

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 8672
930 SCOMM32: AK GENERAL STOCK OWNERSHIP CORP. 1979-80 930

registration requirement of the 33 Act if any of the several statutory exemptions from those requirements is applicable.^{*/} It is quite possible that the distribution of shares in the GSOC can qualify for the "intrastate offering" exemption provided in section 3a(11) of the 33 Act for:

"any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a . . . corporation, incorporated by and doing business within, such State or Territory."^{***}/

^{*/} Although certain classes of securities and certain classes of transactions are exempt from the registration and prospectus delivery requirements of the 33 Act, they remain subject to the antifraud provisions of the 33 Act, including specifically §§ 12 and 17. The exemptions from registration set forth in §§ 3 and 4 of the 33 Act do not relieve an issuer of the registration requirements of the Securities Exchange Act of 1934 (the "34 Act") nor of the duty to comply with the antifraud provisions of that Act. United States v. Tallant, 547 F.2d 1291, 1297 (5th Cir.), cert. denied, 434 U.S. 889 (1977).

^{**}/ 33 Act, § 3(a)(11). Another exemption is set out in § 3(a)(2) of the 33 Act, which exempts "any security issued . . . by any public instrumentality of one or more States or Territories" This "public instrumentality" exemption would not appear applicable since § 601 of the Revenue Act of 1978 provides that, for purposes of the Internal Revenue Code, "a GSOC shall be treated as a private corporation and not as a governmental unit."

^{***}/ The exemption does not derive from any jurisdictional limit on the SEC's powers, since the federal laws can apply to any transaction using any facility of interstate commerce.

This exemption has become the subject of rule 147, which in an effort to define a "safe harbour" for those seeking the benefit of 3(a)(11) explains the particular elements which make up the exemption.^{*/} The section and the rule contain nothing to suggest that either is inapplicable to a GSOC, the shares in which can be owned only by residents of the chartering state, and which is unlikely to do business outside the state in question. Accordingly, if the strictures of the section and rule are observed, the securities of a GSOC can be issued without compliance with the registration and prospectus provisions of the 33 Act.

^{*/} The SEC's rule (17 C.F.R. § 230.147) provides that an issuer shall be deemed to be doing business within a state if its principal office is there and if it derives more than 80% of its gross revenues from the state, has 80% of its assets there, and intends to use 80% of the proceeds from the issue there. In addition, the rule restricts resale to purchasers who are residents of the state for 9 months after the last sale by the issuer; the GSOC restriction is more severe, never allowing sale to nonresidents. A GSOC might, theoretically, hold more than 20% of its assets outside the state, if it invested in an external project, but this seems unlikely as a practical matter.

ii) Possibilities for legislative exemption.

GSOC sponsors also could seek special legislation to exempt ^{*/} shares in a GSOC from the 33 Act by a provision such as that contained in the Alaska Native Claims Settlement Act, 43 U.S.C. § 1625, discussed infra at pp. 23-26. ^{**/} Since the central purpose of the 33 Act

^{*/} A blanket legislative exemption -- unlike the exemptions in § 3 of the Act -- might also provide relief from the federal antifraud provisions of the 33 Act. Most states, however, have antifraud regulations which would apply to a GSOC. See, e.g., § 45.55.010 of the Alaska Blue Sky law.

^{**/} See also the Asian Development Bank Act, which provides that "[a]ny securities issued by the Bank . . . shall be deemed to be exempted securities within the meaning of subsection (a)(2) . . ." of section 3 of the 33 Act. 22 U.S.C. § 285h(a).

As an alternative to a complete legislative exemption, the SEC could be given special rulemaking power to tailor reporting requirements to the unique situation of a GSOC. For example, the Asian Development Bank Act provides:

"The Bank shall file with the Securities and Exchange Commission such annual and other reports with regard to such securities as the Commission shall determine to be appropriate in view of the special character of the Bank and its operations and necessary in the public interest or for the protection of investors." 22 U.S.C. § 285h(a).

The SEC is given authority in 22 U.S.C. § 285h(b) to suspend operation of the filing requirement. The SEC's regulations with respect to filings by the Asian Development Bank are found at [1978] 1 Fed. Sec. L. Rep. (CCH) ¶ 2025.

is to provide information so that an investor can make an informed decision whether to invest in securities being distributed by an issuer, a statutory exemption from the registration requirements of the 33 Act does not seem unreasonable, especially if the initial distribution of GSOC shares is free. An argument along these lines is even more persuasive if disclosure comparable to that required by the 34 Act, discussed below, is provided to the public once the opportunity to buy and sell GSOC shares arises at the end of five years.

b) Securities Exchange Act of 1934.

i) The statute and its application.

Among other things, the Securities Exchange Act of 1934 (the "34 Act"), extends the disclosure obligations of the 33 Act to the trading of securities after their initial distribution. The 34 Act requirements can apply whether the securities are (a) listed and traded on a national exchange or (b) unlisted and sold in the so-called "over-the-counter" market. The criteria which require filing include either (a) a prior 33 Act registration (§ 15(d)) or (b) 500 shareholders and \$1 million in assets (§ 12(g)). For securities to which it

applies, the 34 Act requires the filing with the SEC of information on certain registration forms; the information is comparable to that required by the 33 Act. After an initial filing, the 34 Act requires periodic "updating" reports to the SEC of financial and other information. In addition, issuers whose securities are required to be registered under the 34 Act may not solicit proxies (allowing management or anyone else to vote shares of investors at an annual meeting or to effect any corporate action which under state law must be accomplished by shareholder vote) unless they do so in compliance with the proxy rules of the Commission. Beyond stipulating the form and content of the proxy solicitation material, the proxy rules also allow any shareholder to submit proposals for corporate action for shareholder vote. The 34 Act also provides for the registration and regulation of the national securities exchanges and of brokers, dealers and transfer agents involved in the trading of non-exempt securities. Like the 33 Act, the 34 Act proscribes fraudulent or misleading practices in the purchase or sale of securities.

Although there are provisions in the Act for exemption, we do not believe exemption from the above-described 34 Act provisions can be assured without administrative or legislative action.

ii) Possibilities for exemption --
administrative.

No express statutory exemption in the 34 Act appears applicable to GSOC securities.^{*/} However, the SEC has authority under two separate sections to provide an exemption by administrative action.

*/ Section 3(a)(12) exempts "municipal securities" from all provisions of the 34 Act except those dealing with registration and regulation of brokers and dealers, registration of securities associations, and regulation of associations of brokers and dealers and clearing agencies. However, the definition of "municipal securities" in section 3(a)(29) of the 34 Act appears to apply only to debt securities and therefore not to shares of a GSOC, as it is limited to "direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State" The legislative history confirms that state and municipal bonds were the focus of the section. See, e.g., Hearings before the Senate Banking and Currency Comm. on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.), 73d Cong., 1st Sess. 7543-44 (March 27, 1934). A proposal to substitute "any security issued" for "any direct obligation guaranteed" was rejected. See Hearings before the House Interstate and Foreign Commerce Comm. on H.R. 7852 and H.R. 8720, 73d Cong., 2d Sess. 535 (March 6, 1934). Moreover, it is doubtful whether GSOC shares would be considered as "municipal" since section 601 of the Revenue Act of 1978 provides that a GSOC is a private corporation and not a governmental unit for purposes of the tax laws.

Section 12(h) of the 34 Act provides, in relevant part:

"The Commission may by rules and regulations, or upon application of an interested person, by order, after notice and opportunity for hearing, exempt in whole or in part any issuer or class of issuers from [the registration, reporting and proxy provisions of the 34 Act] . . . any security of which is required to be registered . . . upon such terms and conditions and for such period as it deems necessary or appropriate, if the Commission finds, by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors."

The SEC also has authority under sections 3(a)(12) and 23(a) of the 34 Act to declare the securities of a GSOC "exempted securities." Section 3(a)(12) provides that "exempted securities" includes:

"Such other securities (which may include, among others, unregistered securities, the market in which is predominantly intrastate) as the Commission may, by such rules and regulations as it deems consistent with the public interest and the protection of investors, either unconditionally or upon specified terms and conditions or for stated periods, exempt from the operation of any one or more provisions of this title which by their terms do not apply to an 'exempted security' or to 'exempted securities.'"

Since the anticipated market for the securities of a GSOC will be totally intrastate, the SEC might be convinced to issue some type of conditional or unconditional exemption.^{*/}

iii) Trading Alternatives.

Section 12(g) of the 34 Act will prohibit brokers, dealers and transfer agents from processing trades of GSOC shares in the over-the-counter market unless the securities are registered with the Commission if the securities are not exempted. The traditional mechanisms for creation of a trading market in GSOC shares (the matching of sellers and buyers) thus will not be possible unless exemption from the 34 Act is attained. However, a rule proposed by the SEC provides that persons associated with any issuer of securities shall be deemed not to be brokers solely for performing "the ministerial and clerical work of effecting any transaction" if other tests of the rule are met.^{**/} Hence, it may be possible even lacking total 34 Act exemption to obtain clearance from the SEC that transfers between sellers and the GSOC and buyers and the GSOC

^{*/} Cf. rule 3(a)12-2, 17 C.F.R. § 240.3a12-2, an exemption granted for securities guaranteed and managed by a state or political subdivision.

^{**/} Proposed rule 3a4-1, as proposed in Release No. 34-13195 (January 21, 1977), [1978] 2 Fed. Sec. L. Rep. (CCH) ¶ 21,152.

priced at a pro rata share of the GSOC's current asset value be facilitated by employees of the GSOC -- as long as those employees do not pursue the matching of buyers and sellers and thereby "make" a market.

iv) Possibilities of exemption -- legislative.

Because any administrative exemption from the 34 Act is within the discretion of the SEC, a legislative exemption may be necessary. There are at least two models for such an exemption. The Alaska Native Claims Settlement Act provides for total exemption from the 34 Act during the period that shares cannot be traded, but also accomplishes in large measure the disclosure function of the 34 Act by requiring that the Corporations send an annual report to shareholders. 43 U.S.C. § 1625.^{*/} The Asian Development Bank Act "deemed" the securities of the Bank to be exempt within the meaning of section 3(a)(12) of the 34 Act, but also provided for periodic filings with the Commission. 22 U.S.C. § 285h(a).^{**/}

^{*/} As discussed infra, the exemptions in the Alaska Native Claims Settlement Act only apply until a trading market in the shares commences. Hence, a proposal that the GSOCs be exempt from the 34 Act for the first five years of operation will more likely succeed than a proposal of a permanent exemption.

^{**/} Similar treatment is given securities of the World Bank. [1978] 2 Fed. Sec. L. Rep. (CCH) ¶ 21,200.

c) Investment Company Act of 1940

i.) The statute and its application.

The Investment Company Act of 1940 (the '40 Act") requires the registration of certain companies whose business is principally or entirely investing in the securities of other companies. It also sets forth fiduciary standards for their officers and directors, requires approval by the SEC of certain transactions involving insiders and affiliates of registered companies, provides for shareholder approval of various activities, and otherwise subjects the companies to financial and other disclosure requirements.

A GSOC appears to come within the definition of "investment company" in section 3(a) of the 40 Act, since each GSOC will be a company which "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities"^{*/} or "is engaged or proposes to engage in the

^{*/} The 40 Act's definition of "security" is the broad definition common to the federal securities laws. There may be room to argue that a GSOC's participation in joint ventures is outside the scope of this definition, although the definition specifically includes any "certificate of interest or participation in any profit-sharing agreement . . . or . . . investment contract." Section 2(a)(36).

business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities^{*/} having a value exceeding 40 per centum of the value of such issuer's total assets"

40 Act §§ 3(a)(1) and (3).^{**/} If a GSOC falls within the definition, it is subject to registration and regulation under the 40 Act.

^{*/} "Investment securities" are all securities except government securities, securities of an employees' securities company, and securities of a majority-held subsidiary which is not an investment company. Section 3(a).

^{**/} A GSOC appears to be a closed-end, non-diversified management company under the definitions of sections 4 and 5 of the 40 Act, assuming that shares in a GSOC cannot be redeemed by a resident in exchange for "approximately his proportionate share of the issuer's current net assets" so as to create a "redeemable security" within the meaning of § 2(a)(32) of the 40 Act, and that the GSOC will not invest in a great number of projects nor hold less than a 10% interest in the projects in which it invests.

Any non-management person who for compensation advises the GSOC as to investment decisions may be subject to the Investment Advisers Act unless he can meet the tests of section 203(b)(1) of that Act (1) by having all clients residents of the state where he maintains his principal place of business and (2) by furnishing no advice respecting securities traded on a national exchange.

In addition, if a GSOC comes to own or control 10% or more of the voting securities of an electric public-utility company or a gas utility company (or another holding company) it will become subject to registration and regulation under the Public Utility Holding Company Act of 1935, absent successful application to the SEC for an exemption. Under this Act the Commission can limit a GSOC to a single, integrated public-utility system and incidentally necessary

[Footnote continued on following page]

ii) Possibilities for exemption --
administrative.

The 40 Act does contain statutory exemptions. None of them appears to apply to a GSOC. However, the Act does provide that the SEC, on its motion or by application, may conditionally or unconditionally exempt in whole or in part any person, security, or transaction from any provision or regulation of the 40 Act "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title." § 6(c).

In addition, section 6(d) provides that the Commission "by rules and regulations or order, shall exempt a closed-end investment company from any or all provisions of this title . . ." with or without conditions if certain tests are met. If a GSOC issues its securities without charge, it appears that a GSOC would meet all the tests for this exemption including that "the aggregate sums

[Footnote continued]

business enterprises. The SEC shall exempt a holding company if it and the companies it "holds" operate exclusively or even predominantly in the state of organization under § 3(a)(1) and 17 C.F.R. § 250.2, unless exemption is not in the public interest.

Because of the possible application of the Public Utility Holding Company Act to potential investments of a GSOC, a legislative or administrative exemption from that Act also should be considered.

received by such company from the sale of all its outstanding securities, plus the aggregate offering price of all securities of which such company is the issuer and which it proposes to offer for sale, do not exceed \$100,000." Our review of exemptions issued under § 6(d) indicates that it is probable that if such an exemption were granted, the GSOCs would be freed from many requirements of the Act. For example, the GSOC would not be required to follow the usual registration process; instead, it would be required to file with the SEC a statement of its investment policies. Instead of the usual periodic reporting requirements, a GSOC would be required to file semi-annual reports with its shareholders and the SEC.*

iii) Possibilities for exemption -- legislative.

Because of the uncertainty of obtaining an unconditional administrative exemption from the 40 Act, consideration should be given to seeking legislation including a GSOC in the list of companies that statutorily are exempt under section 3(c) of the 40 Act.

*/ See, e.g., Associated Life Ins. Investors Corp., SEC Investment Company Act Rel. No. 4574 (April 22, 1966); United Life Ins. Sec. Corp., SEC Investment Company Act Rel. No. 4193 (March 17, 1965); I.B.T., Inc., SEC Investment Company Act Rel. No. 3369 (November 23, 1961).

Our Recommendations

a) Questions of Policy.

Opportunities exist to seek administrative or legislative exemption for the GSOCs from SEC regulation. However, the substance of certain federal regulatory provisions governing traditional securities may be desirable in order to promote informed public participation in this new type of private enterprise. A decision should be made at an early stage as to what, if any, federal involvement in GSOC regulation is desirable to further the purposes for which GSOCs were created.

Two goals of the federal securities laws highly relevant to the purposes of the GSOC legislation are:

(1) initial and periodic disclosure of accurate and timely financial and other information to aid the public in making investment decisions and to allow for review of the actions of management; and

(2) a mechanism by which residents can be protected in the exercise of the power given them by state law to participate in control of the investment entity.

The disclosure function is promoted by each of the laws discussed above, but blanket application of these laws to the GSOC may be unduly expensive, burdensome and, in some instances, unnecessary. For example, since the 33 Act is designed primarily to ensure disclosure sufficient to enable an investor to decide whether to invest his funds in the securities of an issuer, the test of disclosure required under the 33 Act and its regulations seems largely irrelevant to the initial distribution of GSOC shares, especially if they are issued without charge. Thus, the disclosure and anti-self-dealing provisions of the 40 Act may be more germane to the GSOCs from their inception. The 34 Act, on the other hand, provides for disclosures to enable an investor to decide whether to buy or sell shares other than in an initial distribution. Since shares may not be transferred for five years (unless a shareholder ceases to be a resident), there should not be any substantial market for GSOC shares during the initial five-year period. Upon expiration of the five-year period, however, disclosure of the kind provided by the 34 Act will become relevant. In spite of the possibilities for exemption, we believe that efforts should be made to disseminate complete and accurate information about a GSOC, its officers and directors, since

dealers in its shares as well as underwriters in its shares remain subject to enforcement action by the SEC, state authorities, and conceivably the Department of Justice, and to civil suit by injured investors if it is determined that fraud was involved in connection with the offer or sale of GSOC shares. It must be recognized that the notion of "fraud" under the securities laws is a very broad concept, and includes not only the dissemination of inaccurate information, but also the failure to disseminate material information necessary in order to make statements not misleading in the context in which they are made. Some courts have found fraud in corporate contexts in which incomplete or misleading disclosures may have arisen through inadvertence, rather than through conscious choice of the persons involved. We believe that disclosure rules specially tailored to the unique nature of the GSOCs could be fashioned to promote these desirable ends at a reasonable cost.

The 34 Act also provides the mechanisms for investor participation in management decisions pursuant to its regulation of solicitation of the votes -- or proxies -- of shareholders. The sponsors should decide how they desire the resident shareholders to exercise the traditional voting powers within the corporation which are given them by operation of state corporate law,

and whether regulation of that method comparable to that provided by the 34 Act and 40 Act is desirable. We believe that protection of shareholder voting rights at a reasonable expense could be accomplished, perhaps through use of the state's ballot process. If the GSOC sponsors agree with the view that reasonable and carefully-tailored regulations designed to promote the ends of disclosure and suffrage should be made a part of the GSOC package, the question remains how to accomplish this end.

b) The Alternative of Legislative Relief.

The Alaska Native Claims Settlement Act, as amended, 43 U.S.C. § 1601 et seq. (the "Settlement Act"), provides an instructive example of a congressional compromise of a range of available options in regulating a unique corporate entity not unlike the GSOC. Under that Act, Congress disbursed federal funds to native peoples of Alaska in settlement of outstanding aboriginal land claims, and authorized the creation under Alaska law of a number of Regional Corporations to administer the funds and oversee land investment on behalf of native residents.

The original legislation, passed in 1971, did not address the question of the applicability of the federal securities laws and regulations to the Regional Corporations, but provided for an annual independent audit of each corporation, the results of which were to be transmitted to each shareholder, to the Secretary of the Interior and to appropriate committees of Congress.^{*/} As a result, the various Corporations were forced to seek individual administrative relief from the SEC.

^{*/} This audit requirement remains in the law as amended. 43 U.S.C. § 1606(o).

An earlier draft of the legislation had, in lieu of the Regional Corporations, provided for two federally chartered corporations, one of which was to handle investments and business functions (the "Investment Corporation"). See Alaska Native Claims Settlement Act, Conference Report, S. Rep. 92-581, 92d Cong., 1st Sess. 41-42 (1971). The Senate bill had provided that those sections of the 40 Act, the Investment Advisers Act, the 33 Act and the 34 Act "relating to public disclosure, reporting, and protection of the interests of stockholders" and "consistent with the purposes of this Act . . ." should be applicable to the activities of the Investment Corporation for 12 years from the date of the Act. However, the Investment Corporation was to be granted statutory authority to apply to the SEC under § 6(c) of the 40 Act for exemption from any provisions of that Act resulting in hardship. In addition, the SEC was to be given explicit rulemaking authority to identify which provisions of any securities laws "consistent with the purposes and provisions of the legislation" would be applied to the Investment Corporation. In addition, the directors were required to prepare an annual report to the SEC including the information required under the ICA and "such additional information" as the SEC would require. Such reports were to be available at the offices of the Corporation, and a summary was to be sent to all shareholders. S. Rep. No. 92-405, 92d Cong., 1st Sess. 20-21, 131 (1971).

In 1975, the Settlement Act was amended to provide for total exemption of the Regional Corporations from operation of the 33 Act, 34 Act and 40 Act for the years during which shares in the Regional Corporations could not be transferred except by divorce, separation or death.

43 U.S.C. § 1625 provides:

"Any corporation organized pursuant to this chapter shall be exempt from the provisions of the Investment Company Act of 1940 (54 Stat. 789), the Securities Act of 1933 (48 Stat. 74), and the Securities Exchange Act of 1934 (48 Stat. 881), as amended, through December 31, 1991. Nothing in this section, however, shall be construed to mean that any such corporation shall or shall not, after such date, be subject to the provisions of such Acts. Any such corporation which, but for this section, would be subject to the provisions of the Securities Exchange Act of 1934 shall transmit to its stockholders each year a report containing substantially all the information required to be included in an annual report to stockholders by a corporation which is subject to the provisions of such Act."

It should be noted that the SEC argued that 40 Act regulation was necessary for the protection of investors and that the Congress nonetheless decided that the Act as well as 33 Act and 34 Act regulation was unnecessarily burdensome and expensive. One reason Congress noted for its decision was that the lack of sophistication of most native residents of Alaska made the elaborate prospectus as required by SEC rules less likely to be useful than the SEC suggested.

Congress also was moved by the assurance that no trading in the shares would occur. It thus decided that application of the 34 Act was unnecessary while the stock could not be transferred. For the first five years, the GSOCs shares will be similarly restricted. However, in the interest of disclosure to the public of relevant information about the Corporations, Congress required an annual report to shareholders -- but not to the SEC -- containing substantially all information required under the annual reports under the 34 Act.^{*/}

Based on the precedent of the Settlement Act, a legislative proposal could be fashioned. However, any legislative proposal might be subject to political opposition as special legislation for the State of Alaska, would have no guarantee of passage and, indeed, might prove unnecessary if an administrative solution can be forged with the SEC.

^{*/} H. Rep. No. 94-729, 94th Cong., 1st Sess. at 17-20 (1975).

c) The Alternative of Administrative Relief.

We propose that representatives of the State of Alaska, on behalf of a proposed GSOC, begin immediate exploration with the SEC of an administrative exemption from the various federal securities laws, conditioned on the undertaking that a GSOC would comply with disclosure and proxy rules specially tailored to circumstances in Alaska and to the unique nature of a GSOC. In particular, we recommend that the State:

(1) Apply for a "no action" letter from the SEC that the 33 Act does not apply to a GSOC on the alternative grounds that (a) the GSOC shares are not issued "for value" or (b) qualify for the intrastate exemption;

(2) Seek a conditional and temporary exemption from the 34 Act and 40 Act patterned after the Alaska Native Claims Settlement Act.^{*/} Under this proposal the only reporting requirement of the GSOC would be to provide an annual report to shareholders containing substantially all the information required in annual reports under the 34 Act. The annual report required by the Revenue Act of 1978 to be submitted to the Treasury

*/ It might also be wise to seek exemption from the Public Utility Holding Company Act when, if ever, it appears that the investments to be made will fall within the Act's coverage.

Department might be used for this purpose. The proposed exemption period would correspond with the period when shares of a GSOC are generally nontransferable.

(3) Utilize the five-year exemption period to engage in a continuing dialogue with the SEC to determine how the securities laws could usefully be applied to a GSOC after the organizational period. For example, it may be desirable to fashion special proxy rules (perhaps utilizing the state's ballot process) to deal with the unique situation of a corporation owned by a large number of investors who in many cases may be less sophisticated than the average investor for whom existing proxy rules were designed.

We believe that the SEC staff would be receptive to preliminary discussions of the problems raised in this memorandum and that those discussions should be initiated.

WILMER, CUTLER & PICKERING

INTERNAL REVENUE CODE SECTIONS

This section contains copies of the following Internal Revenue Code Sections in the order they are referred to in the footnotes to the Federal enabling law contained in Volume I of the Design of an Alaskan General Stock Ownership Plan:

- Section 1504
- Section 248
- Section 38
- Section 46
- Section 47
- Section 48
- Section 301(a)
- Section 316
- Section 116
- Section 6601
- Section 6611
- Section 172(b)
- Section 3402
- Section 1016(a)
- Section 6012

Internal Revenue Code Section 1504

[1 4911]

DEFINITIONS

Sec. 1504 [1954 Code]. (a) DEFINITION OF "AFFILIATED GROUP".—As used in this chapter, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends, employer securities within the meaning of section 301(d)(9)(A) of the Tax Reduction Act of 1975, or qualifying employer securities within the meaning of section 4975(e)(8) while such securities are held under an employee stock ownership plan which meets the requirements of section 301(d) of such Act or section 4975(e)(7), respectively.

1 4910 Reg. § 1.1503-1

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'54 Code

(b) **DEFINITION OF "INCLUDIBLE CORPORATION".**—As used in this chapter, the term "includible corporation" means any corporation except—

- (1) Corporations exempt from taxation under section 501.
- (2) Insurance companies subject to taxation under section 802 or 821.
- (3) Foreign corporations.
- (4) Corporations with respect to which an election under section 936 (relating to possession tax credit) is in effect for the taxable year.
- (5) Corporations organized under the China Trade Act, 1922 [repealed for taxable years beginning after December 31, 1977].
- (6) Regulated investment companies and real estate investment trusts subject to tax under subchapter M of chapter 1.
- (7) A DISC or former DISC (as defined in section 992(a)).

➔ **Caution:** Code Sec. 1504(c), below, is repealed with respect to taxable years beginning after 1980. ➔

(c) **INCLUDIBLE INSURANCE COMPANIES.**—Despite the provisions of paragraph (2) of subsection (b), two or more domestic insurance companies each of which is subject to taxation under the same section of this subtitle shall be considered as includible corporations for the purpose of the application of subsection (a) to such insurance companies alone.

➔ **Caution:** Code Sec. 1504(c), below, is effective for taxable years beginning after 1980. ➔

(c) **INCLUDIBLE INSURANCE COMPANIES.**—Notwithstanding the provisions of paragraph (2) of subsection (b)—

(1) Two or more domestic insurance companies each of which is subject to tax under section 802 shall be treated as includible corporations for purposes of applying subsection (a) to such insurance companies alone.

(2)(A) If an affiliated group (determined without regard to subsection (b)(2)) includes one or more domestic insurance companies taxed under section 802 or 821 the common parent of such group may elect (pursuant to regulations prescribed by the Secretary) to treat all such companies as includible corporations for purposes of applying subsection (a) except that no such company shall be so treated until it has been a member of the affiliated group for the 5 taxable years immediately preceding the taxable year for which the consolidated return is filed.

(B) If an election under this paragraph is in effect for a taxable year—

- (i) section 243(b)(6) and the exception provided under section 243(b)(5) with respect to subsections (b)(2) and (c) of this section,
- (ii) section 542(b)(5), and
- (iii) subsection (a)(4) and (b)(2)(D) of section 1563, and the reference to section 1563(b)(2)(D) contained in section 1563(b)(3)(C),

shall not be effective for such taxable year.

(d) **SUBSIDIARY FORMED TO COMPLY WITH FOREIGN LAW.**—In the case of a domestic corporation owning or controlling, directly or indirectly, 100 percent of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for the purpose of this subtitle as a domestic corporation.

(e) **INCLUDIBLE TAX-EXEMPT ORGANIZATIONS.**—Despite the provisions of paragraph (1) of subsection (b), two or more organizations exempt from taxation under section 501, one or more of which is described in section 501(c)(2) and the others of which derive income from such 501(c)(2) organizations, shall be considered as includible corporations for the purpose of the application of subsection (a) to such organizations alone.

[§ 4911]—Continued

.01 Amended by P. L.'s 94-455, 92-178, 91-172, 89-389, 86-779, 86-376, 86-69, 85-866 and 429 (84th Cong.) For details, see Code Volumes.

Committee Reports on P. L. 94-455

.06 Under present law, life insurance companies, both stock and mutual, (taxed under section 802 of the code and hereafter referred to as life companies) are barred from filing consolidated income tax returns with corporations that are not life companies. A similar restriction applies to mutual insurance companies other than life companies (taxed under section 821 of the code and hereafter referred to as "other mutual insurance companies"). On the other hand, stock property-liability insurance companies (and certain other companies) taxed under section 831 of the code are generally permitted to file consolidated returns with other types of corporations.

Reasons for change

The present ban on life companies filing consolidated returns with other companies historically has been based on the fact that life insurance companies have been taxed quite differently from other companies. In their case, Congress has been concerned that in any event a tax should be imposed, at the regular rate, on an amount approximately equal to their taxable investment income. For this reason, for example, limitations were imposed on the extent to which policyholder dividends could in effect reduce taxable investment income. As a result, Congress in the past has not allowed life insurance companies to file consolidated returns with other types of companies and in this manner offset their taxable investment income against losses realized from other types of operations.

It is recognized, however, that consolidated returns and offsets of losses are allowed in the case of many diverse types of businesses under present law, some of which are subject to special tax provisions. Moreover, it is recognized that the recent recession and inflation in prices has caused many casualty insurance companies to incur large losses. If a stock casualty company and a noninsurance company are affiliated, they can file a consolidated return on which the losses of the casualty company are applied against the other company's profits. However, if the other company is a life insurance company, the losses of the casualty company can only be applied against the casualty company's income for other years (by means of loss carryovers and carrybacks); they cannot be applied against the life company's income. Consequently, the present ban on life-nonlife consolidations has been a hardship for casualty companies which are affiliated with life companies.

The committee amendment deals with this problem by permitting consolidated returns to be filed by life companies and nonlife companies, subject to the restriction that (1) the life company's taxable income cannot be reduced by more than one-half as a result of the consolidation, and (2) no more than one-half of a nonlife company's losses can be applied against a life company's income in any year. Any nonlife company losses not absorbed in this manner will still be available as carryovers of the nonlife companies to subsequent years. This preserves the concept sought by Congress in the past to the effect that some tax will be paid

with respect to the life insurance company's investment income (except where the company itself has an overall loss from operations), but at the same time provides substantial relief in the future for casualty companies with losses.

Explanation of provision

As indicated above, the committee amendment allows mutual or stock life companies and other mutual insurance companies to elect to join in the filing of consolidated returns, with other types of corporations which are under the same common control and which meet the stock ownership requirements of an "affiliated group." Consolidations of life and nonlife companies however, would be subject to certain limitations as to the extent of the loss offsets as indicated below. The filing of a consolidated return by an affiliated group which includes a life company and a property-liability company will permit the tax savings from the property-liability company's losses to be taken into account sooner in computing its statutory surplus. This larger surplus should increase the capacity of these companies to write insurance. There is no comparable provision in the House bill.

Election.—Under regulations prescribed by the Treasury Department, the amendment provides that the common parent of an affiliated group which includes a life company or other mutual insurance company may elect to include such a company in the filing of a consolidated return with other corporations for any taxable year beginning on or after January 1, 1978. Once this election is made, all insurance companies in the affiliated group, as well as other members of the group, must continue to file consolidated returns unless the group obtains the right to revoke its election under the applicable Treasury Department regulations. If this election is not made, existing law will continue to apply. That is, in such cases the life and other mutual insurance companies will continue to be treated as "nonincludible" corporations, but under present law two or more life companies (which meet the definition of an "affiliated group") may still continue to file a consolidated return with each other.

It is understood that although generally companies will probably desire to file consolidated returns with the life or other mutual insurance companies, some may choose to continue to file separate returns under existing law. Where this occurs, it is likely to arise from the fact that the parent corporation (whose year the other members joining in the filing of the consolidated return must follow) uses a fiscal year as its taxable year. Some life companies may not want to adopt a taxable year other than a calendar year since filings with State insurance commissioners are required by these life companies on a calendar year basis.

To facilitate the filing of consolidated returns with life companies where the common parent has a fiscal year, the committee amendment waives in this case the general requirement of the tax law (sec. 843 of the code) that insurance companies must use the calendar year as their taxable year. However, the use of a fiscal year by an insurance company is not intended to affect the applicable method of accounting required of the insurance company by the tax law (subchapter L). In this case it is expected that the regulations will require the insurance companies to maintain adequate records reconciling all of the items on its fiscal year tax return with the corresponding items on its calendar year statements filed with the State insurance commissioners.

50-percent limitation on certain losses.—For reasons previously indicated, the committee amendment imposes limitations on the amount of consolidated net operating loss which can be applied against the income of a life company. Under the limitations, the amount of the loss which may be taken into account in any one year is limited to 50 percent of the taxable income of the life companies included in the group or to 50 percent of the sum of the losses for the current year and for prior years, whichever is less. The taxable income of each life company for this purpose is its "life insurance company taxable income" (as defined in sec. 802(b) of the code), but determined without regard to its so-called phase III income. Any portion of a loss which is not taken into account because of the limitations may be offset against the income of a life company member as a carryforward, but not as a carryback.

The limitations outlined above can be illustrated by an example. Assume a life insurance company has a subsidiary which (1) is not an insurance company, and (2) incurs a net operating loss of \$120 in 1979 (\$20 of which is absorbed by a carryback against the subsidiary's own prior year's income). Assume further that the parent company's life insurance company taxable income for 1979 (determined without regard to its phase III income under sec. 802(b) (3)) is \$150. The amount of the subsidiary's loss which can be applied against the parent's income for 1979 is \$50 (one-half of the available loss), since this is less than one-half of the parent's income for the year. If in 1980 the subsidiary has a net operating loss of \$60 and the parent has income of \$200, the amount of the loss offset for 1980 would be \$55 (one-half of the sum of the current year's loss and the loss carryover). The losses which can be carried over to subsequent years in this case follow the usual rules applicable to the absorption of loss carryovers so that, for example, the loss carryover to 1981 would consist of a \$50 loss from 1979 and a \$5 loss from 1980.

If in the above example the parent had \$80 of income in 1980 (rather than \$200), the amount of the loss offset for that year would be limited to \$40 (one-half of the parent's income for the year) which is less than \$55.

Other rules.—Under the committee amendment the details of the computation of the tax liability of an affiliated group which includes life or other mutual insurance companies is to be determined under regulations issued by the Treasury Department. Also, an election to consolidate life and nonlife companies cannot be revoked without the consent of the Internal Revenue Service. This is the same approach as is generally taken under present law with respect to other affiliated groups.

For other mutual insurance companies included in the affiliated group and included in consolidated returns, the committee amendment requires that the regular normal corporate tax rates apply rather than the special rates provided for small companies.

Another special rule makes it clear that the enactment of the new provisions is not to result in the termination of an affiliated group. For example, assume that a life company owns 100 percent of a subsidiary which in turn owns 100 percent of a second subsidiary. Assume further that the first and second subsidiaries are not life companies but elect to file consolidated returns under this provision. If the life company also elects to join in the filing of a consolidated

return, then the affiliated group of the two subsidiaries would not be treated as having been terminated (as a result, any deferred intercompany transactions between the subsidiaries would not be treated as giving rise to taxable income).

Effective date

The committee amendment is effective for taxable years beginning after December 31, 1977. However, a transitional rule is provided to limit the use of carryovers of losses and credits for pre-1978 years. These carryovers are to be treated as if the committee amendment had not been made. This means that the ability to absorb these losses or credits is not to be changed as a result of the new election to include life or other mutual insurance companies in a consolidated return with other companies. The same principles also apply with respect to losses and credits which may be carried back to pre-1978 years.

To illustrate this rule, assume that a non-insurance company owns both another non-insurance company and also a life company. Assume that the two noninsurance companies presently file consolidated returns. If this affiliated group has consolidated net operating losses in 1977 which can be carried to 1978, even though an election is made for 1978 to include the life company in the consolidated return, the absorption of this loss is to be determined as if the new consolidation rules do not apply. This means that the life company's profits are not to be available to offset any part of this carryover loss. In addition, if in 1978 the parent noninsurance corporation were to acquire a profitable property-liability company (or other company not directly affected by the new rules) and under normal consolidated return rules these profits could be utilized in determining how much of the 1977 loss could be absorbed, the use of these profits in this manner would not be affected by the new rules. However, if the life company were to acquire this profitable corporation, its profits would not be available to offset the noninsurance company 1977 loss, since the profitable member in this case would be a subsidiary of the life company and would not be treated as a member of the nonlife insurance group under present law.—*Senate Finance Committee Report.*

House bill.—No provision.

Senate amendment.—Under present law, life insurance companies cannot file consolidated returns with non-life companies. In addition, mutual casualty insurers are effectively precluded from filing consolidated returns with other types of companies. The Senate amendment allows life insurance companies and other mutual insurance companies to file consolidated returns with other companies under rules limiting the amount of non-life losses applied against life company income to one-half the loss or one-half of life company income, whichever is less. Non-life losses could not be carried back against life company income. Consolidated filing is allowed for taxable years beginning after 1977.

Conference agreement.—The conference agreement follows the Senate amendment but with substantial modifications. First, it postpones for five years, or until 1981, any consolidation of life insurance company returns with non-life insurance company returns. Second, in 1981 and subsequent years consolidated returns may be filed by a life company and another company only where they have been affiliated for the preceding 5 years. Third, the amount of any

[§ 4911.06]—Continued

non-life company loss which may be so applied against life company income in 1981 and the proportion of the life insurance company income which may be so offset in 1981 is limited to 25 percent. Fourth, in 1982 the percentage referred to above is to be 30 percent, and thereafter the percentage is to be 35 percent.—Conference Committee Report.

.075 Committee Reports on P. L. 92-178 are at 1972-1 CB 498, 559.

.08 Committee Reports on P. L. 91-172 are at 1969-3 CB 199.

.085 Committee Reports on P. L. 86-376 are at 1959-2 CB 903.

.09 Committee Reports on P. L. 86-59 are at 1959-2 CB 829.

.095 Committee Reports on P. L. 429 (84th Cong.) are at 1956-1 CB 954, 967.

.10 Committee Reports on 1954 Code Sec. 1504 as originally enacted were reproduced at 564 CCH ¶ 4993.20-4993.21.

Internal Revenue Code Section 248

Sec. 248—ORGANIZATIONAL EXPENDITURES 25,279

[§ 2165] ORGANIZATIONAL EXPENDITURES

Sec. 248 [1954 Code]. (a) ELECTION TO AMORTIZE.—The organizational expenditures of a corporation may, at the election of the corporation (made in accordance with regulations prescribed by the Secretary), be treated as deferred expenses. In computing taxable income, 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 corporation (beginning with the month in which the corporation begins business).

(b) ORGANIZATIONAL EXPENDITURES DEFINED.—The term "organizational expenditures" means any expenditure which—

(1) is incident to the creation of the corporation;

(2) is chargeable to capital account; and

(3) is of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life.

(c) TIME FOR AND SCOPE OF ELECTION.—The election provided by subsection (a) may be made for any taxable year beginning after December 31, 1953, but only if made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). The period so elected shall be adhered to in computing the taxable income of the corporation for the taxable year for which the election is made and all subsequent taxable years. The election shall apply only with respect to expenditures paid or incurred on or after August 16, 1954.

.10 Amended by P. L. 94-455 (Deadwood Act);

.20 Committee Reports on 1954 Code Sec. 248 as originally enacted were reproduced at 562 CCH ¶ 2167.10.

'54 Code

Internal Revenue Code Section 38

11,046

INVESTMENT CREDIT—Sec. 38

[¶ 582]

INVESTMENT IN CERTAIN DEPRECIABLE
PROPERTY

-54 Code-

Sec. 38 [1954 Code]. (a) GENERAL RULE.—There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under subpart B of this part.

(b) REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section and subpart B.

.01 Added by P. L. 87-834.

| .05 Committee Reports on P. L. 87-834
are at 1962-3 CB 111.

Internal Revenue Code Section 46

[§ 586]

AMOUNT OF CREDIT

Sec. 46 [1954 Code]. (a) GENERAL RULE.—

(1) FIRST-IN-FIRST-OUT RULE.—The amount of the credit allowed by section 38 for the taxable year shall be an amount equal to the sum of—

- (A) the investment credit carryovers carried to such taxable year,
- (B) the amount of the credit determined under paragraph (2) for such taxable year, plus
- (C) the investment credit carrybacks carried to such taxable year.

(2) AMOUNT OF CREDIT.—

(A) IN GENERAL.—The amount of the credit determined under this paragraph for the taxable year shall be an amount equal to the sum of the following percentages of the qualified investment (as determined under subsections (c) and (d)):

- (i) the regular percentage,
- (ii) in the case of energy property, the energy percentage, and
- (iii) the ESOP percentage.

(B) REGULAR PERCENTAGE.—For purposes of this paragraph, the regular percentage is 10 percent.^(*)

* Sec. 301(a)(1) of the Energy Act of 1978 (P. L. 95-618) provides that the regular percentage shall return to 7% on January 1, 1981. Sec. 311(a) of the Revenue Act of 1978 (P. L. 95-600) makes the 10% rate permanent. Since Congress intended that the 10% rate be made permanent (see the Committee Reports on P. L. 95-600), subparagraph (B) above reflects this even though technically the signing of the Energy Act after the Revenue Act would cause Energy Act Sec. 301(a)(1) to govern.—CCH.

11,126 AMOUNT OF INVESTMENT CREDIT—§ 46 [p. 11,125]

[§ 586]—Continued

(C) **ENERGY PERCENTAGE.**—For purposes of this paragraph, the energy percentage is—

(i) 10 percent with respect to the period beginning on October 1, 1978, and ending on December 31, 1982, or

(ii) zero with respect to any other period.

(D) **SPECIAL RULE FOR CERTAIN ENERGY PROPERTY.**—For purposes of this paragraph, the regular percentage shall not apply to any energy property which, but for section 48(l)(1), would not be section 38 property.

(E) **ESOP PERCENTAGE.**—For purposes of this paragraph, the ESOP percentage is—

(i) with respect to the period beginning on January 21, 1975, and ending on December 31, 1983,^(**) 1 percent, and

(ii) with respect to the period beginning on January 1, 1977, and ending on December 31, 1983,^(**) an additional percentage (not in excess of $\frac{1}{2}$ of 1 percent) which results in an amount equal to the amount determined under section 48(n)(1)(B).

This subparagraph shall apply to a corporation only if it meets the requirements of section 409A and only if it elects (at such time, in such form, and in such manner as the Secretary prescribes) to have this subparagraph apply.

➡ **Caution: Code Sec. 46(a)(3), before amendment by P. L. 95-600, below, is effective only for tax years ending before 1979.** ←

(3) **LIMITATION BASED ON AMOUNT OF TAX.**—Notwithstanding paragraph (1), the credit allowed by section 38 for the taxable year shall not exceed—

(A) so much of the liability for tax for the taxable year as does not exceed \$25,000, plus

(B) for taxable years ending on or before the last day of the suspension period (as defined in section 48(j)), 25 percent of so much of the liability for tax for the taxable year as exceeds \$25,000, or

(C) for taxable years ending after the last day of such suspension period, 50 percent of so much of the liability for tax for the taxable year as exceeds \$25,000.

In applying subparagraph (C) to a taxable year beginning on or before the last day of such suspension period and ending after the last day of such suspension period, the percent referred to in such subparagraph shall be the sum of 25 percent plus the percent which bears the same ratio to 25 percent as the number of days in such year after the last day of the suspension period bears to the total number of days in such year. The amount otherwise determined under this paragraph shall be reduced (but not below zero) by the credit which would have been allowable under paragraph (1) for such taxable year with respect to suspension period property but for the application of section 48(h)(1).

^{**} Sec. 391(a)(1) of the Energy Act of 1978 (P. L. 95-618) provides for an ESOP percentage through 1980. Sec. 141(e) of the Revenue Act of 1978 (P. L. 95-600) extends the ESOP percentage through 1983. Since Congress intended that the ESOP percentage be extended through 1983 (see the Conference Committee Report on P. L. 95-600), subparagraph (E) above reflects this.—CCH.

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→ **Caution:** Code Sec. 46(a)(3), below, as amended by P. L. 95-600, is effective for tax years ending after 1978. ←

(3) LIMITATION BASED ON AMOUNT OF TAX.—Notwithstanding paragraph (1), the credit allowed by section 38 for the taxable year shall not exceed—

(A) so much of the liability for tax for the taxable year as does not exceed \$25,000, plus

(B) the following percentage of so much of the liability for tax for the taxable year as exceeds \$25,000:

If the taxable year ends in:	The percentage is:
1979	60
1980	70
1981	80
1982 or thereafter	90.

(4) LIABILITY FOR TAX.—For purposes of paragraph (3), the liability for tax for the taxable year shall be the tax imposed by this chapter for such year, reduced by the sum of the credits allowable under—

(A) section 33 (relating to foreign tax credit), and

(B) section 37 (relating to credit for the elderly).

For purposes of this paragraph, any tax imposed for the taxable year by section 56 (relating to minimum tax for tax preferences), section 72(m)(5) (B) (relating to 10 percent tax on premature distributions to owner-employees), section 408(f) (relating to additional tax on income from certain retirement accounts), section 402(e) (relating to tax on lump sum distributions), section 531 (relating to accumulated earnings tax), section 541 (relating to personal holding company tax), or section 1378 (relating to tax on certain capital gains of subchapter S corporations), and any additional tax imposed for the taxable year by section 1351(d)(1) (relating to recoveries of foreign expropriation losses), shall not be considered tax imposed by this chapter for such year.

(5) MARRIED INDIVIDUALS.—In the case of a husband or wife who files a separate return, the amount specified under subparagraphs (A) and (B) of paragraph (3) shall be \$12,500 in lieu of \$25,000. This paragraph shall not apply if the spouse of the taxpayer has no qualified investment for, and no unused credit carryback or carryover to, the taxable year of such spouse which ends within or with the taxpayer's taxable year.

(6) CONTROLLED GROUPS.—In the case of a controlled group, the \$25,000 amount specified under paragraph (3) shall be reduced for each component member of such group by apportioning \$25,000 among the component members of such group in such manner as the Secretary shall by regulations prescribe. For purposes of the preceding sentence, the term "controlled group" has the meaning assigned to such term by section 1563(a).

→ **Caution:** Code Sec. 46(a)(7), below, before amendment by P. L. 95-600, is effective only for tax years ending before 1979. ←

(7) ALTERNATIVE LIMITATION IN THE CASE OF CERTAIN UTILITIES.—

(A) IN GENERAL.—If, for a taxable year ending after calendar year 1974 and before calendar year 1981, the amount of the qualified investment of the taxpayer which is attributable to public utility property is 25 percent or more of his aggregate qualified investment, then subparagraph (C) of paragraph (3) of this subsection shall be applied by substituting for 50 percent his applicable percentage for such year.

(B) APPLICABLE PERCENTAGE.—The applicable percentage of any taxpayer for any taxable year is—

(i) 50 percent, plus

[¶ 586]—Continued

(ii) that portion of the tentative percentage for the taxable year which the taxpayer's amount of qualified investment which is public utility property bears to his aggregate qualified investment.

If the proportion referred to in clause (ii) is 75 percent or more, the applicable percentage of the taxpayer for the year shall be 50 percent plus the tentative percentage for such year.

(C) TENTATIVE PERCENTAGE.—For purposes of subparagraph (B), the tentative percentage shall be determined under the following table:

If the taxable year ends in:	The tentative percentage is:
1975 or 1976	50
1977	40
1978	30
1979	20
1980	10

(D) PUBLIC UTILITY PROPERTY DEFINED.—For purposes of this paragraph, the term "public utility property" has the meaning given to such term by the first sentence of subsection (c)(3)(B).

➡ **Caution:** Code Sec. 46(a)(7), below, as amended by P. L. 95-600, is effective for tax years ending after 1978. ←

(7) ALTERNATIVE LIMITATION IN THE CASE OF CERTAIN UTILITIES.—

(A) IN GENERAL.—If, for the taxable year ending in 1979—

(i) the amount of the qualified investment of the taxpayer which is attributable to public utility property is 25 percent or more of his aggregate qualified investment, and

(ii) the application of this paragraph results in a percentage higher than 60 percent,

then subparagraph (B) of paragraph (3) of this subsection shall be applied by substituting for "60 percent" the taxpayer's applicable percentage for such year.

(B) APPLICABLE PERCENTAGE.—The applicable percentage for any taxpayer for any taxable year ending in 1979 is—

(i) 50 percent, plus

(ii) that portion of 20 percent which the taxpayer's amount of qualified investment which is public utility property bears to his aggregate qualified investment.

If the proportion referred to in clause (ii) is 75 percent or more, the applicable percentage of the taxpayer for the year shall be 70 percent.

(C) PUBLIC UTILITY PROPERTY DEFINED.—For purposes of this paragraph, the term "public utility property" has the meaning given to such term by the first sentence of subsection (c)(3)(B).

➡ **Caution:** Code Sec. 46(a)(8), below, before amendment by P. L. 95-600, is effective only for tax years ending before 1979. ←

(8) ALTERNATIVE LIMITATION IN THE CASE OF CERTAIN RAILROADS.—

(A) IN GENERAL.—If, for a taxable year ending after calendar year 1976, and before calendar year 1983, the amount of the qualified investment of the taxpayer which is attributable to railroad property is 25 percent or more of his aggregate qualified investment, then subparagraph (C) of paragraph (3) of this subsection shall be applied by substituting for 50 percent his applicable percentage for such year.

(B) APPLICABLE PERCENTAGE.—The applicable percentage of any taxpayer for any taxable year under this paragraph is—

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(i) 50 percent, plus

(ii) that portion of the tentative percentage for the taxable year which the taxpayer's amount of qualified investment which is railroad property bears to his aggregate qualified investment.

If the proportion referred to in clause (ii) is 75 percent or more, the applicable percentage of the taxpayer for the year shall be 50 percent plus the tentative percentage for such year.

(C) TENTATIVE PERCENTAGE.—For purposes of subparagraph (B), the tentative percentage shall be determined under the following table:

If the taxable year ends in:	The tentative percentage is:
1977 or 1978	50
1979	40
1980	30
1981	20
1982	10

(D) RAILROAD PROPERTY DEFINED.—For purposes of this paragraph, the term "railroad property" means section 38 property used by the taxpayer directly in connection with the trade or business carried on by the taxpayer of operating a railroad (including a railroad switching or terminal company).

→ **Caution:** Code Sec. 46(a)(8), below, as amended by P. L. 95-600, is effective for tax years ending after 1978. ←

(8) ALTERNATIVE LIMITATION IN THE CASE OF CERTAIN RAILROADS AND AIRLINES.—

(A) IN GENERAL.—If, for a taxable year ending in 1979 or 1980—

(i) the amount of the qualified investment of the taxpayer which is attributable to railroad property or to airline property, as the case may be, is 25 percent or more of his aggregate qualified investment, and

(ii) the application of this paragraph results in a percentage higher than 60 percent (70 percent in the case of a taxable year ending in 1980),

then subparagraph (B) of paragraph (3) of this subsection shall be applied by substituting for "60 percent" ("70 percent" in the case of a taxable year ending in 1980) the taxpayer's applicable percentage for such year.

(B) APPLICABLE PERCENTAGE.—The applicable percentage of any taxpayer for any taxable year under this paragraph is—

(i) 50 percent, plus

(ii) that portion of the tentative percentage for the taxable year which the taxpayer's amount of qualified investment which is railroad property or airline property (as the case may be) bears to his aggregate qualified investment.

If the proportion referred to in clause (ii) is 75 percent or more, the applicable percentage of the taxpayer for the taxable year shall be 90 percent (80 percent in the case of a taxable year ending in 1980).

(C) TENTATIVE PERCENTAGE.—For purposes of subparagraph (B), the tentative percentage shall be determined under the following table:

If the taxable year ends in:	The tentative percentage is:
1979	40
1980	30

[§ 586]—Continued

(D) RAILROAD PROPERTY DEFINED.—For purposes of this paragraph, the term "railroad property" means section 38 property used by the taxpayer directly in connection with the trade or business carried on by the taxpayer of operating a railroad (including a railroad switching or terminal company).

(E) AIRLINE PROPERTY DEFINED.—For purposes of this paragraph, the term "airline property" means section 38 property used by the taxpayer directly in connection with the trade or business carried on by the taxpayer of the furnishing or sale of transportation as a common carrier by air subject to the jurisdiction of the Civil Aeronautics Board or the Federal Aviation Administration.

➔ **Caution:** Code Sec. 46(a)(9), below, is repealed by P. L. 95-600, effective for tax years ending after 1978. ➔

(9) ALTERNATIVE LIMITATION IN THE CASE OF CERTAIN AIRLINES.—

(A) IN GENERAL.—If, for a taxable year ending after calendar year 1976 and before calendar year 1983, the amount of the qualified investment of the taxpayer which is attributable to airline property is 25 percent or more of his aggregate qualified investment, then subparagraph (C) of paragraph (3) of this subsection shall be applied by substituting for 50 percent his applicable percentage for such year.

(B) APPLICABLE PERCENTAGE.—The applicable percentage of any taxpayer for any taxable year under this paragraph is—

(i) 50 percent, plus

(ii) that portion of the tentative percentage for the taxable year which the taxpayer's amount of qualified investment which is airline property bears to his aggregate qualified investment.

If the proportion referred to in clause (ii) is 75 percent or more, the applicable percentage of the taxpayer for the year shall be 50 percent plus the tentative percentage for such year.

(C) TENTATIVE PERCENTAGE.—For purposes of subparagraph (B), the tentative percentage shall be determined under the following table:

If the taxable year ends in:	The tentative percentage is:
1977 or 1978	50
1979	40
1980	30
1981	20
1982	10

(D) AIRLINE PROPERTY DEFINED.—For purposes of this paragraph, the term "airline property" means section 38 property used by the taxpayer directly in connection with the trade or business carried on by the taxpayer of the furnishing or sale of transportation as a common carrier by air subject to the jurisdiction of the Civil Aeronautics Board or the Federal Aviation Administration.

(10) SPECIAL RULES IN THE CASE OF ENERGY PROPERTY.—Under regulations prescribed by the Secretary—

(A) IN GENERAL.—This subsection and subsection (b) shall be applied separately—

(i) first with respect to so much of the credit allowed by section 38 as is not attributable to the energy percentage,

(ii) second with respect to so much of the credit allowed by section 38 as is attributable to the application of the energy percentage to energy property (other than solar or wind energy property), and

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(iii) then with respect to so much of the credit allowed by section 38 as is attributable to the application of the energy percentage to solar or wind energy property.

(B) RULES OF APPLICATION FOR ENERGY PROPERTY OTHER THAN SOLAR OR WIND ENERGY PROPERTY.—In applying this subsection and subsection (b) for taxable years ending after September 30, 1978, with respect to so much of the credit allowed by section 38 as is described in subparagraph (A)(ii)—

(i) paragraph (3)(C) shall be applied by substituting "100 percent" for "50 percent";^(*)

(ii) paragraphs (7), (8), and (9) shall not apply, and

(iii) the liability for tax shall be the amount determined under paragraph (4) reduced by so much of the credit allowed by section 38 as is described in subparagraph (A)(i).

(C) REFUNDABLE CREDIT FOR SOLAR OR WIND ENERGY PROPERTY.—In the case of so much of the credit allowed by section 38 as is described in subparagraph (A)(iii)—

(i) paragraph (3) shall not apply, and

(ii) for purposes of this title (other than section 38, this subpart, and chapter 63), such credit shall be treated as if it were allowed by section 39 and not by section 38.

(b) CARRYBACK AND CARRYOVER OF UNUSED CREDITS.—

(1) IN GENERAL.—If the sum of the amount of the investment credit carryovers to the taxable year under subsection (a)(1)(A) plus the amount determined under subsection (a)(1)(B) for the taxable year exceeds the amount of the limitation imposed by subsection (a)(3) for such taxable year (hereinafter in this subsection referred to as the "unused credit year"), such excess attributable to the amount determined under subsection (a)(1)(B) shall be—

(A) an investment credit carryback to each of the 3 taxable years preceding the unused credit year, and

(B) an investment credit carryover to each of the 7 taxable years following the unused credit year,

and, subject to the limitations imposed by paragraphs (2) and (3), shall be taken into account under the provisions of subsection (a)(1) in the manner provided in such subsection. The entire amount of the unused credit for an unused credit year shall be carried to the earliest of the 10 taxable years to which (by reason of subparagraphs (A) and (B)) such credit may be carried and then to each of the other 9 taxable years to the extent, because of the limitations imposed by paragraphs (2) and (3), such unused credit may not be taken into account under subsection (a)(1) for a prior taxable year to which such unused credit may be carried. In the case of an unused credit for an unused credit year ending before January 1, 1971, which is an investment credit carryover to a taxable year beginning after December 31, 1970 (determined without regard to this sentence), this paragraph shall be applied—

(C) by substituting "10 taxable years" for "7 taxable years" in subparagraph (B), and by substituting "13 taxable years" for "10 taxable years", and "12 taxable years" for "9 taxable years" in the preceding sentence, and

(D) by carrying such an investment credit carryover to a later taxable year (than the taxable year to which it would, but for this subparagraph, be carried) to which it may be carried if, because of the amendments made by section 802(b)(2) of the Tax Reform Act of 1976,

^(*) The amendment of subparagraph (B)(i) by Sec. 301(c) of the 1978 Energy Act (P. L. 95-618) failed to take into account the changes made to Code Sec. 46(a)(3) by Sec. 312(a) of the 1978 Revenue Act. Since the Revenue Act amendments to Code Sec. 46(a)(3) are effective for

tax years ending after 1978, the references in subparagraph (B)(i) for years ending after 1978 should probably be to paragraph (3)(B) rather than (3)(C) and to "the percentage appropriate for the taxable year" rather than to "50 percent."—CCH.

[§ 586]—Continued

carrying such carryover to the taxable year to which it would, but for this subparagraph, be carried would cause a portion of an unused credit from an unused credit year ending after December 31, 1970 to expire.

(2) **LIMITATION ON CARRYBACKS.**—The amount of the unused credit which may be taken into account under subsection (a)(1) for any preceding taxable year shall not exceed the amount by which the limitation imposed by subsection (a)(3) for such taxable year exceeds the sum of—

(A) the amounts determined under subparagraphs (A) and (B) of subsection (a)(1) for such taxable year, plus

(B) the amounts which (by reason of this subsection) are carried back to such taxable year and are attributable to taxable years preceding the unused credit year.

(3) **LIMITATION ON CARRYOVERS.**—The amount of the unused credit which may be taken into account under subsection (a)(1)(A) for any succeeding taxable year shall not exceed the amount by which the limitation imposed by subsection (a)(3) for such taxable year exceeds the sum of the amounts which, by reason of this subsection, are carried to such taxable year and are attributable to taxable years preceding the unused credit year.

(c) **QUALIFIED INVESTMENT.**—

(1) **IN GENERAL.**—For purposes of this subpart, the term “qualified investment” means, with respect to any taxable year, the aggregate of—

(A) the applicable percentage of the basis of each new section 38 property (as defined in section 48(b)) placed in service by the taxpayer during such taxable year, plus

(B) the applicable percentage of the cost of each used section 38 property (as defined in section 48(c)(1)) placed in service by the taxpayer during such taxable year.

(2) **APPLICABLE PERCENTAGE.**—For purposes of paragraph (1), the applicable percentage for any property shall be determined under the following table:

If the useful life is—	The applicable percentage is—
3 years or more but less than 5 years.....	33⅓
5 years or more but less than 7 years.....	66⅔
7 years or more.....	100

For purposes of this subpart, the useful life of any property shall be the useful life used in computing the allowance for depreciation under section 167 for the taxable year in which the property is placed in service.

(3) **PUBLIC UTILITY PROPERTY.**—

(A) To the extent that the credit allowed by section 38 with respect to any public utility property is determined at the rate of 7 percent, in the case of any property which is public utility property, the amount of the qualified investment shall be 4/7 of the amount determined under paragraph (1). The preceding sentence shall not apply for purposes of applying the energy percentage.

(B) For purposes of subparagraph (A), the term “public utility property” means property used predominantly in the trade or business of the furnishing or sale of—

(i) electrical energy, water, or sewage disposal services,

(ii) gas through a local distribution system, or

(iii) telephone service, telegraph service by means of domestic telegraph operations (as defined in section 222(a)(5) of the Communications Act of 1934, as amended; 47 U. S. C. 222(a)(5)), or

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other communication services (other than international telegraph service),

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof. Such term also means communication property of the type used by persons engaged in providing telephone or microwave communication services to which clause (iii) applies, if such property is used predominantly for communication purposes.

(C) In the case of any interest in a submarine cable circuit used to furnish telegraph service between the United States and a point outside the United States of a taxpayer engaged in furnishing international telegraph service (if the rates for such furnishing have been established or approved by a governmental unit, agency, instrumentality, commission, or similar body described in subparagraph (B)), the qualified investment shall not exceed the qualified investment attributable to so much of the interest of the taxpayer in the circuit as does not exceed 50 percent of all interests in the circuit.

(4) COORDINATION WITH SUBSECTION (d).—The amount which would (but for this paragraph) be treated as qualified investment under this subsection with respect to any property shall be reduced (but not below zero) by any amount treated by the taxpayer or a predecessor of the taxpayer (or, in the case of a sale and leaseback described in section 47(a)(3)(C), by the lessee) as qualified investment with respect to such property under subsection (d), to the extent the amount so treated has not been required to be recaptured by reason of section 47(a)(3).

➡ **Caution: Code Sec. 46(c)(5), below, before amendment by P. L. 95-600, applies only to property acquired or constructed before 1979.** ←

(5) APPLICABLE PERCENTAGE IN THE CASE OF CERTAIN POLLUTION CONTROL FACILITIES.—Notwithstanding subsection (c)(2), in the case of property—

(A) with respect to which an election under section 169 applies, and

(B) the useful life of which (determined without regard to section 169) is not less than 5 years,

50 percent shall be the applicable percentage for purposes of applying paragraph (1) with respect to so much of the adjusted basis of the property as (after the application of section 169(f)) constitutes the amortizable basis for purposes of section 169.

➡ **Caution: Code Sec. 46(c)(5), below, as amended by P. L. 95-600, applies only to property acquired or constructed after 1978.** ←

(5) APPLICABLE PERCENTAGE IN THE CASE OF CERTAIN POLLUTION CONTROL FACILITIES.—

(A) IN GENERAL.—Notwithstanding paragraph (2), in the case of property—

(i) with respect to which an election under section 169 applies, and

(ii) the useful life of which (determined without regard to section 169) is not less than 5 years,

100 percent shall be the applicable percentage for purposes of applying paragraph (1) with respect to so much of the adjusted basis of the property as (after the application of section 169(f)) constitutes the amortizable basis for purposes of section 169.

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→ **Caution: Code Sec. 46(c)(5), as amended by P. L. 95-600, below, applies only to property acquired or constructed after 1978.** ←

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(B) **SPECIAL RULE WHERE PROPERTY IS FINANCED BY INDUSTRIAL DEVELOPMENT BONDS.**—To the extent that any property is financed by the proceeds of an industrial development bond (within the meaning of section 103(b)(2)) the interest on which is exempt from tax under section 103, subparagraph (A) shall be applied by substituting "50 percent" for "100 percent."

(6) **SPECIAL RULE FOR COMMUTER HIGHWAY VEHICLES.**—

(A) **IN GENERAL.**—Notwithstanding paragraph (2), in the case of a commuter highway vehicle the useful life of which is 3 years or more, the applicable percentage for purposes of paragraph (1) shall be 100 percent.

(B) **DEFINITION OF COMMUTER HIGHWAY VEHICLE.**—For purposes of subparagraph (A), the term "commuter highway vehicle" means a highway vehicle—

(i) the seating capacity of which is at least 8 adults (not including the driver),

(ii) at least 80 percent of the mileage use of which can reasonably be expected to be (I) for purposes of transporting the taxpayer's employees between their residences and their place of employment, and (II) on trips during which the number of employees transported for such purposes is at least one-half of the adult seating capacity of such vehicle (not including the driver),

(iii) which is acquired by the taxpayer on or after the date of the enactment of the Energy Tax Act of 1978, and placed in service by the taxpayer before January 1, 1986, and

(iv) with respect to which the taxpayer makes an election under this paragraph on his return for the taxable year in which such vehicle is placed in service.

(d) **QUALIFIED PROGRESS EXPENDITURES.**—

(1) **IN GENERAL.**—In the case of any taxpayer who has made an election under paragraph (6), the amount of his qualified investment for the taxable year (determined under subsection (c) without regard to this subsection) shall be increased by an amount equal to his aggregate qualified progress expenditures for the taxable year with respect to progress expenditure property.

(2) **PROGRESS EXPENDITURE PROPERTY DEFINED.**—

(A) **IN GENERAL.**—For purposes of this subsection, the term "progress expenditure property" means any property which is being constructed by or for the taxpayer and which—

(i) has a normal construction period of two years or more, and

(ii) it is reasonable to believe will be new section 38 property having a useful life of 7 years or more in the hands of the taxpayer when it is placed in service.

Clauses (i) and (ii) of the preceding sentence shall be applied on the basis of facts known at the close of the taxable year of the taxpayer in which construction begins (or, if later, at the close of the first taxable year to which an election under this subsection applies).

(B) **NORMAL CONSTRUCTION PERIOD.**—For purposes of subparagraph (A), the term "normal construction period" means the period reasonably expected to be required for the construction of the property—

(i) beginning with the date on which physical work on the construction begins (or, if later, the first day of the first taxable year to which an election under this subsection applies), and

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(ii) ending on the date on which it is expected that the property will be available for placing in service.

(3) QUALIFIED PROGRESS EXPENDITURES DEFINED.—For purposes of this subsection—

(A) SELF-CONSTRUCTED PROPERTY.—In the case of any self-constructed property, the term “qualified progress expenditures” means the amount which, for purposes of this subpart, is properly chargeable (during such taxable year) to capital account with respect to such property.

(B) NON-SELF-CONSTRUCTED PROPERTY.—In the case of non-self-constructed property, the term “qualified progress expenditures” means the lesser of—

(i) the amount paid during the taxable year to another person for the construction of such property, or

(ii) the amount which represents that proportion of the overall cost to the taxpayer of the construction by such other person which is properly attributable to that portion of such construction which is completed during such taxable year.

(4) SPECIAL RULES FOR APPLYING PARAGRAPH (3).—For purposes of paragraph (3)—

(A) COMPONENT PARTS, ETC.—Property which is to be a component part of, or is otherwise to be included in, any progress expenditure property shall be taken into account—

(i) at a time not earlier than the time at which it becomes irrevocably devoted to use in the progress expenditure property, and

(ii) as if (at the time referred to in clause (i)) the taxpayer had expended an amount equal to that portion of the cost to the taxpayer of such component or other property which, for purposes of this subpart, is properly chargeable (during such taxable year) to capital account with respect to such property.

(B) CERTAIN BORROWINGS DISREGARDED.—Any amount borrowed directly or indirectly by the taxpayer from the person constructing the property for him shall not be treated as an amount expended for such construction.

(C) CERTAIN UNUSED EXPENDITURES CARRIED OVER.—In the case of non-self-constructed property, if for the taxable year—

(i) the amount under clause (i) of paragraph (3)(B) exceeds the amount under clause (ii) of paragraph (3)(B), then the amount of such excess shall be taken into account under such clause (i) for the succeeding taxable year, or

(ii) the amount under clause (ii) of paragraph (3)(B) exceeds the amount under clause (i) of paragraph (3)(B), then the amount of such excess shall be taken into account under such clause (ii) for the succeeding taxable year.

(D) DETERMINATION OF PERCENTAGE OF COMPLETION.—In the case of non-self-constructed property, the determination under paragraph (3)(B)(ii) of the proportion of the overall cost to the taxpayer of the construction of any property which is properly attributable to construction completed during any taxable year shall be made, under regulations prescribed by the Secretary, on the basis of engineering or architectural estimates or on the basis of cost accounting records. Unless the taxpayer establishes otherwise by clear and convincing evidence, the construction shall be deemed to be completed not more rapidly than ratably over the normal construction period.

(E) NO QUALIFIED PROGRESS EXPENDITURES FOR CERTAIN PRIOR PERIODS.—In the case of any property, no qualified progress expenditures shall be

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taken into account under this subsection for any period before January 22, 1975 (or, if later, before the first day of the first taxable year to which an election under this subsection applies).

(F) **NO QUALIFIED PROGRESS EXPENDITURES FOR PROPERTY FOR YEAR IT IS PLACED IN SERVICE, ETC.**—In the case of any property, no qualified progress expenditures shall be taken into account under this subsection for the earlier of—

(i) the taxable year in which the property is placed in service, or

(ii) the first taxable year for which recapture is required under section 47(a)(3) with respect to such property,

or for any taxable year thereafter.

(5) **OTHER DEFINITIONS.**—For purposes of this subsection—

(A) **SELF-CONSTRUCTED PROPERTY.**—The term “self-constructed property” means property more than half of the construction expenditures for which it is reasonable to believe will be made directly by the taxpayer.

(B) **NON-SELF-CONSTRUCTED PROPERTY.**—The term “non-self-constructed property” means property which is not self-constructed property.

(C) **CONSTRUCTION, ETC.**—The term “construction” includes reconstruction and erection, and the term “constructed” includes reconstructed and erected.

(D) **ONLY CONSTRUCTION OF SECTION 38 PROPERTY TO BE TAKEN INTO ACCOUNT.**—Construction shall be taken into account only if, for purposes of this subpart, expenditures therefor are properly chargeable to capital account with respect to the property.

(6) **ELECTION.**—An election under this subsection may be made at such time and in such manner as the Secretary may by regulations prescribe. Such an election shall apply to the taxable year for which made and to all subsequent taxable years. Such an election, once made, may not be revoked except with the consent of the Secretary.

(7) **TRANSITIONAL RULES.**—The qualified investment taken into account under this subsection for any taxable year beginning before January 1, 1980, with respect to any property shall be (in lieu of the full amount) an amount equal to the sum of—

(A) the applicable percentage of the full amount determined under the following table:

For a taxable year beginning in:	The applicable percentage is:
1974 or 1975.....	20
1976	40
1977	60
1978	80
1979	100; plus

(B) in the case of any property to which this subsection applied for one or more preceding taxable years, 20 percent of the full amount for each such preceding taxable year.

For purposes of this paragraph, the term “full amount,” when used with respect to any property for any taxable year, means the amount of the qualified investment for such property for such year determined under this subsection without regard to this paragraph.

(c) **LIMITATIONS WITH RESPECT TO CERTAIN PERSONS.**—

(1) **IN GENERAL.**—In the case of—

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(A) an organization to which section 593 applies, and
(B) a regulated investment company or a real estate investment trust subject to taxation under subchapter M (sec. 851 and following), the qualified investment and the \$25,000 amount specified under subparagraphs (A) and (B) of subsection (a)(3) shall equal such person's ratable share of such items.

(2) RATABLE SHARE.—For purposes of paragraph (1), the ratable share of any person for any taxable year of the items described therein shall be—

(A) in the case of an organization referred to in paragraph (1)(A), 50 percent thereof, and

(B) in the case of a regulated investment company or a real estate investment trust, the ratio (i) the numerator of which is its taxable income and (ii) the denominator of which is its taxable income computed without regard to the deduction for dividends paid provided by section 852(b)(2)(D) or 857(b)(2)(B), as the case may be.

For purposes of subparagraph (B) of the preceding sentence, the term "taxable income" means in the case of a regulated investment company its investment company taxable income (within the meaning of section 852(b)(2)), and in the case of a real estate investment trust its real estate investment trust taxable income (within the meaning of section 857(b)(2)).

(3) NONCORPORATE LESSORS.—A credit shall be allowed by section 38 to a person which is not a corporation with respect to property of which such person is the lessor only if—

(A) the property subject to the lease has been manufactured or produced by the lessor, or

(B) the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property, and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.

In the case of property of which a partnership is the lessor, the credit otherwise allowable under section 38 with respect to such property to any partner which is a corporation shall be allowed notwithstanding the first sentence of this paragraph. For purposes of this paragraph, an electing small business corporation (as defined in section 1371) shall be treated as a person which is not a corporation.

(f) LIMITATION IN CASE OF CERTAIN REGULATED COMPANIES.—

(1) GENERAL RULE.—Except as otherwise provided in this subsection, no credit shall be allowed by section 38 with respect to any property which is public utility property (as defined in paragraph (5)) of the taxpayer—

(A) COST OF SERVICE REDUCTION.—If the taxpayer's cost of service for ratemaking purposes is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection); or

(B) RATE BASE REDUCTION.—If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection).

Subparagraph (B) shall not apply if the reduction in the rate base is restored not less rapidly than ratably. If the taxpayer makes an election under this sentence within 90 days after the date of the enactment of this paragraph

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in the manner prescribed by the Secretary, the immediately preceding sentence shall not apply to property described in paragraph (5)(B) if any agency or instrumentality of the United States having jurisdiction for ratemaking purposes with respect to such taxpayer's trade or business referred to in paragraph (5)(B) determines that the natural domestic supply of the product furnished by the taxpayer in the course of such trade or business is insufficient to meet the present and future requirements of the domestic economy.

(2) SPECIAL RULE FOR RATABLE FLOW-THROUGH.—If the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, paragraph (1) shall not apply, but no credit shall be allowed by section 38 with respect to any property which is public utility property (as defined in paragraph (5)) of the taxpayer—

(A) COST OF SERVICE REDUCTION.—If the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit allowable by section 38 (determined without regard to this subsection), or

(B) RATE BASE REDUCTION.—If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection).

(3) SPECIAL RULE FOR IMMEDIATE FLOW-THROUGH IN CERTAIN CASES.—In the case of property to which section 167(l)(2)(C) applies, if the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, paragraphs (1) and (2) shall not apply to such property.

(4) LIMITATION.—

(A) IN GENERAL.—The requirements of paragraphs (1), (2), and (9) regarding cost of service and rate base adjustments shall not be applied to public utility property of the taxpayer to disallow the credit with respect to such property before the first final determination which is inconsistent with paragraph (1), (2), or (9) (as the case may be) is put into effect with respect to public utility property (to which this subsection applies) of the taxpayer. Thereupon, paragraph (1), (2), or (9) shall apply to disallow the credit with respect to public utility property (to which this subsection applies) placed in service by the taxpayer—

(i) before the date that the first final determination, or a subsequent determination, which is inconsistent with paragraph (1), (2), or (9) (as the case may be) is put into effect, and

(ii) on or after the date that a determination referred to in clause (i) is put into effect and before the date that a subsequent determination thereafter which is consistent with paragraph (1), (2), or (9) (as the case may be) is put into effect.

(B) DETERMINATIONS.—For purposes of this paragraph, a determination is a determination made with respect to public utility property (to which this subsection applies) by a governmental unit, agency, instrumentality, or commission or similar body described in subsection (c)(3)(B) which determines the effect of the credit allowed by section 38 (determined without regard to this subsection)—

(i) on the taxpayer's cost of service or rate base for ratemaking purposes, or

(ii) in the case of a taxpayer which made an election under paragraph (2) or the election described in paragraph (9), on the taxpayer's cost of service for ratemaking purposes or in its regulated books of account or rate base for ratemaking purposes.

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(C) SPECIAL RULES.—For purposes of this paragraph—

(i) a determination is final if all rights to appeal or to request a review, a rehearing, or a redetermination, have been exhausted or have lapsed,

(ii) the first final determination is the first final determination made after the date of the enactment of this subsection, and

(iii) a subsequent determination is a determination subsequent to a final determination.

(5) PUBLIC UTILITY PROPERTY.—For purposes of this subsection, the term “public utility property” means—

(A) property which is public utility property within the meaning of subsection (c)(3)(B), and

(B) property used predominantly in the trade or business of the furnishing or sale of (i) steam through a local distribution system or (ii) the transportation of gas or steam by pipeline, if the rates for such furnishing or sale are established or approved by a governmental unit, agency, instrumentality, or commission described in subsection (c)(3)(B).

(6) RATABLE PORTION.—For purposes of determining ratable restorations to base under paragraph (1) and for purposes of determining ratable portions under paragraph (2)(A), the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used.

(7) REORGANIZATIONS, ASSETS ACQUISITIONS, ETC.—If by reason of a corporate reorganization, by reason of any other acquisition of the assets of one taxpayer by another taxpayer, by reason of the fact that any trade or business of the taxpayer is subject to ratemaking by more than one body, or by reason of other circumstances, the application of any provisions of this subsection to any public utility property does not carry out the purposes of this subsection, the Secretary or his delegate shall provide by regulations for the application of such provisions in a manner consistent with the purposes of this subsection.

(8) PROHIBITION OF IMMEDIATE FLOWTHROUGH.—An election made under paragraph (3) shall apply only to the amount of the credit allowable under section 38 with respect to public utility property (within the meaning of subsection (a)(7)(D))^(*) determined as if the Tax Reduction Act of 1975, the Tax Reform Act of 1976, the Energy Act of 1978, and the Revenue Act of 1978 had not been enacted. Any taxpayer who had timely made an election under paragraph (3) may, at his own option and without regard to any requirement imposed by an agency described in subsection (c)(3)(B), elect within 90 days after the date of the enactment of the Tax Reduction Act of 1975 (in such manner as the Secretary shall prescribe) to have the provisions of paragraph (3) apply with respect to the amount of the credit allowable under section 38 with respect to such property which is in excess of the amount determined under the preceding sentence. If such taxpayer does not make such an election, paragraph (1) or (2) (whichever paragraph is applicable without regard to this paragraph) shall apply to such excess credit, except that if neither paragraph (1) nor (2) is applicable (without regard to this paragraph), paragraph (1) shall apply unless the taxpayer elects (in such manner as the Secretary shall prescribe) within 90 days after the date of the enactment of the Tax Reduction Act of 1975 to have the provisions of paragraph (2) apply. The provisions of this paragraph shall not be applied to disallow such excess credit before the first final determination which is inconsistent with such requirements is made, determined in the same manner as under paragraph (4).

* The reference for tax years ending after 1978 should be to subsection (a)(7)(C).—CCH.

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(9) SPECIAL RULE FOR ADDITIONAL CREDIT.—If the taxpayer makes an election under subparagraph (B) of subsection (a)(2), for a taxable year beginning after December 31, 1975, then, notwithstanding the prior paragraphs of this subsection, no credit shall be allowed by section 38 in excess of the amount which would be allowed without regard to the provisions of subparagraph (B) of subsection (a)(2) if—

(A) the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by reason of any portion of such credit which results from the transfer of employer securities or cash to an employee stock ownership plan which meets the requirements of section 301(d) of the Tax Reduction Act of 1975;

(B) the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of such credit which results from a transfer described in subparagraph (A) to such employee stock ownership plan; or

(C) any portion of the amount of such credit which results from a transfer described in subparagraph (A) to such employee stock ownership plan is treated for ratemaking purposes in any way other than as though it had been contributed by the taxpayer's common shareholders.

(g) 50 PERCENT CREDIT IN THE CASE OF CERTAIN VESSELS.—

(1) IN GENERAL.—In the case of a qualified withdrawal out of the untaxed portion of a capital gain account or out of an ordinary income account in a capital construction fund established under section 607 of the Merchant Marine Act, 1936 (46 U. S. C. 1177), for—

(A) the acquisition, construction, or reconstruction of a qualified vessel, or

(B) the acquisition, construction, or reconstruction of barges or containers which are part of the complement of a qualified vessel and to which subsection (f)(1)(B) of such section 607 applies,

for purposes of section 38 there shall be deemed to have been made (at the time of such withdrawal) a qualified investment (within the meaning of subsection (c)) or qualified progress expenditures (within the meaning of subsection (d)), whichever is appropriate with respect to property which is section 38 property.

(2) AMOUNT OF CREDIT.—For purposes of paragraph (1), the amount of the qualified investment shall be 50 percent of the applicable percentage of the qualified withdrawal referred to in paragraph (1), or the amount of the qualified progress expenditures shall be 50 percent of such withdrawal, as the case may be. For purposes of determining the amount of the credit allowable by reason of this subsection for any taxable year, the limitation of subsection (a)(3) shall be determined without regard to subsection (d)(1)(A) of such section 607.

(3) COORDINATION WITH SECTION 38.—The amount of the credit allowable by reason of this subsection with respect to any property shall be the minimum amount allowable under section 38 with respect to such property. If, without regard to this subsection, a greater amount is allowable under section 38 with respect to such property, then such greater amount shall apply and this subsection shall not apply.

(4) COORDINATION WITH SECTION 47.—Section 47 shall be applied—

(A) to any property to which this subsection applies, and

(B) to the payment (out of the untaxed portion of a capital gain account or out of the ordinary income account of a capital construction fund established under section 607 of the Merchant Marine Act, 1936) of the principal of any indebtedness incurred in connection with property with respect to which a credit was allowed under section 38.

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For purposes of section 47, any payment described in subparagraph (B) of the preceding sentence shall be treated as a disposition occurring less than 3 years after the property was placed in service; but, in the case of a credit allowable without regard to this subsection, the aggregate amount which may be recaptured by reason of this sentence shall not exceed 50 percent of such credit.

(5) **DEFINITIONS.**—Any term used in section 607 of the Merchant Marine Act, 1970, shall have the same meaning when used in this subsection.

(6) **NO INFERENCE.**—Nothing in this subsection shall be construed to infer that any property described in this subsection is or is not section 38 property, and any determination of such issue shall be made as if this subsection had not been enacted.

(h) **SPECIAL RULES FOR COOPERATIVES.**—In the case of a cooperative organization described in section 1381(a)—

(1) that portion of the credit allowable to the organization under section 38 which the organization cannot use for the taxable year to which the qualified investment is attributable because of the limitation contained in subsection (a)(3) shall be allocated to the patrons of the organization,

(2) section 47 (relating to certain dispositions, etc., of section 38 property) shall be applied as if any allocated portion of the credit had been retained by the organization, and

(3) the rules necessary to carry out the purposes of this subsection shall be determined under regulations prescribed by the Secretary.

.01 Added by P. L. 87-834. Amended by P. L.'s 95-618, 95-600, 94-455, 94-12, 93-406, 92-178, 91-172, 90-225, 89-800, 89-389, 89-384 and 88-272. For details, see the Code Volumes.

Committee Reports on P. L. 95-618

.0283 The conference agreement generally follows the Senate bill in allowing the full 10-percent investment tax credit for certain vehicles used in van pooling, but it does not allow the additional 10-percent business energy credit for any of these vehicles. The full credit would apply only to vehicles acquired by the taxpayer after the date of enactment and placed in service prior to January 1, 1986.

Several changes are made in the definition of eligible vehicles. The eligible vehicles are redesignated as "commuter highway vehicles," the passenger seating capacity of which is at least 8 adults (not including the driver) and at least 80 percent of the mileage use of which is for vanpooling. Generally, use for vanpooling means use for the purpose of transporting the taxpayer's employees between their residences and their places of employment on trips during which the number of employees transported for this purpose is at least one-half of the adult seating capacity of the vehicle (not including the driver). The mileage use which qualifies as vanpooling use includes not only mileage travelled on trips which transport the required number of employees, but also use which is incident to such trips (such as "deadheading").

This revised definition is intended (*inter alia*) to make it clear that a bus, as well as a van, may qualify for the full investment credit under this provision.

In determining whether employees are transported from their homes to their places of employment, it is not necessary that the employees be picked up at, and transported to,

their homes. It is sufficient to meet this requirement if the employees are transported to and from some central pickup point (or points) or intermediate location between the employees' residences and places of employment. * * *.—**Conference Committee Report.**

.0284 The committee's bill adds this business energy credit to the regular investment credit provisions. (Eligibility for the special energy credit under this provision, however, does not affect the eligibility of the property for the regular investment credit under present law.) As a result, the rules for applying the regular investment credit will also generally apply to the business energy investment credit. For example, business energy credits will be absorbed using the first-in, first-out (FIFO) rules which apply to the regular investment credit. Business energy credits may also be carried back for three years and carried forward for seven years, as is the case with the regular investment credit.—**House Committee Report.**

.0285 The additional credits, except those for solar and wind energy equipment, are not refundable, but may be used to offset 100 percent of tax liability. The rules for applying the limitations based on tax liability to the use of the investment credit in combination with the energy credits provided in the conference agreement will operate under the following stacking order. A taxpayer first will apply the credits attributable to section 38 property (not including the energy credits provided in this agreement) against tax liability to the extent allowed under current law. The first-in, first-out rule of section 46(a) will continue to apply with respect to the stacking of credits within the limitation. Next, a taxpayer will apply the credits attributable to the application of the energy percentage to energy property to the remaining tax liability, up to 100 percent of that tax liability. Finally, if the energy credits exceed tax liability and any of the excess is attributable to solar and wind energy credit, these latter amounts will be treated as an over-

[§ 586.0285]—Continued

payment of tax[,] i. e., as if the amounts were allowed by section 39.—Conference Committee Report.

.0286 For further Committee Reports on P. L. 95-618 that deal with business energy property investment credits, see § 592.0135.

Committee Reports on P. L. 95-600

.029 Under the committee's bill, the temporary investment credit rate of 10 percent for all taxpayers, which is scheduled to return to 7 percent (4 percent for utilities) in 1981, is made permanent. The present temporary \$100,000 annual limitation on used property eligible for the credit, which is scheduled to return to \$50,000 in 1981, is also made permanent. * * *

These amendments will become effective on January 1, 1981, when the temporary extensions are scheduled to expire.—House Committee Report.

.0291 The bill would increase the present 50 percent tax liability limitation to 90 percent, to be phased in at an additional 10 percentage points per year beginning with taxable years which end in 1979. As a result, the limitation will be 60 percent for taxable years ending in 1979, 70 percent for 1980, 80 percent for 1981, and 90 percent for 1982 and subsequent years. For example, in taxable years ending in 1980, taxpayers in general will be entitled to use investment credits (including carryover and carryback credits) to offset the first \$25,000 of tax liability dollar-for-dollar, and 70 percent of tax liability in excess of \$25,000.

Special rules are also provided for railroads, airlines, and certain utilities so that the phase-in of this increased limitation does not reduce the amounts of investment credits these taxpayers may use under the special increased limitations made available to them by present law. For example, present law provides railroads and airlines each with a limitation of up to 80 percent for 1980, when the generally applicable limitations under this bill will be 70 percent. In this situation, taxpayers investing in railroad property or in airline property may apply whichever limitation entitles them to use the greater amount of investment credits.

These amendments are effective for taxable years ending after December 31, 1978.—House Committee Report.

.0292 The bill relaxes the restriction in present law limiting the amount of investment credit available for pollution control facilities which a taxpayer has elected to amortize over a five-year period. Under the bill, the full investment credit will generally be allowed on pollution-control facilities which are amortized over 5 years and which have actual useful lives of at least 5 years. (Pollution control facilities which have useful lives of 3 or 4 years will continue to be subject to the present law rule which, in effect, limits the credit to one-third of the full credit.)

A limitation is provided where five-year amortization is elected and the pollution control facility has also been financed in whole or in part by tax-exempt industrial development bonds. In order to reduce the duplication of tax incentives in such situations, the bill limits the amount of credit to, in effect, one-half of the full credit. In cases where the proceeds of industrial development bonds have been used to partially finance the construction of a plant

or factory, including a pollution control facility for which the taxpayer elects five-year amortization, a pro-rata portion of the tax-exempt financing should be allocated to the pollution control facility for purposes of applying this limitation.

This amendment will apply to pollution control facilities acquired or constructed after December 31, 1978.—House Committee Report.

.0293 House bill.—No provision.

Senate amendment.—Under present law, cooperatives are generally taxed like corporations, but are allowed to deduct certain payments made to patrons and shareholders. The amount of investment credit available for cooperatives is reduced proportionate to the reduction in taxable income because of the special deductions. These otherwise allowable credits expire and are not passed through to the patrons or shareholders.

The Senate amendment allows taxable cooperatives (those defined in Code section 1381(a)) the full investment credit for taxable years ending after December 31, 1978. The credit is not reduced proportionate to the reduction in taxable income because of deductions for payments made to patrons and shareholders. In addition, these cooperatives are allowed an irrevocable annual election to apportion all or part of the credit they have earned each taxable year to their patrons proportionate to patronage business done with the patron during the year.

Conference agreement.—Under the conference agreement, the special limitations on the investment credit by cooperatives are eliminated. Cooperatives will be permitted to use the investment credit in the year property is placed in service to the same extent as corporations generally. To the extent a cooperative cannot use an investment credit in the current year, the credit will not be carried back or carried forward but will be allocated to the patrons of the cooperative. Any recapture of investment credits including credits allocated to patrons, will be effected at the level of the cooperative. These rules will apply for taxable years ending after October 31, 1978. The Secretary is authorized to promulgate regulations to effect the purposes of this section. For this purpose, it is anticipated that the allocation of the credit to patrons will be on a basis similar to that used for patronage dividends under section 1388(a)(1). The rules will provide for the treatment of carryovers of investment credits from years prior to the effective date of this provision which are not to be allocated to patrons of the cooperative.—Conference Committee Report.

.0295 For committee reports on P. L. 95-600 dealing with the ESOP investment credit, see § 2665CA.02.

Committee Reports on P. L. 94-455

EXTENSION OF 10 PERCENT CREDIT AND USED PROPERTY LIMITATION

.03 The bill continues for four additional years, from 1977 through 1980, the 10-percent credit and continues the \$100,000 limitation on qualified investment in used property.—House Ways and Means Committee Report.

FIRST-IN-FIRST-OUT TREATMENT OF INVESTMENT CREDITS

.032 House bill.—No provision.

Senate amendment.—Present law provides in general that the amount of investment credit

used in any year cannot exceed \$25,000 of tax liability plus 50 percent of any liability in excess of \$25,000. A 3-year carryback and 7-year carryforward is then applied to credits which are not used because of the tax liability limitation. (A 10-year carryforward is available for pre-1971 credits.) Generally, investment credits earned in a particular year are applied first to the tax liability for that year, after which carryovers and carrybacks of unused credits from other years may be applied.

Under the Senate amendment, credits carried over are used first and then credits earned currently are used; after that, any carryback credits may be applied. If there is more than one carryforward or carryback to a particular year, the oldest credit is generally used first. The amendment applies to taxable years beginning after December 31, 1975.

Conference agreement.—The conference agreement follows the Senate amendment.—*Conference Committee Report.*

ESOP INVESTMENT CREDIT PROVISIONS

.034 *House bill.*—No provision.

Senate amendment.—Under present law an extra percentage point of investment credit (11 percent rather than 10 percent) is allowed where the additional credit amount is contributed to an employee stock ownership plan (ESOP). The additional credit expires after 1976. The Senate amendment increases the additional ESOP credit to 2 percentage points permanently, for taxable years beginning after December 31, 1976.

The Senate amendment also makes a series of modifications in the case of ESOPs. It (1) prevents flow-through of the investment credit contributed by a public utility to an ESOP; (2) permits employer securities to be contributed to an ESOP as the credit is allowed rather than when it is claimed; (3) provides that future contribution under the investment credit rules may be reduced if investment credits which have been contributed to an ESOP are recaptured or disallowed; (4) permits use of stock of "brother-sister" corporations, "second-tier" subsidiaries and corporations which would be affiliates except for non-voting preferred stock to be contributed to an ESOP under the investment credit rules; (5) excludes employer stock held by an ESOP for purposes of determining whether corporations are sufficiently affiliated to permit the filing of consolidated returns; (6) permits ESOPs to be considered permanent plans even though contributions are contingent upon the availability of the additional investment credit; (7) doubles the dollar amount the overall limitation on contributions permitted to be made to an ESOP and provides that employee compensation for purposes of the ESOP rules is the same as that under the overall limitations; (8) permits a limited amount of "start up" and administrative expenses to be charged against the additional investment credit contributed to an ESOP; and (9) permits an employer to qualify for the additional 1975 investment credit if the additional credit is contributed to an ESOP not later than 90 days after date of enactment. These nine provisions are generally effective for taxable years beginning after December 31, 1974.

Conference agreement.—The conference agreement follows the Senate amendment but limits the additional credit program to qualified investments made before January 1, 1981, and limits the additional credit generally to 1 per-

centage point. An additional one-half percentage point is available only if the first percentage point is contributed to the ESOP, and only to the extent the one-half percent is matched by employee contributions to the ESOP. Under the conference agreement, separate accounting would be required for matching employee and employer contributions continuing present law treatment, an employer contribution for a taxable year in excess of the amount attributable to the additional credit allowed for such year is deductible for that year, subject to the usual rules for deduction of contributions to employee plans.

Under the conference agreement, employer and employee contributions to an investment credit ESOP are subject to overall limitations on contributions and benefits under tax-qualified pension, etc. plans. These limitations may restrict the amount of additional investment credit allowable.

The conferees intend that employee contributions can be taken into account for the additional credit if they are contributed to the plan before the end of the year in which the credit is allowed or if the contributions are pledged by the employees to be paid within 2 years after the close of that year and the pledge is made before the return is filed. If employee contributions are made in excess of the amount pledged and matched with employer contributions, additional credit can be claimed by the employer for the year the property giving rise to the credit was placed in service. Under the agreement, employee contributions made under the matching rules are to be invested in employer securities under the same rules that apply to employee contributions.

If the plan provides, the agreement permits funds contributed by the employer to be withdrawn from an investment credit ESOP (1) to refund employer contributions which are not matched by employee contributions within the period specified, or (2) to permit the employer to recover from the ESOP any portion of the employer's contribution which is recaptured from the employer under the investment credit rules (for example, where the property for which the credit is claimed is disposed of prematurely). The conferees intend that the withdrawal of employer contributions made under the one-half percent credit rules because they are not matched by employee contributions, or a withdrawal of employer contributions under the recapture rules should not cause the plan to be considered as other than for the exclusive benefit of employees and that employee rights to employer-derived benefits under the plan should not be considered forfeitable merely because employer contributions of investment credit may be withdrawn under the matching or recapture rules. Recovery of recaptured investment credit would not be permitted unless the employer contributions for each year are separately accounted for (all contributions made before enactment of the Act could be aggregated for this purpose).

Under the conference agreement, employee funds contributed to an ESOP are subject to employee withdrawal unless they are matched by employer contributions under the one-half percent credit rules. For example, if matching employer contributions cannot be made because of the overall limitations on benefits and contributions (sec. 415 of the Code) the unmatched employee contributions would be refunded to the employee (unless he instructs the plan to the contrary).

[§ 586.034]—Continued

Also, under the agreement employee contributions to an investment credit ESOP are subject to the same antidiscrimination rules as apply to employee contributions under a tax-qualified pension plan, and matched employee contributions are subject to the same restrictions on distribution as employer contributions (generally, no withdrawal is permitted for 84 months).

Employee contributions may not be compulsory; that is, employee contributions may not be made a condition of employment or a condition of participation in the plan. Of course, the level of employer-derived benefits under the matching rules may depend upon employee contributions.

The conference agreement follows the Senate amendment on items (1) through (8) above, but provides that the non-flow through rule applies to credits claimed for taxable years after 1975. The agreement also provides that on recapture a deduction for the employer or recovery of the recaptured contribution from the ESOP are available as additional alternatives. To use the option of recapture from an ESOP for any year's contribution, the ESOP must establish separate accounts for that year's contribution. Under (8), the ESOP may pay "start up" and ongoing administrative expenses, but an annual ceiling of \$100,000 was agreed to with respect to ongoing expenses (in addition to the limits by the Senate amendment). The grace period under (9) was not agreed to. The conferees agreed that contributions could be made to a plan contingent upon an Internal Revenue Service determination that the plan qualifies under the investment credit and employee plan rules.

The conferees understand that some employers may have reduced their estimated tax payments in anticipation of the enactment of the 90-day grace period provision (item (9)) or anti-flow through provisions of the Senate amendment. Because that provision was not agreed to, the agreement provides that no penalties are to be imposed for underpayment of the tax where the underpayment is caused by the taxpayer's inability to avail itself of the grace period or anti-flow through provisions.

The conference agreement follows the Senate amendment on items (1) through (8) above, but provides under (3) that on recapture a deduction for the employer and recapture from the ESOP are available as alternatives. Under (8), the ongoing expenses may not exceed \$100,000 (in addition to the limits in the Senate amendment). The flow-through provisions under (1), will be effective only for taxable years ending after December 31, 1975.—*Conference Committee Report.*

INVESTMENT CREDIT LIMITATION
FOR RAILROADS

.036 House bill.—No provision.

Senate amendment.—Present law provides that investment credits which may be used are generally limited to 50 percent of tax liability for the taxable year. Public utilities, however, are allowed to use their credits up to 100 percent of tax liability for taxable years ending in 1975 and 1976, and in percentages which are reduced annually by 10 percentage points for later years until 1981, when the limitation returns to 50 percent.

The Senate amendment allows railroads to take credits up to 100 percent of tax liability for 1976 and 1977 with annual reductions of 10

percentage points thereafter until the limitation returns to 50 percent in 1982. The amendment applies to tax years ending after December 31, 1975.

Conference agreement.—The conference agreement adopts the Senate amendment but moves the effective date forward one year so that it will begin to apply in taxable years ending after December 31, 1976, and the limitation will return to 50 percent in 1983. In addition, the conferees specified that only a railroad, and not a lessor of railroad property, is entitled to this temporary increase in the investment credit limitation.—*Conference Committee Report.*

.037 Restructuring sequence of credits.—Under the committee amendment in applying investment credits against tax liability in any current tax year, railroads are to be allowed to apply unused credits earned in the earliest year first, then the second earliest year and so forth, until all unused credits earned in prior years have been used up, before credits earned in the current year are to be applied against current tax liability. If the sum of prior year credits exceeds the amount of current tax liability that may be offset, unused credits from the most recent prior years and from the current year are to be carried forward to the next year. There was no comparable provision in the House bill. For illustration, assume that a taxpayer has unused credits from year 1 which have been carried forward 6 years to year 7. Assume there are no unused credits arising in the intervening years. In year 7, the committee amendment provides that the carryforward from year 1 (to the extent not used in prior years) is to be applied against that year's tax liability before any credits earned currently. Under present law, the credit carried over from year 1 would, of course, be applied against year 8 tax liability only to the extent there was income in the current year (within the limitation) that had not been offset by credits earned currently.

Temporary increase in limitation of liability.—The committee also provided a temporary increase in the limitation on the amount of investment tax credit which may be used in a year. This provision permits railroads to apply investment tax credits against 100 percent of their tax liability in 1977 and 1978. This limitation decreases by 10 percentage points in each of the subsequent five years until the limitation reverts to 50 percent in 1983. This provision is analogous to the increase in the limitation on use of the investment credit that was enacted for public utility property in the Tax Reduction Act of 1975.

There are no comparable provisions in the House bill.

Restructuring the carryback and carryforward provisions of the investment credit to permit prior year unused credits to be offset against current tax liability before current year credits is to be effective with respect to computations made in years ending after December 31, 1975.

The temporary increase in the limitation to 100 percent is to be effective with respect to computations made in years ending after December 31, 1976.—*Senate Finance Committee Report.*

INVESTMENT CREDIT LIMITATION
FOR AIRLINES

.038 House bill.—No provision.

Senate amendment.—Present law provides that investment credits which may be used are generally limited to 50 percent of tax liability

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for the tax year. Public utilities, however, are allowed to use their credits up to 100 percent of tax liability for taxable years ending in 1975 and 1976, and in percentages which are reduced annually by 10 percentage points for later years until 1981, when the limitation returns to 50 percent. The Senate amendment allows airlines to take credits up to 100 percent of tax liability for 1976 and 1977 with annual reductions of 10 percentage points thereafter until the limitation returns to 50 percent in 1982. The amendment applies to taxable years ending after December 31, 1975.

Conference agreement.—The conference agreement adopts the Senate amendment but moves the effective date forward one year so that it will begin to apply in taxable years ending after December 31, 1976, and the limitation will return to 50 percent in 1983. The conferees also decided to include all common carrier airlines as eligible for this temporary increase in the limitation and it was specified that only an airline, and not a lessor of airline property, is entitled to the increased limitation.—Conference Committee Report.

POLLUTION CONTROL FACILITIES

.039 House bill.—No provision.

Senate amendment.—From 1969 through December 31, 1975, an election for 5-year amortization was available to a taxpayer who installed a new identifiable, certified pollution control facility in connection with property that was in operation before January 1, 1969. The amortizable basis of the facility was not eligible for the investment tax credit. The Senate amendment provides a 5-year amortization election for facilities installed in property in the past, makes amortization available for facilities that will prevent the creation or emission of pollutants, and provides a two-thirds investment credit for such facilities placed in service after December 31, 1976. The extension of the 5-year amortization election and its availability for preventive facilities apply for taxable years beginning after December 31, 1975. The investment credit provision applies for taxable years beginning after December 31, 1976.

Conference agreement.—The conference agreement follows the Senate amendment with modifications that extend the election to facilities that will prevent the creation or emission of pollutants when installed at the site of a plant or other property in existence before January 1, 1976, which do not lead to a significant increase in output or capacity, a significant extension of useful life, or a significant reduction in total operating costs for such plant or other property (or any unit thereof), or a significant alteration in the nature of a manufacturing production process or facility. For the purposes of this provision, significant means a change of more than 5 percent. Only one-half of the investment credit will be available for such pollution control facilities. In determining how significant is the effect of a pollution control facility upon output, capacity, costs or useful life of property, the relevant area for examination is to be the operating unit most directly associated with the pollution control facility. The conference agreement also provides that the broader definition of a pollution control facility which is eligible for the amortization election does not apply in determining whether a facility is a pollution control facility eligible for tax-exempt industrial development bond financing.

The conference agreement extends the definition of a qualified pollution control facility

to include, for example, a facility located at a plant site which prevents the creation of a pollutant by removing sulphur from fuel before it is burned at the plant. The definition includes such facilities as a recovery boiler that removes pollutants from material at some point in the otherwise unchanged production process at the plant. The conference agreement does not include as a qualified pollution control facility a facility that makes a significant change in a, or functions as a new, manufacturing or production process or facility. Where a plant that has employed heat to process a material changes to an electrolytic process, the latter is not a qualified pollution control facility because it is also a new manufacturing or production process even though it may prevent the creation and emission of pollutants.—Conference Committee Report.

INVESTMENT CREDIT FOR CERTAIN VESSELS

.041 House bill.—No provision.

Senate amendment.—Under current law, the tax on income deposited into a capital construction fund (established under section 21 of the Merchant Marine Act of 1970) for the construction of certain vessels is deferred. When the funds are withdrawn to purchase a qualified vessel, there is no tax basis in the purchase vessel to the extent of the withdrawal. This reduces the amount of investment credit available on the purchased vessel. The Senate amendment provides that the amount of investment tax credit is not to be reduced because of a deposit in, or qualified withdrawal from, a capital construction fund. The Senate amendment takes effect for taxable years beginning after December 31, 1969.

Conference agreement.—The conference agreement provides for an investment credit of one-half the regular credit on the tax-deferred amounts withdrawn from the capital construction fund which are used to purchase qualified vessels. In addition, the conferees intend that taxpayers are to have the right to obtain a court determination as to whether they are, under already existing law, also eligible for the other one-half of the regular investment credit. The conferees intend that no inferences be drawn either way on this issue from the action taken here.

If a taxpayer claims the full investment credit on its tax return, it is expected that the Internal Revenue Service will provide, by regulations, procedures which will require the taxpayer to indicate on its return that the full investment credit is being claimed. This will alert the Internal Revenue Service as to the position taken by the taxpayer on this point. If the IRS asserts a deficiency in this case, the taxpayer will have the option of pursuing its claim for the full credit in the tax court. In addition, the taxpayer may file a claim for a refund which would allow the taxpayer to pursue its claim with the Court of Claims or in the District Courts.

Where a taxpayer purchases a ship with borrowed funds and uses the capital construction fund to pay off the indebtedness, there initially would be allowed a full investment credit and then subsequently there is to be a recapture of no more than 50 percent of the amount of the investment credit taken on the purchase price of the ship representing the indebtedness which is being liquidated with tax deferred amounts from the capital construction fund.

The conference agreement applies to taxable years beginning after December 31, 1975. This

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is not intended to provide any inference as to the application of existing law with respect to the availability of the credit for prior (as well as future) years.—Conference Committee Report.

Committee Reports on P. L. 94-12

INCREASE IN INVESTMENT CREDIT

.049 House bill.—The House bill provides for an increase in the investment credit rate for all taxpayers (including public utilities) to 10 percent from 7 percent (4 percent in the case of certain public utility property). The additional credit for public utilities is limited to \$100 million for any one taxpayer. The House provision modifies the limitation on the amount of tax liability that may be offset by the investment tax credit for a year in the case of most public utility property (which under present law is entitled to only a 4 percent investment credit). The percentage limit for public utility property is to be increased from the general 50 percent limit to 100 percent of the income tax liability for 1975 and 1976. In each of the next five taxable years, the increase for public utilities is to be reduced by 10 percentage points until 1981, and thereafter, at which time the 50 percent limitation again is effective. Additionally, the House provision increases from \$30,000 to \$75,000 the amount of use property which can qualify for the investment credit for any 1 year.

The 10 percent investment credit rate is to be available for property acquired and placed in service after January 21, 1975, and before January 1, 1976. It is also to be available for property placed in service in 1976 if the property was acquired pursuant to an order placed before January 1, 1976. In addition, in the case of property constructed, reconstructed or erected by the taxpayer, the 10 percent investment credit rate is to be available for property completed by the taxpayer after January 21, 1975, but only to the extent of the portion of the value actually attributable to construction, etc., by the taxpayer after January 21, 1975, and before January 1, 1976. The provisions increasing the amount of used property which can qualify for the investment credit apply to taxable years beginning in 1975. The provisions with respect to progress payments apply to payments made after January 21, 1975, in taxable years ending after December 31, 1974.

Senate amendment.—The Senate amendment provides that, if certain requirements are met, a 12 percent investment credit is to be available with respect to property acquired and placed in service after January 21, 1975, and before January 1, 1977. Similarly, in the case of property constructed, reconstructed, or erected by the taxpayer, the 12 percent credit is also to be available with respect to property completed by the taxpayer after January 21, 1975, to the extent of the part of the basis of the property properly attributable to construction, etc., after January 21, 1975, and before January 1, 1977.

In cases where the property on which a taxpayer may claim an investment credit (qualified investment in property) for a year exceeds \$10,000,000, the 12 percent rate is to be available only if the taxpayer establishes or maintains an employee stock ownership plan. To be eligible for the 12 percent rate in this case, a corporation will be required to contribute to the plan for the taxable year common stock or securities convertible into common stock (or

cash for the acquisition of such stock or securities) of the employer in an amount equal to one-half of the additional 2 percentage point increase above the permanent 10 percent rate (i.e., one-twelfth of the total allowable investment credit in this case). If these requirements are not satisfied, the taxpayer will be eligible only for the 10 percent investment credit which the committee provision adopts as a permanent increase in the investment tax credit rate. However, the 12 percent rate will be available without regard to the requirement for an employee stock ownership plan if the qualified investment property of the taxpayer for the taxable year is less than \$10,000,000.

The Senate provision puts no limit on the amount of the increase in the investment credit which will be allowed to a public utility. Additionally, the Senate provision adopts the temporary increase in the 50 percent limitation on the amount of tax liability that may be offset by the investment credit with the modification that such increase shall be available for taxable years ending in 1975 rather than for taxable years beginning in 1975.

The Senate provision also provides that the additional credit provided for a public utility by reason of the rate increase or the increase in the limitation based on tax liability is generally not to be available if the additional credit is used to reduce the rate base, unless the credit is then restored to the rate base at least as fast as ratably over the useful life of the property. The additional credit is generally not to be allowed if it is flowed through to income as a reduction in cost faster than ratably over the useful life of the property to which the increased credit applies. This rule with respect to the additional credit is to apply with respect to property used predominantly in the trade or business of the furnishing or sale of electrical energy, water, or sewage disposal services, gas through a local distribution system, telephone service, domestic telegraph service, or other domestic communication service, if the rates for furnishing or sale are regulated by a governmental body.

If the governmental regulatory agency requires ratable flow through to income, it cannot require any adjustment to the rate base; if the agency requires adjustments to the rate base, it cannot require flow through to income.

A special election is provided to permit the immediate flow through of the additional credit without the consequence of disallowance in certain cases. This election is to be available only with respect to property where the benefits of accelerated depreciation are flowed through to customers. The election must be made by the taxpayer within 90 days after the date of enactment of the bill. In this case the taxpayer must make the election at its own option and without regard to any requirement imposed by a regulatory agency.

If a regulatory agency requires the flowing through of a company's additional investment credit at a rate faster than permitted, or insists upon a greater rate base adjustment than is permitted, the additional investment credit is to be disallowed, but only after a final determination (made after enactment of this provision) is put into effect. The rules provided under present law with respect to determinations made by a regulatory body on the finality of its orders will apply to the flow through provision. Lastly, the Senate provision repeals the limitation on the amount of used property which may be included as qualified investment

for the purposes of the investment credit with respect to used property acquired by the taxpayer after January 21, 1975.

Conference substitute.—The conference substitute provides for a 10-percent investment credit for all taxpayers (including public utilities) for property acquired and placed in service after January 21, 1975, and before January 1, 1977. In the case of property acquired after December 31, 1976, the 7-percent investment credit (or 4 percent for public utility property) provided under present law is to apply (even if ordered by the taxpayer before 1977). In the case of constructed property, the 10-percent credit is to apply to the portion of the basis attributable to construction occurring after January 21, 1975, and before January 1, 1977.

In the case of a corporate taxpayer, a taxpayer may elect an 11-percent credit with respect to qualified investment for the period beginning January 22, 1975, and ending December 31, 1976, if an amount equal to one percent of the qualified investment is contributed to an employee stock ownership plan.

The rules governing such employee stock ownership plans are substantially the same as in the Senate amendment. However, under the conference substitute the entire contribution is to be transferred to the plan at one time, and not over 10 years. Also, participants are to be immediately vested in the full amount of such contributions, as soon as the contributions are allocated to their accounts. Additionally, distributions of such contributions cannot occur for 7 years (or may occur upon death or disability).

The conference substitute is the same as the Senate amendment which deleted the \$100 million limitation on the increase in the investment credit attributable to the rate change that could be claimed by any one public utility.

With respect to the increase in the 50 percent of tax limitation for public utility property, the conference substitute is the same as the Senate amendment.

With respect to the treatment of the increased credit for utility ratemaking purposes, the conference substitute is the same as the Senate amendment but for technical changes which would make new elections by a public utility unnecessary if ratable flow-through, or ratable rate base restoration treatment already applied to a utility under present law.

With respect to the limitation on qualified investment in used property, the conference substitute provides an increase to \$100,000 from \$50,000 for taxable years beginning after December 31, 1974, and before January 1, 1977. Thereafter, the \$50,000 limitation under present law is to apply.—**Conference Committee Report.**

PROGRESS PAYMENTS

.0495 Progress payments.—Under present law, a tax credit may be taken for investment in qualified property at the time the property is placed in service and therefore is ready for use. As indicated previously, the committee con-

cluded that in cases where taxpayers pay for long lead time property as it is being constructed and substantially before the property can be placed in service, to wait for the allowance of the investment credit until the property is placed in service represented too long a delay in the claiming of the credit. The bill overcomes this problem in present law by allowing an investment credit for what are called "progress payments."

Under the bill, a taxpayer, at his election, is to be permitted to treat "qualified progress expenditures" made for new property as a part of the base for which he can claim an investment credit. In general, these qualified progress expenditures are amounts actually paid (or incurred in the case of self-construction property) for construction (or acquisition or reconstruction) of property which has a normal construction period of at least two years and which will have an estimated useful life in the hands of the taxpayer of at least seven years.

The normal construction period generally begins when physical work on the property commences (i. e., not design, blueprints, planning, etc.) and ends when the property is available to be "placed in service" by the taxpayer. However, no normal construction period is to include a period of construction before January 22, 1975 (the general effective date of these provisions), and, where progress payment treatment is elected by the taxpayer for years beginning after that date, no normal construction period will begin before the first day of the taxable year for which the election is in effect.

Where possible, the normal construction period is to be estimated by reference to normal industry practice in producing similar items. The estimate is to be based on the information available at the close of the taxable year in which physical work on the property is started (or, if later, the close of the first taxable year for which the taxpayer has elected to change to this "progress payments" method). Once the normal construction period has been reasonably estimated, the actual time that it takes to complete work on the property would generally be irrelevant for purposes of determining the proper tax treatment of the taxpayer's progress payments.⁴

For purposes of the 2-year test, property which will be placed in service by the taxpayer separately, is to be considered separately (for example, if two ships were contracted for at the same time, each ship would be considered separately). On the other hand, property which must be placed in service by the taxpayer as part of an integrated unit (for example, equipment which will all be placed in service at the same time as part of the same plant) is to be treated as a unit for purposes of the test.⁵ Thus, if the taxpayer is constructing a pipeline which will not be operational for five years after construction begins, the fact that some equipment used in connection with the pipeline (such as pumps for the pumping stations) take less than five years to manufacture, is not to affect the status of the pipeline for progress

⁴ Of course, if there were a significant error in estimating the normal construction period, this could be evidence that the estimate had not been reasonable in the first place, particularly where the error could not be explained by a later change in circumstances.

⁵ Of course, the construction period for property not qualifying for the investment credit, such as real estate, will not affect the "normal

construction period" of any qualifying property which may be used on the premises. Thus, if a plant is being constructed, and qualifying equipment has a normal construction period of less than two years, the progress payments for the equipment are not to be treated as qualified investment, even if the building in which the equipment is to be housed will take more than two years to construct.

11,148 AMOUNT OF INVESTMENT CREDIT—§ 46 [p. 11,125]

[§ 586.0495]—Continued

payment purposes. Also, the taxpayer may treat all amounts expended in connection with the pipeline as progress payments (including amounts expended for the pumps). On the other hand, if some segment of the pipeline can be placed in service in less than two years, progress payment treatment is not to be available with respect to that segment.

In the case of self-constructed property (i. e., property where it is reasonable to believe that the taxpayer will bear more than half of the construction costs directly) "qualified progress expenditures" will generally equal the costs incurred by the taxpayer which are properly chargeable to capital account in connection with that property (for purposes of the investment credit). Thus, qualified progress expenditures would not include any depreciation sustained with respect to other property (machinery, equipment, etc.) used in the construction of new section 38 property (because such depreciation is not part of the basis for purposes of section 38), nor generally would it include the adjusted basis of reconstructed property at the time the reconstruction is commenced.

Also, in the case of self-constructed property, qualified progress expenditures can include amounts expended for materials by the taxpayer to the extent that the taxpayer can establish, to the satisfaction of the Internal Revenue Service, that these materials have been irrevocably allocated to the construction of the property. For purposes of these rules, an item which is suitable only for use in connection with the property is to be regarded as irrevocably allocated, even though the item has not yet become a part of the property, and even though it has not yet been delivered to the site of the property. Other items may be treated as allocated when they have been delivered to the site under circumstances where it would be impractical to then remove the items to some other project (i. e., pumps delivered to locations on a tundra pipeline could be treated as allocated to that pipeline even though they (but for their location on the tundra) would be usable on other projects). In many cases, the items would not be treated as allocated until they were actually attached or consumed in the construction of the property. Mere bookkeeping notations are not to be sufficient to establish to the satisfaction of the Secretary or his delegate that the necessary allocation has occurred.

In the case of acquired property, qualified progress expenditures are to be the amounts

* For example, assume that in 1980 a taxpayer makes a payment of \$11,000 under a contract which provides for delivery of the property in 1985, with a fixed purchase price of \$110,000 and an estimated cost to the manufacturer of \$100,000. During 1980, the manufacturer incurs \$10,000 of cost in connection with the property.

Under these circumstances the manufacturer will be considered to have made 10 percent progress in connection with the property (\$10,000 of costs incurred divided by \$100,000 of total estimated cost). The taxpayer will be permitted to treat his full \$11,000 payment as qualified investment for 1980, since this payment does not exceed 10 percent of the total cost, to the taxpayer, of the section 38 property.

If, on the other hand, the manufacturer had incurred only \$5,000 of costs in connection with the property in 1980, the taxpayer would be allowed to treat only 50 percent of his \$11,000 payment as qualified investment in 1980 (\$5,500)

paid by the taxpayer to the manufacturer, but only to the extent that there is actual progress made in the construction of the property. (This is further limited by the "pro rata" rule, discussed below.)

For this purpose, "progress" will generally be the percentage of completion, measured in terms of the manufacturer's incurred cost, as a fraction of his anticipated cost (as adjusted from year to year) based upon cost accounting records or in some cases on engineer or architect certificates.*

Where several manufacturers or contractors are used in connection with the same property, "progress" is to be measured on a manufacturer by manufacturer basis, so that the taxpayer may utilize payments made to a manufacturer who has made "progress" within the meaning of these rules, even if payments have also been made to another manufacturer who has made no progress. By the same token, payments to one manufacturer in excess of that manufacturer's progress are not to give rise to credits merely because another manufacturer's progress exceeds the payments made to that other manufacturer.

In the case of self-constructed property, "progress" will generally equal "progress expenditures," so no separate percentage-of-completion test is needed.

"Progress expenditures," as well as "progress" are not to be taken into account to the extent that they occur before the start of the "normal construction period" of the property nor to the extent allocable to nonqualified property. Thus, progress expenditures and progress which occur before January 22, 1975, cannot be utilized by the taxpayer to increase his qualified investment prior to the year in which the property is placed in service. Likewise, progress expenditures and progress which occur before the year for which the taxpayer first elects to come under the progress payment rules cannot be so utilized. Similarly, progress expenditures and progress allocable to a building (or its structural components) would not be taken into account.

To prevent a possible abuse situation, where a manufacturer might certify unrealistic amounts of progress in connection with a project, the committee bill contains a "pro rata" rule. Under this rule, it will be presumed that generally progress will not occur with respect to a project more rapidly than ratably over the expected construction period for the property.¹ However, this presumption could be rebutted if the taxpayer shows by clear and convincing evidence that progress had, in fact, been more rapid.

because there had been only 5 percent "progress" in that year. However, in that case, if the manufacturer incurred an additional \$5,000 of cost in connection with the property in 1981, the taxpayer could treat the \$5,500 of unused 1980 payment as qualified investments for 1981 (receiving, in effect, a carryover of his unused 1980 payment) even if no further payments were made to the manufacturer in 1981.

¹ For example, if physical work pursuant to a contract is begun by July 1, 1980, for the manufacture of a machine to be delivered on July 1, 1985, (5 years later) it will be presumed that there would not be more than 10 percent progress during calendar 1980, and not more than 20 percent progress during the fiscal year from July 1, 1980, through June 30, 1981. (The determination as to the normal construction period of the property will be made only once, at the close of the taxable year in which work on the property commences.)

Progress expenditures may be made in cash, or in the form of property furnished by the taxpayer to the manufacturer for use in the construction of the property. However, if the taxpayer furnishes property, that property is to be taken into account only to the extent that that property could be included in the basis of the completed section 38 property at the time that it is placed in service.

Progress payments may be made out of the taxpayer's capital, or from borrowed funds. However, to prevent an obvious abuse situation, the committee bill provides that progress expenditures made with funds borrowed, directly or indirectly, from the manufacturer of the property may not be treated as qualified investment.

Under the Committee bill, the taxpayer is to be allowed to claim the full credit to which he is entitled with respect to property in the year in which it is placed in service. Of course, amounts which were treated as qualified investments with respect to the property in preceding years, due to the operation of the progress payment rules, are to be subtracted from the amount for which the taxpayer may obtain a credit.⁸

The provisions discussed above are to apply only if the taxpayer makes an election (in a time and manner to be prescribed in regulations) to come under these rules. Once made, the election would apply to all subsequent taxable years, and can only be revoked with the permission of the Commissioner. It is anticipated that taxpayers generally will exercise the election because this will accelerate their opportunity to use the investment credit. However, taxpayers who are currently in a loss situation may not wish to make the election, so that progress payments are not treated as qualified investments until the year in which the property is placed in service, in order to obtain a more favorable carryover period with respect to those payments.

If property is sold or otherwise disposed of by the taxpayer before he places it in service, or if (under Treasury regulations) it becomes apparent that the property will not be section 38 property when placed in service, any amounts which were treated as qualified investments in prior years are, of course, to be subject to full recapture in a manner generally similar to present law.⁹

As discussed above, progress expenditure treatment is to be allowed only in the case of property which has an estimated useful life (meas-

ured from the time the property is placed in service by the taxpayer) of seven years or more. If the estimated useful life of the property is less than seven years at the time it is placed in service (even if previous estimates were for a longer useful life and were reasonable when made) any excess credits previously allowed under the progress payment rules are to be subject to recapture.¹⁰

Where the rate of the investment credit for the year in which qualified progress expenditure treatment was allowed with respect to the property is different from the rate in effect for the year of recapture, then recapture is to occur with respect to the rate in effect when qualified progress expenditure treatment was allowed. For example, recapture of 1975 progress expenditures would be 10 percent of those expenditures, since, under the committee bill, the investment credit for 1975 is to be 10 percent.

Where the actual useful life of the property is less than the estimated life (estimated as of the time when the property is placed in service), any excess credits previously allowed under the progress payment rules will be subject to recapture on the same basis as other excess credits.

In the case where property is subject to a sale-leaseback transaction before the property is placed in service, the following rules are applicable. Where the seller-lessee makes progress payments, but the property is sold to a lessor before the property is placed in service, generally this will be treated as a recapture situation. For example, if a seller-lessee makes progress payments of \$10,000 each in 1980, 1981, and 1982, but the section 38 property is sold to a lessor for \$100,000 in 1984, before the property is placed in service, the lessor would be entitled to the investment credit on his \$100,000 basis, but credits previously allowed to the seller-lessee based on his \$30,000 of progress expenditures would be subject to recapture.

However, where the lessor and lessee enter into an agreement providing that the seller-lessee will be entitled to some or all of the credit, it is contemplated that there would be no recapture of the credits previously allowed with respect to the seller-lessee's progress expenditures since recapture would, in effect, permit the seller-lessee to revive otherwise unusable investment credits.¹¹ Accordingly, recapture is provided except to the extent that the

or pursuant to a sec. 381 transaction, but the decedent, or corporation (as the case may be) would be treated as a "predecessor" of the person receiving the sec. 38 property, and progress payments of the predecessor would have to be taken into account in reducing the qualified investment of the successor.

¹⁰ For example, if a taxpayer made \$10,000 of progress expenditures in 1980 with respect to a piece of section 38 property, reasonably believing at that time that the property would have a seven-year useful life in his hands (so that a full credit was allowable with respect to those payments) but reduces the estimated useful life to 5 years in 1983, when the property is placed in service, so that only a two-thirds credit is allowable, the one-third excess credit previously allowed in connection with the 1980 payment is subject to recapture at the time the property is placed in service.

¹¹ For example, assume that the taxpayer (who has elected to use the progress payment rules) has been constructing a long-lead-time

⁸ Otherwise, the taxpayer might obtain two credits with respect to the same property. For example, assume that section 38 property placed in service in 1985 has a basis of \$100,000, and that of that amount \$10,000 has been treated as qualified investment in each of the years 1982, 1983, and 1984 under the progress payment rules. The taxpayer's basis in the property, for purposes of determining his qualified investment in 1985 is to be \$70,000. (Of course, the taxpayer's basis for purposes of determining depreciation, or his gain or loss from the sale of the property, would not be affected by this adjustment, which is made for investment credit purposes.)

⁹ For example, sale of the property, or of the contract rights to the property before the property is placed in service, is to be treated as a disposition. A similar result is to follow if the contract for the property is cancelled, or if the project is abandoned by the taxpayer. Conveyance of the property by gift is also to be treated as a disposition. However, there would be no recapture in the event of a transfer by death,

11,150 AMOUNT OF INVESTMENT CREDIT—§ 46 [p. 11,125]

[§ 585.0495]—Continued

lease agreement provides for the pass-through of the credit to the seller-lessee.

To minimize the possible doubling up effect of these provisions, where taxpayers would be taking investment credits for all property placed in service this year (even though progress payments had been made with respect to that property in prior years) as well as progress payments made in the year, the committee bill provides that the progress payment provisions are to be phased in over a 5-year period.

Under these transition rules, 20 percent of a taxpayer's 1975 progress expenditures may be treated as part of his qualified investment for 1975. The remaining 80 percent of those payments may be taken into account ratably over the next 4 years (20 percent a year): 40 percent of the progress expenditures made in 1976 may be taken into account in 1976, with the remaining 60 percent of the payments to be taken into account in the remaining 3 years of the phase in period; 60 percent of the progress expenditures made in 1977 can be treated as qualified investments in 1977, with 40 percent of the payments to be phased in ratably in the succeeding two years; 80 percent of the taxpayer's progress expenditures in 1978 could be taken into account as qualified investments in 1978, while the remaining 20 percent of the payments would be taken into account in 1979. By 1979, the phase in period would be complete, and all progress expenditures made in that year and later years could be treated as qualified investments. Also, in 1979 the taxpayer would take into account the final 20-percent phase-in portions of the expenditures in fact made in the four preceding years.

For example, assume that a progress expenditure of \$10,000 were made in 1975. Two thousand dollars of this amount would be treated as a qualified investment in that year, and

\$2,000 would be available to be treated as qualified investment in each of the next 4 years. On the other hand, if a \$10,000 progress expenditure were to be made in 1977 then \$6,000 of that payment would be treated as a qualified investment in that year, and the remaining \$4,000 would be taken into account ratably in 1978 and 1979.

When a taxpayer places in service the property with respect to which the taxpayer has been making progress payments, the taxpayer is to be entitled to the full investment credit, reduced by the progress payments credits already taken. In the case of property placed in service by such a taxpayer during the 5-year transition period, this would also include the remaining portions of the credit that otherwise would have been phased in at the rate of 20 percent each year.

The progress payment rules will apply to progress expenditures made after January 21, 1975, in taxable years ending after December 31, 1974.—House Ways and Means Committee Report.

- .05 Committee Reports on P. L. 92-178 are at 1972-1 CB 504, 568 and 645.
- .055 Committee Reports on P. L. 91-172 are at 1969-3 CB 199, 423 and 644.
- .057 Committee Reports on P. L. 90-225 are at 1968-1 CB 640.
- .07 Committee Reports on P. L. 89-800 are at 1966-2 CB 649.
- .08 Committee Report on P. L. 89-389 is at 1966-1 CB 527.
- .09 Committee Report on P. L. 89-384 is at ¶ 4844.10.
- .10 Committee Reports on P. L. 87-834 are at 1962-3 CB 111.

Internal Revenue Code Section 47

[¶ 589]

CERTAIN DISPOSITIONS, ETC., OF
SECTION 38 PROPERTY

Sec. 47 [1954 Code]. (a) GENERAL RULE.—Under regulations prescribed by the Secretary—

(1) EARLY DISPOSITION, ETC.—If during any 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 which was taken into account in computing the credit under section 38, then the tax under this chapter 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 which 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.

(2) PROPERTY BECOMES PUBLIC UTILITY PROPERTY.—If during any taxable year any property taken into account in determining qualified investment becomes public utility property (within the meaning of section 46(c)(3)(B)), then the tax under this chapter 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 which would have resulted solely from treating the property, for purposes of determining qualified investment, as public utility property (after giving due regard to the period before such change in use). If the application of this paragraph to any property is followed by the application of paragraph (1) to such property, proper adjustment shall be made in applying paragraph (1).

(3) PROPERTY CEASES TO BE PROGRESS EXPENDITURE PROPERTY.—

(A) IN GENERAL.—If during any taxable year any property taken into account in determining qualified investment under section 46(d) ceases (by reason of sale or other disposition, cancellation or abandonment of contract, or otherwise) to be, with respect to the taxpayer, property which, when placed in service, will be new section 38 property, then the tax under this chapter 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 which would have resulted solely from reducing to zero the qualified investment taken into account with respect to such property.

(B) CERTAIN EXCESS CREDIT RECAPTURED.—Any amount which would have been applied as a reduction of the qualified investment in property by reason of paragraph (4) of section 46(c) but for the fact that a reduction under such paragraph cannot reduce qualified investment below zero shall be treated as an amount required to be recaptured under subparagraph (A) for the taxable year in which the property is placed in service.

[§ 589]—Continued

(C) CERTAIN SALES AND LEASEBACKS.—Under regulations prescribed by the Secretary, a sale by, and leaseback to, a taxpayer who, when the property is placed in service, will be a lessee to whom section 48(d) applies shall not be treated as a cessation described in subparagraph (A) to the extent that the qualified investment which will be passed through to the lessee under section 48(d) with respect to such property is not less than the qualified progress expenditures properly taken into account by the lessee with respect to such property.

(D) COORDINATION WITH PARAGRAPH (1).—If, after property is placed in service, there is a disposition or other cessation described in paragraph (1), paragraph (1) shall be applied as if any credit which was allowable by reason of section 46(d) and which has not been required to be recaptured before such cessation were allowable for the taxable year the property was placed in service.

(4) SPECIAL RULES FOR COMMUTER HIGHWAY VEHICLES.—

(A) USEFUL LIFE.—For purposes of this subsection, 3 years shall be treated as the useful life which was taken into account in computing the credit under section 38 with respect to any commuter highway vehicle (as defined in section 46(c)(6)(B)).

(B) CHANGE IN USE.—If less than 80 percent of the mileage use of any commuter highway vehicle by the taxpayer during that portion of any taxable year which is within the first 36 months of the operation of such vehicle by the taxpayer meets the requirements of section 46(c)(6)(B), then the tax under this chapter 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 which would have resulted solely from treating such vehicle, for purposes of determining qualified investment, as not being a commuter highway vehicle. If the application of this subparagraph to any property is followed by the application of paragraph (1) to such property, proper adjustment shall be made in applying paragraph (1).

(5) CARRYBACKS AND CARRYOVERS ADJUSTED.—In the case of any cessation described in paragraph (1) or (3) or any change in use described in paragraph (2) or (4), the carrybacks and carryovers under section 46(b) shall be adjusted by reason of such cessation (or change in use).

(6) AIRCRAFT USED OUTSIDE THE UNITED STATES AFTER APRIL 18, 1969.—

(A) GENERAL RULE.—Any aircraft which was new section 38 property for the taxable year in which it was placed in service and which is used outside the United States under a qualifying lease or leases shall be treated as not ceasing to be section 38 property by reason of such use until such aircraft has been so used for a period or periods exceeding $3\frac{1}{2}$ years in total. For purposes of the preceding sentence, the registration of such aircraft under the laws of a foreign country shall be treated as used outside the United States.

(B) COMPUTATION OF QUALIFIED INVESTMENT.—If an aircraft described in subparagraph (A) is disposed of or otherwise ceases to be section 38 property, the increase under paragraph (1) and the adjustment under paragraph (5) shall not be greater than the increase or adjustment which would result if the qualified investment of such aircraft were based upon a useful life equal to the lesser of (i) the actual useful life of such aircraft with respect to the taxpayer, or, (ii) twice the number of full calendar months during which such aircraft was registered by the Administrator of the Federal Aviation Agency and was used in the United States, operated to and from the United States, or operated under contract with the United States. For purposes of the preceding sentence, an aircraft shall be treated as used in the United States for any calendar month beginning after such aircraft was placed in service, if such month

§ 47 [p. 11,229]—SEC. 38 PROPERTY—DISPOSITIONS 1 1, 2 3 1

is included in a taxable year ending before January 1, 1971, for which such aircraft was section 38 property (determined without regard to this paragraph).

(C) QUALIFYING LEASE DEFINED.—For purposes of subparagraph (A), the term "qualifying lease" means a lease from an air carrier (as defined in section 101 of the Federal Aviation Act of 1958, as amended (49 U. S. C. 1301)) which complies with the provisions of the Federal Aviation Act of 1958, as amended, and the rules and regulations promulgated by the Civil Aeronautics Board thereunder, but only if such lease was executed after April 18, 1969.

(7) MOTION PICTURE FILMS AND VIDEO TAPES.—

(A) DISPOSITION WHERE DEPRECIATION EXCEEDS 90 PERCENT OF BASIS OR COST.—A qualified film (within the meaning of section 48(k)(1)(B)) which has an applicable percentage determined under section 48(k)(3) shall cease to be section 38 property with respect to the taxpayer at the close of the first day on which the aggregate amount allowable as a deduction under section 167 equals or exceeds 90 percent of the basis or cost of such film (adjusted for any partial dispositions).

(B) OTHER DISPOSITIONS.—In the case of a disposition of the exclusive right to display a qualified film which has an applicable percentage determined under section 48(k)(3) in one or more mediums of publication or exhibition in one or more specifically defined geographical areas over the remaining initial period of commercial exploitation of the film or tape in such geographical areas, the taxpayer shall be considered to have disposed of all or part of such film or tape and shall recompute the credit earned on all of his basis or cost or on that part of the basis or cost properly allocable to that part of the film or tape disposed of. In the case of an affiliated group of corporations, a transfer within the affiliated group shall not be treated as a disposition until there is a transfer outside the group. For purposes of the preceding sentence, the term "affiliated group" has the meaning given to such term by section 1504 (determined as if section 1504(b) did not include paragraph (3) thereof). For purposes of this paragraph, section 1504(a) shall be applied by substituting "50 percent" for "80 percent" each place it appears.

(b) SECTION NOT TO APPLY IN CERTAIN CASES.—Subsection (a) shall not apply to—

- (1) a transfer by reason of death,
- (2) a transaction to which section 381(a) applies, or
- (3) a transfer to which subsection (c) of section 374 (relating to exchanges under the final system plan for ConRail) applies.

For purposes of subsection (a), 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.

(c) SPECIAL RULE.—Any increase in tax under subsection (a) shall not be treated as tax imposed by this chapter for purposes of determining the amount of any credit allowable under subpart A.

.01 Added by P. L. 87-834. Amended by P. L. 95-618, P. L. 95-600, P. L. 94-455, P. L. 94-12, P. L. 92-178, P. L. 91-676 and P. L. 91-172. For details, see the Code Volumes.

Committee Report on P. L. 95-618

.018 . . .

Under the normal investment credit rules, as applied to this provision, the credit will be re-

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captured if the commuter highway vehicle is disposed of within 3 years after it is placed in service. The conference agreement adds a recapture rule which provides, in effect, that recapture will occur if the full investment credit is claimed under this provision with respect to a vehicle, and within the first 36 months of the operation of the vehicle, the vehicle ceases to be a commuter highway vehicle. In applying the 50 percent of mileage use test to determine whether a vehicle ceases to be a commuter highway vehicle, the test shall be applied on the

Code § 47 ¶ 589

Committee Report on P. L. 95-600

Committee Report on P. L. 91-676

I. Summary

II. Reasons for Bill

¹ Although, as a result of the repeal of the investment credit, an investment credit generally is not available with respect to property acquired after Apr. 18, 1969, in some cases prop-

erty acquired after that date qualifies for the investment credit by reason of one or more of the transition rules which were adopted in connection with the repeal of the credit.

to let their excess planes remain idle or to go through an expensive and often impractical rotation procedure. The committee agrees with the House that it, in general, would be appropriate not to apply the investment credit recapture rules where an airplane is used outside the United States (under a lease which complies with Federal aviation statutes) for less than half the period taken into account in determining the amount of the investment credit previously allowed. In effect, this is applying the concept of the present Treasury regulations on the investment credit which require an airplane to be used principally in the United States during each taxable year, but over the longer period used in computing the amount of the credit allowable with respect to the airplane. Instead of on a year-by-year basis. At the same time, this rule will allow aircraft to be used in a profitable and economic manner without investment credit recapture consequences.

III. Explanation of Bill

In general, the bill provides that a new airplane which qualified for the investment credit under the rules of present law for the year it was placed in service may be used outside the United States without a recapture of the credit for up to half of the period taken into account in determining the amount of the credit allowed with respect to the airplane. This provision only applies, however, if the airplane is used outside the United States under a lease from a U. S. air carrier which is made after April 18, 1969 (in general, the date of the repeal of the investment credit) and which complies with the provisions of the Federal Aviation Act of 1958 and the Civil Aeronautics Board's rules and regulations under that act. A lease entered into after April 18, 1969, to replace a lease made on or before that date, or the renewal or extension after that date of a pre-April 19, 1969, lease, is to be considered a lease made after April 18, 1969, for purposes of this provision.

Inasmuch as the maximum period which may be taken into account in computing the amount of an investment credit is 8 years, the bill provides that there is in all cases to be a recapture of the investment credit if an airplane is used outside the United States under the type of lease described above (or is registered under the laws of a foreign country) for more than 4 years. The amount of the credit to be recaptured in this event is to be determined under the rules described below.

As indicated above, the basic concept of the bill is that an airplane may not be used outside the United States for more than half the period taken into account in determining for recapture purposes the amount of the investment credit allowable with respect to the airplane. Accordingly, the bill provides that if an airplane

which is used outside the United States in the manner described above is disposed of or otherwise ceases to qualify as investment credit property before the end of the period taken into account in determining the amount of the credit originally allowed, then the amount of the investment credit to be recaptured is to be determined in the manner specified below. In computing the period of time the aircraft is considered to have been actually used by the taxpayer, the calendar months during any part of which it was used outside the United States under the type of lease described above may be taken into account only to the extent of the number of calendar months during all the days of which the plane was used in the United States (or was operated to and from the United States or under contract with the United States). The plane also must have been registered with the Federal Aviation Agency during these months. (However, the bill provides that an aircraft (after it is placed in service) for any calendar month in a taxable year ending before 1971 is to be treated as used in the United States if the plane was qualified investment credit property under present law for that year.)

The application of the recapture rules provided by the bill may be illustrated by the following example. Assume an airplane was placed in service by a U. S. air carrier in the middle of a taxable year and was used for the remaining 6 months of that taxable year and the entire following taxable year solely in the United States. Assume further that the airplane was then leased (under a lease of the type described above) for use outside the United States for a period of 3 years and was, in fact, used in that manner for the 3-year period. Assume further that at the end of the 3-year period the plane was sold by the U. S. air carrier. Although the air carrier has actually had the plane for a period of 4½ years, it is considered under the bill to have used the plane for a period of only 3 years. This results from the fact that only 1½ of the 3 years the plane was used outside the United States may be taken into account since the plane had been used in the United States for 1½ years. Accordingly, upon the sale of the plane, there would be a recapture of the entire investment credit previously allowed with respect to it since no credit is allowed with respect to property used less than 4 years.

The amendment made by this bill is to apply to taxable years ending after April 18, 1969.—Senate Committee Report.

.03 Committee Report on P. L. 91-172 is at 1969-3 CB 423.

.05 Committee Reports on P. L. 87-834 are at 1962-3 CB 111.

Internal Revenue Code Section 48

[§ 592]

DEFINITIONS; SPECIAL RULES

Sec. 48 [1954 Code]. (a) SECTION 38 PROPERTY.—

(1) IN GENERAL.—Except as provided in this subsection, the term "section 38 property" means—

(A) tangible personal property (other than an air conditioning or heating unit), or

(B) other tangible property (not including a building and its structural components) but only if such property—

(i) is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or

(ii) constitutes a research facility used in connection with any of the activities referred to in clause (i), or

(iii) constitutes a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state), or

(C) elevators and escalators, but only if—

(i) the construction, reconstruction, or erection of the elevator or escalator is completed by the taxpayer after June 30, 1963, or

(ii) the elevator or escalator is acquired after June 30, 1963, and the original use of such elevator or escalator commences with the taxpayer and commences after such date, or

(D) single purpose agricultural or horticultural structures, or

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(E) in the case of a qualified rehabilitated building, that portion of the basis which is attributable to qualified rehabilitation expenditures (within the meaning of subsection (g)).

Such term includes only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of 3 years or more.

(2) PROPERTY USED OUTSIDE THE UNITED STATES.—

(A) IN GENERAL.—Except as provided in subparagraph (B), the term "section 38 property" does not include property which is used predominantly outside the United States.

(B) EXCEPTIONS.—Subparagraph (A) shall not apply to—

(i) any aircraft which is registered by the Administrator of the Federal Aviation Agency and which is operated to and from the United States or is operated under contract with the United States;

(ii) rolling stock, of a domestic railroad corporation subject to part I of the Interstate Commerce Act, which is used within and without the United States;

(iii) any vessel documented under the laws of the United States which is operated in the foreign or domestic commerce of the United States;

(iv) any motor vehicle of a United States person (as defined in section 7701(a)(30)) which is operated to and from the United States;

(v) any container of a United States person which is used in the transportation of property to and from the United States;

(vi) any property (other than a vessel or an aircraft) of a United States person which is used for the purpose of exploring for, developing, removing, or transporting resources from the outer Continental Shelf (within the meaning of section 2 of the Outer Continental Shelf Lands Act, as amended and supplemented; 43 U. S. C. 1331);

(vii) any property which is owned by a domestic corporation (other than a corporation which has an election in effect under section 936 or which is entitled to the benefits of section 934(b)) or by a United States citizen (other than a citizen entitled to the benefits of section 931, 932, 933, or 934(c)) and which is used predominantly in a possession of the United States by such a corporation or such a citizen, or by a corporation created or organized in or under the law of, a possession of the United States;

(viii) any communications satellite (as defined in section 103(3) of the Communications Satellite Act of 1962, 47 U. S. C. 702), or any interest therein, of a United States person;

(ix) any cable, or any interest therein, of a domestic corporation engaged in furnishing telephone service to which section 46(c)(3) (B)(iii) applies (or of a wholly owned domestic subsidiary of such a corporation), if such cable is part of a submarine cable system which constitutes part of a communication link exclusively between the United States and one or more foreign countries; and

(x) any property (other than a vessel or an aircraft) of a United States person which is used in international or territorial waters within the northern portion of the Western Hemisphere for the purpose of exploring for, developing, removing, or transporting resources from ocean waters or deposits under such waters.

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For purposes of clause (x), the term "northern portion of the Western Hemisphere" means the area lying west of the 30th meridian west of Greenwich, east of the international dateline, and north of the Equator, but not including any foreign country which is a country of South America.

(3) **PROPERTY USED FOR LODGING.**—Property which is used predominantly to furnish lodging or in connection with the furnishing of lodging shall not be treated as section 38 property. The preceding sentence shall not apply to—

(A) nonlodging commercial facilities which are available to persons not using the lodging facilities on the same basis as they are available to persons using the lodging facilities,

(B) property used by a hotel or motel in connection with the trade or business of furnishing lodging where the predominant portion of the accommodations is used by transients, and

(C) coin-operated vending machines and coin-operated washing machines and dryers.

(4) **PROPERTY USED BY CERTAIN TAX-EXEMPT ORGANIZATIONS.**—Property used by an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter shall be treated as section 38 property only if such property is used predominantly in an unrelated trade or business the income of which is subject to tax under section 511. If the property is debt-financed property (as defined in section 514(c)), the basis or cost of such property for purposes of computing qualified investment under section 46(c) shall include only that percentage of the basis or cost which is the same percentage as is used under section 514(b), for the year the property is placed in service, in computing the amount of gross income to be taken into account during such taxable year with respect to such property.

(5) **PROPERTY USED BY GOVERNMENTAL UNITS.**—Property used by the United States, any State or political subdivision thereof, any international organization (other than the International Telecommunications Satellite Consortium or any successor organization) or any agency or instrumentality of any of the foregoing shall not be treated as section 38 property.

(6) **LIVESTOCK.**—Livestock (other than horses) acquired by the taxpayer shall be treated as section 38 property, except that if substantially identical livestock is sold or otherwise disposed of by the taxpayer during the one-year period beginning 6 months before the date of such acquisition and if section 47(a) (relating to certain dispositions, etc., of section 38 property) does not apply to such sale or other disposition, then, unless such sale or other disposition constitutes an involuntary conversion (within the meaning of section 1033), the cost of the livestock acquired shall, for purposes of this subpart, be reduced by an amount equal to the amount realized on such sale or other disposition. Horses shall not be treated as section 38 property.

(7) **PROPERTY COMPLETED ABROAD OR PREDOMINANTLY OF FOREIGN ORIGIN.**—

(A) **IN GENERAL.**—Property shall not be treated as section 38 property if—

- (i) such property was completed outside the United States, or
- (ii) less than 50 percent of the basis of such property is attributable to value added within the United States.

For purposes of this subparagraph, the term "United States" includes the Commonwealth of Puerto Rico and the possessions of the United States.

(B) **PERIOD OF APPLICATION OF PARAGRAPH.**—Except as provided in subparagraph (D), subparagraph (A) shall apply only with respect to property—

- (i) the construction, reconstruction, or erection of which by the taxpayer is begun after August 15, 1971, and on or before the date of termination of Proclamation 4074, or

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(ii) which is acquired pursuant to an order placed on or before the date of termination of Proclamation 4074, unless acquired pursuant to an order which the taxpayer establishes was placed before August 16, 1971.

(C) PRESIDENT MAY EXEMPT ARTICLES.—If the President of the United States shall at any time determine that the application of subparagraph (A) to any article or class of articles is not in the public interest, he may by Executive order specify that subparagraph (A) shall not apply to such article or class of articles. Subparagraph (A) shall not apply to an article or class of articles for the period specified in such Executive order. Any period specified under the preceding sentence shall not apply to property ordered before (or to property the construction, reconstruction, or erection of which began before) the date of the Executive order specifying such period, except that, if the President determines it to be in the public interest, such period shall apply to property ordered (or property the construction, reconstruction, or erection of which began) after a date (before the date of the Executive order) specified in the Executive order.

(D) COUNTRIES MAINTAINING TRADE RESTRICTIONS OR ENGAGING IN DISCRIMINATORY ACTS.—If, on or after the date of the termination of Proclamation 4074, the President determines that a foreign country—

(i) maintains nontariff trade restrictions, including variable import fees, which substantially burden United States commerce in a manner inconsistent with provisions of trade agreements, or

(ii) engages in discriminatory or other acts (including tolerance of international cartels) or policies unjustifiably restricting United States commerce,

he may provide by Executive order for the application of subparagraph (A) to any article or class of articles manufactured or produced in such foreign country for such period as may be provided by Executive order.

(8) AMORTIZED PROPERTY.—Any property with respect to which an election under section 167(k), 184, 188, or 191 applies shall not be treated as section 38 property.

(9) RAILROAD TRACK.—In the case of a railroad (including a railroad switching or terminal company) which uses the retirement-replacement method of accounting for depreciation of its railroad track, the term "section 38 property" includes replacement track material, if—

(A) the replacement is made pursuant to a scheduled program for replacement,

(B) the replacement is made pursuant to observations by maintenance-of-way personnel of specific track material needing replacement,

(C) the replacement is made pursuant to the detection by a rail-test car of specific track material needing replacement, or

(D) the replacement is made as a result of a casualty.

Replacements made as a result of a casualty shall be section 38 property only to the extent that, in the case of each casualty, the qualified investment with respect to the replacement track material exceeds \$50,000. For purposes of this paragraph, the term "track material" includes ties, rail, other track material, and ballast.

(10) BOILERS FUELED BY OIL OR GAS.—

(A) IN GENERAL.—The term "section 38 property" does not include any boiler primarily fueled by petroleum or petroleum products (including natural gas) unless the use of coal is precluded by Federal air pollution regulations (or by State air pollution regulations in effect on October 1,

1978) or unless the use of such boiler will be an exempt use within the meaning of subparagraph (B).

(B) EXEMPT USE DEFINED.—For purposes of subparagraph (A), the term "exempt use" means—

- (i) use in an apartment, hotel, motel, or other residential facility,
- (ii) use in a vehicle, aircraft, or vessel, or in transportation by pipeline,
- (iii) use on a farm for farming purposes (within the meaning of section 6420(c)),
- (iv) use in—
 - (I) a shopping center,
 - (II) an office building,
 - (III) a wholesale or retail establishment,
 - (IV) any other facility which is not an integral part of manufacturing, processing, or mining, or
 - (V) any facility for the production of electric power having a heat rate of less than 9,500 Btu's per kilowatt hour and which is capable of converting to synthetic fuels (as certified by the Secretary),
- (v) use in the exploration for, or the development, extraction, transmission, or storage of, crude oil, natural gas, or natural gas liquids, and
- (vi) use in Hawaii.

Except as provided in clauses (iv)(V) and (vi) of the preceding sentence, the term "exempt use" does not include use of a boiler which is public utility property (within the meaning of section 46(f)(51)).

(b) NEW SECTION 38 PROPERTY.—For purposes of this subpart, the term "new section 38 property" means section 38 property—

- (1) the construction, reconstruction, or erection of which is completed by the taxpayer after December 31, 1961, or
- (2) acquired after December 31, 1961, if the original use of such property commences with the taxpayer and commences after such date.

In applying section 46(c)(1)(A) in the case of property described in paragraph (1), there shall be taken into account only that portion of the basis which is properly attributable to construction, reconstruction, or erection after December 31, 1961.

(c) USED SECTION 38 PROPERTY.—

(1) IN GENERAL.—For purposes of this subpart, the term "used section 38 property" means section 38 property acquired by purchase after December 31, 1961, which is not new section 38 property. Property shall not be treated as "used section 38 property" if, after its acquisition by the taxpayer, it is used by a person who used such property before such acquisition (or by a person who bears a relationship described in section 179(d)(2)(A) or (B) to a person who used such property before such acquisition).

(2) DOLLAR LIMITATION.—

(A) IN GENERAL.—The cost of used section 38 property taken into account under section 46(c)(1)(B) for any taxable year shall not exceed \$100,000. If such cost exceeds \$100,000, the taxpayer shall select (at such time and in such manner as the Secretary shall by regulations prescribe) the items to be taken into account, but only to the extent of an aggregate cost of \$100,000. Such a selection, once made, may be changed only in the manner, and to the extent, provided by such regulations.

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(B) **MARRIED INDIVIDUALS.**—In the case of a husband or wife who files a separate return, the limitation under subparagraph (A) shall be \$50,000 in lieu of \$100,000. This subparagraph shall not apply if the spouse of the taxpayer has no used section 38 property which may be taken into account as qualified investment for the taxable year of such spouse which ends within or with the taxpayer's taxable year.

(C) **CONTROLLED GROUPS.**—In the case of a controlled group, the \$100,000 amount specified under subparagraph (A) shall be reduced for each component member of the group by apportioning \$100,000 among the component members of such group in accordance with their respective amounts of used section 38 property which may be taken into account.

(D) **PARTNERSHIPS.**—In the case of a partnership, the limitation contained in subparagraph (A) shall apply with respect to the partnership and with respect to each partner.

(3) **DEFINITIONS.**—For purposes of this subsection—

(A) **PURCHASE.**—The term "purchase" has the meaning assigned to such term by section 179(d)(2).

(B) **COST.**—The cost of used section 38 property does not include so much of the basis of such property as is determined by reference to the adjusted basis of other property held at any time by the person acquiring such property. If property is disposed of (other than by reason of its destruction or damage by fire, storm, shipwreck, or other casualty, or its theft) and used section 38 property similar or related in service or use is acquired as a replacement therefor in a transaction to which the preceding sentence does not apply, the cost of the used section 38 property acquired shall be its basis reduced by the adjusted basis of the property replaced. The cost of used section 38 property shall not be reduced with respect to the adjusted basis of any property disposed of if, by reason of section 47, such disposition involved an increase of tax or a reduction of the unused credit carrybacks or carryovers described in section 46(b).

(C) **CONTROLLED GROUP.**—The term "controlled group" has the meaning assigned to such term 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).

(d) **CERTAIN LEASED PROPERTY.**—

(1) **GENERAL RULE.**—A person (other than a person referred to in section 46(e)(1)) who is a lessor of property may (at such time, in such manner, and subject to such conditions as are provided by regulations prescribed by the Secretary) elect with respect to any new section 38 property (other than property described in paragraph (4)) to treat lessee as having acquired such property for an amount equal to—

(A) except as provided in subparagraph (B), the fair market value of such property, or

(B) if the property is leased by a corporation which is a component member of a controlled group (within the meaning of section 46(a)(6)) to another corporation which is a component member of the same controlled group, the basis of such property to the lessor.

(2) **SPECIAL RULE FOR CERTAIN SHORT-TERM LEASES.**—

(A) **IN GENERAL.**—A person (other than a person referred to in section 46(e)(1)) who is a lessor of property described in paragraph (4) may (at such time, in such manner, and subject to such conditions as are provided by regulations prescribed by the Secretary) elect with respect to such property to treat the lessee as having acquired a portion of such property for the amount determined under subparagraph (B).

(B) DETERMINATION OF LESSEE'S INVESTMENT.—The amount for which a lessee of property described in paragraph (4) shall be treated as having acquired a portion of such property is an amount equal to a fraction, the numerator of which is the term of the lease and the denominator of which is the class life of the property leased (determined under section 167(m)), of the amount for which the lessee would be treated as having acquired the property under paragraph (1).

(C) DETERMINATION OF LESSOR'S QUALIFIED INVESTMENT.—The qualified investment of a lessor of property described in paragraph (4) in any such property with respect to which he has made an election under this paragraph is an amount equal to his qualified investment in such property (as determined under section 46(c)) multiplied by a fraction equal to the excess of one over the fraction used under subparagraph (B) to determine the lessee's investment in such property.

(3) LIMITATIONS.—The elections provided by paragraphs (1) and (2) may be made with respect to property which would be new section 38 property if acquired by the lessee. For purposes of the preceding sentence and section 46(c), the useful life of property in the hands of the lessee is the useful life of such property in the hands of the lessor. If a lessor makes the election provided by paragraph (1) with respect to any property, the lessee shall be treated for all purposes of this subpart as having acquired such property. If a lessor makes the election provided by paragraph (2) with respect to any property, the lessee shall be treated for all purposes of this subpart as having acquired a fractional portion of such property equal to the fraction determined under paragraph (2)(B) with respect to such property.

(4) PROPERTY TO WHICH PARAGRAPH (2) APPLIES.—Paragraph (2) shall apply only to property which—

(A) is new section 38 property,

(B) has a class life (determined under section 167(m)) in excess of 14 years,

(C) is leased for a period which is less than 80 percent of its class life, and

(D) is not leased subject to a net lease (within the meaning of section 57(c)(1)(B)).

(e) SUBCHAPTER S CORPORATIONS.—In the case of an electing small business corporation (as defined in section 1371)—

(1) the qualified investment for each taxable year shall be apportioned pro rata among the persons who are shareholders of such corporation on the last day of such taxable year; and

(2) any person to whom any investment has been apportioned under paragraph (1) shall be treated (for purposes of this subpart) as the taxpayer with respect to such investment, and such investment shall not (by reason of such apportionment) lose its character as an investment in new section 38 property or used section 38 property, as the case may be.

(f) ESTATES AND TRUSTS.—In the case of an estate or trust—

(1) the qualified investment for any taxable year shall be apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each,

(2) any beneficiary to whom any investment has been apportioned under paragraph (1) shall be treated (for purposes of this subpart) as the taxpayer with respect to such investment, and such investment shall not (by reason of such apportionment) lose its character as an investment in new section 38 property or used section 38 property, as the case may be, and

(3) the \$25,000 amount specified under subparagraphs (A) and (B) of section 46(a)(3) applicable to such estate or trust shall be reduced to an amount which bears the same ratio to \$25,000 as the amount of the qualified investment allocated to the estate or trust under paragraph (1) bears to the entire amount of the qualified investment.

→ **Caution:** Code Sec. 48(g), as added by P. L. 95-600, applies to property placed in service after October 1978. ←

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(g) SPECIAL RULES FOR QUALIFIED REHABILITATED BUILDINGS.—For purposes of this subpart—

(1) QUALIFIED REHABILITATED BUILDING DEFINED.—

(A) IN GENERAL.—The term “qualified rehabilitated building” means any building (and its structural components)—

- (i) which has been rehabilitated,
- (ii) which was placed in service before the beginning of the rehabilitation, and
- (iii) 75 percent or more of the existing external walls of which are retained in place as external walls in the rehabilitation process.

(B) 20 YEARS MUST HAVE ELAPSED SINCE CONSTRUCTION OR PRIOR REHABILITATION.—A building shall not be a qualified rehabilitated building unless there is a period of at least 20 years between—

- (i) the date the physical work on this rehabilitation of the building began, and
- (ii) the later of—
 - (I) the date such building was first placed in service, or
 - (II) the date such building was placed in service in connection with a prior rehabilitation with respect to which a credit was allowed by reason of subsection (a)(1)(E).

(C) MAJOR PORTION TREATED AS SEPARATE BUILDING IN CERTAIN CASES.—Where there is a separate rehabilitation of a major portion of a building, such major portion shall be treated as a separate building.

(D) REHABILITATION INCLUDES RECONSTRUCTION.—Rehabilitation includes reconstruction.

(2) QUALIFIED REHABILITATION EXPENDITURE DEFINED.—

(A) IN GENERAL.—The term “qualified rehabilitation expenditure” means any amount properly chargeable to capital account which is incurred after October 31, 1978—

- (i) for property (or additions or improvements to property) with a useful life of 5 years or more, and
- (ii) in connection with the rehabilitation of a qualified rehabilitated building.

(B) CERTAIN EXPENDITURES NOT INCLUDED.—The term “qualified rehabilitation expenditure” does not include—

- (i) PROPERTY OTHERWISE SECTION 38 PROPERTY.—Any expenditure for property which constitutes section 38 property (determined without regard to subsection (a)(1)(E)).
- (ii) COST OF ACQUISITION.—The cost of acquiring any building or any interest therein.
- (iii) ENLARGEMENTS.—Any expenditure attributable to the enlargement of the existing building.
- (iv) CERTIFIED HISTORIC STRUCTURES.—Any expenditure attributable to the rehabilitation of a certified historic structure (within the meaning of section 191(d)(1)), unless the rehabilitation is a certified rehabilitation (within the meaning of section 191(d)(4)).

(3) PROPERTY TREATED AS NEW SECTION 38 PROPERTY.—Property which is treated as section 38 property by reason of subsection (a)(1)(E) shall be treated as new section 38 property.

→ **Caution:** Code Sec. 48(h), below, is repealed by P. L. 95-600 for tax years ending after 1978. ←

(h) **SUSPENSION OF INVESTMENT CREDIT.**—For purposes of this subpart—
(1) **GENERAL RULE.**—Section 38 property which is suspension period property shall not be treated as new or used section 38 property.

(2) **SUSPENSION PERIOD PROPERTY DEFINED.**—Except as otherwise provided in this subsection and subsection (i), the term "suspension period property" means section 38 property—

(A) the physical construction, reconstruction, or erection of which (i) is begun during the suspension period, or (ii) is begun, pursuant to an order placed during such period, before May 24, 1967, or

(B) which (i) is acquired by the taxpayer during the suspension period, or (ii) is acquired by the taxpayer, pursuant to an order placed during such period, before May 24, 1967.

In applying subparagraph (A) to any section 38 property, there shall be taken into account only that portion of the basis which is property attributable to construction, reconstruction, or erection before May 24, 1967.

(3) **BINDING CONTRACTS.**—To the extent that any property is constructed, reconstructed, erected, or acquired pursuant to a contract which was, on October 9, 1966, and at all times thereafter, binding on the taxpayer, such property shall not be deemed to be suspension period property.

(4) **EQUIPPED BUILDING RULE.**—If—

(A) pursuant to a plan of the taxpayer in existence on October 9, 1966 (which plan was not substantially modified at any time after such date and before the taxpayer placed the equipped building in service), the taxpayer has constructed, reconstructed, erected, or acquired a building and the machinery and equipment necessary to the planned use of the building by the taxpayer, and

(B) more than 50 percent of the aggregate adjusted basis of all the property of a character subject to the allowance for depreciation making up such building as so equipped is attributable to either property the construction, reconstruction, or erection of which was begun by the taxpayer before October 10, 1966, or property the acquisition of which by the taxpayer occurred before such date,

then all section 38 property comprising such building as so equipped (and any incidental section 38 property adjacent to such building which is necessary to the planned use of the building) shall be treated as section 38 property which is not suspension period property. For purposes of subparagraph (B) of the preceding sentence, the rules of paragraphs (3) and (6) shall be applied. For purposes of this paragraph, a special purpose structure shall be treated as a building.

(5) **PLANT FACILITY RULE.**—

(A) **GENERAL RULE.**—If—

(i) pursuant to a plan of the taxpayer in existence on October 9, 1966 (which plan was not substantially modified at any time after such date and before the taxpayer placed the plant facility in service), the taxpayer has constructed, reconstructed or erected, a plant facility, and either

(ii) the construction, reconstruction, or erection of such plant facility was commenced by the taxpayer before October 10, 1966, or

(iii) more than 50 percent of the aggregate adjusted basis of all the property of a character subject to the allowance for depreciation making up such plant facility is attributable to either property the construction, reconstruction, or erection of which was begun by the taxpayer before October 10, 1966, or property the acquisition of which by the taxpayer occurred before such date,

→ **Caution:** Code Sec. 48(h), below, is repealed by P. L. 95-600 for tax years ending after 1978. ←

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then all section 38 property comprising such plant facility shall be treated as section 38 property which is not suspension period property. For purposes of clause (iii) of the preceding sentence, the rules of paragraphs (3) and (6) shall be applied.

(B) **PLANT FACILITY DEFINED.**—For purposes of this paragraph, the term "plant facility" means a facility which does not include any building (or of which buildings constitute an insignificant portion) and which is—

- (i) a self-contained, single operating unit or processing operation,
- (ii) located on a single site, and

(iii) identified, on October 9, 1966, in the purchasing and internal financial plans of the taxpayer as a single unitary project.

(C) **SPECIAL RULE.**—For purposes of this subsection, if—

(i) a certificate of convenience and necessity has been issued before October 10, 1966, by a Federal regulatory agency with respect to two or more plant facilities which are included under a single plan of the taxpayer to construct, reconstruct or erect such plant facilities, and

(ii) more than 50 percent of the aggregate adjusted basis of all the property of a character subject to the allowance for depreciation making up such plant facilities is attributable to either property the construction, reconstruction, or erection of which was begun by the taxpayer before October 10, 1966, or property the acquisition of which by the taxpayer occurred before such date,

such plant facilities shall be treated as a single plant facility.

(D) **COMMENCEMENT OF CONSTRUCTION.**—For purposes of subparagraph (A)(ii), the construction, reconstruction, or erection of a plant facility shall not be considered to have commenced until construction, reconstruction, or erection has commenced at the site of such plant facility. The preceding sentence shall not apply if the site of such plant facility is not located on land.

(6) **MACHINERY OR EQUIPMENT RULE.**—Any piece of machinery or equipment—

(A) more than 50 percent of the parts and components of which (determined on the basis of cost) were held by the taxpayer on October 9, 1966, or are acquired by the taxpayer pursuant to a binding contract which was in effect on such date, for inclusion or use in such piece of machinery or equipment, and

(B) the cost of the parts and components of which is not an insignificant portion of the total cost,

shall be treated as property which is not suspension period property.

(7) **CERTAIN LEASE-BACK TRANSACTIONS, ETC.**—Where a person who is a party to a binding contract described in paragraph (3) transfers rights in such contract (or in the property to which such contract relates) to another person but a party to such contract retains a right to use the property under a lease with such other person, then to the extent of the transferred rights such other person shall, for purposes of paragraph (3), succeed to the position of the transferor with respect to such binding contract and such property. The preceding sentence shall apply, in any case in which the lessor does not make an election under subsection (d), only if a party to such contract retains a right to use the property under a long-term lease.

(8) **CERTAIN LEASE AND CONTRACT OBLIGATIONS.**—Where, pursuant to a binding lease or contract to lease in effect on October 9, 1966, a lessor or lessee is obligated to construct, reconstruct, erect, or acquire property specified in such lease or contract, any property so constructed, reconstructed, erected,

→ **Caution:** Code Sec. 48(h), below, is repealed by P. L. 95-600 for tax years ending after 1978. ←

or acquired by the lessor or lessee which is section 38 property shall be treated as property which is not suspension period property. In the case of any project which includes property other than the property to be leased such lessee, the preceding sentence shall be applied, in the case of the lessor, to such other property only if the binding leases and contracts with all lessees in effect on October 9, 1966, cover real property constituting 25 percent or more of the project (determined on the basis of rental value). For purposes of the preceding sentences of this paragraph, in the case of any project where one or more vendor-vendee relationships exist, such vendors and vendees shall be treated as lessors and lessees. Where, pursuant to a binding contract in effect on October 9, 1966, (i) the taxpayer is required to construct, reconstruct, erect, or acquire property specified in the contract, to be used to produce one or more products, and (ii) the other party is required to take substantially all of the products to be produced over a substantial portion of the expected useful life of the property, then such property shall be treated as property which is not suspension period property. Clause (ii) of the preceding sentence shall not apply if a political subdivision of a State is the other party to the contract and is required by the contract to make substantial expenditures which benefit the taxpayer.

(9) CERTAIN TRANSFERS TO BE DISREGARDED.—

(A) If property or rights under a contract are transferred in—

(i) a transfer by reason of death, or

(ii) a transaction as a result of which the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 371(a), 374(a), 721, or 731,

and such property (or the property acquired under such contract) would not be treated as suspension period property in the hands of the decedent or the transferor, such property shall not be treated as suspension period property in the hands of the transferee.

(B) If—

(i) property or rights under a contract are acquired in a transaction to which section 334(b)(2) applies,

(ii) the stock of the distributing corporation was acquired before October 10, 1966, or pursuant to a binding contract in effect October 9, 1966, and

(iii) such property (or the property acquired under such contract) would not be treated as suspension period property in the hands of the distributing corporation,

such property shall not be treated as suspension period property in the hands of the distributee.

(10) PROPERTY ACQUIRED FROM AFFILIATED CORPORATION.—For purposes of this subsection, in the case of property acquired by a corporation which is a member of an affiliated group from another member of the same group—

(A) such corporation shall be treated as having acquired such property on the date on which it was acquired by such other member,

(B) such corporation shall be treated as having entered into a binding contract for the construction, reconstruction, erection, or acquisition of such property on the date on which such other member entered into a contract for the construction, reconstruction, erection, or acquisition of such property, and

(C) such corporation shall be treated as having commenced the construction, reconstruction, or erection of such property on the date on which such other member commenced such construction, reconstruction, or erection.

→ **Caution:** Code Sec. 48(h), below, is repealed by P. L. 95-600 for tax years ending after 1978. ←

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For purposes of the preceding sentence, the term "affiliated group" has the meaning assigned to it by section 1504(a), except that all corporations shall be treated as includible corporations (without any exclusion under section 1504(b)).

(11) **CERTAIN TANGIBLE PROPERTY CONSTRUCTED DURING SUSPENSION PERIOD AND LEASED NEW THEREAFTER.**—Tangible personal property constructed or reconstructed by a person shall not be suspension period property if—

(A) such person leases such property after the close of the suspension period and the original use of such property commences after the close of such period,

(B) such construction or reconstruction, and such lease transaction, was not pursuant to an order placed during the suspension period, and

(C) an election is made under subsection (d) with respect to such property which satisfies the requirements of such subsection.

(12) **WATER AND AIR POLLUTION CONTROL FACILITIES.**—

(A) **IN GENERAL.**—Any water pollution control facility or air pollution control facility shall be treated as property which is not suspension period property.

(B) **WATER POLLUTION CONTROL FACILITY.**—For purposes of subparagraph (A), the term "water pollution control facility" means any section 38 property which—

(i) is used primarily to control water pollution by removing, altering, or disposing of wastes, including the necessary intercepting sewers, outfall sewers, pumping, power, and other equipment, and their appurtenances; and

(ii) is certified by the State water pollution control agency (as defined in section 13(a) of the Federal Water Pollution Control Act) as being in conformity with the State program or requirements for control of water pollution and is certified by the Secretary of Interior as being in compliance with the applicable regulations of Federal agencies and the general policies of the United States for cooperation with the States in the prevention and abatement of water pollution under the Federal Water Pollution Control Act.

(C) **AIR POLLUTION CONTROL FACILITY.**—For purposes of subparagraph (A), the term "air pollution control facility" means any section 38 property which—

(i) is used primarily to control atmospheric pollution or contamination by removing, altering, or disposing of atmospheric pollutants or contaminants; and

(ii) is certified by the State air pollution control agency (as defined in section 302(b) of the Clean Air Act) as being in conformity with the State program or requirements for control of air pollution and is certified by the Secretary of Health, Education, and Welfare as being in compliance with the applicable regulations of Federal agencies and the general policies of the United States for cooperation with the States in the prevention and abatement of air pollution under the Clean Air Act.

(D) **STANDARDS FOR FACILITY.**—Subparagraph (A) shall apply in the case of any facility only if the taxpayer constructs, reconstructs, erects, or acquires such facility in furtherance of Federal, State, or local standards for the control of water pollution or atmospheric pollution or contaminants.

(13) **CERTAIN REPLACEMENT PROPERTY.**—Section 38 property constructed, reconstructed, erected, or acquired by the taxpayer shall be treated as prop-

→ **Caution: Code Sec. 48(h), below, is repealed by P. L. 95-600 for tax years ending after 1978.** ←

erty which is not suspension period property to the extent such property is placed in service to replace property which was—

(A) destroyed or damaged by fire, storm, shipwreck, or other casualty, or

(B) stolen,

but only to the extent the basis (in the case of new section 38 property) or cost (in the case of used section 38 property) of such section 38 property does not exceed the adjusted basis of the property destroyed, damaged, or stolen.

→ **Caution: Code Sec. 48(i), below, is repealed by P. L. 95-600 for tax years ending after 1978.** ←

(i) EXEMPTION FROM SUSPENSION OF \$20,000 OF INVESTMENT.—

(1) IN GENERAL.—In the case of property acquired by the taxpayer by purchase for use in his trade or business which would (but for this subsection) be suspension period property, the taxpayer may select items to which this subsection applies, to the extent of an aggregate cost, for the suspension period, of \$20,000. Any item so selected shall be treated as property which is not suspension period property for purposes of this subpart (other than for purposes of paragraphs (4), (5), (6), (7), (8), (9), and (10) of subsection (h)).

(2) APPLICABLE RULES.—Under regulations prescribed by the Secretary, rules similar to the rules provided by paragraphs (2) and (3) of subsection (c) shall be applied for purposes of this subsection. Subsection (d) shall not apply with respect to any item to which this subsection applies.

→ **Caution: Code Sec. 48(j), below, is repealed by P. L. 95-600 for tax years ending after 1978.** ←

(j) SUSPENSION PERIOD.—For purposes of this subpart, the term "suspension period" means the period beginning on October 10, 1966, and ending on March 9, 1967.

(k) MOVIE AND TELEVISION FILMS.—

(1) ENTITLEMENT TO CREDIT.—

(A) IN GENERAL.—A credit shall be allowable under section 38 to a taxpayer with respect to any motion picture film or video tape—

(i) only if such film or tape is new section 38 property (determined without regard to useful life) which is a qualified film, and

(ii) only to the extent that the taxpayer has an ownership interest in such film or tape.

(B) QUALIFIED FILM DEFINED.—For purposes of this subsection, the term "qualified film" means any motion picture film or video tape created primarily for use as public entertainment or for educational purposes. Such term does not include any film or tape the market for which is primarily topical or is otherwise essentially transitory in nature.

(C) OWNERSHIP INTEREST.—For purposes of this subsection, a person's "ownership interest" in a qualified film shall be determined on the basis of his proportionate share of any loss which may be incurred with respect to the production costs of such film.

(2) APPLICABLE PERCENTAGE TO BE 66⅔.—Except as provided in paragraph (3), the applicable percentage under section 46(c)(2) for any qualified film shall be 66⅔ percent.

(3) ELECTION OF 90-PERCENT RULE.—

(A) IN GENERAL.—If the taxpayer makes an election under this paragraph, the applicable percentage under section 46(c)(2) shall be determined as if the useful life of the film would have expired at the close of the first taxable year by the close of which the aggregate

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amount allowable as a deduction under section 167 would equal or exceed 90 percent of the basis of the film.

(B) **MAKING OF ELECTION.**—An election under this paragraph shall be made at such time and in such manner as the Secretary may by regulations prescribe. Such an election shall apply for the taxable year for which it is made and for all subsequent taxable years and may be revoked only with the consent of the Secretary.

(C) **WHO MAY ELECT.**—If for any prior taxable year paragraph (2) of this subsection applied to the taxpayer or any related business entity, or if for the taxable year paragraph (2) applies to any related business entity, an election under this paragraph may be made by the taxpayer only with the consent of the Secretary.

(D) **RELATED BUSINESS ENTITY.**—Two or more corporations, partnerships, trusts, estates, proprietorships, or other entities shall be treated as related business entities if 50 percent or more of the beneficial interest in each of such entities is owned by the same or related persons (taking into account only persons who own at least 10 percent of such beneficial interest). For purposes of this subparagraph, a person is a related person to another person if—

(i) such persons are component members of a controlled group of corporations (within the meaning of section 1563(a), except that section 1563(b)(2) shall not apply and except that “more than 50 percent” shall be substituted for “at least 80 percent” each place it appears in section 1563(a)), or

(ii) the relationship between such persons would result in a disallowance of losses under section 267 or 707(b), except that for these purposes a family of an individual includes only his spouse and minor children.

For purposes of this subparagraph, the term “beneficial interest” means voting stock in the case of a corporation, profits interest or capital interest in the case of a partnership, or beneficial interest in the case of a trust or estate.

(4) **PREDOMINANT USE TEST; QUALIFIED INVESTMENT.**—In the case of any qualified film—

(A) section 48(a)(2) shall not apply, and

(B) in determining qualified investment under section 46(c)(1), there shall be issued (in lieu of the basis of the property) an amount equal to the qualified United States production costs (as defined in paragraph (5)).

(5) **QUALIFIED UNITED STATES PRODUCTION COSTS.**—

(A) **IN GENERAL.**—For purposes of this subsection, the term “qualified United States production costs” means with respect to any film—

(i) direct production costs allocable to the United States, plus

(ii) if 80 percent or more of the direct production costs are allocable to the United States, all other production costs other than direct production costs allocable outside the United States.

(B) **PRODUCTION COSTS.**—For purposes of this subsection, the term “production costs” includes—

(i) a reasonable allocation of general overhead costs,

(ii) compensation (other than participations described in clause (vi)) for services performed by actors, production personnel, directors, and producers,

(iii) costs of “first” distribution of prints,

(iv) the cost of the screen rights and other material being filmed,

(v) "residuals" payable under contracts with labor organizations, and

(vi) participations payable as compensation to actors, production personnel, directors, and producers.

Participations on all qualified films placed in service by a taxpayer during a taxable year shall be taken into account under clause (vi) only to the extent of the lesser of 25 percent of each such participation or 12½ percent of the aggregate qualified United States production costs (other than costs described in clauses (v) and (vi) of this subparagraph) for such films, but taking into account for both the 25 percent limit and 12½ percent limit no more than \$1,000,000 in participations for any one individual with respect to any one film. For purposes of this subparagraph (other than clauses (v) and (vi) and the preceding sentence), costs shall be taken into account only if they are capitalized.

(C) DIRECT PRODUCTION COSTS.—For purposes of this paragraph, the term "direct production costs" does not include items referred to in clause (i), (iv), (v), or (vi) of subparagraph (B). The term also does not include advertising and promotional costs and such other costs as may be provided in regulations prescribed by the Secretary.

(D) ALLOCATION OF DIRECT PRODUCTION COSTS.—For purposes of this paragraph—

(i) Compensation for services performed shall be allocated to the country in which the services are performed, except that payments to United States persons for services performed outside the United States shall be allocated to the United States. For purposes of the preceding sentence, payments to an electing small business corporation (within the meaning of section 1371) or a partnership shall be considered payments to a United States person only to the extent that such payments are included in the gross income of a United States person other than an electing small business corporation or partnership.

(ii) Amounts for equipment and supplies shall be allocated to the country in which, with respect to the production of the film, the predominant use occurs.

(iii) All other items shall be allocated under regulations prescribed by the Secretary which are consistent with the allocation principle set forth in clause (ii).

(6) UNITED STATES.—For purposes of this subsection, the term "United States" includes the possessions of the United States.

(I) ENERGY PROPERTY.—For purposes of this subpart—

(1) TREATMENT AS SECTION 38 PROPERTY.—For the period beginning on October 1, 1978, and ending on December 31, 1982—

(A) any energy property shall be treated as meeting the requirements of paragraph (1) of subsection (a), and

(B) paragraph (3) of subsection (a) shall not apply to any energy property.

(2) ENERGY PROPERTY DEFINED.—The term "energy property" means property—

(A) which is—

- (i) alternative energy property,
- (ii) solar or wind energy property,
- (iii) specially defined energy property,
- (iv) recycling equipment,
- (v) shale oil equipment, or

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(vi) equipment for producing natural gas from geopressured brine,

(B)(i) the construction, reconstruction, or erection of which is completed by the taxpayer after September 30, 1978, or

(ii) which is acquired after September 30, 1978, if the original use of such property commences with the taxpayer and commences after such date, and

(C) with respect to which depreciation (or amortization in lieu of depreciation) is allowable, and which has a useful life (determined as of the time such property is placed in service) of 3 years or more.

(3) ALTERNATIVE ENERGY PROPERTY.—

(A) IN GENERAL.—The term "alternative energy property" means—

(i) a boiler the primary fuel for which will be an alternate substance,

(ii) a burner (including necessary on-site equipment to bring the alternate substance to the burner) for a combustor other than a boiler if the primary fuel for such burner will be an alternate substance,

(iii) equipment for converting an alternate substance into a synthetic liquid, gaseous, or solid fuel (other than coke or coke gas),

(iv) equipment designed to modify existing equipment which uses oil or natural gas as a fuel or as feedstock so that such equipment will use either a substance other than oil and natural gas, or oil mixed with a substance other than oil and natural gas (where such other substance will provide not less than 25 percent of the fuel or feedstock),

(v) equipment which uses coal (including lignite) as a feedstock for the manufacture of chemicals or other products (other than coke or coke gas),

(vi) pollution control equipment required (by Federal, State, or local regulations) to be installed on or in connection with equipment described in clause (i), (ii), (iii), (iv), or (v),

(vii) equipment used for the unloading, transfer, storage, reclaiming from storage, and preparation (including, but not limited to, washing, crushing, drying, and weighing) at the point of use of an alternate substance for use in equipment described in clause (i), (ii), (iii), (iv), (v), or (vi), and

(viii) equipment used to produce, distribute, or use energy derived from a geothermal deposit (within the meaning of section 613(e)(3)), but only, in the case of electricity generated by geothermal power, up to (but not including) the electrical transmission stage.

(B) EXCLUSION FOR PUBLIC UTILITY PROPERTY.—The terms "alternative energy property", "solar or wind energy property", and "recycling equipment" do not include property which is public utility property (within the meaning of section 46(f)(5)).

(C) ALTERNATE SUBSTANCE.—The term "alternate substance" means any substance other than—

(i) oil and natural gas, and

(ii) any product of oil and natural gas.

(D) SPECIAL RULE FOR CERTAIN POLLUTION CONTROL EQUIPMENT.—The term "pollution control equipment" does not include any equipment which—

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(i) is installed on or in connection with property which, as of October 1, 1978, was using coal (including lignite), and

(ii) was required to be installed by Federal, State, or local regulations in effect on such date.

(4) **SOLAR OR WIND ENERGY PROPERTY.**—The term "solar or wind energy property" means any equipment which uses solar or wind energy—

(A) to generate electricity, or

(B) to heat or cool (or provide hot water for use in) a structure.

(5) **SPECIALLY DEFINED ENERGY PROPERTY.**—The term "specially defined energy property" means—

(A) a recuperator,

(B) a heat wheel,

(C) a regenerator,

(D) a heat exchanger,

(E) a waste heat boiler,

(F) a heat pipe,

(G) an automatic energy control system,

(H) a turbulator,

(I) a preheater,

(J) a combustible gas recovery system,

(K) an economizer, or

(L) any other property of a kind specified by the Secretary by regulations,

the principal purpose of which is reducing the amount of energy consumed in any existing industrial or commercial process and which is installed in connection with an existing industrial or commercial facility.

(6) **RECYCLING EQUIPMENT.**—

(A) **IN GENERAL.**—The term "recycling equipment" means any equipment which is used exclusively—

(i) to sort and prepare solid waste for recycling, or

(ii) in the recycling of solid waste.

(B) **CERTAIN EQUIPMENT NOT INCLUDED.**—The term "recycling equipment" does not include—

(i) any equipment used in a process after the first marketable product is produced, or

(ii) in the case of recycling iron or steel, any equipment used to reduce the waste to a molten state and in any process thereafter.

(C) **10 PERCENT VIRGIN MATERIAL ALLOWED.**—Any equipment used in the recycling of material which includes some virgin materials shall not be treated as failing to meet the exclusive use requirements of subparagraph (A) if the amount of such virgin materials is 10 percent or less.

(D) **CERTAIN EQUIPMENT INCLUDED.**—The term "recycling equipment" includes any equipment which is used in the conversion of solid waste into a fuel or into useful energy such as steam, electricity, or hot water.

(7) **SHALE OIL EQUIPMENT.**—The term "shale oil equipment" means equipment for producing or extracting oil from oil-bearing shale rock but does not include equipment for hydrogenation, refining, or other process subsequent to retorting.

(8) **EQUIPMENT FOR PRODUCING NATURAL GAS FROM GEOPRESSURED BRINE.**—The term "equipment for producing natural gas from geopressured brine" means equipment which is used exclusively to extract natural gas described in section 613A(b)(3)(C)(i).

¶ 592]—Continued

(9) **EQUIPMENT MUST MEET CERTAIN STANDARDS TO QUALIFY.**—Equipment qualifies under paragraph (3), (4), (5), (6), (7), or (8) only if it meets the performance and quality standards (if any) which—

(A) have been prescribed by the Secretary by regulations (after consultation with the Secretary of Energy), and

(B) are in effect at the time of the acquisition of the property.

(10) **EXISTING.**—For purposes of this subsection, the term “existing” means—

(A) when used in connection with a facility, 50 percent or more of the basis of such facility is attributable to construction, reconstruction, or erection before October 1, 1978, or

(B) when used in connection with an industrial or commercial process, such process was carried on in the facility as of October 1, 1978.

(11) **SPECIAL RULE FOR PROPERTY FINANCED BY INDUSTRIAL DEVELOPMENT BONDS.**—In the case of property which is financed in whole or in part by the proceeds of an industrial development bond (within the meaning of section 103(b)(2)) the interest on which is exempt from tax under section 103, the energy percentage shall be 5 percent.

(12) **INDUSTRIAL INCLUDES AGRICULTURAL.**—The term “industrial” includes agricultural.

(m) **APPLICATION OF CERTAIN TRANSITIONAL RULES.**—Where the application of any provision of subsection (1) of this section or subsection (a)(2) or (c)(3) of section 46 is expressed in terms of a period, such provision shall apply only to—

(1) property to which section 46(d) does not apply, the construction, reconstruction, or erection of which is completed by the taxpayer on or after the first day of such period, but only to the extent of the basis thereof attributable to the construction, reconstruction, or erection during such period,

(2) property to which section 46(d) does not apply, acquired by the taxpayer during such period and placed in service by the taxpayer during such period, and

(3) property to which section 46(d) applies, but only to the extent of the qualified investment (as determined under subsections (c) and (d) of section 46) with respect to qualified progress expenditures made during such period.

→ **Caution: Code Sec. 48(n), below, as added by P. L. 95-600, is effective as to qualified investment for tax years beginning after 1978.** ←

(n) **REQUIREMENTS FOR ALLOWANCE OF ESOP PERCENTAGE.**—

(1) **IN GENERAL.**—

(A) **BASIC ESOP PERCENTAGE.**—The basic ESOP percentage shall not apply to any taxpayer for any taxable year unless the taxpayer on his return for such taxable year agrees, as a condition for the allowance of such percentage—

(i) to make transfers of employer securities to an ESOP maintained by the taxpayer having an aggregate value equal to 1 percent of the amount of the qualified investment (as determined under subsections (c) and (d) of section 46) for the taxable year, and

(ii) to make such transfers at the times prescribed in subparagraph (C).

(B) **MATCHING ESOP PERCENTAGE.**—The matching ESOP percentage shall not apply to any taxpayer for any taxable year unless the basic ESOP percentage applies to such taxpayer for such taxable year, and the taxpayer on his return for such taxable year agrees, as a condition for the allowance of the matching ESOP percentage—

→ **Caution:** Code Sec. 48(n), below, as added by P. L. 95-600, is effective as to qualified investment for tax years beginning after 1978. ←

(i) to make transfers of employer securities to an ESOP maintained by the taxpayer having an aggregate value equal to the sum of the qualified matching employee contributions made to such ESOP for the taxable year, and

(ii) to make such transfers at the times prescribed in subparagraph (C).

(C) **TIMES FOR MAKING TRANSFERS.**—The aggregate of the transfers required under subparagraphs (A) and (B) shall be made—

(i) to the extent allocable to that portion of the ESOP credit allowed for the taxable year or allowed as a carryback to a preceding taxable year, not later than 30 days after the due date (including extensions) for filing the return for the taxable year, or

(ii) to the extent allocable to that portion of the ESOP credit which is allowed as a carryover in a succeeding taxable year, not later than 30 days after the due date (including extensions) for filing the return for such succeeding taxable year.

The Secretary may by regulations provide that transfers may be made later than the times prescribed in the preceding sentence where the amount of any credit or carryover or carryback for any taxable year exceeds the amount shown on the return for the taxable year.

(D) **ORDERING RULES.**—For purposes of subparagraph (C), the portion of the ESOP credit allowed for the current year or as a carryover or carryback shall be determined—

(i) first by treating the credit or carryover or carryback as attributable to the regular percentage,

(ii) second by treating the portion (not allocated under clause (i)) of such credit or carryover or carryback as attributable to the basic ESOP percentage, and

(iii) finally by treating the portion (not allocated under clause (i) or (ii)) as attributable to the matching ESOP percentage.

(2) **QUALIFIED MATCHING EMPLOYEE CONTRIBUTION DEFINED.**—

(A) **IN GENERAL.**—For purposes of this subsection, the term "qualified matching employee contribution" means, with respect to any taxable year, any contribution made by an employee to an ESOP maintained by the taxpayer if—

(i) each employee who is entitled to an allocation of employer securities transferred to the ESOP under paragraph (1)(A) is entitled to make such a contribution,

(ii) the contribution is designated by the employee as a contribution intended to be taken into account under this subparagraph for the taxable year,

(iii) the contribution is paid in cash to the employer or plan administrator not later than 24 months after the close of the taxable year, and is invested forthwith in employer securities, and

(iv) the ESOP meets the requirements of subparagraph (B).

(B) **PLAN REQUIREMENTS.**—For purposes of subparagraph (A), an ESOP meets the requirements of this subparagraph if—

(i) participation in the ESOP is not required as a condition of employment and the ESOP does not require matching employee contributions as a condition of participation in the ESOP,

→ **Caution:** Code Sec. 48(n), below, as added by P. L. 95-600, is effective as to qualified investment for tax years beginning after 1978. ←

[§ 592]—Continued

(ii) employee contributions under the ESOP meet the requirements of section 401(a)(4), and

(iii) the ESOP provides for allocation of all employer securities transferred to it or purchased by it (because of the requirements of paragraph (1)(B)) to the account of each participant in an amount equal to such participant's matching employee contributions for the year.

(3) CERTAIN CONTRIBUTIONS OF CASH TREATED AS CONTRIBUTIONS OF EMPLOYER SECURITIES.—For purposes of this subsection, a transfer of cash shall be treated as a transfer of employer securities if the cash is, under the ESOP, used within 30 days to purchase employer securities.

(4) ADJUSTMENTS IF ESOP CREDIT RECAPTURED.—If any portion of the ESOP credit is recaptured under section 47 or the ESOP credit is reduced by a final determination—

(A) the employer may reduce the amount required to be transferred to the ESOP under paragraph (1) for the current taxable year or any succeeding taxable year by an amount equal to such portion (or reduction), or

(B) notwithstanding the provisions of paragraph (5) and to the extent not taken into account under subparagraph (A), the employer may deduct an amount equal to such portion (or reduction), subject to the limitations of section 404.

(5) DISALLOWANCE OF DEDUCTION.—No deduction shall be allowed under section 162, 212, or 404 for amounts required to be transferred to an ESOP under this subsection.

(6) DEFINITIONS.—For purposes of this subsection—

(A) EMPLOYER SECURITIES.—The term "employer securities" has the meaning given to such term by section 409A(1).

(B) VALUE.—The term "value" means—

(i) in the case of securities listed on a national exchange, the average of closing prices of such securities for the 20 consecutive trading days immediately preceding the due date for filing the return for the taxable year (determined with regard to extensions), or

(ii) in the case of securities not listed on a national exchange, the fair market value as determined in good faith and in accordance with regulations prescribed by the Secretary.

→ **Caution:** Code Sec. 48(o), below, as added by P. L. 95-600, is effective as to qualified investment for tax years beginning after 1978. ←

(o) CERTAIN CREDITS DEFINED.—For purposes of this title—

(1) REGULAR INVESTMENT CREDIT.—The term "regular investment credit" means that portion of the credit allowable by section 38 which is attributable to the regular percentage.

(2) ENERGY INVESTMENT CREDIT.—The term "energy investment credit" means that portion of the credit allowable by section 38 which is attributable to the energy percentage.

(3) ESOP CREDIT.—The term "ESOP credit" means the sum of—

(A) the basic ESOP credit, and

(B) the matching ESOP credit.

→ **Caution: Code Sec. 48(o), below, as added by P. L. 95-600, is effective as to qualified investment for tax years beginning after 1978.** ←

(4) **BASIC ESOP CREDIT.**—The term "basic ESOP credit" means that portion of the credit allowable by section 38 which is attributable to the basic ESOP percentage.

(5) **MATCHING ESOP CREDIT.**—The term "matching ESOP credit" means that portion of the credit allowable by section 38 which is attributable to the matching ESOP [percentage].

(6) **BASIC ESOP PERCENTAGE.**—The term "basic ESOP percentage" means the 1-percent ESOP percentage set forth in section 46(a)(2)(E)(i).

(7) **MATCHING ESOP PERCENTAGE.**—The term "matching ESOP percentage" means the additional ESOP percentage (not to exceed ½ of 1 percent) set forth in section 46(a)(2)(E)(ii).

(p) **SINGLE PURPOSE AGRICULTURAL OR HORTICULTURAL STRUCTURE DEFINED.**—For purposes of this section—

(1) **IN GENERAL.**—The term "single purpose agricultural or horticultural structure" means—

- (A) a single purpose livestock structure, and
- (B) a single purpose horticultural structure.

(2) **SINGLE PURPOSE LIVESTOCK STRUCTURE.**—The term "single purpose livestock structure" means any enclosure or structure specifically designed, constructed, and used—

- (A) for housing, raising, and feeding a particular type of livestock and their produce, and
- (B) for housing the equipment (including any replacements) necessary for the housing, raising, and feeding referred to in subparagraph (A).

(3) **SINGLE PURPOSE HORTICULTURAL STRUCTURE.**—The term "single purpose horticultural structure" means—

- (A) a greenhouse specifically designed, constructed, and used for the commercial production of plants, and
- (B) a structure specifically designed, constructed and used for the commercial production of mushrooms.

(4) **STRUCTURES WHICH INCLUDE WORK SPACE.**—An enclosure or structure which provides work space shall be treated as a single purpose agricultural or horticultural structure only if such work space is solely for—

- (A) the stocking, caring for, or collecting of livestock or plants (as the case may be) or their produce,
- (B) the maintenance of the enclosure or structure, and
- (C) the maintenance or replacement of the equipment or stock enclosed or housed therein.

(5) **SPECIAL RULE FOR APPLYING SECTION 47.**—For purposes of section 47, any single purpose agricultural or horticultural structure shall be treated as meeting the requirements of this subsection for any period during which such structure is held for the use under which it qualified under this subsection.

(6) **LIVESTOCK.**—The term "livestock" includes poultry.

(q) **CROSS REFERENCE.**—

For application of this subpart to certain acquiring corporations, see section 381(c)(23).

.01 Added by P. L. 87-834. Amended by P. L. 95-618, P. L. 95-600, P. L. 94-455, P. L. 94-12, P. L. 92-178, P. L. 91-172, P. L. 90-26, P. L. 89-809, P. L. 89-800 and P. L. 88-272. For details, see the Code Volumes.

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Committee Reports on P. L. 95-618

.0135 A. Additional Investment Tax Credit for Alternative Energy Property.

House Bill.—The bill provides for an additional 10-percent investment credit which is not

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[§ 592.0135]—Continued

available to taxpayers who claim credit against the user tax. The credit is limited to 100 percent of tax liability, and this additional credit rate is 5 percent for property financed with tax-exempt industrial development bonds. Utilities will receive the credit for new boilers only to the extent that an existing oil- or gas-fired boiler is phased down to less than 1,500 hours of use per year. The credit is available only to persons engaged in a trade or business, and the credit is recaptured according to the rules for the regular investment credit.

Qualifying property includes equipment which uses a fuel or feedstock other than oil or gas or their products, i. e., an alternate substance. Equipment must be new and must be used in connection with a building or structure located in the United States and is eligible even if considered a structural component or used in connection with lodging facilities.

Alternative energy property includes:

- (1) Boilers;
- (2) Burners for combustors other than boilers;
- (3) Nuclear and hydroelectric power equipment, not including turbines or generators;
- (4)(a) Geothermal power equipment, not including turbines or generators;
- (b) Geothermal equipment to provide heating, cooling and electricity used in connection with an existing building and an existing commercial or industrial process;
- (5) Equipment for producing synthetic gas;
- (6)(a) Equipment for modifying existing equipment so that an alternate substance is at least 25 percent of the fuel or feedstock;
- (b) Equipment for modifying an existing boiler in an existing electric generating facility so that an alternate substance is at least 25 percent of the fuel; the rate of credit depends on fuel savings percentage;
- (7) Pollution control equipment required by Federal, State, and local regulations to be installed in connection with equipment in categories (1), (2), (5), and (6);
- (8) Equipment used to handle, store, and prepare an alternate substance, at the point of use as a fuel or feedstock, for use in equipment in categories (1), (2), (3), (4)(a), (5), (6) and (7); facilities to manufacture coke are excluded;
- (9) Equipment which uses solar and wind energy to provide heat, cooling or electricity in connection with an existing building and existing industrial or commercial process, and
- (10) Plans and designs for equipment in the above categories.

The credit is available for investments after April 19, 1977, and before January 1, 1983.

Conference Agreement.—The conference agreement follows the House bill with the following modifications.

The eligible equipment includes the Senate provision of equipment for producing synthetic liquid, gaseous or solid fuel, but not coke or coke gas, and equipment which uses coal (including lignite) as a feedstock for the manufacture of chemicals or other products, except

coke or coke gas. Geothermal equipment is defined as in the Senate bill.

Hydroelectric and nuclear equipment, structures and dams are excluded.

Solar and wind energy equipment are included, as defined in the Senate amendment, and are eligible for a refundable credit. The definition of solar equipment does not include so-called "passive solar" equipment.

The additional investment credit for alternative energy property is not available to the tax-exempt organizations that were included in the Senate amendment: State and local governments and organizations exempt under sections 501(c)(3) and (12). In addition, the credit is not available to public utility property, as defined in section 46(f)(5): property used predominantly in the trade or business of the furnishing or sale of:

- (i) electrical energy, water, or sewage disposal services,
- (ii) gas through a local distribution system,
- (iii) telephone service, telegraph service by means of domestic telegraph operations or other communication services, or
- (iv) steam through a local distribution system or the transportation of gas or steam by pipeline.

The additional credits, except those for solar and wind energy equipment, are not refundable, but may be used to offset 100 percent of tax liability. The rules for applying the limitations based on tax liability to the use of the investment credit in combination with the energy credits provided in the conference agreement will operate under the following stacking order. A taxpayer first will apply the credits attributable to section 38 property (not including the energy credits provided in this agreement) against tax liability to the extent allowed under current law. The first-in-first-out rule of section 46(a) will continue to apply with respect to the stacking of credits within the limitation. Next, a taxpayer will apply the credits attributable to the application of the energy percentage to energy property to the remaining tax liability, up to 100 percent of that tax liability. Finally, if the energy credits exceed tax liability and any of the excess is attributable to solar and wind energy credit, these latter amounts will be treated as an overpayment of tax[, i. e., as if the amounts were allowed by section 39.

The credits are available for eligible property acquired and placed in service after September 30, 1978, and before January 2, 1983, to the extent of basis attributable to this period.

B. Specially Defined Energy Property Tax Credit.

House Bill.—An additional 10-percent investment credit is provided for this category of energy property. The credit is limited to 50 percent of tax liability. Qualifying property is required to be new depreciable property, with a useful life of at least 3 years, used in connection with a structure located in the United States. All categories of qualifying property must satisfy performance and quality standards prescribed by the Secretary. The recapture rules under the regular investment credit also apply to this credit. The credit is reduced to 5 percent for property financed by industrial development bonds.

Eligible property includes: (1) a recuperator, (2) a heat wheel, (3) a regenerator, (4) a heat exchanger, (5) a waste heat boiler, (6) a heat pipe, (7) an automatic energy control system, (8) a turbulator, (9) a preheater, (10) a combustible gas recovery system, (11) an economizer, or (12) any other property of a kind specified by the Secretary by regulations, the principal purpose of which is reducing the amount of energy consumed in any existing industrial or commercial process and which is installed in connection with an existing industrial or commercial facility.

The additional credit applies to investments in qualifying property after April 19, 1977, and before January 1, 1983.

Senate Amendment.—The Senate made available the same 10-percent credit as the House bill, but amended the House bill in several other respects.

The credit is refundable, under the same terms applicable to alternative energy property (No. 27 above).

The list of eligible property was expanded to include industrial heat pumps; energy efficient replacement electric motors; fuel cells, gas turbines and external combustion engines with demonstrated fuel efficiency; fluorescent replacement lighting systems; and silicone controlled rectifier units.

In addition, the Secretary's administrative authority has been extended to equipment that reduces the amount of heat wasted, and equipment in this category of energy property may be installed in connection with utility and agricultural facilities.

This credit applies to investments in qualifying property after April 19, 1977, and before January 1, 1986.

Conference Agreement.—The conference agreement generally follows the House bill, but the credit may be applied against 100 percent of tax liability as in the Senate amendment. The Secretary is authorized to specify other similar items of energy conservation equipment eligible for this credit, including modifications which are made to existing industrial processes, the principal purpose of which is the reduction in the amount of energy consumed or heat wasted. The conferees expect the Secretary to consult with [the] Department of Energy and the Bureau of Standards in determining additional items to be eligible as specially defined energy property. The credit will be available for qualifying property placed in service after September 30, 1978, and before January 1, 1983, and for qualified expenditures incurred during this period.

C. Energy Property Tax Credit.

House Bill.—The additional nonrefundable 10-percent investment credit is available for two additional types of energy property:

(1) Cogeneration property for the production of steam, heat or other forms of useful energy and also electric energy; and

(2) Recycling equipment which is used exclusively in the recycling of solid waste or to sort and prepare solid waste for recycling.

This credit is limited to 50 percent of tax liability and the additional credit is reduced to 5 percent if the property is financed in whole or in part with industrial development bonds.

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The credit applies to qualifying property placed in service after April 19, 1977, and before January 1, 1983.

Senate Amendment.—Under the Senate amendment, the credit is an additional 10 percent, applicable up to 100 percent of tax liability. Eligible property includes:

(1) Cogeneration property defined as in the House bill plus cogeneration for agricultural purposes, and water purification and desalination.

(2) Recycling equipment defined as in the House bill, but the exclusive use requirement is modified to permit use of up to 10 percent virgin materials; in addition, eligible equipment includes recycling equipment to the point where a marketable product has been produced, e. g., newsprint, paperboard, metal ingots, or textile fibers.

(3) Shale oil equipment which is used to mine, extract or produce oil from oil-bearing shale rock;

(4) Transportation equipment which includes commuter vans and equipment designed to reduce energy consumption when added to existing motor vehicles and commercial carriers;

(5) Equipment used to produce natural gas from geopressured brine;

(6) On-site electrical heat processing equipment which is replacement equipment and which uses electricity produced with an alternate substance; and

(7) Electric motor vehicles, primarily for use on public streets, roads and highways, when purchased for use in a trade or business.

The credit applies to eligible equipment placed in service after April 19, 1977, and before January 1, 1986.

Conference Agreement.—The conference agreement provides that the additional 10 percent credit will be available to be applied against 100 percent of tax liability. Eligible property includes (1) recycling equipment defined as in the Senate bill except that in the iron and steel industry, the credit is limited to equipment used before the solid waste is reduced to a molten state, (2) shale oil equipment, as in the Senate amendment, and (3) equipment to produce natural gas from geopressured brine, as in the Senate amendment. For the latter equipment, the rules of the Federal Energy Regulatory Commission will be applied to determine which well qualifies as a well producing natural gas from geopressured brine under the terms of the definition in the Natural Gas Pricing Act, but the Secretary of the Treasury will determine whether the equipment used in connection with that well is eligible for the credit.

The additional credit will be available for eligible equipment acquired or placed in service after September 30, 1978, and before January 1, 1983, and for qualified expenditures in this period.—Conference Committee Report.

[Air conditioning and space heating units]

.0137 Under the committee bill, several tax incentives would be repealed for new investments in certain energy property. In particular, the committee bill deletes air conditioning and space heating units (that is, those not considered structural components) from the definition of tangible personal property so that such property no longer will be eligible for the regular

[§ 592.0137]—Continued

Investment tax credit. Boilers or other combustors fueled by oil or natural gas also would be denied the regular (or any additional) investment tax credit, unless the use of coal or another alternate substance is precluded by existing Federal or State air pollution regulations, or unless the use of such a boiler or other combustor is an exempt use under sec. 4992(b) of the bill.

An exempt use of oil or natural gas is defined by sec. 4992(b) as a use in a residential facility, in transportation (including by pipeline), on a farm for farming purposes, in a shopping center, office building or wholesale or retail establishment, in any other facility which is not an integral part of manufacturing, processing or mining, or use in the exploration or development, extraction, transmission or storage of crude oil, natural gas, or natural gas liquids, and an exempt process use.

In addition, new oil or natural gas boilers would be required to use straight-line depreciation, rather than any accelerated depreciation method, and the useful life of such property must equal the class life prescribed by the Secretary, without regard to the 20 percent variance in class life available under sec. 167(m)(1) of the Code.

The denial of the investment tax credit would apply to property placed in service after June 20, 1977, but the denial would not apply to property which is constructed, reconstructed, erected or acquired under the terms of a binding contract to which the taxpayer was a party on June 20, 1977, and at all times thereafter. This provision would pertain only to contracts in which the construction, reconstruction, erection, or acquisition of property is itself the subject matter of the contract and would not apply to a contract with a person other than the builder or supplier under which the taxpayer becomes obligated to construct, reconstruct, erect or acquire property. A contract which is binding on the taxpayer on June 19, 1977, would not be considered binding at all times thereafter if it is substantially modified after that date.—House Committee Report.

.0138 The conference agreement generally follows the House provision, modified to apply only to portable air conditioners, portable space heaters and boilers fueled by oil or gas. Other combustors fueled by oil or natural gas will not be subject to the investment tax credit and accelerated depreciation denial rules under the conference agreement. In addition, the conference agreement includes the range of exempt uses under the House bill, which generally exempt from the provision those uses which are not part of manufacturing, production or mining. In addition, the credit is not available to public utility property, as defined in section 46(f)(5): property used predominantly in the trade or business of the furnishing or sale of:

- (i) electrical energy, water, or sewage disposal services,
- (ii) gas through a local distribution system,
- (iii) telephone service, telegraph service by means of domestic telegraph operations or other communication services, or
- (iv) steam through a local distribution system or the transportation of gas or steam by pipeline.

The provision applies to property placed in service after September 30, 1973, except for

property for which a binding contract was in effect on that date.—Conference Committee Report.

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.014 * * * The conference agreement modifies the Senate amendment to specifically extend the investment credit to special purpose structures used for livestock and horticultural products and to adopt the general conditions and requirements of H. R. 12846, as passed by the House of Representatives on October 13, 1978.

In order to be included under this provision, a livestock structure must be specifically designed, constructed, and used for the housing, raising and feeding of livestock and their produce. The term "livestock" for this purpose includes poultry. The full range of livestock breeding, raising and production activities is intended to be included so that special purpose structures will qualify for credit if used, for example, to breed chickens or hogs, to produce milk from dairy cattle, or to produce feeder cattle or pigs, broiler chickens, or eggs. In addition, the structure or enclosure must be designed and used to house equipment necessary to feed and care for the livestock. As a result, such facilities must include, as an integral part of the structure or enclosure, equipment to contain the livestock and to provide water, feed and temperature control, if necessary.

Similarly, a horticultural structure is made specifically eligible for the credit under this provision if it has been designed, constructed, and used for the commercial production of plants, including mushrooms.

The issues which have arisen concerning allowance of the credit under present law are also resolved by providing that the life of the structure need not be contemporaneous with the equipment it houses. In addition, working space is permitted within an eligible structure. Under this latter rule, the property will be eligible for the credit even if working space is provided for caring for the livestock or plants or for gathering their produce (such as eggs, tomatoes or flowers). In addition, working space may be provided to maintain the structure and to maintain or replace the equipment within the structure.

It should be emphasized that the structure must be used exclusively for the purpose for which it was specifically designed and constructed. As a result of this requirement, a hog structure will not be eligible property, for example, if it is used for the housing and feeding of poultry or cattle or if more than incidental use of a structure is made to store feed or machinery. (However, mere vacancy of the facility will not violate this usage test.) Similarly, the use of part of a greenhouse for the purpose of selling plants or their produce, such as by installation of a check-out stand, will make the greenhouse ineligible for the credit. If a single purpose structure becomes ineligible because of this usage test within seven years from the time it was placed in service, investment credits claimed on the structure may be partially or entirely recaptured under the investment credit recapture rules in present law. In addition, the conferees wish to emphasize that the specific provisions concerning the eligibility of these structures for the investment credit are not to create a negative inference regarding the eligibility of other special purpose agricultural and productive structures for