregon
Puerto Rico
Pennsylvania
Rhode Island
South Carolina
South Dakota
Tennessee
Texas
Utah
Vermont
Virginia
Washington
West Virginia
Wisconsin
Wyoming
Virgin Islands

Signed at Washington, D.C., on October 31, 1980.

RAY MARSHALL,
Secretary of Labor.

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26 CFR 601.602: Forms and instructions. (Also Part I, Section 6302; 31.6302(c)-1, 31.6302(c)-3.)

Rev. Proc. 80-31

SECTION 1. PURPOSE

.01 The purpose of this revenue procedure is to outline the requirements and instructions for reporting agents who perform a payroll service and who, in connection with this service, submit employment federal tax deposit payments for their clients. These payments are described in the Employment Tax Regulations (26 CFR Part 31) under section 6302 of the Internal Revenue Code. All federal tax deposit payments are required to be deposited through a qualified federal tax depositary, as defined in 31 CFR Part 203. Each payment must be accompanied by the appropriate federal tax deposit card.

[1] Filed by the Office of the Federal Register on November 6, 1980, 8:45 a.m., and published in the issue of the Federal Register for November 7, 1980, 45 F.R. 74115.

.02 Under the provisions of this revenue procedure, qualifying agents may request permission to prepare federal tax deposit cards instead of using the prepunched cards provided by the Treasury Department. These agent-prepared federal tax deposit cards must accompany the payments of clients who have been approved under this program. Authorization will extend only to those agents who have a minimum of 500 clients and who satisfy all the requirements of this revenue procedure.

SEC. 2. BACKGROUND

.01 The Treasury Department furnishes federal tax deposit cards to those taxpayers who can reasonably be expected to make tax deposits. These cards are prepunched and preprinted with essential identifying information for processing the payment data to the appropriate tax account. Many payroll and tax preparation businesses have not had the prepunched deposit cards for making the required tax deposits, and, in most instances, this occurred because the agent had not requested that the client forward the deposit cards furnished by the Treasury Department. Some of these reporting agents have mailed deposits directly to an Internal Revenue Service office when the deposit cards were not available to them. This practice is not in conformity with the Employment Tax Regulations.

.02 Authorization for preparing Form FTD 501, Federal Tax Deposit, Withheld Income and FICA Taxes (FTDs), first appeared in Rev. Proc. 75-12, 1975-1 C.B. 653. The authority to prepare federal tax deposit cards is no longer dependent on the authority to file Form 941, Employer's Quarterly Federal Tax Return, on magnetic tape.

SEC. 3. FTD PAYMENTS SUBMITTED BY REPORTING AGENTS

.01 All federal tax deposit cards prepared by an authorized agent must be submitted with payment to a qualified federal tax depositary. The only acceptable agent-prepared deposit cards are those relating to Forms 941, 940, and 943. Form 501 is used to report a deposit for withheld income and FICA taxes (Form 941). Deposit Form 508 is used to report a deposit for unemployment taxes (Form 940). Deposit Form 511 is used to report a deposit for agricultural FICA taxes and voluntarily withheld income tax (Form 943).

.02 Authorized agents will be furnished a supply of blank FTD cards. The same type of card is used for all three taxes. The agent will identify the type of tax by a tax class code punched in column 19 of the card.

.03 Deposits for other taxes and for clients who have not been accepted under this program must be made to a depositary by means of the prepunched cards provided by the Treasury Department. Reporting agents authorized under this program who mail payments directly to an Internal Revenue Service office will have their remittances returned to them under instructions that they obtain the appropriate deposit cards from their client and that they submit the same through a qualified federal tax depositary, as required. Taxpayers whose payments are returned to their reporting agent may be subject to appropriate penalty and interest charges. Unless the client delivers the prepunched cards to them, reporting agents should not assume the responsibility of making tax deposits on behalf of a client as to any deposit that may become due before the client is actually under this program.

.04 Agent-prepared FTD cards must be submitted to a qualified depositary separate from the prepunched deposit cards which were mailed to the taxpayer by the Treasury Department.

SEC. 4. APPLICATION TO PREPARE FTD CARDS

.01 Agents who wish to prepare federal tax deposit cards must first file a letter of application with the Director of the Internal Revenue Service Center where the deposits will be processed. In most cases this will be the same service center that processes the related tax forms. See Exhibit 1 for a list of service centers and their respective addresses.

The letter of application should include all the following information:

1 The full name, address, and employer identification number of the firm making the application. If the reporting agent will prepare and submit deposit cards at more than one branch or location, each location must be identified in the letter of application, or each location must submit an individual letter of application.

2 The name, title, and telephone number of a person the Service can contact regarding the application. In most cases, any problem with the letter of application can be resolved by telephone and this will expedite processing by the service center.

3 The name, address, employer identification number, Federal Reserve Bank code, bank identification number/check digit code, and the branch code of the federal tax depositary which will forward the agent-prepared deposit cards to the Service. Prior to submitting the letter of application, the reporting agent must have an agreement with a depositary that the depositary will accept the agent-prepared FTDs and will submit them under a transmittal separate from Treasury Deprtment prepunched FTDs.

4 A listing of the taxpayers who will have their federal tax deposit cards prepared by the reporting agent. See Section 5 for the information required on this listing. See Exhibit 2 for an example of a list of clients.

5 A power of attorney for each taxpayer on the listing. See Section 6 for information concerning the power of attorney. See Exhibit 3 for an example of a properly prepared power of attorney.

6 A statement of the approximate number of deposit cards the agent expects to prepare during the first six months after approval. The Service will issue a six-month supply of blank deposit cards with the authorization letter.

.02 Applications containing a listing of less than 500 clients will be denied.

If an agent has previously been preparing federal tax deposit cards under the provisions of Rev. Proc. 75-12 before supercession by Rev. Proc. 79-15, 1979-1 C.B. 498, the agent is exempt from this qualification.

SEC. 5. LISTING OF CLIENTS

.01 Each letter of application must include a listing of the taxpayers who will have their federal tax deposits prepared by the reporting agent. The listing must include each taxpayer's complete business name, address (including ZIP code), employer identification number, and an account number not exceeding five digits assigned to the client by the agent. For each client, the listing must specify the types of taxes for which deposit cards will be prepared.

.02 The listing must be double spaced to allow room for notations by the service center. The clients must be listed in account number sequence. A duplicate listing must be submitted so that the Service can maintain a file of taxpayers accepted under this program. See Section 8 for updates to the initial listing of clients. See Exhibit 2 for an example of the way the listing should be submitted.

SEC. 6. POWER OF ATTORNEY

.01 A power of attorney must be submitted for each client on the listing. The power of attorney may be submitted on Form 2848, Power of Attorney, which is available on request. A sample power of attorney is set forth in Exhibit 3. If this form is not used, the power of attorney must clearly state that the reporting agent is granted the authority to prepare and submit federal tax deposits for the applicable tax forms. The power of attorney must be signed by the taxpayer and the reporting agent.

.02 If a power of attorney is already on file for full tax reporting, it is not necessary to execute a new agreement. If a power of attorney is already on file for magnetic tape filing of Form 941, it does not need to be revoked. However, a new power of attorney must be submitted to cover any federal tax deposits not already covered.

.03 The power of attorney for agent-prepared FTDs will be a limited power of attorney. Notices, refunds, tax forms, and other output will be mailed to the taxpayer. Requests from a reporting agent for information or adjustments on an account will be honored by the Service only to the extent covered by the power of attorney.

.04 Requests for taxpayer name and address changes may not be made by a reporting agent with a limited power of attorney. The only requests that will be honored will be those originating from the taxpayer or an attorney-in-fact if the attorney has a full power of attorney for all tax matters concerning a taxpayer and has filed a copy of the full power of attorney with the Internal Revenue Service Center.

.05 The reporting agent must keep copies of the power of attorney on file at the agent's principal place of business for examination by the Internal Revenue Service upon request. If the power of attorney includes the authority to sign and file tax returns, it must be retained until the statute of limitations for the last return filed under its authority expires.

.06 The power of attorney will remain in effect until such time as it is revoked by the taxpayer, terminated by written notification by the reporting agent, or expires under its own terms.

.07 The power of attorney is automatically revoked when the reporting agent notifies the Service that the taxpayer will no longer have FTDs submitted by the agent. It is also automatically revoked when the Service notifies the reporting agent that the requirements of this revenue procedure have not been adhered to and the Service will no longer accept the agent-prepared FTDs from that agent.

.08 Any time a power of attorney has been terminated or revoked, a new power of attorney will be required if a client re-enters this program. The new power of attorney must be signed and dated subsequent to the revocation.

SEC. 7. ACCEPTANCE OF AGENT'S APPLICATION

.01 The Service will process each letter of application within thirty days of receipt. The authorization letter will include a three-digit identifying number which the Service will assign to the reporting agent. If the reporting agent will prepare deposit cards at more than one location or branch, each location or branch will be assigned a separate identifying number. After an agent has been assigned an identifying number, all communication regarding the preparation of federal tax deposit cards should include this number. Updates to the agent's listing of clients must always contain the identifying number of the location or branch handling the particular client's records. The agent-identifying number must be punched in card columns 72-74 of the agent-prepared deposit cards.

.02 One copy of the listing of the reporting agent's clients will be returned with the authorization letter. The Service will verify each client's employer identification number and will provide the client's name control which must be punched in card columns 13-16 of the deposit cards. An Internal Revenue Service district office code will be written in for each taxpayer and must be punched in card columns 17 and 18. If there is a discrepancy, the Service will also provide the business name as it is maintained on record with the Service. Corrections will be indicated by a line through the agent's information with the corrected information written above.

.03 Reporting agents must not change the validated employer identification number, name control, or district office code except when notified to do so by the Internal Revenue Service.

.04 All discrepancies in taxpayer filing requirements will be resolved by telephone if a contact is established in the letter of application. If, for any reason, a particular taxpayer whose name is recited on the agent's list is

not accepted by the Service under this program, the name of the taxpayer will be circled out and the reason for non-acceptance will be stated in the acceptance letter.

.05 Based on the request by the reporting agent in the letter of application, the Service will issue a six-month supply of blank deposit cards with the acceptance letter. Orders of additional blank cards should be made by the reporting agent to the FTD Coordinator at the appropriate service center. Requests for more cards should be made at least thirty days before the expected depletion of the stock each agent has on hand. Reporting agents are cautioned that blank federal tax deposit cards are intended only for clients accepted under this program. Misuse of this privilege will be cause for disqualification of the agent.

SEC. 8. UPDATES TO THE AGENT'S LIST OF CLIENTS

.01 After acceptance of the reporting agent's initial list of clients, all additions and deletions must be reported to the service center immediately. New clients may not be included in the preparation of federal tax deposits by a reporting agent until they are accepted and the entity information (EIN, name control, district office code, and filing requirements) is validated and provided by the Service. If the reporting agent chooses to make federal tax deposits for a new client prior to being accepted, the agent must use the Treasury Department prepunched deposit cards and deposit the payment with a qualified depositary separate from the agent-prepared deposit cards.

.02 The Internal Revenue Service will process the agent's update listing within two weeks of receipt. The update listing should be in the same format as the initial listing, with the additions preceding and on a separate page from the deletions. Two copies of this listing should be submitted to enable the Service to maintain a file copy. The service center will process the additions on an expedite basis and in the same manner as the initial listing. Deletions will be acknowledged to the reporting agent.

.03 Once a client has been deleted under this program, the reporting agent may not request to re-enter that client until the next quarter. For example, if a client is deleted in the first quarter of the year (Jan., Feb., Mar.), the client may not be added back onto the accepted list of clients until the second quarter of the year (Apr., May, June). A new power of attorney must be submitted when the request to reenter the program is sent to the Service.

.04 Once each six months, the reporting agent must send a consolidated listing of their clients currently accepted by the Service. The consolidated listing is for information only and will not be returned to the agent. If no clients have been added or deleted during a six-month period, it is not necessary to submit this listing.

SEC. 9. PREPARATION OF THE DEPOSIT CARDS

.01 Keypunch instructions for agent-prepared federal tax deposits are included in this revenue procedure as Exhibit 4. The deposit cards must be interpreted across the top of the card. If the agent uses card columns 1-3 for internal control, interpretation of these three card columns should be suppressed, if possible. All other fields may be interpreted immediately above the punches, or each field may be separated by a single space. An uninterpreted card should never be included in the agent's shipment of deposit cards.

.02 The employer identification number, name control, and district office code fields must be punched with the information provided and verified by the Service. No change should be made to this information for a particular client unless the Service notifies the reporting agent to do so.

.03 The tax class field must be either a "1" for a Form 501 deposit (Form 941), a "6" for a Form 511 deposit (Form 943), or an "8" for a Form 508 deposit (Form 940).

.04 The tax period ending field must always contain the month in card column 20 and the year in card column 21. The month will be either a "3" for March, a "6" for June, a "9" for September, or a "12 (&) punch" for December. If the deposit is a Form 501 deposit (Form 941), the month will be either a "3", "6", "9", or "12" (&) punch". If the deposit is a Form 511 deposit (Form 943) or a Form 508 deposit (Form 940), the month will always be a "12 (&) punch". The year will always be the last position of the tax period year (8 = 1978, 9 = 1979, 0 = 1980, etc.).

.05 The payment date must always be punched in card columns 26-29. Punch the month (01-12) in card columns 26-27 and the day (01-31) in card columns 28-29. It is essential that the payment date punched in this field be the same date the depositary receives payment for the deposit and date stamps the deposit card.

.06 The payment amount must be punched unedited and right-justified in card columns 30-38. If the amount exceeds 9 digits or if the payment amount is changed prior to submission, the corrected money amount should be punched unedited and right-justified in card columns 39-50. If not, leave card columns 39-50 blank.

.07 The three-digit agent-identifying number must be punched in card columns 72-74. The agent's account number assigned to the client must be punched in card columns 76-80.

SEC. 10. SUBMISSION OF AGENT-PREPARED FEDERAL TAX DEPOSITS

.01 After all applicable deposit cards are punched and interpreted, the cards should be grouped and delivered with the appropriate payment to the qualified depositary specified in the agent's letter of application. It is required that the reporting agent deliver the deposit cards early in the day so that the depositary can date stamp each card and prepare transmittals on the same day as the payment date punched in card columns 26-29 of the deposit cards. The deposit cards should be in groups of 100 cards with a machine listing of each deposit amount and a total for each group. The de-

positary will prepare the transmittals and ship the deposit cards to the appropriate service center. The group of agent-prepared FTDs must be diagonally red-striped with a felt pen across the tops of the cards and the boxes must clearly indicate that the FTDs are prepunched agent-prepared FTDs. The boxes must be marked for the attention of the FTD Inter-agency Coordinator at the appropriate service center. See Exhibit 1 for the service center addresses.

.02 If the reporting agent is a bank business service and is authorized by the bank to prepare the transmittals (Form 2284, Advice of Credit), the agent-prepared federal tax deposits must be boxed separately from the prepunched cards. The group of agent-prepared FTDs must be diagonally red-striped with a felt pen across the tops of the cards and the boxes must clearly indicate that the FTDs are prepunched agent-prepared FTDs. The boxes must be marked for the attention of the FTD Inter-agency Coordinator at the appropriate service center. See Exhibit 1 for the service center addresses.

SEC. 11. TERMINATION OF THIS AUTHORIZATION

The Service reserves the right to terminate this agreement with reporting agents because of possible systemic changes which may preclude the use of punched cards. If the reporting agent cannot modify processing to accommodate these changes, the agreement may be terminated with sixty days notice.

EXHIBIT 1

Requests for additional copies of this Revenue Procedure, applications to prepare Federal tax deposits, update listings of authorized clients, and requests for additional blank cards should be addressed to the Director, Internal Revenue Service Center, Attn: FTD Inter-agency Coordinator, at one of the following addresses:

1. NORTH-ATLANTIC REGION
   (a) Andover Service Center
   P.O. Box 311
   Andover, MA 01810
   (b) Brookhaevn Service Center
   P.O. Box 400
   Holtsville, NY 11742
2. MID-ATLANTIC REGION
   Philadelphia Service Center
   P.O. Box 245
   Cornwells Heights, PA 19020
3. CENTRAL REGION
   Cincinnati Service Center
   P.O. Box 267
   Covington, KY 41012
4. SOUTHEAST REGION
   (a) Atlanta Service Center
   P.O. Box 47421
   Doraville, GA 30340
   (b) Memphis Service Center
   P.O. Box 30309
   Airport Mail Facility
   Memphis, TN 38130
5. MIDWEST REGION
   Kansas City Service Center
   P.O. Box 5321
   Kansas City, MO 64131
6. SOUTHWEST REGION
   Austin Service Center
   P.O. Box 934
   Austin, TX 78767
7. WESTERN REGION
   (a) Ogden Service Center
   P.O. Box 9941
   Ogden, UT 84409
   (b) Fresno Service Center
   P.O. Box 12866
   Fresno, CA 93779

Shipments of agent-prepared Federal tax deposit cards should be addressed to the Director, Internal Revenue Service Center, Attn: Inter-agency Coordinator, at one of the following addresses:

1. NORTH-ATLANTIC REGION
   (a) Andover Service Center
   P.O. Box 540
   Andover, MA 01810
   (b) Brookhaven Service Center
   P.O. Box 950
   Holtsville, NY 11742
2. MID-ATLANTIC REGION
   Philadelphia Service Center
   P.O. Box 6075
   Philadelphia, PA 19114
3. CENTRAL REGION
   Cincinnati Service Center
   P.O. Box 1488
   Cincinnati, OH 45201
4. SOUTHWEST REGION
   (a) Atlanta Service Center
   P.O. Box 47272
   Doraville, GA 30362
   (b) Memphis Service Center
   P.O. Box 2500
   Memphis, TN 38101
5. MIDWEST REGION
   Kansas City Service Center
   P.O. Box 337
   Kansas City, MO 64141
6. SOUTHWEST REGION
   Austin Service Center
   P.O. Box 443
   Austin, TX 78767
7. WESTERN REGION
   (a) Ogden Service Center
   1160 W. 1200 Street
   Ogden, UT 84201
   (b) Fresno Service Center
   P.O. Box 12147
   Fresno, CA 93776

EXHIBIT 2

Agent Identifying Number: (assigned by IRS)
Agent EIN:
Type of List: (additions, deletions, consolidations)

DATE OF LIST:
Name of Reporting Agent:
Address of Reporting Agent:

Client Account #	EIN	Name Control	D.O. Code	Client Business Name and Address	Type of Tax 941	940	943
01234	11-1111111			Blossom Corp. 16 Tulip Blvd. Flower, CA 91111	X	X	
01235	99-9999999			Animal Farm Rural Rt. 1 Orwell, CA 93333			X

1. Heading data may be positioned differently but should contain ALL requested information.
2. Sort by account number assigned to client by agent.
3. Leave Name Control and D.O. Fields blank—these will be entered by IRS.
4. Double-space between entries of clients.
5. Indicate the type of tax in the appropriate column.

EXHIBIT 3

Form **2848**
(Rev. July 1976)
Department of the Treasury
Internal Revenue Service

Power of Attorney

(See the separate Instructions for Forms 2848 and 2848–D.)

Name, identifying number, and address including ZIP code of taxpayer(s)

Client's name, address, and employer identification number

hereby appoints (Name, address including ZIP code, and telephone number of appointee(s)) (See Treasury Department Circular No. 230 as amended (31 C.F.R. Part 10), Regulations Governing the Practice of Attorneys, Certified Public Accountants, and Enrolled Agents before the Internal Revenue Service, for persons recognized to practice before the Internal Revenue Service.)

Reporting agent's name and address

as attorney(s)-in-fact to represent the taxpayer(s) before any office of the Internal Revenue Service for the following Internal Revenue tax matters (specify the type(s) of tax and year(s) or period(s) (date of death if estate tax)):

The preparation and submission of federal tax deposit Forms 501, 508. and/or 511 (specify applicable form numbers) and the remittance of federal tax deposit payments to accompany such forms.

The attorney(s)-in-fact (or either of them) are authorized, subject to revocation, to receive confidential information and to perform on behalf of the taxpayer(s) the following acts for the above tax matters:

(Strike through any of the following which are not granted.)

~~To receive, but not to endorse and collect, checks in payment of any refund of Internal Revenue taxes, penalties, or interest. (See "Refund checks" on page 2 of the separate instructions.)~~

~~To execute waivers (including offers of waivers) of restrictions on assessment or collection of deficiencies in tax and waivers of notice of disallowance of a claim for credit or refund.~~

~~To execute consents extending the statutory period for assessment or collection of taxes.~~

~~To execute closing agreements under section 7121 of the Internal Revenue Code.~~

~~To delegate authority or to substitute another representative.~~

Other acts (specify) to receive information concerning Forms 941, 940 and/or 943 acct.

Send copies of notices and other written communications addressed to the taxpayer(s) in proceedings involving the above matters to (Name, address including ZIP code, and telephone number):

and

This power of attorney revokes all earlier powers of attorney and tax information authorizations on file with the same Internal Revenue Service office for the same matters and years or periods covered by this form, except the following:

(Specify to whom granted, date, and address including ZIP code, or refer to attached copies of earlier powers and authorizations.)

Signature of or for taxpayer(s)

If signed by a corporate officer, partner, or fiduciary on behalf of the taxpayer, I certify that I have the authority to execute this power of attorney on behalf of the taxpayer.

(Signature) (Title, if applicable) (Date)

(Signature) (Title, if applicable) (Date)

(The applicable portion of the back page must also be completed.)

Form **2848** (Rev. 7-76)

KEYPUNCH INSTRUCTIONS FOR AGENT-PREPARED FEDERAL TAX DEPOSITS

Card Column	Description
1–3	Blank (may be used by agent for internal control)
4–12	Employer Identification Number—9 numerics (verified by IRS)
13–16	Name control (provided by IRS)
17–18	District office code—2 numerics (provided by IRS)
19	Tax class—1 numeric 1 = 941 (Withheld Income and FICA taxes) 8 = 940 (Unemployment taxes) 6 = 943 (Agricultural FICA and Voluntarily Withheld Income taxes)
20–21	Tax Period Ending (MY) M = month = 3, 6, 9, or & (12 punch) Y = year = units position of year NOTE: If the tax class is "1", the month must be a 3, 6, 9, or & (12 punch) If the tax class is "6" or "8", the month must be a & (12 punch) EXAMPLES: 38 = March 1978 68 = June 1978 98 = September 1978 &8 = December 1978
22–25	Blank (not available for agent use)
26–29	Payment date (MMDD)—4 numerics MM = month = 01–12 DD = day = 01–31
30–38	Payment amount field—9 numerics (do not edit—right justify)
39–50	Alternate amount field—12 numerics or blank (Do not use unless amount exceeds 9 digits or amount in cc 30–38 is being corrected. Do not edit—right justify)
51–71	Blank (not available for agent use)
72–74	Agent identifying number assigned by IRS
75	Blank
76–80	Account number assigned to taxpayer by agent—left justify

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability. (Also Part I, Sections 62, 162, 170, 213, 217, 274, 1016; 1.62-1, 1.162-17, 1.170A-1, 1.213-1, 1.217-2, 1.274-5, 1.1016-3.)

Rev. Proc. 80-32

This revenue procedure modifies Rev. Proc. 80-7, 1980-1 C.B. 590, with respect to the optional standard mileage rates for the business use of an automobile and for use in computing deductions for transportation expenses relating to charitable contributions, medical expenses, and moving expenses.

The first paragraph of subsection 1 of section 3.01 of Rev. Proc. 80-7 is amended to read as follows:

Subject to the conditions and limitations set forth below, with respect to transportation expenses paid or incurred after December 31, 1979, deductions will be accepted if computed at a standard mileage rate of (a) 20 cents per mile for the first 15,000 miles of use each year for business purposes, and (b) 11 cents per mile for use for business purposes in excess of 15,000 miles per year. Computation under this method is optional on a yearly basis.

The sixth paragraph of subsection 2 of section 3.01 of Rev. Proc. 80-7 is amended to read as follows:

With respect to automobiles that have been, or are considered to be,

fully depreciated under the straight-line method, based upon their use for business purposes, deductions will be accepted if computed at a standard mileage rate of 11 cents per mile for all miles of use of such automobiles attributable to business purposes.

The first paragraph of section 3.02 of Rev. Proc. 80-7 is amended to read as follows:

A taxpayer who incurs costs of operating an automobile for transportation in connection with rendering gratuitous services to a charitable organization under section 170 of the Code, in connection with medical care under section 213, or for moving expenses under section 217 will be permitted to claim as a deduction the standard mileage rate of nine cents per mile, subject to the conditions and limitations set forth in these sections.

These amendments are effective with respect to transportation expenses paid or incurred after December 31, 1979.

EFFECTS ON OTHER DOCUMENTS

Rev. Proc. 80-7 is modified.

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26 CFR 601.105: Examinations of returns and claims for refund credit or abatement; determination of correct tax liability.
(Also Part I, Sections 167, 6402; 1.167(a)-11, 301.6402-3.)

Rev. Proc. 80-33

In this revenue procedure, the Assistant Secretary (Tax Policy) of the Treasury prescribes revised effective dates for Rev. Proc. 79-26, 1979-1 C.B. 566 and Rev. Proc. 79-35, 1979-2 C.B. 498, both of which prescribed certain changes to Rev. Proc. 77-10, 1977-1 C.B. 548, regarding the Class Life Asset Depreciation Range system.

The effective date of Rev. Proc. 79-26, concerning waste reduction and resource recovery plants, central steam utility production and distribution, electric utility steam production plants, gas utility manufactured gas production plants, and industrial steam and electric generation and/or distribution systems, is revised to be April 30, 1979. The effective date of Rev. Proc. 79-35, concerning the manufacture of chemicals and allied products and the manufacture of professional, scientific, and controlling instruments, is revised to be July 16, 1979. These new effective dates are the dates of publication in the Internal Revenue Bulletin and are to be applied in accordance with section 1.167(a)-11(b)(4) of the Income Tax Regulations. That is, the asset guideline classes, periods, and ranges determined for such periods in effect as of the last day of a taxable year of election shall apply to all vintage accounts of such taxable year, except that neither the asset guideline period nor the lower limit of the asset depreciation range for any such account shall be longer than the asset guideline period or lower limit of the asset depreciation range, as the case may be, for such account in effect as of the first day of the taxable year.

Also, under the provisions of section 1.167(a)-11(b)(4) of the regulations this revenue procedure expressly provides that taxpayers, who were precluded from depreciating assets by application of Rev. Proc. 79-26 and Rev. Proc. 79-35 because of the prior effective dates, may, if tax returns have been filed for the taxable year beginning prior to January 1, 1979, at their option, utilize the asset depreciation ranges or periods described therein by filing an amended return in accordance with section 301.6402-3 of the regulations, provided section 1.167(a)-11(b)(4), as stated above, is applicable.

Rev. Procs. 79-26 and 79-35 modified.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 304, 357; 1.304-2, 1.357-1.)

Rev. Proc. 80-34

SECTION 1. BACKGROUND

Section 4.01 of Rev. Proc. 80-22, 1980-1 C.B. 654, provides a list of those areas of the Internal Revenue Code under the jurisdiction of the Assistant Commissioner (Technical) in which the Internal Revenue Service will not ordinarily issue advance ruling or determination letters. A list of these areas is set forth in section 4.01 of the revenue procedure.

SEC. 2. PROCEDURE

Rev. Proc. 80-22 is amplified to include the following under section 4.01:

Sections 304 and 357.—Redemption Through Use of Related Corporation; Assumption of Liability.—A transaction similar to that described in Rev. Rul. 80-240, at page 116, holding that sections 304(a)(1) and 357(a) of the Code are inapplicable because there was no assumption of liability, unless the taxpayer can satisfy the Internal Revenue Service that the liability was incurred by the taxpayer as a mere intermediary agent for the newly created corporate transferee. To establish this, the taxpayer must submit to the Internal Revenue Service documented evidence, composed at the time the liability was incurred, which indicates that the unrelated lender had agreed to release the transferor-borrower from any and all obligation on the liability in favor of the corporate transferee. Further, the taxpayer must show, or represent to, the Internal Revenue Service that the transfer and assumption actually occurred, or will actually occur, within 12 months of the date the debt was incurred.

SEC. 3. EFFECTIVE DATE

This revenue procedure will apply to all ruling requests on hand in the National Office on September 8, 1980, the date of publication of this revenue procedure in the Internal Revenue Bulletin, as well as to requests received thereafter.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 80-22 is amplified.

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26 CFR 601.401: Employment taxes.
(Also Part I, Sections 3102, 3111, 3301,

3403; 31.3102-1, 31.3111-4, 31.3301-1, 31.3403-1.)

Rev. Proc. 80-35

SECTION 1. PURPOSE

The purpose of this revenue procedure is to amend Sec. 2 and Sec. 3.03 of Rev. Proc. 78-35, 1978-2 C.B. 536, which provides instructions for implementing the provisions of section 530 of the Revenue Act of 1978, Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1, 119, relating to the employment tax status of independent contractors and employees.

SEC. 2. BACKGROUND

Rev. Proc. 78-35 is modified to reflect changes made to section 530 of the Act by Pub. L. 96-167, 1980-1 C.B. 483, 486, pertaining to the extension of certain dates in section 530 of the Act.

SEC. 3. IMPLEMENTATION

.01 Sec. 2 of Rev. Proc. 78-35 is modified to read as follows:

"Section 530(a)(1) of the Act, as amended, provides that if, for purposes of the employment taxes under subtitle C of the Internal Revenue Code, a taxpayer did not treat an individual as an employee for any period ending before January 1, 1981, then the individual will be deemed not to be an employee for that period, unless the taxpayer had no reasonable basis for not treating the individual as an employee. For any period during 1979 or 1980, the relief applies only if (1) all federal tax returns (including information returns) required to be filed by the taxpayer with respect to the individual for the period are filed on a basis consistent with the taxpayer's treatment of the individual as not being an employee, and (2) the treatment is consistent with the treatment for periods beginning after December 31, 1977."

.02 Sec. 3.03 of Rev. Proc. 78-35 is modified to read as follows:

".03 *Consistency in 1979 and 1980*

The relief under section 530(a)(1) of the Act, as amended, does not apply to the employment tax treatment of any individual for any period during 1979 or 1980, if the taxpayer (or a predecessor) treated any individual holding a substantially similar position as an employee for employment tax purposes for any period beginning after December 31, 1977. This provision prevents taxpayers from changing the way they treat workers solely to take advantage of the relief provisions. The application of this provision to predecessors is intended to prevent evasion of this rule, for example, by reincorporations. H.R. Rep. No. 95-1748, indicates that it is expected that legislation is to be developed to clarify the employment tax status of individuals."

SEC. 4. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 78-35 is modified.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Section 44C; 1.44C-5.)

Rev. Proc. 80-36

SECTION 1. PURPOSE

The purpose of this revenue procedure is to set forth procedures necessary for a manufacturer to make application for "certification" that an item will be treated as insulation, an energy-conserving component, or renewable energy source property, under the provisions of section 44C of the Internal Revenue Code.

SEC. 2. BACKGROUND

Section 44C of the Code allows an individual a credit against federal income tax in an amount equal to the sum of the qualified energy conservation expenditures plus the qualified renewable energy source expenditures. Manufacturers of items may apply to the Secretary to certify that such items will be treated for purposes of the residential energy credit as insulation, other energy-conserving components, or renewable energy source property. Section 44C(c)(6)(A)(ii) provides that the Secretary shall by regulations establish a procedure for obtaining this certification. Such procedure is established in section 1.44C-5 of the Income Tax Regulations and is implemented in this revenue procedure.

SEC. 3. GENERAL PRACTICES AND DEFINITIONS

.01 This revenue procedure covers applications for "certification" that for purposes of the residential energy credit, an item will be treated as:

(a) insulation,

(b) other energy-conserving components, or

(c) renewable energy source property.

.02 A "certification" is a written statement given by the National Office of the Internal Revenue Service to a manufacturer of an item certifying that the item meets the definition of insulation, other energy-conserving components, or renewable energy source property as defined in section 1.44C-2 of the regulations.

.03 A "certification" means only that the item meets the applicable definitional requirement in the case of any person claiming a residential energy credit with respect to such an item. It does not mean that the Service certifies that the item meets any performance or quality standards (if any) in effect at the time, that the item will save energy or money, or that the Service assumes any warranty or liability for the item's performance.

.04 Certification is available only to the manufacturer of an item. Requests for certifications will not be accepted from wholesalers, distributors, jobbers, importers, retailers, trade, business, or industry associations, consumer groups, governmental agencies, or individual taxpayers who are not the manufacturers of the item.

.05 Nothing in this revenue procedure is to be construed as preventing a taxpayer from requesting a ruling on the eligibility of any item for the residential energy credit. Such requests for a ruling are to be made in accordance with the procedures of Rev. Proc. 80-20, 1980-1 C.B. 633.

.06 Applications for certification of an item that has been specified by the Secretary as an energy-conserving com-

ponent pursuant to section 1.44C-2(d)(4)(viii) of the regulations or as a renewable energy source pursuant to section 1.44C-2(e)(2) may be made under this revenue procedure.

.07 A manufacturer may apply on the same application for one or several items to be certified as meeting the definitional requirement of one or more categories. For example, the item, or items meet the definition of (1) more than one type of energy-conserving component, (2) insulation, and (3) renewable energy source properties, or any combination of these three categories. However, no more than five items may be included in any one application.

.08 It is not necessary to apply for separate certification of similar items that differ only in model number, size, or other parameters that do not change the inherent nature of the item.

.09 Granting of a certification to one manufacturer of an item does not grant certification to a similar product made by another manufacturer.

.10 Lack of certification of an item does not in itself disqualify that item for the residential energy credit if it otherwise qualifies.

.11 The Service in making the decision whether an item meets the definitional requirement in order to be certified may consult with the Secretary of the Department of Energy, the Secretary of the Department of Housing and Urban Development or any other appropriate sources to obtain their views concerning the item in question.

.12 The definitional requirements of items qualifying for certification are found in the following sections of the regulations:

Insulation, section 1.44C-2(c) with the exception of subparagraphs (2), (3), and (4).

Energy-conserving components, section 1.44C-2(d)(4).

Solar energy property, section 1.44C-2(f).

Wind energy property, section 1.44C-2(g).

Geothermal energy property, section 1.44C-2(h).

.13 Certifications granted for items that are specified in section 44C of the Code as added by the Energy Tax Act of 1978, Pub. L. 95-618, 1978-3 C.B. (Vol. 2) 1, will be applied retroactively to April 20, 1977. However, certifications granted to energy-conserving components or renewable energy source property that were added in accordance with section 1.44C-6 of the regulations will be applied retroactively only to the date the applicable energy-conserving component or renewable energy source property was added by Treasury Decision 7717, page 7, this Bulletin, to the lists of qualifying energy-conserving components or renewable energy sources.

SEC. 4. INSTRUCTIONS TO THE MANUFACTURER

.01 It is necessary to submit only one copy of an application for certification unless the application requests certification for more than one item; if so, a duplicate copy is to be submitted for each item in excess of one.

.02 An application for certification and any factual information subsequently submitted must be accompanied by a declaration in the following form: "Under penalties of perjury, I declare that I have examined this application including accompanying documents, and to the best of my knowledge and belief, the facts presented in support of the application are true, correct, and complete." In the case of a noncorporate manufacturer, it must be signed by the person or persons on whose behalf the application is made. In the case of a corporate manufacturer, the person who signs must be an officer of the corporation who has personal knowledge of the facts.

.03 In cases in which application for certification is requested for more than one item, or one item is to be certified in more than one category, the Service generally will issue a single certification. However, the manufacturer may apply for a separate certification for each item or each category. Unless the Service determines that it is not feasible or not in the best interest of the Service to comply with the manufacturer's application in such cases, separate certifications will be issued.

.04 Each application for certification must contain a complete statement of all the facts concerning each item. These facts must include but are not limited to:

(1) an explanation of the purpose and function of the item;

(2) a complete description of the item including design drawings and material specifications necessary to demonstrate the purpose and functions of the item; and

(3) the manner in which the item is to be used for its intended purpose.

In addition, photographs, appropriate samples, or other information to demonstrate that the item meets the definition of the claimed category may be included. Original documents or other material that the manufacturer may want returned should not be submitted because they will become part of the Service file and will not be returned. Material facts furnished to the Service by telephone or orally at a conference must be promptly confirmed by letter to the Service accompanied by a declaration in the form described in section 4.02. This confirmation must be furnished within 21 calendar days to be considered part of the application. Procedures for requesting an extension of the 21-day period and notifying the manufacturer or the manufacturer's representative of the Service's decision are the same as those stated in section 9.05 of Rev. Proc. 80-20.

.05 The application for a certification should be addressed to the Internal Revenue Service, Assistant Commissioner (Technical), Attention T:C:E, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

.06 A manufacturer may obtain information regarding the status of an application by calling the person whose name and telephone number is shown on the acknowledgement of receipt of the application.

.07 A manufacturer who desires a conference in the event an adverse de-

termination is proposed to its application for certification may indicate such desire in writing when filing the application or soon thereafter.

.08 Replies to applications for certification sent to manufacturers under section 44C of the Code will be made open to public inspection under the procedures in section 6110, the regulations thereunder, and the Statement of Procedural Rules. In order to assist the National Office in complying with the provisions of section 6110, the manufacturer must follow the provisions of section 9.09 of Rev. Proc. 80-20.

.09 If the application is signed by a representative of the manufacturer or if the representative is to appear before the Service in connection with the application, the provisions of Rev. Proc. 80-20, section 9.10, are to be followed.

.10 If the manufacturer has more than one representative see Rev. Proc. 80-20, section 9.11.

.11 Any application for a certification that does not comply with all the provisions of this revenue procedure will be handled in the manner provided in Rev. Proc. 80-20, section 9.13.

.12 The order in which the Service processes applications for certification and requests for expeditious handling is explained in section 9.15 of Rev. Proc. 80-20.

.13 If a dispute arises between the manufacturer and the Service over the Service's intention to disclose the determination in regard to an application for certification pursuant to section 6110(f) of the Code or notations of third party contacts pursuant to section 6110(d), such disputes will be handled according to sections 9.19 and 9.20 of Rev. Proc. 80-20.

SEC. 5. CONFERENCES IN THE NATIONAL OFFICE

If the National Office considers it to be helpful in reaching a decision or when an adverse decision to an application for certification is indicated and the manufacturer had requested a conference in such circumstances, the manufacturer will be notified by telephone, if possible. The conference must be held within 21 calendar days after such contact has been made. Procedures for requesting an extension of the 21-day period and notifying the manufacturer or the manufacturer's representative of the Service's decision are the same as those stated in section 9.05 of Rev. Proc. 80-20.

If such a conference is held the procedure for the conference will be handled as provided for in section 11 of Rev. Proc. 80-20.

SEC. 6. WITHDRAWAL OF REQUESTS

An application for a certification may be withdrawn at any time prior to the signing of the letter of reply. Even though an application is withdrawn, all correspondence and exhibits will be retained by the Service and will not be returned to the manufacturer. In appropriate cases, the Service may publish its determination in a revenue ruling or revenue procedure.

SEC. 7. AREAS NOT COVERED BY THIS REVENUE PROCEDURE

This revenue procedure covers application for certification only. Applications for additions to the list of other energy-conserving components or other forms of renewable energy property as provided in section 1.44C-6 of the regulations or additions to the list of specially defined energy property under section 48(1) of the Code may not be made under this revenue procedure.

SEC. 8. EFFECTIVE DATE

This revenue procedure is effective September 22, 1980, the date of publication in the Internal Revenue Bulletin.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 80-37

Rev. Proc. 80-22, 1980-1 C.B. 654, sets forth areas in which advance rulings or determination letters will not be issued by the Internal Revenue Service. Section 4.018 of Rev. Proc. 80-22 states that rulings or determination letters will not ordinarily be issued on the tax effect of the transfer when part of the consideration received by the transferors consists of bonds, debentures, or any other evidences of indebtedness of the transferee. Section 4.018 is hereby amplified to read as follows:

8 Section 351—Transfers to Controlled Corporation.—

The tax effect of the transfer when part of the consideration received by the transferors consists of bonds, debentures, or any other evidence of indebtedness of the transferee and the term of the "indebtedness" is either less than ten years or a determination as to whether the "indebtedness" is properly classified as debt or equity is required in order to establish that the requirements of section 351 are met.

Rev. Proc. 80-22 is amplified.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Section 871; 1.871-1.)

Rev. Proc. 80-38

SECTION 1. BACKGROUND

Section 4.01 of Rev. Proc. 80-22, 1980-1 C.B. 654, sets forth areas in which advance rulings and determination letters will not ordinarily be issued by the Internal Revenue Service.

SEC. 2. PROCEDURE

Rev. Proc. 80-22 is amplified to include the following under section 4.01:

Section 871—Classification of alien individuals as resident or nonresident —The determination as to whether an alien individual is either a resident or nonresident of the United States will not be made with respect to situations in which the determination is dependent on factual representations that cannot be confirmed until the close of the alien individual's affected taxable year(s), that is, representations concerning an alien individual's projected stay and activities in the United States.

SEC. 3. EFFECTIVE DATE

This revenue procedure will apply to all ruling requests on hand in the National Office on September 29, 1980, the date of publication of this revenue procedure in the Internal Revenue

Bulletin, as well as to requests received thereafter.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 80-22 is amplified.

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26 CFR 601.602: Forms and instructions. (Also Part I, Sections 4945, 7805; 53. 4945-4, 301.7805-1.)

Rev. Proc. 80-39

SECTION 1. PURPOSE

.01 The purpose of this revenue procedure is to provide guidelines for determining whether educational loans made by a private foundation under an employer-related loan program are taxable expenditures under section 4945 of the Internal Revenue Code.

.02 Ruling requests seeking advance approval of loan procedures are to be submitted to the Assistant Commissioner (Employee Plans and Exempt Organizations), Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: E:EO:T, and must include the statements required by section 53.4945-4(d) of the Foundation Excise Tax Regulations.

SEC. 2. BACKGROUND

.01 Rev. Rul. 77-434, 1977-2 C.B. 420, holds that educational loans made by a private foundation on an objective and nondiscriminatory basis, pursuant to a procedure approved in advance by the Secretary or the Secretary's delegate, are individual grants within the meaning of section 4945(g)(3) of the Code. Thus, the loans are not taxable expenditures.

.02 Section 53.4945-4(b) of the regulations provides that a private foundation's grants are made on an objective and nondiscriminatory basis if the foundation's loan program is consistent with its exempt status under section 501(c)(3) of the Code and the allowance of deductions under section 170 for contributions to the foundation.

.03 Educational loans made by a private foundation to employees of a particular company or to their children are made for a purpose inconsistent with the foundation's exempt status under section 501(c)(3) of the Code and the allowance for deductions under section 170 for contributions to the foundation if the loans serve the private interests of the employer, rather than serving charitable purposes. A long-term, low-interest educational loan provided by a private foundation is of substantial value to students who could not obtain them from any source other than the employer-related program. The Service will assume that employer-related educational loans are made on an objective and nondiscriminatory basis, within the meaning of section 4945(g), and thus are not taxable expenditures, if they meet the guidelines contained in Sec. 4 of this revenue procedure.

SEC. 3. APPLICATION OF GUIDELINES

.01 The guidelines in Sec. 4 apply only to educational loans made on or after January 1, 1970, by a private foundation under an employer-related program to individuals who are employees, or the children of employees, of the employer to which the program relates. Rev. Proc. 76-47, 1976-2 C.B. 670, provides guidelines for determining whether a grant made by a private foundation under an employer-related grant program to an employee or to a child of an employee of the particular employer to which the program relates is a scholarship or fellowship grant under section 117 of the Code.

.02 An employer-related program is a program that treats some or all of the employees, or the children of some or all of the employees, of a particular employer as a group from which the recipients of some or all of the foundation's loans will be selected; limits the potential loan recipients for some or all of the foundation's loans to individuals who are employees, or the children of employees, of the particular employer; or otherwise gives such individuals a preference or priority over others in being selected as loan recipients.

.03 The guidelines assume that the other applicable requirements of section 53.4945-4 of the regulations concerning loans to individuals are met.

.04 These guidelines do not determine whether loans to disqualified persons are taxable expenditures under section 4945 of the Code or would subject the disqualified persons to the tax on acts of self-dealing under section 4941.

SEC. 4. GUIDELINES

.01 *General rule.*

If a private foundation's educational loan program satisfies the seven conditions set forth in Secs. 4.03 through 4.09 below, and meets the percentage test described in Sec. 4.10, the Service will assume such loans are not taxable expenditures.

.02 *Facts and circumstances test.*

1 If a private foundation's loan program satisfies the seven conditions set forth in Secs. 4.03 through 4.09, but does not meet the percentage test of Sec. 4.10, the Service will consider, as a substitute for the percentage test of Sec. 4.10, all the relevant facts and circumstances to determine whether the primary purpose of the program is to further the private interests of the employer, or whether the primary purpose is to educate recipients in their individual capacities. The availability of loans under the program to employees of their children must be controlled and limited by substantial nonemployment-related factors so that the preferential treatment derived from employment is not of any significance beyond initial qualification for the loan. Such qualification must not lead to any significant probability that employment will make loans available for a qualified employee or his or her children interested in applying for one.

2 Such relevant facts and circumstances include, but are not limited to: the history of the program (such as the source of the program's funding), the courses of study for which the loans are available, any eligibility requirements imposed by the program (other than employment of the applicants or their parents and the age

and grade level prerequisites for the studies for which the loans are available), the publicity given the loan program, the degree of independence of the selection committee, the particular standards used for selection, the specific means used to determine whether those standards have been met, the precise nature of the employee limitation or preference, the number of loans available, the number of employees or their children who would be eligible for the loans, the percentage of eligible employees or their children applying for loans who normally (*e.g.*, on an average basis) receive loans under the program, and whether and how many loans are awarded to individuals who do not qualify as employees or the children of employees.

.03 *Inducement.*

The program must not be used by the employer, the private foundation, or the creator of the foundation, to recruit employees or to induce employees to continue their employment or otherwise follow a course of action sought by the employer.

.04 *Selection committee.*

1 Selection of loan recipients must be made by a committee consisting wholly of individuals totally independent (except for participation on this committee) and separate from the private foundation, the foundation's creator, and the relevant employer. An individual who is a former employee of either the foundation or the employer concerned will not be considered totally independent. Such committees preferably should consist of individuals knowledgeable in the educational field so that they have the background and knowledge to evaluate properly the potential of the applicants.

2 The forwarding of the selections by the independent selection committee to the employer or the private foundation for the sole purpose of verifying the eligibility requirements and selection criteria used by the committee in considering the candidates and in making its selection will not disqualify the program. Any public announcement of the awards, however, must be made by the selection committee or by the foundation.

3 Loans must be awarded in the order recommended by the selection committee. The number of loans to be awarded may be reduced but may not be increased from the number recommended by the selection committee. Only the committee may vary the amounts of the loans awarded.

.05 *Eligibility requirements.*

1 The program must impose identifiable minimum requirements for loan eligibility. Such requirements must be related to the purpose of the program and must limit the independent selection committee's consideration to those employees, or children of employees, who meet the minimum standards for admission to an educational institution (as defined in section 170(b)(1)(A)(ii) of the Code) for which the loans are available. No persons will be considered eligible if they are not reasonably expected to attend such an institution, even if they meet the minimum standards.

2 If an employee must have been employed for some minimum period by the employer to which the program relates to be eligible to receive a loan, or to make that employee's children eligible to receive a loan, the minimum period of employment may not exceed three years. Moreover, eligibility must not be related to any other employer-related factors, such as the employee's position, or duties.

.06 *Objective basis of selection.*

Selection of loan recipients must be based solely upon substantial objective standards that are completely unrelated to the employment of the recipients or their parents and to the employer's line of business. Acceptable standards include, but are not limited to: prior academic performance, performance on tests designed to measure ability and aptitude for higher education, recommendations from instructors or other individuals not related to the potential loan recipients, financial need, and conclusions drawn from personal interviews as to motivation and character.

.07 *Employment.*

1 A loan may not be terminated solely because the recipient or the recipient's parent subsequently terminates employment with the employer, regardless of the reason for the termination of employment.

2 If a loan is awarded for one academic year and the recipient must reapply for an additional loan or loans to continue studies in a subsequent year, the recipient may not be considered ineligible for a subsequent loan simply because that individual or the individual's parent is no longer employed by the relevant employer. The standards for additional loans must be based solely upon nonemployment-related factors such as need and maintenance of scholastic standards.

3 At the time the loan or additional loans are awarded, there must be no requirement, condition or suggestion, express or implied, that the recipient or the recipient's parent is expected to render future employment services for the foundation or the relevant employer, or be available for such future employment, even though such future employment is at the discretion of the foundation or the employer.

.08 *Course of study.*

The courses of study for which loans are available must not be limited to those that would be of particular benefit to the relevant employer or to the foundation. If the courses of study for which loans are available include one or more that would be of such particular benefit, a loan may not be conditioned on the recipient's choosing such a course of study; the recipient must have a free choice to use the loan in the pursuit of a course of study for which the loan is otherwise available that is not of particular benefit to the employer or to the foundation.

.09 *Other objectives.*

The terms of the loan and the

courses of study for which loans are available must be consistent with a disinterested purpose of enabling the recipients to obtain an education in their individual capacities solely for their personal benefit and they must not include any commitments, understandings or obligations, conditional or unconditional, suggesting that the studies are undertaken by the recipients for the benefit of the relevant employer or the foundation, or have as their objective the accomplishment of any purpose of the employer or the foundation (even though consistent with its exempt status) other than enabling the recipients to obtain an education in their individual capacities and solely for their personal benefit.

.10 *Percentage test.*

1 In the case of a program that awards loans to children of employees of a particular employer, the program meets this percentage test if the number of children receiving loans under that program in any given year does not exceed 25 percent of the number of employees' children who (i) were eligible, (ii) were applicants for such grants, and (iii) were considered by the selection committee in selecting the recipients of loans in that year, or 10 percent of the number of employees' children who can be shown to be eligible for loans (whether or not they submitted an application) in that year.

2 In the case of a program that awards loans to employees of a particular employer, the program meets this percentage test if the number of employees receiving loans under that program in any year does not exceed 10 percent of the number of employees who (i) were eligible, (ii) were applicants for such grants, and (iii) were considered by the selection committee in selecting the recipients of grants in that year.

3 For the purpose of applying these percentage tests, an employee or child of an employee will be considered eligible only if the individual meets all of the eligibility requirements imposed by the program and such requirements satisfy the conditions of Sec. 4.05 of this revenue procedure. Renewals of loans awarded in prior years will not be considered in determining the number of loans awarded in the current year. Loans awarded to children of employees and those awarded to employees will be considered as having been awarded under separate programs for purposes of all of the applicable requirements of this revenue procedure whether or not the loans are awarded under separately administered programs.

4 If a private foundation's employer-related program encompasses educational loans and scholarship or fellowship grants to the same group of eligible employees or employees' children, the percentage tests in Sec. 4.10 of this revenue procedure apply to the total number of individuals receiving combined grants of scholarships, fellowships, and educational loans.

SEC. 5. RELIANCE ON PRE-SEPTEMBER 29, 1980, RULING LETTERS

.01 A private foundation that holds a ruling letter issued before September 29, 1980, approving its employer-related educational loan program under section 4945(g)(3) of the Code, may continue to rely on the ruling letter provided its loan program fully complies with Secs. 4.01-4.10 continuously from the date on which the ruling letter was issued. Upon written request, the Service will issue a current ruling letter affirming the qualification of the loan program under the relevant portions of this revenue procedure.

.02 Pursuant to the authority contained in section 7805(b) of the Code, where a private foundation holds a ruling letter issued before September 29, 1980, approving its employer-related educational loan program, and where its loan program does not fully comply with Secs. 4.01-4.10, the private foundation may rely on the ruling letter through March 31, 1981.

.03 Educational loan programs modified to conform with Secs. 4.01-4.10 should be submitted for advance approval under section 4945(g)(3) of the Code in accordance with section 53.4945-4 of the regulations.

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability. (Also Part I, Section 6694; 1.6694-1.)

Rev. Proc. 80-40 [1]

SECTION 1. PURPOSE

The purpose of this revenue procedure is to provide guidelines for the application of the penalty under section 6694(a) of the Internal Revenue Code for the negligent disregard of rules and regulations by an income tax return preparer. The revenue procedure indicates some of the factors that will be taken into consideration in determining whether this penalty will be applied.

SEC. 2. BACKGROUND

.01 Section 6694(a) of the Code provides that if any part of any understatement with respect to any return or claim for refund is due to the negligent or intentional disregard of rules and regulations by any person who is an income tax return preparer with respect to such return or claim, such person shall pay a penalty of $100 with respect to such return or claim.

.02 Section 6694(e) of the Code provides that an "understatement of liability" means any understatement of the net amount payable with respect to any income tax.

.03 Section 1.6694-1(a)(1) of the Income Tax Regulations provides that a preparer is not considered to have negligently or intentionally disregarded a rule or regulation if the preparer exercises due diligence in an effort to apply the rules and regulations to the information given to the preparer to determine the taxpayer's correct liability for tax.

.04 Section 1.6694-1(a)(5) of the regulations provides that the preparer bears the burden of proof on the issue

[1] Also released as New Release IR-80-94 dated Sept. 15, 1980.

of whether the preparer has negligently or intentionally disregarded a rule or regulation.

.05 The Conference Report on the Revenue Act of 1978 relating to Technical Corrections to the Tax Reform Act of 1976, H.R. Rep. No. 95-1800, 95th Cong., 2d Sess. 284 (1978), 1978-3 C.B. (Vol. 1) 521, 618, states that the Service shall reasonably interpret section 6694(a) according to the standards of section 6653(a) and in light of all the facts and circumstances of each case taking into account any and all mitigating factors.

.06 The case of *Marcello v. Commissioner,* 380 F. 2d 499, 506 (5th Cir. 1967) holds that negligence is lack of due care or failure to do what a reasonable and ordinary prudent person would do under the circumstances.

SEC. 3. SCOPE

The scope of this revenue procedure is to provide guidelines for the application of the penalty under section 6694(a) of the Code for the negligent disregard of rules and regulations by an income tax return preparer. These guidelines do not apply to the penalty under section 6694(a) for the intentional disregard of rules and regulations by an income tax return preparer.

SEC. 4. APPLICATION

.01 In determining whether the penalty under section 6694(a) of the Code is to be asserted, all the relevant facts and circumstances of each case will be taken into account. In making this determination, the following factors will be taken into consideration.

1 *Nature of the Error Causing the Understatement.* Was the provision that was misapplied or not discovered so complex, uncommon, or highly technical that a competent preparer of returns of the type at issue might reasonably be unaware or mistaken as to its applicability? Should a general review of the return have disclosed the error to the preparer? For example, although an isolated mathematical or clerical error ordinarily reflects no more than mere inadvertence and thus will not result in the assertion of the penalty, such an error may be of such a magnitude or be so conspicuous that it should have been discovered after its commission.

2 *Frequency of Errors.* Is the understatement the result of an isolated error or is it the result of a number of errors? Although an isolated error may result in the assertion of the penalty if sufficiently obvious, flagrant or material, the negligence penalty generally will not be asserted for an isolated error. On the other hand, a pattern of errors on a return is presumptive of negligence and generally will result in the assertion of the penalty even though no one error occurring in isolation would have triggered the penalty.

3 *Materiality of Errors.* Is the understatement material in relation to the correct tax liability? The negligence penalty generally will not be asserted if the understatement is of a relatively immaterial amount. Nevertheless, the understatement, even though immaterial in amount, may result in the assertion of the penalty if the error or errors creating the understatement are sufficiently obvious, flagrant or numerous. An error resulting in a material understatement may be a greater indication of negligence than a similar error resulting in a less material understatement.

.02 Where all the relevant facts and circumstances suggest that the return was negligently prepared, the penalty under section 6694(a) of the Code generally will not be asserted if (1) the preparer's normal office practice, when considered together with other facts and circumstances such as the knowledge of the preparer, indicates that the error in question would rarely occur and (2) the normal office practice was followed in preparing the return in question. Examples of normal office practice include a system to promote acuracy and consistency in the preparation of returns, such as a checklist, a method for obtaining the necessary information from the taxpayer, examining the prior year's return, and review procedures. The normal office practice of the preparer will not be relevant where the error is flagrant, or there is either a pattern of errors on a particular return or an error is repeated on numerous returns.

.03 The penalty under section 6694(a) of the Code generally will not apply where a preparer in good faith relies without verification upon information furnished by the taxpayer. Thus, the preparer is not required to audit, examine or review books and records, business operations, or documents or other evidence in order to verify independently the taxpayer's information. However, the preparer may not ignore the implications of information furnished to the preparer or which was actually known by the preparer. The preparer shall make reasonable inquiries if the information as furnished appears to be incorrect or incomplete. Additionally, some sections of the Code require the existence of specific facts and circumstances, such as maintenance of specific documents, before a deduction may properly be claimed. The preparer shall make appropriate inquiries to determine the existence of facts and circumstances required by a Code section or regulations as a condition to claiming a deduction.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 80-41

Rev. Proc. 80-22, 1980-1 C.B. 654, sets forth areas in which advance rulings or determination letters will not be issued by the Internal Revenue Service. Section 5 of Rev. Proc. 80-22 lists areas under extensive study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations, or otherwise. Section 5 is amplified to include the following:

Section 820.—Optional Treatment of Policies Reinsured Under Modified Coinsurance Contracts. The tax consequences of modified coinsurance contracts to which section 820 of the

Code may apply, including whether taxpayers who have entered into a modified coinsurance contract may allocate between the reinsured and reinsurer certain items to which section 820(c) applies.

Rev. Proc. 80-22 is amplified.

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, Section 4997; 150.4997-1.)

Rev. Proc. 80-42 [1]

SECTION 1. PURPOSE

.01 The purpose of this revenue procedure is to set forth guidelines specifying the basic record requirements that the Internal Revenue Service considers to be essential in cases where a taxpayer's records are maintained within an automatic data processing (ADP) system. References here to ADP systems include all accounting systems which process all or part of a taxpayer's transactions, records, or data by other than manual methods.

.02 The technology of ADP is evolving rapidly; new methods and techniques are constantly being devised and adopted. Accordingly, the five points set forth in section 4 of this revenue procedure are not intended to restrict or prevent taxpayers from obtaining the maximum benefits of ADP provided the appropriate information is present or can be produced by the system. These guidelines will be modified and admended as the need indicates to keep pace with developments in ADP.

SEC. 2. BACKGROUND

The inherent nature of ADP is such that it may not be possible to trace transactions from source documents to end results or to reconstruct a given account unless the system is designed to provide audit trails. Taxpayers already using ADP or contemplating its use have requested information concerning the types of records that should be developed and maintained in order to meet the requirements of section 4997 of the Internal Revenue Code and the corresponding regulations. This section of the Code reads in part as follows:

Each taxpayer liable for the windfall profit tax, each partnership, trust, or estate producing domestic crude oil, each purchaser of domestic crude oil, and each operator of a well from which domestic crude oil was produced shall keep such records, make such returns, and furnish such information with respect to such oil as the Secretary may by regulations prescribe.

SEC. 3. OBJECTIVES

Modern machine accounting systems are capable of recording business transactions much more rapidly and with greater accuracy than manual systems, and they are capable of retaining and producing vast amounts of data. The ability to produce in legible form the data necessary to determine, at a later date, whether or not the correct tax liability has been reported must be carefully considered in designing and programming a machine system. This factor may add to the complexity of the system and require additional cost, but this cost may be negligible in comparision to the expense that may be incurred at a later date if the system cannot practically and readily provide the information needed to support and substantiate the accuracy of the previously reported tax liability.

SEC. 4. ADP RECORD GUIDELINES

.01 ADP accounting systems will vary, just as manual systems vary, from taxpayer to taxpayer. However, the procedures built into a computer's accounting program must include a method of producing from the punched cards or tapes visible and legible records which will provide the necessary information for the verification of the taxpayer's tax liability.

.02 In determining the adequacy of records maintained with an ADP system, the Service will consider as acceptable those systems that comply with the guidelines for record requirements as follows:

1 *General and subsidiary books of account.* A general ledger, with source references, should be written out to coincide with financial reports for tax reporting periods. In cases where subsidiary ledgers are used to support the general ledger accounts, the subsidiary ledgers should also be written out periodically.

2 *Supporting documents and audit trail.* The audit trail should be designed so that the details underlying the summary accounting data, such as invoices and vouchers, may be identified and made available to the Service upon request.

3 *Recorded or reconstructible data.* The records must provide the opportunity to trace any transaction back to the original source or forward to a final total. If printouts are not made of transactions at the time they are processed, then the system must have the ability to reconstruct these transactions.

4 *Data storage media.* Adequate record retention facilities must be available for storing tapes and printouts as well as all applicable supporting documents. These records must be retained in accordance with the provisions of the Code and the regulations prescribed thereunder.

5 *Program documentation.* A description of the ADP portion of the accounting system should be available. The statements and illustrations as to the scope of operations should be sufficiently detailed to indicate (a) the application being performed, (b) the procedures employed in each application (which, for example, might be supported by flow charts, block diagrams or other satisfactory descriptions of input or output procedures), and (c) the controls used to insure accurate and reliable processing. Important changes, together with their effective dates, should be noted in order to preserve an accurate chronological record.

SEC. 5. COMMENTS OR INQUIRIES

Comments or inquiries relating to

[1] Also released in News Release IR-80-96 dated September 23, 1980.

this revenue procedure should be addressed to the Assistant Commissioner (Compliance), Attention: CP:E, Washington, D.C., 20224.

SEC. 6. EFFECTIVE DATE

This revenue procedure is effective October 14, 1980, the date of its publication.

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26 CFR 601.602: Forms and instructions.

Rev. Proc. 80-43

SECTION 1. PURPOSE

This revenue procedure establishes a handling and shipping charge for processing requests for bulk quantities of tax forms. This charge only applies to those engaged in the preparation of tax returns for private gain.

SEC. 2. CHARGES

.01 Charges for tax forms and instructions will be established on the basis of each 1,000 printed units ordered, or fraction thereof, in excess of the first 500 printed units requested during any 12 month period. The schedule of charges for handling and shipping bulk quantities of tax forms and instructions is:

Up to but not exceeding 500 printed units ----------No Charge
Each 1,000 units or fraction thereof in excess of the first 500 units ----------$5.00

A $1.00 discount per 1,000 units will be applied to any bulk order postmarked on or before the discount deadline date published in Publication 1045.

.02 No charge will be made: (a) to an individual or organization for the first 500 printed units requested; (b) to individuals picking up tax forms or instructions at Internal Revenue Service offices; or (c) to a bank, post office or other organization for any quantity of forms and instructions for the convenience and use of the taxpayer, so long as such organization is not engaged in the preparation of tax returns for private gain.

.03 Single copies of Publications 17 and 334 will be provided without charge. Multiple copies of either publication shall not be provided to individuals or organizations except where the Regional Commissioner or District Director determines that such distribution will further the interest of taxpayer service or education. A user charge will apply to all such approved multiple copy requests; however, Regional Commissioners, District Directors and appropriate National Office officials may continue to provide multiple copies without charge for use in Service sponsored programs (e.g. Understanding Taxes and VITA). Priority must be given to filling single copy requests for Publications 17 and 334; requests for bulk quantities of either publication which jeopardize the Service's ability to respond timely to such single copy demand should not be honored. For individuals who wish, for their own purposes, to print bulk quantities of Publications 17 and 334, the Service will provide page negatives of either publication for a user charge. The schedule of charges is:

Publications 17 and 334
$.50 per copy for each approved request
$3.00 per page negative

.04 All user charges will be commensurate with the prevailing postage and handling costs and will be established by the Commissioner.

.05 Publication 1045 will contain Form 2333, Request for Blank Income Tax Forms. The instructions on Form 2333 outline the handling and shipping charge for processing orders of bulk quantities of tax forms.

.06 Checks, made payable to the Internal Revenue Service, should be submitted with Form 2333.

SEC. 3. EFFECT ON OTHER DOCUMENTS

This revenue procedure supersedes Rev. Proc. 67-36, 1967-2 C.B. 666.

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26 CFR 601.602: Forms and instructions. (Also Part I, Section 6033; 1.6033-2.)

Rev. Proc. 80-44

SECTION 1. PURPOSE

The purpose of this revenue procedure is to establish and maintain for reference purposes a current list of those organizations exempt from federal income tax because they are described in section 501(c) of the Internal Revenue Code that are not rerequired to file an annual information return on Form 990. This list does not include organizations, such as private foundations, that are required to file (under an annual information return) on forms other than the Form 990.

SEC. 2. BACKGROUND

.01 Section 6033(a)(1) of the Code, as amended by the Tax Reform Act of 1969, Pub. L. 91-172, 1969-3 C.B. 10, 27, generally requires the filing of annual information returns by exempt organizations.

.02 Section 6033(a)(2)(A) of the Code provides certain mandatory exceptions to this filing requirement.

.03 In addition, section 6033(a)(2)(B) of the Code provides discretionary exceptions from filing such returns where the Secretary "determines such filing is not necessary to the efficient administration of the internal revenue laws." Section 1.6033-2(g)(6) of the Income Tax Regulations delegates authority to the Commissioner to excuse organizations from the filing requirement. It provides that, "the Commissioner may relieve any organization or class of organizations from filing, in whole or in part, the annual return required by section 6033 where he determines that such returns are not necessary for the efficient administration of the internal revenue laws."

.04 Section 1.6033-2(g)(1) of the regulations provides a partial list of organizations that are not required to file annual returns either because they are excepted by statute or because the Commissioner has exercised the authority referred to above in Sec. 2.03.

.05 In Announcement 77-62, 1977-17 I.R.B. 22, the Commissioner announced that he had exercised his

discretionary authority to excuse an additional category of exempt organizations from filing Form 990. This category consisted of exempt organizations described in section 501(c) of the Code (other than private foundations) the gross receipts of which in each taxable year are normally not more than $10,000. These organizations are excused from filing the annual information return for tax years ending on or after December 31, 1976.

.06 From time to time, the Commissioner may excuse additional organizations from filing such returns by publishing an announcement in the Internal Revenue Bulletin, revising the instructions accompanying Form 990, amending the regulations, or other appropriate publication. As these changes to the filing requirements may occur, subsequent revisions to this procedure will be made.

SEC. 3. ORGANIZATIONS CURRENTLY NOT REQUIRED TO FILE ANNUAL RETURNS

.01 The list of organizations described in section 501(c) of the Code that are not required to file annual returns by reason of section 6033(a)(2) is as follows:

1 A church, an interchurch organization of local units of a church, a convention or association of churches, or an integrated auxiliary of a church (such as a men's or women's organization, religious school (such as a seminary), mission society, or youth group).

2 A school (described in section 170(b)(1)(A)(ii) of the Code) below college level affiliated with a church or operated by a religious order, even though it is not an integrated auxiliary of a church.

3 A mission society sponsored by or affiliated with one or more churches or church denominations, more than one-half of the activities of which society are conducted in, or directed at persons in, foreign countries.

4 An exclusively religious activity of any religious order.

5 For tax years ending on or after December 31, 1976, an organization (other than a private foundation) that normally has gross receipts in each taxable year of not more than $10,000. (See Sec. 4.)

6 A state institution, whose income is excluded from gross income under section 115.

7 An organization described in section 501(c)(1).

.02 This list does not include organizations, such as private foundations, that are required to file annual information returns on forms other than Form 990.

SEC. 4. DEFINITIONS — NORMALLY NOT MORE THAN $10,000

For purposes of Sec. 3 above, the annual gross receipts of an organization are normally not more than $10,000 if:

1 in the case of an organization which has been in existence for one year or less, the organization has received, or donors have pledged to give, gross receipts of $15,000 or less during the first taxable year of the organization;

2 in the case of an organization which has been in existence for more than one, but less than three years, the average of the gross receipts received by the organization in the first two taxable years is $12,000 or less; and,

3 in the case of an organization which has been in existence for three years or more, the average of the gross receipts received by the organization in the immediately preceding three years, including the year for which the return would be filed, is $10,000 or less.

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26 CFR 601.602: Forms and instructions. (Also Part I, Section 6651; 301.6651-1.)

Rev. Proc. 80-45 [1]

SECTION 1. PURPOSE

The purpose of this revenue procedure is to further extend the time set forth in Rev. Proc. 77-47, 1977-2 C.B. 580, in which contractors or subcontractors with contracts subject to the Vinson-Trammell Act, 48 Stat. 503 (current version at 10 U.S.C. sections 2382 and 7300 (1970)) in taxable years that end after September 30, 1976, must file certain reports.

Section 1005(a) of the Department of Defense Authorization Act, 1981, Pub. L. 96-342, 96th Cong., 2d Sess. (September 8, 1980), exempts from the profit limitations of the Vinson-Trammell Act contracts for the construction or manufacture of aircraft or naval vessels and parts thereof when the final payment under such contracts is made before October 1, 1981. Further, section 1005(b) of such Act prohibits the Internal Revenue Service from requiring any reports under the Vinson-Trammell Act to be filed before October 1, 1981.

SEC. 2. EXTENSION AND EFFECT ON OTHER DOCUMENTS

Section 4.02 of Rev. Proc. 77-47, as modified by Rev. Proc. 78-38, 1978-2 C.B. 542, Rev. Proc. 79-25, 1979-1 C.B. 566, Rev. Proc. 79-53, 1979-2 C.B. 538, and Rev. Proc. 80-13, 1980-1 C.B. 617, is further modified by extending to October 1, 1981, the time for filing Forms 949 and 949-A for taxpayers with taxable years that end before January 1, 1981.

An extension of the time granted taxpayers for filing Forms 949 and 949-A does not extend the time for filing their federal income tax returns.

Interest on any excess profits will be charged from the due date of the report, without regard to any extensions, to the date of payment. However, taxpayers who repay excess profits by October 1, 1981, will not be subject to the penalty for failure to pay tax with respect to the excess profits under section 6651 of the Internal Revenue Code.

Rev. Proc. 80-13, which provides that Rev. Proc. 77-47 is extended to October 15, 1980, for taxpayers with tax years that ended before January 31, 1981, is superseded.

Rev. Proc. 77-47 is further modified.

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26 CFR 601.502: Requirements for conference—recognition to practice and, in cer-

[1] Also released in News Release IR-80-107, dated October 15, 1980.

tain cases, power of attorney or tax information authorization.
(Also Part I, Section 6103; 301.6103(c)-1.)

Rev. Proc. 80-46

SECTION 1. PURPOSE

The purpose of this revenue procedure is to enhance the ability of the Internal Revenue Service district offices to respond fully and effectively to inquiries by employees of business entities. This procedure is intended to facilitate the resolution of account related questions and does not provide for the furnishing of tax returns to third parties. It has no effect on the Conference and Practice Requirements (26 CFR 601.501 et seq.), technical advice requests or ruling determination letters. Nor does it affect the ability of a taxpayer, or any person acting on behalf of a taxpayer, to contact the Internal Revenue Service by telephone for the purpose of obtaining general information regarding the meaning of a bill, notice, or letter.

SEC. 2. BACKGROUND

The Internal Revenue Code specifies that confidential tax information with respect to sole proprietorships, partnerships, corporations, estates and trusts may be disclosed to certain persons. The Service is prohibited from disclosing confidential tax information to another person acting on behalf of a taxpayer in the absence of a written authorization from the taxpayer. It is recognized that the limitations on disclosure often cause delays in servicing requests for tax assistance. The restrictions are particularly troublesome for businesses that have a number of employees who need to contact the Service to resolve day to day tax matters. For example, an employee who is not specifically authorized in writing to receive confidential tax information might contact the Service to resolve a tax matter of the business, such as a notice or a bill. In these situations, the Service makes every effort to resolve the issue by discussing it in general terms without disclosing confidential tax information from our records. However, on many occasions, due to the complexity of the business's tax matters, the question cannot be resolved without disclosure of confidential tax information by the Service. Accordingly, the Service will accept letters of authorization, pursuant to the requirements of this revenue procedure, with attached lists specifying employees of business entities who are authorized to receive confidential tax information.

SEC. 3. PERSONS WHO MAY SUBMIT A LIST.

.01 A sole proprietor may submit a list.

.02 With respect to a partnership, any partner may submit a list but the scope of the authorization is limited to those tax periods during which he or she is a partner.

.03 Authorization lists may be submitted on behalf of a corporation by the corporate president/chief executive officer or an officer authorized by law to bind the corporation. As an alternative, the list may be submitted by any principal officer if attested to by the secretary or any other officer.

.04 If the business entity is included in an estate, a list may be submitted by the administrator, executor or trustee of the estate.

.05 A trustee may submit an authorization list on behalf of a business entity that is a trust.

.06 In the case of business matters of an incompetent, an authorization list may be submitted by the trustee, guardian or committee for the incompetent.

.07 If substantially all of the property of the business is in the hands of a receiver or trustee in bankruptcy, such persons may submit a list.

SEC. 4. CONTENTS OF THE LETTER OF AUTHORIZATION

.01 The letter of authorization shall:

1 be dated, provide the employer identification number (EIN) for the entity and reference this revenue procedure;

2 specify the tax periods and type of tax with respect to which information may be provided;

3 contain a statement that the listed authorized employees have granted permission for the use of their social security numbers for the purpose of identification;

4 contain a statement that the taxpayer assumes the responsibility to notify the addressee in writing of any changes to be made to the list;

5 provide a statement as to the authority of the person to authorize the disclosure of the confidential tax information;

6 be signed by the appropriate person;

7 have attached a copy of any appropriate documentation such as an officer's authority contained in a corporate charter, etc. However, documentation is not needed if the authorization is submitted by two corporate officers;

8 be received by the Service within sixty days of the date it is signed and dated.

.02 The attached list shall set forth the names of the authorized employees in alphabetical order and include their social security numbers for identification purposes.

.03 The following format should be used for authorizations by a president/chief executive officer or an officer authorized by law to bind the corporation:

Corporate Letterhead

(*Date*)

Disclosure Officer

_____ District Office

In accordance with Revenue Procedure 80-46, the employees named in the attached list are authorized to receive return information pertaining to (*name of corporation and employer identification number*) [or (*name of subsidiary and employer identification number*) a subsidiary of (*name of corporation*)] with respect of Form(s) (*941, 1120, etc.*), for tax period(s) _____.

Each of the employees named in

the attached list have granted permission for the use of their social security numbers for identity verification purposes prior to receipt of confidential tax information.

(*Name of corporation or subsidiary*) will notify the addressee in writing of any changes to be made to the list.

I certify that I am the President/Chief Executive Officer or an officer authorized by law to bind (*name of corporation or subsidiary*).

/s/ _____
(*Title*)

.04 The following format should be used for authorizations signed by a principal corporate officer and attested to by the secretary or another officer:

Corporate Letterhead

(*Date*)

Disclosure Officer

_____ District Office

In accordance with Revenue Procedure 80-46, the employees named in the attached list are authorized to receive return information pertaining to (*name of corporation and employer identification number*) [*or name of subsidiary and employer identification number a subsidiary of* (*name of corporation*)] with respect to Form(s) (*941, 1120 etc.*), for tax period(s) _____.

• Each of the employees named in the attached list has granted permission for the use of their social security numbers for identity verification purposes prior to receipt of confidential tax information.

(*Name of corporation or subsidiary*) will notify the addressee in writing of changes to be made to the list.

This authorization is intended to comply with Internal Revenue Code Section 6103(e)(1)(D)(ii).

/s/ _____
(Any) Principal Officer (*Title*)
and

/s/ _____
Secretary or any other officer (*Title*)

.05 The following format should be used for authorizations with respect to business entities which are not corporations:

Business Letterhead (if any)

(*Date*)

Disclosure Officer

_____ District Office

In accordance with Revenue Procedure 80-46, the employees named in the attached list are authorized to receive return information pertaining to (*name of entity and employer identification number or social security number*) with respect to Form(s) (*941, 940, etc.*) for tax period(s) _____.

Each of the employees named in the attached list have granted permission for use of their social security numbers for identity verification purposes prior to receipt of confidential tax information.

(*Name of entity*) assumes the responsibility to notify the addressee in writing of any changes to be made to the list.

I certify that (*statement of authority to authorize individuals to receive confidential tax information of the taxpayer*).

/s/ _____

SEC. 5. WHERE TO SEND THE LETTER OF AUTHORIZATION

The letter of authorization shall be submitted to the Disclosure Officer for the Internal Revenue Service district office with which contacts are expected. A list of Disclosure Officer addresses appears in Sec. 7. If contact with more than one district office is anticipated, a letter must be sent to each District Disclosure Officer. The Disclosure Officer will acknowledge receipt by letter, which will provide a telephone number for contacts pursuant to Sec. 6.03.

SEC. 6. MODIFICATION OF THE AUTHORIZATION LIST

.01 It is the responsibility of the taxpayer to keep the authorization lists current and to modify the list when necessary. The Service will recognize authorizations as effective until revised or revoked, unless otherwise specified in the letter of authorization.

.02 The taxpayer shall modify the authorization list by sending a letter which meets the requirements of Secs. 3 and 4. The letter shall be addressed to the appropriate District Disclosure Officer(s) and shall clearly indicate the names of employees to be deleted from the list and the names of employees to be added to the list. If revocation of the Disclosure Authorization List is desired, the letter shall so state. Modifications will become effective when the Disclosure Officer receives the letter.

.03 To quickly effect deletions from the list, taxpayers may advise the Disclosure Officer of the deletions by telephone. The deletions become effective upon notification of the Disclosure Officer but shall then be confirmed in writing.

.04 The Disclosure Officer should be contacted five days after the modification letter is mailed to confirm receipt.

SEC. 7. DISCLOSURE OFFICER ADDRESSES

The following is a listing of district disclosure officer mailing addresses:

Central Region

Cincinnati	P.O. Box 1818 Cincinnati, OH 45201
Cleveland	P.O. Box 99181 Cleveland, OH 44199
Detroit	P.O. Box 32513 Detroit, MI 48232
Indianapolis	P.O. Box 44211 Indianapolis, IN 46244
Louisville	P.O. Box 1735 Louisville, KY 40201
Parkersburg	P.O. Box 1388 Parkersburg, WV 26101

Mid-Atlantic Region

Baltimore	FOB, P.O. Box 1018 Baltimore, MD 21203
Newark	P.O. Box 476 Room 1135 Newark, NJ 07101

Philadelphia	600 Arch Street Philadelphia, PA 19106
Pittsburgh	P.O. Box 2488 Pittsburgh, PA 15230
Richmond	P.O. Box 10049 Richmond, VA 23240
Wilmington	P.O. Box 1206 844 King Street Wilmington, DE 19899

Midwest Region

Aberdeen	P.O. Box 370 Aberdeen, SD 57401
Chicago	230 S. Dearborn St. Room 2865 Chicago, IL 60690
Des Moines	P.O. Box 1337 Room 579 Des Moines, IA 50305
Fargo	P.O. Box 8 Fargo, ND 58102
Milwaukee	P.O. Box 493 Room 528B Milwaukee, WI 53201
Omaha	P.O. Box 1052 Downtown Station Room 102 Omaha, NE 68101
St. Louis	P.O. Box 1147 Room 702 St. Louis, MO 63188
St. Paul	316 No. Robert Street Room 482 St. Paul, MN 55101
Springfield	320 W. Washington St. P.O. Box 398 Springfield, IL 62705

North-Atlantic Region

Albany	Leo O'Brien Federal Office Building Clinton Avenue & Pearl Street Albany, NY 12207
Augusta	P.O. Box 1964 Augusta, ME 04330
Boston	P.O. Box 9097 JFK Post Office Boston, MA 02203
Brooklyn	35 Tillary Street Brooklyn, NY 11201
Buffalo	P.O. Box 1040 Niagara Square Station Buffalo, NY 14201
Burlington	11 Elmwood Avenue Burlington, VT 05401
Hartford	450 Main Street Hartford, CN 06115
Manhattan	P.O. Box 3036 Church Street Station New York, NY 10008
Portsmouth	80 Daniel Street Portsmouth, NH 03801
Providence	130 Broadway Providence, RI 02903

Southeast Region

Atlanta	275 Peachtree St., N.E. P.O. Box 904 Room 230 Atlanta, GA 30301
Birmingham	2121 Eighth Avenue, N. Room 1205 Birmingham, AL 35203
Columbia	Federal Office Building 1835 Assembly St. Room 466 Columbia, SC 29201
Greensboro	Federal Office Building 320 Federal Plaza Room 305 Greensboro, NC 27401
Jackson	301 Building 100 W. Capitol St. Suite 504 Stop 9 Jackson, MS 39201
Jacksonville	Federal Office Building 400 W. Bay Street Room 544 P.O. Box 35045 (Stop #610) Jacksonville, FL 32202
Nashville	U.S. Courthouse 801 Broadway, Room 481 P.O. Box 1107 Nashville, TN 37202

Southwest Region

Albuquerque	P.O. Box 1967 Albuquerque, NM 87103
Austin	P.O. Box 1448 Mail Stop 620 Austin, TX 78767
Cheyenne	308 West 21st Street Cheyenne, WY 82001
Dallas	1100 Commerce Street Code 428 Dallas, TX 75242
Denver	1050 17th Street Denver, CO 80265
Little Rock	P.O. Box 3778 Stop 25 Little Rock, AR 72203
New Orleans	P.O. Box 30350 Stop 40 New Orleans, LA 70190
Oklahoma City	P.O. Box 66 Stop T-D Oklahoma City, OK 73101
Wichita	P.O. Box 400 Wichita, KS 67201

Western Region

Anchorage	P.O. Box 1500 Anchorage, AK 99510
Boise	550 West Fort Street P.O. Box 041 Boise, ID 83724
Helena	2nd Floor West Federal Building Helena, MT 59601
Honolulu	P.O. Box 50089 Honolulu, HI 96850
Los Angeles	P.O. Box 3151 Los Angeles, CA 90053
Phoenix	2120 N. Central Stop 450 Phoenix, AZ 85004
Portland	1220 S.W. 3rd Avenue Portland, OR 97201
Reno	300 Booth Street Reno, NV 89502
Salt Lake City	465 S. 400 East Salt Lake City, UT 84111
San Francisco	450 Golden Gate Avenue San Francisco, CA 94102
Seattle	915 2nd Avenue M.S. 180 Seattle, WA 98174

Office of International Operations

1325 K. Street, N.W.
Room 900
Washington, DC 20225

SEC. 8. INQUIRIES

Inquiries in regard to this revenue procedure should be directed to the District Disclosure Officer.

SEC. 9. EFFECTIVE DATE

This revenue procedure becomes effective December 10, 1980.

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26 CFR 601.602: Forms and instructions. (Also Part I, Sections 6001, 6011; 1.6001-1, 1.6011-1.)

Rev. Proc. 80-47

SECTION 1. PURPOSE

This revenue procedure states the requirements of the Internal Revenue Service relating to the preparation of acceptable reproductions and private design and printing of substitute federal tax return forms (*i.e.*, Forms 1040, 1040A, 1120, 940, 941, etc.) and related forms (schedules) for filing purposes in place of the official forms and schedules.

SEC. 2. DEFINITIONS

.01 Definitions Used in This Publication (Relating to Tax Forms).

1 *Substitute Form.* A tax form or related form or schedule that differs in any way from the official version and is intended to replace the entire form that is printed and distributed by the Service. This term also covers those approved substitute formats and forms described in this revenue procedure. (A photocopy of an official form or a copy produced from an unchanged reproduction proof, supplied by the Service, is not a substitute form.)

2 *Supporting Statement (Supplemental Schedule).* A document filed as a part of a tax return that provides detailed information to support an entry for a line (or lines) on an official form. A supporting statement cannot take the place of an official form.

3 *Computer-Prepared Form.* A preprinted form in which the taxpayer's name, address and tax entry information has been printed by a computer, computer-printer or other computer-type equipment, such as word-processing equipment.

4 *Manually Prepared Form.* A preprinted form in which the taxpayer's name, address and tax entry information is entered by an individual using a pen, pencil, typewriter or other non-automated equipment.

5 *Computer-Generated Tax Form.* A document that is entirely prepared by the use of a computer printing device so that all the line numbers, line captions, and the tax amount data entries are in the same type face. No graphics appear on the form.

6 *Graphics.* Those parts of the tax form that are not the tax amount entries or called-for information. Generally, these are line numbers, captions, instructions, rules and borders, special indicators, rules or strokes created by type-setting, photo-graphics, photo-composition, etc.

7 *Printed Form.* A form produced using conventional printing processes, photocopying, or other similar processes.

8 *Preprinted Pin-Fed Form.* A form printed beforehand by conventional methods on paper that has marginal perforations for use with automated and high-speed printing equipment.

SEC. 3. SUMMARY OF CONTENTS

.01 MESSAGE TO TAX RETURN PREPARERS

IF YOU PLAN TO CHANGE OR MODIFY *ANY* TAX FORMS, YOU MUST FOLLOW INTERNAL REVENUE PROCEDURES AND, IN MOST CASES, *YOU MUST GET OFFICIAL APPROVAL BEFORE USING SUBSTITUTE FORMS. THE SERVICE IS CONTINUING A NATIONWIDE PROGRAM TO IDENTIFY AND CONTACT TAX RETURN PREPARERS USING UNAPPROVED FORMS*

.02 Additional information you may also need is contained in Rev. Proc. 80-48, page 792, this Bulletin. You can get this procedure by (1) ordering it on the form provided in Package X, Informational Copies of Federal Income Tax Forms, or (2) by writing to: IRS REV. PROC., P.O. Box 27322, Richmond, VA 23261. They are also obtainable at your local district office.

.03 THINGS YOU *CAN DO* TO INTERNAL REVENUE SERVICE PRINTED TAX FORMS.

1 *You can PHOTOCOPY* any federal tax form or schedule and use it instead of the official one.

2 *You can REPRODUCE ANY CURRENT* form (or schedule) as cut sheets, snap-sets, marginally-punched pin-fed forms, so long as you use an official Service version as the master copy. An official version is one supplied by the Service, such as those in the taxpayer's tax package, those in Package X, reproduction proofs (sold by the Service) and those printed in revenue procedures.

3 *You can ADJUST* the graphics on printed Forms 1040 and 1040A (and other forms) to allow for computer-printed or word processor fill-in. Guidelines for making these adjustments are listed in Rev. Proc. 80-48.

4 *You can PRINT AND DUPLICATE* the substitute "worksheet-type" versions of Schedules A and B (see exhibits section) for use when you need a "worksheet." The Service will accept these substitute schedules instead of the official versions. These schedules serve different purposes. One allows the form to contain state tax information which is blocked-out before submission to the Service. The other allows the form to be used singly or as part of a snap-set.

.04 THINGS YOU *CANNOT* DO TO INTERNAL REVENUE SERVICE PRINTED TAX FORMS.

1 *You cannot* change any Internal Revenue Service tax form or use your own (non-approved) version, unless permitted by revenue procedures without prior Service approval.

2 *You cannot* change any of the graphics on Forms 1040 and 1040A (except those specified in revenue procedures) without prior approval from the Service.

3 *You cannot* use your own version of Schedule A (Itemized Deductions) UNLESS YOU FIRST GET IT APPROVED. When using attachements to the official Schedule A, you must

COMPLETELY FILL OUT ALL REFERENCED (NUMBERED OR LETTERED) LINES OF THE OFFICIAL SCHEDULE A; not just the total lines, but the line items that make up the totals as well. In other words, you may not enter just the totals for the various deduction categories, *i.e.*, "Medical," "Taxes," etc., and write "See Attached Schedule" across the part of the form. The Service wants only one Schedule A—either yours or an official version; yours needs prior approval from the Service.

4 *You cannot* use your own preprinted label on tax returns filed with the Service. The ONLY label permitted is the one provided the taxpayers in their tax packages. Otherwise, the taxpayer's name and address must be entered on the return in the spaces provided.

5 *Other items are also not permitted.* Please read the rest of this revenue procedure for details.

SEC. 4. SPECIFICATIONS FOR FILING SUBSTITUTE FORMS

.01 *Computer-Prepared Tax Forms.* For filing purposes, the Service will accept computer-prepared tax forms (*i.e.*, Forms 1040, 1040A, 1120, 940, 941, etc.) filled in by a computer or by word-processing equipment, but these forms MUST be preprinted.

.02 *Computer-Generated Forms.* For filing purposes, the Service will accept computer-generated versions of schedules and forms that are attached to individual and business income tax returns, provided they meet the requirements prescribed in Rev. Proc. 80-48.

.03 *Combination of Manually Prepared and Computer-Prepared/Generated Forms.* For filing purposes, the Service will accept substitute tax forms that contain a combination of computer prepared/generated and manually filled in information.

.04 *Substitute Schedules K-1.* Prior approval is NOT required for Schedules K-1 that accompany Forms 1065, for partnerships, 1120-S, for small businesses, and 1041, for fiduciaries, when the K-1's meet the following requirements:

(a) The K-1 must contain only the line items required for use by the taxpayer,

(b) These line items must be in the same order and arrangement as the official form,

(c) The line items must be numbered, titled, and/or captioned exactly as shown on the official form, and

(d) Each taxpayer's information must be on a separate piece of paper.

SEC. 5. APPROVAL INFORMATION

.01 *Approvals.*

1 *Guidelines.* Preparers who desire to file privately designed and printed substitute tax forms must develop such substitutes using these guidelines and those contained in Rev. Proc. 80-48 and, unless permitted by revenue procedures, must obtain approval from the Service before the forms are filed.

2 *Changes to Tax Forms.* Any person making changes to any tax form or schedule (EXCEPT THOSE STATED IN THIS OR OTHER REVENUE PROCEDURES) must obtain approval from the Service before filing the substitute.

Because a substitute form is a variation from the official form, you should know the requirements of the official form before you modify it to meet your needs. For the most frequently used tax forms, the quickest way to obtain an official form is to request reproduction proofs of these forms. Reproduction proofs can only be ordered by using the Form M-5368, Order for Reproduction Proofs. Form M-5368 can be obtained in two ways: (1) by written request to Internal Revenue Service, RM:FM:P, Room 1528, 1111 Constitution Ave., N.W., Washington, D.C. 20224, or (2) by telephone request (at your expense) to the Reproduction Proof Coordinator at (202) 566-2473.

(a) THE GUIDELINES FOR PRIVATELY DESIGNED AND PRINTED TAX FORMS ARE AS FOLLOWS:

(1) Each form must follow the design of the official form as to format, arrangement, item caption, line numbers, line references and sequence.

(2) When a form is designed with both federal and state columns, *THE FEDERAL COLUMN MUST BE TO THE LEFT OF THE STATE COLUMN AND ADJACENT TO THE LINE CAPTION.*

(3) When a form is to be manually prepared (see definitions), the federal column must have a vertical line in the amount field to separate dollars from cents if the official form has a vertical line. The cents column must be at least ⅛th inch wide.

(4) Please note that certain forms have a newly added "sequence number" located just below the year designation in the upper right corner of the form. The Service uses this number to indicate the order in which forms are processed when filed with a return. It must be printed on the affected form, in no less than 12-point bold-face type, and centered below the form's year designation. THE SEQUENCE NUMBER IS REQUIRED ON FORMS LISTED BELOW. Please note: some of the numbers have been changed since last year.

Form 1040 Schedule/Form	*Sequence Number*
A	08
C	09
D	15
E	16
F (front)	17
F (reverse) print in top margin at least 2½" from left edge	18
G	21
R and RP	22
SE	23
2119	25
2440	26
2441	27
2555	36
3468	28
4136	29
4136-T	29
4625	30
4726	31
5329	32
5695	34
6251	35

3 *Mailing Address.* Proposed substitutes should be forwarded by letter to the Internal Revenue Service, Attention: Substitute Forms Program, TX:R:I, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

4 *When to Submit.* Proposed substitutes should be sent to the address

listed in 3 above, as much in advance of the filing period for the form as possible. This is to allow adequate time for analysis and response and to permit notice to our field offices. Quarterly filed forms, such as the Form 941, must be submitted by the first day of the last month of the quarter.

5 *Required Statement.* When the sample substitute is submitted, there must also be an accompanying statement that lists the form number of each substitute requested and details those items that deviate from the official form in position, arrangement, appearance, line numbers, additions, deletions, etc. Included with each of the items must be a detailed reason or justification for the change and an approximation of the number of forms expected to be filed.

6 *Approval Letter.* Upon determination that approval can be given, the Service sends a formal letter of approval which also may contain qualifications for use of the substitutes.

7 *Duration of Approval.* Approvals, when granted, are good for only one calendar year (January through December) or, in the case of corporation tax forms (with the exception noted below), for the remainder of the quarters of the calendar year.

PLEASE NOTE: Each new filing season requires a new approval, even if the official form does not change.

Exception: Certain quarterly tax forms in the 94X series (941, 942, etc.) are approved for only one quarter. Each new quarter requires a new approval.

8 *Required Copies.* Once an approval is granted for the use of a substitute form, you may be requested to send to the Service eleven (11) copies of each approved form. When requested, the copies will be used to notify Internal Revenue Service Centers that your substitute forms are approved. The requested forms must be assembled in sets. A set constitutes a return with the related schedules and forms in order as they will be filed, *i.e.*, Form 1040, Schedules A, B, C, etc., Forms 2440, 2441, etc. The Service reserves the right to reject sets not assembled in the order specified.

9 *Other Forms Not Listed.* Other Service forms, such as Forms W-2, 1087, 1099, and 1040-ES, are governed by different revenue procedures. These procedures are available at your local district office.

Sec. 6. Physical Aspects and Requirements

.01 *Printing Medium.* The private printing of these substitutes must be produced by conventional printing processes, photocopying or other similar reproduction process.

1 *Remove Government Printing Office Symbol.* When privately printing a tax form, the Government Printing Office symbol and jacket numbers must be removed, and in its place (using the same type size) *print the Employer Identifying Number (EIN) of the printer or the Social Security Number (SSN) of the form designer.*

.02 *Paper Requirements.* The paper must be chemical wood writing paper that is equal to or better than the quality used for the official forms.

1 Official tax forms are printed on 18 pound (17″ × 22″, 500 sheets) white, chemical wood writing paper, or

2 45 pound offset white (25″ × 38″, 500 sheets).

3 The thickness of the stock cannot be less than .003 inch.

.03 *Prohibited Paper.* Carbon bonded paper is prohibited from use for forms filed with the Service.

.04 *Chemical Transfer Paper—LIMITED USE.* Chemical transfer paper may be used ONLY when the following specifications are met:

1 Each ply within the chemical transfer set of forms or schedules must be labeled.

2 Only the top ply (ply one and white in color), the one which contains chemical on the back only (coated back), may be filed with the Service. For example, a set containing three plies would be constructed as follows: Ply one (coated back), "Federal Return, File with IRS"; Ply two (coated front and back), "Taxpayer's copy"; and Ply three (coated front), "Preparer's copy."

3 The file designation, "Federal Return, File with IRS," for ply one must be printed in the bottom right margin (just below the last line of the form) in 12-point bold-face type. It is not mandatory, but recommended, that the file designation, "Federal Return, File with IRS," be printed using a contrasting ink to be clearly visible to the taxpayer.

.05 *Paper and Ink Color.* The color of paper and ink must substantially duplicate that of the original form in order to be accepted. This means that your substitute *must be printed in black ink and on the color paper the Service form is printed on.* An exception to this rule is that Forms 1040A and 1040 reproductions may be in black ink without the colored screening. Any additional exceptions to this rule require written approval from the Service.

.06 *Legibility.* Reproductions must have a high standard of legibility, both as to original form and as to fill-in matter. The Service reserves the right to reject any reproductions with poor legibility.

.07 *Size of Page.* Reproductions and privately designed and printed substitutes may be the same size as the official form (8″ × 11″, in most cases) or they may be the standard commercial size (8½″ × 11″).

.08 *Image Size, Text Removal, and Type Font.* The image size of printed material should be as close as possible to that of the official form. You may omit any text that is solely instructional in nature.

1 To allow a larger top margin for marginal printing (see .09 below), the title line(s) for all forms (not including the form's year designation and sequence code when present) may be photographically reduced by 40 percent or reset as one line of type. When reset as one line, the type size may be no smaller than 14 point. You may omit the "Department of the Treasury-Internal Revenue Service" and all references to instructions that appear in the form's title area.

2 Almost all federal tax forms are

printed using "News Gothic" as the basic type font. We request that this type font be used when composing substitute forms.

3 Maintain at least a one-half (½) inch margin on all sides of the form. This allows room for Service employees to make necessary entries on the form during processing.

.09 *Marginal Printing — Limited Area.* You may print your logo, company or firm name, identifying and collation symbols, etc., in the *top left margin* of any Service form. The area you may use extends vertically from the top of the form's title designation to the top edge of the form and horizontally 3½ inches from the left edge. *No printing is permitted in the top right margin.* With the exception of the actual tax return form (*i.e.*, Forms 1040, 1040A, 1120, 940, 941, etc.) you may also print in the left vertical and bottom left margins. The bottom left margin you may use extends 3½ inches from the left edge of the form.

SEC. 7. APPROVED SUBSTITUTE FORMATS FOR FORM 1040 SCHEDULES A AND B

.01 *Schedules A and B (Form 1040).*

1 *Exhibits of Approved Formats.* There are two sets of exhibits (Exhibits A-1 & B-1 and A-2 & B-2) shown in this publication. They are acceptable substitutes for the official forms. Both sets are usable for manual entry or computer preparation. (Vertical spacing is six (6) lines to the inch.)

.02 *Duplication of Exhibits A-1 & A-2 and B-1 & B-2.* You are permitted to duplicate these exhibits photographically or using photo-reproduction techniques, PROVIDING YOUR PRINTED IMAGES ARE EXACTLY LIKE THE ONES IN THE EXHIBITS. WITH THE EXCEPTION NOTED BELOW, NOTHING CAN BE CHANGED. **Please note: The Service does NOT supply reproduction proofs for these exhibits.**

.03 *Use of Duplicated Exhibits.*

1 If your forms are *EXACT DUPLICATES* of these exhibits, THEY MAY BE USED WITHOUT PRIOR AUTHORIZATION.

2 *SIZE OF EXHIBITS.* The exhibits are shown at 92 percent of actual size. These substitutes should be restored to their original size during your reproduction process.

ANY CHANGE TO THE FORMAT, CAPTIONS, SPACING, ARRANGEMENT AND/OR POSITION OF THE VARIOUS CATEGORIES, ETC., OF THESE EXHIBITS REQUIRES PRIOR WRITTEN APPROVAL.

EXCEPTION—The areas in the Exhibits A-1 and A-2 identified by the circled numbers 1 through 9 may be changed as follows. The areas inside the perimeter of the boxes containing the dash-leaders, *i.e.*, ----, (designated by the circled numbers), may be used to print any particular deduction item associated with the corresponding deduction category. You may remove the dash-leaders if you wish. *YOU MAY NOT CHANGE THE AMOUNT COLUMN BOX SIZE OR POSITION.* Strip out the circled numbers before use.

3 *Exhibit A-1.* This substitute Schedule A format may be used as a single sheet or as one of the copies of a snap-set. It is designed to be used in place of the official Schedule A (Form 1040).

4 *Exhibit A-2.* This substitute Schedule A format may be used as a single sheet when both federal and state tax information is placed on the same form.

NO STATE TAX INFORMATION CAN APPEAR ON THESE FORMS WHEN FILED WITH THE FORM 1040. THE STATE COLUMN MAY BE PRESENT BUT THE STATE TAX INFORMATION MUST NOT BE VISIBLE WHEN FILED WITH THE SERVICE. We prefer that the entire state column be COMPLETELY BLOCKED OUT.

5 *Exhibits B-1 and B-2.* These exhibits correspond to Exhibits A-1 and A-2 and the provisions in 3 and 4 apply. Both of these exhibits are acceptable for use in place of the official Schedule B (Form 1040). Both are designed for either manual or computer-generated entries.

6 *Exhibits A-1 and B-1 or A-2 and B-2.* These exhibits may be used as sets when the return calls for both Schedules A and B. PLEASE NOTE: DO NOT USE BOTH THESE SUBSTITUTES AND THE OFFICIAL VERSIONS. USE ONE OR THE OTHER.

7 *BLOCK OUT METHODS.* A suggested method to block out the state tax information is: (1) place the substitute form in a clear plastic folder, (2) on the folder place a strip of opaque material the exact width and length of the column you wish to block out, then (3) photocopy the substitute form while still in the folder. The result will be a form with only the federal tax information visible. Another method is to take a black marking pen and using either vertical or horizontal strokes cross out the state figures. Carbon interleaved sets may be used where the amounts entered in the state column are filled in with black carbon overprint. This copy may be filed with the return.

SEC. 8. OTHER CONSIDERATIONS

.01 Reproductions of official forms and substitute forms which do not meet the requirements of this revenue procedure may not be filed instead of the official forms and schedules.

.02 *Required Preparation of Forms.* You must completely fill out all the numbered or referenced lines on official forms (NOT JUST THE TOTALS, BUT ALL THE ITEMS THAT MAKE UP THE TOTALS AS WELL) before attaching any supporting statement (see exceptions below). The Service processes the return based on information entered on the official or approved version of the tax forms. References are made to attachments ONLY as required by law and as processing requirements direct. When you fail to complete all the lines on the official forms, Internal Revenue Service Tax Examiners have to locate the information on your attachment and write it on the proper line of the official form. This unfortunate process

causes delays in processing the return and increases the potential for errors both in transcription and in interpretation. *THE SERVICE IS CONTINUING A NATIONWIDE PROGRAM TO NOTIFY PREPARERS WHO FAIL TO MEET THIS REQUIREMENT.*

.03 *Exceptions.*

1 *Lines Captioned "Other."* It is not necessary to fill in every numbered or referenced line of tax forms when the line caption calls for "Other," *i.e.*, "Other (itemize)," "Other (specify)," "Other (attach schedule)," etc. Examples of this exception are lines 6c, 15, 19, 21b and 31 for Schedule A (Form 1040). When this occurs, a supporting statement may be used and only the total amount of these "Other" items entered on the line of the official form. However, we prefer that the space on the official form be used when it is adequate.

2 *Schedule A (Form 1040).* All numbered and lettered lines must be filled in, if applicable. Supporting statements may be used to give the details of the totals entered on such lines but may not be used as a substitute for a collection of lines. For example, the detailed information for "Taxes" may not be shown on a supporting statement (supplemental schedule) and only line 16 filled in; but the details of "State and local income taxes" may be shown on a supporting statement and the total of such taxes entered on line 11. Also, lines 33 through 38 need not be shown, but the total of itemized deductions must be shown on line 39.

3 *Schedule B (Form 1040).* Lines 1 and 3 need not be filled in on the form. A supporting statement may be used for the details of interest and dividend income and the appropriate totals of such income entered on lines 2 and 4 unless nominee distribution or accrued interest criteria apply. (See the tax package instructions concerning interest.)

4 *Schedule C (Form 1040).* All lines on page 1 must be filled in when applicable except the line where "Other expenses-specify" is listed. (See instruction (2) above.) All information for Schedule C-1 must be entered. Schedule C-2 information may be entered on a supporting statement so long as the method of depreciation used (if any) is entered on the form in column (e). Schedule C-3 information may be shown on a supporting statement and not entered on the form.

5 *Schedule E (Form 1040).*

(a) When there are entries on page 1 for any of the Parts I through IV, the following requirements must be met: (1) in Part I, lines 1a through 4, the questions must be answered and tax information must be entered on the lines provided, (2) in Part II, lines 5a through 6b, the question boxes must be answered; if the answer to question 6a is "yes," the amortizable basis must be entered on line 6b. Be sure there is a place on line 6b for the amount.

(b) Supporting statements may be used for the details of rental income and expenses and for royalty income. The appropriate totals must be carried to line 7, columns (b) and (g), when a Form 4835 is filed with the return. Totals must also be entered on line 8, columns (b) through (g).

(c) The income and loss from various partnerships, estates or trusts, and small business corporations also may be detailed on a supporting statement, but the appropriate total income and total loss must be entered on lines 10 through 18 and also on line 19 when applicable.

(d) Page 2 need not be used so long as the information is provided on a supporting statement. The supporting statement must show the details required by the form.

6 *Schedule F (Form 1040).* Depending on which accounting method is used (cash or accrual), all of parts I and II or II and V must be printed in their entirety.

.04 *Supporting Statements.*

1 You may attach supporting statements to explain or support any line item on an official or approved form. Supporting statements must provide details and explain entries made on the official form or schedule, must furnish all required information in the same sequence as called for on the official forms or schedules, and must be attached to the return following all other official forms. All tax returns must be arranged in this order: the tax return, lettered forms in alphabetical order, numbered forms in numerical sequence and supporting statements. Information on supporting statements must be in the same order as the items appeared on the form to which it is referenced. THEIR USE MUST BE TO SUPPORT LINE ENTRIES ON THE OFFICIAL FORM AND NOT TO AVOID COMPLETING REQUIRED LINES ON THE OFFICIAL FORM.

2 Additionally, each of your supporting statements must be referenced to the form it supports, and the entry on the form must be cross-referenced to the supporting statement. For example, put "See Statement X" on the line of the form that references the statement and put "Statement X" on the top of the supporting statement that contains the identified line number and the supporting information.

.05 *Printing On One Side of Paper.* While it is preferred that both sides of the paper be used in making reproductions, resulting in the same page arrangement as that of the official form or schedule, the Service will not object if only one side of the paper is used or if the reproduction has a different fold from that provided on the official form.

.06 *Paid Preparer's Information and Signature Area.* On both Forms 1040A and 1040, the "Paid Preparer's Information" area may not be rearranged or relocated. You may add one extra line to the paid preparer's address area. An exact facsimile must appear on Page 1 of Form 1040A and Page 2 of Form 1040. This applies to other tax forms as well.

.07 *Use Preaddressed Label.* When filing reproduced or privately printed federal tax returns and related schedules, use the preaddressed label furnished to the taxpayer in the tax package by the Service on the copy that is to be filed with the Service. Use of the label avoids larger processing

costs because it reduces the potential for error—the kind of error which can delay the receipt of refund and information needed by the taxpayer. **No other label may be used.**

.08 *State Tax Information Prohibited.* State tax information must not appear on the federal tax return which is filed with the Internal Revenue Service Center, except where amounts are claimed on or required by the federal return, *e.g.*, line 11, Schedule A (Form 1040).

.09 *Use Internal Revenue Service Envelope.* When filing reproduced or privately printed federal tax returns use the envelope enclosed with the taxpayer's tax package. This envelope is coded for sorting into several categories. Use of the envelope can help speed up the processing and reduce processing costs. Do not use the Service-provided tax package envelope for other correspondence with the Service, as its misuse could delay the correspondence.

.10 *Filing Substitute Forms.* Follow the same instructions as for filing official forms. These instructions are in the taxpayer's tax package.

.11 *Voluntarily Submitted Information.* Additional information required or voluntarily submitted should be on the same size paper as the official form.

SEC. 9. REPRODUCTION PROOFS.

Camera-ready, reproduction-quality, proof copies of many of the tax forms issued by the Service are available to the public. Order blanks for reproduction proofs will be mailed to requestors of record and, on request, to prospective users. Printers and others wishing to obtain reproduction proofs may send their requests to the Internal Revenue Service, Attention: Publishing Services, RM:FM:P, Room 1528, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

Basic specifications, such as margin, pagination, etc., will be printed in the margins of the reproduction proofs and must be removed before printing. The official reproduction proof margins across the top, bottom, and sides must be maintained on all reproductions and privately printed federal tax returns and related schedules.

A charge of $1.00 per page will be made for each reproduction proof regardless of page size. After an order has been filled, invoices will be mailed to the requestor.

SEC. 10. ADDITIONAL INSTRUCTIONS

.01 *Photocopy Equipment.* The Service does not undertake to approve or disapprove the specific equipment or process used in reproducing official forms, but requires only that the reproduced forms and schedules satisfy the conditions stated in revenue procedures.

.02 *Taxpayer and Preparer Signatures.* All taxpayer signatures on forms to be filed with the Service must be original signatures, affixed subsequent to the reproduction process. However, the income tax preparer can satisfy the manual signature requirement by signing a completed income tax return form, making a photocopy of the return form, and having the taxpayer sign and file the photocopy. (See Rev. Rul. 78-370, 1978-2 C.B. 336.)

.03 *Requests for Approvals.* When specific approval of a reproduction of any form is desired, or if the use of a reproduction of any form is not listed or specified herein or otherwise specifically authorized, a sample of the proposed reproduction should be forwarded by letter to the Internal Revenue Service, Attention: Substitute Forms Program, TX:R:I, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, for consideration. When copies of privately designed forms are submitted for approval, please follow the instructions listed near the beginning of this revenue procedure.

SEC. 11. AGREEMENT

Any person or company who uses substitute forms and makes all or part of the changes specified in this revenue procedure, agrees to the following stipulation: The Service presumes the changes are made in accordance with these procedures and, as such, will be noninterruptive to the processing of the tax return. Should any of the changes prove to be not exactly as described, and as a result become disruptive to the Service during processing of the tax return, the person or company agrees to accept the determination of the Service as to whether or not the form may continue to be used during the filing season, and also agrees to work with the Service in correcting noted deficiencies. Notification of deficiencies may be made by letter, phone call or both.

SEC. 12. EFFECT ON OTHER DOCUMENTS

This revenue procedure supersedes Rev. Proc. 79-57, 1979-2 C.B. 540.

SEC. 13. EXHIBITS SECTION

Exhibits shown in this section are acceptable substitutes for official forms and are intended to be used *in place of* their corresponding official forms. No prior approval is needed before using them so long as all other requirements in this revenue procedure are met.

Exhibit A-1 (Substitute Schedule A—Preferred Format)

Schedule A (Form 1040)
Department of the Treasury
Internal Revenue Service

Itemized Deductions

▶ Attach to Form 1040. ▶ See Instructions for Schedule A (Form 1040)

1980
08

Name(s) as shown on Form 1040 | Your social security number

Medical and Dental Expenses — Federal

1 ½ Insurance premiums
2 Medicine and drugs
3 Enter 1% of Form 1040, line 31
4 Subtract line 3 from line 2
5 Balance of insurance premiums

Doctors, dentists, nurses, etc.

①

6(a) Total doctors, dentists, nurses, etc.

Hospitals

②

6(b) Total hospitals

Other medical and dental expenses (itemize—hearing aids, eyeglasses, transportation, etc.)

③

6(c) Total other medical and dental expenses

7 Total (add lines 4 through 6c)
8 Enter 3% of Form 1040, line 31
9 Subtract line 8 from line 7
10 **Total (add lines 1 and 9)**

Taxes

11 State $..... Local $.....
12 Real estate
13 General sales
14 Personal property

Other (itemize) ▶

④

15 Total other
16 Total taxes ▶

Interest Expense

17 Home mortgage
18 Credit and charge cards

Other (itemize) ▶

⑤

19 Total other
20 Total interest expense ▶

Contributions — Federal

Cash contributions for which you have receipts, cancelled checks, etc.

⑥

21a Total receipts cash

Other cash contributions (show to whom you gave and how much)

⑦

21b Total no receipt cash

Other than cash

⑧

22 Total other than cash
23 Carryover from prior years
24 **Total contributions**

Casualty or Theft Loss(es)

25 Loss before insurance
26 Insurance reimbursement
27 Subtract line 26 from line 25
28 Enter $100 or smaller of line 27
29 **Total casualty or theft loss(es)** ▶

Miscellaneous Deductions

A

30 Union dues

Other (itemize) ▶

⑨

31 Total other
32 **Total miscellaneous deductions** ▶

39 **Total deductions** ▶

40 If you checked Form 1040, Filing Status box:
2 or 5, enter $3,400
1 or 4, enter $2,300
3, enter $1,700

41 Subtract line 40 from line 39 ▶

Federal copy—File with Form 1040

Exhibit B-1 (Substitute Schedule B—Preferred Format)

Schedule B (Form 1040)
Department of the Treasury
Internal Revenue Service

Interest and Dividend Income

▶ Attach to Form 1040. ▶ See Instructions for Schedule B (Form 1040)

1980

Name(s) as shown on Form 1040 (Do not enter name and social security number if shown on other side) | Your social security number

Part I Interest Income

	Federal
1	
2 Total interest income	

Part II Dividend Income

3 gross dividends	
4 Total of line 3	
5 Capital gain distributions. Enter here and on appropriate line(s) on Schedule D	
6 Nontaxable distributions	
7 Total (add lines 5 and 6)	
8 Dividends before exclusion	

Part III Foreign Accounts and Foreign Trusts

	Yes	No
A At any time during the tax year, did you have an interest in or a signature or other authority over a bank account, securities account, or other financial account in a foreign country (see page 19 of instructions)?		
B Were you the grantor of, or transferor to, a foreign trust which existed during the current tax year, whether or not you have any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520-A, or 926.		

Federal Copy **B**

Exhibit A-2 (Substitute Schedule A—Acceptable Format)

Schedule A (Form 1040)
Department of the Treasury
Internal Revenue Service

Itemized Deductions

▶ Attach to Form 1040. ▶ See Instructions for Schedule A (Form 1040)

1980
08

Name(s) as shown on Form 1040 | Your social security number

Medical and Dental Expenses

	Federal
1 ½ Insurance premiums	
2 Medicine and drugs	
3 Enter 1% of Form 1040, line 31	
4 Subtract line 3 from line 2	
5 Balance of insurance premiums.	
Doctors, dentists, nurses, etc. ▶	
①	
6(a) Total doctors, dentists, etc.	
Hospitals ▶	
②	
6(b) Total hospitals	
Other medical and dental expenses (itemize) ▶	
③	
6(c) Total other medical	
7 Total (add lines 4 through 6c)	
8 Enter 3% of Form 1040, line 31	
9 Subtract line 8 from line 7	
10 Total (add lines 1 and 9)	

Taxes

11 State $..... Local $.....	
12 Real estate	
13 General sales	
14 Personal property	
Other (itemize) ▶	
④	
15 Total other	
16 Total taxes ▶	

Interest Expense

17 Home mortgage	
18 Credit and charge cards	
Other (itemize) ▶	
⑤	
19 Total other	
20 Total interest expense ▶	

Contributions

	Federal
Cash contributions for which you have receipts, cancelled checks, etc. ▶	
⑥	
21a Total receipts cash	
Other cash contributions (show to whom you gave and how much) ▶	
⑦	
21b Total no receipt cash	
Other than cash	
⑧	
22 Total other than cash	
23 Carryover from prior years	
24 Total contributions	

Casualty or Theft Loss(es)

25 Loss before insurance	
26 Insurance reimbursement	
27 Subtract line 26 from line 25	
28 Enter $100 or smaller of line 27	
29 Total casualty or loss(es)	

Miscellaneous Deductions

30 Union dues	
31 Other (itemize) ▶	
⑨	
Total other	
32 Total miscellaneous deductions ▶	
39 Total deductions ▶	
40 If you checked Form 1040, Filing Status box: 2 or 5, enter $3,400 / 1 or 4, enter $2,300 / 3, enter $1,700	
41 Subtract line 40 from line 39 ▶	

A

Federal copy—File with Form 1040

Exhibit B-2 (Substitute Schedule B—Acceptable Format)

Schedule B (Form 1040)
Department of the Treasury
Internal Revenue Service

Interest and Dividend Income

▶ Attach to Form 1040. ▶ See Instructions for Schedule B (Form 1040)

1980

Name(s) as shown on Form 1040 (Do not enter name and social security number if shown on other side) | Your social security number

Part I		Federal
Interest Income	1	
	2 Total interest income	
Part II Dividend Income	3 gross dividends	
	4 Total of line 3	
	5 Capital gain distributions. Enter here and on appropriate line(s) on Schedule D	
	6 Nontaxable distributions	
	7 Total (add lines 5 and 6)	
	8 Dividends before exclusion	

Part III Foreign Accounts and Foreign Trusts		Yes	No
	A At any time during the tax year, did you have an interest in or a signature or other authority over a bank account, securities account, or other financial account in a foreign country (see page 19 of instructions)?		
	B Were you the grantor of, or transferor to, a foreign trust which existed during the current tax year, whether or not you have any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520-A, or 926.		

Federal Copy **B**

26 CFR 601.602: Forms and instructions. (Also Part I, Sections 6001, 6011; 1.6001-1, 1.60011-1.)

Rev. Proc. 80-48

SECTION 1. PURPOSE

This Revenue procedure states the requirements of the Internal Revenue Service regarding the acceptance of computer-prepared tax forms (i.e., Forms 1040, 1040A, 1120, 940, 941, etc.) and computer-generated forms (and schedules) to be attached thereto.

SEC. 2. DEFINITIONS

.01 *Definitions Used in This Procedure (Relating to Tax Forms).*

1 *Substitute Form.* A tax form or related form that differs in any way from the official versions and is intended to replace the entire form printed and distributed by the Service. This term also covers those approved substitute formats and forms described in this revenue procedure. (A photocopy or a copy produced from an unchanged reproduction proof, supplied by the Service, is not a substitute form.)

2 *Supporting Statement (Supplemental Schedule).* A document filed as a part of a tax return that provides detailed information to support an entry for a line (or lines) on an official form. A supporting statement cannot take the place of an official form.

3 *Computer-Prepared Form.* A preprinted form in which the taxpayer's name, address and tax entry information has been printed by a computer, computer-printer or other computer-type equipment, such as word-processing equipment.

4 *Manually Prepared Form.* A preprinted form in which the taxpayer's name, address and tax entry information is entered by an individual using pen, pencil, typewriter or other non-automated equipment.

5 *Computer-Generated Tax Forms.* A document that is entirely prepared by the use of a computer-printing device so that all the line numbers, line captions, and the tax amount data entries are in the same typeface. No graphics appear on the form.

6 *Graphics.* Those parts of the tax form that are not the tax amount entries or called-for information. Generally, these are line numbers, captions, instructions, rules and borders, special indicators, and rules or strokes created by type-setting, photo-graphics, photocomposition, etc.

7 *Printed Form.* A form produced using conventional printing processes, photocopying, or other similar processes.

8 *Preprinted Pin-Fed Form.* A form printed beforehand by conventional methods on paper with marginal perforations for use with automated and/or high-speed printing equipment.

SEC. 3. SUMMARY OF CONTENTS

.01 MESSAGE TO TAX RETURN PREPARERS.

IF YOU PLAN TO CHANGE OR MODIFY *ANY* TAX FORMS, YOU MUST FOLLOW THESE INTERNAL REVENUE PROCEDURES. IN MOST CASES, *YOU MUST GET OFFICIAL APPROVAL BEFORE USING SUBSTITUTE FORMS.*

THE SERVICE IS CONTINUING A NATIONWIDE PROGRAM TO IDENTIFY AND CONTACT TAX RETURN PREPARERS USING UNAPPROVED FORMS.

.02 Additional information you may also need is contained in Rev. Proc. 80-47, page 782, this Bulletin. You can obtain this revenue procedure by (1) ordering it on the form included in Package X, Informational Copies of Federal Tax Forms, or (2) writing to: IRS Rev. Proc., P.O. Box 27322, Richmond, VA 23261. They are also obtainable at your local district office.

.03 THINGS YOU *CAN DO* TO INTERNAL REVENUE SERVICE PRINTED TAX FORMS TO MAKE THEM SUITABLE FOR COMPUTER PREPARATION.

1 *You can PHOTOCOPY* any federal tax form or schedule and use it instead of the official one.

2 *You can REPRODUCE ANY CURRENT* form (or schedule) cut sheets, snap-sets, and marginally-punched pin-fed forms, so long as you use an official Service version as the master copy. An official version is one supplied by the Service, such as those in the taxpayer's tax package, those in Package X, reproduction proofs (sold by the Service), and those printed in revenue procedures.

3 *You can ADJUST* the graphics on printed Forms 1040, 1040A, 1120, 940, 941, etc., to allow for computer-printed or word processor fill-in. Only the areas listed in revenue procedures may be changed without prior approval.

4 *You can PRINT AND DUPLICATE* the substitute "worksheet-type" versions of Schedules A and B (shown as exhibits) in Rev. Proc. 80-47 when you need a "worksheet-type" format. The Service will accept these substitute schedules instead of the official versions. These schedules serve different purposes. One allows the form to contain a state tax column. (The state tax information must not be visible on the copy filed with the Service.) The other allows the form to be used singly or as part of a snap-set.

.04 THINGS YOU *CANNOT* DO TO INTERNAL REVENUE SERVICE PRINTED TAX FORMS.

1 *You cannot* change any Internal Revenue Service form or use your own (non-approved) version, unless permitted by revenue procedures, without prior Service approval.

2 *You cannot* change any of the graphics on Forms 1040 and 1040A (except those specified in revenue procedures) without prior approval from the Service.

3 *You cannot* use your own version of Schedule A (Itemized Deductions) *UNLESS YOU FIRST GET IT APPROVED.* When using attachments to the official Schedule A, you must *COMPLETELY FILL OUT ALL REFERENCED (NUMBERED OR LETTERED) LINES OF THE OFFICIAL SCHEDULE A,* not just the total lines, but also the line items that make up the totals. In other words,

you may not enter just the totals for the various deduction categories, *i.e.*, "Medical," "Taxes," etc., and write "See Attached Schedule" across that part of the form. The Service wants only one Schedule A—either yours or an official version; yours needs prior approval from the Service.

4 *You cannot* use your own preprinted label on tax returns filed with the Service. The ONLY label permitted is the one provided the taxpayers in their tax packages. Otherwise, the taxpayer's name and address must be entered on the return in the spaces provided.

5 *Other items are also not permitted.* Please read the rest of this revenue procedure for details.

.05 THINGS YOU *CAN DO* TO FILE COMPUTER-PREPARED/GENERATED FORMS.

1 *You can* DUPLICATE the approved, computer-generated formats of Schedules A, B, C, D, E, F, G, R, RP, SE and TC (shown in the Exhibit Section of this revenue procedure) and use them without prior approval.

2 *You can* FILL IN official Internal Revenue Service supplied forms using computer or word-processing equipment. Internal Revenue Service forms are designed for a vertical spacing of six lines to the inch, with money amount columns wide enough to allow for the computer printing of ten characters.

3 *You can* CHANGE CERTAIN SPECIFIED AREAS on the Forms 1040 and 1040A (spelled out in the revenue procedures) to assist computer-printing requirements and to allow for a little more room on certain lines.

4 *Other items are also permitted.* Please read the rest of this revenue procedure for more details.

.06 THINGS YOU *CANNOT DO* TO INTERNAL REVENUE SERVICE FORMS.

1 *You cannot* use computer graphics on any Internal Revenue Service form without prior approval.

2 *You cannot* computer-generate the TAX FORMS THEMSELVES (i.e., forms requiring signatures; for example, Forms 1040, 1040A, 1120, 940, and 941). These forms must be preprinted using conventional printing processes, photocopying or similar reproduction processes. The forms may be filled in by a computer, by a word processor, or the like, but the forms themselves must be printed like the Service versions are. Forms designed using computer graphics may be submitted for approval.

3 *You cannot* use your own computer-generated version of any tax form that is to be attached to the tax return, unless permitted by revenue procedures, without prior Service approval.

4 *Other items are also not allowed.* Please read the rest of this revenue procedure for more details.

SEC. 4. SPECIFICATIONS FOR FILING SUBSTITUTE FORMS

.01 *Computer-Prepared Tax Forms.* For filing purposes the Service will accept computer-prepared tax forms (i.e., Forms 1040, 1040A, 1120, 940, 941, etc.) filled in by a computer or by word-processing equipment, but these forms MUST be pre-printed.

.02 *Computer-Generated Forms.* For filing purposes, the Service will accept computer-generated versions of forms that are attached to individual and business income tax returns, provided the substitutes and their manner of completion meet the guidelines prescribed herein.

.03 *Combination of Manually Prepared and Computer-Prepared/Generated Forms.* For filing purposes, the Service will accept substitute tax forms that contain a combination of computer-prepared/generated and manually filled in information.

SEC. 5. GENERAL INFORMATION

.01 *Approvals.*

1 *Guidelines.* Preparers who desire to file substitute computer-prepared forms and/or computer-generated forms must develop such substitutes using guidelines in revenue procedures. Substitutes other than those described here must be approved by the Service before being filed.

2 *Changes to Tax Forms.* Any person making changes to any tax form (EXCEPT THOSE ALLOWED BY REVENUE PROCEDURES) must obtain approval from the Service before filing the substitute.

3 *Mailing Address.* Proposed substitutes should be forwarded by letter to the Internal Revenue Service, Attention: Substitute Forms Program, TX: R:I, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

4 *When to Submit.* Proposed substitutes should be sent to the address in 3 above, as much in advance of the filing period for the form as possible. This is to allow adequate time for analysis and response and to permit notice to our field offices. Quarterly filed forms, such as the Form 941, must be submitted by the first day of the last month of the quarter.

5 *Required Statement.* When the sample substitute is submitted, there must also be an accompanying statement that lists the form number of each substitute requested and details those items that deviate from the official form in position, arrangement, appearance, line numbers, additions, deletions, etc. Included with each of the items must be a detailed reason or justification for the change and an approximation of the number of forms expected to be filed.

6 *Approval Letter.* Upon determination that approval can be given, the Service sends a formal letter of approval which also may contain qualifications for the substitute's use.

7 *Duration of Approval.* Approvals when granted are good for only one calendar year (January-December) or, in the case of corporation tax forms (with the exception noted below), for the remainder of the quarter of the calendar year.

PLEASE NOTE: Each new filing season requires a new approval, even if the official form does not change.

Exception: Forms in the 94X series (941, 942, etc.) are approved only for one quarter. Each new quarter requires a new approval from the Service.

8 *Required Copies.* Once an approval is granted for the use of a com-

puter-prepared or computer-generated substitute form, you may be requested to send the Service eleven (11) copies of each approved form. When requested, the form(s) must be assembled in sets and submitted to the Service so that we can notify our Service Centers of the approvals we have given. A set constitutes a return with the related schedules and forms in order as they will be filed, i.e., Forms 1040, Schedules A, B, C, D, etc., Form 2440, 2442, etc. We reserve the right to reject sets which are not assembled in the order specified.

SEC. 6. PHYSICAL ASPECTS AND REQUIREMENTS

.01 *Lined Paper.* Computer-generated substitute forms must be submitted on quality, lined, machine paper. Lined, color-barred paper is also acceptable. Lined paper assists Service employees during processing of the returns by allowing speedy location of tax entries corresponding to line captions. The lines provide the basic means for eye-travel from one side of the form to the other.

.02 *Margins.* A one-half inch margin must be maintained across the top, bottom, and both sides (exclusive of any pin-feed holes) of all computer-generated substitutes. One-half inch margins allow for slight printing misalignment when forms are prepared on high-speed equipment. The margin area is also used by Service employees to make necessary entries on the form during processing.

.03 *Page Size.* Computer-prepared/generated substitutes may be the same size as the official (8″ × 11″, in most cases) or they may be the standard commercial size (8½″ × 11″). Computer-generated forms must be on the same size paper as the tax form to which it is attached.

.04 *Prohibited Paper.* Carbon-bonded paper is prohibited from use for forms filed with the Service.

.05 *Chemical Transfer Paper—Limited Use.*

Chemical transfer paper may be used ONLY when the following specifications are met:

1 Each ply within the chemical-transfer set of forms must be labeled.

2 Only the top ply (ply one), the one which contains chemical on the back only (coated back), may be filed with the Service. For example, a set containing three plies would be constructed as follows: Ply one (coated back), "Federal Return, File with IRS"; Ply two (coated front and back), "Taxpayer's copy"; and Ply three (coated front), "Preparer's copy."

SEC. 7. CONDITIONS—TAX FORMS (1040A, 1040, 1120, 940, 941, ETC.)

.01 *PROHIBITED FORMS.*

1 *COMPUTER-GENERATED VERSIONS.* Computer-generated versions of a tax form which requires a signature are not permitted. Only preprinted substitutes of these forms are allowed.

2 *COMPUTER-GENERATED GRAPHICS.* Computer - generated graphics CANNOT be used on any form without prior approval.

.02 *FILL - IN INFORMATION.* The tax form itself (i.e., 1040, 1040A, 1120, 940, 941, etc.) may be filled in by a computer printer or other similar automated equipment, but the form itself must be created beforehand (i.e. preprinted) using conventional printing methods, photocopying or other similar reproduction processes.

.03 *CHANGES PERMITTED TO THE FORMS 1040 & 1040A.*

1 Certain changes (listed below) are permitted to the graphics of the form without prior approval, but these changes apply only to preprinted forms as described in .02 above.

2 Changes not requiring prior approval are good only for the filing period January through December 1981.

3 *OTHER CHANGES NOT LISTED.* All changes not listed here require prior approval from the Service *BEFORE* the form may be filed with the Service.

4 *OTHER FORMS NOT LISTED.* Other Internal Revenue Service forms, such as Forms W-2, 1087, 1099, and 1040-ES, are governed by different revenue procedures. These revenue procedures are available at your local district office.

SEC. 8. AGREEMENT

Any person who uses substitute forms and makes all or part of the changes specified in this revenue procedure, agrees to the following stipulation: The Service presumes the changes are made in accordance with these procedures and, as such, will be noninterruptive to the processing of the tax return. Should any of the changes prove to be not exactly as described, and as a result become disruptive to the Service during processing of the tax return, the preparer agrees to accept the determination of the Service as to whether or not the form may continue to be used during the filing season, and also agrees to work with the Service in correcting noted deficiencies. Notification of deficiencies may be made by letter, phone call or both.

SEC. 9. CHANGES PERMITTED TO THE GRAPHICS ON BOTH FORM 1040 AND 1040A AND, WHERE APPLICABLE, ON OTHER FORMS AS WELL (FOR USE WITH COMPUTER-PREPARED FORMS ONLY)

.01 *Adjustments.* You may make minor vertical and horizontal spacing adjustments to allow for computer or word-processing printing. This includes widening the amount columns or tax entry areas so long as the adjustments do not exceed other provisions stated in revenue procedures. No prior approval is needed for these changes. However, the user of forms with such changes are bound by the "Agreement" in Section 8.

.02 *NAME AND ADDRESS AREA.*

1 The horizontal rules and instructions within the name and address area may be removed and the entire area left blank; no line or instruction can remain in the area.

2 The heavy ruled border (when present) that outlines the name and address area must not be removed, relocated, expanded or contracted.

3 *Required Format.*

(a) When the name and address area is left blank, as provided in 1 above, the following format *MUST* be used when printing the taxpayer's name and address. Otherwise, unless the taxpayer's preprinted label is affixed over the information entered in this area, the lines must be filled-in as shown.

1st name line (35 characters maximum)

In-care-of name line (35 characters maximum)

Street address (35 characters maximum)

City, State (24 char. max.), one blank char., & zip (five char.)

(b) When there is no in-care-of name line, the name and address will consist of only three lines. Examples of the formats follow:

Example of name and address with NO in-care-of name line:

JOHN AND MARY JONES
1234 ANYWHERE ST. APT 111
ANYTOWN, VA. 12345

Example of name and address WITH in-care-of name line:

JOHN AND MARY JONES
C/O THOMAS A. JONES
4311 SOMEWHERE AVE.
SAMETOWN, VA. 54321

(c) YOU *MAY NOT* USE YOUR OWN PREADDRESSED LABEL ON ANY INTERNAL REVENUE SERVICE FORM.

(d) The *ONLY* label that may be used is the OFFICIAL INTERNAL REVENUE SERVICE LABEL SUPPLIED to the taxpayer in his/her tax package. Please use the official Internal Revenue Service supplied label to help reduce errors.

(e) For identification purposes, you may computer print the taxpayer's name and address on the form and afterward affix the OFFICIAL INTERNAL REVENUE SERVICE SUPPLIED LABEL over the computer printed address. This applies whether or not the horizontal rules and the instructions have been removed.

.03 *SOCIAL SECURITY NUMBER (SSN) AND EMPLOYER IDENTIFICATION NUMBER (EIN) AREA.*

1 The vertical lines separating the format arrangement of the SSN/EIN may be removed.

2 When the vertical lines are removed, the SSN and EIN formats must be 000-00-0000 and 00-0000000, respectively.

.04 *CENSUS INFORMATION.* When present, this area may be vertically compressed into two lines; one for captions and one line below for computer entries. The areas A-D (Forms 1040 and 1040A) must NOT be rearranged or relocated. You may remove the vertical dash-leader in section A that separates "State" and "City." Captions may be shortened to fit in the space but sufficient "key words" must be used to identify the items requested.

.05 *CENTS COLUMNS.*

1 You may remove the vertical rule that separates the dollars from the cents.

2 All entries in the amount column must have a decimal point following the whole dollar amounts whether or not the vertical line that separates the dollars from the cents is present.

3 You may omit printing the cents, but all amounts entered on the form must follow a consistent format. YOU ARE STRONGLY URGED TO ROUND OFF THE FIGURES TO WHOLE DOLLAR AMOUNTS.

4 When printing money amounts, you must use one of the following ten-character formats:

(a) 0,000,000.
(b) 000,000.00

5 When there is no entry for a line, leave the line blank.

.06 *PAID PREPARER'S INFORMATION AREA.*

1 On all forms, where present, the paid preparer's information area may NOT be rearranged or relocated.

2 You may add one line to the preparer's address area.

SEC. 10. CHANGES PERMITTED TO FORM 1040A GRAPHICS (for use with computer-printed forms only)

.01 *LINE 4.*

This line may be compressed vertically to one line (to allow for a larger entry area for the name of the qualifying unmarried child) by using the following line caption:

"Head of household; unmarried child's name. . . . . ."

.02 *LINE 5d.*

1 The vertical lines separating columns (1) through (5) may be removed.

2 The number of lines for listing "other dependents" may be expanded to a maximum of 5.

.03 *LINE 9a (and 9b).*

These lines may be changed to allow larger amount entry fields by removing references to instructions.

.04 *LINE 11.*

This line may be vertically compressed to one line by using the following line caption:

"Adjusted Gross Income."

.05 *LINES 12a, 12b, 14a, 14b, and 17.*

These lines may be vertically compressed to one line by removing references to instructions.

SEC. 11. MARGINAL PRINTING

You may print your logo, company or firm name, identifying and collation symbols, etc., in the top left margin of the form. The area you may use extends vertically from the top of the Form 1040A title designation to the top edge of the form and horizontally 3½ inches from the left edge.

SEC. 12. OTHER CHANGES PROHIBITED

NO OTHER CHANGES TO THE FORM 1040A GRAPHICS ARE ALLOWED WITHOUT PRIOR APPROVAL.

SEC. 13. CHANGES PERMITTED TO THE FORM 1040 GRAPHICS (FOR USE WITH COMPUTER-PREPARED FORMS ONLY)

.01 *LINE 4.* This line may be compressed horizontally (to allow for a

larger entry area for the name of the qualifying unmarried child) by using the following line caption:

"Head of household; unmarried child's name."

.02 *LINE 6d.*

1 The vertical lines separating columns (1) through (5) may be removed. The captions may be shortened to allow a one-line caption for each column.

2 The number of lines for listing "other dependents" may be expanded to a maximum of 5 by compressing other noted areas listed here.

.03 *LINES 10a and 10b.* This line may be horizontally compressed to allow for larger entry fields for Dividends and Exclusions by the use of the following line caption (on one line):

"10a Dividends . . . (15 char.) . . . 10b Exclusion . . . (15 char.)."

.04 *LINE 11.* This line may be vertically compressed to one line by using the following line caption:

"State and local income tax refunds."

.05 *LINES 20a and b.* These lines may be compressed horizonally and vertically to allow a larger entry field for "total received" and to make a two-line entry on one line by using the following caption:

"a. Total unempl. comp. rec'd (10 char.) b. Taxable amt."

.06 *LINE 21.*

1 This line may be expanded vertically to a maximum of 4 lines.

2 The amount entry box must remain a single entry and the cross-hatched shading must extend down the numbered line box by the same number of lines you add.

.07 *LINE 31.* This line may be vertically compressed to one line by removing references to instructions.

.08 *LINE 35.* You may change the line caption to read "Tax" and computer-print either the words "FROM TAX TABLES" or "FROM SCHEDULE TC."

.09 *LINE 36.* You may change the caption to read:

"Additional taxes from Form/Section" and computer-print only the form(s) or/and section number that apply.

SEC. 14. OTHER CHANGES PROHIBITED

NO OTHER CHANGES TO THE FORM 1040 GRAPHICS ARE PERMITTED WITHOUT PRIOR APPROVAL.

SEC. 15. ACCEPTABLE FORMATS — COMPUTER-GENERATED FORMS AND SCHEDULES

.01 *Exhibits of Acceptable Formats for Form 1040 Schedules.*

1 Exhibits of acceptable computer-generated formats for the schedules usually attached to the Form 1040 are shown in the Exhibits section of this revenue procedure. The exhibits are for Schedules A, B, C, D, E, F, G, R, RP, SE, and TC.

Because a substitute form is a variation from the official form, you should know the requirements of the official form before you modify it to meet your needs. For the most frequently used tax forms, the quickest way to obtain an official form is to request reproduction proofs of these forms. Reproduction proofs can only be ordered by using Form M-5368, Order for Reproduction Proofs. Form M-5368 can be obtained in two ways: (1) by written request to Internal Revenue Service, RM:FM:P, Room 1528, 1111 Constitution Ave., N.W., Washington, D.C. 20224, or (2) by telephone request (at your expense) to the Reproduction Proof Coordinator at (202) 566-2473.

2 *Use of Acceptable Formats.* If your computer-generated forms appear exactly like the exhibits, no prior authorization is needed.

3 *CHANGES TO EXHIBITS NOT PERMITTED WITHOUT PRIOR APPROVAL.* Any change to the text or format of any of the exhibits requires PRIOR WRITTEN APPROVAL.

SEC. 16. COMPUTER - GENERATED FORMS NOT SHOWN AS EXHIBITS IN THIS REVENUE PROCEDURE

.01 Persons or companies desiring to change the computer-generated forms shown as exhibits MUST obtain prior approval before use.

.02 Those desiring to computer-generate forms not shown here may do so, but they must design such forms themselves by following the manner and style of those in the Exhibits section of this publication and by taking care to observe other requirements and conditions stated here.

.03 Computer-generated forms so designed DO NOT require prior approval from the Service. However, the user of such forms is bound by the "Agreement" in Sec. 8 above.

.04 If you wish, you may submit any substitute form to the Service for approval consideration.

SEC. 17. INSTRUCTIONS FOR PREPARING COMPUTER-GENERATED SUBSTITUTES

.01 *Format Arrangement.*

The format of each substitute schedule must follow the format of the official schedule as to item caption, line reference, line numbers, sequence, form arrangement and format, etc. Basically try to make the form look like the official one, with readability being a primary factor. Use periods and/or other special characters to separate the various parts and sections of the form. With the exceptions in .02 below, all line numbers and items must be printed even though an amount is not entered on the line.

.02 *Exceptions.*

1 *Zero Entries.* Detailed information for any deduction or income category may be omitted from the printout if the category total to be reported is zero. However, the substitute form must show the total (zero when applicable) for each category.

2 *Lines Captioned "Other."* It is not necessary to fill in every numbered or referenced line of forms when the line caption calls for "Other," e.g., "Other (itemize)," "Other (specify)," "Other (attach schedule)," etc. Examples of this exception are lines 6c, 15, 19, 21b and 31 for Schedule A (Form 1040). When this occurs, a supporting statement may be used and only the total amount of these "Other" items

entered on the line of the official form. However, we prefer that the space on the official form be used when it is adequate.

3 *Schedule A (Form 1040).* All numbered and lettered lines must be filled in, if applicable. Supporting statements may be used to give the details of the totals entered on such lines but may not be used as a substitute for a collection of lines. For example, the detailed information for "Taxes" may not be shown on a supporting statement (supplemental schedule) and only line 16 filled in; but the details of "state and local income taxes" may be shown on a supporting statement and the total of such taxes entered on line 11. Also, lines 33 through 38 need not be shown, but the total of itemized deductions must be shown on line 39.

4 *Schedule B (Form 1040).* Lines 1 and 3 need not be filled in on the form. A supporting statement may be used for the details of interest and dividend income and the appropriate totals of such income entered on lines 2 and 4 unless nominee distribution or accrued interest criteria apply. (See the tax package instructions concerning interest.)

5 *Schedule C (Form 1040).* All lines on page 1 must be filled in when applicable except the line where "Other expenses (specify)" is listed. (See instruction 2 above.) All information for Schedule C-1 must be entered. Schedule C-2 information may be entered on a supporting statement so long as the method of depreciation used (if any) is entered on the form in column (e). Schedule C-3 information may be shown on a supporting statement and not entered on the form.

6 *Schedule E (Form 1400).*

(a) When there are entries on page 1 for any of the Parts I and IV, the following requirements and/or questions must be answered and tax information must be entered on the lines provided, in Part II, lines 5a through 6b, the question boxes must be answered; if the answer to question 6a is "yes," the amortizable basis must be entered on line 6b. Be sure there is a place on line 6b for the amount.

(b) Supporting statements may be used for the details of rental income and expenses and for royalty income. The appropriate totals must be carried to line 7, columns (b) through (g).

(c) The income and loss from various partnerships, estates or trusts, and small business corporations also may be detailed on a supporting statement, but the appropriate total income and total loss must be entered on lines 10 through 18 and also on line 19 when applicable.

(d) Page 2 need not be used so long as the information is provided on a supporting statement. The supporting statement must show the details required by the form.

7 *Schedule F (Form 1040).* Depending on which accounting method is used (cash or accrual), all of parts I and II or II and V must be printed in their entirety.

.03 *Vertical Alignment of Amount Fields.* Vertically align the amount entry fields where possible.

.04 *Line Numbers.*

1 When a line on an official form is designated by a number or a letter, that designation (reference code) must be used on a computer-generated substitute form.

2 The reference code must be printed to the left of the corresponding captioned line and also immediately preceding the data field even if there is no reference code immediately preceding the data field on the official form.

3 In addition, the reference code that is immediately before the data field must be either followed by a period or enclosed in parentheses. There also must be at least two blank spaces between the period or the right parenthesis and the first character of the data field. (See example in 4 below.)

4 A decimal point (i.e., a period) must be used for each money amount regardless of whether the amount is reported in dollars and cents or in whole dollars or whether or not the vertical line that separates the dollars from the cents is present. The decimal points must be vertically aligned when possible.

Example:

12 Real Estate _____	12.	495.00
13 General Sales _____	13.	
14 Personal Property __	14.	198.00
or		
12 Real Estate _____	(12)	496.00
13 General Sales _____	(13)	
14 Personal Property __	(14)	198.00

.05 *Sequence Numbers.*

1 Please note that certain forms have a newly added "sequence number" located in the upper right hand corner of official forms. On computer-generated forms, place this sequence number following the year designation for the tax form and separate with an asterisk. (Example. 1980 * 08)

2 The affected forms and their respective sequence numbers follow:

Please note that some of the numbers have been changed since the 1979 tax forms.

Form 1040 Schedule/Form	*Sequence Number*
A	08
C	09
D	15
E	16
F (front)	17
F (reverse)	18
G	21
R and RP	22
SE	23
2119	25
2440	26
2441	27
2555	36
3468	28
4136	29
4136-T	29
4625	30
4726	31
5329	32
5695	34
6251	35

.06 *Multiple Page Forms.* With the exceptions noted above, when printing multiple page forms and no entries are present in an entire section of the form, you may omit printing the line numbers, captions, etc. by following these rules:

1 the section title/description must be printed

2 skip one blank line following the title/description

3 on the second print line print the following statement: SECTION/PART XX DOES NOT APPLY

4 skip one blank line, and

5 begin the next section.

SEC. 18. ADDITIONAL INSTRUCTIONS FOR ALL FORMS

.01 Internal control numbers and identifying symbols of the computer preparer may be shown on the substitute, if the use of such numbers or symbols is acceptable to the taxpayer and the taxpayer's representative. If shown, such information *must not* be printed in the top one-half inch clear area, from the center to the right edge, of any form or schedule requiring a signature.

With the exception of the actual tax return form (i.e., Forms 1040, 1120, 940, 941, etc.) you may also print in the left vertical and bottom left margins. The bottom left margin you may use extends 3½ inches from the left edge of the form.

.02 Descriptions for captions, lines, etc., appearing on the substitute forms may be limited to one print line by using abbreviations and contractions and by omitting articles, prepositions, etc. However, sufficient key words must be retained to permit ready identification of the caption, line or item.

1 Explanatory details and/or intermediate calculations for derivation of final line totals, may be included on the substitute. We prefer that such calculations be submitted in the form of a supporting statement. If intermediate calculations are included on the substitute, the lines on which they appear may not be numbered or lettered. Intermediate calculations may not be printed in the right column. This column is reserved for official numbered and lettered lines that correspond to the ones on the official form. If a supporting statement is submitted, intermediate calculations or subtotals may be formatted at the preparer's option.

All supporting statements submitted must be referenced to the schedule entry which it supports, and the entry on the schedule, in turn, must be cross-referenced to the supporting statement. However, all total lines on supporting forms must have a total printed. This total must be carried forward from any supporting statements.

2 Text prescribed for the official form, which is solely instructional in nature, e.g., "Attach this schedule to Form 1040," "See instructions," etc., may be omitted from the substitute form.

3 Information for more than one schedule *may not* be shown on the same printout page without prior approval from the Service. Except for computer-generated Schedules A and B (Form 1040), any form may be continued on two or more pages if necessary. When a form is continued on two or more pages, clearly identify at the bottom of each page, including page 1, that it is continued, e.g., "page 1, Schedule C continued." **It is strongly recommended that a substitute form not exceed the same number of pages used for the official form.**

4 Identify all computer-prepared substitutes clearly; print the form designation one-half inch from the top margin and one and one-half inches from the left margin; print the title centered on the first line of print; and print the taxable year and, where applicable, the sequence number on the same line one-half to one inch from right margin. Include the taxpayer's name and SSN on all forms and attachments.

5 State tax information must not appear on the federal tax return which is filed with the Internal Revenue Service Center, except where amounts are claimed as a state tax deduction, e.g., line 11, Schedule A (Form 1040).

The state column may be present, but the state tax information must NOT be visible on the copy filed with the Service. When a form is designed with both federal and state columns, *THE FEDERAL COLUMN MUST BE TO THE LEFT OF THE STATE COLUMN AND ADJACENT TO THE LINE CAPTION.*

6 Use the preaddressed label supplied with the taxpayer's tax package on all computer-prepared substitute forms that will be filed with the Service. Use of the label avoids larger processing costs because it reduces the potential for error—the kind of error which can delay the receipt of refund and information needed by the taxpayer.

7 When filing substitute computer-prepared or computer-generated schedules, use the envelope enclosed with the taxpayer's tax package. This envelope is coded for sorting into several categories. Use of the coded envelope can help speed up the processing of the return and reduce processing costs. Use of the Service provided tax package envelope for other correspondence with the Service could delay the correspondence.

8 Attach all schedules in alphabetical order and forms in numerical order followed by supporting statements. The sequence of information on supporting statements must be the same order as the items appear on the form(s) to which it is referenced.

9 Additional information required or voluntarily submitted should be on the same size paper as the official form and attached to the return following the supporting statements.

10 Attach all payments (checks or money order, no cash) to the front of the tax return.

11 Reproductions must have a high standard of legibility, both as to original form and as to fill-in matter. The Service reserves the right to reject any computer-generated or computer-prepared substitutes or related forms that have poor legibility or that do not meet the specifications of this revenue procedure.

SEC. 19. FILING SUBSTITUTE FORMS WITH IRS

Follow the same instructions as for filing official forms. These instructions are in the taxpayer's tax package.

SEC. 20. EFFECT ON OTHER DOCUMENTS

This revenue procedure supersedes Rev. Proc. 79-58, 1979-2 C.B. 549.

SEC. 21. EXHIBITS SECTION

Exhibit CG-A1 (Schedule A—Preferred Format)

```
SCHEDULE A (FORM 1040)        ITEMIZED DEDUCTIONS                    1980 * 08

JOHN Q. & MARY J. TAXPAYER                                  SSN 000-00-0000
*************************************************************************
**** MEDICAL AND DENTAL EXPENSES ****  | ********** CONTRIBUTIONS *********
                                       | 21A CASH CONTRIB.. 21A.  00,000.00
1  1/2 INSURANCE PREM.   1.  00,000.00 |    (WITH RECEIPTS)
                                       | 21B OTHER CASH.... 21B.
2  MEDICINE & DRUGS .... 2.            |    (NO RECEIPTS)
3  1% OF LINE 31, 1040.. 3.            |  LIST DONEES & AMTS
4  LINE 2 LESS LINE 3... 4.            |  1ST
                                       |  2ND
5  BALANCE OF INS PREM.. 5.            |  3RD   } OR SEE STATEMENT XX
                                       |  4TH
6  OTHER MEDICAL & DENT.               |  5TH
   (A) DOCTORS, DENT... 6A.            |  6TH
   (B) HOSPITALS ..... 6B.             | 22 OTHER THAN CASH. 22.
   (C) OTHER (ITEMIZE)                 |  SEE STATEMENT XX
1ST "OTHER" ITEM..... 6C.              | 23 CARRY OVER..... 23.
2ND                                    | 24 TOTAL CONTRIB... 24.
3RD                                    |
4TH } OR SEE STATEMENT XX              | ***** CASUALTY, THEFT LOSS ******
5TH                                    | 25 LOSS BEFORE INS. 25.
6TH                                    | 26 INSUR. REIMBURSE 26.
7TH                                    | 27 L 25 LESS L 26.. 27.
7  TOTAL (4 THRU 6C).... 7.            | 28 $100 OR L27..... 28.
8  3% OF LINE 31, 1040.. 8.            |
9  LINE 7 LESS LINE 8... 9.            | 29 TOTAL LOSS ..... 29.
                                       |
                                       | ******* MISC. DEDUCTIONS *********
                                       | 30 UNION DUES..... 30.
10 TOTAL ( LINES 1+9)   10.  00,000.00 | 31 OTHER (ITEMIZE). 31.
                                       |  1ST
****** TAXES ************************** |  2ND
11 ST & LOCAL INCOME... 11.            |  3RD
12 REAL ESTATE..... 12.                |  4TH
13 GENERAL SALES..... 13.              |  5TH   } OR SEE STATEMENT XX
14 PERSONAL PROPERTY... 14.            |  6TH
15 OTHER (ITEMIZE)      15.            |  7TH
   1ST OTHER.....                      |  8TH
   2ND } OR SEE STATEMENT XX           |  9TH
   3RD                                 |  10TH
16 TOTAL TAXES ..... 16.               |  11TH
** INTEREST EXPENSE ****************** | 32 TOTAL MISC DED..32.
17  HOME MORTGAGE..... 17.             | ************************************
18  CREDIT & CHG CARDS. 18.            |
19 OTHER (ITEMIZE)..... 19.            | 39 TOTAL DEDUCTIONS.39.
  1ST ITEM                             |
  2ND                                  | 40 ZERO BRACKET AMT.40.
  3RD   OR SEE STATEMENT XX            |
                                       | 41 L 40 LESS L 39...41.
20 TOTAL INTEREST ..... 20.            |
```

Exhibit CG-A2 (Schedule A—Acceptable Format)

SCHEDULE A-1040 ITEMIZED DEDUCTIONS 1980 * 08

JOHN W. & MARY J. TAXPAYER SSN 000-00-0000

***** MEDICAL AND DENTAL EXPENSES *****			FEDERAL
1	ONE HALF MED INS PREM	1.	000,000.00
2	MEDICINE & DRUGS	2.	
3	1% L31 1040	3.	
4	L2 LESS L3	4.	
5	BAL INS PREMS	5.	
6	OTHER MED & DENT EXP		
A	DOCTORS, DENTISTS, ETC.	6A.	
B	HOSPITALS	6B.	
C	OTHER (ITEMIZE) - SEE STATEMENT XX	6C.	
7	ADD LN 4 THRU LN 6C	7.	
8	3% L31 1040	8.	
9	L7 LESS L8	9.	
10	TOTAL MED LT PLUS L9	10.	
***** TAXES *****			
11	ST & LOCAL INCOME	11.	
12	REAL ESTATE	12.	
13	GENL SALES	13.	
14	PERS PROP	14.	
15	OTHER (ITEMIZE)- SEE STATEMENT XX	15.	
16	TOTAL TAXES (ADD LTT THRU L15)	16.	
***** INTEREST EXPENSE *****			
17	HOME MTG	17.	
18	CREDIT & CHG CARDS	18.	
19	OTHER (ITEMIZE) -SEE STATEMTMENT XX	19.	
20	TOTAL INTEREST EXPENSE (ADD L17 THRU L19)	20.	
***** CONTRIBUTIONS *****			
21A	TOTAL CASH	21A.	
21B	TOTAL OTHER CASH (ITEMIZE) -SEE STATEMENT XX	21B.	
22	OTHER THAN CASH - SEE STATEMENT XX	22.	
23	CARRYOVER	23.	
24	TOTAL CONTRIBUTIONS (ADD L21A THRU L23)	24.	
***** CASUALTY OR THEFT LOSS *****			
25	LOSS BEFORE INSURANCE REIMBURSMENT	25.	
26	INSURANCE REIMBURSEMENT	26.	
27	L25 LESS L26	27.	
28	SMALLER OF $100 or L27	28.	
29	TOTAL CASUALTY OR THEFT LOSS (L27 LESS L28)	29.	
***** MISCELLANEOUS DEDUCTIONS*****			
30	UNION DUES	30.	
31	OTHER MISC-SEE STMNT A8	31.	
32	TOT MISC DED (L30 PLUS L31)	32.	
39	TOTAL ITEM DEDUCTIONS - SUM OF L10,16,20,24,29,32	39.	
40	ZERO BRACKET AMOUNT	40.	
41	EXCESS ITEMIZED DEDUCTIONS (L39 LESS L40)	41.	000,000.00

Exhibit CG-B1 (Schedule B—Preferred Format)

SCHEDULE B (FORM 1040) DIVIDEND AND INTEREST INCOME 1980

JOHN Q. & MARY J. TAXPAYER SSN 000-00-0000

****

PART I INTEREST INCOME

1 IF YOU RECEIVED MORE THAN $400 IN INTEREST, COMPLETE PARTS I AND III

NAME OF PAYER	AMOUNT
(1ST PAYER)	
(2ND PAYER) OR SEE STATEMENT XX	00,000.00
(3RD PAYER)	

2 TOTAL INTEREST INCOME 2.

PART II DIVIDEND INCOME

3 GROSS DIVIDENDS (INCLUDING CAPITAL GAIN DISTRIBUTIONS) AND OTHER DISTRIBUTIONS ON STOCK.

NAME OF PAYER	AMOUNT
(1ST PAYER)	
(2ND PAYER) OR SEE STATEMENT XX	00,000.00
(3RD PAYER)	

4 TOTAL OF LINE 3 . 4.

5 CAPITAL GAIN DISTRIBUTIONS ... 5.

6 NONTAXABLE DIS-. 6.
TRIBUTIONS

7 TOTAL LN 5+LN 6 7.

8 DIVIDENDS BEFORE EXCLUSION 8. 00,000.00

PART III FOREIGN ACCOUNTS & TRUSTS

A AT ANY TIME DURING THE YEAR DID YOU HAVE ANY INTEREST, SIGNATURE AUTHORITY OVER A BANK, SECURITIES, OR FINANCIAL ACCOUNT IN A FOREIGN COUNTRY...(ANS)

B WERE YOU GRANTOR,TRANSFEROR IN CURRENT TAX YEAR TO FOREIGN TRUST WHETHER OR NOT IT WAS TO YOUR BENEFIT?.....(ANS)

Exhibit CG-B2 (Schedule B—Acceptable Format)

SCHEDULE B (FORM1040) DIVIDEND AND INTEREST INCOME 1980

JOHN Q. & MARY J. TAXPAYER SSN 000-00-0000

****

PART I INTEREST INCOME

1 IF YOU RECEIVED MORE THAN $400 IN INTEREST, COMPLETE PARTS I

NAME OF PAYER	AMOUNT
(1ST PAYER) (2ND PAYER) OR SEE STATEMENT XX (3RD PAYER)	00,000.00

2 TOTAL INTEREST INCOME 2. 00,000.00

****

PART II DIVIDEND INCOME

3 GROSS DIVIDENDS (INCLUDING CAPITAL GAIN DISTRIBUTIONS) AND OTHER DISTRIBUTIONS ON STOCK.

NAME OF PAYER	AMOUNT
(1ST PAYER) (2ND PAYER) OR SEE STATEMENT XX (3RD PAYER)	00,000.00

4. TOTAL ALL ITEMS FOR LINE 3	4.	
5. CAPITAL GAIN	5.	
6. NONTAXABLE DISTRIBUTIONS	6.	
7. TOTAL LINES 5 AND 6	7.	
8. DIVIDENDS BEFORE EXCLUSION LN 4 LESS LN 7	8.	00,000.00

****

PART III FOREIGN ACCOUNTS & TRUSTS

A AT ANYTIME DURING THE YEAR DID YOU HAVE ANY INTEREST, SIGNATURE AUTHIORITY OVER A BANK ACCOUNT,SECURITIES ACCOUNT OR OTHER FINANCIAL ACCOUNT IN A FOREIGN COUNTRY? (ANS)

B WERE YOU THE GRANTOR OF, OR TRANSFEROR TO, A FOREIGN TRUST DURING CURRNT TAX YEAR WHETHER OR NOT IT WAS TO YOUR BENEFIT. (ANS)

Exhibit CG-C (Schedule C—Page 1)

SCHEDULE C (FORM 1040) — PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION (SOLE PROPRIETORSHIP) — 1980 * 09

JOHN Q. & MARY J. TAXPAYER — SSN 000-00-0000

A MAIN BUSINESS ACTIVITY: SALES REPRESENTATIVE — PRODUCT: MACHINE TOOLS
B BUSINESS NAME: MY COMPANY
C EMPLOYER ID NO.: 00-0000000
D BUSINESS ADDRESS: 1 SOUTH MAIN ST.
CITY STATE & ZIP: WASHINGTON, DC 12345
E ACCOUNTING METH.: (1) XX CASH
F METHOD(S) USED TO VALUE CLOSING INVENTORY:
(1) X COST
G WAS THERE ANY SUBSTANTIAL CHANGE IN THE METHOD OF VALUATION ? (ANS)
H DID YOU DEDUCT EXPENSES FOR OFFICE IN HOME ? (ANS)
I DID YOU CLAIM AMORT. OR DEPREC. FOR REHAB. HISTORIC STRUCTURE ? (ANS)

PART I-INCOME:

1 A GROSS RECEIPTS OR SALES		1A.	0,000,000.
B RETURNS AND ALLOWANCES		1B.	
C BALANCE (LINE 1A LESS LINE 1B)		1C.	
2 COSTS OF GOODS SOLD AND/OR OPERATIONS		2.	
3 GROSS PROFIT (LINE 1C LESS LINE 2)		3.	
4 OTHER INCOME - SEE STATEMENT XX		4.	
5 TOTAL INCOME (ADD LINES 3 AND 4)		5.	0,000,000.

PART II-DEDUCTIONS:

6 ADVERTISING	0,000,000.	31A	WAGES		0,000,000.
7 AMORTIZATION		B	JOBS CREDIT		
8 BAD DEBTS		C	WIN CREDIT		
9 BANK CHARGES		D	TOTAL CREDITS		
10 CAR/TRUCK EXPENSES		E	31A LESS 31D		
11 COMMISSIONS		32	OTHER EXPENSES (SPECIFY)		
12 DEPLETION		A			
13 DEPRECIATION (SEE C-2).		B			
14 DUES AND PUBLICATIONS		C			
15 EMPLOYEE BENEFIT PROGMS		D			
16 FREIGHT (NOT ON C-1)		E			
17 INSURANCE		F			
18 INTEREST ON BUS. INDEBT		G			
19 LAUNDRY AND CLEANING		H			
20 LEGAL/PROF'L SERVICES		I			
21 OFFICE SUPPLIES		J	OR SEE STATEMENT XX		
22 PENSION/PROFIT SHARING		K			
23 POSTAGE		L			
24 RENT ON BUSINESS PROP.		M			
25 REPAIRS		N			
26 SUPPLIES (NOT ON C-1)		O			
27 TAXES		P			
28 TELEPHONE		Q			
29 TRAVEL AND ENTERTAINMNT		R			
30 UTILITIES		S			

33 TOTAL DEDUCTIONS (ADD COLS. 6 THROUGH 32S)		33.	
34 NET PROFIT (OR LOSS) (LINE 5 LESS LINE 33)		34.	0,000,000.
35 IF LOSS, DO YOU HAVE AMTS IN THIS BUSINESS NOT AT RISK?	(ANS)		

SCHEDULE C CONTINUED ON NEXT PAGE

Exhibit CG-C (Schedule C—Page 2)

SCHEDULE C (CONT'D) PAGE 2 1980 * 09
(FORM 1040)
JOHN Q. & MARY J. TAXPAYER SSN 123-45-6789

***** SCHEDULE C-1 COST OF GOODS SOLD AND/OR OPERATIONS **********

1	INVENTORY AT BEGINNING OF YEAR (EXPLAIN IF NOT 1980).	1.	0,000,000.
2A	PURCHASES	2A.	
2B	COST OF ITEMS WITHDRAWN	2B.	
2C	BALANCE (LINE 2A LESS LINE 2B)	2C.	
3	COST OF LABOR (DO NOT INCLUDE OWN SALARY)	3.	
4	MATERIALS AND SUPPLIES	4.	
5	OTHER COSTS (SEE STATEMENT XX)	5.	
6	ADD LINES 1, 2C, AND 3 THROUGH 5	6.	
7	INVENTORY AT END OF YEAR	7.	
8	COST OF GOODS AND/OR OPERATIONS (LN 6 LESS LN 7)	8.	

***** SCHEDULE C-2 - DEPRECIATION **********

DESCRIPTION OF PROP. (A)	DATE ACQ. (B)	COST OR BASIS (C)	DEPRECIATION PRIOR (D)	METHOD (E)	LIFE /RATE (F)	DEPRECIATION 1980 (G)
1 TOTAL ADDITIONAL FIRST YEAR DEPRECIATION						0,000,000.
2 OTHER DEPRECIATION						
BUILDINGS	2/80	0,000,000.	0,000,000.	SL	R	0,000,000.
FURN & FIXTURES						
TRANS. EQUIP.	OR SEE STATEMENT XX					
MACHINERY/EQUIP.						
OTHER (SPECIFY)						
3 TOTALS		0,000,000.				
4 DEPRECIATION IN C-1						
5 BALANCE, ENTER ON PART II, LINE 13						0,000,000.

TYPE OF METHOD MUST BE HERE IN ORDER TO USE STATEMENT OPTION

ENTER INFORMATION FOR YOURSELF AND 5 HIGHEST PAID EMPLOYEES. TO DETERMINE HIGHEST PAID EMPLOYEES, ADD EXPENSE ACCT. TO SALARIES AND WAGES.

	NAME (A)	EXP. ACCOUNT (B)	SALARIES/WAGES (C)
	OWNER	0,000,000.	0,000,000.
1	1ST HIGHEST PAID EMPLOYEE'S NAME		
2	2ND		
3	3RD		
4		OR SEE STATEMENT XX	
5			

	DID YOU CLAIM A DEDUCTION FOR EXPENSES CONNECTED WITH:	YES	NO
A	ENTERTAINMENT FACILITY (BOAT, RESORT, RANCH, ETC.)		
B	LIVING ACCOMODATIONS (EXCEPT EMPL. ON BUSINESS)		
C	CONVENTIONS OR MEETINGS OUTSIDE THE UNITED STATES		
D	EMPLOYEES' FAMILIES AT CONVENTIONS/MEETINGS		
	IF YES, WERE ANY OUTSIDE OF U.S. OR POSSESSIONS		
E	VACATIONS FOR EMPLOYEES AND FAMILIES NOT ON W-2		

Exhibit CG-D (Schedule D—Page 1)

SCHEDULE D (FORM 1040) — CAPITAL GAINS AND LOSSES — 1980 * 15

JOHN Q. & MARY J. TAXPAYER — SSN 000-00-0000

********** PART I - SHORT-TERM CAPITAL GAINS AND LOSSES **********

	(A) KIND OF PROPERTY	(B) DATE ACQ.	(C) DATE SOLD	(D) GROSS SALE PRICE	(E) COST OR BASIS	(F) LOSS: (E) LESS (D)	(G) GAIN: (D) LESS (E)
1	1ST PROP	2/80	6/80	0,000,000.	0,000,000.	0,000,000.	0,000,000.
	2ND						
	3RD	OR SEE STATEMENT XX					
2	GAIN FROM SALE/EXC RES.HELD 1 YEAR OR LESS			2. XXXXXXXXXX			0,000,000.
3	YOUR SHARE OF NET S-TERM GAIN PARTN/FUDIC..			3.		0,000,000.	0,000,000.
4	ADD LN 1, 2, 3, COLS F & G			4.			
5	COMBINE LN 4, COLS F & G			5.			
6	SHORT TERM GAIN OR (LOSS) CARRYOVER (AFTER 1969) ...			6.			
7	NET ST GAIN OR LOSS ADD LNS 5 & 6.....			7.			0,000,000.

********** PART II - LONG-TERM CAPITAL GAINS AND LOSSES **********

8	1ST PROP	2/80	7/80	0,000,000.	0,000,000.	0,000,000.	0,000,000.
	2ND						
	OR SEE STATEMENT XX						
9	GAINS FROM SALE/EXC RES. HELD OVER 1 YEAR..			9. XXXXXXXXXX			0,000,000.
10	YOUR SHARE OF NET L-TERM GAIN/LOSS ..... PARTNERSHIP, FIDUCIARY			10.		0,000,000.	0,000,000.
11	ADD LNS 8, 9 & 10, COLS F & G			11.			
12	ADD LN 11 COL F & G, ENTER GAIN OR LOSS			12.			
13	CAPITAL GAIN DISTRIBUTIONS			13.			
14	GAIN FROM FORM 4797			14.			
15	YOUR SHARE NET L-TERM GAIN FROM S-BUSINESS CORP.....			15.			
16	ADD LNS 12 THRU 15			16.			
17	L-TERM CAPITAL LOSS CARRYOVER AFTER 1969			17.			
18	NET L-TERM GAIN OR (LOSS) ADD LNS 16 AND 17			18.			0,000,000.

SCHEDULE D CONTINUED ON PAGE 2

Exhibit CG-D (Schedule D—Page 2)

SCHEDULE D (CON'T) PAGE 2 1980 * 15
(FORM 1040)
JOHN Q.& MARY J. TAXPAYER SSN 000-00-0000

********** PART III SUMMARY OF PARTS I & II **********

19	NET GAIN OR LOSS - ADD LNS 7 AND 18	19.	
20	IF LN 19 IS GAIN -		
A	ENTER SMALLER OF 60% OF LN 18 or 60% OF LN 19.....	20A.	
B	LN 19 LESS LN 20A	20B.	
21	IF LN 19 IS LOSS -		
A	ENTER ONE OF THE FOLLOWING: (I) 50% OF LN 19 IF LN 7 IS ZERO OR NET GAIN (II) L 19, IF LN 18 IS ZERO OR NET GAIN (III) L 7 PLUS 50% OF L 18,IF 7 & 18 ARE NET LOSSES	21A.	
B	ENTER SMALLEST OF: AMOUNT ON LN 21A, $3,000 ($1,500 IF FST 3), OR ADJUSTED TAXABLE INCOME	21B.	

PART IV COMPUTATION OF POST-1969 CAPITAL LOSS CARRYOVERS FROM 1980 TO 1981

22	ENTER LOSS ON LN 7 OR ENTER ZERO AND SKIP TO LN 28 ...	22.	
23	ENTER GAIN ON LN 18. IF BLANK OR LOSS, ENTER ZERO ...	23.	
24	REDUCE LOSS ON LN 22 TO EXTENT OF GAIN ON LN 23	24.	
25	ENTER AMOUNT ON LN 21B	25.	
26	ENTER SMALLER OF LN 24 OR 25	26.	
27	LN 24 LESS LN 26	27.	

********** SECTION B - LONG-TERM CAPITAL LOSS CARROVER **********

28	L 25 LESS L 26 OR AMOUNT FROM L 21B IF L 23-27 NOT USED	28.	
29	ENTER LOSS FROM L 18 OR ENTER ZERO AND SKIP L 30-33)	29.	
30	ENTER GAIN FROM LN 7. IF BLANK OR LOSS, ENTER ZERO ...	30.	
31	REDUCE LOSS ON LN 29 TO EXTENT OF GAIN ON LN 30	31.	
32	MULTIPLY AMOUNT ON LN 28 BY 2	32.	
33	LN 31 LESS LN 32	33.	0,000,000.

Exhibit CG-E (Schedule E—Page 1)

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SCHEDULE E                    SUPPLEMENTAL INCOME                    1980 * 16
(FORM 1040)
JOHN Q. & MARY J. TAXPAYER                                  SSN 000-00-0000
******************** PART I - PENSION AND ANNUITY INCOME ********************

1A  DID YOU & YOUR EMPLOYER CONTRIB.TO PENSION OR ANNUITY?  1A.    (ANS)
 B  IF YES, WILL CONTRIBUTION BE REPAID TO YOU IN 3 YEARS?  1B.    (ANS)
 C  IF YES, SHOW YOUR CONTRIB  $ 0,000,000  RECD PRIOR YRS  1C.  0,000,000.
2   AMOUNT RECEIVED THIS YEAR ..................................  2.
3   AMOUNT ON LN 2 THAT IS NOT TAXABLE..........................  3.
4   TAXABLE PART (LN 2 LESS LN 3)  (ENTER ALSO ON LN 18)          4.

***************  PART II - RENT AND ROYALTY INCOME OR LOSS  ***************
5A  CLAIMED EXPENSES ON VACATION HOME RENTED TO OTHERS?      5A.    (ANS)
5B  IF YES, DID YOU/FAMILY OCCUPY VAC HOME 14+ DAYS          5B.    (ANS)
6A  CLAIMED AMORT OR DEPREC FOR REHAB OF HISTORIC BLDG.?     6A.    (ANS)
6B  AMORTIZABLE BASIS-$ 0,000,000.

(A) DESCR    (B)TOTAL    (C)TOTAL   (D)DEPRE-   (E)OTHER    (F)LOSS     (G) NET
PROPERTY      RENTS       ROYLTS     CIATION     EXPENSES
1ST PROP  0,000,000.  0,000,000.  0,000,000.  0,000,000.  0,000,000.  0,000,000.
2ND
3RD       OR SEE STATMENT XX
7  F4835  0,000,000.  XXXXXXXXXX  0,000,000.  0,000,000.  0,000,000.  0,000,000.
8  TOTALS
9  TOTAL RENT & ROYALTY INC.(LOSS), LINE 8 COL F & G  .......9.  0,000,000.

******************** PART III - INCOME OR LOSSES FROM - ********************
(A) PARTNERSHIP NAME (B) EMPL ID #          (C) LOSS          (D) INCOME
1ST                  00-0000000          0,000,000.          0,000,000.
2ND       OR SEE STATEMENT XX
3RD
10  ADD COLS (C) & (D)..............  10.  0,000,000.          0,000,000.
11  ADD COLS (C) & (D) LN 10 ..................................  11.
12  ADDITIONAL 1ST YEAR DEPRECIATION............................  12.
13  TOTAL PARTNR INCOME ADD LNS 11 & 12.........................  13.
  ESTATES & TRUSTS:
1ST                  00-0000000          0,000,000.            000,000.
2ND       OR SEE STATEMENT XX
14. ADD COLS (C) & (D) ..............  14.  0,000,000.          0,000,000.
15  TOTAL ESTATE OR TRUST INCOME COLS (C) & (D) LN 14 ......15.

  SMALL BUSINESS CORP.:
1ST NAME             00-0000000          0,000,000.          0,000,000.
2ND       OR SEE STATEMENT XX
3RD
4TH
16 ADD COLS (C) & (D)..............  16.
17 TOTAL S-BUS INCOME/LOSS (C)+(D) LN 16.....................  17.

************  PART IV  ************************************************
18  TOT INC/LOSS ADD LNS 4, 9, 13, 15, & 17 ..................18.
19  YOUR SHARE OF GROSS FARM/FISH INCOME .....................19.  0,000,000.


SCHEDULE E CONTINUED ON NEXT PAGE OR SEE PAGE 2 INFORMATION ON STATEMENT XX
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Exhibit CG-E (Schedule E—Page 2)

SCHEDULE E (CON'T) PAGE 2 1980 * 16
(FORM 1040)
JOHN Q. & MARY J. TAXPAYER SSN 000-00-0000

********** PART V - PROPERTY REPORTED IN PART II **********
KIND AND LOCATION OF PROPERTY
A
B
C

********** PART VI - DEPRECIATION CLAIMED IN PART II **********

(A) PROP DESCRIPTION	(B) DATE AQUIRED	(C) COST	(D) PRIOR YR DEPR	(E) DEPR METHOD	(F) L/R	(G) DEPR 1980
PROPERTY A . . . TOTAL ADD'L 1ST YEAR DEPRECIATION.....						
1ST	(2/80)	0,000,000.	0,000,000.	SL	L	0,000,000.
(ADD LINES AS NEEDED)						
TOTAL PROP A						
PROPERTY B . . . TOTAL ADD'L 1ST YEAR DEPRECIATION.....						
1ST						
(ADD LINES AS NEEDED)						
TOTAL PROP B						

(C PROPERTY-ADD AS NEEDED)

********** PART VII - EXPENSES CLAIMED IN PART II **********

DESCRIPTION OF EXPENSES	A PROPERTY	B PROPERTY	C PROPERTY
TAXES	0,000,000.	0,000,000.	0,000,000.
INSURANCE			
INTEREST			
COMMISSIONS			
OTHER (LIST)			
TOTALS	0,000,000.	0,000,000.	0,000,000.

Exhibit CG-F (Schedule F—Page 1)

SCHEDULE F FARM INCOME AND EXPENSES 1980 * 17
(FORM 1040)
JOHN Q. & MARY J. TAXPAYER SSN 000-00-0000
AMERICAN FARM 0000 FARM ROAD, ANYTOWN, ANYSTATE 00000 EIN 00-0000000

**** PART I - FARM INCOME **** | **** PART II - FARM DEDUCTIONS ****
CASH METHOD | CASH AND ACCRUAL METHOD

SALE OF PURCHASED LIVESTOCK & OTHER ITEMS

(A) DESCRIBE	(B)AMT REC'D	(C) COST
1 LIVESTOCK	0,000,000.	0,000,000.
SEE STATEMENT XX		
2 OTHER ITEMS		
SEE STATEMENT XX		
3 TOTALS	0,000,000.	0,000,000.
4 PROFIT(LOSS) L3 LESS L3C		0,000,000.

** LVSTK & PROD SALES + OTHER FARM INCOME **

KIND	AMOUNT
5 CATTLE	0,000,000.
6 CALVES	
7 SHEEP	
8 SWINE	
9 POULTRY	
10 DAIRY PRODUCTS	
11 EGGS	
12 WOOL	
13 COTTON	
14 TOBACCO	
15 VEGETABLES	
16 SOYBEANS	
17 CORN	
18 OTHER GRAINS	
19 HAY	
20 STRAW	
21 FRUITS AND NUTS	
22 MACHINE WORK	
23A PATRONAGE DIVIDENDS	
B LESS NON-INCOME ITEMS	
C NET PATRONAGE DIVIDENDS	
24 PER-UNIT RETAINS	
25 NONPATRONAGE DISTRIBUTION	
26 AGRICULTURAL PAYMENTS	
26A AGRIG PMTS--CASH PMTS	
B MATERIALS/SERVICES	
27 COMMODITY CREDIT LOANS	
28 FEDERAL GAS TAX CREDIT	
29 STATE GAS TAX REFUND	
30 OTHER-SPECIFY-SEE STMT XX	
31 ADD LNS 5 THRU 30	000,000.00
32 GROSS PROFITS ADD LNS 4&31	000,000.00

33A LABOR HIRED	0,000,000.
33B NEW JOBS CREDIT	
33C WIN CREDIT	
33D TOTAL CREDITS	
33E BALANCE	
33A LESS LN 33D)	
34 REPAIRS	
35 INTEREST	
36 RENT OF FARM	
37 FEED PURCHASED	
38 SEEDS & PLANTS	
39 FERTILIZERS, LIME	
40 MACHINE HIRE	
41 SUPPLIES PURCH	
42 BREEDING FEES	
43 VET & MEDICINE	
44 GAS, FUEL, OIL	
45 STORAGE	
46 TAXES	
47 INSURANCE	
48 UTILITIES	
49 FREIGHT, TRUCKING	
50 CONSERVATION EXP.	
51 LAND CLEARING	
52 PENSION & PROFIT SHARING	
53 EMPL BENEFIT	
54 OTHER (SPECIFY).	
1ST, 2ND, 3RD } OR SEE STATEMENT XX	
(OTHERS AS NEEDED)	
55 ADD LNS 53E-54	
56 DEPR FR PT III	
57 TOT-LNS 55 + 56	0,000,000.

58 NET FARM PROFIT/LOSS LN 32 LESS LN 57 . . . . . 58. 0,000,000.

59 IF LOSS, DO YOU HAVE AMTS FOR FARM THAT ARE NOT "AT RISK" . . . . .(ANS)

SCHEDULE F CONTINUTED ON PAGE 2

Exhibit CG-F (Schedule F—Page 2)

SCHEDULE F (CON'T) PAGE 2 1980 * 18
(FORM 1040)
JOHN Q. & MARY J. TAXPAYER SSN 000-00-0000

********** PART III - DEPRECIATION **********

60 TOTAL ADD'L 1ST YEAR DEPRECIATION Q00,000.00

61 OTHER DEPRECIATION

(A) DESCRIP OF PROP	(B) DATE ACQ.	(C) COST BASIS	(D) DEPREC PRIOR	(E) METHOD	(F) L/R	(G) DEPRC 1980
BUILDINGS		000,000.00	000, 000.00			000,000.00
ANIMALS						
TRANS.EQUIPT.						
MACHINERY						
OTHER (SPECIFY)		OR SEE STATEMENT XX				
(1ST OTHER)						
(2ND)						
(ADD LINES AS NEEDED)						
62 TOTALS.		000,000.00	000,000.00.			000,000.00

********** PART IV AND V **********

(ADD THESE SECTIONS ONLY AS NEEDED OR REQUIRED AND FOLLOW ABOVE EXAMPLES. SEE INSTRUCTIONS IN SECTION 15.)

Exhibit CG-G (Schedule G)

SCHEDULE G (FORM 1040) — INCOME AVERAGING — 1980 * 21

JOHN Q AND MARY J TAXPAYER — SSN 000-00-0000

********** BASE PERIOD INCOME AND ADJUSTMENTS **********

	(A) 1ST PREC YR 1979	(B) 2ND PREC YR 1978	(C) 3RD PREC YR 1977	(D) 4TH PREC YR 1976
1 AMT FROM FORM 1040/1040A	00,000.00	00,000.00	00,000.00	XXXXXXXXX
2A EXPMT X $750	XXXXXXXXX			XXXXXXXXX
B EXPMT X $1000		XXXXXXXXX	XXXXXXXXX	XXXXXXXXX
3 TAXABLE INCOME L1-L2A/B	00,000.00	00,000.00	00,000.00	00,000.00
4 INC NOT U.S. EARNED	00,000.00	00,000.00	00,000.00	00,000.00
5 $3200/$2200/$1600	XXXXXXXXX	XXXXXXXXX	XXXXXXXXX	00,000.00
6 BASE INCOME (3+4+5)	00,000.00	00,000.00	00,000.00	00,000.00

********** COMPUTATION OF AVERAGEABLE INCOME **********

7	TAXABLE INCOME (SCHED TC, PART I, LINE 3)	7. 00,000.00
8	CERTAIN AMOUNTS RECEIVED BY OWNER-EMPLOYEES SUBJECT TO PENALTY, SECTION 72(M)(5)	8.
9	SUBTRACT LINE 8 FROM LINE 7	9.
10	EXCESS COMMUNITY INCOME	10.
11	ADJUSTED TAXABLE INCOME (LN 9-LN 10) ZERO IF NEGATIVE	11.
12	ADD COLUMNS (A) THROUGH (D), LINE 6	12.
13	ENTER 30% OF LINE 12	13.
14	AVERAGEABLE INCOME (SUBTRACT LINE 11 FROM LINE 13)	14.

********** COMPUTATION OF TAX **********

15	AMOUNT FROM LINE 13	15.
16	20% OF LINE 14	16.
17	TOTAL (ADD LINES 15 AND 16)	17.
18	EXCESS COMMUNITY INCOME FROM LINE 10	18.
19	TOTAL (ADD LINES 17 AND 18)	19.
20	TAX ON AMOUNT ON LINE 19	20.
21	TAX ON AMOUNT ON LINE 17	21.
22	TAX ON AMOUNT ON LINE 15	22.
23	SUBTRACT LINE 22 FROM LINE 21	23.
24	MULTIPLY THE AMOUNT ON LINE 23 BY 4	24.
25	TAX ON AMOUNT ON LINE 7	25.
26	TAX ON AMOUNT ON LINE 9	26.
27	SUBTRACT LINE 26 FROM LINE 25	27.
28	TAX (ADD LINES 20, 24 AND 27). ENTER ON SCHED TC	28.

Exhibit CG-R (Schedule R)

SCHEDULE R (FORM 1040) CREDIT FOR THE ELDERLY 1980 * 22

JOHN Q. TAXPAYER SSN 000-00-0000

****

SCHEDULE R - INDIVIDUAL(S) 65 OR OVER HAVING ANY KIND OF INCOME

FILING STATUS (B XX MARRIED FILING JOINT RETURN, ONLY ONE OVER 65)

1	ENTER $3750, $2500 OR $1875	1.	000,000.00
2A	ENTER AMOUNTS RECEIVED AS NON-TAX PENSIONS OR ANNUITIES	2A.	
2B	ENTER AMOUNT FROM FORM 1040 LN 32	2B.	
2C	ENTER $10,000, $7500 OR $5000	2C.	
2D	LINE 2B LESS LINE 2C	2D.	
2E	ENTER 50% OF LINE 2D	2E.	
3	ADD LINES 2A AND 2E	3.	
4	SUBTRACT LINE 3 FROM LINE 1	4.	
5	MULTIPLY LINE 4 BY 15%	5.	
6	ENTER AMOUNT OF TAX FROM FORM 1040, LINE 37	6.	
7	ENTER SMALLER AMOUNT FROM LINE 5 OR LINE 6 (ENTER THIS AMOUNT ON FORM 1040, LINE 39)	7.	

****

Exhibit CG-RP (Schedule RP)

SCHEDULE RP CREDIT FOR ELDERLY UNDER 65 YEARS 1980 * 22
(FORM 1040)
JOHN Q.& MARY J. TAXPAYER SSN 000-00-0000
****

FILING STATUS (B) MARRIED FILING JOINT RETURN, ONE UNDER 65

			(A)	(B)
1	ENTER $3750, $2500 OR $1875	1.	00,000.00	00,000.00
2A	ENTER AMTS REC'D NON-TAX (PENS, ANNUT).	2A.		
2BI	UNDER 62 ENTER ALL OVER $900	2BI.		
2BII	62 + ENTER AMTS PER INSTRUCTIONS..	2BII.		
3	ADD LINES 2A AND 2B	3.		
4	SUBTRACT LINE 3 FROM LINE 1.....	4.		
5A	UNDER 65 ENTER OTHER $ NOT ON LN 2A...	5A.		
5B	65+ ENTER OTHER $ RECIEVED	5B.		
6	ENTER SMALLER OF LN 4 OR 5	6.		
7	ADD COLS (A) & (B) LINE 6	7.		
8	MULTIPLY LINE 7 BY 15%	8.		
9	ENTER TAX FROM FORM 1040, LINE 37....	9.		
10	ENTER SMALLER OF LN 8 OR 9.....	10.		

(ENTER THIS AMOUNT ON FORM 1040, LINE 39)

Exhibit CG-SE (Schedule SE)

SCHEDULE SE 1980 * 23

COMPUTATION OF SOCIAL SECURITY SELF-EMPLOYMENT TAX

(FORM 1040)

MARY J. TAXPAYER SSN 000-00-0000

****

****** PART I - COMPUTATION OF NET EARNINGS FROM FARM SELF-EMPLOYMENT *****

1A	NET PROFIT/LOSS FROM SCHEDULE F	1A.	0,000,000.
1B	NET PROFIT/LOSS FROM FARM PARTNERSHIPS	1B.	
2	NET EARNINGS FROM FARMS (ADD LNS 1A & 1B)	2.	
3 A	IF GROSS PROFITS NOT $2400+ ENTER 66% OF GROSS, OR	3.	
B	IF GR PROFIT $2400+ NET NOT $1600 ENTER $1,600		
4	AMOUNT FROM LINE 2 OR LINE 3	4.	

****

**** PART II - COMPUTATION OF NET EARNING FROM NONFARM SELF-EMPLOYMENT ****

5A	NET PROFIT/LOSS FROM SCHEDULE C	5A.	
5B	PARTNERSHIPS, JOINT VENTURES, ETC.	5B.	
5C	SERVICE AS MINISTER, MEMBER OF RELIGIOUS ORDER,ETC.	5C.	
5D	SERVICE WITH A FOREIGN GOVT. OR INTERNAT. ORG.	5D.	
5E	OTHER: SPECIFY- SEE STATEMENT XX	5E.	
6	TOTAL (ADD LINES 5A THRU 5E)	6.	
7	OTHER ADJUSTMENTS	7.	
8	ADJUSTED NET EARNINGS (LOSS) (LN 6 LESS LN 7)	8.	
9A	MAX AMOUNT REPORTABLE USING BOTH OPTIONAL METHODS	9A.	1,600.
9B	AMOUNT ON LINE 3	9B.	
9C	BALANCE (LN 9A LESS LN 9B	9C.	
10	SMALLER OF 2/3 OF GROSS NONFARM PROFITS OR $1,600	10.	
11	SMALLER OF LN 9C OR 10	11.	

****** PART III - COMPUTATION OF SOCIAL SECURITY SELF-EMPLOYMENT TAX ******

12A	NET EARNINGS (LOSS) FROM FARMING (LINE 4)	12A.	
12B	FROM NONFARM (LINE 8, OR 11 IF OPTION USED)	12B.	
13	TOTAL NET EARNINGS (LOSS) ADD LN 12A & 12B	13.	
14	THE LARGEST AMOUNT SUBJECT TO 1980 S. S. TAX:	14.	25,900.
15A	TOTAL FICA FROM W-2 FORM OR RRTA	15A.	
15B	UNREPORTED TIPS FROM FORM 4137 OR RRTA	15B.	
15C	TOTAL OF LNS 15A & 15B	15C.	
16	BALANCE (LINE 14 LESS LINE 15C)	16.	
17	SELF-EMPLOYMENT INCOME (SMALLER OF LINE 13 OR 16)	17.	
18	S-EMPLY TAX.(LN 17 $25900 = $2097.90 OR LN 17X.081)	18.	0,000,000.

Exhibit CG-TC (Schedule TC)

SCHEDULE TC 1980

TAX COMPUTATION SCHEDULE

(FORM 1040)

JOHN Q. & MARY J. TAXPAYER SSN 000-00-0000

****

*** PART I - TAX COMPUTATION FOR TAXPAYERS WHO CANNOT USE THE TAX TABLES **

1	AMOUNT FROM FORM 1040, LINE 34	1. 0,000,000.
2	MULTIPLY $1000 BY THE TOTAL NUMBER OF EXEMPTIONS	2.
3	TAXABLE INCOME. LN 1 LESS LN 2	3.
4	INCOME TAX. FROM: TAX RATE SCHEDULE X, Y, Z,	4.

****

PART II - COMPUTATION FOR CERTAIN TAXPAYERS WHO MUST ITEMIZED DEDUCTIONS

1	AMOUNT FROM FORM 1040 LINE 31	1.
2	AMOUNT FROM SCHEDULE A LINE 40	2.
3	AMOUNT FROM SCHEDULE A LINE 39	3.
4	LN 2 LESS LN 3	4.
5	ADD LNS 1 & 4 (ENTER HERE & ALSO ON 1040 LN 34)	5.

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, Section 2032A; 20.2032A-8.)

Rev. Proc. 80-49

SECTION 1. PURPOSE

The purpose of this revenue procedure is to outline the procedure for electing to value less than all qualified real property in a decedent's gross estate under section 2032A of the Internal Revenue Code where an election to value all the qualified real property under section 2032A was previously made on or before August 30, 1980.

SEC. 2. BACKGROUND

.01 Section 2032A of the Code provides that, under certain conditions, an executor may elect to value real property included in a decedent's gross estate which was used as a farm or a closely held business at a value based upon its current use rather than at its full fair market value. This election must be made no later than nine months after the decedent's death (unless an extension of time to file the estate tax return is granted) pursuant to section 2032A(d)(1).

.02 Prior to the publication of section 20.2032A-8(a)(2) of the Estate Tax Regulations on July 31, 1980, it was unclear whether an election could be made to value less than all qualified real property included in an estate. That regulation clarifies the issue by permitting such an election, provided the threshold requirements of section 2032A(b)(1)(B) of the Code have been met by property actually valued under section 2032A.

.03 Those executors who made an election on or before August 30, 1980, to value all qualified real property included in a decedent's estate at its current use value may now want to withdraw a portion of that property from section 2032A treatment. Such a change is a partial revocation of the section 2032A election.

.04 Section 20.2032A-8(a)(1) of the regulations provides that once made, an election is irrevocable. However, section 20.2032A-8(d) provides an exception to this general rule. Elections to use section 2032A of the Code made on or before August 30, 1980, may be revoked. The deadline for filing a notice of revocation is January 31, 1981 (six months after the publication of section 20.2032A-8 in the Federal Register). However, if the period of limitations for assessments for the affected estate (normally three years and nine months from date of death) will expire earlier than January 31, 1981, such expiration date is the last day for filing the notice of revocation.

.05 Provided the threshold requirements of section 2032A(b)(1)(B) of the Code will be met following the revocation, a revocation may be made as to part of the qualified property. A partial revocation is made by filing a notice of revocation and paying any additional estate tax and interest due. The notice must contain the decedent's name, date of death, and taxpayer identification number.

Appropriate revised schedules should be attached showing the property for which the election is being made and the tax recomputation. If the partial revocation results in a decrease in tax, the executor should, in addition, file a claim for refund for the amount of refund to which the estate is entitled. Such a reduction may result for example, if after the partial revocation, the remaining specially valued property satisfies the requirements for valuation based under section 2032A(e)(7), but section 2032A(e)(8) was used prior to the revocation. *See* section 20.2032A-8(d) of the regulations for the requirement concerning the filing of an amended return to conform an election.

.06 As a result of the revocation the agreement required under sections 2032A(b)(1)(D) and (d)(2) of the Code must be conformed to specify by legal description the property which remains subject to section 2032A.

SEC. 3. EFFECTIVE DATE

Section 2032A of the Code is restricted to estates of decedents dying after December 31, 1976. This revenue procedure applies only to executors desiring to make partial revocations for estates where the original election under section 2032A was made on or before August 30, 1980. The notice of revocation must be filed by January 31, 1981 (six months after the publication of section 20.2032A-8 in the Federal Register). However, if the period of limitations for assessments for the affected estate will expire (normally three years and nine months from date of death) earlier than January 31, 1981, such expiration date is the last day for filing the notice of revocation.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Section 412.)

Rev. Proc. 80-50

SECTION 1. PURPOSE

This revenue procedure provides approval for certain defined benefit pension plans to change the funding method for plan years described in Section 7.

SEC. 2. BACKGROUND

Section 412(c)(5) of the Internal Revenue Code, as amended, and section 302(c)(5) of the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. 93-406, 1974-3 C.B. 1, 40, state that if the funding method of a plan is changed, the new funding method shall become effective only if the change is approved by the Secretary.

SEC. 3. APPROVAL FOR SPECIFIED CHANGES

Except as restricted by Section 6 of this revenue procedure, approval is granted to the following:

.01 Approval 1—A change to either of the three Aggregate Methods described in sections 3.01(1), 3.01(2) or 3.01(3).

(1) The normal cost is computed in the aggregate as the normal cost accrual rate multiplied by compensation. The normal cost accrual rate is (A) the present value of future benefits less adjusted assets divided by (B) the present value of future compensation.

(2) The normal cost is computed in the aggregate as the normal cost per participant multiplied by the number of participants who are currently employed by employers maintaining the plan. The normal cost per participant is (A) the present value of future benefits less adjusted assets divided by (B) the sum of the present value of an annuity of $1 per year payable from the attained age to retirement age for each participant who is currently employed.

(3) The normal cost is computed in the aggregate as (A) the present value of future benefits less adjusted assets divided by (B) a temporary annuity factor. The temporary annuity factor is the present value of future individual level premium normal costs divided by the current year's individual level premium normal cost. For purposes of this subsection, the individual level premium normal cost for each participant is the sum of the level amounts to fund each increment of projected benefit from the attained age at which the increment occurs to the anticipated retirement age.

(4) In methods (1), (2), and (3), for purposes of section 412 of the Code, the assets are adjusted by subtracting any credit balance in the funding standard account or adding any funding deficiency. For purposes of section 404, the assets are adjusted by subtracting any undeducted contributions. Also, all existing amortization bases under sections 404 or 412 shall be considered fully amortized.

.02 Approval 2—A change to an Individual Aggregate Method that satisfies paragraphs (1), (2), (3), (4) and (5) of this subsection.

(1) The normal cost is the sum of individual normal costs for each participant for whom a normal cost is determined. The normal cost for a participant is (A) the present value of future benefits less allocated adjusted assets, divided by (B) a temporary annuity factor from attained age to the anticipated retirement age. (The temporary annuity factor may also be determined as the present value of future compensation for the participant divided by current compensation.)

(2) For purposes of section 412 of the Code, prior to the allocation of assets each year the assets are adjusted by subtracting any credit balance in the funding standard account or adding any funding deficiency. For purposes of section 404, any undeducted contributions are subtracted from the assets. Also, if the plan retains the liabilities for any participant or beneficiary for whom a normal cost is not computed, the assets are adjusted by subtracting the present value of such liabilities.

(3) In the first year the method is used, the adjusted assets are allocated on the basis of the present value of accrued benefits, the present value of future benefits, or the accrued liability under a funding method of the immediate gain type.

(4) After the first year the method is used, adjusted assets are allocated in the proportion that the sum of the allocated assets plus calculated normal cost of the prior year for each participant for whom a normal cost is computed bears to the total for all such participants.

(5) In the first year the method is used, all unamortized bases under sections 404 and 412 of the Code will be considered fully amortized.

.03 Approval 3—A change to a method described in paragraphs (1) or (2) if the requirements in paragraphs (3), (4), and (5) are also satisfied.

(1) The normal cost is computed in the aggregate as the normal cost accrual rate multiplied by compensation. The normal cost accrual rate is (A) the present value of future benefits less assets less unfunded liability divided by (B) the present value of future compensation.

(2) The normal cost is computed in the aggregate as the normal cost per participant multiplied by the number of participants who are currently employed by employers maintaining the plan. The normal cost per participant is (A) the present value of future benefits less assets less the unfunded liability divided by (B) the sum of the present value of an annuity of $1 per year payable from the attained age to retirement age for each participant who is currently employed.

(3) As of the date of change, the unfunded liability under the new method is determined under an acceptable funding method of the immediate gain type.

For years subsequent to the plan year of the change in method, the unfunded liability for any year equals

(A) the unfunded liability for the prior plan year plus the normal cost for the prior plan year, minus

(B) the actual contributions for the the prior plan year

where the amounts in (A) and (B) are adjusted with interest to the date as of which the unfunded liability is determined.

(4) The new amortization base resulting from the change in funding method is the difference between

(A) the unfunded liability under the new method as determined under 3.03(3), and

(B) the net sum of the outstanding balance of all amortization bases (including the gain or loss base for the immediately preceding period), treating credit bases as negative bases, less the credit balance (or plus the funding deficiency) in the funding standard account.

(5) The amortization period for the new amortization base for purposes of sections 302 of ERISA and 412 of the Code is as follows:

(A) If the plan was in existence on January 1, 1974, any decrease in unfunded liability will be amortized over 40 years reduced by the number of prior plan years to which section 302 has applied, and any increase will be amortized over 30 years.

(B) If the plan was not in existence on January 1, 1974, any increase will be amortized over 30 years reduced by the number of prior plan years to which section 302 has applied, and any decrease will be amortized over 30 years.

SEC. 4. APPROVAL FOR TAKEOVER PLANS

.01 Approval is granted by this sub-

section for a change in funding method where all the conditions set forth in subsections .02 through .05 are satisfied.

.02 There has been both a change in the enrolled actuary for the plan and a change in the business organization providing actuarial services to the plan.

.03 The method used by the new actuary is substantially the same as the method used by the prior actuary, and is consistent with the information contained in the prior actuarial valuation reports or prior Schedule B's of Form 5500. Also, the method used by the new actuary must be applied to the prior year (using the assumptions of the prior actuary) and the net charge in the funding standard account produced must not differ by more than five percent from the net charges computed by the prior actuary for that year.

.04 The new enrolled actuary signs and attaches a statement to Schedule B of Form 5500 that the procedures and formula currently being used may produce different results from the prior procedures and formula, but that information is not available to reproduce the prior method exactly.

.05 The change in costs due to the change in method is treated in the same manner as an experience gain or loss, unless the actuarial assumptions are being changed, in which case the change in method is treated as part of the change in assumptions.

SEC. 5. CHANGE IN YEAR OF TERMINATION

.01 For a plan year beginning before a plan terminates, the funding method may be changed to a method that satisfies subsection .02 provided that the conditions set forth in subsection .03 are satisfied. As part of the change in method, the valuation date may be changed, if desired, to the date of termination, or the asset valuation method may be changed to fair market value.

.02 A method is described in this subsection if the normal cost for the plan year is the present value of the benefits accruing in the plan year under the method, and the accrued liability is the present value of the benefits accrued under the method as of the valuation date.

.03 The conditions in this subsection are satisfied if:

(1) as of the date of termination as approved by the Pension Benefit Guaranty Corporation (PBGC), the fair market value of the assets of the plan is not less than the present value of all accrued benefits (whether or not vested). The actuarial assumptions used for determining such present value must be acceptable to PBGC for use under section 4044 of ERISA, *supra*, at 194; and

(2) a timely notice of intention to terminate was filed with the PBGC.

SEC. 6. RESTRICTIONS

.01 This revenue procedure does not apply unless an actuarial valuation is made for the plan year for which a change in method is effective, and such valuation is used for purposes of section 302 of ERISA for such plan year.

.02 This revenue procedure does not apply unless the plan administrator or plan sponsor signs and attaches a statement to Schedule B of Form 5500 for the plan year for which a change is effective stating that the plan administrator or plan sponsor agrees to the change in funding method which is being made as approved by this revenue procedure.

.03 This revenue procedure does not apply if:

(1) The funding method (including the asset valuation method) is being changed in any manner other than that described above.

(2) A waiver of the minimum funding standards has been granted for the plan or the amortization charge described in section 412(b)(2)(C) of the Code is applicable in the plan year of the change.

(3) Except as described in Section 5, the change is made for a plan year in which the plan is terminated.

.04 The approvals under sections 3.01(1), 3.02(1), and 3.03(1) do not apply if the temporary annuity factor is weighted by compensation but the plan benefits are not based on compensation.

.05 Section 4 does not apply to any plan for any plan year beginning on or after the date final regulations under section 6059 of the Code are adopted.

.06 This revenue procedure does not apply for any plan year if Schedule B of Form 5500 has been filed or if the date (without extension) by which it must be filed has passed.

SEC. 7. EFFECTIVE DATE

This revenue procedure is effective for changes in funding methods made with respect to plan years commencing on or after July 1, 1979, and before January 1, 1986.

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26 CFR 601.602: Forms and instructions. (Also Part I, Sections 446, 481; 1.446-1, 1.481-1.)

Rev. Proc. 80-51

SECTION 1. PURPOSE

The purpose of this revenue procedure is to provide general procedures under section 1.446-1(e) of the Income Tax Regulations for obtaining the consent of the Commissioner of Internal Revenue to requests for changes in methods of accounting for federal income tax purposes.

This revenue procedure modifies and/or supersedes Rev. Proc. 70-27, 1970-2 C.B. 509; Rev. Proc. 71-16, 1971-1 C.B. 682; Rev. Proc. 71-16 Amendment I, 1971-2 C.B. 527; Rev. Proc. 72-24, 1972-1 C.B. 749; Rev. Proc. 74-51, 1974-2 C.B. 507; Rev. Proc. 75-18, 1975-1 C.B. 687; and Rev. Proc. 76-8, 1976-1 C.B. 547.

SEC. 2. BACKGROUND

.01 Section 446(e) of the Internal Revenue Code and section 1.446-1(e) of the regulations provide that in order to change a method of accounting for federal income tax purposes, the taxpayer must obtain the consent of the Commissioner. Section 1.446-1(e)(3)(i) requires that in order to obtain such consent, an application must be made within 180 days after the beginning of the taxable year in which the

proposed change is requested to be made. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to a change in its method of accounting in accordance with section 446(e).

.02 Section 481(a) of the Code requires that those adjustments necessary to prevent amounts from being duplicated or omitted be taken into account when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year. Section 481(c) and section 1.481-5 of the regulations provide that the adjustment required by section 481(a) may be taken into account in determining taxable income in the manner and subject to the conditions agreed to by the Commissioner and the taxpayer.

.03 Methods of accounting should clearly reflect income on a continuing basis, and the Internal Revenue Service administers its discretion under sections 446(e) and 481(c) of the Code so that, in general, any distortion of income on an annual basis is minimized. When there is a change in method of accounting, income for the year preceding the year of change must be determined under the method of accounting that was then employed, and income for the year of change and the following years is determined under the new method of accounting. The section 481(a) adjustment, while necessary to prevent duplications or omissions of income or deductions, by its nature is distortive since it does not reflect the economic income of the year. An adjustment period for the section 481(a) adjustment is provided for in sections 5.05 and 5.06 of this revenue procedure and is intended to reduce the possibility of a change in method of accounting from itself creating a material distortion in income in the year of change and to reduce any distortion when it does exist. Also, amounts attributable to changes in methods of accounting are taken into account in determining earnings and profits in a manner consistent with the provisions of this revenue procedure.

.04 While the adjustment period is designed to ameliorate, at least in part, the otherwise distortive effect of the section 481(a) adjustment, the Service believes that in order to further compliance with proper methods of accounting, situations exist when allowing an adjustment period of more than 1 year is not appropriate. In such cases, a period of only 1 year is available. (See section 4.012 of this revenue procedure.) Similarly, the Service believes that certain situations exist when it is not appropriate to allow more than a 5-year period. (See section 5.11.) In addition, the Service believes as a general matter that it is appropriate that the adjustment period not be greater than the period that gave rise to the section 481(a) adjustment. (See section 5.06.)

SEC. 3. CHANGES

.01 This revenue procedure contains several major changes and amplifications in the procedures for obtaining the Commissioner's consent to a change in method of accounting. These changes and amplifications are made to encourage compliance with proper methods of accounting when a taxpayer is determining taxable income in accordance with one or more methods of accounting that are proscribed by the Code, regulations, decisions of the Supreme Court of the United States, revenue rulings and revenue procedures. This section highlights the major changes and amplifications.

.02 Section 4.012 provides new procedures that preclude a taxpayer that is using a Category A method of accounting from applying for a change in such method of accounting under this revenue procedure after the taxpayer is contacted in any manner by a representative of the Service for the purpose of scheduling an examination. A Category A method of accounting is defined in section 6.02 as a method of accounting that is specifically not permitted by the Code, regulations, or by a decision of the Supreme Court of the United States.

.03 Section 5, in general, amplifies the procedures to be followed in requesting consent to change a method of accounting.

.04 Section 5.02 expands the rules and procedures to be followed when a taxpayer files an application for change in method of accounting before and after the first 180 days of the taxable year for which the change is requested. Early applications filed up to 6 months before the beginning of the taxable year of change will be processed in accordance with section 5.03 of this revenue procedure. Late applications not accepted by the Service under the provisions of section 1.9100-1 of the regulations may be considered to apply to the subsequent taxable year.

.05 Section 5.06 explains the section 481(a) adjustment periods for the purpose of taking into account the appropriate adjustment resulting from the change in method of accounting. These adjustment periods are similar to the "spread periods" referred to in Rev. Proc. 80-5, 1980-1 C.B. 582. The period of years over which a section 481(a) adjustment is to be made now depends upon the facts and circumstances in each case. However, the adjustment period may not exceed 10 taxable years and in some cases may be 1 taxable year.

.06 Section 5.10 eliminates the 20-year adjustment period provided for by Rev. Proc. 71-16, Rev. Proc. 71-16, Amendment I, and Rev. Proc. 72-24, with respect to the discontinuance of the last-in, first-out (LIFO) inventory method. The adjustment period over which the section 481(a) adjustment is to be taken will be determined under the rules set forth in section 5.06. The adjustment period will not exceed 10 taxable years and once the change has been made to discontinue the use of the LIFO inventory method the taxpayer will be required to stay on the new method of accounting for a period

of at least 10 taxable years unless the Commissioner consents to a change at an earlier time.

.07 Sections 5.11, 10.02 and 11.03 modify and supersede Rev. Proc. 74-51 and allow an adjustment period for the section 481(a) adjustment of up to 5 taxable years with respect to certain changes to the full absorption method of inventory costing prescribed by section 1.471-11(a) of the regulations. During the transition period prescribed by section 1.471-11(e)(3), taxpayers were allowed an adjustment period not to exceed the lesser of 10 taxable years commencing with the year of transition or the number of years the taxpayer had been on the inventory method from which it was changing. Since the transitional rules of section 1.471-11(e) do not apply to taxable years beginning after September 19, 1975, the Service issued Rev. Proc. 74-51 to prevent taxpayers from applying under Rev. Proc. 70-27 for an adjustment period that would tend to frustrate the purpose of the transitional rules. Rev. Proc. 74-51 modified Rev. Proc. 70-27 to provide that it will not apply to a taxpayer changing to the full absorption method of inventory costing as required by section 1.471-11(e)(1)(i). Now, applications filed in accordance with the procedures set forth in Rev. Proc. 75-40, 1975-2 C.B. 571, will be allowed an adjustment period of up to 5 taxable years.

.08 Section 5.12 modifies the procedures that apply to taxpayers under examination by providing that a taxpayer using a Category B method of accounting (defined in section 6.03) may change its method of accounting while under examination. However, certain conditions (such as year of change) are imposed, and in the case of certain types of changes of methods of accounting (generally those designated by a revenue ruling or revenue procedure) the adjustment period is limited to 5 taxable years.

.09 Section 5.121 changes the year of change for which a change is granted with respect to taxpayers under examination. If the method being changed involves an issue raised by the Service during such examination, the year of change will be the most recent taxable year that is being examined by the Service, but not later than the most recent taxable year for which a federal income tax return has been filed as of the date such examination began.

.10 Section 11 is a new provision that sets forth the effective dates. Generally the provisions of this revenue procedure will be effective on December 1, 1980. However, except for changes in method of accounting to which Rev. Proc. 80-5 and Rev. Proc. 74-51 applied, the provisions of sections 4.012 and 5.12 are effective with respect to applications for change in accounting method (Form 3115) filed on or after December 1, 1982. Special effective dates are provided with respect to the elimination of the 20-year adjustment period provided when LIFO is discontinued and for the allowance of a 5-year adjustment period when changing the full absorption method of inventory costing.

SEC. 4. SCOPE

.01 This revenue procedure applies to Form 3115, Application for Change in Accounting Method, filed by all taxpayers except those cases:

1 Under examination by the Service in which the year or years under examination encompass the taxable year in which the erroneous method was initiated by the taxpayer or in which the taxpayer changed to a method of accounting without consent of the Commissioner;

2 In which the method to be changed is a Category A method of accounting (as defined in section 6.02 of this revenue procedure), and the taxpayer has been contacted in any manner by a representative of the Service for the purpose of scheduling an examination of its federal income tax return(s) and such examination has not been completed (but see section 4.02);

3 When at the time of filing Form 3115 the taxpayer is:

(a) Under examination by the district director, except as provided in sections 4.02, 5.12 and 7.03 of this revenue procedure;

(b) Under consideration by an appeals office of the Service with respect to an examination; or

(c) Before any federal court with respect to an income tax issue, unless the taxpayer has obtained an agreement from counsel for the Government that there is no objection to the proposed change in method of accounting;

4 Involving a termination of a taxpayer's use of the LIFO inventory method by the Service (see section 3.01 of Rev. Proc. 79-23, 1979-1 C.B. 564); or

5 In which there is pending a criminal investigation or proceeding concerning, (a) directly or indirectly the taxpayer's federal tax liability, or (b) the possibility of false or fraudulent statements made by the taxpayer with respect to its federal tax liability.

.02 Section 4.01 2 will not apply during a 90-day period following the date of issuance by the Service of either a letter stating that there is no change in the tax liability or a basic report form (a report of Individual Income Tax Examination Changes, a report of Income Tax Examination Changes, a report of Income Tax Audit Changes, or an Unagreed and Excepted Agreed report) signifying notice of results of an examination by the Service of the taxpayer's liability for certain taxable years. The examination of cases placed or held in suspense under subsection 4559 of the Internal Revenue Manual should be completed for all issues not in suspense and a partial agreement requested. The issuance of a basic report form in such cases begins the 90-day period specified above. However, section 4.01 2 will be applied and the 90-day rule set forth above will not apply with respect to a Category A method of accounting that is included as an item of adjustment as a result of the exami-

nation by the Service or the method of accounting (Category A) issue is placed in suspense by the Service.

.03 Should a Category B method of accounting (defined in section 6.03 of this revenue procedure) be an issue that is placed in suspense by the Service and the taxpayer desires to change such Category B method of accounting to a proper method of accounting, the taxpayer may file an application for change in accounting method under the provisions of this revenue procedure.

.04 If section 4.012 applies, the change in method of accounting shall be made by the district director.

.05 Except as provided in section 5.12, this revenue procedure does not provide for retroactive changes for a taxable year for which a federal income tax return has been filed.

.06 The Service reserves the right to decline to process an application for change in accounting method filed under this revenue procedure in situations in which it would not be in the best interest of sound tax administration to permit the requested change. In this regard the Service will consider whether such change in method of accounting would clearly and directly frustrate compliance efforts of the Service in administering the income tax laws.

SEC. 5. PROCEDURES

.01 *Submission of application for change in method of accounting.*

In general, an application for a change in method of accounting should be filed on Form 3115 within 180 days after the beginning of the taxable year for which the change in method of accounting is requested to be made.

.02 *Late applications for change in method of accounting.*

1 The purpose of the 180-day rule is to provide the Service adequate time to process the numerous applications prior to the original due date of taxpayers' returns. A Form 3115 that is not filed within the 180-day period may, under section 1.9100-1 of the regulations, nevertheless be considered as timely filed upon the showing of good cause in accordance with the requirements of Rev. Proc. 79-63, 1979-2 C.B 578. However, for purposes of this revenue procedure, applications received beyond 9 months after the beginning of the year of change will be considered to jeopardize the interests of the Government (see section 1.9100-1(a)(3) of the regulations and section 2 of Rev. Proc. 79-63) except in very unusual and compelling circumstances.

2 If a Form 3115 has been filed after the 180-day period and the Service does not grant relief under section 1.9100-1 of the regulations, the taxpayer may choose to have the application apply to the subsequent taxable year under the procedures prescribed in section 5.03 below. Such choice must be made within 30 days after the issuance by the Service of a denial of relief under section 1.9100-1, by filing a statement with the National Office addressed in accordance with section 7.01 of this revenue procedure. If such choice is timely made and the requirements of section 5.03 are met, the application will be considered a qualified application timely filed for purposes of this revenue procedure at the time Form 3115 was filed for which relief under section 1.9100-1 was requested.

.03 *Early applications for change in method of accounting.*

A qualified application for a change in method of accounting filed within a 6-month period before the beginning of the year of change will be considered as being timely filed for purposes of this revenue procedure. To qualify, (a) the Form 3115 must be complete in all respects except for the amount of the adjustment under section 481(a) for the year of change, and (b) the amount of such section 481(a) adjustment be furnished to the Service within the first 90 days after the beginning of the year of change. The filing of a qualified application for change in method of accounting in this manner will be considered to be an application for a change in method of accounting at the time of the original filing of the Form 3115. The processing order of a Form 3115 filed under the provisions of this subsection will be determined by the date all information (including the amount of the section 481(a) adjustment), has been furnished. In order to assist in the processing of Forms 3115 filed under this early filing procedure, and to insure proper handling, reference to this special procedure should be made a part of the Form 3115 by putting at the top of the Form 3115: **"FILED UNDER SEC. 5.03 of REV. PROC. 80-51."**

.04 *Processing applications (Form 3115).*

In processing applications for change in method of accounting the Service will consider all facts and circumstances. Such consideration will include:

1 Whether the method of accounting requested is consistent with the Code, regulations, revenue rulings, revenue procedures and decisions of the Supreme Court of the United States;

2 Whether the use of that method will clearly reflect income;

3 The taxpayer's reason(s) for the change; and

4 The tax effect of the adjustment under section 481(a) of the Code.

.05 *Approval.*

Approval of an application for change in method of accounting will normally be conditioned on the taxpayer proposing and agreeing as one of the conditions to the change to take the adjustment required under section 481(a) of the Code ("adjustment") into account in computing taxable income and earnings and profits (see Rev. Proc. 79-47, 1979-2 C.B. 528) over a period considered appropriate by the Commissioner, and proposing and agreeing to those other terms and conditions deemed appropriate by the Commissioner to clearly reflect, or prevent a distortion of, income. Such an approved change shall be considered

to be a change in method of accounting initiated by the taxpayer.

.06 *Section 481(a) adjustment period.*

1 The appropriate period for taking into account an adjustment, whether positive or negative, referred to in section 5.05 ("adjustment period") is generally determined as follows:

(a) When the entire net amount of an adjustment is attributable to the taxable year immediately preceding the year of change (first preceding year), the total net adjustment is to be taken into account in computing taxable income for the year of change. The amount attributable to the taxable year immediately preceding the year of change is the difference in the amount of the adjustment determined under section 481(a) of the Code for the year of change and the amount of the adjustment that would have been required under section 481(a) if the same change in method of accounting had been made in such preceding year.

(b) When (a) does not apply and 67 percent or more of the net amount of an adjustment is attributable to the 1-taxable year period, 2-taxable year period, or 3-taxable year period immediately preceding the year of change, the highest percent attributable to such 1, 2, or 3-taxable year period is to be taken into account ratably over a 3-taxable year period beginning with the year of change. Any remaining balance is to be taken into account ratably over an additional period equal to the remainder of the number of taxable years the taxpayer has used the method of accounting that is being changed. However, the total adjustment period shall not exceed 10 taxable years. This subparagraph 5.06 1(b) only applies if the taxpayer has used the method being changed for more than 3 taxable years. If the method of accounting being changed has been used for no more than 4 taxable years, 75 percent shall be substituted for 67 percent. An amount attributable to such 1, 2, or 3-taxable year period is the difference in the amount of the adjustment determined under section 481(a) of the Code for the year of change and the amount that would have been required under section 481(a) if the same change had been made at the beginning of such preceding 1, 2, or 3-taxable year period.

(c) In all other situations in which (a) and (b) above do not apply, the total net adjustment is to be taken into account ratably over the number of taxable years (not to exceed 10) the taxpayer has used the method of accounting that is being changed.

2 In applying sections 5.061(a) or (b), if a taxpayer's books and records do not contain sufficient information to compute the section 481(a) adjustment attributable to the 1, 2, or 3-taxable year period immediately preceding the year of change, the taxpayer may reasonably estimate such amounts and attach and sign (or have signed by an officer who has personal knowledge of the facts) the following statement to the Form 3115:

Under penalty of perjury, I hereby certify that:

(a) the books and records of [name of the taxpayer] do not contain sufficient information to permit a computation of the section 481(a) adjustment attributable to the 1-taxable year period, 2-taxable year period, or 3-taxable year period immediately preceding the year of change as required by section 5.061(b) of Rev. Proc. 80-51.

(b) Based on the information that is contained in such records, to the best of my information and belief, the entire amount of the section 481(a) adjustment for the year of change [indicate either "is" or "is not," as the case may be] attributable to the taxable year immediately preceding the year of change, and 67 percent [or "75 percent," in applicable cases] or more of the section 481(a) adjustment for the year of change [indicate "is" or "is not," as the case may be] attributable to the 1-taxable year period, 2-taxable year period, or 3-taxable year period immediately preceding the year of change.

3 A cooperative within the meaning of section 1381(a) of the Code shall generally take the total net amount of an adjustment into account in computing taxable income for the year of change. See Rev. Rul. 79-45, 1979-1 C.B. 284. The Service in its discretion may, however, require the adjustment to be taken into account ratably over a period of taxable years when it determines such action is appropriate.

.07 *LIFO Election.*

If a taxpayer elects the LIFO method of inventory valuation during the adjustment period referred to in section 5.06, the balance of the unamortized section 481(a) adjustment referred to in sections 5.05 and 5.06 attributable to a change in inventory valuation from a method with respect to which an adjustment under section 472(d) of the Code would have been required, must be taken into account in full in computing taxable income in the year for which such election is made. This subsection shall only apply to the portion of the unamortized section 481(a) adjustment attributable to the portion of the inventory with respect to which LIFO is elected.

.08 *Reduction in Inventory Value.*

1 If the change in method of accounting involves a change in method of inventory valuation and on the last day of any taxable year during the adjustment period referred to in section 5.06 the value of the taxpayer's inventory to which the section 481(a) adjustment relates is reduced by more than 33⅓ percent of such inventory value at the beginning of the first taxable year in the adjustment period (see sections 5.05 and 5.06), the balance of the net section 481(a) adjustment must be taken into account in full in determining taxable income in the year of such inventory reduction.

2 Section 5.081 shall not apply if the taxpayer has shown to the satisfaction of the Commissioner that such reduction is attributable to a strike, involuntary conversion, or involuntary

interruption of the availability of goods. This paragraph 5.082 shall apply only if the taxpayer has obtained the consent of the Commissioner. Such consent must be requested no later than 90 days after the end of the taxable year in which section 5.081 would otherwise apply.

.09 *Ceasing to engage in the trade or business.*

1 With respect to a corporation:

If the taxpayer ceases to engage in the trade or business, to which the adjustment (sections 5.05 and 5.06) relates, at any time prior to the expiration of the adjustment period referred to in section 5.06, the taxpayer shall take into account in such year the balance of the adjustment not previously taken into account in computing taxable income. See Rev. Rul. 80-39, 1980-1 C.B. 112, which holds that if a division of a corporation, for which a change in method of accounting had been granted, ceases to operate the trade or business for which the change in method was granted, the remaining section 481(a) adjustment applicable to the business conducted by that division of the corporation must be taken into income in the year the corporation ceases to engage in that trade or business. For purposes of this condition, the taxpayer is not considered to have ceased the trade or business if such cessation is the result of a transaction to which section 381 of the Code applies, but in such case the acquiring corporation shall continue to be subject to this revenue procedure as though it were the acquired corporation.

2 With respect to a partnership:

In the event a partnership terminates or ceases to engage in the trade or business (within the meaning of section 708 of the Code), to which the adjustment (sections 5.05 and 5.06) relates, at any time prior to the expiration of the adjustment period referred to in section 5.06, the balance of the adjustment not previosuly taken into account in computing ordinary income shall be taken into account in such year. A partnership ceasing to engage in the trade or business includes the incorporation of such trade or business in a transaction to which section 351 applies (see Rev. Rul. 77-264, 1977-2 C.B. 187).

3 With respect to a sole proprietor:

If the taxpayer ceases to engage in the trade or business, to which the adjustment (sections 5.05 and 5.06) relates, at any time prior to the expiration of the adjustment period referred to in section 5.06, the balance of the adjustment not previously taken into account in computing taxable income shall be taken into account in such year. A sole proprietor ceasing to engage in the trade or business includes the incorporation of such trade or business in a transaction to which section 351 of the Code applies (see Rev. Rul. 77-264). A sole proprietorship does not cease to engage in that trade or business when the individual taxpayer sells a partial interest in the proprietorship and continues to be actively engaged in the management of the business that is subsequently operated as a partnership. The section 481(a) adjustment remaining at the time the partnership is formed is taken into account by the partnership as though there had been no change in ownership (see Rev. Rul. 66-206, 1966-2 C.B. 206).

.10 *Discontinuance of LIFO.*

Rev. Proc. 71-16, Rev. Proc. 71-16 Amendment I and Rev. Proc. 72-24 concern a taxpayer's request to discontinue the use of the LIFO inventory method. Such a change is a change in method of accounting within the meaning of sections 446 and 481 of the Code and is subject to the provisions of this revenue procedure. Consent to discontinue the use of the LIFO inventory method and change to another acceptable method of inventory accounting that the Service determines will clearly reflect income normally will be granted subject to the requirements of section 1.472-6 of the regulations and the provisions of this revenue procedure, provided the taxpayer agrees to:

1 an adjustment period determined in accordance with the rules set forth in section 5.06 of this revenue procedure;

2 not to elect the LIFO inventory method of accounting for a period of at least 10 taxable years beginning with the year of change, unless consent is granted by the Commissioner to change the method of accounting at an earlier time based on a showing of extraordinary circumstances; and

3 to comply with any other terms and conditions that may be prescribed by the Commissioner (see section 5.05).

.11 *Full absorption method of inventory costing.*

With respect to applications filed by manufacturers and producers for consent to change to the full absorption method of inventory costing prescribed by section 1.471-11(a) of the regulations, the adjustment period otherwise determined in section 5.06 shall not exceed 5 taxable years.

.12 *Taxpayer under examination.*

A taxpayer that has been contacted by a representative of the Service for the purpose of scheduling an examination of its federal income tax return may obtain consent to change its method of accounting under this revenue procedure provided the method to be changed is a Category B method as defined in section 6.03 of this revenue procedure. Consent to make the requested change will normally be granted provided the taxpayer proposes and agrees:

1 That the year of change shall generally be,

(a) if the method being changed involves an issue raised by the Service during such examination, the most recent taxable year that is being examined by the Service during the examination of the taxpayer's returns, but not later than the most recent taxable year for which a federal income tax return has been filed as of the date the examination began, or,

(b) in other cases, the applicable taxable year that would apply at the time the application is filed if the tax-

payer had not been under examination;

2 If the method to be changed has been designated by a revenue ruling or revenue procedure that was published in the Internal Revenue Bulletin more than 2 years prior to the date the Form 3115 is filed, as a change in method of accounting with respect to which section 5.12 2 applies, the adjustment period otherwise determined under section 5.06 shall not exceed 5 taxable years; and

3 To comply with any other terms and conditions that may be prescribed by the Commissioner (see section 5.05).

.13 Examples of the rules prescribed in section 5.061 with respect to the section 481(a) adjustment.

Example A:

Z timely files an application to change its method of accounting for a specific item of expense to a method that the Service determines will clearly reflect income beginning with the taxable year ending December 31, 1981 (year of change). *Z* has used the method of accounting that is being changed for 12 taxable years. The adjustment required under section 481 (a) of the Code for the year of change is $60,000. If *Z* had made the requested change in method of accounting for the taxable years ended December 31, 1978, 1979 or 1980, the amount of the adjustment would have been $42,000, $5,400 or $48,500, respectively. The percent of the section 481(a) net adjustment attributable to the 1, 2, or 3-taxable year period preceding the year of change is determined as follows:

1-Taxable Year Period

Adjustment as of January 1, 1981	$60,000
Less: Hypothetical adjustment as of January 1, 1980	48,500
Amount attributable to 1-taxable year period	$11,500

Percent of adjustment attributable to 1-taxable year period: $\frac{\$11,500}{60,000} = 19\%$

2-Taxable Year Period

Adjustment as of January 1, 1981	$60,000
Less: hypothetical adjustment as of January 1, 1979	5,400
Amount of adjustment attributable to the 2-taxable year period	$54,600

Percent of adjustment attributable to the 2-taxable year period: $\frac{\$54,600}{60,000} = 91\%$

3-Taxable Year Period

Adjustment as of January 1, 1981	$60,000
Less: hypothetical adjustment as of January 1, 1978	42,000
Amount of adjustment attributable to the 3-taxable year period	$18,000

Percent of adjustment attributable to the 3-taxable year period: $\frac{\$18,000}{60,000} = 30\%$

Because 91 percent of the adjustment is attributable to the 2 taxable year period preceding the year of change, *Z* will take such 91 percent of the adjustment ($54,600) into account ratably over 3 taxable years beginning with the year of change (the taxable year ending December 31, 1981) and the remaining balance of the adjustment ($5,400) into account ratably over the next 7 taxable years beginning with the taxable year ending December 31, 1984.

Example B

Y timely files an application to change its method of accounting for valuing inventory to a method that is in accord with the provisions of section 1.471-4 of the regulations, beginning with its taxable year ending November 30, 1981. The information furnished shows that *Y* used its present method of valuing inventory for 9 taxable years prior to the year of change and that the net adjustment required under section 481(a) of the Code for the year of change is $300,000. The information furnished further shows that had the change been made for the taxable year ending November 30, 1980, the adjustment required under section 481(a) would have been zero or a negative amount. Thus, the entire amount of the adjustment is attributable to the taxable year immediately preceding the proposed year of change. Under these circumstances and based on the provisions of section 5.061(a) of this revenue procedure, *Y* will take the entire $300,000 net adjustment into account in computing its taxable income for the taxable year ending November 30, 1981. If the information furnished had shown that had the change been made for the taxable year ending November 30, 1980, the adjustment required under section 481(a) would have been $300,000 and had the change been made for the taxable year ending November 30, 1979, the adjustment required under section 481 (a) would be zero or a negative amount, the $300,000 would be taken into account ratably over the 3 taxable years beginning with the taxable year ending November 30, 1981.

Example C

W timely files an application to change its method of accounting for reporting income from long-term contracts from the percentage of completion method to the completed contract method, beginning with its taxable year ending September 30, 1981. The information furnished shows that *W* used the percentage of completion method for 4 taxable years prior to the year of change and the net negative adjustment required under section 481(a) of the Code for the year of change is $55,000. The information furnished further shows that the highest percent of the net negative adjustment attributable to the 1, 2, or 3-taxable year peiod preceding the proposed year of change was 63 percent. Under these circumstances and based on the provisions of section 5.061(c) of this revenue procedure, *W* will take the $55,000 adjustment into account ratably over 4 taxable years beginning with the taxable year ending September 30, 1981.

Example D

The taxpayer, a wholesaler, has for the past 10 years omitted freight-in from the computation of inventories and now desires to correct this practice. The year of change is the taxable year beginning January 1, 1981. The value of the taxpayer's inventory as of December 31, 1980 (the end of the year preceding the year of change),

was $365,000, which did not include freight-in. The amount of freight-in omitted from that inventory was $45,000. The value of the inventory as of January 1, 1981 (the beginning of the year of change), computed in accordance with the new method of accounting to be adopted by the taxpayer is $410,000. The change in method of accounting is treated as a change initiated by the taxpayer, and thus the net section 481(a) adjustment is $45,000 ($410,000 — $365,000).

The hypothetical section 481(a) adjustments that would have been required if made in the 1, 2, or 3-taxable year period immediately preceding the year of change are as follows:

1-taxable year period (Ending December 31, 1980)	$30,000
2-taxable year period (Ending December 31, 1979)	$25,000
3-taxable year period (Ending December 31, 1978)	$35,000

Computation of percentage of adjustment attributable to the 1, 2, or 3-taxable year period preceding the year of change.

	1-taxable year period	2-taxable year period	3-taxable year period
Section 481(a) adjustment as of 1-1-81	$45,000	$45,000	$45,000
Less: Hypothetical section 481(a) adjustment	30,000	25,000	35,000
Amount attributable to each taxable year period	$15,000	$20,000	$10,000
Percentage of adjustment attributable to each taxable year period	$\frac{\$15,000}{\$45,000} = 33\%$	$\frac{\$20,000}{\$45,000} = 44\%$	$\frac{\$10,000}{\$45,000} = 22\%$

Under the provisions of section 5.06 1(c) of this revenue procedure the $45,000 will be taken into income over 10 taxable years beginning January 1, 1981. Thus, the taxable income for the year ended December 31, 1981, based on the foregoing and the amounts indicated below, should be computed as follows:

Sales		$800,000
Inventory at beginning of year (freight-in of $45,000 included)	$410,000	
Purchases (including freight-in)	585,000	
	$995,000	
Inventory at end of year including freight-in	335,000	
Cost of Goods Sold		660,000
Gross Profit		140,000
Less deductions		85,000
		55,000
Agreed-to section 481(a) adjustment to be taken over the adjustment period of 10 years (1/10 × $45,000)		4,500
Taxable income December 31, 1981		$ 59,500

Sec. 6. Definitions

.01 *Year of change.*

The taxable year for which a change is effective is the year of change. The year of change is the first taxable year for taking the adjustment referred to in section 5.06 of this revenue procedure into account and for complying with any other terms and conditions set forth in the Commissioner's consent letter (see section 1.446-1(e)(3)(ii) of the regulations). See also section 5.12 of this revenue procedure.

.02 *Category A method of accounting.*

A Category A method of accounting is a method of accounting that is specifically not permitted to be used by the taxpayer by the Code, regulations, or by a decision of the Supreme Court of the United States. Examples of methods within Category A are:

1 Methods of inventory valuation listed in sections 1.471-2(f)(1) through (7) of the regulations.

2 A write-down of goods in inventory that does not comply with section 1.471-2(c) of the regulations. For example, goods are written down without being sold or offered for sale.

3 A write-down of any goods in inventory that does not comply with section 1.471-4(b) of the regulations. For example, see Rev. Rul. 77-364, 1977-2 C.B. 183, in which a taxpayer determined the market value of goods in inventory by dividing the inventory into classes based upon sales activities and then reducing the value of each class by a percentage of cost assigned thereto.

4 The write-down of what is regarded as "excess" inventory by a taxpayer to a net realizable value although such inventory has not been scrapped, sold, or offered for sale at the reduced price. (*Thor Power Tool Co. v. Commissioner,* 439 U.S. 522 (1979), 1979-1 C.B. 167, and section 1.471-4(b) of the regulations.)

5 In the absence of a specific statutory or regulatory exception, the use of the cash receipts and disbursements method of accounting for the sale of merchandise when such merchandise is an income-producing factor and therefore inventories are required. (Section 1.446-1(c)(2) and Example 1 of section 1.446-1(e)(2)(iii) of the regulations.)

6 The use of a long-term contract method of accounting for income from contracts that clearly do not involve building, installation, construction or manufacturing. (Section 1.451-3(b) of the regulations.)

7 The use by a manufacturer of a method of inventory costing that does not conform to the requirements of section 1.471-11 of the regulations relating to the full absorption method of inventory costing.

8 The use of a method of accounting other than that prescribed by section 447 of the Code by a farming corporation subject to that section.

9 The use, in taxable years beginning on or after September 19, 1979, of a method of accounting under section 1.163-4(a) of the regulations, which provides for the deduction of interest as original issue discount, with respect to obligations with a term of 1 year or less. (Section 1.1232-3(b)(1)(iii).)

.03 *Category B method of accounting.*

Category B methods are all methods

other than those specifically not permitted to be used by the taxpayer by the Code, regulations or decisions of the Supreme Court of the United States.

.04 *Filed.*

For purposes of this revenue procedure, a Form 3115 is filed at the time it is mailed (under the rules of section 7502 of the Code) or delivered to, and received by, the Service.

SEC. 7. APPLICATION

.01 A taxpayer wishing to invoke the provisions of this revenue procedure should complete and file a current Form 3115 with the Commissioner of Internal Revenue, Attention: T:C:C:1, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, and request the application of Rev. Proc. 80-51. The taxpayer must provide all the information required on such application (current Form 3115) and state that it proposes to take the adjustment into account over the appropriate period required by section 5.06 above. If the Service receives an application that is not properly completed in accordance with the instructions on the Form 3115, it will notify the taxpayer. Such notification will specify those items that need to be corrected and, when appropriate, transmit a current blank Form 3115 for the taxpayer's use. For example: The General Instructions contained on page 4 of the Form 3115 require a taxpayer to set forth all relevant facts regarding its present and proposed methods (as set forth in the application), including an explanation of why the taxpayer believes the application should be approved. In its notification, the Service will allow the taxpayer a reasonable period of time, ordinarily not more than 30 days, in which to submit the necessary information. If such information is submitted within the period of time granted by the Service, the application will be considered properly completed as of the date of original filing. If the information is not submitted within the time allowed, the application will be closed. If the information is received after the application is closed, it will be reopened and treated as a new application filed as of the date the information is received. The preceding four sentences shall not apply in the case of early applications submitted in accordance with section 5.03 of this revenue procedure.

.02 The signature of the individual or person preparing the application for the taxpayer must appear in the space at the bottom of page 1 on the Form 3115. An application made by an agent on behalf of a taxpayer must be accompanied by a power of attorney authorizing the agent to sign for the taxpayer. If the agent is also authorized to represent the taxpayer before the Service, receive the original or a copy of correspondence concerning the request, or perform any other act(s) regarding the application on behalf of the taxpayer, the power of attorney must reflect such authorization(s). If the taxpayer is a member of an affiliated group that has elected to file a consolidated federal income tax return, a Form 3115 submitted on behalf of the taxpayer must be signed by a duly authorized officer of the common parent. (See section 1.1502-77 of the regulations.)

.03 A request for the application of this revenue procedure under section 5.12 of this revenue procedure shall be made by the taxpayer in a letter addressed to the Commissioner of Internal Revenue, Attention: T:C:C:1. This request together with a properly completed current Form 3115 should be sent to the district director for the district in which the return is being examined. The district director will forward the application and pertinent comments to the National Office and suspend examination action on the accounting method issue pending completion of action by the National Office on the taxpayer's request. The district director should verify that the amount of the section 481 (a) adjustment is correct, that it has not been reduced by an amount attributable to taxable years prior to 1954, and that the adjustment period and year of change have been determined in accordance with section 5.12. The Form 3115 should not be sent to the National Office unless the taxpayer and district director are in agreement with respect to the year of change, the amount of the section 481(a) adjustment and the adjustment period. If the taxpayer and district director cannot agree as to these items, a technical advice request may be submitted to the National Office in accordance with Rev. Proc. 80-26, 1980-1 C.B. 671.

.04 Sections 9 (specifically subsections 9.10, 9.11, 9.15 and 9.21), 11, 15, 16 and 17 of Rev. Proc. 80-20, 1980-1 C.B. 633, pertaining respectively to Instructions to Taxpayers, Conference in the National Office, Withdrawal of Requests, Oral Advice to Taxpayers, and Effect of Rulings, are applicable to applications for changes in accounting methods (Form 3115) filed under this revenue procedure.

SEC. 8. MISCELLANEOUS

.01 *Conferences in the National Office.*

1 The taxpayer should state in writing at the time the Form 3115 is filed under this revenue procedure whether the taxpayer or the taxpayer's authorized representative desire a conference if an adverse response is contemplated by the Service. If a conference is not specifically requested in writing at the time the taxpayer files Form 3115 under this revenue procedure or in a later written communication, the Service will presume that the taxpayer does not desire a conference.

2 If the taxpayer specifically states in writing that a conference is desired if an adverse response is contemplated by the Service, a conference will be arranged in the National Office prior to the Service's formal reply to the taxpayer's application. See section 11, Rev. Proc. 80-20.

.02 *Other offices of the Service.*

The provisions of this revenue procedure are not intended to preclude an appropriate representative of the Service (including an appeals officer)

from settling a particular taxpayer's case involving an accounting method issue by means of agreeing to terms and conditions in the best interest of the Government. In such case, the terms and conditions used for this purpose may not contain a provision that:

1 Permits an adjustment period of more than 10 taxable years or more years than the method has been used by the taxpayer, whichever is shorter;

2 Permits an adjustment period of more than 5 taxable years when the change is to the full absorption method of inventory costing; or

3 Establishes the year of change as a year later than the year specified in section 5.121(a).

However, the terms and conditions may be more restrictive than those provided by this revenue procedure.

SEC. 9. INQUIRIES

Inquiries in regard to this revenue procedure should refer to its number and be addressed to the Commissioner of Internal Revenue, Attention: T:C:C:1, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

SEC. 10. EFFECT ON OTHER DOCUMENTS

.01 Rev. Proc. 74-11, 1974-1 C.B. 420 (pertaining to changes in method of depreciation accounting); Rev. Proc. 64-51, 1964-2 C.B. 1003 (pertaining to procedures for changing the method of accounting for bad debts from the specific charge-off method to the reserve method) as amplified by Rev. Proc. 70-15, 1970-1 C.B. 441 and as modified by Rev. Proc. 77-39, 1977-2 C.B. 573; and Rev. Proc. 80-5, 1980-1 C.B. 582 (pertaining to the decision of the Supreme Court of the United States in *Thor Power Tool Co. v. Commissioner*), are not affected by this revenue procedure. Form 3115 submitted by the taxpayer with respect to Rev. Proc. 74-11 is to be filed with the appropriate Internal Revenue Service Center and is not to be sent to the National Office.

.02 Rev. Proc. 76-8, and Rev. Proc. 74-51 are modified and superseded effective December 1, 1980.

.03 Rev. Proc. 72-24 is superseded effective December 1, 1980.

.04 Rev. Proc. 71-16 and Rev. Proc. 71-16 Amendment I are modified and superseded effective for applications for changes in accounting method (Form 3115) filed after December 1, 1980.

.05 Section 4.03 of Rev. Proc. 70-27 and section 2.03 of Rev. Proc. 75-18 are superseded effective December 1, 1982. All other provisions of Rev. Proc. 70-27 and Rev. Proc. 75-18 are superseded effective December 1, 1980.

SEC. 11. EFFECTIVE DATE

.01 The provisions of section 4.012 (taxpayer using a Category A method of accounting scheduled for an examination) and section 5.12 (taxpayer under examination, Category B method of accounting involved) of this revenue procedure are effective with respect to applications for change in accounting method (Form 3115) filed on or after December 1, 1982. However, the provisions of section 4.01 2 are effective with respect to Forms 3115 filed on or after December 1, 1980 with respect to changes in method of accounting to which: (1) Rev. Proc. 80-5 (which waives the 180-day rule and grants consent to taxpayers' applications to change from a method of accounting for inventory valuation of excess inventory, which is not in accordance with the prescribed method, to such prescribed method for the first taxable year ending on or after December 25, 1979) applies, or (2) Rev. Proc. 74-51 (full absorption inventory costing) applied.

.02 The provisions of section 5.10 (concerning discontinued use of the LIFO inventory method) are effective with respect to applications for change in accounting method (Form 3115) filed on or after December 1, 1980.

.03 The provisions of section 5.11 (concerning changes to the full absorption method) are effective with respect to changes granted after December 1, 1980. However, taxpayers who applied for and received the Commissioner's consent to change to the full absorption method of inventory costing prescribed by section 1.471-11(a) of the regulations and, pursuant to Rev. Proc. 74-51, an adjustment period of only 1 year was provided, may resubmit an application by March 1, 1981, requesting the adjustment period under section 5.06 (limited to 5 taxable years). This subsection 11.03 shall apply only if the taxable year the change to the full absorption method was originally granted is an open year under provisions of section 6501 of the Code and the taxpayer's change to the full absorption method of inventory costing was not in connection with an examination by the Service of the taxpayer's federal income tax return. Taxpayers that contemplate resubmitting an application under this subsection 11.03 may wish to protect the period of limitations for the year in which the change in method of accounting was first granted.

The application, a new Form 3115, should be filed with the National Office (see section 7 of this revenue procedure), together with a copy of the previous Form 3115 and a copy of the letter granting the full absorption change in method of accounting. As a condition to the granting of a revised Commissioner's consent letter, the taxpayer must propose and agree to pay the additional federal income tax due for the taxable years involved in the adjustment period. Upon the receipt of a revised Commissioner's consent letter granted pursuant to this subsection 11.03, the taxpayer must file an amended federal income tax return for the year of change with the appropriate Internal Revenue Service Center. Such amended return must be accompanied by a copy of the revised Commissioner's consent letter and amended returns prepared in accordance with the Commissioner's revised consent letter for all taxable years during the adjustment period with respect to which the original return has al-

ready been filed at the time of the filing of the amended return for the year of change. In order to assist in the processing of these amended returns, the taxpayer should include a covering letter clearly indicating that the amended returns are being filed in accordance with the provisions of subsection 11.03 of Rev. Proc. 80-51 and put at the top of each amended return: **"FILED UNDER SECTION 11.03 OF REV. PROC. 80-51."**

.04 All other provisions of this revenue procedure are effective December 1, 1980.

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26 CFR 601.602: Forms and instructions. (Also Part I, Sections 6041, 6042, 6043, 6047, 6049, 6109; 1.6041-1, 1.6041-4, 1.6041-5, 1.6041-7, 1.6042-2, 1.0642-3, 1.6043-2, 1.6047-1, 301.6047-1, 1.6049-1, 301.6109-1.)

Rev. Proc. 80-52

PART A.—GENERAL

SECTION 1. PURPOSE

.01 The purpose of this revenue procedure is to provide the requirements and conditions for filing information returns in the Forms 1099 and 1087 series, on magnetic tape instead of paper returns. Specifications for filing the following forms are contained in this procedure:

a) Form 1099R, Statement for Recipients of Total Distributions from Profit-Sharing, Retirement Plans, and Individual Retirement Arrangements.

b) Form 1099-DIV, Statement for Recipients of Dividends and Distributions.

c) Form 1099-INT, Statement for Recipients of Interest Income.

d) Form 1099-MISC, Statement for Recipients of Miscellaneous Income.

e) Form 1099-MED, Statement for Recipients of Medical and Health Care Payments.

f) Form 1099-OID, Statement for Recipients of Original Issue Discount.

g) Form 1099-PATR, Statement for Recipients (Patrons) of Taxable Distributions received from Cooperatives.

h) Form 1099L, U.S. Information Return for Distributions in Calendar Year.

i) Form 1099-NEC, Statement for Recipients of Nonemployee Compensation.

j) Form 1099-UC, Statement for Recipients of Unemployment Compensation Payments.

k) Form 1087-DIV, Statement for Recipients of Dividends and Distributions.

l) Form 1087-INT, Statement for Recipients of Interest Income.

m) Form 1087-MISC, Statement for Recipients of Miscellaneous Income.

n) Form 1087-MED, Statement for Recipients of Medical and Health Care Payments.

o) Form 1087-OID, Statement for Recipients of Original Issue Discount.

p) Agriculture Subsidy Payment Report.

.02 This procedure supersedes Rev. Proc. 79-66, 1979-2 C.B. 581.

SEC. 2. NATURE OF CHANGES

.01 Format changes have been made to Form 1099-PATR, Statement for Recipients (Patrons) of Taxable Distributions Received From Cooperatives. Amount Code 5, Investment Credit, and Amount Code 6, Energy Investment Credit, have been deleted.

.02 The Total original issue discount field, Amount Code 1, on Forms 1099-OID and 1087-OID, has been expanded to two fields. Amount Code 1 now contains total original issue discount in 1980 for all holders of discount obligations from financial institutions; Amount Code 2 now contains total original issue discount in 1980 for all holders of corporate obligations.

SEC. 3. WAGE AND PENSION INFORMATION

.01 Section 8(b) of Pub. L. 94-202, 1976-1 C.B. 503, enacted in January 1976, authorized the combined reporting of FICA detailed information (previously reported quarterly on Form 941, Schedule A) and annual W-2 (Copy A), Wage and Tax Statement, information in one consolidated annual W-2 (Copy A) to the Federal Government. As a result, Forms W-2 and W-2P are to be filed with the Social Security Administration (SSA).

.02 SSA will accept magnetic media for filing Forms W-2 and W2P and has issued TIB-4a, *Magnetic Tape Reporting,* Submitting wage and tax data to Federal and State Agencies, TIB-4b, *Magnetic Tape Reporting,* Submitting Annuity, Pension, Retired Pay or IRA Payment to the Federal Government on Magnetic Tape, and TIB-4c, *Diskette and Disk Cartridge Reporting,* Submitting Wage and Tax Data to the Federal Government on Diskette and Disk Cartridge, for this purpose. Applications for filing Forms W-2 and W-2P on magnetic media appear in TIBs-4a, 4b, and 4c.

.03 Copies of Social Security Administration publications TIB-4a, 4b, and 4c are available from any Internal Revenue Service Center or local Social Security Administration office.

SEC. 4. APPLICATION FOR MAGNETIC MEDIA REPORTING

.01 For the purposes of this revenue procedure, the payer is the organization making the payments and the transmitter is the organization which is preparing the tape file. Payers or transmitters who decide to file information returns, in the Forms 1099 and 1087 series, on magnetic tape must complete Form 4419, Application for Magnetic Media Reporting of Information Return (Exhibit "A" attached). Instructions for completing the application appear on the reverse side of the form.

.02 The Service will act on an application and notify the applicant of authorization to file within 30 days of receipt of the application. No magnetic tape returns may be filed with the Service until authorization to file is received.

.03 The Service will assist new filers with their initial magnetic tape submission by encouraging the submission of test tapes for review in ad-

vance of the filing season. Approved payers or transmitters who wish to submit a test tape should contact the magnetic media coordinator at the Service Center where the application was filed.

.04 Once authorization to file on magnetic tape has been granted to a payer or transmitter, it will remain in effect in succeeding years, provided that all the requirements of this revenue procedure are met and there are no equipment changes by the filer. If a filer discontinues filing on magnetic tape, a new application must be filed before this method of filing may be resumed.

.05 In accordance with Section 1.6041-7 of the Income Tax Regulations, medical payments from separate departments of a health care carrier may be reported as separate returns on magnetic tape. In this case, the headquarters office will be considered to be the transmitter and the individual departments of the company filing reports will be considered to be payers. A single application form covering all the departments which will be filing on magnetic tape should be submitted.

SEC. 5. FILING OF TAPE REPORTS

.01 A magnetic tape reporting package, which includes all the necessary transmittals, labels, and instructions, will be mailed to all approved filers between October and December of each year.

.02 Payers may submit a portion of their information returns on magnetic tape and the remainder on paper forms, provided there is NO DUPLICATE FILING. The magnetic tape records and paper forms must be filed at the same location, but in separate shipments. A Form 1096 must accompany paper submissions and a Form 4804 must accompany magnetic tape submissions.

.03 The affidavit which appears on Forms 1096 and 4804 must be signed by the payer. A transmitter, service bureau, or disbursing agent may, however, sign the affidavit on behalf of the payer if all of these conditions are met:

a. It has the authority to sign the affidavit under an agency agreement (either oral, written, or implied) that is valid under State law; and

b. It has the responsibility (either oral, written, or implied) conferred on it by the payer to request the taxpayer identifying numbers of payees reported on magnetic tape or paper returns; and

c. It signs the affidavit and adds the caption "For: [name of payer]".

.04 Although a duly authorized agent signs the affidavit, the payer is held responsible for the accuracy of the Form 4804 and will be liable for penalties for failure to comply with filing requirements.

.05 These requirements also apply to paper filers submitting Form 1096, Annual Summary and Transmittal of U.S. Information Returns. Paper filers are responsible for the filing of a correct, complete, and timely Form 1096. The failure of duly authorized "agents" of paper filers to comply with the filing requirements of Form 1096 and attachments does not relieve the payers of any penalties that may arise as a result of such failure to comply.

.06 If a portion of the returns are submitted on paper documents, include a statement on the Form 1096 that the remaining returns are being filed on magnetic tapes. Please note that Form 1096 instructions normally apply to the filing of information returns on paper; however, filers of magnetic tape must review the Form 1096 instructions and file Form 1096 if appropriate.

.07 Health care carriers, or their agents, filing Form 1099-MED per Section 4.05 above, may submit part of their returns on paper documents and part on magnetic tape if the records of some departments are not maintained on computer files. However, an information return is required if the aggregate amount paid to a health care service provider from all departments equals $600 or more. For example, Department A pays $200, Department B pays $300, and Department C pays $100 to the same health care service provider. The aggregate amount paid from all departments equals $600. The health care carrier or agent must submit either one information return for the aggregate amount of $600 or three separate returns, one from each department, indicating the amount paid by each department.

SEC. 6. FILING DATES

.01 Magnetic tape reporting to the Service for all types of Forms 1099 and 1087 must be on a calendar year basis.

.02 The dates prescribed for filing paper returns with the Service will also apply to magnetic tape filing. Tapes must be submitted to the Service Center by February 28. The copies of this information required to be furnished to recipients must be furnished by January 31.

SEC. 7. EXTENSIONS TO FILE

.01 If a payer or transmiter is unable to submit its tape file by the date prescribed in Section 6.02 above, a letter requesting an extension must be filed before February 28. The letter should be sent to the attention of the magnetic media coordinator at the Service Center which will receive the tape file. The request should include the estimated number of returns which will be filed late and the reason for the delay.

.02 If an extension is granted by the Service, a copy of the letter granting the extension must be attached to the transmittal Form 4804 when the file is submitted.

SEC. 8. PROCESSING OF TAPE RETURNS

.01 The Service will process tax information from the tapes. Tapes which are timely received by the Service will be returned to the filers by August 15 of the year in which submitted.

02. All tapes submitted must conform *totally* to this revenue procedure. If tapes are unprocessable, they will be returned to the filer for correction. Corrected tapes must be filed with the Service as soon as possible. Corrected files will be returned by the Service within six months of receipt.

SEC. 9. CORRECTED RETURNS

.01 If a large volume of corrected returns is necessary, and the payer or transmitter possesses the capability to provide such corrections on tape, they are encouraged to do so. The filer must contact the magnetic media coordinator for format and shipping instructions. A corrected Form 4804 must accompany the shipment and be marked "Magnetic Media Correction" on the upper portion of the form.

.02 If corrections are not submitted on tape, payers must submit them on official Forms 1099 or 1087 (Copy A) or on approved paper substitutes. Revenue procedures containing specifications for paper returns are available from most Internal Revenue Service offices.

.03 Form 1096 instructions are to be followed when paper returns are filed to correct returns submitted on magnetic media. An "X" must be entered in the box in the left margin and the caption "Magnetic Media Correction" must appear on the top of the form to the left of "FOR OFFICIAL USE ONLY". Corrections must be sent to the attention of the magnetic media coordinator where the original tape file was filed.

SEC. 10. TAXPAYER IDENTIFICATION NUMBERS

.01 Under Section 6109 of the Internal Revenue Code, recipients of dividends, interest, or other payments are required to furnish taxpayer identification numbers (TINs) to the payer. The number must be furnished to the payer whether or not the payee is required to file a tax return or is covered by Social Security.

.02 The Service expects that payers will keep to a minimum those statements submitted without TINs. It is particularly important that correct social security and employer identification numbers for payees be provided on magnetic media or paper forms submitted to the Service.

.03 For each omission of a required TIN, Section 6676 of the Internal Revenue Code provides that the Service charge a $5 penalty, unless the payer or payee responsible for furnishing the number supplies an explanation, upon request from the Service, that establishes reasonable cause for not having done so.

.04 The TIN to be furnished the Service depends primarily upon the manner in which the account is maintained or set up on the record of the payer. The number to be provided must be that of the owner of record. If the account is recorded in more than one name, furnish the TIN and name of one of the holders of the record. The number provided must be associated with the name of the holder provided in the first name line of the Payee "B" Record of Part B of this procedure. For those engaged in a trade or business (including employee trusts, retirement systems, etc.) the TIN is the employer identification number, EIN (00-0000000). For individuals, it is a social security number, SSN (000-00-0000).

.05 Sole proprietors who are payers should show their employer identification numbers in the Payer/Transmitter "A" Record. However, the payer should use the social security number of a sole proprietor in the Payee "B" Record. The table below will help you determine the number to be furnished to the Service.

CHART 1. Guidelines for Social Security Numbers

For this type of account:	*In tape positions 12-20 of the Payee "B" Record, enter the Social Security Number of—*	*In the Payee 1st Name Line of the Payee "B" Record, enter the name of—*
1. An individual's account.	The individual.	The individual.
2. Joint account of:		
a. husband and wife	The actual owner of the account. (If more than one owner, the principal owner.)	The individual whose SSN is entered.
b. adult and minor	The actual owner of the account. (If more than one owner, the principal owner.)	The individual whose SSN is entered.
c. two or more individuals	The actual owner of the account. (If more than one owner, the principal owner.)	The individual whose SSN is entered.
3. Account in the name of a guardian or committee for a designated ward, minor, or incompetent person.	The ward, minor, or incompetent person.	The individual whose SSN is entered.
4. Custodian account of a minor (Uniform Gifts to Minors Acts).	The minor.	The minor.
5. a. The usual revocable savings trust account (grantor is also trustee)	The grantor-trustee.	The grantor-trustee.
b. So-called trust account that is not a legal or valid trust under State law.	The actual owner.	The actual owner.
6. Sole proprietorship.	The owner.	The owner.

CHART 2. Guidelines for Employer Identification Numbers

For this type of account—	*In tape positions 12-20 of the Payee "B" Record enter the Employer Identification Number of—*	*In the Payee 1st Name Line of the Payee "B" Record, enter the name of—*
1. A valid trust, estate, or pension trust.	Legal entity.[1]	The legal trust, estate, or pension trust.
2. Corporate account.	The corporation.	The corporation.
3. Religious, charitable, or educational organization.	The organization.	The organization.
4. Partnership account held in the name of the business.	The partnership.	The partnership.
5. Association, club or other tax-exempt organization.	The organization.	The organization.
6. A broker or registered nominee.	The broker or nominee.	The broker or nominee.
7. Accounts with the Department of Agriculture in the name of a public entity (such as a State or local government, school district or prison that receives agriculture program payments).	The public entity.	The public entity.

[1] Do not furnish the identifying number of the personal representative or trustee unless the legal entity itself is not designated in the account title.

SEC. 11. EFFECT ON PAPER RETURNS

.01 Magnetic tape reporting of the information returns listed in Section 1 above applies only to the original (Copy A).

.02 Payers are permitted considerable flexibility in designing the copy of the information return to be furnished to the payee. The payer may combine the information return data with other reports or financial or commercial notices, or expand them to include other information of interest to a depositor, patron, or shareholder. This is permissible so long as all required information present on the official form is included and the payees' copies are conducive to proper reporting of income on tax returns. Payers must include the message "This information is being furnished on Form 1099 (or 1087) to the Internal Revenue Service" on the recipients' copies.

.03 If a portion of the returns is reported on magnetic tape and the remainder is reported on paper forms, those returns not submitted on magnetic tape must be filed on official forms or on paper substitutes meeting specifications in the revenue procedure on the reproduction of Forms 1099, 1087, and W-2G. Form 1099 BCD, 1099 F, and W-2G cannot currently be filed on magnetic tape.

SEC. 12. ADDITIONAL INFORMATION

Requests for additional copies of this revenue procedure or for additional information on tape reporting should be addressed to the attention of the magnetic media coordinator of one of the following:

(a) Internal Revenue Service
Andover Service Center
Post Office Box 311
Andover, MA 01810

(b) Internal Revenue Service
Brookhaven Service Center
P.O. Box 486
Holtsville, NY 11742

(c) Internal Revenue Service
Philadelphia Service Center
Post Office Box 245
Bensalem, PA 19020

(d) Internal Revenue Service
Atlanta Service Center
Post Office Box 47-421
Doraville, GA 30362

(e) Internal Revenue Service
Memphis Service Center
P.O. Box 1900
Memphis, TN 38101

(f) Internal Revenue Service
Cincinnati Service Center
Post Office Box 267
Covington, KY 41019

(g) Internal Revenue Service
Kansas City Service Center
Post Office Box 1040, Stop 43
Kansas City, MO 64141

(h) Internal Revenue Service
Austin Service Center
Post Office Box 934
Austin, TX 78767

(i) Internal Revenue Service
Ogden Service Center
Post Office Box 9941
Ogden, UT 84409

(j) Internal Revenue Service
Fresno Service Center
Post Office Box 12866
Fresno, CA 93779

PART B.—MAGNETIC TAPE SPECIFICATIONS

SECTION 1. GENERAL

.01 The magnetic tape specifications contained in this Part prescribe the required format and contents of the records to be included in the file. These specifications *must* be adhered to unless deviations have been specifically granted by the Service in writing.

.02 In most instances, the Service will be able to process any compatible tape files. Compatible tape files must meet any one set of the following:

(a) 7 channel BCD (binary coded decimal) with

(1) Either Even or Odd Parity and

(2) A density of 556 or 800 BPI

(b) 9 channel EBCDIC (Extended Binary Coded Decimal Interchange Code) with

(1) Odd Parity and

(2) A density of 800, or 1600.

(c) 9 channel ASCII (American Standard Coded Information Interchange) with

(1) Odd Parity and

(2) A density of 800 or 1600.

.03 Although the Service can process, after translation, tapes created at 6250 BPI, it is preferred that filers submit 1600 PBI tapes if possible. Payers/Transmitters must request permission from the service center magnetic media coordinator before submitting 6250 BPI tapes.

04. All compatible tape files must have the following characteristics:

(a) Type of tape—½ inch Mylar base, oxide coated; and

(b) Interrecord Gap—¾ inch.

.05 Service programs are capable of accommodating some minor deviations. Payers who can substantially conform to these specifications, but do require some minor deviations, must contact the magnetic media coordinator at the service center where the file will be submitted. *Under no circumstances may tapes deviating from the specifications in this revenue procedure be submitted without prior written approval from the Service.*

Sec. 2. Record Length

.01 The tape records prescribed in these specifications may be blocked or unblocked, subject to the following:

(a) *A block must not exceed 4,000 tape positions.*

(b) A record must be a minimum of 200 positions and a maximum of 360 positions.

(c) If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9's. *Do not pad a block with blanks.*

(d) All records except the Header and Trailer Labels, may be blocked.

.02 Provision is made in the Payee "B" Records for special data entries. These entries are optional. If the field is utilized, it must be present on all Payee "B" Records. The field is intended to serve one or both of these purposes:

(a) Contain information required by state or local governments. Filers who wish to use this option for satisfying state or local reporting requirements should contact their state or local department of revenue for filing instructions.

(b) Facilitate making all records the same length.

Sec. 3. Options for Filing

.01 For filing convenience, this procedure contains two options for using Header Labels and Payer/Transmitter "A" Records. For the purposes of this procedure the following conventions must be used:

Header Label:

1. Payers may use standard headers, provide they begin with 1HDR, HDR1, VOL1 or VOL2.

2. Consist of a maximum of 80 positions.

3. May not contain the letters A, B, C, D, E, or F in position 9.

Trailer Label:

1. Standard trailer labels may be used provided that they begin with 1EOR, 1EOF, EOR1, or EOF1.

2. Consist of a maximum of 80 positions.

Record Mark:

1. Special character used to separate blocked records on tape.

2. Can be written only at the end of a record or block.

3. For odd parity tapes, use BCD bit configuration 011010 ("A82").

Tape Mark:

1. Used to signify the physical end of the recording on tape.

2. For even parity, use BCD configuration 001111 ("8421").

3. May follow the header label and precede and/or follow the trailer label.

Option 1: When using this option, a correct Payer/Transmitter "A" Record, described in Sec. 4 below, is required as the first record on each reel. Filers using this option may have Header Labels preceding the "A" Record, however, headers are not required. The reel sequence number must appear in positions 3-5 of each "A" Record and must be incremented by 1 on each tape reel of the file after the first reel.

Option 2: Requires a Header Label as the first record on each reel. The Header Label must contain the reel sequence number and it must be incremented by 1 on each reel after the first reel. The "A" Record will contain the location of the reel sequence number in the Header Label. If your system generates a four-digit reel sequence number, ignore the first digit when determining the location for the purposes of the "A" Record.

Example: If your Header Label reel sequence is four digits (e.g. 0001) and is in position 28-31, enter 29 as the location in positions 3 and 4 of the "A" Record and also enter an "X" in position 5 of the "A" Record.

Example: If your Header Label reel sequence number is 3 digits (e.g. 001) and is in positions 10-12, enter 10 as the location in positions 3 and 4 of the "A" Record and also enter an "X" in position 5 of the "A" Record. This option requires a Trailer Label at the end of *each* reel. Also, ignore the "D" Record instructions in this Part if you use Option 2.

Sec. 4. Payer/Transmitter "A" Record

Identifies the payer and transmitter of the tape file and provides parameters for the succeeding Payee "B" Records. The Service's computer programs rely on the absolute relationship between the parameters in the "A" Record and the data fields in the "B" Records to which they apply.

The number of "A" Records appearing on a tape reel will depend on the number of payers and the different types of returns being reported. A transmitter may include Payee "B"

Records for more than one payer on a tape reel, however, each separate payer's Payee "B" Record(s) must be preceded by an "A" Record. A single tape reel may also contain different types of returns, but the returns may not be intermingled. A separate "A" Record is required for each type of return being reported. An "A" Record may be blocked with "B" Records, however, the "A" Record must appear as the first record in the block.

RECORD NAME: PAYER/TRANSMITTER "A" RECORD

Tape Position	Field Title	Length	Description and Remarks
1	Record Type	1	Required. Enter "A".
2	Payment Year	1	Required. Must be the right most digit of the year for which payments are being reported (e.g. if payments were made in 1980, enter 0). This number must be incremented each year.
3-5	Reel Sequence Number	3	Required. Sequence number of the reel in the tape file. (See explanation in Sec. 3 above). Position 5 *must* contain an "X" if you are using Option 2.
6-14	Payer's Federal EIN	9	Required. Must be the valid 9-digit number assigned to the payer by IRS. DO NOT ENTER HYPHENS, ALPHA CHARACTERS OR ALL 9's or ZEROS.
15	Type of Payer	1	Required. Enter the appropriate code from the table below: *Type of Payer* — *Code* Non-government — P Federal government — F State or local government — W
16	Blank	1	Enter blank (Reserved for IRS Use).
17	Type of Return	1	Required. Enter appropriate code from the table below: *Type of Return* — *Code* 1099R — 9 1099-DIV — 1 1099-INT — 6 1099-MISC — A 1099L — E 1099-MED — C 1099-OID — D 1099-PATR — 7 1099-NEC — Q 1099-UC — P 1087-DIV — 2 1087-INT — M 1087-MISC — G 1087-MED — K 1087-OID — H Agriculture Subsidy Payments — 4
18-24	Amount Indicator	Variable	Required. The amount code entered for a given return indicates the type(s) of payment(s) which were made. Example: If position 17 of the Payer/Transmitter "A" Record is 6 (for 1099-INT) and positions 18-24 are "24bbbbb", this indicates that two amount fields are present in all the following Payee "B" Records. The first field contains interest from Savings and Loan Association and the other contains Amount of forfeiture.
	Amount Indicator Form 1099R		For Reporting Payments on Form 1099R:

Tape Position	Field Title	Length	Description and Remarks

Amount Code — *Amount Type*

1 Amount includable as income (add amounts for codes 2, 3, and 4). *MUST BE GROSS AMOUNT.*
2 Capital gain (for lump-sum distributions only).
3 Ordinary income.
4 Premiums paid by trustee or custodian for current insurance.
5 Employee contributions to profit-sharing or retirement plans.
6 Amount of IRA distributions (do not include code 4 amount).
7 Net unrealized appreciation in employer's securities.
8 Other

Example: If position 17 of the Payer/Transmitter "A" Record is 9 (for 1099R), and positions 18-24 are "1354bbb", this indicates that 4 amount fields are present in all the following Payee "B" Records. The first field represents Amount includable as income; the second, Ordinary income; the third, Premiums paid by trustee or custodian for current insurance; the fourth, Employee contributions to profit-sharing or retirement plans.

Please Note: If you are reporting IRA distributions using amount code 6, only one payment amount may be present—all others *must* be blank.

Amount Indicator Form 1099-DIV

For Reporting Payments on Form 1099-DIV:

Amount Code — *Amount Type*

1 Gross dividends and other distributions on stock (*must* be gross amount).
4 Dividends qualifying for exclusion (included in amount for code 1).
5 Dividends not qualifying for exclusion (included in amount for code 1).
6 Capital gain distributions.
7 Non-taxable distribution (if determinable).
8 Foreign tax paid (if eligible for foreign tax credit).

Example: If position 17 of the Payer/Transmitter "A" Record is 1 (for 1099-DIV) and positions 18-24 are "16bbbbb", this indicates that 2 amount fields are present in all the following Payee "B" Records. The 1st field represents Gross dividends and other distributions on stock; the 2nd, Capital gain distributions.

Please Note: The sum of the amounts for codes 4 and 5 *must* equal that for code 1. Amounts for codes 6 and 7 must be included in that for code 1; however, they will not necessarily equal that for code 1.

Amount Indicator Form 1099-INT

For Reporting Payments on Form 1099-INT:

Tape Position	Field Title	Length	Description and Remarks

Amount Code — *Amount Type*

- 2 — Earnings from savings and loan associations, credit unions, etc.
- 3 — Other interest on bank deposit (Do not include amounts reported for code 2).
- 4 — Amount of forfeiture
- 9 — Foreign tax credit

Example: If position 17 of the Payer/Transmitter "A" Record is 6 (for 1099-INT), and positions 18-24 are "34bbbbb", this indicates that 2 amount fields are present in all the following Payee "B" Payee Records. The 1st field represents Other interest on bank deposits, etc.; the 2nd, Amount of forfeiture.

Please Note: Do not subtract the amount for code 4 from the amount in code 2 or 3 (for certificates of deposit only).

Amount Indicator Form 1099-MISC

For Reporting Payments on Form 1099-MISC:

Amount Code — *Amount Type*

- 1 — Royalties
- 2 — Prizes and awards (No Forms W-2 or 1099-NEC items)
- 5 — Rents
- 6 — Other fixed or determinable income

Example: If position 17 of the Payer/Transmitter "A" Record is "A" (for 1099-MISC) and positions 18-24 are "125bbbb", this indicates that 3 amount fields are present in all the following Payee "B" Records. The 1st field represents Royalties; the 2nd, Prizes and awards, and the 3rd, Rents.

Amount Indicator Form 1099L

For Reporting Payments on Form 1099L:

Amount Code — *Amount Type*

- 1 — Cash
- 2 — Fair market value at date of distribution

Example: If position 17 of the Payer/Transmitter "A" Record is "E" (for 1099L) and positions 18-24 are "1bbbbbb", this indicates that 1 amount field is present in all the following Payee "B" Records. This amount field represents Cash.

Amount Indicator Form 1099-MED

For Reporting Payments on Form 1099-MED:

Amount Code — *Amount Type*

- 1 — Total medical and health care payments

Example: If position 17 of the Payer/Transmitter "A" Record is "C" (for 1099-MED), positions 18-24 must be "1bbbbbb". This indicates one amount field is present in all the following

Tape Position	Field Title	Length	Description and Remarks
			Payee "B" Records and represents Total medical and health care payments. *No other coding is permissible for this type of payment.*
	Amount Indicator Form 1099-OID		For Reporting Payments on Form 1099-OID: *Amount Code* — *Amount Type* 1 — Total original issue discount in 1980 for all holders of discount obligations from financial institutions 2 — Total original issue discount in 1980 for all holders of corporate obligations 3 — Issue price of obligation 4 — Stated redemption price at maturity 5 — Ratable monthly portion *Example:* If position 17 of the Payer/Transmitter "A" Record is "D" (for 1099-OID), and positions 18-24 are "134bbbb", this indicates that all three amount fields are present in all the Payee "B" Records following. The 1st field represents total original issue discount in 1980 for all holders of discount obligations from financial institutions; the 2nd Issue price of obligation; and the 3rd Stated redemption price at maturity.
	Amount Indicator Form 1099-PATR		For Reporting Payments on Form 1099-PATR: *Amount Code* — *Amount Type* 1 — Patronage dividends 2 — Nonpatronage dividends 3 — Per-unit retain allocations 4 — Redemption of nonqualified notices and retain allocations *Example:* If position 17 of the Payer/Transmitter "A" Record is "7" (for 1099-PATR) and positions 18-24 are "134bbbb", this indicates that 3 amount fields are present in all the following Payee "B" Records. The 1st field represents Patronage Dividends; the 2nd, Per-Unit Retain Allocations; the 3rd, Redemption of Nonqualified Notices and Retain Allocations.
	Amount Indicator Form 1099-NEC		For Reporting Payments on Form 1099-NEC: *Amount Code* — *Amount Type* 1 — Fees, commissions, and other compensation *Example:* If position 17 of the Payer/Transmitter "A" Record is "Q" (for 1099-NEC), positions 18-24 must be "1bbbbbb". This indicates one amount field is present in all the following Payee "B" Records and represents Fees, commissions and other compensation. *No other coding is permissible for this type of payment.*
	Amount Indicator Form 1099-UC		For Reporting Payments on Form 1099-UC:

Tape Position	Field Title	Length	Description and Remarks
			Amount Code — *Amount Type* 1 — Total unemployment compensation payments *Example:* If position 17 of the Payer/Transmitter "A" Record is "P" (for 1099-UC), positions 18-24 must be "1bbbbbb". This indicates one amount field is present in all the following Payee "B" Records and represents Total unemployment compensation payments. *No other coding is permissible for this type of payment.*
	Amount Indicator Form 1087-DIV		For Reporting Payment on Form 1087-DIV: *Amount Code* — *Amount Type* 1 — Gross dividends and other distribution on stock 2 — Dividends not qualifying for exclusion (included in amount for code 1) 3 — Capital gain distributions (included in amount of code 1) 4 — Foreign tax paid (if eligible for foreign tax credit) *Example:* If position 17 of the Payer/Transmitter "A" Record is "2" (for 1087-DIV) and positions 18-24 are "12bbbbb", this indicates that two amounts fields are present in all the following Payee "B" Records. The 1st field represents Gross dividends and other distributions on stock; the 2nd, Dividends not qualifying for exclusion (included in amount for code 1). Please Note: The sum of the amounts for codes 2 and 3 must equal that for code 1.
	Amount Indicator Form 1087-INT		For Reporting Payments on Form 1087-INT: *Amount Code* — *Amount Type* 1 — Earnings from savings and loan associations, credit unions, etc. 2 — Other interest on bank deposits, etc. (Do not include amounts reportable under Amount Code 1.) 3 — Foreign tax paid (if eligible for foreign tax credit) 4 — Amount of forfeiture *Example:* If position 17 of the Payer/Transmitter "A" Record is "M" (or 1087-INT) and positions 18-24 are "123bbbb", this indicates that all 3 amount fields are present in all the Payee "B" Records. The 1st field represent Earnings from savings and loan associations, credit unions, etc.; the 2nd, Other interest on bank deposits, etc.; and 3rd, Foreign tax paid. Please Note: Do not subtract the amount for code 4 from the amount in code 2 or 3.
	Amount Indicator Form 1087-MISC		For Reporting Payments on Form 1087-MISC:

Tape Position	Field Title	Length	Description and Remarks
			Amount Code — *Amount Type* 1 Royalties 2 Prizes and awards (No Forms W-2 or 1099-NEC items) 3 Rents 4 Other fixed or determinable income *Example:* If position 17 of the Payer/Transmitter "A" Record is "G" (for 1087-MISC) and positions 18-24 are "13bbbbb", this indicates that 2 amount fields are present in all the following Payee "B" Records. The 1st field represents Royalties; the 2nd, Rents.
	Amount Indicator Form 1087-MED		For Reporting Payments on Form 1087-MED: *Amount Code* — *Amount Type* 1 Total medical and health care payments *Example:* If position 17 of the Payer/Transmitter "A" Record is "K" (for 1087-MED), positions 18-24 must be "1bbbbbb". This indicates one amount field is present in all the following Payee "B" Records and represents Total medical and health care payments. *No other coding is permissible for this type of payment.*
	Amount Indicator Form 1087-OID		For Reporting Amounts on Form 1087-OID: *Amount Code* — *Amount Type* 1 Total original issue discount in 1980 for all holders of discount obligations from financial institutions 2 Total original issue discount in 1980 for all holders of corporate obligations 3 Issue price of obligation 4 Stated redemption price at maturity 5 Ratable monthly portion *Example:* If position 17 of the Payer/Transmitter "A" Record is "H" (for 1087-OID), and positions 18-24 are "134bbbb", this indicates that three amount fields are present in all the Payee "B" Records. The 1st field represents total original issue discount in 1980 for all holders of discount obligations from financial institutions; the 2nd, issue price of obligation; and the 3rd, stated redemption price at maturity.
25	Savings and Loan Code	1	Enter "S" if the payer is a savings and loan, building and loan, mutual savings bank, or credit union. If the payer is none of these, enter blank.
26	Blank	1	Enter blank.
27	Surname Indicator	1	Enter "1" if the payees' surnames appear first in the name line of the "B" Records. Enter "2" if the payees' names appear last.

RECORD NAME: PAYER/TRANSMITTER "A" RECORD—Continued

Tape Position	Field Title	Length	Description and Remarks
			If business and individual entities are contained in the file, enter blanks.
28-30	"A" Record Length	3	Required. Enter the number of positions allowed for the 'A" Record.
31-33	"B" Record Length	3	Required. Enter the number of positions allowed for the "B" Records. Include positions used for the special data fields, if used.
34	Blank	1	Enter blank.
35-39	Transmitter Control Code	5	Required. Enter the 5-digit Transmitter Control Code assigned by the IRS.
40	Blank	1	Enter blank.
41-120	Payer Name	80	Required. Enter the name of the payer in the manner in which it is used in normal business. *Any extraneous information (such as bond maturity dates)* must *be deleted from the name line* Left justify and fill with blanks.
121-160	Payer Street Address	40	Required. Enter the street address of the payer. Left justify and fill with blanks. If the payer does not have a street address, this field *must* be blank-filled.
161-200	Payer City, State and Zip Code	40	Required. Enter the city, state and zip code of the payer. Left justify and fill with blanks. DO NOT FILL WITH ALL BLANKS OR ALL 9's.
201-280	Transmitter's Name	80	Enter the name of the transmitter in the manner in which it is used in normal business. *The name of the transmitter should be constant through the entire file.* Left justify and fill with blanks.
281-320	Transmitter Street Address	40	Enter the street address of the transmitter. Left justify and fill with blanks. If the transmitter does not have a street address, this field must be blank.
321-360	Transmitter City, State and Zip Code	40	Enter the city, state, and zip code of the transmitter. Left justify and fill with blanks. DO NOT FILL WITH ALL BLANKS OR ALL 9's.

SEC. 5. PAYEE "B" RECORDS

.01 Contains payment record from individual statements. All records must be fixed length. Records may be blocked or unblocked. A block may not exceed 4000 positions. Do not pad unused blocks with blank records.

.02 All payee records must contain correct payee name and address information entered in the fields prescribed in this Part.

.03 The Service must be able to identify the surname associated with the taxpayer identifying number (SSN or EIN) furnished on a statement. The specifications below include a field in the payee records called "Name Control" in which the first four alphabetic characters of the payee surname are to be entered by the payers. In addition, a blank *must* precede the identifying surname in the first name line of all Payee "B" Records unless the surname begins in the first position of the field.

.04 If payers are unable to provide the first four characters of the surname, the specifications permit the submission of statements on magnetic tape with the Name Control Field left blank; however, compliance with the following will facilitate the Service computer programs required to generate the Name Control.

(a) The surname of the payee whose taxpayer identifying number (SSN or EIN) is shown in the Payee "B" Record, *must* be the *only* name in the first name line.

(b) A blank must precede the surname unless the surname begins in the first position of the field.

(c) In the case of multiple payees, only the surname of the payee whose taxpayer identifying number (SSN or EIN) is shown in the Payee "B" Record, must be present in the first name line. Surnames of any other payees in the record must be entered in the second name line.

05. Provision is also made in these specifications for data entries required by state or local governments. This should minimize the Payer/Transmitter's programming burden should payers desire to report on tape to state or local governments.

RECORD NAME: PAYEE "B" RECORD

Tape Position	Field Title	Length	Description and Remarks
1	Record Type	1	Required. Enter "B".
2-3	Payment Year	2	Required. Must be the two last digits of the year for which payments are being reported (e.g. if payments were made in 1980, enter "80"). Must be incremented each year.
4	Category of Distribution (*for reporting IRA income only*)	1	Use *only* for Form 1099R. Identify the category of distribution and enter the applicable code from the table below. *Category* — *Code* Premature distribution (other than codes 2, 3, 4, or 5 below) — 1 Rollover — 2 Disability — 3 Death — 4 Prohibited transaction — 5 Other — 6 Normal — 7 Excess contributions refunded plus earnings on such excess contributions — 8 Transfers to an IRA for a spouse incident to a divorce — 9
5-6	Blank	2	Enter blanks. (Reserved for Service use).
7-10	Name Control	4	Enter the first 4 letters of the surname of the payee. Last names of less than four (4) letters should be left justified, filling the unused positions with blanks. Special characters and imbedded blanks should be removed. If the Name Control is not determinable by the payer, leave this field blank.
11	Type of Account	1	This field is used to identify the data in 12-20 as to Employer Identification Number, Social Security Number, or the reason no number is shown. Enter a "blank" if a taxpayer identifying number is required but unobtainable due to legitimate cause; e.g., number applied for but not received. 1) Enter the digit "1" if the payee is a business or any organization for which an EIN was provided. 2) Enter the digit "2" if the payee is an individual and an SSN is provided in positions 12-20.
12-20	Taxpayer Identifying Number	9	Required. Enter the valid 9-digit taxpayer identifying number of the payee (SSN or EIN, as appropriate). Where an identifying number has been applied for but not received or any other legitimate cause for not having an identifying number, enter blanks. DO NOT ENTER HYPHENS, ALPHA CHARACTERS, OR ALL 9's OR ALL ZEROS.
21-30	Account Number	10	Optional. Payers may use this field to enter the payee's account number. Although this item is optional, its use will facilitate easy reference to specific records in the payer's file, should any questions arise. *Do Not Enter a Customer Identification Number in This Field.*

Tape Position	Field Title	Length	Description and Remarks
31-110	Payment Amount Fields		The number of payment amounts is dependent on the number of Amount Indicators in positions 18-24 of the "A" Record. Each payment amount field *must* contain 10 characters. Do not provide a payment amount field when the Amount Indicator is blank. Each payment amount must be entered in dollars and cents. *Do not enter dollar signs, commas, decimal points, or negative payments.* Example: The Amount Indicator contains 123bbbb. Payee "B" Records in this field should have only three payment amount fields. If Amount Indicator contains 12367bb, the "B" Records should have 5 payment amount fields. Payment amounts MUST be right-justified and unused portions MUST be zero-filled.
31-40	Payment Amount Field 1	10	This amount is identified by the amount code in position 18 of the Payer/Transmitter "A" Record. This entry must always be present.
41-50	Payment Amount Field 2	10	This amount is identified by the amount code in position 19 of the Payer/Transmitter "A" Record. If position 19 of the Payer/Transmitter "A" Record is blank, do not provide for this payment field.
51-60	Payment Amount Field 3	10	This amount is identified by the amount code in position 20 of the Payer/Transmitter "A" Record. If position 20 of the Payer/Transmitter "A" Record is blank, do not provide for this payment field.
61-70	Payment Amount Field 4	10	This amount is identified by the amount code in position 21 of the Payer/Transmitter "A" Record. If position 21 of the Payer/Transmitter "A" Record is blank, do not provide for this payment field.
71-80	Payment Amount Field 5	10	This amount is identified by the amount code in position 22 of the Payer/Transmitter "A" Record. If position 22 of the "A" Record is blank, do not provide for this payment field.
81-90	Payment Amount Field 6	10	This amount is identified by the amount code in position 23 of the Payer/Transmitter "A" Record. If position of the "A" Record is blank, do not provide for this payment field.
91-100	Payment Amount Field 7	10	This amount is identified by the amount code in position 24 of the "A" Record. If position 24 of the "A" Record is blank, do not provide for this payment field.
Next 40 positions after the last Payment Amount Field used	Payee-Name (1st name line) (A blank must precede the surname unless the surname begins in the first position of the field)	40	Required. Enter the name of the payee whose taxpayer identifying number appears in tape positions 12-20 above. If fewer than 40 characters are required, left justify and fill unused positions with blanks. If more space is required, utilize the 2nd Name Line field below. If there are multiple payees, *only* the name of the payee whose taxpayer identifying number has been provided can be entered in this field. The names of the other payees may be entered in the 2nd Name Line field. The order in which the payee's name appears in this field must correspond with the Surname Indicator entered in tape position 27 of the Payer/Transmitter "A" Record. No descriptive or other data is to be entered in this field.

RECORD NAME: PAYEE "B" RECORD—Continued

Tape Position	Field Title	Length	Description and Remarks
Next 40 positions after the 1st Name Line	Payee Name (2nd Name Line)	40	If the payee name requires more space than is available in the 1st Name Line, enter the remaining portion of the name in this field. If there are multiple payees, this field may be used for those payees' names who are *not* associated with the taxpayer identifying number provided in tape positions 12-20 above. Left justify and fill unused positions with blanks. Fill with blanks if this field is not required.
Next 40 positions after 2nd Name Line	Payee Street Address	40	Enter street address of payee. Left justify and fill unused positions with blanks. Address *must* be present. This field *must not* contain any data other than the payee's street address.
Next 40 positions after the street address	Payee City, State and Zip Code	40	Required. Enter the city, state and ZIP code of the payee, in that sequence. Use U.S. Postal Service abbreviations for states. Left justify and fill unused positions with blanks. City, state and ZIP code *must* be present.
Next field after City, State and Zip Code	Special Data Entries		Optional. The last portion of the "B" Record may be used to record information required for State or local government reporting, or for other purposes. The special data entries will begin in positions 201, 211, 221, 231, 241, 251, or 261, depending on the number of payment amount fields included in the record. Special Data Entries may be used to make all records the same length; however, the record length may not exceed 360 positions. Payers should contact their state or local revenue departments for their filing requirements.

NOTE 1: The first name of the Payee shown as beginning the tape position 101 must be shifted to the field immediately following the last payment amount field used. *For example,* if two payment amount fields are used, the first name line field would be shifted to position 51. Succeeding fields would be shifted accordingly. Also see SEC. 11 below for a record layout reflecting 2 payment amount fields.

SEC. 6. END OF PAYER "C" RECORD

.01 The End of Payer "C" Record is a summary record for a given payer. It must be the same length as the "B" Records in the payer's file.

.02 The "C" Record will contain the totals of the payment amount fields and the payees filed by a given payer. The "C" Record must be written after the last payee record for each payer. For each "A" Record on the file, there must be a corresponding "C" Record.

.03 Payers/transmitters must verify the accurary of the totals in the "C" Record and must enter the totals on the transmittal, Form 4804, which will accompany the shipment.

.04 The "C" Record cannot be followed by a Tape Mark

RECORD NAME: END OF PAYER "C" RECORD

Tape Position	Field Title	Length	Description and Remarks
1	Record Type	1	Required. Enter "C".
2-7	Number of Payees	6	Required. Enter the number of payees covered by the payer on this tape reel. Right justify and zero fill.
	Totals from Payment Amount Fields		Right justify and zero fill each Control Total amount. If less than seven amount fields are being reported, zero fill tape fields for Control Totals 3, 4, 5, 6, and 7. Option 1—Enter the grand total of each payment amount field for the given payer of this reel.

RECORD NAME: END OF PAYER "C" RECORD

Tape Position	Field Title	Length	Description and Remarks
			Option 2—If the given payer's file is continued on multiple reels, enter the grand total of each payment amount field for that payer on this tape reel and on prior reel(s).
8-19	Control Total 1	12	
20-31	Control Total 2	12	
32-43	Control Total 3	12	
44-55	Control Total 4	12	
56-67	Control Total 5	12	
68-79	Control Total 6	12	
80-91	Control Total 7	12	
92-end of record	Blanks		Enter blanks.

SEC. 7. END OF REEL "D" RECORD —OPTIONAL

0.1 The End of Reel "D" Record will be present for Option 1 only. It must be the same length as the "B" Records.

.02 Write this record when the end of the normal writing area of the reel has been reached, but all the records of the file have not been written. This record indicates that there are additional reels in the file.

.03 Each "D" Record must contain a count of payees and totals of each payment amount reported for all "B" Records not summarized in the preceding "C" Records on the reel.

.04 If you do not wish to use a "D" Record, or your system is unable to generate it, you may delete it; however, the last "B" Record on the tape reel *MUST* be followed by a Tape Mark.

SEC. 8. END OF TRANSMISSION "F" RECORD

.01 The "F" Record is a summary of the number of payers and tapes in the entire file.

.02 This record should be written after the last "C" Record.

.03 Only a Tape Mark or a Tape Mark and Trailer Label may follow the "F" Record.

.04 The "F" Record *must* be the same length as the "B" Records.

RECORD NAME: END OF TRANSMISSION "F" RECORD

Tape Position	Field Type	Length	Description and Remarks
1	Record Type	1	Required. Enter "F".
2-5	Number of Payers	4	Required. Enter the total number of payers in the transmission. Right justify and zero fill.
6-8	Number of Tapes	3	Required. Enter the total number of tapes in the transmission.
9-30		22	Right justify and zero fill.
31-end of record			Required. Enter zeroes. Enter blanks.

SEC. 9. TAPE LAYOUTS—OPTION 1

The following charts show, by type of file, the record types to be used in the first two and the last three records written on a tape reel when only one type of document (file) is reported on a reel or series of reels.*

Type of File	1st record type	2nd record type	2nd from last record type	Next to last record type	Last record type
Single payer, single reel	A	B	B	C [1]	F
Single payer, multiple reels:					
Reel 1	A	B	B	B	TM [2]
Last reel	A	B	B	C [1]	F
Multiple payers, single reel:					
Payer 1	A	B	B	B	C [1]
Payer 2	A	B	B	B	C [1]
Last payer	A	B	B	C [1]	F
Multiple payers, multiple reels: First payer's records split between reel 1 and reel 2; second payer's records split between reel 2 and reel 3:					
Reel 1: Payer 1	A	B	B	B	TM [2]
Reel 2:					
Payer 1	A	B	B	B	C [1]
Payer 2	A	B	B	B	TM [2]
Reel 3:					
Payer 2	A	B	B	B	C [1]
Payer 3	A	B	B	C [1]	TM [2]
Reel 4: Last Payer	A	B	B	C [1]	F
Multiple payers, single transmitter, separate files for each payer:					
File 1: Payer 1: Last reel	A	B	B	C [1]	F
File 2: Payer 2:					
Reel 1	A	B	B	B	TM [2]
Last reel	A	B	B	C [1]	F
File 3: Payer 3: Last reel	A	B	B	C [1]	F
Single payer, multiple transmitter (payer submits files from various locations):					
Payer 1:					
Location 1: Last reel	A	B	B	C [1]	F
Location 2: Last reel	A	B	B	C [1]	F
Single payer, multiple transmitter, etc.:					
Location 3:					
Reel 1	A	B	B	B	TM [2]
Reel 2	A	B	B	B	TM [2]
Last reel	A	B	B	C [1]	F

[1] Must contain "Number of Payers" and "Control Totals" summarizing all Payee Records written for this Payer on this reel.
[2] Tape Mark.
*When more than one type of document (file) is reported on a tape reel, there will be a corresponding increase in the series of "A," "B—B" and "C" records since, within a tape reel, a file is equivalent to an "A" record, a series of "B" records and a "C" record for a single payer.

SEC. 10. TAPE LAYOUTS—OPTION 2

(REEL SEQUENCE NUMBER IS IN THE HEADER LABEL).

Where the Header Label is the first record, the following charts show, by type of file, the record types to be used in the 2nd and 3rd records and the last three records written on a tape reel prior to the Trailer label when only one type of document (file) is reported on a reel or series of reels.*

Type of File	1st record type after Header Label	2nd record type after Header Label	2nd from last record type	Next to last record type	Last record type
Single payer, single reel	A	B	B	C [1]!	F
Single payer, multiple reels:					
Reel 1	A	B	B	B	B
Last reel	B	B	B	C [2]	F
Multiple payers, single reel:					
Payer 1	A	B	B	B	C [1]
Payer 2	A	B	B	B	C [1]
Last payer	A	B	B	B	B
Multiple payers, multiple reels; first payer's records split between reel 1 and reel 2; second payer's records split between reel 2 and reel 3:					
Reel 1: Payer 1	B	B	B	B	C [3]
Reel 2:					
Payer 1	A	B	B	B	B
Payer 2	A	B	B	C [1]	F
Reel 3:					
Payer 2	B	B	B	B	C [3]
Payer 3	A	B	B	C [3]	A
Reel 4:					
Payer 4	B	B	B	C [3]	F
Multiple payers, single transmitter, separate files for each payer:					
File 1: Payer 1: Last reel	B	B	B	C [2]	F
File 2: Payer 2:					
Reel 1	A	B	B	B	B
Last reel	B	B	B	C [2]	F
Single payer, multiple transmitter (payer submits files from various locations):					
Each Location:					
1st reel	A	B	B	B	B
Last reel	B	B	B	C [2]	F
Single payer, multiple transmitter, etc.:					
Location 3:					
Reel 1	A	B	B	B	B
Reel 2	B	B	B	B	B
Last reel	B	B	B	C [2]	F

[1] Must contain "Number of Payees" and "Control Totals" summarizing all Payee "B" Records written for this payer on this reel.
[2] Must contain "Number of Payees" and "Control Totals" summarizing all Payee "B" Records written for this payer on this reel and on prior reel(s).
[3] Must contain "Number of Payees" and "Control Totals" summarizing all Payee "B" Records written for this payer on this reel and for this payer on the prior reel(s).
*When fore than one type of document (file) is reported on a tape reel, there will be a corresponding increase in the series of "A," "B—B" and "C" records since, within a tape reel, a file is equivalent to an "A" record, a series of "B" records and a "C" record for a single payer.

Sec. 11. Effect on other Documents

Rev. Proc. 79-66 is superseded.

Exhibit "A"

Form **4419** (Revised October 1980) Department of the Treasury Internal Revenue Service	**Application for Magnetic Media Reporting of Information Returns**	IRS Use Only TCC:

1. Please fill in this form and send to:

Internal Revenue Service Center

2. Name and address of organization *(street, city, State and ZIP code)*

3. Payment year for which you plan to begin reporting on magnetic media: _____

4. Employer identification number

5. Kind of magnetic media you plan to submit: *(check one)*

☐ Tape ☐ Diskette

☐ Disk pack ☐ Cartridge disk

6. Person to contact about this request

Name:

Title:

Telephone number *(include area code)*

7. **Documents To Be Reported**

Form	Estimated Volume		Form	Estimated Volume	
	Magnetic media	Paper		Magnetic media	Paper
☐ 1099-DIV			☐ 1087-DIV		
☐ 1099-INT			☐ 1087-INT		
☐ 1099-MISC			☐ 1087-MISC		
☐ 1099-MED			☐ 1087-MED		
☐ 1099-OID			☐ 1087-OID		
☐ 1099-R			☐ 1042S		
☐ 1099-L			☐ 1099-NEC		
☐ 1099-PATR			☐ 1099-UC *(for use by States only)*		

8. **Kind of equipment on which media will be prepared**

Main frame *(all media types)*		Drive unit *(all media)*	
Manufacturer	Model	Manufacturer	Model

Tape only			All media types
Width	Tracks ☐ 7 ☐ 9	Density	Recording code (e.g., FBCDIC, BCD, or ASCII)

9. **Internal Revenue Service office where paper information returns, if any, will be filed**

Form 1099 Series	Form 1087 Series	Form W-2G

10. If your firm is acting as agent, please list the name and employer identification number of each payer on a separate sheet and attach it to this application.

11. Person responsible for preparation of tax reports.	Name *(type or print)*	Title
	Signature	Date

Form **4419** (Rev. 10-80)

Instructions for Form 4419

Payers or agents who decide to file information returns on magnetic media must complete Form 4419 to receive authorization for filing. Please be sure to complete all appropriate blocks as explained in the following instructions:

Block 2: Enter the name and complete address of the person or organization that will prepare and submit the magnetic media.

Block 3: Show the tax (payment) year for which you intend to begin filing information returns on magnetic media.

Block 5: Check the kind of magnetic media you plan to submit. If you plan to submit more than one kind of magnetic media, you should complete a separate application for each kind.

Block 7: Check the boxes next to all of the information returns you file with the Internal Revenue Service.

a. Magnetic media column: Enter the total number of individual information returns to be reported on magnetic media (an estimate is acceptable).

b. Paper column: Enter the total number of individual information returns to be reported on paper if all returns will not be filed in magnetic media form (an estimate is acceptable). In BLOCK 9 indicate the IRS office where you will file the paper returns.

Block 10: If your firm is preparing information returns on magnetic media for payers other than itself, attach to your application a list of the names and employer identification numbers of the payers. If you add or delete any payers from your file, you *must* submit an updated list of payers.

Block 11: The form must be signed and dated by an official of the company or organization requesting authorization to report on magnetic media.

Filing Your Application

1. The completed application and any attached lists should be mailed to the Internal Revenue Service Center at the address shown in BLOCK 1.

2. Upon receipt of the application, we will review it. If it is acceptable, we will send you an authorization letter within 30 days. Do not submit magnetic media until you receive an authorization letter.

3. We encourage new filers to submit test data on magnetic media for review before the filing season. If you want to submit test data, contact the magnetic media coordinator where you file your application.

4. Your authorization will be valid as long as the magnetic media submitted conforms to the specifications of the applicable revenue procedures. However, a new application is required if:

   a. filing is discontinued and then resumed,

   b. there is any change in the equipment listed on the application,

   c. there is any addition or deletion to the list of information returns to be filed on magnetic media.

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also Part I, Sections 61, 3401, 6041; 1.61-2, 31.3401(a)-1, 1.6041-2.)

Rev. Proc. 80-53

SECTION 1. PURPOSE

The purpose of this revenue procedure is to set forth the procedures the Internal Revenue Service will follow to implement the decision of the Supreme Court of the United States in *Central Illinois Public Service Company v. United States*, 435 U.S. 21 (1978), 1978-1 C.B. 310.

SEC. 2. BACKGROUND

.01 In *Central Illinois*, the Supreme Court of the United States held that cash reimbursements for lunch expenses of employees on nonovernight company travel were not wages for purposes of income tax withholding under section 3401(a) of the Internal Revenue Code. The reimbursements were includible in the gross incomes of the employees, but the Court indicated that the requirement to withhold income tax is narrower than the requirement to include in gross income and that the Service's regulations and rulings did not put the employer on notice that it was obligated to withhold income tax on such payments.

.02 Pub. L. No. 95-427, section 1, 1978-2 C.B. 363, 364, as amended by Pub. L. No. 96-167, section 1, 1980-1 C.B. 483, 484, provides that the Treasury Department (Internal Revenue Service) is precluded from issuing final regulations, under section 61 of the Code, that would govern the income tax treatment of fringe benefits, prior to June 1, 1981. In addition, no regulations relating to the treatment of fringe benefits under section 61 are to be proposed that would be effective prior to June 1, 1981. Pub. L. Nos. 95-427 and 96-167 relate only to the issuance of regulations. However, it was also Congressional intent that no revenue rulings or revenue procedures be issued if they altered, or deviated from, in any significant way, the historical treatment of fringe benefits. See H.R. Rep. No. 95-1232, 95th Cong., 2d Sess. 5 (1978), 1978-2 C.B. 365, 366, and S. Rep. No. 96-433, 96th Cong., 1st Sess. 5 (1979), 1980-1 C.B. 486, 488, respectively.

.03 Section 6041 of the Code provides that all persons engaged in a trade or business and making payments in the course of such trade or business to another person of salaries, wages, compensations, remunerations, or other fixed or determinable gains, profits, and income, of $600 or more, in any taxable year must file a return.

.04 Section 1.6041-2 of the Income Tax Regulations provides that payments of compensation other than wages, as defined in section 3401, including the cash value of payments made in any medium other than cash, to an employee by an employer in the course of the trade or business of the employer must be reported on Form W-2, Wage and Tax Statement, if the total of such payments and the amount of the employee's wages required to be reported on Form W-2 aggregates $600 or more in a calendar year. The employer may elect to report the compensation other than wages on a separate Form W-2.

SEC. 3. TREATMENT OF FRINGE BENEFITS UNDER SECTIONS 61, 3401, AND 6041 OF THE CODE

.01 The Internal Revenue Service will continue to follow existing regulations, revenue rulings, revenue procedures, and case law in determining whether particular fringe benefits are compensation includible in gross income under section 61 of the Code.

.02 However, those fringe benefits that the Service will continue to treat as includible in gross income under .01 above will not be treated as wages under section 3401(a) of the Code, if

1 the payments are not the type of benefit treated as wages under the statute, a regulation, a revenue ruling, a revenue procedure, or a court decision; and

2 there is a reasonable basis for the belief that such benefits should not be considered as remuneration for services.

.03 Those fringe benefits that are includible in gross income as compensation under section 61 of the Code, but that are not treated as wages under section 3401(a), must be reported by employers as other compensation on a Form W-2 prepared for each employee if the total of such compensation paid to the employee and the amount of the employee's wages to be reported on Form W-2 aggregates $600 or more in a calendar year. Section 1.6041-2 of the regulations. For example, the cash reimbursements for lunch expenses of employees on non-overnight company travel must be reported, if the total of such compensation paid to the employee and the amount of the employee's wages to be reported on Form W-2 aggregates $600 or more in a calendar year.

SEC. 4. FEDERAL INSURANCE CONTRIBUTIONS ACT AND FEDERAL UNEMPLOYMENT ACT

.01 This revenue procedure has no effect upon the rules for determining whether fringe benefits are wages for purposes of the taxes imposed by the Federal Insurance Contributions Act and the Federal Unemployment Tax Act.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Section 7701; 301.7701-4.)

Rev. Proc. 80-54

SECTION 1. PURPOSE

The purpose of this revenue procedure is to modify and supersede Rev. Proc. 79-1, 1979-1 C.B. 481, by specifying revised conditions that must be present before the Internal Revenue Service will consider issuing advance rulings concerning the classification of organizations as liquidating trusts under section 301.7701-4 of the Procedure and Administration Regulations.

SEC. 2. SCOPE

The operating rules published in this revenue procedure are intended solely to assist taxpayers and their representatives in preparing ruling requests. These operating rules do not define, as a matter of law, the circumstances under which an organization will be classified as a liquidating trust for federal income tax purposes. That determination can be made only after examination of all the facts and circumstances in connection with the operation and activities of the trust. An organization will be considered a liquidating trust if it is organized for the primary purpose of liquidating and distributing assets transferred to it, and if its activities are all reasonably necessary to, and consistent with the accomplishment of that purpose. If the liquidation is unreasonably prolonged or if the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation can be said to be lost or abandoned, the status of the organization will no longer be that of a liquidating trust.

A ruling requested under this revenue procedure will usually be issued if the operating rules in Section 4 of this revenue procedure and the pertinent provisions of the Internal Revenue Code, Income Tax Regulations, revenue rulings and other revenue procedures are complied with.

The authority and general procedures of the National Office and the Offices of the District Directors of the Internal Revenue Service for the issuance of advance rulings and determination letters are outlined in Rev. Proc. 80-20, 1980-1 C.B. 633, and section 601.201 of the Statement of Procedural Rules (26 CFR section 601.201 (1977)). See also Rev. Proc. 80-22, 1980-1 C.B. 654. Careful attention to all of the requirements of these documents will also serve to minimize delays in processing requests for rulings.

SEC. 3. CHANGES

.01 Section 3, "Operating Rules," has been redesignated Section 4.

.02 Former Section 3.02 has been changed to provide that the trust instrument must contain a fixed termination date "generally" not more than three years from the date of creation of the trust.

.03 Former Section 3.04 has been changed to delete the requirement that deposits need be made in banks or savings institutions that are federally insured and to permit short-term investments such as Treasury bills.

.04 Former Section 3.06 has been changed to provide that the trust may not receive transfers of any unlisted stock of a single issuer that "represents 80 percent or more" of the stock of such issuer.

.05 Former Section 3.07 has been deleted.

.06 Former Section 3.08 has been changed to provide that the trustee is required to distribute at least "annually" to known shareholders any proceeds from the sale of assets or income from investments.

.07 Section 4, "Inquiries," has been redesignated Section 5.

SEC. 4. OPERATING RULES

A ruling generally will be issued that an organization is classified as a liquidating trust if the following conditions are met:

.01 The trust is organized for the primary purpose of liquidating the assets transferred to it with no objective to continue or engage in the conduct of a trade or business and its governing instrument so provides.

.02 The trust instrument contains a fixed termination date that is generally not more than three years from the date of creation of the trust and that is reasonable based on all the facts and circumstances.

.03 In the case of a trust created incident to a corporate liquidation, the trustee is selected by the shareholders of record or a court of competent jurisdiction.

.04 The investment powers of the trustee are limited to powers to invest in demand and time deposits in banks or savings institutions, or temporary investments such as short-term certificates of deposit or Treasury bills.

.05 The trust does not receive transfers of any listed stocks or securities, any readily-marketable assets or any operating assets of a going business. The trust does not receive or retain cash in excess of a reasonable amount to meet claims and contingent liabilities.

.06 The trust does not receive transfers of any unlisted stock of a single issuer that represents 80 percent or more of the stock of such issuer and does not receive transfers of any general or limited partnership interests.

.07 The trust is required to distribute at least annually to known shareholders any proceeds from the sale of assets or income from investments.

.08 The ruling request contains representations that the trustee will make continuing efforts to dispose of the trust assets, make timely distributions, and not unduly prolong the duration of the trust.

SEC. 5. INQUIRIES

Inquiries regarding this revenue procedure should refer to its number and should be addressed to the Assistant Commissioner (Technical), Attention: T:I:I, Internal Revenue Service, Washington, D.C. 20224.

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 79-1, 1979-1 C.B. 481, is modified and superseded.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Section 265; 1.265-2.)

Rev. Proc. 80-55

SECTION 1. PURPOSE

The purpose of this revenue procedure is to amplify Rev. Proc. 70-20, 1970-2 C.B. 499 and Rev. Proc. 72-18,

1972-1 C.B. 740, to provide that section 265(2) of the Internal Revenue Code will be applied to disallow deductions for interest paid by commercial banks on certain time deposits made by a state when such deposits are made for a specific period of time and are secured by pledges of tax-exempt obligations.

SEC. 2. BACKGROUND

.01 Rev. Proc. 70-20 sets forth guidelines for taxpayers and field offices of the Internal Revenue Service for the application of section 265(2) of the Code to banks holding tax-exempt state and local obligations. Section 265(2) provides that no deduction shall be allowed for interest on indebtedness "incurred or continued to purchase or carry obligations . . . the interest on which is wholly exempt" from federal income tax.

.02 Section 3.11 of Rev. Proc. 70-20 provides that types of borrowing not specifically dealt with in Rev. Proc. 70-20 are to be decided on the basis of all the facts and circumstances surrounding the borrowings and in light of the general principles set forth in Rev. Proc. 70-20.

.03 A bank deposit secured by tax-exempt obligations is one of the types of borrowings not specifically dealt with in Rev. Proc. 70-20.

.04 Rev. Proc. 72-18 provides guidelines for the application of section 265(2) of the Code to banks in situations not dealt with in Rev. Proc. 70-20. Section 3.01 of Rev. Proc. 72-18 sets forth the general rule that section 265(2) is only applicable where the indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt securities. Accordingly, the application of section 265(2) requires a determination, based on all the facts and circumstances, of the taxpayer's purpose in incurring each item of indebtedness. The taxpayer's purpose may be established either by direct evidence or by circumstantial evidence.

.05 Section 3.03 of Rev. Proc. 72-18 provides that direct evidence of a purpose to carry tax-exempt obligations exists where tax-exempt obligations are used as collateral for indebtedness. "[O]ne who borrows to buy tax-exempts and one who borrows against tax-exempts already owned are in virtually the same economic position. Section 265(2) makes no distinction between them." *Wisconsin Cheeseman v. United States,* 338 F. 2d 420 at 422 (7th Cir. 1968).

.06 In Rev. Proc. 78-34, 1978-2 C.B. 535, the Service amplified Rev. Proc. 70-20 to provide that section 265(2) of the Code will not be applied to disallow deductions for interest paid by commercial banks on borrowings of Treasury tax and loan funds when those borrowings are secured by pledges of tax-exempt obligations. This treatment afforded to borrowings of Treasury tax and loan funds is permitted because the borrowing of such funds, notwithstanding the pledge of tax-exempt obligations, is in the nature of a demand deposit. Also, the availability of these funds is subject to the exclusive discretion of the Treasury. In addition, access to these funds by depository banks is not subject to negotiated rates of interest or any other market factors that normally influence arm's length money market transactions.

SEC. 3. APPLICATION

.01 State law will often permit state funds to be placed on deposit with local banks. The state law generally requires that a contract be entered into designating the rate of interest to be paid on such deposit and the duration of the deposit. The contract may provide, with respect to the duration of the deposit, that funds will remain on deposit for a specified period of time (30 days to 1 year), or it may provide that the availability of the state funds is subject to the exclusive discretion of the state. In addition, the bank may also be required to deposit with the proper state authority certain securities at least equal in market value to the money deposited by the state in that bank. The state law generally lists those securities that are acceptable for this purpose. A bank receiving such deposits often pledges tax-exempt securities as collateral.

.02 A depository bank that holds demand deposits that it has collateralized with tax-exempt obligations is not in virtually the same economic position as one who borrows to buy tax-exempt obligations. That depository bank does not have the unrestricted use of the amount of the borrowed funds because such amount is subject to immediate withdrawal at any moment in time. See Rev. Proc. 78-34.

.03 A depository bank that holds state funds as time-deposits that it has collateralized with tax-exempt obligations is in virtually the same economic position as one who has borrowed to buy tax-exempt obligations. The depository bank knows with certainty that it will have the amount of deposited funds available to it, without restriction, for a fixed period of time. Accordingly, direct evidence of a purpose to purchase or carry tax-exempt obligations exists under section 3.03 of Rev. Proc. 72-18.

.04 Commercial banks that participate in a state program that requires them to bid for state funds, negotiate the rate of interest, and requires the state to leave such deposits for a specified period of time will create an indebtedness of the type described in section 265(2) of the Code. Thus, the interest paid by commercial banks on such deposit will be disallowed under section 265(2).

.05 Commercial banks that participate in a state program in which funds are awarded in the manner described in Rev. Proc. 78-34 and where the placement of such funds is at the discretion of the state do not create indebtedness of the type described in section 265(2) of the Code. Thus, section 265(2) will not be applied to disallow a deduction for interest paid by the commercial banks on such funds.

SEC. 4. PROSPECTIVE APPLICATION

Under the authority of section 7805 (b) of the Code, sections 3.03 and 3.04 of Rev. Proc. 80-55 will be applied prospectively to interest paid on deposits made after May 31, 1981.

SEC. 5. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 70-20 and Rev. Proc. 72-18 are amplified.

SEC. 6. INQUIRIES

Inquiries in regard to this revenue procedure should refer to its number and be addressed to Assistant Commissioner (Technical), Attention TC: C:C, Washington, DC 20224.

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26 CFR 601.602: Forms and instructions. (Also Part I, Sections 164, 901, 1401, 3101, 3111; 1.164-1, 1.901-1, 1.1401-1, 31.3101-1, 31.3111-1; Part III, Section 601.401.)

Rev. Proc. 80-56

SECTION 1. PURPOSE

The purpose of this revenue procedure is to state the procedures for implementing amendments to the Internal Revenue Code that provide for an exemption from social security taxes in cases covered by certain international agreements (sometimes referred to as totalization agreements), and to state the effect that such agreements have on the income tax liability of certain employees and self-employed persons.

SEC. 2. BACKGROUND

.01 Section 1401(c) of the Code, relating to the Self-Employment Contributions Act (SECA), section 3101 (c) of the Code, relating to the employee's share of the taxes imposed by the Federal Insurance Contributions Act (FICA), and section 3111 (c) of the Code, relating to the employer's share of the taxes imposed by the FICA, were added to the Code by section 317(b) of the Social Security Amendments of 1977, 1978-1 C.B. 462, 467.

.02 These provisions grant an exemption from the social security taxes imposed by the SECA and the FICA during any period in which there is in effect an agreement entered into under section 233 of the Social Security Act, 42 U.S.C. section 433 (added by section 317(a) of the Social Security Amendments of 1977) with any foreign country to the extent the wages or self-employment income are subject under such agreement to taxes or contributions under the social security system of such foreign country.

.03 For example, assume that the United States has entered into an international social security agreement with foreign country *X* under section 233 of the Social Security Act. Employee *A*, a citizen of *X*, is employed in the United States by a corporation incorporated in *X* under circumstances that require social security payments to country *X* and that would ordinarily also require payment of the taxes imposed by the FICA. However, because of the agreement between the foreign country and the United States, wages paid to *A* may be exempt from the taxes imposed by sections 3101 and 3111 of the Code.

.04 Section 317(b)(4) of the Social Security Amendments of 1977 provides that, notwithstanding any other provision of law, taxes paid by any individual to any foreign country with respect to any period of employment or self-employment that is covered under the social security system of such foreign country in accordance with the terms of an agreement entered into pursuant to section 233 of the Social Security Act shall not, under the income tax laws of the United States, be deductible by, or creditable against the income tax of, any such individual.

.05 This provision precludes both a deduction from adjusted gross income and a credit against income tax liability under sections 164(a) and 901(b) of the Code, respectively, for taxes paid by any employee or self-employed person with respect to a period of employment or self-employment that is covered under the social security system of such foreign country under the terms of a totalization agreement between the United States and such foreign country.

.06 For example, the social security tax payments made to foreign country *X* in .03 above are neither allowable as a deduction under section 164 (a) nor allowable as a credit under section 901(b) of the Code.

SEC. 3. EXEMPTION FROM SECA TAXES

.01 In order to substantiate an exemption under section 1401(c) of the Code from the taxes imposed by the SECA, the self-employed individual should obtain from a duly authorized official or agency of the foreign country involved a statement—

(1) setting forth the individual's name, address, and taxpayer identifying number,

(2) stating that there is in effect an agreement between the foreign country and the United States under which the self-employment income of the individual is subject to taxes or contributions under the social security system of the foreign country, and

(3) showing the date on which the agreement commenced to apply and, if determined, the ending date.

.02 No particular form is prescribed for this statement. A copy of the statement or other suitable substantiation must be attached to the individual's federal income tax return for each year the agreement is in effect. The taxpayer should enter "Exempt, see attached statement," on the line designated for self-employment tax liability on the taxpayer's income tax return.

.03 The exemption applies to that portion of the taxpayer's net earnings from self-employment that is attributable to that portion of the taxable year that occurs on and after the effective date of the agreement. Thus, for a taxpayer using the cash receipts and disbursements method of accounting the SECA tax liability for the taxable year is determined by computing the taxpayer's net earnings from self-employment for such year without regard to the exemption and

then eliminating any of such amount that results from an excess of income received over deductions paid by the taxpayer on and after the date the agreement becomes effective.

SEC. 4. EXEMPTION FROM FICA TAXES

.01 In order to substantiate an exemption from the taxes imposed by the FICA under sections 3101(c) and 3111(c) of the Code, the employer must obtain a statement issued by a duly authorized official or agency of the foreign country involved—

(1) setting forth the employee's name, as well as the employee's address and taxpayer identifying number, if known,

(2) setting forth the employer's name, address, and taxpayer identifying number, if any,

(3) stating that there is in effect an agreement between the foreign country and the United States under which wages received by or paid to the employee by the employer are subject to taxes or contributions under the social security system of such foreign country, and

(4) showing the date on which the agreement commenced to apply and, if determined, the ending date.

.02 No particular form is prescribed for this statement. It should be retained in the employer's files.

.03 The exemption from the FICA taxes applies to wages paid on and after the effective date of the agreement but not to wages paid before that date. For example, if the agreement is approved and becomes effective on November 1, the wages paid on and after that date may be exempt from FICA taxes during the time the agreement is in effect.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 80-57

SECTION 1. PURPOSE

The purpose of this revenue procedure is to prescribe the procedures to be used by the Internal Revenue Service and taxpayers for resolving issues arising when a taxpayer is or would be subject to inconsistent tax treatment by the Service and the Puerto Rico or Virgin Islands tax authorities. Such issues generally involve: (1) allocations of income, deductions, credits, or allowances between related persons; (2) determination of residency; and (3) determinations of the source of income and related expenses. This revenue procedure does not provide procedures to be used by possession tax authorities.

SEC. 2. BACKGROUND

.01 The Service has in accordance with the Agreements on Coordination of Tax Administration ("Agreements") with the Department of the Treasury of Puerto Rico (Internal Revenue News Release IR-2123, April 25, 1979, Announcement 79-84, 1979-23 I.R.B. 19) and the Department of Finance of the United States Virgin Islands (Internal Revenue News Release IR-1926, December 30, 1977, Announcement 78-21, 1978-7 I.R.B. 42) (hereinafter "the possession tax agencies") established cooperative programs to resolve tax disputes arising from inconsistent positions taken by the Service and the possession tax agencies.

.02 The Agreements provide that when by reason of inconsistent positions taken by the Service and the possession tax agency a taxpayer is or would be subject to inconsistent tax treatment by the two jurisdictions, the Director of International Operations and the designated possession tax official shall endeavor to resolve by mutual agreement any difficulties arising from the application of the tax laws of the United States and the possession. In particular, but not by way of limitation, the Director of International Operations and the designated possession tax official may consult together to endeavor to agree: (a) to the same allocation of income, deductions, credits, or allowance between related persons; (b) to the same determination of residency of a particular taxpayer; or (c) to the same determination of the source of particular items of income.

.03 The Agreements provide that the Director of International Operations will be the representative of the Service to handle exchanges of tax returns and tax return information with the possessions, as well as to develop and coordinate cooperative programs designed to improve the administration and enforcement of both federal and possession tax laws.

.04 Requests for assistance under these mutual agreement procedures should be addressed to the Director of International Operations, Internal Revenue Service, 1325 K Street, N.W., Washington, D.C. 20225.

SEC. 3. PROCEDURES TO BE FOLLOWED

.01 A taxpayer, or a taxpayer with a related person in a possession, that is subject to double taxation because of inconsistent tax treatment by the Service and the possession tax agency may request assistance in accordance with this revenue procedure.

.02 In addition to the tax assistance request, the taxpayer should file a claim for credit or refund of any overpayment of federal tax that was paid on the income in question, provided the period of limitations prescribed under section 6511 of the Internal Revenue Code, with respect to the claim for credit or refund, has not expired. The taxpayer, or a related person in a possession, should also take whatever steps are necessary under the possession tax code to prevent the expiration of the period of limitations with respect to a claim for credit or refund of the possession tax.

.03 When, in conjunction with a request for assistance under this revenue procedure, a taxpayer seeks relief in the form of a credit or refund of either possession or United States tax, the allowance of such relief is subject to the applicable tax and procedural rules of the possession and the United States.

.04 Federal income tax claims are to be made as appropriate, on: Form 1040X, Amended U.S. Individual Income Tax Return; Form 1120X,

Amended U.S. Corporation Income Tax Return; or Form 1041, U.S. Fiduciary Income Tax Return. The taxpayer should indicate on the appropriate form that a request for assistance under the possession mutual agreement procedure has been filed pursuant to this revenue procedure and should attach a copy of such request to that form. The claim should be computed on the assumption that the taxpayer does not qualify for relief through mutual agreement procedures for the year or years in question.

.05 With respect to the computation of the foreign tax credit, either Form 1116, Computation of Foreign Tax Credit, Individual, Fiduciary, or Nonresident Alien Individual, which also covers credits for foreign tax on income received from foreign partnerships and other business organizations, or Form 1118, Computation of Foreign Tax Credit-Corporations, shall be attached to the Form 1040X, Form 1120X, or Form 1041, as appropriate.

.06 If any possession tax issues subject to consideration under the possession mutual agreement procedures are expected to reoccur in the future and if the period for filing Form 1040X, Form 1120X, or Form 1041 is about to expire, the taxpayer should, before the expiration of the period of limitations for the taxable year involved, file a protective claim on Form 1040X, Form 1120X, or Form 1041 and transmit a copy to the Director of International Operations. The claim should describe the expected possession tax agency action and state that the taxpayer plans to file a request for assistance under the possession mutual agreement procedure. If the taxpayer later decides not to file the request, the Director of International Operations should be promptly notified by the taxpayer.

.07 The taxpayer should file a written request for assistance with the Director of International Operations, Internal Revenue Service, 1325 K Street N. W., Washington, D.C. 20225, as soon as the issues are sufficiently developed to indicate that the taxpayer is or would be subject to inconsistent tax treatment by the Service and the possession tax agency. This will: (1) insure consideration while the facts are more easily obtainable; (2) insure adequate time for the representatives of the two jurisdictions to consult and attempt to arrive at an agreement prior to the imposition of any procedural barriers under federal or possession law; and (3) avoid unnecessary delay in the final determination of tax liability.

.08 The Director of International Operations will not accept any taxpayer's request for consideration of a case that is pending in court without the consent of the Chief Counsel of the Service. If the case is pending in the United States Tax Court, the Chief Counsel may in appropriate cases request the court to delay trial pending mutual agreement action. If the case is pending in any other court, the Chief Counsel will consult with the Department of Justice. Final decision on delaying trial rests with the court. Suspension of litigation pending any possession mutual agreement consideration will not relieve the United States taxpayer from any obligation to act with respect to that litigation.

.09 A request for assistance under this revenue procedure shall be signed by the taxpayer or a person having authority to sign the taxpayer's federal income tax returns; shall contain a statement that assistance is requested under the possession mutual agreement procedure; and shall include the following information:

1 the taxpayer's name, address, and employer identification number (individuals not engaged in a trade or business should use their Social Security number) and where applicable the name, address and employer identification number (or for individuals not engaged in a trade or business a Social Security number) of a related person in the United States possession;

2 the taxable year or years in question and the Service Center where the taxpayer's federal income tax return was filed, or if no return was filed, a statement to that effect;

3 when income tax is involved, the type of income at issue (such as salary, dividends, or interest), a description of the transaction, activities, or other circumstances pertinent to the issue and the respective positions taken by the possession tax agency and the taxpayer on the issue raised;

4 the amount of the particular item involved in the issue raised and the amount of the possession tax assessed or proposed for assessment;

5 when applicable, a decription of the control and business relationships between the United States taxpayer and a related person in the possession;

6 when applicable, a statement of the status of the tax liability of the taxpayer and a related person in the possession for the year or years in question, as well as a statement as to whether the taxpayer or related person is entitled to any possession tax incentive or subsidy program benefits for the year or years in question;

7 a copy of any correspondence received from the possession tax agency and also copies of any briefs, protests and other relevant material submitted to the possession tax agency;

8 a copy of possession tax returns for the year or years in question;

9 a statement whether the federal tax return of the United States taxpayer, and where applicable the tax return of a related person in the possession, for the year or years in question were examined, or are in the process of being examined;

10 a statement as to whether a foreign tax credit was claimed in the taxpayer's federal tax return for the taxable year or years in question and, if a credit was claimed, whether it was claimed for all or part of the possession tax paid or accrued with respect to the particular item that is the subject of the request for assistance under a possession mutual agreement procedure;

11 on a separate and single document, a statement that the United States taxpayer consents to the dis-

closure to the designated possession tax official of any or all of the items of information set forth or enclosed in the request for assistance under this revenue procedure; this statement shall be dated and signed by a person having authority to sign the United States taxpayer's federal tax returns; and

12 other pertinent material the taxpayer may wish to supply.

SEC. 4. NOTIFICATION TO TAXPAYER

.01 The taxpayer will be notified whether the facts submitted provide a basis for assistance under the possession mutual agreement procedure.

.02 The Director of International Operations will not assist the taxpayer if:

1 under the facts and circumstances the taxpayer is not entitled to such assistance (for example, the facts do not indicate that inconsistent positions have been taken by the Service and the possession tax agency).

2 the taxpayer indicates unwillingness to accept an agreement under the possession mutual agreement procedure except under conditions that are clearly unreasonable or unfairly prejudicial to the interests of the United States; or

3 the taxpayer does not furnish, upon request, sufficient information to determine the applicability of the possession mutual agreement procedure or otherwise fails to act as required by this revenue procedure.

.03 If the Director of International Operations accepts a request for assistance, the continuing cooperation of the taxpayer is essential. The taxpayer shall supply any additional information needed to resolve the case and keep the Director of International Operations informed as to proceedings in the possession and any other pertinent developments. The taxpayer may also be requested to execute a consent extending the period of limitations on assessment of tax for the taxable year or years in question.

.04 The Director of International Operations will notify a taxpayer requesting assistance under this revenue procedure of any agreement or partial agreement that the Service and the possession tax agency reach with respect to the taxpayer's request. If such agreement or partial agreement is not acceptable to the taxpayer, the taxpayer may pursue all rights to administrative and judicial review otherwise available under the law of the possession and the United States.

.05 When appropriate, in cases covered by this revenue procedure, the taxpayer will be requested to enter into a closing agreement in accordance with sections 6.07 and 6.17 of Rev. Proc. 68-16, 1968-1 C.B. 770.

.06 Rev. Proc. 65-17, 1965-1 C.B. 833, and Amendment I of Rev. Proc. 65-17, 1966-2 C.B. 1211, as amplified by Rev. Proc. 65-31, 1965-2 C.B. 1024, provide that a United States taxpayer must file a request for the treatment provided by Rev. Proc. 65-17 in writing with the appropriate district director before closing action is taken on issues arising under section 482 of the Code that forecloses availability of Rev. Proc. 65-17. Accordingly, if a United States taxpayer desires assistance under this revenue procedure and the benefits provided by Rev. Proc. 65-17, the request filed under this revenue procedure should state that the taxpayer desires the benefits of Rev. Proc. 65-17 before entering into any closing agreement or before any other closing action (as defined in section 4.03 of Rev. Proc. 65-31) is taken.

SEC. 5. EFFECTIVE DATE

This revenue procedure is effective immediately.

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability. (Also Part I, Section 167; 1.167(a)-11.)

Rev. Proc. 80-58

SECTION 1. PURPOSE

In this revenue procedure, the Assistant Secretary (Tax Policy) of the Treasury prescribes certain changes in the Class Life Asset Depreciation Range System. The purpose is to delete existing asset guideline classes 15.1 (Contract Construction Other than Marine) and 15.2 (Marine Contract Construction), which also includes assets used in offshore oil and gas drilling, and to establish two new classes with new depreciation periods and ranges, and annual repair allowance percentages for assets used in construction and in offshore oil and gas drilling. These changes are adopted pursuant to section 1.167(a)-11 of the Income Tax Regulations.

The new asset guideline classes, and associated asset guideline depreciation periods, asset depreciation ranges, and annual asset guideline repair allowance percentages are set forth in Section 2 of this revenue procedure.

SEC. 2. ASSET GUIDELINE CLASSES, ASSET DEPRECIATION RANGES, AND ANNUAL ASSET GUIDELINE REPAIR ALLOWANCE PERCENTAGES

The asset guideline classes, asset guideline periods, asset depreciation ranges, and the annual asset guideline repair allowance percentages are prescribed as set forth on next page.

SEC. 3. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 77-10, 1977-1 C.B. 548, as modified, is further modified by the deletion of existing asset guideline classes 15.1 (Contract Construction Other than Marine) and 15.2 (Marine Contract Construction) and the prescription of two new asset guideline classes 13.0 (Offshore Drilling) and 15.0 (Construction) with new asset guideline periods and asset depreciation ranges and annual asset guideline repair percentages. To be consistent with the aforementioned modifications, the reference to Class 15.2 in asset guideline class 13.2 should now read Class 13.0.

SEC. 4. EFFECTIVE DATE

The revisions set forth in this revenue procedure are effective as of December 29, 1980, the date of publication in the Internal Revenue Bulletin.

Asset Guideline Class	Description of Assets Included	Asset Depreciation Range (in years) Lower Limit	Asset Guideline Period	Upper Limit	Annual Asset Guideline Repair Allowance Percentage
13.0	*Offshore Drilling:* Includes assets used in offshore drilling for oil and gas such as floating, self-propelled and other drilling vessels, barges, platforms, and drilling equipment and support vessels such as tenders, barges, towboats and crew boats. Excludes oil and gas production assets	6	7.5	9	3
15.0	*Construction:* Includes assets used in construction by general building, special trade, heavy and marine construction contractors, operative and investment builders, real estate subdividers and developers, and others except railroads	5	6	7	9

26 CFR 601.602: Forms and instructions. (Also Part I, Section 6012; 1.6012-1.)

Rev. Proc. 80-59

SECTION 1. PURPOSE

The purpose of this revenue procedure is to establish the conditions under which a Presidential appointee who has an interest in a blind trust that meets the requirements of section 202(f)(4)(B) of the Ethics in Government Act of 1978, P.L. 95-521, 92 Stat. 1825 (1978), will be granted permission to have a trustee file the appointee's income tax return and to state the procedure that the trustee must follow in filing the appointee's income tax return.

SEC. 2. CHANGES

This revenue procedure modifies Rev. Proc. 79-43, 1979-2 C.B. 507, by setting forth the requirement that the letter granting permission for the trustee to make the appointee's return and a power of attorney both accompany the appointee's income tax return. It also sets forth the effect the Internal Revenue Service will give the power of attorney.

SEC. 3. BACKGROUND

.01 Section 202(f)(4)(B) of the Ethics in Government Act of 1978 provides that in the case of a trust created for the benefit of an individual appointed by the President, by and with the consent of the Senate, an asset placed in trust will not be considered a financial interest of the individual for purposes of section 208 of title 18, United States Code, and any other conflict of interest statutes or regulations if certain requirements are met including giving the trustee the power to prepare on behalf of the individual the personal income tax return and similar returns which may contain information relating to the trust.

.02 Section 1.6012-1(a)(5) of the Income Tax Regulations, concerning returns made by agents, permits a return to be made by an agent if the taxpayer requests permission, in writing, of the appropriate district director and the district director determines that good cause exists for permitting an agent to make the return. That section provides that whenever a return is made by an agent it must be accompanied by a power of attorney (or copy thereof) authorizing the agent to represent the principal in making the return.

.03 Section 601.502(c)(1) of the Statement of Procedural Rules provides that a power of attorney which specifies the specific act to be performed is required if a taxpayer wishes to authorize his or her representative to perform any of the following acts: (1) Receive (but not endorse or collect) a check in payment of any refund of taxes, penalties or interest; (2) Execute a waiver of restriction on assessment or collection of a deficiency in tax, or a waiver of notice of disallowance of a claim for credit or refund; (3) Execute a consent to extend the statutory period for assessment or collection of a tax; or (4) Execute a closing agreement under section 7121 of the Code.

.04 Section 601.506(a) of the Statement of Procedural Rules provides that any notice or communication (or

a copy thereof) required or permitted to be given to a taxpayer in any matter before the Service shall be given to the taxpayer's recognized representative. However, if such notice or communication contains confidential information with respect to the taxpayer, the notice or communication will be given to the representative only if there is on file with the Service a power of attorney or a tax information authorization in the matter signed by the taxpayer.

SEC. 4. PROCEDURE

.01 A presidential appointee who has an interest in a blind trust that meets the requirements of section 202 (f) (4) (B) of the Ethics in Government Act of 1978 and who requests permission, in writing, of the appropriate district director, for the taxpayer's federal income tax return to be filed by the trustee of the blind trust, will be considered to have shown good cause for receiving permission to have the return filed by the trustee, and will automatically be granted such permission. A separate request must be made for each taxable year.

.02 The trustee must submit with the return a copy of the letter from the Internal Revenue Service granting the trustee permission to sign the appointee's return. In addition, the return must be accompanied by a power of attorney (or copy thereof) that grants the trustee authority to sign the return, to receive (but not endorse or collect) a refund check, to execute a waiver of restriction on assessment or collection, to execute a waiver of notice of disallowance, to execute a consent to extend the period for assessment or collection, and to execute a closing agreement.

.03 All notices or other written communication required or permitted to be given to the appointee will be given to the trustee.

SEC. 5. EFFECTIVE DATE

This revenue procedure is effective as of December 29, 1980, the date of its publication in the Internal Revenue Bulletin.

SEC. 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 79-43 is modified and superseded.

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26 CFR 601.602: Forms and instructions. (Also Part I, Section 3302; 31.3302(c)-1.)

Rev. Proc. 80-60 [1]

SECTION 1. PURPOSE

The purpose of this revenue procedure is to bring up to date the procedure to be followed in computing reductions in the credit against the tax reportable on Form 940, Employer's Annual Federal Unemployment Tax Return, for 1980.

SEC. 2. BACKGROUND

.01 Section 3301 of the Internal Revenue Code imposes an excise tax on employers based on wages paid to employees. Section 3306(a) defines the term "employer" for purposes of the tax imposed by section 3301.

.02 Section 3302 of the Code provides for credits against the tax imposed by section 3301. Reductions in the amount of credit otherwise allowable are provided for in section 3302 (c). Section 3302(c) (2) provides that reductions shall occur if an employer pays wages for services performed in a state that has not restored amounts that were advanced under title XII of the Social Security Act, 42 U.S.C. sections 1321-1324(1976).

.03 Section 3302(c) (2) (A) of the Code, in conjunction with section 3302(d), provides that for each consecutive calendar year beginning with the second consecutive calendar year in which the advances have not been repaid, the reduction is equal to 0.3 percent of the wages (as defined in section 3306(b)) paid.

.04 Section 3302(c) (2) (B) of the Code provides for an additional reduction for the third or fourth consecutive year in which the advances have not been repaid if the average employer contribution rate for such state for the preceding year is less than 2.7 percent. Section 3302(d) (7) provides that the percentage of the additional reduction is determined by the Secretary of Labor.

.05 Section 3302(d) (3) of the Code provides that credit reductions for any year may be forestalled if a state restores to the United States Treasury, before November 10 of that year, the full amount of the advances.

.06 For purposes of the tax imposed by section 3301 of the Code, section 3306(j) (1) provides that the term "State" includes the District of Columbia, the Commonwealth of Puerto Rico, and the Virgin Islands.

SEC. 3. CREDIT REDUCTIONS FOR 1980

.01 As of November 10, 1980, the Commonwealth of Puerto Rico, the Virgin Islands, and the States of Illinois, Maine, and New Jersey had not repaid the advances for the second consecutive year, within the meaning of section 3302(c) (2) of the Code. Therefore, the credit reductions will take effect in the amount of 0.3 percent of the wages (as defined in section 3306(b)) paid by employers during 1980 that are attributable to those "States."

.02 As of November 10, 1980, the District of Columbia and the States of Delaware, Pennsylvania, Rhode Island, and Vermont had not repaid the advances for the third consecutive year, within the meaning of section 3302(c) (2) of the Code. Therefore, the credit reductions will take effect in the amount of 0.6 percent of the wages (as defined in section 3306(b)) paid by employers during 1980 that are attributable to those "States."

.03 As of November 10, 1980, the State of Connecticut had not repaid the advances for the third consecutive year, within the meaning of section

[1] Also released as News Release IR-80-131, dated December 17, 1980.

3302(c)(2) of the Code. Also, the Secretary of Labor has timely certified to the Secretary of the Treasury that in accordance with the provisions of section 3302(c)(2)(B) an additional credit reduction will apply. Therefore, the credit reduction will take effect in the amount of 0.7 percent (0.6 percent for the two consecutive years plus an additional 0.1 percent) of the wages (as defined in section 3306(b)) paid by employers during 1980 that are attributable to the State of Connecticut.

SEC. 4. PROCEDURE

.01 If a credit reduction applies, it is computed on Part I, lines 6 and 7, of the Form 940 for 1980.

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26 CFR 601.401: Employment taxes.

Procedures for exemption from social security taxes under totalization agreements. See Rev. Proc. 80-56, page 851.

Social Security Contribution and Benefit Base

Under authority contained in the Social Security Act, the Secretary, Department of Health and Human Services, has determined and announced (F.R. 76252, dated November 18, 1980) that the contribution and benefit base for remuneration paid in 1981 and self-employment income earned in taxable years beginning in 1981 is $29,700.

Announcement of the Disbarment, Suspension, or Consent to Voluntary Suspension of Attorneys, Certified Public Accountants, Enrolled Agents and Enrolled Actuaries from Practice before the Internal Revenue Service

Under 31 Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent or enrolled actuary, in order to avoid the institution or conclusion of a proceeding for his disbarment or suspension from practice before the Internal Revenue Service, may offer his consent to suspension from such practice. The Director of Practice, in his discretion, may suspend an attorney, certified public accountant, enrolled agent or enrolled actuary in accordance with the consent offered.

Attorneys, certified public accountants, enrolled agents and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by or sharing fees with, any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify practitioners under consent suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent or enrolled actuary, and the date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended and will later be consolidated and published in the Cumulative Bulletin.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Term of Suspension
John H. Frazier	Nashville, TN	Certified Public Accountant	Fifteen months effective June 16, 1980
Clifford Y. Pierce	Miami, FL	Certified Public Accountant	Indefinite effective June 13, 1980
Robert L. Hamersley	Boise, ID	Certified Public Accountant	Indefinite from July 7, 1980
Daniel C. Lukensow	Arcadia, CA	Enrolled Agent	Eighteen months effective July 28, 1980
Ralph D. Lider	New Bedford, MA	Attorney	Indefinite effective August 18, 1980
Anthony G. Bellas	Littleton, CO	Enrolled Agent	Twelve months effective September 1, 1980
Roy W. Lynch	New Bedford, MA	Enrolled Agent	Indefinite effective August 28, 1980
Roger C. Hennings	Stillwater, MN	Attorney	Indefinite effective August 28, 1980
Vincent E. Heyworth	Hagerstown, MD	Enrolled Agent	Six months effective September 30, 1980

Name	Address	Designation	Term of Suspension
H. Jim Uchida	Oakland, CA	Certified Public Accountant	Indefinite effective November 5, 1980
Stanley E. Galkin	Fort Worth, TX	Attorney	Indefinite effective November 17, 1980

Under Section 1026, Title 31 of the United States Code (1970 ed.), the Secretary of the Treasury, after due notice and opportunity for hearing, is authorized to suspend or disbar from practice before the Internal Revenue Service any person who has violated the rules and regulations governing the recognition of attorneys, certified public accountants, enrolled agents or enrolled actuaries to practice before the Internal Revenue Service.

Attorneys, certified public accountants and enrolled agents are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by or sharing fees with, any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify such disbarred or suspended practitioners, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been disbarred or suspended from such practice, their designation as attorney, certified public accountant, enrolled agent or enrolled actuary, and the date of disbarment or period of suspension. This announcement will appear and will continue to appear in the weekly Bulletins for five successive weeks for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended or disbarred and will later be consolidated and published in the Cumulative Bulletin.

After due notice and opportunity for hearing, the following individual has been disbarred from further practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
J. Franklin Moore	Lenoir, NC	Certified Public Accountant	August 18, 1980

Announcement of the Suspension, Termination, or Consent to Voluntary Suspension or Termination of Enrollment to Perform Actuarial Services Under the Employee Retirement Income Security Act of 1974

Under 20 Code of Federal Regulations, Part 901, an enrolled actuary, in order to avoid the initiation or conclusion of a suspension or termination proceeding, may offer his/her consent to suspension of enrollment. The Executive Director, Joint Board for the Enrolment of Actuaries, may suspend enrolment in accordance with the consent offered. An enrolled actuary whose enrollment is suspended is prohibited from performing actuarial services under the Employee Retirement Income Security Act of 1974 (ERISA) during the period of suspension.

To enable employees of the Internal Revenue Service and others to identify enrolled actuaries under suspension, the Executive Director will announce in the Internal Revenue Bulletin the names and addresses of enrolled actuaries who have been suspended. This announcement will appear in the weekly Bulletin at the earliest practicable date following suspension and will continue to appear in the weekly Bulletin for at least three successive weeks for each enrolled actuary so suspended and will later be consolidated and published in the Cumulative Bulletin.

Mr. Charles L. Cormack, Birmingham, Alabama, has been placed under consent suspension from enrollment to perform actuarial services under ERISA. An announcement of his reinstatement will be placed in the Bulletin at the end of the period of suspension.

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Key to Abbreviations:

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RP	Revenue Procedure
TD	Treasury Decision
CD	Court Decision
PL	Public Law
EO	Executive Order
DO	Delegation Order
TDO	Treasury Department Order
TC	Tax Convention
SPR	Statement of Procedural Rules
PTE	Prohibited Transaction Exemption

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