

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 8672

931 SCCMM32: AK GENERAL STOCK OWNERSHIP CORP. 1979-80 931

the credit under existing law.—Conference Committee Report.

.0142 * * * The bill extends the investment credit to rehabilitation expenditures incurred in connection with existing buildings used in all types of business or productive activities except buildings, such as apartments, which are used for residential purposes. Eligible buildings would include factories, warehouses, office buildings, hotels,¹ and retail and wholesale stores. The type of building would be determined on the basis of its use when placed in service after rehabilitation, e. g., an apartment building rehabilitated for use as an office building would be treated as an eligible office building.

In order to qualify as a rehabilitation expenditure, the expenditure must be incurred after [October 31, 1978], in connection with the rehabilitation or reconstruction of a building which has been in use for a period of at least [20] years before the commencement of the rehabilitation. In addition, a rehabilitation of a building, or a major portion thereof, which had previously been rehabilitated would not be eligible for the credit until [20] years after completion of the prior rehabilitation. However, this latter limitation should not be interpreted to require continuous rehabilitation activity and preclude allowing the credit where there are delays between phases of a rehabilitation plan. In addition, in order to exclude minor repairs or improvements, the costs must be required under existing law to be capitalized (and not expensed) and must be incurred for property which has a useful life of at least five years.

Under these rules and existing law, qualifying expenditures will be eligible for a two-thirds investment credit if the improvements attributable to the expenditures have a useful life of five or six years, and a full credit where the useful life is seven years or more. Useful life for this purpose is the useful life used by the taxpayer for depreciation purposes. In addition, the existing rules concerning the recapture of investment credits will apply so that if the property is disposed of or ceases to be qualifying property before the end of the appropriate useful life period for which the credit was allowed, all or part of the credit will be recaptured.

The costs of acquiring a building or an interest in a building (such as a leasehold interest) will not be considered as qualifying expenditures nor will costs that are incurred in connection with facilities, such as parking lots, which are related to an existing building. In addition, construction costs for a new building, or for completing a new building after it has been placed in service will not qualify.

Qualified rehabilitation costs will be considered as incurred for new property, and, therefore not subject to the \$100,000 used property limitation, except to the extent such costs are for property (such as used elevators) which otherwise qualify for the investment credit. In these latter cases, the costs will not be considered as rehabilitation expenditures.

For purposes of this provision, the rehabilitation of a building will include the renovation,

restoration, and reconstruction of an existing building. Thus, interior or exterior renovation or restoration to materially extend the useful life of the building, to significantly upgrade its usefulness, or to preserve it will normally qualify. Capital expenditures for the replacement of plumbing, electrical wiring, flooring, permanent interior partitions and walls, and the heating or air conditioning systems (including temperature control systems) could qualify as qualified rehabilitation expenditures when incurred in connection with a rehabilitation. In addition, expenditures for the removal of existing interior walls, plumbing, electrical wiring, flooring, etc., would qualify if the expenditures were incurred in connection with the rehabilitation of a building and treated as capital expenditures for property with a useful life of at least 5 years.

Limitations are also provided to exclude costs incurred for new construction or enlargement of an existing building. In the case of an enlargement, costs will not be considered qualifying expenditures to the extent incurred to expand the total volume of the existing building. However, an increase in floor space resulting from interior remodeling will not be considered an enlargement. In addition, construction costs will be considered for new construction rather than for the rehabilitation of a building if more than 25 percent of the existing external walls of the building are replaced. This latter restriction, however, is not intended to be interpreted to cover situations where existing walls are covered (e. g., the outer walls are covered by new siding in connection with the rehabilitation) or reinforced.

In the case where expenditures are eligible for 5-year rapid amortization as rehabilitation expenditures for a certified historic structure, a taxpayer must choose between the benefits of 5-year rapid amortization for the rehabilitation expenditures or the investment tax credit on the expenditures. If rapid amortization is chosen, the expenditures will not be eligible for the investment tax credit.

* * *

These amendments will be effective for taxable years ending after [October 31], 1978, with respect to qualifying rehabilitation expenditures incurred after that date. The amendment relating to certified historic structures applies to property placed in service after [October 31], 1978.—House Committee Report.

.0143 * * * The conference agreement modifies and follows the House bill. Under the conference agreement, a building must have been in use for at least 20 years, and the costs must be incurred at least 20 years after the last rehabilitation was completed, in order to qualify for the credit. In addition, under the conference agreement, rehabilitation expenditures in connection with a certified historic structure must themselves be certified as appropriate by the Secretary of the Interior in order to qualify for the investment credit in those situations where the taxpayer elects to claim the credit rather than 5-year amortization. These provisions will be effective for qualifying expenditures incurred after October 31, 1978.—Conference Committee Report.

¹ Buildings used for lodging will not generally be eligible (sec. 48(a)(3)). However, the exception for lodging facilities would not apply

to hotels and motels where the predominant portion of the accommodations is used by transients.

[§ 592]—Continued

Committee Reports on P. L. 94-455

.015 House bill.—The House bill provides that for the future, as a general rule, taxpayers will receive $\frac{2}{3}$'s of a full investment credit for all their films regardless of the actual useful life of any particular film. For the past, taxpayers may elect to take a 40-percent compromise credit for all of their films, regardless of the actual useful life or foreign use of any particular film. Alternatively, taxpayers may determine their investment credit on a film-by-film basis.

Senate amendment.—The Senate amendment is generally the same as the House bill. However, the amendment clarifies that the investment credit is to be available for educational films as well as entertainment films. It also deletes a restriction imposed by the House bill on investment credit carryovers. Unlike the House bill, the Senate amendment permits participations to be included in the credit base of an 80 percent or more U. S. produced film, but not in excess of (a) \$1 million with respect to any one individual for any one film and (b) not in excess of the lesser of (i) 50 percent of participations qualifying under rule (a) or (ii) 25 percent of the production costs of the taxpayer's films for the year. The amendment also provides that any taxpayer who filed a petition in a court by January 1, 1976, may have his investment credit for prior years determined under present law (rather than under the rules of the bill) if he elects present law treatment within 30 days after the date of enactment.

Conference agreement.—The conference agreement follows the Senate amendment except in two respects. First, in the case of participations the conference agreement provides one-half of the amount of participations permitted to be included in the credit base by the Senate amendment. As a result, under the conference agreement, participations are limited to the lesser of (a) \$1,000,000 with respect to any one individual for any one film, but (b) not in excess of the lesser of (i) 25 percent of participations qualifying under rule (a) or (ii) 12½ percent of the production costs of the taxpayer's films for the year. Second, a taxpayer who wishes to elect present law treatment for prior years may do so within 90 days from the date of enactment if the taxpayer had filed a petition in a court by January 1, 1976.

In addition, the conferees wish to clarify that under certain circumstances, it may be possible for the rights to the film to be leased under section 48(d) before the film is placed in service. However, it is intended that this right is to be available only where the lessee acquires full rights to exploit the movie or film for its estimated useful life through a particular medium or in a particular geographic area; it is not to be available where the lessee is precluded (by law, regulation or governmental action) from acquiring all rights to commercially exploit the film or tape.—**Conference Committee Report.**

.016 The committee amendment provides somewhat different rules in this area with respect to the past than it does for the future, because the rules for the past are intended to compromise the litigating positions of the Internal Revenue Service and members of the

film industry, based on transactions which have already occurred. Also, the rules are different for the future because the emphasis for the future is to be on providing jobs in the United States.

Films placed in service in future years

General rule.—For the future, as a general rule, under the committee amendment, taxpayers are to receive two-thirds of a full credit for all their films regardless of the actual useful life (or foreign use) of any particular film. This rule will apply to all films placed in service (i. e., initially released for public exhibition in any medium) in taxable years beginning after December 31, 1974, regardless of whether any particular film had a useful life of 7 years or more (so that it would be entitled to a full credit if judged on an individual basis), or less than 3 years (so that it would not be entitled to any credit if judged separately). The credit is to be available only for "qualified films", i. e., motion picture films or television films or tapes created primarily for use as public entertainment, and educational films, i. e., generally films used in primary or secondary schools, colleges and universities, vocational and post-secondary educational institutions, public libraries and government agencies (thus for example, excluding industrial training films).¹ Also, the credit would be available for TV pilot films and dramatic or comedy series, such as "Mod Squad" or "The Mary Tyler Moore Show." However, the credit would not be available for films which were topical or transitory in nature, such as news shows, interview shows such as "Johnny Carson" or "Firing Line", or films or tapes of sports events, even though some of these shows might be shown in subsequent years. Also, the credit would not be available for used films (i. e., films shown previously in any market).

The 90-percent method.—Under the committee amendment, as an alternative to the general rule, taxpayers may elect to have the investment credit determined for all of their qualified films placed in service in the future on a film-by-film basis. Thus, if a particular film had a useful life of 7 years or more, the taxpayer would be entitled to a full credit for that film. On the other hand, if a film had a useful life of less than 3 years the taxpayer would not be entitled to any credit for that film. For purposes of these rules the film's useful life is to be treated as ending at the close of the year by the end of which the aggregate allowable deductions for depreciation equal at least 90 percent of the basis of the film (adjusted for any partial dispositions, but determined without regard to any other adjustments).

For example, assume that a taxpayer who is on a calendar year basis releases (i. e., places in service) a film with a basis of \$100 on February 1, 1975. The film is depreciated under the income forecast method and \$50 of depreciation is allowable with respect to this film for 1975, \$30 for 1976 and \$10 is for 1977. Thus, \$90 of depreciation is allowable by the close of 1977, and since this represents 90 percent of the basis of the film the useful life of the film is to be treated as having ended on December 31, 1977, or less than three years after the film was placed in service; therefore, no credit would be available with respect to this film, and any credit or partial credit which had been claimed would be subject to recapture.

¹ The inclusion of educational films is a change in the House bill made by the committee amendment.

On the other hand, if less than \$90 of basis had been recovered by the close of 1977, the film would be eligible for at least a partial credit.²

Of course, films of a transitory or topical nature would not be eligible for the investment credit, no matter when their basis was recovered through depreciation.

If the actual useful life of a film is less than its anticipated useful life in the case of a taxpayer using the 90-percent method, the credit is to be subject to recapture under essentially the same rules which apply in the case of any other section 38 property where the actual useful life proves to be shorter than the anticipated life. Also, in the case of a disposition or partial disposition of rights in the film before the end of the anticipated useful life of the film, there would be a full or partial recapture.³

A partial disposition includes the sale of commercial exploitation rights in any medium (television, for example) or in any geographic area (such as Great Britain, or any other foreign country). On the other hand, an ordinary commercial license for less than the full rights of exploitation in a particular medium or area generally does not constitute a disposition or partial disposition for purposes of these rules.

Also, a sale of exploitation rights to a member of an "affiliated group" does not constitute a partial disposition. For example, U. S. film distributors commonly exploit the foreign rights to a U. S.-made film through use of a foreign affiliate. For purposes of these rules, the term "affiliated group" is to have the same meaning as it does for purposes of section 1504, but with a 50-percent control test (instead of 80 percent), and with no exclusion of corporations (such as foreign affiliates) described in section 1504(b). Also where stock in a foreign film distributor is held by the trust of a pension plan which benefits the employees of that foreign distributor, any U. S. corporation holding stock in the foreign distributor may add the stock held by the pension trust to its own stock holdings for purposes of determining if the foreign film distributor is an "affiliate" of the U. S. corporation. For example, if two American distributors each hold 49 percent of the stock in a foreign distributor, and the pension trust of the foreign distributor holds the remaining 2 percent, the foreign distributor would be an affiliate of both of the American corporations (because each would add the 2 percent interest held by the pension trust to its own 49 percent interest).

Some of the principles above may be illustrated as follows. A film distributor having a 100 percent ownership interest in a television dramatic series, consisting of 24 weekly episodes, elects to use the 90 percent method of determining its investment credit for movie films. The distributor estimates the useful life of the series will be 7 years or more and

claims a full credit. The distributor licenses a United States television network; under the agreement the network acquires first-run U. S. television rights for \$100, with the right to repeat each episode over the network one time for an additional fee of \$25.

In the following year,⁴ the American distributor sells the exclusive rights to exhibit the series in Great Britain to a British corporation which is not affiliated with the American distributor. This constitutes a partial disposition of the series which triggers a partial recapture of the credit.

If, on the other hand, the American distributor entered into a limited licensing agreement with the foreign corporation (similar to the agreement which it had entered with the American network), or sold the British rights to the series to a member of an affiliated group, there would be no partial disposition, and consequently, no recapture.

Films placed in service for taxable years beginning after December 31, 1974, are not subject to the foreign use rule. This is because, in the case of a movie film, jobs are created where the film is produced, not where it is shown. To use the 90-percent method, the taxpayer would have to make an election, in a time and manner to be prescribed in regulations.

Once the taxpayer (or any related business entity) has operated under the general rule for the future, or has elected to use the 90-percent method, he cannot change his method of operation without the consent of the Internal Revenue Service. The committee intends that permission will be granted where the taxpayer undergoes a substantial transformation in its operations, but generally will not be granted otherwise. For example, it might be appropriate to grant permission if a film studio using the 90-percent method merged with a studio using the two-thirds method; or in cases where a studio shifted from the production of short-lived grade B westerns to long-lived classic films.

For purposes of these rules, related business entities include all component members of a controlled group of corporations (within the meaning of section 1563(a), without regard to subsection 1563(b)(2)) but subject to a 50-percent control test. Also classified as "related business entities" are any corporations, partnerships, trusts, estates, proprietorships, or other entities, if "related persons", each of whom have at least a 10-percent interest in each entity, also have, in the aggregate, at least 50 percent of the beneficial interests in those entities.⁵

Thus, for example, if individuals A, B, C, and D each have a 25-percent interest in studio 1, which uses the two-thirds method in 1975, studio 2, formed in 1976, with A and B each having a 50-percent profits interest, cannot elect the 90-percent method for 1976 without the per-

² For purposes of these calculations, salvage value would not be taken into account: thus, if a film has a basis of \$100, and a salvage value of \$10, the useful life would not end until \$90 of depreciation was recoverable (i. e., 90 percent of the \$100 basis, not 90 percent of the \$100 basis minus the \$10 salvage value, which would equal \$81).

³ This rule is not to apply to a taxpayer using the general rule (the two-thirds method), however, since the amount of the credit under this method does not depend on the useful life of any particular film.

⁴ Where a TV series is involved, each weekly segment is placed in service when it is first shown. Thus, the various segments of the series will not necessarily be placed in service in the same year.

⁵ The term "beneficial interest" means voting stock in the case of a corporation, profits or capital interest in the case of a partnership, and beneficial interest in the case of a trust or estate. "Related persons" are generally as described in section 267 or 707(b), but for purposes of these rules members of a family consist only of the individual, his spouse, and his minor children.

[§ 592.016]—Continued

mission of the Internal Revenue Service, Studio 1 and studio 2 are related, because A and B each have at least a 10-percent interest in both studios and together A and B have at least 50 percent of the beneficial interest of both studios. Since studio 1 used the two-thirds method in 1975, studio 2 must have permission to use a different method in 1976.

Credit base.—Since the primary purpose of the investment credit is to create jobs, the committee amendment is designed to encourage the production of films in the United States. Thus, the credit base for motion picture films includes the direct costs which are allocable to production of the film in the United States (including its commonwealths and possessions) and, in addition, if at least 80 percent of the direct production costs are allocable to United States production, the credit base also includes certain indirect "production costs."

Direct production costs include compensation payable to the actors and other production personnel. However, under the committee amendment, certain special rules apply in the case of participations (described below in connection with indirect production costs). (The House bill would not allow the investment credit for participations.)

Direct production costs also include expenses for costumes, props, scenery, and similar items, as well as the cost of the film, and the cost of preparing the first distribution of prints (i. e., prints placed in service within 12 months after the film is first released).

Where the film is produced partly in the United States and partly abroad, the direct production costs must be allocated between the U. S. and foreign production of the film. Under the committee amendment, compensation for services is to be allocated to the country where the services are performed. However, compensation paid to United States citizens is to be allocated to the United States, even if the services are performed outside of the United States. Also, payments to a subchapter S corporation or to a partnership are to be treated as United States production costs if (and to the extent) that the payments are includable in gross income by a U. S. citizen or any other United States person (which is not a partnership or subchapter S corporation). Amounts paid for equipment and supplies are to be allocated to the country in which the materials are predominantly used (where this can be established for particular materials). Subject to these guidelines, allocation of direct production costs is to be determined under regulations. The committee intends that generally (in the absence of better evidence as to the actual place of predominant use of personnel and materials) direct production costs are to be allocated in accordance with the shooting time of the film.

If 80 percent or more of the direct production costs are allocable to U. S. production, then the credit base for the film is to include all "production costs" of the film (other than the direct foreign production costs, if any). These would include not only the direct production costs, as outlined above, but also certain capitalized costs, including a reasonable allocation of the general overhead of the taxpayer, the cost of obtaining the screen rights to the film,

as well as the cost of developing the screenplay, and "residuals" (whether or not capitalized) paid under agreements with labor organizations, such as the Actor's Guild. Generally, residuals are amounts paid under a collective bargaining agreement to all members of the union involved (or in some cases to a guild or union pension, health, or welfare fund). The collective bargaining agreement generally covers all films produced over a period of several years. Residuals may be a percentage of gross receipts from nontheatrical uses of a theatrical film, or a percentage of the minimum salary payable (i. e., scale) to the union member.

Under the committee amendment, participations may be included in the credit base of an 80 percent or more U. S. produced film subject to certain limitations. First, participations may be included in the credit base only to the extent that participations paid to any one person in connection with any one film do not exceed \$1 million.* Subject to this rule, participations are includible in the investment credit tax base to the extent of the lesser of: (1) 50 percent of participations qualifying under the \$1 million limitation, or (2) 25 percent of the production costs of the taxpayer's films for the year (i. e., his investment credit tax base determined without regard to participations or residuals). These limitations are to be applied on a vintage year basis (i. e., participations in films released in the same year are to be considered in the aggregate for purposes of determining whether the 25 percent limitation with respect to those films has been exceeded).

If less than 80 percent of the direct production costs of a film are allocable to U. S. production, then the credit base with respect to that film includes only the direct U. S. production costs.

Some of the principles discussed above may be illustrated as follows. Assume that the total production costs of a film equal \$150. Of this amount, \$50 are indirect production costs, including \$30 for general overhead, \$10 for the screen rights and \$10 of residuals. The direct production costs include \$75 of salary and \$25 for supplies and materials. Fifty dollars of compensation are paid to United States citizens, and \$25 of compensation are paid to non-U. S. actors and production crew, and these individuals perform services both in the U. S. and abroad. Of the \$25 used for costume and supplies, \$10 are paid for supplies used only in the United States, \$5 are paid for costumes used only in a foreign country, and \$10 worth of supplies are used both in domestic and foreign shooting. 60 percent of the shooting time for the film occurs in the U. S., and 40 percent occurs abroad. The calculation is as follows.

U. S. COSTS

Compensation paid to U. S. citizens...	\$50
60 pct. of compensation paid to non-U. S. citizens	15
Supplies used only in United States	10
60 pct. of the cost of supplies used in the United States and abroad	6
Total	81

FOREIGN COSTS

40 pct. of compensation paid to non-U. S. citizens	\$00
--	------

der the tax law (i. e., the taxpayer's basis for depreciation). The committee intends that such questions be determined under the rules of present law.

*These rules affecting participations apply only for purposes of the investment credit tax base and no inference is intended that similar rules should be applied for other purposes un-

Supplies used only abroad.....	5
40 pct. of the cost of supplies used in the United States and abroad.....	4
Total	19

Since 81 percent of the direct cost of production is allocable to United States production, the credit base also includes the \$50 of indirect production costs. However, the \$10 cost for residuals is not to be eligible for the credit until the year in which these amounts are actually paid.

Of course, under the committee amendment, where a film is purchased before it is placed in service in any medium, the credit base cannot exceed the purchase price of the film (if this is less than the credit base for the film as computed under the rules outlined above). Also, in the case of the transfer of a film to a lessee (under section 48(d) of the code), the lessee is generally to be treated as having acquired the film for an amount equal to the lessor's credit base with respect to that film (rather than its fair market value).

The rules outlined above concerning the credit base apply regardless of whether the taxpayer uses the general rule (two-thirds method) or the 90 percent method.

Who is entitled to the credit.—Under the committee amendment, a taxpayer is to be entitled to the investment credit for a movie film if, and to the extent, that he has an "ownership interest" in the film at the time it is placed in service. For purposes of these rules, a taxpayer will be treated as having an ownership interest to the extent that his capital is at risk.

Thus, if the expenses of producing a movie are incurred by the producer, but are reimbursed by the distributor, either by means of a nonrecourse loan or otherwise, the distributor would be entitled to the credit, because the distributor's capital is at risk. Also, if the production costs are paid from the proceeds of a nonrecourse loan supplied by a bank but guaranteed by the distributor, then the distributor would be entitled to the credit because its capital was at risk in connection with the film. A similar result would follow if the producer was liable to the bank on the loan, but the distributor had contracted to pay at least the amount of the loan to the producer in connection with the film.

The determination as to whose capital is at risk in connection with the film (and, therefore, as to who is entitled to the credit) is to be made as of the time the film is first placed in service (i.e., released). Thereafter, the film would be considered used property, which is not to be eligible for the credit under the committee bill.

Generally, where the distributor has borne the cost of producing a film, and first releases it through the medium of movie houses, it is the distributor who is entitled to the credit. In the case of a film or series which is made for television, the producer-distributor will also generally be entitled to the credit where the film is exhibited over the network pursuant to a licensing agreement. On the other hand, if the network purchased all rights to the film or series before it was placed in service, the network would be entitled to the credit.

It is possible that more than one taxpayer may be entitled to a share of the credit for the same film as, for example, where several investors put up a portion of the capital needed to produce the film pursuant to a joint venture

agreement. Generally, where more than one party bears the risk of loss with respect to a particular film, the Secretary of the Treasury or his delegate may establish procedures for determining who is entitled to the credit, or partial credit. (Of course, where there are several parties to a transaction involving a movie film, and one party is entitled to the investment credit with respect to that film under these rules, whereas the other party is not, the committee anticipates that the availability of the investment credit may often be taken into account by the parties in determining their contract arrangements.)

It is also possible that more than one taxpayer may be entitled to the credit for a particular film where the film is placed in service in more than one medium or more than one geographic area. For example, suppose that a producer creates a U. S. produced film having a credit base of \$100. A distributor acquires exclusive perpetual distribution rights within the United States in exchange for a lump-sum payment of \$50 and the film is subsequently placed in service. The distributor is entitled to a credit with respect to the film based on his cost of \$50 in acquiring the U. S. rights. The producer, who retains the other rights to the film, would also be entitled to a part of the credit based on his capital at risk. The producer's credit base would be computed by subtracting the cost borne by the U. S. distributor (\$50) from the credit base which the producer would otherwise be entitled to (i.e., the \$100 cost of production). Thus, the producer's credit base would equal \$50 in this case.

Films Placed in Service in the Past

For the past (i.e., for taxable years beginning before January 1, 1975), in general, taxpayers will come under one of two rules, either the "90-percent method," as described above, with certain modifications to deal with the foreign-use problem, or a "40-percent method," under which a taxpayer would be entitled to receive 40 percent of a full credit for all of his films, regardless of the useful life or predominant foreign use of any particular film. However, taxpayers may elect to come under the general rule for the future (the two-thirds method, as described above) for all section 50 property placed in service after the restoration of the investment credit under the Revenue Act of 1971. Finally, certain taxpayers, who have already filed suit for a determination as to their entitlement to the investment credit for past years, elect the application of the rules of present law, rather than the provisions of this Act, in determining their entitlement to the credit for all past periods.

General rule for past.—Under the committee amendment, as a general rule, the investment credit for films placed in service in taxable years beginning before January 1, 1975, is to be computed on a film-by-film basis. In determining the useful life of the film, taxpayers would use the 90-percent method as described above. However, an additional rule is necessary for the past to determine whether or not there was predominant foreign use of the film.

Under the committee amendment, a film is to be treated as having a predominant foreign use in the first taxable year in which 50 percent or more of the gross revenues received or accrued from the film were received or accrued from showing the film outside the United States. This is a year-by-year test (not a cumulative test). For example, assume a film was released on February 1, 1972, and revenues of \$100 were

[§ 592.016]—Continued

received that year from showing the film in the United States (with no foreign revenues), while in 1973 there were \$75 of income from U. S. showings, and \$25 of income from foreign exhibitions, and in 1974 there were \$40 of U. S. revenues, and \$60 of revenue from foreign exhibitions. In this case, there would be a predominant foreign use of the film in 1974, and as a result the film would cease to qualify as section 50 property in that year. This would mean that the taxpayer would not be entitled to an investment credit with respect to the film because the disqualifying event would have occurred less than 3 years after the property had been placed in service.⁷

Films of a transitory or topical nature would not be eligible for an investment credit.⁸

The 40-percent method.—Under the committee amendment the taxpayer can elect to receive 40 percent of a full credit for all of his films placed in service in taxable years beginning before January 1, 1975.⁹ If the taxpayer makes this election, he is to receive the 40-percent credit, regardless of the actual useful life or predominant foreign use of any particular film. This 40-percent method is offered as a way of avoiding costly litigation with respect to past years. It is believed that this method achieves, for the average member of the film industry, about the same size credit which he would receive for all his films, on the average, were he actually to litigate.

A taxpayer is not to receive a credit for any films of a transitory or topical nature (because almost all of these films have a useful life of less than three years). Also, a taxpayer using the 40-percent method for the past is not entitled to credits for any films which were produced and shown exclusively abroad.

The election to use the 40-percent method is to be made by the taxpayer within six months after the date of enactment of this bill in a manner to be prescribed in regulations. Any such election, once made, is to apply to all of the taxpayer's films placed in service in the past (except those, if any, covered under the general rule for the future), and can be revoked only with the consent of the Internal Revenue Service.

To prevent a situation where two different taxpayers may attempt to claim the credit for the same film, the committee bill provides that any taxpayer making the 40-percent election must consent to join in a judicial proceeding to determine which of the competing claimants was entitled to the credit, or whether each of the parties was entitled to part of the credit.¹⁰ The rules with respect to entitlement to the

credit (i. e., the capital at risk rules, etc.) are the same for the past as for the future.

Credit base.—In general, under the committee amendment, the rules as to the size of the credit base for the past (including those with respect to participations) are similar to the rules which are to apply for the future. However, for the past there has not been a U. S. production test in connection with movie films, and the committee does not believe it would be appropriate to impose such a test retroactively. (Although the committee amendment does impose a U. S. production test for the future, in order to encourage the U. S. production of movie films.) Thus, for the past, taxpayers may include in the credit base all the direct and indirect expenses of production, as described above, regardless of whether the film would have satisfied the 80-percent United States direct production expenses test and regardless of whether some of the expenses (actors' pay, costumes, etc.) included in the credit base were paid for services performed abroad, or for equipment and supplies which were used abroad.

The rules described above with respect to the credit base would apply both to taxpayers using the 90-percent method for the past, and to taxpayers using the 40-percent method.

Application of the general rule for the future to certain past years.—In connection with the Revenue Act of 1971 Congress made clear that it intended the investment credit to be available for movie films (whereas this question had not been completely resolved prior to that time) even though, as described above, certain subsidiary issues were not settled in that Act. For this reason, the committee amendment provides that those taxpayers who wish to do so are to be allowed to use the general rule for the future with respect to all of their section 50 property (generally property placed in service after August 15, 1971). Thus, the committee amendment provides that taxpayers may elect to use the general rule for the future for all of their section 50 movie films. (Taxpayers making this election could still use either the 90-percent method or the 40-percent method for all films placed in service in the past which do not qualify as section 50 property.)

Taxpayers who make this election are to be covered under the general rule for the future for all purposes, including, for example, the rules with respect to the size of the credit base, which include an 80 percent U. S. production test and exclude expenses of foreign production from the credit base.

The election to use the general rule for the future for section 50 films would have to be made within one year after the date of enactment of the bill, in a manner to be prescribed

⁷ For this limited purpose, gross foreign revenues from showing films in future years must also be taken into account. In other words, if a taxpayer uses the 90-percent method for 1974, and 50 percent or more of the revenues from showing the film in 1975 are from foreign exhibitions, this would constitute a predominant foreign use of the film placed in service in 1974, and the taxpayer would not be entitled to an investment credit with respect to that film.

⁸ The committee intends that no influence should be drawn from this report or this legislation as to what constitutes useful life, predominant foreign use, the basis on which the credit is to be computed or any other aspect of the application of the investment credit under present law.

⁹ As described below, the taxpayer can also use this method for films placed in service on or before August 15, 1971, but elect to use the general rule for the future for all of his section 50 films.

¹⁰ The committee is concerned, however, that this procedure should not unnecessarily delay the allowance of the credit in cases where it is reasonably clear that there is only one plausible person who has a right to claim the credit. The committee intends that the Service will develop such reporting and other procedures as it deems necessary to determine whether there is a likelihood that several persons may claim a credit with respect to the same film, and that where there is no such likelihood, allowance of the credit will not be unduly delayed.

§ 48 [p. 11,285]—SEC. 38 PROPERTY—DEFINITION 11,315

in regulations. The election would have to apply to all of the taxpayer's section 50 films, and the election, once made, could not be revoked without the consent of the Internal Revenue Service. Other rules with respect to use of this method for the past may also be prescribed by regulations.

Taxpayers who have already litigated

Some taxpayers have already litigated the issues outlined above for certain prior years. The committee believes that these taxpayers should be entitled to the fruits of their litigation because of the substantial effort and expense which they have incurred in connection with their suits. Accordingly, the committee amendment provides that any taxpayer who has filed a petition before any court before January 1, 1976, with respect to his entitlement to the investment credit for any prior year, may elect (within 30 days after the date of enactment) to have his right to the investment credit for all years beginning prior to January 1, 1975, determined under present law, as interpreted by the courts, rather than under one of the methods prescribed in this bill. (As an alternative, taxpayers who have filed suit prior to January 1, 1976, may elect to have their credit determined under present law for years prior to 1971, and elect the general rule for the future for all their section 50 property.) But, of course, issues which have not already been resolved by court proceedings (such as predominant foreign use, the size of the credit base, etc.) must be settled by further litigation, and it is intended that no inference be drawn from the provisions of this bill as to how such issues should be resolved under present law.

Generally, under this procedure, a taxpayer wishing to make an election under these provisions may do so by mailing a letter to this effect to the Commissioner of Internal Revenue

within the 30-day period. Any such election is to be irrevocable.

Taxpayers relying on litigation to determine their credits for past years still must use either the general rule for the future or the 90-percent method for all taxable years beginning after December 31, 1974.

Effective dates.—The effective dates of these provisions have been described above. In general, the rules with respect to the general rule for the future and the 90-percent method apply to films placed in service in taxable years beginning after December 31, 1974. In general, taxpayers may use either the 90-percent or the 40-percent method for all prior years, but may alternatively elect to use the general rule for the future for all section 50 property.—Senate Finance Committee Report.

- .02 Committee Reports on P. L. 92-178
are at 1972-1 CB 504, 568 and 645.
- .021 Committee Reports on P. L. 91-172
are at 1969-3 CB 311, 564 and 672.
- .022 Committee Reports on P. L. 90-26
are at 1967-2 CB 481.
- .023 Committee Reports on P. L. 89-809
are at 1966-2 CB 656.
- .04 Committee Reports on P. L. 89-800
are at 1966-2 CB 649.
- .05 Committee Reports on P. L. 88-272
are at 1964-1 CB (Part 2) 6.
- .08 Committee Reports on P. L. 87-834
are at 1962-3 CB 111.

CORPORATE DISTRIBUTIONS

[§ 2303]

DISTRIBUTIONS OF PROPERTY

Sec. 301 [1954 Code]. (a) **IN GENERAL.**—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) **AMOUNT DISTRIBUTED.**—

(1) **GENERAL RULE.**—For purposes of this section, the amount of any distribution shall be—

(A) **NONCORPORATE DISTRIBUTEES.**—If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.

(B) **CORPORATE DISTRIBUTEES.**—If the shareholder is a corporation, unless subparagraph (D) applies, the amount of money received, plus whichever of the following is the lesser:

- (i) the fair market value of the other property received; or
- (ii) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of the other property received, increased in the amount of gain to the distributing corporation which is recognized under subsection (b), (c), or (d) of section 311, under section 341(f), or under section 617(d)(1), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a).

(C) **CERTAIN CORPORATE DISTRIBUTEES OF FOREIGN CORPORATION.**—Notwithstanding subparagraph (B), if the shareholder is a corporation and the distributing corporation is a foreign corporation, the amount taken into account with respect to property (other than money) shall be the fair market value of such property; except that, if any deduction is allowable under section 245 with respect to such distribution, then the amount taken into account shall be the sum (determined under regulations prescribed by the Secretary) of—

- (i) the proportion of the adjusted basis of such property (or, if lower, its fair market value) properly attributable to gross income which is effectively connected with the conduct of a trade or business within the United States, and
- (ii) the proportion of the fair market value of such property properly attributable to gross income which is not effectively connected with the conduct of a trade or business within the United States.

For purposes of clause (i), the gross income of a foreign corporation for any period before its first taxable year beginning after December 31, 1966, which is effectively connected with the conduct of a trade or business within the United States is an amount equal to the gross income for such period from sources within the United States. For purposes of clause (ii), the gross income of a foreign corporation for any period before its first taxable year beginning after December 31, 1966, which is not effectively connected with the conduct of a trade or business within the United States is an amount equal to the gross income for such period from sources without the United States.

(D) **FOREIGN CORPORATE DISTRIBUTEES.**—In the case of a distribution to a shareholder which is a foreign corporation, if the amount received by the foreign corporation is not effectively connected with the conduct by it of a trade or business within the United States, the amount of the money received, plus the fair market value of the other property received.

[T 2303]—Continued

(2) **REDUCTION FOR LIABILITIES.**—The amount of any distribution determined under paragraph (1) shall be reduced (but not below zero) by—

(A) the amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and

(B) the amount of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution.

(3) **DETERMINATION OF FAIR MARKET VALUE.**—For purposes of this section, fair market value shall be determined as of the date of the distribution.

(c) **AMOUNT TAXABLE.**—In the case of a distribution to which subsection (a) applies—

(1) **AMOUNT CONSTITUTING DIVIDEND.**—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) **AMOUNT APPLIED AGAINST BASIS.**—That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) **AMOUNT IN EXCESS OF BASIS.**—

(A) **IN GENERAL.**—Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) **DISTRIBUTIONS OUT OF INCREASE IN VALUE ACCRUED BEFORE MARCH 1, 1913.**—That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

(d) **BASIS.**—The basis of property received in a distribution to which subsection (a) applies shall be—

(1) **NONCORPORATE DISTRIBUTEES.**—If the shareholder is not a corporation, the fair market value of such property.

(2) **CORPORATE DISTRIBUTEES.**—If the shareholder is a corporation, unless paragraph (3) applies, whichever of the following is the lesser:

(A) the fair market value of such property; or

(B) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property, increased in the amount of gain to the distributing corporation which is recognized under subsection (b), (c), or (d) of section 311, under section 341(f), or under section 617(d)(1), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a).

(3) **FOREIGN CORPORATE DISTRIBUTEES.**—In the case of a distribution of property to a shareholder which is a foreign corporation, if the amount received by the foreign corporation is not effectively connected with the conduct by it of a trade or business within the United States, the fair market value of the property received.

(4) **CERTAIN CORPORATE DISTRIBUTEES OF FOREIGN CORPORATION.**—In the case of property described in subparagraph (C) of subsection (b)(1), the basis shall be determined by substituting the amount determined under such subparagraph (C) for the amount described in paragraph (2) of this subsection.

➡ **Caution:** Subsection (e), below, is repealed by P. L. 94-455, but remains effective for taxable years beginning before January 1, 1977. ←

(e) **EXCEPTION FOR CERTAIN DISTRIBUTIONS BY PERSONAL SERVICE CORPORATIONS.**—Any distribution made by a corporation, which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 or the Revenue Act of 1921, out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 (40 Stat. 1070), or section 218 of the Revenue Act of 1921 (42 Stat. 245), shall be exempt from tax to the distributees.

→ *Caution: Subsection (e), below, was subsection (g) before redesignation by P. L. 94-455.* ←

(e) SPECIAL RULES.—

- (1) For distributions in redemption of stock, see section 302.
- (2) For distributions in partial or complete liquidation, see part II (sec. 331 and following).
- (3) For distributions in corporate organizations and reorganizations, see part III (sec. 351 and following).
- (4) For partial exclusion from gross income of dividends received by individuals, see section 116.

→ *Caution: Subsection (f) is repealed by P. L. 94-455 but remains effective for taxable years before January 1, 1977.* ←

(f) SPECIAL RULES FOR DISTRIBUTIONS OF ANTITRUST STOCK TO CORPORATIONS.—

(1) DEFINITION OF ANTITRUST STOCK.—For purposes of this subsection, the term "antitrust stock" means stock received, by a corporation which is a party to a suit described in section 1111(d) (relating to definition of antitrust order), in a distribution made after September 6, 1961, either pursuant to the terms of, or in anticipation of, an antitrust order (as defined in subsection (d) of section 1111).

(2) AMOUNT DISTRIBUTED.—Notwithstanding subsection (b)(1) (but subject to subsection (b)(2)), for purposes of this section the amount of a distribution of antitrust stock received by a corporation shall be the fair market value of such stock.

(3) BASIS.—Notwithstanding subsection (d), the basis of antitrust stock received by a corporation in a distribution to which subsection (a) applies shall be the fair market value of such stock decreased by so much of the deduction for dividends received under the provisions of section 243, 244, or 245 as is, under regulations prescribed by the Secretary, attributable to the excess, if any, of—

(A) the fair market value of the stock, over

(B) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of the stock, increased by the amount of gain which is recognized to the distributing corporation by reason of the distribution.

.05 Amended by P. L. 94-455 (Deadwood Act), P. L. 92-178, P. L. 91-172, P. L. 89-809, P. L. 89-570, P. L. 88-484, P. L. 88-272, P. L. 87-834 and P. L. 87-403. For details, see the Code Volumes.

Senate Committee Report on P. L. 92-178

.09 Under present law, the amount of a distribution made in property (rather than money) by a domestic corporation differs in the case of shareholders which are not corporations from that applicable to corporate shareholders. In the case of a corporate shareholder receiving the property the amount of the distribution is its cost or other basis to the distributing corporation, if this is lower than the property's fair market value. The effect of limiting the amount considered a distribution in this manner is to specify that this is the largest amount which can be treated as a dividend out of earn-

ings. The basis of the property received by the corporate shareholder is the same as the amount of the distribution which must be taken into income.

The committee reports accompanying the 1954 code make it clear that it is the intention of the present provision to make certain that the corporate shareholder receiving the property does not obtain a high basis without the payment of a significant dividend tax (because of the 85-percent dividends received deduction).¹ A high basis would, of course, decrease the gain on a later sale of the property or increase the depreciation deductions if the property is retained and used in the business.

Recent court decisions have held that this treatment is applicable to distributions of property by a domestic corporation to a foreign corporate shareholder not doing business in the United States, although such a corporation does not receive a dividends received deduction. Un-

¹ The committee reports accompanying the Internal Revenue Code of 1954 state that in the case of a distribution in property, the dividend income to a corporate shareholder is limited to the basis of such property in order " . . . to correlate the treatment of distributions in property to a corporate shareholder with section 243 of the bill (relating to the deduction for dividends received by a corporation)." It was fur-

ther stated that: "This manner of treatment . . . insures that the adjusted basis of the property to the corporate recipient, for purposes of computing depreciation and gain or loss upon a sale or exchange will be the same as the adjusted basis to the distributor." (83rd Congress, 2nd Session, Report of Committee on Ways and Means to accompany H. R. 8300, House Report 1337, March 9, 1954, page A71.)

28,010 DISTRIBUTIONS OF PROPERTY—Sec. 301 [page 28,007]

[§ 2303.09]—Continued

der this interpretation of the law, the foreign corporate shareholder can receive a distribution of appreciated property by paying a tax on its adjusted basis, and then sell the property without paying a U. S. tax on the appreciation. Thus, the treatment provided by present law is not appropriate in the case of a foreign corporation since it is not subject to U. S. tax on a possible later sale of the property.

In view of the above, the committee has added an amendment to the House bill generally providing that a distribution in property to a foreign corporation is to be treated as a distribution to the extent of the fair market value of the property. The basis to the distributee corporation, when the amount of the distribution is the entire fair market value, will also be such fair market value.

An exception to this rule is made in the case of distributions which are effectively connected with the conduct of a trade or business by the

distributee foreign corporation within the United States. Since the business in such a case is treated essentially as a domestic business, the present treatment is retained.

The amendments made by this section of the bill are to be effective with respect to distributions made on or after November 8, 1971.—
Senate Finance Committee explanation.

.10 Committee Reports on P. L. 89-570 are at 1966-2 CB 600.

.15 Committee Reports on P. L. 87-834 are at 1962-3 CB 405, 707, 1129.

.17 Committee Reports on P. L. 87-403 are at 1962-1 CB 370.

.20 Committee Reports on 1954 Code Sec. 301, as originally enacted, were reproduced at 562 CCH § 2303.01 and 2303.20.

CORPORATE DISTRIBUTIONS

[§ 2375]

DIVIDEND DEFINED

Sec. 316 [1954 Code]. (a) GENERAL RULE.—For purposes of this subtitle, the term "dividends" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property of which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

(b) SPECIAL RULES.—

(1) CERTAIN INSURANCE COMPANY DIVIDENDS.—The definition in subsection (a) shall not apply to the term "dividend" as used in subchapter L in any case where the reference is to dividends of insurance companies paid to policyholders as such.

(2) DISTRIBUTIONS BY PERSONAL HOLDING COMPANIES.—

(A) In the case of a corporation which—

(i) under the law applicable to the taxable year in which the distribution is made, is a personal holding company (as defined in section 542), or

(ii) for the taxable year in respect of which the distribution is made under section 563(b) (relating to dividends paid after the close of the taxable year), or section 547 (relating to deficiency dividends), or the corresponding provisions of prior law, is a personal holding company under the law applicable to such taxable year,

the term "dividend" also means any distribution of property (whether or not a dividend as defined in subsection (a)) made by the corporation to its shareholders, to the extent of its undistributed personal holding company income (determined under section 545 without regard to distributions under this paragraph) for such year.

(B) For purposes of subparagraph (A), the term "distribution of property" includes a distribution in complete liquidation occurring within 24 months after the adoption of a plan of liquidation, but—

(i) only to the extent of the amounts distributed to distributees other than corporate shareholders, and

(ii) only to the extent that the corporation designates such amounts as a dividend distribution and duly notifies such distributees of such designation, under regulations prescribed by the Secretary, but

(iii) not in excess of the sum of such distributees' allocable share of the undistributed personal holding company income for such year, computed without regard to this subparagraph or section 562(b).

(3) DEFICIENCY DIVIDEND DISTRIBUTIONS BY A REAL ESTATE INVESTMENT TRUST.

—The term "dividend" also means any distribution of property (whether or not a dividend as defined in subsection (a)) which constitutes a "deficiency dividend" as defined in section 859(d).

'54 Code

29,006

DIVIDEND DEFINED—Sec. 316 [page 29,005]

[¶ 2375]—Continued

.01 Amended by P. L. 94-455 (Deadwood Act), P. L. 88-272, and P. L. 429 (84th Cong., 2d Sess.). For details, see the Code Volumes.

.05 Committee Report on P. L. 88-272 is at 1964-1 (Part 2) CB 352.

.08 Committee Reports on P. L. 429, 84th Cong., 2d Sess., are at 1956-1 CB 954, 967.

.10 Committee Report on 1954 Code Sec. 316, as originally enacted, was reproduced at 562 CCH ¶ 2375.10.

Internal Revenue Code Section 116

➡ *Caution: Reg. § 1.116-1 does not reflect amendments to Code Sec. 116 made by P. L. 94-455.* ←

• Regulations

[¶ 1167] § 1.116-1. Partial exclusion of dividends. — (a) *In general.* Section 116 excludes from gross income the first \$100 (\$50 for dividends received in a taxable year which ends after July 31, 1954 and begins before January 1, 1964, whether or not the dividend is received after July 31, 1954) of dividends from domestic corporations received by an individual in a taxable year beginning after December 31, 1963.

¶ 1164 Reg. § 1.116-1(a)

© 1978, Commerce Clearing House, Inc.

→ **Caution:** Reg. § 1.116-1 does not reflect amendments to Code Sec. 116 made by P. L. 94-455. ←

(b) *Joint returns of husband and wife.* In the case of a joint return of husband and wife, each spouse is entitled to the exclusion in an amount not in excess of \$100 (\$50 for dividends received in taxable years beginning before January 1, 1964), with respect to the dividends received by such spouse. Thus, if in the calendar year 1955, a husband receives \$200 of dividends and his wife \$100, the amount to be included in gross income is \$200 (\$150 of the husband's dividends and \$50 of the wife's dividends). If the amounts are received in a taxable year beginning after December 31, 1963, the amount to be included in gross income is \$100 (\$100 of the husband's dividends and none of the wife's dividends). If the wife receives only \$30 of dividends, the entire \$30 is excludable, and there is included in gross income in the joint return in the case of a taxable year beginning before January 1, 1964, only \$150 (\$200 less his \$50 exclusion) or in the case of a taxable year beginning after December 31, 1963, only \$100 (\$200 less his \$100 exclusion) consisting of the dividends received by the husband.

(c) *Individuals receiving dividends.* Where two or more persons hold stock as tenants in common, as joint tenants, or as tenants by the entirety, the dividends received with respect to such stock shall be considered as being received by each tenant to the extent that he is entitled under local law to a share of such dividends. Where dividends constitute community property under local law each spouse shall be considered as receiving one-half of such dividends.

(d) *Dividends to which the exclusion applies—*(1) *General rule.* The exclusion under section 116 applies only to distributions of property defined as dividends by section 316. Thus, the exclusion is not allowed with respect to patronage dividends paid by either exempt or taxable farm cooperatives. Nor is it allowed for distributions to nonstockholding policy holders by an insurance company having shares of stock or for any distribution by a mutual insurance company. See subparagraph (2)(i) of this paragraph for an additional restriction with respect to stock life insurance companies. The exclusion is, however, allowed with respect to dividends paid on capital stock by nonexempt cooperatives and with respect to dividends paid on capital stock by building and loan associations. However, see subparagraph (2)(ii) of this paragraph with respect to so-called dividends paid by building and loan associations ineligible for the exclusion. The exclusion is allowed with respect to distributions from any organization taxed as a corporation if the distribution falls within the definition of a dividend in section 316.

(2) *Dividends from certain corporations.* (i) Section 116(b) and (c) contains further restrictions on the type of distributions which are treated as dividends for purposes of the exclusion. Thus, no exclusion is applicable with respect to dividends received from a corporation organized under the China Trade Act, 1922; from stock life insurance companies before January 1, 1959, in taxable years ending before such date; from corporations which during their taxable year of the distribution or their preceding taxable year were corporations to which section 931 applies (relating to income from sources within possessions of the United States); from corporations which during the taxable year of the distribution or the preceding taxable year are corporations exempt from tax either under section 501, relating to charitable, etc., organizations, or under section 521, relating to farmers' cooperative associations.

14,390 PARTIAL EXCLUSION OF DIVIDENDS—§ 116 [p. 14,388]

➡ **Caution:** *Reg. § 1.116-1 does not reflect amendments to Code Sec. 116 made by P. L. 94-455.* ←

[¶ 1167]—Continued

(ii) So-called dividends paid by mutual savings banks, cooperative banks, and building and loan associations which are allowed as a deduction under section 591 are ineligible for the exclusion.

(iii) For special rules as to the limitation on the amount of dividends for which an exclusion is allowable in the case of dividends paid by a regulated investment company, see section 854 and the regulations thereunder.

(iv) See section 857(c) and paragraph (d) of § 1.857-4 for special rules which deny an exclusion under section 116 in the case of dividends received from a real estate investment trust with respect to a taxable year for which such trust is taxable under part II, subchapter M, chapter 1 of the Code.

(e) *Taxpayers not entitled to exclusion.* (1) For taxable years beginning after December 31, 1966, the exclusion allowed by section 116(a) and paragraph (a) of this section shall, in the case of a nonresident alien individual, apply only (i) in determining the tax imposed for the taxable year pursuant to section 871(b)(1), and the regulations thereunder, and only in respect of dividends which are effectively connected for the taxable year with the conduct of a trade or business in the United States by such individual, or (ii) in determining the tax imposed for the taxable year pursuant to section 877(b). For taxable years beginning before January 1, 1967, the exclusion is not available to nonresident alien individuals with respect to whom a tax is imposed for the taxable year under section 871(a).

(2) For additional rules for the treatment of dividends received by estates or trusts, and the allocation of such dividends between an estate or trust and the beneficiary thereof, see sections 652 and 662 and the regulations thereunder.

(3) For treatment of dividends received by a partnership, see section 702 and the regulations thereunder.

(4) For treatment of dividends received by a common trust fund, see section 584 and the regulations thereunder.

(f) *Time dividends are received.* In cases where it is necessary to determine the time of receipt of dividends the rules established to determine in which taxable year dividends must be included in gross income apply, including the rules relating to constructive receipt. See section 451 and regulations thereunder.

(g) *Special rule relating to receipt of dividends by beneficiary of an estate or trust.* In general, dividends are deemed received by a beneficiary in the taxable year in which they are includible in his gross income under section 652 or 662. However, solely for purposes of determining the amount of the exclusion applicable to dividends received by a beneficiary from an estate or trust, the time of receipt of such dividends by the estate or trust is also considered the time of receipt by the beneficiary. [Reg. § 1.116-1.]

.10 **Historical Comment:** Proposed 7/13/55. Adopted 2/3/56 by T. D. 6161. Amended 12/15/64 by T. D. 6777 to reflect P. L. 88-272. Amended 12/20/74 by T. D. 7332 to reflect Sec. 103 of P. L. 89-809.

The Preamble to T. D. 7332 is reported at 759 CCH ¶ 6312.

➡ **Caution:** Reg. § 1.116-2 does not reflect amendments to Code Sec. 116 made by P. L. 94-455. ⬅

• **Regulations**

[¶ 1168] § 1.116-2. **Effective date; taxable years ending after July 31, 1954, subject to the Internal Revenue Code of 1939.**—Pursuant to section 7851(a)(1)(C), the regulations prescribed in § 1.116-1 shall also apply to taxable years beginning before January 1, 1954, and ending after July 31, 1954, and to taxable years beginning after December 31, 1953, and ending after July 31, 1954, but before August 17, 1954, though such years are subject to the Internal Revenue Code of 1939. [Reg. § 1.116-2.]

.10 **Historical Comment:** Proposed 7/13/55. Adopted 2/3/56 by T. D. 6161.

[¶ 1169] **Partial Exclusion of Dividends Received
by Individuals**

• • **CCH Explanation**

.01 **Amount of exclusion.**—Individuals are allowed to exclude from gross income \$100 of dividends received during the taxable year from domestic corporations. The dividends-received exclusion applies to dividends received from all domestic corporations, including life and mutual insurance companies, but it does not apply to dividends paid or credited by mutual savings banks, cooperative banks, domestic and Federal savings and loan associations, and Federal credit unions. Such payments or credits are interest income, rather than dividends.

The part of dividends received from regulated investment companies that is designated by the payer as capital gains dividends is not subject to the exclusion. For a discussion of regulated investment company dividends, see ¶ 4096.05.

No exclusion is allowed for dividends received from the following types of corporations: (1) exempt corporations (including exempt farmers' cooperatives), and (2) real estate investment trusts. Prior to the enactment of P. L. 94-455, this exclusion denial also extended to China Trade Act corporations and to corporations deriving most of their income from United States possessions.

U. S. citizens and resident aliens are allowed the dividend exclusion. Expatriates who are taxable under Code Sec. 877 are also entitled to the exclusion. However, the exclusion for nonresident aliens is limited to dividends which are effectively connected with the conduct of a trade or business in the United States.

.02 **Husband and wife.**—If husband and wife each have dividend income in excess of \$100, the \$100 exclusion is available to both. This is true regardless of whether they file joint or separate returns. But the mere fact that they do file a joint return does not warrant two exclusions if the stock is owned by only one of the spouses. Nor may one spouse use any portion of the exclusion not used by the other. For instance, if the husband has \$200 in dividends in the taxable year, and the wife only \$25, only \$125 can be excluded even on a joint return.

.023 **Stock certificate in two or more names.**—Where two or more individuals hold stock as tenants in common, as joint tenants,

14,392 PARTIAL EXCLUSION OF DIVIDENDS—§ 116 [p. 14,388]

Partial Exclusion of Dividends Received by Individuals

[¶ 1169.023]—Continued

• • **CCH Explanation**

or as tenants by the entirety, the dividends received are considered as being received by each tenant to the extent that he is entitled under local law to a share of such dividends (Reg. § 1.116-1, ¶ 1167). In most states each tenant is entitled to a share of the dividends in proportion to the number of tenants. If there are two tenants, each is entitled to half the dividends; if there are three, each is entitled to a third.

Example: Assume that during the taxable year a husband and wife receive \$40 as dividends from jointly owned stock. The husband also receives \$120 as dividends from stock which he owns separately. Under state law the husband and wife are entitled to share equally in the dividends from the jointly owned stock. In such a situation, the wife can exclude \$20 and the husband can exclude \$100. On a joint return, the total exclusion would be \$120.

If the dividends are community income of residents of community property states, a maximum of \$200 aggregate exclusion is allowable each year for both husband and wife, on joint or separate returns.

.024 Estates and trusts.—Gifts in trust or otherwise may serve to increase the exclusion, since an exclusion is allowable to each individual (including a trust or estate to the extent that the dividends are not allocable to a beneficiary). See the official instructions for Form 1040. Code Sec. 116(c)(3) provides that the amount of dividends properly allocable to a beneficiary of an estate or trust will be deemed to have been received by the beneficiary ratably on the same day that the dividends were received by the estate or trust. See ¶ 3621.01.

.025 Federal instrumentalities.—There is no tax exemption for dividends on stocks of agencies or instrumentalities of the United States, as to issues on and after March 28, 1942. Such dividends do not qualify for the partial exclusion granted by Code Sec. 116. The only exception is dividends on stock of the Federal National Mortgage Association. See .035.—CCH.

.026 Dividends not required to be itemized.—A stockholder who receives or has credited to his account dividends in a taxable year through brokerage houses or similar institutions, which are the record owners of the stock, shall include in the appropriate schedule of his Form 1040, U. S. Individual Income Tax Return, without itemization, the total amount of dividends reported on each Form 1087, Nominee's Information Return, or other statement furnished by a brokerage house or similar institution. He is no longer required to list each dividend separately.

Rev. Rul. 64-324, 1964-2 CB 463, revoking Rev. Rul. 56-567, 1956-2 CB 933; and modifying Rev. Proc. 59-11, and Special Ruling, Jan. 11, 1957, below.

A record owner of stock who is not the actual owner may file a single Form 1087 reporting his name and address, the name and address of the actual owner and the total amount of dividends received during the calendar year without itemizing the dividends so received.

Rev. Proc. 59-11, 1959-1 CB 821.
Special Ruling, Jan. 11, 1957, 575 CCH ¶ 6252.
Special Ruling, Dec. 27, 1950, 515 CCH ¶ 6060.

.0265 Employee's profit-sharing trust.—Dividends paid on common stock allocated to an employee's profit-sharing trust account and included in a total distribution to the employee upon separation from employment do not qualify for the dividend exclusion.

Rev. Rul. 72-99, 1972-1 CB 115.

¶ 1169.024 Reg. § 1.116-2

© 1978, Commerce Clearing House, Inc.

Sec. 117—SCHOLARSHIPS AND FELLOWSHIPS 14,393

.0267 **Exclusion amount.**—An individual was entitled to exclude only \$100 of the amounts received as dividends.

R. W. Towne, 36 TCM 1422, Dec. 34,687(M), TC Memo 1977-356.

.027 **Fiscal year 1963-1964.**—The following ruling dealt with the 1963-1964 fiscal year computations of the dividend exclusion and dividend credit. The exclusion was \$50 for 1963 and increased to \$100 beginning with 1964. Also, the dividend received credit was 4% for 1963 and 2% for 1964 and was repealed with respect to dividends received after 1964.

Rev. Rul. 66-70, 1966-1 CB 5.

.03 **Husband and wife.**—A husband and wife, whether filing a joint or separate return, may not use any portion of the exclusion not used by the other.

Release, March 19, 1955.

Rev. Rul. 55-476, 1955-2 CB 35.

.032 **Where a nonresident alien and his wife, a citizen of the United States resident in a foreign country, own stock of a domestic corporation as joint tenants with right of survivorship, or as tenants by the entirety, any dividends paid on such stock will be considered as owned by them in equal proportions. The corporation is required to withhold the tax only on that one-half of the total dividend paid which is considered as paid to the nonresident alien husband, but is not required to withhold any tax on that one-half of the total dividend paid which is considered as paid to the wife who is a United States citizen.**

Rev. Rul. 57-299, 1957-1 CB 606.

.035 **Instrumentalities of U. S.**—The Federal National Mortgage Association, a constituent agency of the Housing and Home Finance Agency, is a corporate

instrumentality of the United States and is, in effect, subject to Federal income taxes as a result of the Housing Act of 1954. Consequently, dividends paid on common stock of the Association are eligible for the partial exclusion privileges.

Special Ruling, April 20, 1956, 565 CCH ¶ 6402.
Rev. Rul. 56-510, 1956-2 CB 168.

.04 **Investment expenses.**—Fees paid to banks, trust companies, brokers, etc., for acting as agents to collect an individual's dividends do not affect the taxpayer's dividend exclusion or credit. The dividend received credit is computed on the amount of dividends included in gross income, which means the gross amount collected by the agent (after the exclusion).—CCH.

.07 **Short sale.**—An amount equal to a cash dividend, paid to a lender of stock by a "short-seller" with respect to stock borrowed to cover a short sale, is not a dividend for which the lender is entitled an exclusion under Code Sec. 116. The purchaser in the short sale transaction, the real owner of the stock, is entitled to the partial exclusion with respect to the cash dividends received on such stock.

Rev. Rul. 60-177, 1960-1 CB 9.

.10 **Stock held individually and by estate.**—A taxpayer receiving dividends from stock owned individually by him and from stock held by an estate may include the dividends received from both sources.

Rev. Rul. 55-728, 1955-2 CB 36.

.15 **Trust with excess deductions.**—A beneficiary of a trust may not avail himself of the dividend exclusion where the trust in its last taxable year has excess deductions within the meaning of Code Sec. 642(h)(2).

Rev. Rul. 59-100, 1959-1 CB 165.

INTEREST—FAILURE TO FILE—FAILURE TO PAY
[19915] INTEREST ON UNDERPAYMENT, NONPAYMENT,
OR EXTENSIONS OF TIME FOR
PAYMENT, OF TAX

SEC. 6601 [1954 Code]. (a) GENERAL RULE.—If any amount of tax imposed by this title (whether required to be shown on a return, or to be paid by stamp or by some other method) is not paid on or before the last date prescribed for payment, interest on such amount at an annual rate established under section 6621 shall be paid for the period from such last date to the date paid.

(b) LAST DATE PRESCRIBED FOR PAYMENT.—For purposes of this section, the last date prescribed for payment of the tax shall be determined under chapter 62 with the application of the following rules:

(1) EXTENSIONS OF TIME DISREGARDED.—The last date prescribed for payment shall be determined without regard to any extension of time for payment.

(2) INSTALLMENT PAYMENTS.—In the case of an election under section 6152(a) or 6156(a) or 6158(a) to pay the tax in installments—

(A) The date prescribed for payment of each installment of the tax shown on the return shall be determined under section 6152(b) or 6156(b), or 6158(a) as the case may be, and

(B) The last date prescribed for payment of the first installment shall be deemed the last date prescribed for payment of any portion of the tax not shown on the return.

For purposes of subparagraph (A), section 6158(a) shall be treated as providing that the date prescribed for payment of each installment shall be not later than the date prescribed for payment of the 1985 installment.

(3) JEOPARDY.—The last date prescribed for payment shall be determined without regard to any notice and demand for payment issued, by reason of jeopardy (as provided in chapter 70), prior to the last date otherwise prescribed for such payment.

(4) LAST DATE FOR PAYMENT NOT OTHERWISE PRESCRIBED.—In the case of taxes payable by stamp and in all other cases in which the last date for payment is not otherwise prescribed, the last date for payment shall be deemed to be the date the liability for tax arises (and in no event shall be later than the date notice and demand for the tax is made by the Secretary).

(c) SUSPENSION OF INTEREST IN CERTAIN INCOME, ESTATE, GIFT, AND CHAPTER 42, 43 OR 44 TAX CASES.—In the case of a deficiency as defined in section 6211 (relating to income, estate, gift, and certain excise taxes), if a waiver of restrictions under section 6213(d) on the assessment of such deficiency has been filed, and if notice and demand by the Secretary for payment of such deficiency is not made within 30 days after the filing of such waiver, interest shall not be imposed on such deficiency for the period beginning immediately after such 30th day and ending with the date of notice and demand.

* * *

(e) APPLICABLE RULES.—Except as otherwise provided in this title—

(1) INTEREST TREATED AS TAX.—Interest prescribed under this section on any tax shall be paid upon notice and demand, and shall be assessed, collected, and paid in the same manner as taxes. Any reference in this title (except subchapter B of chapter 63, relating to deficiency procedures) to any tax imposed by this title shall be deemed also to refer to interest imposed by this section on such tax.

(2) NO INTEREST ON INTEREST.—No interest under this section shall be imposed on the interest provided by this section.

(3) INTEREST ON PENALTIES, ADDITIONAL AMOUNTS, OR ADDITIONS TO THE TAX.—Interest shall be imposed under subsection (a) in respect of any assessable penalty, additional amount, or addition to the tax only if such assessable penalty, additional amount, or addition to the tax is not paid within 10 days

[§ 9915]—Continued

from the date of notice and demand therefor, and in such case interest shall be imposed only for the period from the date of the notice and demand to the date of payment.

(4) PAYMENTS MADE WITHIN 10 DAYS AFTER NOTICE AND DEMAND.—If notice and demand is made for payment of any amount, and if such amount is paid within 10 days after the date of such notice and demand, interest under this section on the amount so paid shall not be imposed for the period after the date of such notice and demand.

* * *

(j) 4-PERCENT RATE ON CERTAIN PORTION OF ESTATE TAX EXTENDED UNDER SECTION 6166.—

(1) IN GENERAL.—If the time for payment of an amount of tax imposed by chapter 11 is extended as provided in section 6166, interest on the 4-percent portion of such amount shall (in lieu of the annual rate provided by subsection (a)) be paid at the rate of 4 percent. For purposes of this subsection, the amount of any deficiency which is prorated to installments payable under section 6166 shall be treated as an amount of tax payable in installments under such section.

(2) 4-PERCENT PORTION.—For purposes of this subsection, the term "4-percent portion" means the lesser of—

(A) \$345,800 reduced by the amount of the credit allowable under section 2010(a); or

(B) the amount of the tax imposed by chapter 11 which is extended as provided in section 6166.

(3) TREATMENT OF PAYMENTS.—If the amount of tax imposed by chapter 11 which is extended as provided in section 6166 exceeds the 4-percent portion, any payment of a portion of such amount shall, for purposes of computing interest for periods after such payment, be treated as reducing the 4-percent portion by an amount which bears the same ratio to the amount of such payment as the amount of the 4-percent portion (determined without regard to this paragraph) bears to the amount of the tax which is extended as provided in section 6166.

* * *

Source: Secs. 890(a), 890(b), 891, 892, 893(a), 893(b), 925, 1020(a), 1020(b), 1021, 1022, 1023(a), 1023(b), 1939 Code.

.01 Amended by P. L.'s 94-455, 94-452, 93-625, 93-406, 87-61 and 85-866. For details, see "The Law" division.

Committee Reports

.09 House Ways and Means Committee Report on P. L. 94-455. * * * Your committee's bill provides that a special 4-percent interest rate is allowed on the estate tax attributable to the first \$1 million of farm or other closely held business property, and interest on amounts of estate tax in excess of this amount will bear interest at the regular rate for interest on deferred payments (currently 7%).

Allowing the reduced interest rate at a 4-percent level for a limited amount of tax is

intended to reflect the problems that smaller businesses have in generating enough income and cash flow to pay interest at a normal rate and amortize the principal amount of the estate tax liability. It is felt that the 5-year deferral period plus the reduced interest rate on the tax attributable to the first \$1 million in value of a closely held business should, in most cases, give the business time to generate sufficient funds to pay the estate tax and interest thereon without the business having to be sold to satisfy the estate tax liability (including a period for adjustment after the loss of one of the principal owners). * * *—House Ways and Means Committee.

.10 Committee Reports on P. L. 93-625 are at 1975-1 CB 517 and 538.

Internal Revenue Code Section 6611

[¶ 9920]

INTEREST ON OVERPAYMENTS

—'54 Code—

Sec. 6611 [1954 Code]. (a) RATE.—Interest shall be allowed and paid upon any overpayment in respect of any internal revenue tax at an annual rate established under section 6621.

(b) PERIOD.—Such interest shall be allowed and paid as follows:

(1) CREDITS.—In the case of a credit, from the date of the overpayment to the due date of the amount against which the credit is taken.

(2) REFUNDS.—In the case of a refund, from the date of the overpayment to a date (to be determined by the Secretary) preceding the date of the refund check by not more than 30 days, whether or not such refund check is accepted by the taxpayer after tender of such check to the taxpayer. The acceptance of such check shall be without prejudice to any right of the taxpayer to claim any additional overpayment and interest thereon.

* * *

Source: Secs. 3771(a), 3771(b)(1), 3771(b)(2), 3771(c), 1939 Code.

.01 Amended by P. L.'s 94-455 (Title XIX, Deadwood Act), 93-625 and 85-866. For details, see "The Law" division.

.10 Committee Reports on P. L. 93-625 are at 1975-1 CB 517 and 538.

DEDUCTIONS

NET OPERATING LOSS

CIRCULATION • RESEARCH

[¶ 1917]

NET OPERATING LOSS DEDUCTION

Sec. 172 [1954 Code]. (a) DEDUCTION ALLOWED.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) NET OPERATING LOSS CARRYBACKS AND CARRYOVERS.—

(1) YEARS TO WHICH LOSS MAY BE CARRIED.—

(A)(i) Except as provided in clause (ii) and in subparagraphs (D), (E), (F), and (G), a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss.

(ii) In the case of a taxpayer with respect to a taxable year ending on or after December 31, 1962, for which a certification has been issued under section 317 of the Trade Expansion Act of 1962, a net operating loss for such taxable year shall be a net operating loss carryback to each of the 5 taxable years preceding the taxable year of such loss.

(B) Except as provided in subparagraphs (C), (D), and (E), a net operating loss for any taxable year ending after December 31, 1955, shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss. Except as provided in subparagraphs (C), (D), (E), and (F), a net operating loss for any year ending after December 31, 1975, shall be a net operating loss carryover to each of the 7 taxable years following the taxable year of such loss.

(C) In the case of a taxpayer which is a regulated transportation corporation (as defined in subsection (g)(1)), a net operating loss for any taxable year ending after December 31, 1955, shall (except as provided in subsection (g)) be a net operating loss carryover to each of the 7 taxable years following the taxable year of such loss. For any taxable year ending after December 31, 1975, the preceding sentence shall be applied by substituting "9 taxable years" for "7 taxable years."

(D) In the case of a taxpayer which has a foreign expropriation loss (as defined in subsection (h)) for any taxable year ending after December 31, 1958, the portion of the net operating loss for such year attributable to such foreign expropriation loss shall not be a net operating loss carryback to any taxable year preceding the taxable year of such loss and shall be a net operating loss carryover to each of the 10 taxable years following the taxable year of such loss (or, with respect to that portion of the net operating loss for such year attributable to a Cuban expropriation loss, to each of the 20 taxable years following the taxable year of such loss).

(E) In the case of a taxpayer which has a net operating loss for any taxable year for which the provisions of part II of subchapter M (relating to real estate investment trusts) apply to such taxpayer, such loss shall not be a net operating loss carryback to any taxable year preceding the taxable year of such loss and shall be a net operating loss carryover to each of the 8 taxable years following the taxable year of such loss, except, in the case of a net operating loss for a taxable year ending before

[§ 1917]—Continued

January 1, 1976, such loss shall not be carried to the 6th, 7th, or 8th taxable year following the taxable year of such loss unless part II of subchapter M applied to the taxpayer for the taxable year to which the loss is carried and for all intervening taxable years following the year of loss. A net operating loss shall not be carried back to a taxable year for which part II of subchapter M applied to the taxpayer.

(F) In the case of a financial institution to which section 585, 586, or 593 applies, a net operating loss for any taxable year beginning after December 31, 1975, shall be a net operating loss carryback to each of the 10 taxable years preceding the taxable year of such loss and shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

(G) In the case of a Bank for Cooperatives (organized and chartered pursuant to section 2 of the Farm Credit Act of 1933 (12 U. S. C. 1134)), a net operating loss for any taxable year beginning after December 31, 1969, shall be a net operating loss carryback to each of the 10 taxable years preceding the taxable year of such loss and shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

(2) AMOUNT OF CARRYBACKS AND CARRYOVERS.—Except as provided in subsection (g), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed—

(A) with the modifications specified in subsection (d) other than paragraphs (1), (4), and (6) thereof; and

(B) by determining the amount of the net operating loss deduction—

(i) without regard to the net operating loss for the loss year or for any taxable year thereafter, and

(ii) without regard to that portion, if any, of a net operating loss for a taxable year attributable to a foreign expropriation loss, if such portion may not, under paragraph (1)(D), be carried back to such prior taxable year,

and the taxable income so computed shall not be considered to be less than zero. For purposes of this paragraph, if a portion of the net operating loss for the loss year is attributable to a foreign expropriation to which paragraph (1)(D) applies, such portion shall be considered to be a separate net operating loss for such year to be applied after the other portion of such net operating loss, and, if a portion of a foreign expropriation loss for the loss year is attributable to a Cuban expropriation loss, such portion shall be considered to be a separate foreign expropriation loss for such year to be applied after the other portion of such foreign expropriation loss.

(3) SPECIAL RULES.—

(A) Paragraph (1)(A)(ii) shall apply only if—

(i) there has been filed, at such time and in such manner as may be prescribed by the Secretary, a notice of filing of the application under section 317 of the Trade Expansion Act of 1962 for tax assistance, and, after its issuance, a copy of the certification under such section, and

(ii) the taxpayer consents in writing to the assessment, within such period as may be agreed upon with the Secretary of any deficiency for any year to the extent attributable to the disallowance of a deduction previously allowed with respect to such net operating loss, even though at the time of filing such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

(B) In the case of—

- (i) a partnership and its partners, or
- (ii) an electing small business corporation under subchapter S and its shareholders,

paragraph (1)(A)(ii) shall apply as determined under regulations prescribed by the Secretary. Such paragraph shall apply to a net operating loss of a partner or such a shareholder only if it arose predominantly from losses in respect of which certifications under section 317 of the Trade Expansion Act of 1962 were filed under this section.

(C) Paragraph (1)(D) shall apply only if—

(i) the foreign expropriation loss (as defined in subsection (h)) for the taxable year equals or exceeds 50 percent of the net operating loss for the taxable year,

(ii) in the case of a foreign expropriation loss for a taxable year ending after December 31, 1963, the taxpayer elects (at such time and in such manner as the Secretary by regulations prescribes) to have paragraph (1)(D) apply, and

(iii) in the case of a foreign expropriation loss for a taxable year ending after December 31, 1958, and before January 1, 1964, the taxpayer elects (in such manner as the Secretary by regulations prescribes) on or before December 31, 1965, to have paragraph (1)(D) apply.

(D) If a taxpayer makes an election under subparagraph (C)(iii), then (notwithstanding any law or rule of law), with respect to any taxable year ending before January 1, 1964, affected by the election—

(i) the time for making or changing any choice or election under subpart A of part III of subchapter N (relating to foreign tax credit) shall not expire before January 1, 1966,

(ii) any deficiency attributable to the election under subparagraph (C)(iii) or to the application of clause (i) of this subparagraph may be assessed at any time before January 1, 1969, and

(iii) refund or credit of any overpayment attributable to the election under subparagraph (C)(iii) or to the application of clause (i) of this subparagraph may be made or allowed if claim therefor is filed before January 1, 1969.

(E) Any taxpayer entitled to a carryback period under paragraph (1) may elect to relinquish the entire carryback period with respect to a net operating loss for any taxable year ending after December 31, 1975. Such election shall be made in such manner as may be prescribed by the Secretary, and shall be made by the due date (including extensions of time) for filing the taxpayer's return for the taxable year of the net operating loss for which the election is to be in effect. Such election, once made for any taxable year, shall be irrevocable for that taxable year.

Internal Revenue Code Section 3402

Sec. 3402—COLLECTION AT SOURCE

59,151

[§ 4944]

INCOME TAX COLLECTED AT SOURCE

[As amended by P. L. 95-30, Code Sec. 3402(a), below,
applies only to wages paid after May 31, 1977
and before January 1, 1979.—CCH.]

Sec. 3402 [1954 Code]. (a) REQUIREMENT OF WITHHOLDING.—Except as otherwise provided in this section, every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables prescribed by the Secretary. With respect to wages paid after May 31, 1977, and before January 1, 1979, the tables so prescribed shall be the same as the tables prescribed under this subsection which were in effect on January 1, 1976; except that such tables shall be modified to the extent necessary so that, had they been in effect for all of 1977, they would reflect the full year effect of the amendments made by sections 101 and 102 of the Tax Reduction and Simplification Act of 1977. With respect to wages paid after December 31, 1978, the tables so prescribed shall be the same as the tables prescribed under this subsection which were in effect on January 1, 1975, except that such tables shall be modified to the extent necessary to reflect the amendments made by sections 101 and 102 of the Tax Reduction and Simplification Act of 1977. For purposes of applying such tables, the term "the amount of wages" means the amount by which the wages exceed the number of withholding exemptions claimed, multiplied by the amount of one such exemption as shown in the table prescribed under subsection (b)(1).

For percentage method withholding tables prescribed by the IRS, under Code Sec. 3402(a), see § 159.—CCH

(b) PERCENTAGE METHOD OF WITHHOLDING.—

(1) The table referred to in subsection (a) is as follows:

Percentage Method Withholding Table

Payroll period	Amount of one withholding exemption:
Weekly	\$ 14.40
Biweekly	28.80
Semimonthly	31.30
Monthly	62.50
Quarterly	187.50
Semiannual	375.00
Annual	750.00
Daily or miscellaneous (per day of such period)...	2.10

(2) If wages are paid with respect to a period which is not a payroll period, the withholding exemption allowable with respect to each payment of such wages shall be the exemption allowed for a miscellaneous payroll period containing a number of days (including Sundays and holidays) equal to the number of days in the period with respect to which such wages are paid.

(3) In any case in which wages are paid by an employer without regard to any payroll period or other period, the withholding exemption allowable with respect to each payment of such wages shall be the exemption allowed for a miscellaneous payroll period containing a number of days equal to the number of days (including Sundays and holidays) which have elapsed since the date of the last payment of such wages by such employer during the calendar year, or the date of commencement of employment with such employer during such year, or January 1 of such year, whichever is the later.

(4) In any case in which the period, or the time described in paragraph (3), in respect of any wages is less than one week, the Secretary, under regulations prescribed by him, may authorize an employer, in computing the tax required to be deducted and withheld, to use the excess of the aggregate of the wages paid to the employee during the calendar week over the withholding exemption allowed by this subsection for a weekly payroll period.

[§ 4944]—Continued

(5) In determining the amount to be deducted and withheld under this subsection, the wages may, at the election of the employer, be computed to the nearest dollar.

(c) WAGE BRACKET WITHHOLDING.—

(1) At the election of the employer with respect to any employee, the employer shall deduct and withhold upon the wages paid to such employee a tax (in lieu of the tax required to be deducted and withheld under subsection (a)) determined in accordance with tables prescribed by the Secretary in accordance with paragraph (6).

(2) If wages are paid with respect to a period which is not a payroll period, the amount to be deducted and withheld shall be that applicable in the case of a miscellaneous payroll period containing a number of days (including Sundays and holidays) equal to the number of days in the period with respect to which such wages are paid.

(3) In any case in which wages are paid by an employer without regard to any payroll period or other period, the amount to be deducted and withheld shall be that applicable in the case of a miscellaneous payroll period containing a number of days equal to the number of days (including Sundays and holidays) which have elapsed since the date of the last payment of such wages by such employer during the calendar year, or the date of commencement of employment with such employer during such year, or January 1 of such year, whichever is the later.

(4) In any case in which the period, or the time described in paragraph (3), in respect of any wages is less than one week, the Secretary, under regulations prescribed by him, may authorize an employer to determine the amount to be deducted and withheld under the tables applicable in the case of a weekly payroll period, in which case the aggregate of the wages paid to the employee during the calendar week shall be considered the weekly wages.

(5) If the wages exceed the highest wage bracket, in determining the amount to be deducted and withheld under this subsection, the wages may, at the election of the employer, be computed to the nearest dollar.

(6) In the case of wages paid after December 31, 1969, the amount deducted and withheld under paragraph (1) shall be determined in accordance with tables prescribed by the Secretary. In the tables so prescribed, the amounts set forth as amounts of wages and amounts of income tax to be deducted and withheld shall be computed on the basis of the table for an annual payroll period prescribed pursuant to subsection (a).

For wage-bracket withholding tables prescribed by the IRS, under Code Sec. 3402(c)(6), see ¶ 161-162.—CCH.

(d) TAX PAID BY RECIPIENT.—If the employer, in violation of the provisions of this chapter, fails to deduct and withhold the tax under this chapter, and thereafter the tax against which such tax may be credited is paid, the tax so required to be deducted and withheld shall not be collected from the employer; but this subsection shall in no case relieve the employer from liability for any penalties or additions to the tax otherwise applicable in respect of such failure to deduct and withhold.

(e) INCLUDED AND EXCLUDED WAGES.—If the remuneration paid by an employer to an employee for services performed during one-half or more of any payroll period of not more than 31 consecutive days constitutes wages, all the remuneration paid by such employer to such employee for such period shall be deemed to be wages; but if the remuneration paid by an employer to an employee for services performed during more than one-half of any such payroll period does not constitute wages, then none of the remuneration paid by such employer to such employee for such period shall be deemed to be wages.

[As amended by P. L. 95-30, Code Sec. 3402(f)(1), below, applies only to wages paid after May 31, 1977.—CCH.]

(f) WITHHOLDING EXEMPTIONS.—

(1) IN GENERAL.—An employee receiving wages shall on any day be entitled to the following withholding exemptions:

(A) an exemption for himself;

(B) one additional exemption for himself if, on the basis of facts existing at the beginning of such day, there may reasonably be expected to be allowable an exemption under section 151(c)(1) (relating to old age) for the taxable year under subtitle A in respect of which amounts deducted and withheld under this chapter in the calendar year in which such day falls are allowed as a credit;

(C) one additional exemption for himself if, on the basis of facts existing at the beginning of such day, there may reasonably be expected to be allowable an exemption under section 151(d)(1) (relating to the blind) for the taxable year under subtitle A in respect of which amounts deducted and withheld under this chapter in the calendar year in which such day falls are allowed as a credit;

(D) if the employee is married, any exemption to which his spouse is entitled, or would be entitled if such spouse were an employee receiving wages, under subparagraph (A), (B), or (C), but only if such spouse does not have in effect a withholding exemption certificate claiming such exemption;

(E) an exemption for each individual with respect to whom, on the basis of facts existing at the beginning of such day, there may reasonably be expected to be allowable an exemption under section 151(e) for the taxable year under subtitle A in respect of which amounts deducted and withheld under this chapter in the calendar year in which such day falls are allowed as a credit;

(F) any allowance to which he is entitled under subsection (m), but only if his spouse does not have in effect a withholding exemption certificate claiming such allowance; and

(G) a zero bracket allowance which shall be an amount equal to one exemption unless (i) he is married (as determined under section 143) and his spouse is an employee receiving wages subject to withholding or (ii) he has withholding exemption certificates in effect with respect to more than one employer.

For purposes of this title, any zero bracket allowance under subparagraph (G) shall be treated as if it were denominated a withholding exemption.

(2) EXEMPTION CERTIFICATES.—

(A) ON COMMENCEMENT OF EMPLOYMENT.—On or before the date of the commencement of employment with an employer, the employee shall furnish the employer with a signed withholding exemption certificate relating to the number of withholding exemptions which he claims, which shall in no event exceed the number to which he is entitled.

(B) CHANGE OF STATUS.—If, on any day during the calendar year, the number of withholding exemptions to which the employee is entitled is less than the number of withholding exemptions claimed by the employee on the withholding exemption certificate then in effect with respect to him, the employee shall within 10 days thereafter furnish the employer with a new withholding exemption certificate relating to the number of withholding exemptions which the employee then claims, which shall in no event exceed the number to which he is entitled on such day. If, on any day during the calendar year, the number of withholding exemptions to which the employee is entitled is greater than the number of withholding exemptions claimed, the employee may furnish the employer with a new withholding exemption certificate relating to the number of withholding exemptions which the employee then

[§ 4944]—Continued

claims, which shall in no event exceed the number to which he is entitled on such day.

(C) CHANGE OF STATUS WHICH AFFECTS NEXT CALENDAR YEAR.—If on any day during the calendar year the number of withholding exemptions to which the employee will be, or may reasonably be expected to be, entitled at the beginning of his next taxable year under subtitle A is different from the number to which the employee is entitled on such day, the employee shall, in such cases and at such times as the Secretary may by regulations prescribe, furnish the employer with a withholding exemption certificate relating to the number of withholding exemptions which he claims with respect to such next taxable year, which shall in no event exceed the number to which he will be, or may reasonably be expected to be, so entitled.

(3) WHEN CERTIFICATE TAKES EFFECT.—

(A) FIRST CERTIFICATE FURNISHED.—A withholding exemption certificate furnished the employer in cases in which no previous such certificate is in effect shall take effect as of the beginning of the first payroll period ending, or the first payment of wages made without regard to a payroll period, on or after the date on which such certificate is so furnished.

(B) FURNISHED TO TAKE PLACE OF EXISTING CERTIFICATE.—A withholding exemption certificate furnished the employer in cases in which a previous such certificate is in effect shall take effect with respect to the first payment of wages made on or after the first status determination date which occurs at least 30 days from the date on which such certificate is so furnished, except that at the election of the employer such certificate may be made effective with respect to any payment of wages made on or after the date on which such certificate is so furnished; but a certificate furnished pursuant to paragraph (2) (C) shall not take effect, and may not be made effective, with respect to any payment of wages made in the calendar year in which the certificate is furnished. For purposes of this subparagraph the term "status determination date" means January 1, May 1, July 1, and October 1 of each year.

(4) PERIOD DURING WHICH CERTIFICATE REMAINS IN EFFECT.—A withholding exemption certificate which takes effect under this subsection, or which on December 31, 1954, was in effect under the corresponding subsection of prior law, shall continue in effect with respect to the employer until another such certificate takes effect under this subsection.

(5) FORM AND CONTENTS OF CERTIFICATE.—Withholding exemption certificates shall be in such form and contain such information as the Secretary may by regulations prescribe.

(6) EXEMPTION OF CERTAIN NONRESIDENT ALIENS.—Notwithstanding the provisions of paragraph (1), a nonresident alien individual (other than an individual described in section 3401(a)(6)(A) or (B)) shall be entitled to only one withholding exemption.

(7) EXEMPTION WHERE CERTIFICATE WITH ANOTHER EMPLOYER IS IN EFFECT.—If a withholding exemption certificate is in effect with respect to one employer, an employee shall not be entitled under a certificate in effect with any other employer to any withholding exemption which he has claimed under such first certificate.

(g) OVERLAPPING PAY PERIODS, and PAYMENT BY AGENT OR FIDUCIARY.—If a payment of wages is made to an employee by an employer—

(1) with respect to a payroll period or other period, any part of which is included in a payroll period or other period with respect to which wages are also paid to such employee by such employer, or

(2) without regard to any payroll period or other period, but on or prior to the expiration of a payroll period or other period with respect to which wages are also paid to such employee by such employer, or

(3) with respect to a period beginning in one and ending in another calendar year, or

(4) through an agent, fiduciary, or other person who also has the control, receipt, custody, or disposal of, or pays, the wages payable by another employer to such employee,

the manner of withholding and the amount to be deducted and withheld under this chapter shall be determined in accordance with regulations prescribed by the Secretary under which the withholding exemption allowed to the employee in any calendar year shall approximate the withholding exemption allowable with respect to an annual payroll period.

(h) **ALTERNATIVE METHODS OF COMPUTING AMOUNT TO BE WITHHELD.**—The Secretary or his delegate may, under regulations prescribed by him, authorize—

(1) **WITHHOLDING ON BASIS OF AVERAGE WAGES.**—An employer—

(A) to estimate the wages which will be paid to any employee in any quarter of the calendar year,

(B) to determine the amount to be deducted and withheld upon each payment of wages to such employee during such quarter as if the appropriate average of the wages so estimated constituted the actual wages paid, and

(C) to deduct and withhold upon any payment of wages to such employee during such quarter (and, in the case of tips referred to in subsection (k), within 30 days thereafter) such amount as may be necessary to adjust the amount actually deducted and withheld upon the wages of such employee during such quarter to the amount required to be deducted and withheld during such quarter without regard to this subsection.

(2) **WITHHOLDING ON BASIS OF ANNUALIZED WAGES.**—An employer to determine the amount of tax to be deducted and withheld upon a payment of wages to an employee for a payroll period by—

(A) multiplying the amount of an employee's wages for a payroll period by the number of such payroll periods in the calendar year,

(B) determining the amount of tax which would be required to be deducted and withheld upon the amount determined under subparagraph (A) if such amount constituted the actual wages for the calendar year and the payroll period of the employee were an annual payroll period, and

(C) dividing the amount of tax determined under subparagraph (B) by the number of payroll periods (described in subparagraph (A)) in the calendar year.

(3) **WITHHOLDING ON BASIS OF CUMULATIVE WAGES.**—An employer, in the case of any employee who requests to have the amount of tax to be withheld from his wages computed on the basis of his cumulative wages, to—

(A) add the amount of the wages to be paid to the employee for the payroll period to the total amount of wages paid by the employer to the employee during the calendar year,

(B) divide the aggregate amount of wages computed under subparagraph (A) by the number of payroll periods to which such aggregate amount of wages relates,

(C) compute the total amount of tax that would have been required to be deducted and withheld under subsection (a) if the average amount of wages (as computed under subparagraph (B)) had been paid to the employee for the number of payroll periods to which the aggregate amount of wages (computed under subparagraph (A)) relates,

(D) determine the excess, if any, of the amount of tax computed under subparagraph (C) over the total amount of tax deducted and withheld by the employer from wages paid to the employee during the calendar year, and

(E) deduct and withhold upon the payment of wages (referred to in subparagraph (A)) to the employee an amount equal to the excess (if any) computed under subparagraph (D).

(4) **OTHER METHODS.**—An employer to determine the amount of tax to be deducted and withheld upon the wages paid to an employee by any other

[§ 4944]—Continued

method which will require the employer to deduct and withhold upon such wages substantially the same amount as would be required to be deducted and withheld by applying subsection (a) or (c), either with respect to a payroll period or with respect to the entire taxable year.

(i) **ADDITIONAL WITHHOLDING.**—The Secretary is authorized by regulations to provide, under such conditions and to such extent as he deems proper, for withholding in addition to that otherwise required under this section in cases in which the employer and the employee agree (in such form as the Secretary may by regulations prescribe) to such additional withholding. Such additional withholding shall for all purposes be considered tax required to be deducted and withheld under this chapter.

[For CCH Comment on 1954 Code Sec. 3402(j), see § 4964.01.]

(j) **NONCASH REMUNERATION TO RETAIL COMMISSION SALESMAN.**—In the case of remuneration paid in any medium other than cash for services performed by an individual as a retail salesman for a person, where the service performed by such individual for such person is ordinarily performed for remuneration solely by way of cash commission an employer shall not be required to deduct or withhold any tax under this subchapter with respect to such remuneration, provided that such employer files with the Secretary such information with respect to such remuneration as the Secretary may by regulation prescribe.

(k) **TIPS.**—In the case of tips which constitute wages, subsection (a) shall be applicable only to such tips as are included in a written statement furnished to the employer pursuant to section 6053(a), and only to the extent that the tax can be deducted and withheld by the employer, at or after the time such statement is so furnished and before the close of the calendar year in which such statement is furnished, from such wages of the employee (excluding tips, but including funds turned over by the employee to the employer for the purpose of such deduction and withholding) as are under the control of the employer; and an employer who is furnished by an employee a written statement of tips (received in a calendar month) pursuant to section 6053(a) to which paragraph (16)(B) of section 3401(a) is applicable may deduct and withhold the tax with respect to such tips from any wages of the employee (excluding tips) under his control, even though at the time such statement is furnished the total amount of the tips included in statements furnished to the employer as having been received by the employee in such calendar month in the course of his employment by such employer is less than \$20. Such tax shall not at any time be deducted and withheld in an amount which exceeds the aggregate of such wages and funds (including funds turned over under section 3102(c)(2) or section 3202(c)(2)) minus any tax required by section 3102(a) or section 3202(a) to be collected from such wages and funds.

(l) **DETERMINATION AND DISCLOSURE OF MARITAL STATUS.**—

(1) **DETERMINATION OF STATUS BY EMPLOYER.**—For purposes of applying the tables in subsections (a) and (c) to a payment of wages, the employer shall treat the employee as a single person unless there is in effect with respect to such payment of wages a withholding exemption certificate furnished to the employer by the employee after the date of the enactment of this subsection indicating that the employee is married.

(2) **DISCLOSURE OF STATUS BY EMPLOYEE.**—An employee shall be entitled to furnish the employer with a withholding exemption certificate indicating he is married only if, on the day of such furnishing, he is married (determined with the application of the rules in paragraph (3)). An employee whose marital status changes from married to single shall, at such time as the Secretary may by regulations prescribe, furnish the employer with a new withholding exemption certificate.

(3) **DETERMINATION OF MARITAL STATUS.**—For purposes of paragraph (2), an employee shall on any day be considered—

(A) as not married, if (i) he is legally separated from his spouse under a decree of divorce or separate maintenance, or (ii) either he or his spouse is, or on any preceding day within the calendar year was, a nonresident alien; or

(B) as married, if (i) his spouse (other than a spouse referred to in subparagraph (A)) died within the portion of his taxable year which precedes such day, or (ii) his spouse died during one of the two taxable years immediately preceding the current taxable year and, on the basis of facts existing at the beginning of such day, the employee reasonably expects, at the close of his taxable year, to be a surviving spouse (as defined in section 2(a)).

[As amended by P. L. 95-30, Code Sec. 3402(m), below, applies only to wages paid after May 31, 1977.—CCH.]

(m) WITHHOLDING ALLOWANCES BASED ON ITEMIZED DEDUCTIONS.—

(1) GENERAL RULE.—An employee shall be entitled to withholding allowances under this subsection with respect to a payment of wages in a number equal to the number determined by dividing by \$750 the excess of—

(A) his estimated itemized deductions, over

(B) an amount equal to \$3,200, \$2,200 in the case of an individual who is not married (within the meaning of section 143) and who is not a surviving spouse (as defined in section 2(a)).

For purposes of this subsection, a fractional number shall not be taken into account unless it amounts to one-half or more, in which case it shall be increased to 1.

(2) DEFINITIONS.—For purposes of this subsection—

(A) ESTIMATED ITEMIZED DEDUCTIONS.—The term “estimated itemized deductions” means the aggregate amount which he reasonably expects will be allowable as deductions under chapter 1 (other than the deductions referred to in section 151 and other than the deductions required to be taken into account in determining adjusted gross income under section 62 (other than paragraph (13) thereof) for the estimation year. In no case shall such aggregate amount be greater than the sum of (i) the amount of such deductions (or the zero bracket amount (within the meaning of section 63(d))) reflected in his return of tax under subtitle A for the taxable year preceding the estimation year or (if such a return has not been filed for such preceding taxable year at the time the withholding exemption certificate is furnished the employer) the second taxable year preceding the estimation year, and (ii) the amount of his determinable additional deductions for the estimation year.

(B) ESTIMATED WAGES.—The term “estimated wages” means the aggregate amount which he reasonably expects will constitute wages for the estimation year.

(C) DETERMINABLE ADDITIONAL DEDUCTIONS.—The term “determinable additional deductions” means those estimated itemized deductions which (i) are in excess of the deductions referred to in subparagraph (A) (or the zero bracket amount) reflected on his return of tax under subtitle A for the taxable year preceding the estimation year, and (ii) are demonstrably attributable to an identifiable event during the estimation year or the preceding taxable year which can reasonably be expected to cause an increase in the amount of such deductions on the return of tax under subtitle A for the estimation year.

(D) ESTIMATION YEAR.—In the case of an employee who files his return on the basis of a calendar year, the term “estimation year” means the calendar year in which the wages are paid.

In the case of an employee who files his return on a basis other than the calendar year, his estimation year, and the amounts reflected and withheld to be governed by such estimation year, shall be determined under regulations prescribed by the Secretary.

[As amended by P. L. 95-30, Code Sec. 3402(m), below,
applies only to wages paid after May 31, 1977.—CCH.]

[§ 4944]—Continued

(3) SPECIAL RULES.—

(A) MARRIED INDIVIDUALS.—The number of withholding allowances to which a husband and wife are entitled under this subsection shall be determined on the basis of their combined wages and deductions. This subparagraph shall not apply to a husband and wife who filed separate returns for the taxable year preceding the estimation year and who reasonably expect to file separate returns for the estimation year.

(B) LIMITATION.—In the case of employees whose estimated wages are at levels at which the amounts of deducted and withheld under this chapter generally are insufficient (taking into account a reasonable allowance for deductions and exemptions) to offset the liability for tax under chapter 1 with respect to the wages from which such amounts are deducted and withheld, the Secretary may by regulation reduce the withholding allowances to which such employees would, but for this subparagraph, be entitled under this subsection.

(C) TREATMENT OF ALLOWANCES.—For purposes of this title, any withholding allowance under this subsection shall be treated as if it were denominated a withholding exemption.

(4) AUTHORITY TO PRESCRIBE TABLES.—The Secretary may prescribe tables pursuant to which employees shall determine the number of withholding allowances to which they are entitled under this subsection (in lieu of making such determination under paragraphs (1) and (3)). Such tables shall be consistent with the provisions of paragraphs (1) and (3), except that such tables—

(A) shall provide for entitlement to withholding allowances based on reasonable wage and itemized deduction brackets,

(B) may increase or decrease the number of withholding allowances to which employees in the various wage and itemized deduction brackets would, but for this subparagraph, be entitled to the end that, to the extent practicable, amounts deducted and withheld under this chapter (i) generally do not exceed the liability for tax under chapter 1 with respect to the wages from which such amounts are deducted and withheld, and (ii) generally are sufficient to offset such liability for tax, and

(C) may take into account tax credits to which employees are entitled.

(n) EMPLOYEES INCURRING NO INCOME TAX LIABILITY.—Notwithstanding any other provision of this section, an employer shall not be required to deduct and withhold any tax under this chapter upon a payment of wages to an employee if there is in effect with respect to such payment a withholding exemption certificate (in such form and containing such other information as the Secretary may prescribe) furnished to the employer by the employee certifying that the employee—

(1) incurred no liability for income tax imposed under subtitle A for his preceding taxable year, and

(2) anticipates that he will incur no liability for income tax imposed under subtitle A for his current taxable year.

The Secretary shall by regulations provide for the coordination of the provisions of this subsection with the provisions of subsection (f).

(o) EXTENSION OF WITHHOLDING TO CERTAIN PAYMENTS OTHER THAN WAGES.—

(1) GENERAL RULE.—For purposes of this chapter (and so much of subtitle F as relates to this chapter)—

(A) any supplemental unemployment compensation benefit paid to an individual, and

(B) any payment of an annuity to an individual, if at the time the payment is made a request that such annuity be subject to withholding under this chapter is in effect,

*[As amended by P. L. 95-30, Code Sec. 3402(m), below,
applies only to wages paid after May 31, 1977.—CCH.]*

shall be treated as if it were a payment of wages by an employer to an employee for a payroll period.

(2) DEFINITIONS.—

(A) SUPPLEMENTAL UNEMPLOYMENT COMPENSATION BENEFITS.—For purposes of paragraph (1), the term "supplemental unemployment compensation benefits" means amounts which are paid to an employee, pursuant to a plan to which the employer is a party, because of an employee's involuntary separation from employment (whether or not such separation is temporary), resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions, but only to the extent such benefits are includible in the employee's gross income.

(B) ANNUITY.—For purposes of this subsection, the term "annuity" means any amount paid to an individual as a pension or annuity, but only to the extent that the amount is includible in the gross income of such individual.

(3) REQUEST FOR WITHHOLDING.—A request that an annuity be subject to withholding under this chapter shall be made by the payee in writing to the person making the annuity payments, shall be accompanied by a withholding exemption certificate, executed in accordance with the provisions of subsection (f)(2), and shall take effect as provided in subsection (f)(3). Such a request may, notwithstanding the provisions of subsection (f)(4), be terminated by furnishing to the person making the payments a written statement of termination which shall be treated as a withholding exemption certificate for purposes of subsection (f)(3)(B).

(p) VOLUNTARY WITHHOLDING AGREEMENTS.—The Secretary or his delegate is authorized by regulations to provide for withholding—

(1) from remuneration for services performed by an employee for his employer which (without regard to this subsection) does not constitute wages, and

(2) from any other type of payment with respect to which the Secretary finds that withholding would be appropriate under the provisions of this chapter, if the employer and the employee, or in the case of any other type of payment the person making and the person receiving the payment, agree to such withholding. Such agreement shall be made in such form and manner as the Secretary may by regulations provide. For purposes of this chapter (and so much of subtitle F as relates to this chapter) remuneration or other payments with respect to which such agreement is made shall be treated as if they were wages paid by an employer to an employee to the extent that such remuneration is paid or other payments are made during the period for which the agreement is in effect.

(q) EXTENSION OF WITHHOLDING TO CERTAIN GAMBLING WINNINGS.—

(1) GENERAL RULE.—Every person, including the Government of the United States, a State, or a political subdivision thereof, or any instrumentalities of the foregoing, making any payment of winnings which are subject to withholding shall deduct and withhold from such payment a tax in an amount equal to 20 percent of such payment.

(2) EXEMPTION WHERE TAX OTHERWISE WITHHELD.—In the case of any payment of winnings which are subject to withholding made to a nonresident alien individual or a foreign corporation, the tax imposed under paragraph (1) shall not apply to any such payment subject to tax under section 1441(a) (relating to withholding on nonresident aliens) or tax under section 1442(a) (relating to withholding on foreign corporations).

(3) WINNINGS WHICH ARE SUBJECT TO WITHHOLDING.—For purposes of this subsection, the term "winnings which are subject to withholding" means proceeds from a wager determined in accordance with the following:

(A) IN GENERAL.—Except as provided in subparagraphs (B) and (C), proceeds of more than \$1,000 from a wagering transaction, if the

[§ 4944]—Continued

amount of such proceeds is at least 300 times as large as the amount wagered.

(B) STATE-CONDUCTED LOTTERIES.—Proceeds of more than \$5,000 from a wager placed in a lottery conducted by an agency of a State acting under authority of State law, but only if such wager is placed with the State agency conducting such lottery, or with its authorized employees or agents.

(C) SWEEPSTAKES, WAGERING POOLS, CERTAIN PARIMUTUEL POOLS, JAI ALAI, AND LOTTERIES.—Proceeds of more than \$1,000 from—

(i) a wager placed in a sweepstakes, wagering pool, or lottery (other than a wager described in subparagraph (B)), or

(ii) a wagering transaction in a parimutuel pool with respect to horse races, dog races, or jai alai if the amount of such proceeds is at least 300 times as large as the amount wagered.

(4) RULES FOR DETERMINING PROCEEDS FROM A WAGER.—For purposes of this subsection—

(A) proceeds from a wager shall be determined by reducing the amount received by the amount of the wager, and

(B) proceeds which are not money shall be taken into account at their fair market value.

(5) EXEMPTION FOR BINGO, KENO, AND SLOT MACHINES.—The tax imposed under paragraph (1) shall not apply to winnings from a slot machine, keno, and bingo.

(6) STATEMENT BY RECIPIENT.—Every person who is to receive a payment of winnings which are subject to withholding shall furnish the person making such payment a statement, made under the penalties of perjury, containing the name, address, and taxpayer identification number of the person receiving the payment and of each person entitled to any portion of such payment.

(7) COORDINATION WITH OTHER SECTIONS.—For purposes of sections 3403 and 3404 and for purposes of so much of subtitle F (except section 7205) as relates to this chapter, payments to any person of winnings which are subject to withholding shall be treated as if they were wages paid by an employer to an employee.

.01 Amended by P. L. 95-30, P. L. 94-455, P. L. 94-331, P. L. 94-164, P. L. 94-12, P. L. 92-178, P. L. 91-172, P. L. 91-53, P. L. 91-36, P. L. 90-364, P. L. 89-368, P. L. 89-212, P. L. 89-97, P. L. 88-272, P. L. 87-256 and P. L. 306 (84th Cong.). For details, see the Code Volumes.

Committee Reports on P. L. 95-30

.011 *Withholding changes.*—The increase in the "standard deduction" will be reflected in reduced withholding beginning May 1, 1977. The withholding changes will be at the proper annual rate rather than an accelerated rate to reflect the entire year's liability change in only eight months of withholding. The reduction in withholding will apply to both "standard deductors" and itemizers, for whom the reduction in withholding will generally represent smaller refunds but in some cases will require larger final payments.

The higher standard deduction provided by the committee for heads of households requires a special withholding adjustment because heads of households are withheld under present law according to the rate schedule for single per-

sons. In order to avoid overwithholding, heads of households will be permitted to claim an additional personal exemption only for withholding purposes. Since the difference between the standard deduction for single persons and married persons is \$1,000 (\$3,200 for joint returns and \$2,200 for single persons), the additional personal exemption will reflect \$750 of this \$1,000 difference. This has the effect of reflecting \$2,950 for withholding instead of the full head of household standard deduction amount of \$3,200. If head of household withholding were based on the joint return rate schedule, there would be substantial underwithholding because the joint tax rates are lower than the head of household rates. Heads of households may elect to have the \$2,950 reflected in their withholding by filing a new form W-4 (Employee's Withholding Allowance Certificate) on which they claim the extra personal exemption with their employer. The Internal Revenue Service will be required to modify this form to enable heads of households to claim an additional personal exemption for withholding purposes.

For wages paid after December 31, 1978, the withholding tables are to be the same as those in effect on January 1, 1975, except that they

will be modified to reflect the higher "standard deduction" (the new zero bracket amount) provided by this bill. This 1979 change in withholding is made because the general tax credit is scheduled to expire at the end of 1978.

—Senate Finance Committee Report.

House bill.—Under present law, the standard deduction is 16 percent of adjusted gross income with a minimum of \$1,700 for single returns and \$2,100 for joint returns, and a maximum of \$2,400 for single returns and \$2,800 for joint returns. The House bill increases the present standard deduction to a flat amount of \$2,400 for single persons and \$3,000 for joint returns and simplifies the tax return forms. It adopts a tax table based on tax table income and the number of exemptions and builds the general tax credit, the standard deduction and the personal exemption into the table. For people who do not itemize their deductions, "tax table" income equals adjusted gross income, as currently defined. Itemizers must subtract itemized deductions in excess of the new standard deduction to obtain "tax table" income. Conforming changes are made to the Code references to taxable income. The bill also changes the tax rates to apply above a "zero bracket amount" equal to the new standard deduction amount. The \$35 per capita tax credit is made available for the extra age and blindness exemptions, and married individuals filing separately are limited to the \$35 per capita credit. These changes apply to taxable years beginning after December 31, 1976.

Senate amendment.—Senate amendments numbered 12, 16, 18, and 24 set the standard deduction at \$2,200 for single persons and \$3,200 for joint returns (\$1,600 for married individuals filing separate returns). Senate amendments numbered 15 and 17 extended the \$3,200 standard deduction for joint returns to heads of households. (Under present law, heads of households have the same standard deduction as single taxpayers.) Senate amendment numbered 5 changes the general tax credit to apply only against the section 1 tax (and other taxes in lieu of section 1 taxes), rather than against all the taxes imposed by Chapter 1 of the Internal Revenue Code. Senate amendment numbered 4 substitutes tax rate tables to reflect the Senate amendments. The effective date is the same as the House bill.

Conference agreement.—The conference agreement is the same as the Senate amendment except that the joint return standard deduction is not extended to heads of households and conforming changes are made. The effective date is the same as in the House bill and the Senate amendment.

—Conference Committee Report.

Senate amendment.—The Senate amendment modifies the requirement for withholding on gambling winnings to provide that withholding is required on proceeds of more than \$1,000 from wagers placed in parimutuel pools involving horses, dogs or jai alai, but only if the amount of the proceeds is at least 300 times as large as the amount wagered. The provision applies to payments made after April 30, 1977.

Conference agreement.—The conference agreement is the same as the Senate amendment.

In addition, the conferees understand that there has been some question as to the inter-

797 CCH—Standard Federal Tax Reports

pretation of section 3402(q)(3)(B), which requires withholding on proceeds of more than \$5,000 from wagers placed in State-conducted lotteries. The conferees intend that this provision be interpreted to include State-conducted lotteries in which the amount of the proceeds is determined by a parimutuel system. The conferees understand that the Treasury Department and the Internal Revenue Service agree with this interpretation.—Conference Committee Report.

Committee Reports on P. L. 94-455

.012 Withholding tables.—• • • The committee amendment also requires the Internal Revenue Service to continue until June 30, 1977, to use the withholding rates in effect since the enactment of the Tax Reduction Act of 1975. Declarations of estimated tax payments in 1977, insofar as they relate to payments made in the first half of the year, are to be made on the assumption that the provisions in effect for the first half of the year continue in effect for the entire year. After June 30, 1977 (if no change is made in subsequent action by Congress), the Service is to issue new withholding tables that are the same as the pre-1975 tables except to reflect the changes in the standard deduction made by the committee amendment.

The committee amendment also permanently raises the income tax filing requirement to reflect the increases in the minimum standard deduction.—Conference Committee Report.

Withholding of income tax on certain gambling winnings.—Under present law, withholding on racetrack winnings is not required although payouts to winners of the daily double, Exacta, Perfecta and similar type pools are reportable on Form 1099 information returns if the payout is based on betting odds of 300 to one or higher.

The regulations require that winnings be reported on 1099's whenever the winnings are \$600 or more from a \$2 bet because it is not practical to enforce reporting for odds lower than 300 to 1.

In addition, Nevada gambling casinos are required to report certain large winnings from Keno and bingo games on Form 1099 to the Internal Revenue Service depending on the price of ticket as well as the amount won.

Reasons for change

Although most wagering transactions have no tax significance since the majority of bettors end up the year with no net wagering gains, the special types of wagers mentioned above represent unique and occasional windfalls that generally produce a significant tax liability. Even with the information reporting requirements, many taxpayers do not report these winnings on their income tax returns. One source of this nonreporting of income is, for example, the use of the so-called "10 percenters" at the racetrack. A 10 percenter is a person hired by the winner to cash his ticket for 10 percent of the winnings and provide fictitious identification so that the reporting on Form 1099 is provided in a name other than that of the actual winner. These 10 percenters themselves seldom pay any income tax either by filing no tax return or claiming sufficient offsetting losses.

Explanation of provision

To deal with the underreporting of gambling winnings, the committee amendment supple-

Code § 3402 ¶ 4944

[§ 4944.012]—Continued

ments the information reporting requirement with a provision for withholding on certain winnings at a 20-percent withholding rate. The House bill provision is identical to the committee amendment except for the effective date.

The person making the payment of winnings subject to withholding would be required to deduct and withhold from the payment 20 percent of such payment. The withholding would be based on the entire payment rather than the amount of the winnings for ease of compliance. The winnings subject to withholding would be the proceeds of more than \$1,000 from wagers in sweepstakes, wagering pools, or lotteries (whether or not conducted by a State or agency or instrumentality of a State). In the case of winnings other than those mentioned above, withholding is to be required on payments of more than \$1,000 from the wagering transaction if the amount of such proceeds were at least 300 times as large as the amount wagered. This withholding requirement would also apply to winnings over \$1,000 from slot machines. This type of winning is no different from other games of chance with large payoffs because, in case of slot machines, when a payoff in excess of \$1,000 occurs, the winner is paid by check or cash at the cashier's window rather than by, for example, in the case of a quarter machine, 4,000 quarters being paid out of the machine itself.

The person who is to receive the payment of winnings subject to withholding would be required to furnish the payor with the name, address and taxpayer identification number of the person receiving the payment and of each person entitled to any portion of such payment, under penalty of perjury.

Effective date

These new withholding rules are to apply to wagering transactions occurring 30 days after the enactment of this Act.—*Senate Committee Report.*

House bill.—Under present law, withholding of Federal income tax from gambling winnings is not required although information reports must be submitted on winnings of \$600 or more. The House bill imposes withholding at a 20-percent rate on winnings of more than \$1,000 from sweepstakes, wagering pools, and lotteries and from other types of gambling if the odds are 300 to 1 or more. The withholding applies to wagers made after December 31, 1975.

Senate amendment.—The Senate amendment is the same as the House bill except that it does not apply to winnings from slot machines, keno, and bingo, or from State-conducted lotteries. This withholding applies to wagers made after September 30, 1977.

Conference agreement.—The conference agreement follows the Senate amendment except that the exemption for State-conducted lotteries applies only to winnings of \$5,000 or less, and the withholding begins to apply 90 days after date of enactment. State-conducted sweep-

stakes and wagering pools are not included in the \$5,000 exemption, but rather are treated the same as privately-conducted sweepstakes and wagering pools (and thus are subject to withholding on any net winnings exceeding \$1,000). Under the conference agreement, it is intended that the term "wagering pools" is to include all pari-mutuel betting pools, including on- and off-track racing pools, and similar types of betting pools.

The conference agreement also makes it clear that withholding applies to winnings net of the ticket price, taking into account all tickets for identical wagers. For example, if one \$100 bet and two \$50 bets are placed on a single horse to win a single racetrack event, any winnings from the three tickets should be added together and the ticket prices of all three tickets should be deducted to determine net winnings. However, if the bets are placed on different horses or on different events, the net winnings are to be determined separately for each ticket.

In addition, under the conference agreement, the Internal Revenue Service is to report, prior to 1979, to the House Committee on Ways and Means and the Senate Committee on Finance on the operation of the present reporting system (IRS Form 1099) as applied to winnings from keno, bingo, and slot machine winnings and is to make a recommendation whether or not such winnings should be subject to withholding. The conferees also urge that, in the interim, the Internal Revenue Service modify the reporting requirements (on IRS Form 1099) with respect to winnings from these sources. This modification should include a lower threshold for the requirement that the payor report payments to the Internal Revenue Service to the extent that current reporting practices differ from that set out in the Internal Revenue Code (sec. 6041).—*Conference Committee Report.*

Committee Reports on P. L. 94-164

.013 *Withholding provisions (sec. 4 of the bill and sec. 3402(a) of the code)*

Under present law, the withholding rates incorporate the individual income tax changes made by the Tax Reduction Act of 1975 but reflect them on an eight-month basis rather than a 12-month basis.¹

The bill provides that the existing withholding rates are to continue to apply to wages paid through June 30, 1976. For purposes of the first two estimated tax payments, calendar-year taxpayers are to estimate their tax as if the full year tax reductions were applicable for 1976.

A continuation of the 1975 withholding rates would reduce receipts by nearly \$13 billion in 1976 on a full year basis or by \$6.3 billion on a one-half year basis. For fiscal year 1976 the continuation of the existing withholding rates will reduce receipts by \$5.54 billion.²—*Senate Finance Committee.*

¹ The withholding rates do not reflect the earned income credit because on an eight-month basis a substantial portion of the people eligible for the earned income credit had their withholding reduced to zero.

² The impact for fiscal year 1976 of extending the 1975 withholding rates is not to increase the withholding rates to the early 1975 levels. If these rates were increased to the early 1975

levels, the effect on fiscal year 1976 would be less than the \$6.3 billion of increased withholding that would occur under the higher rates because of the time lags between the time taxes are withheld and the time they are recorded by the Treasury as receipts. Consequently, the fiscal year 1976 receipts effect of not increasing withholding rates is estimated to be \$5.54 billion.

Individual Income Tax Withholding and Estimated Tax Payments.—House bill.—No provision.

Senate amendment.—The Senate amendment extends withholding tax rates in effect on December 10, 1975 through June 30, 1976. It also provides that the estimated tax payments made before July 1, 1976, are to take into account all reductions made by this Act.

Conference substitute.—The conferees agreed to the Senate provision.—**Conference Committee Report.**

Committee Report on P. L. 94-12

.014 The bill provides a new annual percentage withholding table, which reflects the increases in the low income allowance, the percentage standard deduction, and the provision for an earned income credit provided in the House bill. The Internal Revenue Service is required to calculate withholding tables for other periods and for wage bracket withholding.

Senate amendment.—The Senate amendment requires the Secretary of the Treasury to prescribe new withholding tables which reflect the \$200 personal exemption tax credit provided by the Senate amendment, the reduction in income tax rates provided by the Senate amendment, and the earned income credit as modified by the Senate amendment. The changes in the withholding tables are to take effect, as in the House bill, on May 1, 1975.

Conference substitute.—The conference substitute requires the Secretary to prescribe new withholding tables which reflect the temporary increases in the minimum standard deduction and the percentage standard deduction, the earned income credit, and the additional tax credit provided in the conference substitute. The changes in the withholding tables are to take effect on May 1, 1975.—**Conference Committee Report.**

Committee Reports on P. L. 92-178

.015 *Withholding changes [adjustments of withholding]*

Present law provides a percentage withholding method for 1971, 1972, and 1973, which incorporates the personal exemption, the low-income allowance and the percentage standard deduction provided by present law for those years. Wage bracket withholding tables based on the percentage method are prescribed by the Secretary of the Treasury.

Because of the increase in the low-income allowance to \$1,300 for 1972 and the acceleration of the increases in the personal exemption and the percentage standard deduction scheduled for 1973 to 1972 provided by the bill, it is necessary to change the withholding rates to reflect these changes. In addition, the present withholding structure does not withhold a sufficient amount in many instances. The principal sources of this underwithholding are: (1) the incorporation of the low-income allowance into the withholding structure results in a married couple receiving two low-income allowances for withholding purposes when both spouses work, whereas they are entitled to only one on their tax return (the same problem also occurs where a person works for more than one employer at the same time); (2) the \$2,000 ceiling on the percentage standard deduction is not reflected in the withholding rates

so that a taxpayer whose standard deduction is limited by the ceiling will have too little tax withheld; and (3) the top withholding rates are not high enough.

The committee agrees with the House that it is desirable to correct these sources of underwithholding by adopting a new withholding system. The House bill provided for the new system to take effect in two stages, in 1972 and 1973. The committee believes that it is desirable to correct this underwithholding as soon as possible to avoid an additional year of large final tax payments. Consequently, the committee bill makes the entire withholding change effective in 1972.

The bill provides new withholding rates which reflect the \$750 personal exemption, the \$1,300 low-income allowance and the 15-percent standard deduction. In addition, the bill changes the withholding structure to eliminate the underwithholding caused by the low-income allowance.

The new withholding structure provided by the bill has a bottom bracket of \$550 to which a zero rate applies in place of the \$1,000 bracket of present law. A single person with only one employer or a married taxpayer if his spouse is not employed will be able to have the full \$1,300 low-income allowance taken into account for withholding purposes by claiming a "standard deduction allowance" on the withholding certificate (W-4) filed with his employer. In this case, this result is obtained by allowing an additional \$750—referred to as a standard deduction allowance—which may be claimed by a single person and the working spouse. This plus the bottom \$550 zero rate bracket provides assurance that income will not be subject to withholding below the \$1,300 low-income allowance level.

A married taxpayer will not be allowed to claim an extra \$750 "standard deduction allowance" if his spouse is also an employee receiving wages subject to withholding. In that case, the taxpayer and his spouse will each have the bottom withholding bracket amount of \$550 exempt from withholding, a total of \$1,100. This is \$200 less than the \$1,300 low-income allowance and would tend to create overwithholding. This tendency, however, is partly or wholly offset by the fact that when two earners combine their income on the tax return, it is generally subject to higher tax rates than the withholding rates applicable to the separate earnings of each spouse. In addition, a taxpayer will not be allowed to claim the "standard deduction allowance" if he has withholding exemption certificates in effect with more than one employer.

Another source of underwithholding which is corrected is the practice of taxpayers claiming withholding exemptions with more than one employer at the same time. The result of this is in effect to allow exemptions twice. For example, a single individual who claims a \$750 exemption with each of two employers can have as much as \$1,500 exempt from withholding on account of exemptions even though he is entitled to only one \$750 exemption on his tax return. The bill deals with this source of underwithholding by instructing an employee not to claim the same withholding exemptions with more than one employer at a time.

To correct the underwithholding caused by the lack of a standard deduction dollar limit and the inadequate top withholding rates, the

[§ 4944.015]—Continued

withholding change, in effect, incorporates the \$2,000 ceiling on the percentage standard deduction by increasing the appropriate withholding rates. In addition, a seventh withholding bracket is added and the withholding rates generally are adjusted upward. These changes will result in withholding the full amount of tax liability up to a wage level of approximately \$25,000 for a single person and \$31,000 for a married couple (with only one spouse working) compared to the level of about \$13,500 in each instance under present law. (These levels assume the standard deduction.)

The House bill provided that the withholding change (the first stage under the House bill) was to be effective after November 14, 1971. The committee concluded that this date is not practical since it takes several weeks after the Act is passed by the Congress for the Internal Revenue Service to produce the new withholding tables and new (form W-4) withholding certificates and provide the material to employers. Additional time also is required for employers to incorporate the new withholding changes into their payroll operation, particularly giving their employees the opportunity to file new withholding certificates and explaining the use of the new certificates to them. Consequently, the committee bill provides that the withholding change applies to wages paid and withholding certificates filed after December 31, 1971.

The changes in the withholding structure to correct underwithholding are estimated to increase tax withheld by \$2 billion in calendar year 1972 before taking account of any offsetting adjustments. To the extent that taxpayers use the provision for excess itemized deductions (discussed below) or reduce their voluntary overwithholding correspondingly, the \$2 billion could be reduced or eliminated entirely.

In conjunction with the withholding changes, the provision of present law which permits a taxpayer with large itemized deductions to avoid overwithholding is changed by permitting an additional withholding allowance for each \$750 of itemized deductions in excess of 15 percent of estimated wages or \$2,000, whichever is less. This provision is also liberalized to make it easier to use. Under present law, a taxpayer's estimate of his itemized deductions for the current year generally may not exceed the deductions claimed on his tax return for the preceding taxable year or, if he has not yet filed his tax return for the preceding year, the second preceding year. After April 30 of the current year, or after he has filed his tax return for the preceding year, however, the estimated deductions may not exceed those of the preceding year. If a taxpayer wishes to reduce his withholding under this provision, it is preferable for him to take advantage of the provision at the beginning of the year. The above rule may, however, require him to file a second exemption certificate during the year.

The committee agrees with the House that this rule is unnecessarily restrictive and is likely to deter taxpayers from making use of the provision. Consequently, the bill provides that a taxpayer who has not yet filed his return for the preceding year must base his estimate of his deductions (other than his "determinable additional deductions") on the amount of deductions claimed for the second preceding year but need not file a new exemp-

tion certificate after filing his return, even if the itemized deductions for the preceding year are less than those of the second preceding year.

In addition, the bill provides that the additional allowances are to remain in effect until the taxpayer files a new withholding exemption certificate with his employer because of a change in circumstances (which the employee is required to do). Under present law, the additional allowances are not effective after April 30 of the following year.—Senate Committee Report.

Withholding changes. Amendment No. 47: Existing law provides a percentage withholding method for 1971, 1972, and 1973 which incorporates the personal exemption and the standard deduction provided by existing law for those years. Wage bracket withholding tables based on the percentage method are prescribed by the Secretary of the Treasury. Under existing law, there is significant underwithholding in many cases. The bill as passed by the House amended the withholding provisions to reflect changes made by the bill in the personal exemption and standard deduction and to minimize underwithholding. These changes in withholding would take effect in two stages, the first stage was to be effective with respect to wages paid after November 14, 1971, and before January 1, 1973, and the second stage with respect to wages paid after December 31, 1972.

Senate amendment No. 47 amended the withholding provisions to reflect changes made by the Senate amendments in the personal exemption and standard deduction and to minimize underwithholding. Under the Senate amendments, these changes would take effect in one stage, that is, with respect to wages paid after December 31, 1971.

The House recedes with amendments. Under the conference agreement the withholding provisions are amended to reflect changes made by the action recommended in the accompanying conference report in the personal exemption and the standard deduction and to minimize underwithholding. Under the conference agreement, these changes are to take effect in one stage, effective with respect to wages paid after January 15, 1972.—Conference Committee Report.

- .019 Committee Reports on P. L. 91-172 (withholding) are at 1969-3 CB 591, 675.
- .02 Committee Reports on P. L. 90-364 are at 1968-2 CB 780, 790, 810.
- .023 Committee Reports on P. L. 89-368 are at 1966-1 CB 436, 476, 512.
- .025 Committee Reports on P. L. 89-97 are at 1965-2 CB 733, 758, 771.
- .03 Committee Reports on P. L. 88-272, Sec. 302, are at 1964-1 CB (Part 2) 125, 505, 774.
- .05 Committee Reports on P. L. 87-256 are at 1961-2 CB 419.
- .10 Committee Reports on P. L. 306 (84th Cong.) are at 1955-2 CB 843.

Internal Revenue Code Section 1016(a)

[¶ 4534]

ADJUSTMENTS TO BASIS

Sec. 1016 [1954 Code]. (a) GENERAL RULE.—Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made—

(A) for taxes or other carrying charges described in section 266, or

(B) for expenditures described in section 173 (relating to circulation expenditures),

for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years;

(2) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and

(B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this subtitle or prior income tax laws. Where no method has been adopted under section 167 (relating to depreciation deduction), the amount allowable shall be determined under section 167(b)(1). Subparagraph (B) of this paragraph shall not apply in respect of any period since February 28, 1913, and before January 1, 1952, unless an election has been made under section 1020 (as in effect before

[§ 4534]—Continued

the date of the enactment of the Tax Reform Act of 1976). Where for any taxable year before the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

(3) in respect of any period—

(A) before March 1, 1913,

(B) since February 28, 1913, during which such property was held by a person or an organization not subject to income taxation under this chapter or prior income tax laws,

(C) since February 28, 1913, and before January 1, 1958, during which such property was held by a person subject to tax under part I of subchapter L (or the corresponding provisions of prior income tax laws), to the extent that paragraph (2) does not apply, and

(D) since February 28, 1913, during which such property was held by a person subject to tax under part II of subchapter L (or the corresponding provisions of prior income tax laws), to the extent that paragraph (2) does not apply,

for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained;

(4) in the case of stock (to the extent not provided for in the foregoing paragraphs) for the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax-free or were applicable in reduction of basis (not including distributions made by a corporation which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 (40 Stat. 1057), or the Revenue Act of 1921 (42 Stat. 227), out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or 1921);

(5) in the case of any bond (as defined in section 171(d)) the interest on which is wholly exempt from the tax imposed by this subtitle, to the extent of the amortizable bond premium disallowable as a deduction pursuant to section 171(a)(2), and in the case of any other bond (as defined in section 171(d)) to the extent of the deductions allowable pursuant to section 171(a)(1) with respect thereto;

(6) in the case of any municipal bond (as defined in section 75(b)), to the extent provided in section 75(a)(2);

(7) in the case of a residence the acquisition of which resulted, under section 1034, in the nonrecognition of any part of the gain realized on the sale, exchange, or involuntary conversion of another residence, to the extent provided in section 1034(e);

(8) in the case of property pledged to the Commodity Credit Corporation, to the extent of the amount received as a loan from the Commodity Credit Corporation and treated by the taxpayer as income for the year in which received pursuant to section 77, and to the extent of any deficiency on such loan with respect to which the taxpayer has been relieved from liability;

(9) for amounts allowed as deductions as deferred expenses under section 616(b) (relating to certain expenditures in the development of mines) and resulting in a reduction of the taxpayer's taxes under this subtitle, but not less than the amounts allowable under such section for the taxable year and prior years;

(11) for deductions to the extent disallowed under section 268 (relating to sale of land with unharvested crops), notwithstanding the provisions of any other paragraph of this subsection;

(12) to the extent provided in section 28(h) of the Internal Revenue Code of 1939 in the case of amounts specified in a shareholder's consent made under section 28 of such code;

(13) to the extent provided in section 551(e) in the case of the stock of United States shareholders in a foreign personal holding company;

(14) for amounts allowed as deductions as deferred expenses under section 174(b)(1) (relating to research and experimental expenditures) and resulting in a reduction of the taxpayers' taxes under this subtitle, but not less than the amounts allowable under such section for the taxable year and prior years;

(15) for deductions to the extent disallowed under section 272 (relating to disposal of coal or domestic iron ore), notwithstanding the provisions of any other paragraph of this subsection;

(16) for amounts allowed as deductions for expenditures treated as deferred expenses under section 177 (relating to trademark and trade name expenditures) and resulting in a reduction of the taxpayer's taxes under this subtitle, but not less than the amounts allowable under such section for the taxable year and prior years;

(17) in the case of any evidence of indebtedness referred to in section 818(b) (relating to amortization of premium and accrual of discount in the case of life insurance companies), to the extent of the adjustments required under section 818(b) (or the corresponding provisions of prior income tax laws) for the taxable year and all prior taxable years;

(18) to the extent provided in section 1376 in the case of stock of, and indebtedness owing, shareholders of an electing small business corporation (as defined in section 1371(b));

(19) to the extent provided in section 961 in the case of stock in controlled foreign corporations (or foreign corporations which were controlled foreign corporations) and of property by reason of which a person is considered as owning such stock;

(20) for amounts allowed as deductions for payments made on account of transfers of franchises, trademarks, or trade names under section 1253 (d)(2);

(23) to the extent provided in section 1023, relating to carryover basis for certain property acquired from a decedent dying after December 31, 1976.

Internal Revenue Code Section 6012

[1 5009]

PERSONS REQUIRED TO MAKE
RETURNS OF INCOME

Sec. 6012 [1954 Code]. (a) GENERAL RULE.—Returns with respect to income taxes under subtitle A shall be made by the following:

(1)(A) Every individual having for the taxable year a gross income of \$750 or more, except that a return shall not be required of an individual (other than an individual referred to in subparagraph (C))—

(i) who is not married (determined by applying section 143), is not a surviving spouse (as defined in section 2(a)), and for the taxable year has a gross income of less than \$2,950,

1 5008.053 Code § 6012

© 1978, Commerce Clearing House, Inc.

'54 Code

(ii) who is a surviving spouse (as so defined) and for the taxable year has a gross income of less than \$3,950, or

(iii) who is entitled to make a joint return under section 6013 and whose gross income, when combined with the gross income of his spouse, is, for the taxable year, less than \$4,700 but only if such individual and his spouse, at the close of the taxable year, had the same household as their home.

Clause (iii) shall not apply if for the taxable year such spouse makes a separate return or any other taxpayer is entitled to an exemption for such spouse under section 151(e).

(B) The amount specified in clause (i) or (ii) of subparagraph (A) shall be increased by \$750 in the case of an individual entitled to an additional personal exemption under section 151(c)(1), and the amount specified in clause (iii) of subparagraph (A) shall be increased by \$750 for each additional personal exemption to which the individual or his spouse is entitled under section 151(c);

(C) The exception under subparagraph (A) shall not apply to—

(i) a nonresident alien individual;

(ii) a citizen of the United States entitled to the benefits of section 931;

(iii) an individual making a return under section 443(a)(1) for a period of less than 12 months on account of a change in his annual accounting period;

(iv) an individual who has income (other than earned income) of \$750 or more and who is described in section 63(e)(1)(D); or

(v) an estate or trust.

(2) Every corporation subject to taxation under subtitle A;

(3) Every estate the gross income of which for the taxable year is \$600 or more;

(4) Every trust having for the taxable year any taxable income, or having gross income of \$600 or over, regardless of the amount of taxable income;

(5) Every estate or trust of which any beneficiary is a nonresident alien; except that subject to such conditions, limitations, and exceptions and under such regulations as may be prescribed by the Secretary, nonresident alien individuals subject to the tax imposed by section 871 and foreign corporations subject to the tax imposed by section 881 may be exempted from the requirement of making returns under this section;

(6) Every political organization (within the meaning of section 527(e)(1)), and every fund treated under section 527(g) as if it constituted a political organization, which has political organization taxable income (within the meaning of section 527(c)(1)) for the taxable year; and

(7) Every homeowners association (within the meaning of section 528(c)(1)) which has homeowners association taxable income (within the meaning of section 528(d)) for the taxable year.

(b) RETURNS MADE BY FIDUCIARIES AND RECEIVERS.—

(1) RETURNS OF DECEDENTS.—If an individual is deceased, the return of such individual required under subsection (a) shall be made by his executor, administrator, or other person charged with the property of such decedent.

(2) PERSONS UNDER A DISABILITY.—If an individual is unable to make a return required under subsection (a) or section 6015(a), the return of such individual shall be made by a duly authorized agent, his committee, guardian, fiduciary or other person charged with the care of the person or property of such individual. The preceding sentence shall not apply in the case of a receiver appointed by authority of law in possession of only a part of the property of an individual.

[§ 5009]—Continued

(3) **RECEIVERS, TRUSTEES AND ASSIGNEES FOR CORPORATIONS.**—In a case where a receiver, trustee in bankruptcy, or assignee, by order of a court of competent jurisdiction, by operation of law or otherwise, has possession of or holds title to all or substantially all the property or business of a corporation, whether or not such property or business is being operated, such receiver, trustee, or assignee shall make the return of income for such corporation in the same manner and form as corporations are required to make such returns.

(4) **RETURNS OF ESTATES AND TRUSTS.**—Returns of an estate or a trust shall be made by the fiduciary thereof.

(5) **JOINT FIDUCIARIES.**—Under such regulations as the Secretary may prescribe, a return made by one of two or more joint fiduciaries shall be sufficient compliance with the requirements of this section. A return made pursuant to this paragraph shall contain a statement that the fiduciary has sufficient knowledge of the affairs of the person for whom the return is made to enable him to make the return, and that the return is, to the best of his knowledge and belief, true and correct.

(c) **CERTAIN INCOME EARNED ABROAD OR FROM SALE OF RESIDENCE.**—For purposes of this section, gross income shall be computed without regard to the exclusion provided for in section 121 (relating to sale of residence by individual who has attained age 65) and without regard to the exclusion provided for in section 911 (relating to earned income from sources without the United States).

(d) **CONSOLIDATED RETURNS.**—

For provisions relating to consolidated returns by affiliated corporations, see chapter 6.

.01 Amended by P. L. 95-30, P. L. 94-455, P. L. 94-164, P. L. 94-12, P. L. 93-625, P. L. 93-443, P. L. 92-178, P. L. 91-172, P. L. 88-272 and P. L. 85-866. For details, see the Code Volumes.

Committee Report on P. L. 95-30

.011 *House bill.*—The House bill increases the income level for filing tax returns to \$3,150 for a single person and a head of household and to \$4,500 for a joint return. The changes apply to taxable years beginning after December 31, 1976.

Senate amendment.—Senate amendment numbered 34 changes the filing requirement to \$2,950 for a single person. Amendments 35 and 36 make the requirement \$3,950 for a head of household. Amendment 37 makes the requirement \$4,700 for a joint return. Senate amendment numbered 38 establishes that individuals with unearned income who are claimed as dependents on other individuals' tax returns (and who thus have an unused zero bracket amount) are subject to the special, stricter filing requirements only if their unearned income exceeds \$750, because only in that case can they possibly have any tax liability at income levels below the normal filing requirements. The effective date is the same as the House bill.

Conference agreement.—The conference agreement sets the filing requirement at \$2,950 for single persons and heads of households and \$4,700 for joint returns. These increased levels in the filing requirements conform to the increases in the standard deduction. The effective date is the same as the House bill and the Senate amendment.—*Conference Committee Report.*

¶ 5009 Code § 6012

.012 *Committee Report on P. L. 94-455* is at ¶ 1201.022.

.013 *Committee Report on P. L. 94-164* is at ¶ 1201.023.

.015 *Committee Report on P. L. 94-12* is at ¶ 1201.025.

Committee Report on P. L. 93-625

.02 * * * Under the bill every exempt political organization that has gross income (less deductions directly connected with the production of that income) in excess of \$100 is to file a tax return for the years in which it has such income. The bill also provides that political organizations with \$100 or less of such income need not file tax returns for years beginning after December 31, 1971, and before January 1, 1975. * * *—*Senate Finance Committee Report.*

Committee Report on P. L. 92-178

.03 *Senate Finance Committee.*—*Filing requirements (sec. 204 of the bill and sec. 6012(a) of the code):*

Under present law, the income level at which a tax return must be filed is designed to correspond to the tax-free income levels. The level for 1971 and 1972 is \$1,700 for a single taxpayer and \$2,300 for a married couple under age 65 (or a single person age 65 or over), \$2,900 for a married couple where only one spouse is age 65 or over, and \$3,500 where both spouses are age 65 or over. For 1973 and thereafter, these income levels are scheduled to be further increased to \$1,750, \$2,500, \$3,250 and \$4,000, respectively, to reflect the scheduled increase of the personal exemption to \$750 in that year.

© 1978, Commerce Clearing House, Inc.

Representative Duncan

DESIGN OF AN ALASKAN
GENERAL STOCK OWNERSHIP PLAN
VOLUME I

A REPORT TO THE ALASKA STATE LEGISLATURE

PRINCIPAL RESEARCHERS:

LOUIS O. KELSO

JOHN A. MISKIMEN

NORMA R. JOHNSON

KELSO & CO., INCORPORATED
SAN FRANCISCO, CALIFORNIA

FEBRUARY 15, 1979

STATE OF ALASKA

THE LEGISLATURE

BUDGET AND AUDIT COMMITTEE

February 21, 1979

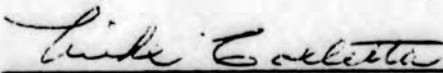
FINANCE DIVISION
POUCH WF-STATE CAPITOL
JUNEAU, ALASKA 99811
PHONE: (907) 465-3795

All Members
Alaska State Legislature
Pouch V
Juneau, Alaska 99811

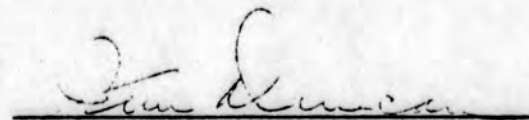
Pursuant to an appropriation to the Legislative Finance Division contained in Chapter 163, SLA 1978, the Budget and Audit Committee entered into a contract with Kelso & Co., Inc. of San Francisco to provide a legal and financial design of a corporation which would (1) be owned by all Alaskan citizens; (2) invest in the development of Alaska's resources and its economy; and (3) do so with special tax status, in furtherance of the first two goals.

Enclosed is Volume I of Kelso & Co.'s report which provides an analysis of the salient features of such a corporation, now designated as General Stock Ownership Corporations (GSOC's) under Subchapter "U" of the Internal Revenue Code. Volume I contains a summary of the report, proposed Alaska legislation to establish a GSOC, recently enacted amendments to the Internal Revenue Code which provide special tax treatment for such corporations, and proposed articles of incorporation and by-laws.

Volume II of Kelso & Co.'s report is available from the Legislative Finance Division. Volume II is an appendix which contains legal memoranda regarding (1) federal constitutional issues and (2) the application of federal securities laws to GSOC's. Also contained in Volume II are other sections of the Internal Revenue Code referenced in Subchapter "U".



Senator Mike Colletta
Project Director



Representative Jim Duncan
Project Director

TABLE OF CONTENTS

FOREWORD	1
SUMMARY	2
ECONOMIC REASONING SUPPORTING THE BILL	15
STOCK AND FINANCING MATTERS	27
PROPOSED BILL	42
PROPOSED BILL ANNOTATED	52
ANALYSIS RECOMMENDED TO ACCOMPANY AGSOC BILL	69
FEDERAL ENABLING LAW	81
FOOTNOTES TO FEDERAL ENABLING LAW	89
PROPOSED ARTICLES OF INCORPORATION	102
PROPOSED BY-LAWS	109
DIAGRAM	130

FOREWORD

This volume contains the salient features of the design for an Alaskan General Stock Ownership Plan.

Included are the basic documents needed for legislative review. The separate appendix report (Volume II) covering the subject in greater detail is available from the Legislative Finance Division.

SUMMARY OF REPORT

The Nature of This Report

This report has been prepared by Kelso & Co., Incorporated pursuant to its contract dated September 1, 1978, with the State of Alaska, Legislative Finance Division. That contract provided that Kelso & Co., Incorporated (the "Contractor") will provide to the Legislative Finance Division and the Alaska State Legislature, on or before February 1, 1979, a design study for a General Stock Ownership Plan in the manner described in Contractor's proposal to the State of Alaska dated July 10, 1978, as amended by modifications indicated on an exhibit attached to the contract. The delivery date for the completed report was subsequently extended by Amendment I to February 15, 1979.

Broadly speaking, Contractor's proposal to the State of Alaska contemplated the development of a legal and financial design of a corporation to acquire and finance investments involved in the economic development of Alaska in such manner as to build broad capital ownership into all "residents" or "citizens" of the State of Alaska as these may be, from time to time, defined by the Legislature. Absent correlative legislation at the Congressional level, which did not exist at the time the contract was entered into, it was anticipated that a corporate entity could be designed of such nature that it could, during an initial period of years while major payments on the purchase price or construction price of its assets were being amortized, and prior to its distribution of dividend income to its shareholders, enjoy the character of an agency of the State of Alaska.

Such an agency would be entitled to the immunity of the sovereign State of Alaska from Federal taxation. It would in the most specific way be devoted to promoting the general welfare of the people of Alaska. Nevertheless, it was contemplated that efforts would be made, beginning immediately after the activation of such a corporate entity, to seek appropriate Federal legislation giving it and its shareholders tax exemption under Federal law so long as its income is being used to amortize the acquisition cost of assets, and to thereafter function as a private corporation broadly owned by its Alaskan shareholders.

As it happened, however, Senator Mike Gravel of Alaska, with our cooperation, drew a Federal General Stock Ownership Corporation Bill that would take, if enacted, the long first step towards making GSOCs readily feasible. Against incalculable odds, Senator Gravel managed to get Congress to adopt the law, and on November 6, 1978, the President signed into law the Revenue Act of 1978, Title VI of which authorizes the establishment of General Stock Ownership Corporations, giving immunity from Federal corporate income taxes to corporations specially chartered by a State Legislature and containing the requisite characteristics set forth in the Federal law. Thus the ultimate goal of the contract was in part accomplished: General Stock Ownership Corporations (GSOCs) organized after December 31, 1978, and before January 1, 1984, were granted permanent immunity from Federal corporate income tax. The new Federal law, however, has one shortcoming: The corporate taxes that would otherwise be collectible from the corporation itself are to be borne, pro rata, by its shareholders, even before amortization of the purchase

price it pays for productive assets has been amortized.

In terms of practical meaning, this would suggest that Alaska General Stock Ownership Corporation (AGSOC) should initially invest in income producing assets of such nature that the combined investment tax credit, depreciation and interest costs would eliminate any tax on shareholders in the early years of operation and quite possibly permit the payment of dividends. Such dividends would be taxed as ordinary income in the particular stockholder's tax bracket.

Discussion with the Legislative Finance Division yielded a mutual understanding that Kelso & Co.'s contract should be interpreted as calling for the design of a General Stock Ownership Corporation that would take advantage of the pioneering new Federal law, and this report reflects that accommodation. Implicit in favorable action by the Alaskan Legislature in the adoption of AGSOC as herein proposed, or any variation thereof, is the assumption that efforts would soon thereafter be initiated to persuade Congress to perfect the one shortcoming in Title VI of the Revenue Act of 1978 to ultimately extend the immunity from Federal income taxation to GSOC shareholders to the extent of income applied to purchase productive capital assets for the corporation. If the assets initially purchased by AGSOC are characterized by high depreciation and investment credit deductions, and if Congress is ultimately persuaded to make such alteration, the end result would be better than the design contemplated by the literal terms of the contract because of the permanent immunity to corporate Federal income taxes, the limits on concentration of ownership, and the requirement of a high payout of

earnings as dividends.

Recommendations of the Report Concerning the Operations of AGSOC

The Federal law makes the initially issued stock non-transferable by the shareholders for a period of five years following initial issuance except in the case of death of a shareholder or upon the shareholder's ceasing to be a "qualified resident" of the incorporating state. In addition, legislation proposed in this report restricts transfers of shares until the shareholder reaches the age of majority as provided for by Alaska law and does not permit any assignment, pledge, mortgage or other encumbrance of shares for five years. The Federal law does not require that a shareholder leaving the state sell, transfer or forfeit his stock, and the design proposed in this report permits such emigrating shareholder to take his stock with him in order to continue to enjoy its income in the future. However, he would not be able to sell, or otherwise transfer, his share to any person who is not, at the time of such transfer, a qualified resident of the State of Alaska. The object both of the Federal GSOC law and of the enabling legislation proposed herein is to broaden the ownership of productive capital by individual residents. The whole tenor of both the Federal law and the enabling legislation contemplated herein is to inhibit concentration of the ownership of AGSOC shares.

Marketability and Sale Value of AGSOC Shares

Since AGSOC shares can only be owned by individuals, and no individual may acquire more than ten shares of the corpora-

tion's stock, a public market in the shares in the usual sense of public stock markets in the United States today will presumably never arise. Public stock markets are in essence speculator markets. For the most part, buyers buy to sell at higher prices, and sellers sell with a view to purchasing something else that will rise in value so that it can be sold "for profit". This does not mean, however, that limited selling and buying of AGSOC shares as permitted in the event of death of a shareholder, or emigration of a shareholder from the state, cannot occur during the period of the five year non-transferability restriction imposed by Federal law. Undoubtedly, in the event of a desire to sell such shares, either a direct qualified resident buyer would be found by the seller, or the shares would be temporarily transferred into a general escrow account either in the trust and escrow division of AGSOC, or in any duly appointed outside transfer and escrow agent, until the seller's representatives, or a qualified stock broker, could find a buyer. In such case, the broker would be precisely that, bringing seller and buyer together and charging a fee, with the transfer being made directly from the individual seller to the individual buyer. This proposed design recommends that such sales during the initial five year restriction period, in the case of emigrants from the state, be at the then current book value. During this five year period, the corporation shall have the right of first refusal to purchase such shares if it desires to do so.

After the expiration of the five year period of restricted alienability, or the attaining of majority age by the shareholder, whichever is later, a strictly investor market for AGSOC

shares will undoubtedly arise. The report recommends that during the initial five year period, the price obtainable upon any sale of AGSOC stock, where the reason for the sale is emigration, be pegged at book value, which could significantly discourage such sales. Sales of AGSOC stock by estates of decedents would be determined by negotiations of the buyer and seller. After all, the object of AGSOC is to build the ownership of income producing capital into Alaskan residents. GSOCs, by Federal law, confer a high degree of private property upon their shareholders inasmuch as they will effectively be required to pay out 90% of their net income in dividends each year. This gives the "wages of capital" represented by AGSOC stock something of the character of private property enjoyed by the wages of labor: They are paid periodically and dependably, if earned. Kelso & Co. recommends a far-ranging educational and communications program between AGSOC and its shareholders to encourage them to not sell their AGSOC shares, and to look to them as a source of income.

Kelso & Co. also recommends that quarterly valuations of AGSOC shares be made and that this information be made available, as speedily as possible after each valuation report, to all shareholders. Presumably, therefore, in a free investor market, the expert appraisal of independent professional appraisers will influence the price at which shares of AGSOC stock are traded. The investor interest of buyers should dominate such a market and it should be relatively free of speculator interest.

The Governance of AGSOC

As a private business corporation, AGSOC, it is recommended, would have a management made up of the most highly trained professionals available and a Board of Directors of which a majority would be Alaska residents. Because it would be owned initially by all residents of Alaska, it could properly enjoy financial support of the State or its agencies in a number of ways. It could receive, if authorized by the Legislature, a loan or guaranty of a loan of start-up funds to enable it to organize, hire professional management, pay directors' fees, negotiate for the acquisition or construction of productive assets, and negotiate financing. Such financing might be made, if properly authorized, by the State, or receive State guaranty or guaranty by a State agency.

There is no limit on the number or amount of assets which AGSOC could acquire under the recommendations herein set forth. While, with the passage of time, there will be a growing number of Alaska residents who did not meet the eligibility test at the time of the original issue of AGSOC stock, these could be taken in as shareholders through the issuance of additional stock.

Recommended drafts of Articles, By-Laws, and general recommendations concerning stock issue and transfer procedures, dividend procedures, the applicability of Federal securities laws, and the Federal constitutional provisions affecting Alaska GSOC are also included in the report. The proposed Bill would eliminate regulation under State securities law as unnecessary. State constitutional questions have been referred to the Alaska Attorney General's office for review.

State Partial Guaranty of AGSOC's Project Financing

Project financing for AGSOC, whether for the acquisition or development and construction of productive capital assets, will evolve from a request from AGSOC to the State of Alaska. The AGSOC Bill provides that if the Legislature determines that the partial financing or the guaranty of financing for an AGSOC project is necessary or desirable, a special election (if a general election is not scheduled to be held within sixty days) will be scheduled for voter approval.

The Future of AGSOC

Certainly great care in the establishment of AGSOC is warranted. At the same time, it needs to be recognized that the old techniques of business finance, by which the already rich are constantly made still richer, are deeply entrenched, and will tacitly insist upon the divine right of the rich to get richer, and the nonexistent right of the poor to get richer. So the courageous, deliberate and speedy efforts of all involved in this attempt to change the course of American economic history, and eventually world economic history, should remain uppermost in the minds of all concerned. The ownership of productive capital by a tiny minority of 5% of the consumer units of the population and the non-ownership of productive capital by the 95% of such consumer units, combined with their present practical inability to attain such ownership, is the weakness that insures the collapse

either of political freedom, or of economic stability in all market economies of the world. The proposal here under discussion is one that involves an attack on the cause of poverty, not another feeble stab at the symptoms or effects of poverty.

General Explanation of the General Stock Ownership Provisions of the Revenue Act of 1978

The Revenue Act of 1978 provides income tax advantages to specially chartered corporations which are broadly owned. These companies, known as General Stock Ownership Corporations, will be exempt from the corporate income tax which may be as high as 48%. Through this legislation Congress hopes to encourage broadened ownership of capital and explore the viability of capital income as a substitute for transfer payments. General Stock Ownership Corporations are to be privately owned and managed, but to insure that all of a state's citizens have an opportunity to become shareholders, Federal law requires that each corporation be separately authorized by the State Legislature or by referendum prior to January 1, 1984. For purposes of identification, we have in this report called the corporation to be authorized in Alaska "Alaska General Stock Ownership Corporation" or "AGSOC" for short.

Charter Provisions

Special charter provisions are required for a company to qualify as a GSOC under the new Federal law. To assure broad distribution of GSOC stock, the charter must provide for a single class of stock distributed to each "qualified resident" who does

not elect against receiving the stock within one year of issuance. Corporations, trusts, partnerships and other organizations are not eligible to become shareholders -- only individual persons. Transfers of the initially issued stock must be restricted and may not occur before the earliest of (1) the date five years from the date of issue, (2) death of the shareholder, or (3) the shareholder's emigration from Alaska. In addition, no shareholder may own or acquire more than ten shares of GSOC stock.

GSOC Investments

GSOC investments are subject to only two limitations. A GSOC may not own more than 20% of the stock in another corporation and it may not use the power of condemnation to acquire a business investment from an unwilling seller. The Federal law does not otherwise limit the nature of a GSOC's business nor the extent of its operations within the state of its incorporation. However, from a tax standpoint, investment by a GSOC in stock of other corporations defeats the special tax advantages offered GSOCs because the income of the subsidiary corporation, unlike the income of the GSOC, is subject to Federal corporate income tax.

Taxation of GSOC

If AGSOC meets the requirements of Federal law, it may elect to be taxed as a General Stock Ownership Corporation. This election may not be revoked without consent of the Secretary of the Treasury. The election exempts the corporation from Federal income taxes. Instead, the shareholders report their proportionate

share of AGSOC's income on their personal tax returns.

Income (or loss) is computed by the GSOC in the same manner as other corporations, except that the GSOC is not eligible for the dividend received deduction nor any tax credits. Credit adjustments by the Internal Revenue Service are treated as income or deductions of the corporation in the year during which they are finally agreed upon.

The GSOC receives special treatment with respect to net losses, should any occur, and investment tax credits. Net losses are retained at the corporate level and may be carried over as an offset to future income for ten years. Investment tax credits are treated in a comparable manner to income and prorated to the shareholders as a credit on an annual basis. Net recapture of investment tax credit will be treated as prorated additional tax liability to shareholders.

For tax purposes, the GSOC is required to use an October 31st fiscal year end and, in addition to filing an information return with the IRS on corporate operations, it must provide a statement to each shareholder of his GSOC income, withholdings and tax credits for the year.

Taxation of Shareholders

Shareholders of the GSOC report on their personal income tax returns their share of GSOC income for the GSOC year ending within the taxable year for which they are filing a return. This income will be treated as "ordinary income" for tax purposes and will not be eligible for the \$100.00 dividend exclusion or the maximum tax on earned income. If a shareholder disposes of

his stock during the year, the income of the GSOC will be prorated to him on a daily basis. The shareholder will increase the basis in his stock for purposes of determining gain on a sale by the amount of GSOC income attributed to him and reduced by the amount of cash distributions received by him from the GSOC.

Since the shareholders of the corporation report their pro rata share of corporate income on their personal returns and are taxed on that amount, distributions of cash from the corporation are generally tax free. Distributions greater than the amount of prorated taxable income which the shareholder reported will first be treated as nontaxable to the extent of the shareholder's basis in his stock and then the balance will be taxed at capital gains rates.

In order to assure that shareholders have sufficient cash on hand to pay taxes generated by their pro rata share of GSOC taxable income, the GSOC is required to distribute 90% of its taxable income by January 31st each year. If the corporation fails to comply with this requirement, the corporation itself will be subject to a tax equal to 20% of the difference between what should have been distributed and what actually was distributed.

To assure payment of taxes by shareholders, the GSOC is required to withhold and pay to the Treasury 25% of each distribution. This withheld amount is treated just like the payroll withholding on salary checks. The full amount withheld is a dollar for dollar credit against income taxes due at the end of the year. It is simply a prepayment of taxes to assure that a shareholder does not find himself cash short at tax time, having

failed to set aside an amount from his GSOC distributions to cover his taxes. Individuals who are not required to pay taxes (because of insufficient or tax exempt income) may avoid the withholding on their GSOC distributions.

THE ECONOMIC REASONING SUPPORTING ADOPTION BY THE LEGISLATURE
OF THE STATE OF ALASKA OF ENABLING LEGISLATION DIRECTING THE
ESTABLISHMENT OF A GENERAL STOCK OWNERSHIP CORPORATION FOR THE
PURPOSE OF FACILITATING THE BUILDING OF CAPITAL OWNERSHIP INTO
EVERY ALASKAN CITIZEN IN THE COURSE OF DEVELOPMENT OF THE
NATURAL RESOURCES OF ALASKA

Everywhere the realization is growing that something basic in modern society is radically wrong; that in the words of Pope Paul's economic encyclical of a decade or so ago, "The world is sick." This assessment applied to the U.S. economy by former Chairman of the Federal Reserve Board who, before leaving that office, observed, "The old rules do not seem to work today." The most obvious symptom of this sickness is the accelerating tendency of the rich to grow richer, and of the poor to remain poor. But while the evidence of defective social structure everywhere stands out, it does not readily lead its victims to identify the responsible institutions. The very familiarity of institutions makes them invisible; the efforts of critics and reformers are invariably deflected to what they can see -- symptoms and effects. This is what prompted Thoreau to observe: "There are a thousand hacking at the branches of evil to one who is striking at the root."

The proposal of Kelso & Co., Incorporated (Kelso & Co.) involves an application of the theory of Universal Capitalism or Two-Factor Economics, as it is called with equal propriety, to the development of a financial and economic design for a General Stock Ownership Corporation (GSOC) for the State of Alaska, showing the efficiency with which a properly designed GSOC for

the State of Alaska can build general affluence into all Alaskan citizens over a reasonably brief span of time. It will lay bare the false concepts and institutions responsible for the relentless concentration of wealth in an industrial society; it will show how they work, how they malfunction in the economy, and how many of the economic evils of contemporary life are directly and indirectly related to these false concepts and deficient institutions.

Endemic poverty in a world which has all the physical, managerial and engineering prerequisites for producing general affluence is only one symptom of the wealth concentration syndrome. Less obvious, but just as causally connected, are misuse of technology, resource waste, despoliation of the environment, declining personal freedom, increasing lawlessness and civil disorder, the waning of liberal education, the civil rights impasse, the youth revolt, urban concentration, rising public and private debt, public loss of confidence in leadership and the seemingly irreversible advance toward a totalitarian society.

We believe that our study, if accepted and underwritten by the State of Alaska, will demonstrate that the specific mechanisms that concentrate wealth are correctable through the detailed methods we have outlined for achieving the correction.

It is appropriate here to ask why society has so long tolerated, and indeed remained officially oblivious to, institutional defects that were brutally apparent even in the earliest years of the Industrial Revolution. Why have we ignored the solid facts and so desperately clung to the straws of illusion? Why, for example, are we still pretending to believe that

labor's productivity is rising? That technology creates toil? That we have achieved, within about five percent, legitimate "full employment" in the United States today, or in any other industrial economy, or that full employment is a possible, or even an adequate economic goal?

The explanation for such massive intellectual dishonesty, we believe, is to be found in a simple but ancient misconception about how wealth is produced in the real physical world. Transmitted through generations of economists like a defective gene, the misconception has kept economics from developing into a rational science -- very much as the doctrine of spontaneous generation kept medicine from developing into a science until Pasteur's experimental researches crumbled organized resistance to the germ theory.

What the doctrine of spontaneous generation (the "hypothetical" production of living things from inanimate matter) was to 19th Century medicine, the labor theory of value and its offspring, the idea of full employment as an adequate economic goal and a pragmatic solution to the problem of income distribution, are to 20th Century economics. The notion that labor is the only, or chief, factor of production is the keystone of the conventional economic wisdom. Laissez-faire, Marxian Socialist and Keynesian theoreticians all treat the physical things that are factually the chief producers of wealth in an industrial economy -- tools, machines, structures and increasingly productive land -- as if they were extensions of the worker himself (the hammer, an extension of the hand; the wheel, of the foot; the computer, of the brain), or as if they were magic helpers that

miraculously increased labor's productivity, or as if they were natural resources functioning gratuitously like the sun to raise labor productivity. So long as we indulge this myth, we need not concern ourselves with who owns what capital in the economy, nor with the fact that its ownership is unbelievably concentrated.

In the pre-industrial past, where labor was the principal factor of production and nature had endowed every individual with the power to labor, the labor theory of value was at least half a truth; the events that would expose the other, and most important, half had not yet occurred. But with the invention of the spinning jenny, the Newcomen engine, and the power loom, and hundreds of other non-human producers, the non-human factor of production moved explosively into the forefront and began its rapid conquest of the domain of production of goods and services. Unnoticed and uncomprehended, reality swiftly outgrew one-factor economic thought and the economic institutions erected upon it.

Technology was the momentum behind the Industrial Revolution, but pre-industrial laborcentric concepts were not able to provide a rational philosophy of technology; hence, enlightened, realistic human goals logically consistent with the tendency of technology were impossible to formulate. In the humanistic medieval world, toil had been only a means. Now in an industrial age where technology is eliminating toil, means has become elevated into end. Instead of toiling to live, man now finds himself obliged to live to toil. Under one-factor economic thought, technology itself must function to create toil, and the enormous evidence of the absurdity of this contention must be ignored, falsified,

or rationalized away.

In his great quarrel with the medical traditionalists who upheld the doctrine of spontaneous generation, Louis Pasteur wrote that "the characteristic of erroneous theories is the impossibility of ever foreseeing new facts; whenever such a fact is discovered, those theories have to be grafted with further hypotheses in order to account for them."

For the past forty-eight years, the public economic policies of the Western industrial nations, and the public philosophy advanced to justify them, have borne witness to the accuracy of Pasteur's observation, and demonstrated the theoretical inadequacy of one-factor economic thought. As expedients are grafted onto expedients, the official explanations of reality become more and more contrived; finally, the bonds of credulity are reached and overreached; the practitioners of the conventional wisdom are obliged to side-step reason entirely and resort to open intellectual fraud. In the United States, where advancing technology has created the widest gap between reality as it is and reality as it is interpreted through defective one-factor theories, the Federal Government spends an incalculable amount of man-hours and money to persuade an increasingly skeptical and suspicious public that policies and goals which are irrational, dangerous and destructive are rational, effective and sound.

When an intellectually false theory persists against all evidence, it must be drawing sustenance from a live, powerful, non-rational source. We believe that the viability of the labor theory of value, the exclusive full employment goal and the

Procrustean institutions built upon them can be traced to the Puritan ethic -- the idea that "if any would not work, neither should he eat." In essence, the Puritan ethic is a production ethic. Its meaning is that human beings ought to produce the economic equivalent of the wealth they wish to consume. This injunction is philosophically, economically, and morally sound. Experience shows that men hate being objects of charity just as much as they hate being the victims of parasitism; it is economically motivating both for people to produce the wealth they consume, and to receive the wealth they produce. In a pre-industrial world, where labor was the only active factor of production, it was natural that production was interpreted as synonymous with toil. The Marxian ethic is based on the identical assumption; it and the Puritan ethic are indistinguishable.

But what was practical common sense and moralistically sound in a pre-industrial economy becomes nonsense in an industrial one, not because the principle has changed, but because the methods and character of production have changed. The rhetorical statement of the rationale of the Puritan ethic for a one-factor economy simply will not suffice in a two-factor economy; it does not accommodate itself to the changed facts. Indeed, a principle of unquestioned justice becomes a source of woeful injustice. In attempting to impose a one-factor ethic in a two-factor world, older generations are unconsciously seeking to make new generations suffer the same hardships that pre-industrial life forced on them and their predecessors. The poet Robert Frost understood the intent, if not the mechanics, of conventional economic policies that uncomprehendingly exort toil and self-denial in an age

where technology has shifted most of the burden of production onto machines, and where mass consumption is essential to support the mass production which is the point of an industrial economy. Thus, a one-factor interpretation of the Puritan ethic threatens the very source of general affluence.

Institutional renewal and reform, we believe, must begin with the restatement of the Puritan ethic. If its moral essence is not that men and women should toil for toil's sake, but that they should produce for production's sake, the question becomes: How are people to be economically productive in an age when wealth is chiefly produced by things? An updated Puritan ethic would hold that individuals produce just as legitimately through their ownership of productive things as they do through their personal toil (i.e., through their privately and personally owned labor power). In the economic sense, the owner of a significant equity interest in an oil pipeline, or gas pipeline, or petrochemical production facilities is immeasurably more productive than the most skilled and industrious blacksmith in a pre-industrial village. Modern institutions must recognize this physical fact, and modern ethical and philosophical concepts must deal with it. Our reverence for toil is purely historical and hypothetical -- what sane man, in real life, seeks to toil for goods and services of subsistence that can be better produced with machines and processes? Much closer to reality is the historical fact that human slavery partially originated in man's revulsion for toil, and that moral sentiment was incapable of abolishing slavery until technology provided us with machines to take the place of the slave. Also much closer to reality than our pious

affection for "full employment" is the historical use of hard labor as punishment for crime.

Until we understand the modern implications of a pre-industrial interpretation of the Puritan ethic, we shall not be able to design a rational economic system for a two-factor world. We shall continue to misuse, misdirect and waste technology; to concentrate its ownership into those who already own too much of it, and to deny the just requirements of those who need to own it but who do not have any legitimate means of acquiring it; to squander resources, talent and human lives; to throw away man's opportunity for peaceful, affluent leisure in our political and institutional attempts -- futile, absurd and monstrously hypocritical -- to recreate the pre-industrial state of toil that management, engineering and technology constantly seek to destroy.

Not toil, but leisure; not the pinnacle affluence which has characterized all Western industrial societies to date, but general affluence -- these clearly must be the goals of a rational and free industrial economy. Moreover, once recognized and acknowledged, they are goals that are easily achievable, as, we believe, the Alaska General Stock Ownership Corporation feasibility study shows.

Since affluence is not the product of the human factor, but the non-human factor, it is necessary to structure the economy so that a growing proportion of families, and eventually all families, produce an expanding proportion of their incomes through their private ownership of capital stock representing tools, machines, structures, facilities and productive land that

produce wealth, and (under the irrefutable Say's Law) simultaneously generate exactly enough purchasing power to enable the producers to consume it. For although the "boom-bust" cycles characteristic of industrial economies are caused by insufficient purchasing power (this is the defect Keynesian redistribution purports to correct), the physical fact is that every production cost in a market economy is the income of some participant in production. Thus, there could be no physical shortage of purchasing power in an economy where every household made a viable productive input and received the income its input produced.

The techniques involved in the General Stock Ownership Plan are techniques for connecting every household in the economy with the productive power of capital instruments, through financing methods that make stockholders of all Alaskan residents, such as the Alaska General Stock Ownership Corporation. Today, under financing techniques inherited from the pre-industrial past, individual ownership of the non-human factor of production is concentrated in no more than the top five percent of U.S. families. Conventional business finance operates to shrink the proprietary base even further. Financing methods, such as the Employee Stock Ownership Plan (ESOP), the Consumer Stock Ownership Plan (CSOP), and the General Stock Ownership Plan (GSOP), developed by Kelso & Co., Incorporated, finance capital ownership for individuals at the same time they finance corporate expansion or changes in the ownership of capital assets. Thus financing techniques employing two-factor economic principles create new capital owners simultaneously with new productive power, and can

create broader individual ownership in connection with transfers of ownership from one entity to another.

New productive power is an absolute requisite for general affluence, simply because -- not withstanding the assertions of politicians and economists to the contrary -- no economy in the world today is physically capable of providing an affluent stream of goods and services to all the people in it, although the potential physical capacity to do so through accelerated growth of new capital formation and broad ownership of capital is present in most of the world's economies. The "affluent economy" of the United States, we flatly assert, is illusory. But the United States, Canada and most of the Western economies have or have access to the physical ingredients necessary to produce general affluence within a space of two decades or so, and so does the State of Alaska. The limitations that bind them now are not physical, but institutional. What is lacking is an economic system built on the rationale of two-factor concepts that would build the economic power of the people to consume simultaneously with building the industrial power of their economies to produce and distribute a level of goods and services equivalent to general affluence.

In today's illogical economies, the corporate sector puts new productive power into place by means that channel the income it will produce to the already affluent few who perforce must invest it, rather than to the many, who perforce would spend it on much-needed consumer goods and services, and in so doing, fully close the production-consumption circuit. Thus, consumption is increasingly achieved today through coercive re-

distribution by government and organized power blocs in the private sector (with the blessing of government) and through that delusive doctrine, full employment. Since the corporate sector produces 87% of non-agricultural, non-governmental goods and services, it also generates 87% of the economy's purchasing power. In not structuring the invisible sector of corporate enterprise so that a growing number of families are connected with the productive power of capital, management is neglecting one-half of its prime responsibility and opportunities. In so doing, it is spearheading the destruction of private property in the American economy, and hastening the totalitarian society in which the corporation will serve as the welfare arm of the state. The Alaska General Stock Ownership Corporation can correct this for Alaskans, beginning in a very short time.

The proposed GSOP for Alaska should appeal to the three executive powers of modern society -- business, labor and government -- to begin now to plan an economy in which every family has the opportunity to produce wealth in a way compatible with a technologically advanced economy: through employment (to the extent the legitimate demand for employment has not been technologically eliminated), and through its private ownership of the non-human factor of production. This is what the techniques of two-factor financing are designed to accomplish. Through updating the Puritan ethic to conform to the technological facts of production, we would be renewing our institutions in the spirit of the American ideal, rather than seeking, as do the proponents of the Negative Income Tax, the Guaranteed Annual Income, and similar schemes, to repeal the underlying ethical

law. For American political institutions assume a citizenry which is economically independent and productive. The Founding Fathers knew that freedom is inseparable from property. On that premise they designed political institutions that were an inspiration to all mankind.

The State of Alaska has before it the opportunity to lead our nation and the world through economic change that would underpin our political heritage with economic institutions designed to provide effective economic opportunity to the many in an industrialized world -- and to do it before time and hope run out.

STOCK AND FINANCING MATTERS

MARKET ASPECTS

We recommend that AGSOC be a private company as differentiated from a publicly-traded security, at least for its first five years of existence. Even though AGSOC will have some 400,000 shareholders, there are a number of considerations which suggest that private company status would be preferable to that of a publicly-traded security. Firstly, the Federal GSOC legislation places considerable restrictions on the transferability of shares during the first five years. Secondly, the requirement of the Federal legislation which limits shareholders to individuals will prohibit the ownership of shares by broker-dealers required for over-the-counter type trading transactions. Third, the unit of trading in security markets generally is 100 shares, yet in the case of AGSOC only one share will be issued to each eligible shareholder. While this is not an insurmountable obstacle, it presents unique problems if a public market were to be established. Fourth, the concept of AGSOC is as a long-term investment, rather than a short-term or transitory type of commitment. Fifth, ownership of shares is restricted to residents of Alaska, limiting the ability to develop a competitive and realistic market for the shares of AGSOC.

Section 6 of the AGSOC Act provides for the company to have a right of first refusal to purchase any shares of stock

offered to be transferred by the holder. Thus, AGSOC itself could probably provide an adequate market for those shares that must be sold. We further recommend that the price paid for those shares by AGSOC during the initial five-year restricted trading period be set at the tangible book value per share as of the most recent quarterly reporting date.

The acquisition by AGSOC of these limited number of shares each year provides a modest supply of shares which can be used to allow new residents to Alaska to participate in the ownership of AGSOC. The Board of Directors of AGSOC could set some reasonable waiting period before new residents would be eligible to apply for purchase of the shares acquired by the company in this manner. A waiting list could be established based on the date of application to AGSOC by the new residents. By this procedure those who had completed the necessary length of residence during the initial five-year period following original issue, would be able to purchase, at book value, the shares that are acquired by AGSOC from time to time. While constitutional issues with regard to this procedure will have to be carefully reviewed by the Attorney General's office, we believe that this procedure would offer the most fair solution to the problem of the new resident versus the resident who qualified as of January 1, 1979.

Over the longer term, the management of AGSOC and the Board of Directors will have to carefully monitor the market aspects of AGSOC stock. Economic and stock market conditions change as well as State and Federal law so that what is appropriate today may of necessity be changed in future years. There are several possible ways to accommodate the problem of the otherwise "qualified resident" who becomes such after the specific date fixed by the AGSOC law and as required by the Federal GSOC law. One approach would be, after a substantial number of residents who were not originally eligible has arisen, to issue a new class of stock, representing a newly-financed investment, and issuing the shares to all then-qualified residents. This would require modifications in the State and Federal GSOC laws which now permit only one class of stock.

STOCK TRANSFER FUNCTION

The essentials for the transfer of stock are (1) a change in ownership; (2) proper endorsement, either on the certificate itself or by a separate instrument; (3) surrender of the certificate for cancellation; and (4) issuance of a new certificate to the transferee.

A stock certificate assigned in blank may be passed from transferor to transferee any number of times without change of the assignment. If the name of the transferee is inserted, the certificate must be surrendered and a new certificate issued in the name of the transferee before it may again be transferred. If the certificate is delivered without endorsement, but is accompanied by an assignment, it has the same effect as an endorsement upon the certificate itself and must be surrendered for the issuance of a new certificate in the name of the transferee.

A corporation is responsible for any fraud or error committed by its officers or agents in the issuance or transferring of its stock. To prevent the possibility of liability or forged assignment, the corporate secretary or transfer agent should demand a guarantee of the signature of the transferor. Proof of the authority should be demanded when the assignment is made by an executor, trustee, and the like.

The management of AGSOC must decide whether to employ a transfer agent or provide the stock transfer function internally. If a corporation has a transfer agent, usually the issuance, transfer, and the detail of keeping a stock ledger are handled by him. The extent of the transfer agent's work and liability depends upon the agreement between him and the corporation. Generally, a transfer agent is authorized to sign and impress the corporate seal on the corporation's stock certificates issued by him and to maintain the stock books and stockholders ledger containing the names and addresses of all stockholders. The secretary should receive a daily record from the transfer agent of all stock transfers made by him.

If, however, the company does not employ a transfer agent, the secretary is responsible for the proper issuance and transfer of corporate stock and maintenance of proper stock books, ledgers and records.

A registrar maintains a record of all stock certificates issued and surrendered showing the name of the transferor and transferee. He maintains a record to assure that there is no overissue of the securities. He passes upon the correctness of all certificates issued. If correctly issued, he countersigns them. The national stock exchanges require that securities listed by them be issued through a transfer

agent and registrar. This requirement is not applicable to AGSOC as no listing is currently contemplated. Article VI, Section 6.06, of the proposed AGSOC By-Laws prohibits the company from acting both as transfer agent and as registrar for its own shares.

It is our recommendation that AGSOC's corporate secretary assume the duties of stock transfer and dividend disbursement and employ an independent outside registrar. Our studies indicate that this decision would reduce costs, improve control and assure conformance with applicable laws and regulations.

PROJECT FINANCING

Section 11 of the AGSOC Act states that "at such time as AGSOC comes forward with a request for project financing that the Governor shall call a special session of the legislature to consider such request." In the event that the Legislature determines that the financing or the guaranty of the financing for an AGSOC project is necessary or desirable, the Legislature would then call a special election for voting on the approval of the extension of the credit or the guarantying of credit to AGSOC by the State of Alaska.

Prior to going to the Legislature with a request for financing, the management of AGSOC will have to accomplish many preparatory investigations and studies. Although each management function will be important to the overall success of AGSOC, buying a going business is probably the most important decision the company has to make. The objective of this section is to provide guidance by setting forth the elements of a buy decision: investigation, valuation, and financing proposals for the Legislature.

Each situation is obviously unique, but experience has shown that typically what hindsight concluded were purchase mistakes were not the result of poor judgment based on known facts. Most mistakes result, instead, from elements of the transaction that were not known at the time the decision was made.

1. INVESTIGATION

Much information is required prior to undertaking a business acquisition. This information can be gathered by trained people in the AGSOC organization, or with the assistance of independent accountants, lawyers, marketing analysts, management consultants or others who can be called on or combined to carry out an appropriate investigation. Set forth in the appendix is an outline to assist in carrying out an acquisition investigation. Obviously it is an assist only, for there can be no substitute for an experienced investigator performing the work.

2. VALUATION

The "value" of a business is normally meant as its potential for earning income, not the present replacement cost, that is, appraisal value of the assets.

Generally, the basis for determining the asking or offering price of a business whose present worth is dependent largely on a continuance of the business -- as against liquidation of assets -- is the present value of the potential for future earnings. The primary problems of valuation, then, are (1) the question of estimating the future earnings of the business and (2) the multiplier to apply to the estimate (price/earnings ratio).

FUTURE EARNINGS

Consider first the question of estimating future earnings:

1. Are past earnings a guide to earnings potential?
 - a) How many year's past earnings should be used in the computation?
 - b) Should average earnings for the past period be used or should earnings be weighted?
2. Alternatively, if past earnings are not a guide because anticipated changes will, it is believed, render historical earnings meaningless, an item-by-item sales and costs business forecast is called for.
3. In either (1) or (2) above, adjustments should be made for any cost savings as a result of the acquisition by AGSOC:
 - a) In personnel.
 - b) In elimination of facilities.

PRICE/EARNINGS RATIO

Having established potential earnings, what price should be paid for those earnings? There is considerable guidance in this area which must be searched out and evaluated.

SECONDARY FACTORS

In addition to earnings and the appropriate multiplier, there are secondary factors which should be weighed in determining relative values. No one of the secondary factors is necessarily determinative, but they tend to be cumulative in effect.

Capital Employed in the Business

Capital employed in the business is a factor which cannot be lost sight of completely, because there may be capital invested not required to produce earnings potential, upon which the primary evaluation is based.

Book Value

Occasionally, accounting book values possibly giving effect to replacement costs are a valuation factor, especially if a capitalized earnings power evaluation results in a figure below book.

Dividend-Paying Capacity

Dividend-paying capacity is a factor, for one aim of business is to pay dividends to justify the employment of capital in the business. Thus, a company should have not only earnings potential, but a cash throw-off potential sufficient to produce a return commensurate with the risk.

Profit Sharing, Bonus Arrangements and Employment Contracts

Profit sharing and bonus arrangements may be factors because the method of compensating the management in the company to be bought may effectively represent part of the

purchase price rather than compensation for services.

3. FINANCING AN AGSOC ACQUISITION

After the valuation question, the management of AGSOC's attention will be directed toward ways to finance the acquisition. AGSOC basically has two choices in a cash acquisition: 1) Debt capital from third parties; 2) Debt capital from the seller.

Debt Capital from Third Parties

Debt capital from third parties is frequently a necessary ingredient to effect a cash acquisition. The ability to obtain loans depends upon: 1) the specific assets that can be assigned or pledged as security; 2) the cash throw-off available for repayment of the principal of the loan plus the interest; 3) the earnings potential of the business to be acquired.

The security requirement can be met by the acquiring company's resources or the acquired company's resources. Security can include accounts receivable, inventory, real property and equipment. The ability to repay a loan with interest depends ultimately upon earnings power and cash throw-off. Lenders are usually more concerned about the prospective ability to pay off debt than the underlying net worth of the balance sheet, just as purchasers and sellers of businesses are more concerned about potential earnings than