"In addition this will allow CanCel to accelerate its plans for a major expansion of its Castlegar pulp mill which might otherwise be delayed because of limited financing options. BCRIC would then have greater flexibility to participate more directly in such financing options."

CanCel is one of the world's major suppliers of bleached kraft "market" pulp. The kraft mills are at Prince Rupert and Castlegar, British Columbia and have a combined production capacity of 1600 tonnes per day. At its sawmills at Kitwanga, Terrace and Castlegar it can produce 380,000,000 board feet of lumber annually. Nearly 3,000 persons are employed by CanCel.

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DESIGN OF AN ALASKAN
GENERAL STOCK OWNERSHIP PLAN
VOLUME II

DESIGN OF AN ALASKAN

GENERAL STOCK OWNERSHIP PLAN

VOLUME II

A REPORT TO THE ALASKA STATE LEGISLATURE

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FEBRUARY 15, 1979

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FOREWORD

This volume contains the appendix to the "Design of an Alaskan General Stock Ownership Plan" prepared for the Alaska State Legislature which supplements documents and information contained in Volume I.

AGSOC

INVESTMENT INVESTIGATION OUTLINE

I. Determine the rationale for considering the acquisition in as much depth as possible.

   A. Is the purchaser looking for a passive investment?
   B. Is he looking to add his managerial ability or other special ability to the acquired company?
   C. Is there an unusual advantage in an acquisition that combines one company with another so that the combined companies appear to have greater earnings potential than the companies operating separately -- for example, combining raw material supplier, manufacturer, or marketing organization?
   D. Is the seller's reason for sale a satisfactory explanation from the prospective buyer's view?

II. Make a "businessman's" review of the prospective acquisition including the following:

   A. General and administrative.
      1. History of business.
      2. Legal form of organization -- major rights, provisions, and restrictions.
      3. Ownership of business. Will any acquired stockholder obtain a major position in combined company?
      4. General policies of corporation.
      5. Organization chart.
      6. Description of management personnel.
      7. Interest of management personnel in continuing after acquisition.
      8. Contracts and patents.

   B. Product.
      1. Description of product.
      2. Competition.
      3. Distribution methods.
      4. New product development.
      5. Pricing policies.
      6. Marketing methods.

   C. Manufacturing
      1. Process.
      2. Geographical location of plant.
      3. Plant facilities.
      4. Work force.
      5. Efficiency of plant.

D. Financial.

1. Obtain financial statements for at least five years.
2. Determine the reliability of the financial statements.
   a. Audited or unaudited.
   b. Unqualified opinion by CPA or otherwise.
3. If prospective purchaser is a company, ascertain similarities or differences in accounting principles, practices, and methods. Compare earnings, cash throw-off, net worth, and the like, of the two companies.
4. Assemble financial data with the view to determining a fair price to pay for the prospective acquisition.
   a. Summarize earnings for last five years, setting out nonrecurring and other extraneous items separately.
   b. Analyze variation between years.
   c. Determine gross profit percentages of major products for recent years, if possible.
   d. Schedule estimated sales and gross profits in total and by product for next two to three years, or longer if longer-range forecasts can be developed.
   e. Determine changes in selling, general, and administrative expenses for the period covered by the sales forecast.
      (1) Pay particular attention to the effect of the acquisition on expenses including:
         (a) Depreciation charges if higher values will be assigned to fixed assets as a result of the acquisition.
         (b) Amortization of goodwill arising in the acquisition.
         (c) Changes in management, manufacturing product lines, or marketing programs.
   f. Compute the standard financial ratios for the period under review, and undergone significant or unusual relationships and compare with industry ratios.
      (1) Sales to accounts receivable.
      (2) Inventory to cost of sales (turnover).
      (3) Working capital ratio.
      (4) Quick asset ratio.
      (5) Earnings as a percentage of sales.
      (6) Income taxes to net income.
      (7) Earnings, cash throw-off, and sales growth rate.

(8) Earnings stability test.
(9) Earnings and book value per share if stock acquisition.
(10) Cash throw-off.

g. Prepare summary source and application of funds statement for the period under investigation and projected statements for two or three years, or longer if possible.
   (1) Again, these should reflect post-acquisition changes.
   (2) One major obstacle which must be overcome for a useful projection of source and application of funds is an estimate of capital addition requirements.
   (3) Attention must also be directed to the maximum and minimum cash position itself during the year, particularly if a bootstrap purchase is contemplated.

h. All major balance sheet accounts should be reviewed with probably the closest attention being directed to the following potential trouble spots:
   (1) Accounts receivable.
      (a) Past-due customer notes and accounts receivable.
      (b) Balances in excess of 10 percent of total receivables.
      (c) Adequacy of reserve for bad debts.
   (2) Inventories.
      (a) Latest review for obsolete stock and action taken thereon -- if there are long-term contracts in process, it is of special importance to ensure that costs to complete will not result in material losses not provided for.
      (b) Relative balance of materials, especially month's supply of larger-value items.
      (c) Physical inventory.
   (3) Plant assets.
      (a) Differences between book and tax basis of assets.
      (b) Latest physical inventory of fixed assets and reconciliation of books.
   (4) Investments in unconsolidated, partially owned companies.
      (a) Market value, book value, and earnings of such investments with carrying amounts.

(5) Income taxes.
   (a) Differences between book and tax income for years under review (at least five) and satisfaction as to reasonableness of differences.
   (b) Open tax years and potential areas of controversy.
(6) Contingent liabilities and commitments.
   (a) Contingent liabilities, particularly lawsuits, guarantees on behalf of customers, and service guarantees.
   (b) Major purchase commitments for raw materials, plant expansion, and sales agreements.
   (c) Liabilities under pension plans and profit-sharing plans.
   (d) Lease commitments.

ESTIMATED POTENTIAL IMPACT OF AGSOC DIVIDEND PAYMENTS ON THE FLOW OF FEDERAL FUNDS TO RESIDENTS OF THE STATE OF ALASKA

(This information was prepared by Mr. Gordon Landes, Department of Social Services, Division of Public Assistance, Juneau, Alaska.)

There are five major welfare programs that provide federal funds to Alaska or directly to residents of Alaska. All of these programs would be affected by AGSOC income paid to Alaskan residents.

Following are the programs and a discussion of funding for Alaska fiscal year 1980 (July 1, 1979 to June 30, 1980).

1. Medicaid. This $33,934,300 program is funded 50% federal and 50% state, both benefits and administrative costs.

Eligibility is dependent primarily on eligibility for a cash assistance program listed below. If, for instance, an AGSOC dividend payment of $200 per person were made in a month, the following would be the effect on each program:

Aid for Families With Dependent Children (AFDC)

a. ($22,734,500) Ineligibility for month of payment receipt for all recipients. Small reduction in Medicaid federal dollars (AFDC recipients are not large Medicaid consumers by total dollars expended). Increase in administrative expense. Some major medical needs experienced in the month of ineligibility would have to be met by one of two existing state-only medical programs.

b. Possible ineligibility in subsequent months for

family units which retained the AGSOC payment. This would create a small federal dollar loss.

Supplemental Income Program (SSI)

Ineligibility for a few recipients who have other non-SSI income. SSI programs are on a quarterly basis. Effective 7/1/79 maximum standard payment per individual will be approximately $610 with a $60 per quarter total unearned income excluded. A very small loss of federal Medicaid dollars because most of those becoming ineligible for SSI would become eligible for some supplemental program and therefore ineligible for Medicaid.

2. Supplemental Security Income (SSI). Federally funded and administered cash assistance for aged, blind and disabled. Eligibility on a quarterly basis with $20 per month of unearned income disregarded. A $200 AGSOC payment would reduce SSI payments by $140 for the quarter of receipt of the AGSOC dividend. Large loss of federal dollars and increased federal administrative expense.

3. Aid for Families With Dependent Children (AFDC). Under current AFDC state payment standards and program operations, a $200 AGSOC payment would make all recipients ineligible for the month of receipt. Large administrative burden for the state. Loss of $930,000 in federal program funds. Savings in state AFDC funds of $930,000.

4. Adult Public Assistance (APA). ($6,898,600) State funded and state administered program for aged, blind and disabled. Decrease in federal SSI expenditures will increase state

expense for those who become ineligible for SSI by AGSOC payment but remain within higher income limits of APA. Increased state administrative costs. Some persons over income for SSI but close to or under APA standards would become ineligible for the month AGSOC payment received. (Some of those would have continued eligibility for Medicaid which is important because SSI/APA's are large -- 50% or more of total dollars -- Medicaid users.) Overall effect would be a total decrease in APA state expenditures, $20 monthly disregard of total unearned income. Eligibility established month-by-month.

5. Food Stamp Program (FSP). ($8,000,000) State administered, 100% federally funded. Recent major changes in the FSP program have potential to change the characteristics of the food stamp participants in Alaska. At present it is likely that a $200 per person payment in any one month would render a majority of the 6,000 Alaskan FSP households ineligible for the payment month. Large administration burden for the state. Large loss of federal dollars.

In addition to these programs, the Bureau of Indian Affairs operates a general assistance program in Alaska. This program operates with financial criteria similar to the state's AFDC program. Approximate expenditures for federal forthcoming fiscal year $6,000,000. It is probable that many BIA-GA recipients would become ineligible for the month of AGSOC payment. Large loss of federal dollars and large federal administrative expense.

FEDERAL CONSTITUTIONAL ISSUES

The following memorandum was prepared for the Commissioner of Revenue of the State of Alaska by the firm of Wilmer, Cutler and Pickering, Washington, D.C.

It appears to thoroughly consider all of the relevant constitutional questions concerning a General Stock Ownership Corporation (GSOC) as provided for under Subchapter U of Title VI of the Revenue Act of 1978 and raises no serious consitutional impediments.

WILMER, CUTLER & PICKERING
1666 K STREET, N.W.
WASHINGTON, D.C. 20006

December 15, 1978

MEMORANDUM

Summary of Conclusions and Recommendations
Regarding Constitutionality of Residency
Restrictions and Other Features of
General Stock Ownership Corporations

In light of the history of constitutional challenges to a number of Alaskan laws that have treated residents more favorably than non-residents, an eventual constitutional challenge to the state's creation of a General Stock Ownership Corporation ("GSOC") would not be unexpected. Many of the requirements restricting ownership and transferability of GSOC shares to Alaskan residents are mandated by Congress in the Internal Revenue Code and appear to have a rational basis that would withstand constitutional scrutiny. We believe also that certain additional limitations that may be added by the state legislature can be formulated in a way that will minimize the possibility of success of any constitutional challenge. However, a favorable result cannot be guaranteed because of the ever-shifting and sometimes inconsistent application of constitutional principles in this area.

To lessen the risk of a successful constitutional challenge, we recommend that the following points be considered by the state legislature in drafting the enabling legislation:

(1) The most difficult constitutional problem is caused by the "closed-class" feature of the GSOC, i.e., limiting ownership to residents on a certain date and precluding persons who later qualify as residents from becoming shareholders. Whether to provide a mechanism for opening the class is a policy decision for the legislature. One possibility would be to rely on the apparent requirement in the Internal Revenue Code for a closed-class and open the class only if required by court decision. Another possibility would be to provide a mechanism for extending GSOC membership to new residents; this approach, however, should be cleared with the Internal Revenue Service as being consistent with the federal legislation.

(2) The Internal Revenue Code requires that a person eligible to receive GSOC shares must be a resident on an eligibility date specified by the legislature and on the date of issuance of the shares. The time lapse between the eligibility date and date of issuance should

be minimized and the state law definition of resident liberally set in order to counter the argument that any substantial delay infringes the right to travel.

(3) The federal legislation does not require a resident to dispose of his GSOC shares if he ceases to be a resident. However, the state may wish to consider a provision requiring redemption by the GSOC or sale to a third party whenever a shareholder ceases to be a resident. This could be attacked as an infringement on the right to travel, but the success of any such challenge would be lessened if a shareholder is permitted to sell to a third party or redeem at fair market value.

(4) Great care should be exercised in drafting Alaska's legislative findings in support of the GSOC enabling legislation. Such findings provide an opportunity, in anticipation of litigation, to describe the government's interest and how the legislation is rationally related to the accomplishment of legitimate government ends. In particular, the record should show why each restriction is the most effective or only way to accomplish specific goals.

The major rationale of the federal legislation, which should be reaffirmed by the state, is that citizens should have a greater ownership stake in the private

enterprise system which would lead to a better understanding and operation of that system. Sen. Rep. No. 1263, 95th Cong., 2d Sess., at 107. A secondary rationale of Congress was that an experimental GSOC program would enable Congress to study a method of replacing transfer payments with dividend income. The state should not emphasize the reduction of transfer payment rationale because of a number of cases that impose stricter tests for residency restrictions on "necessities of life" -- such as welfare -- than on other benefits.

Our conclusions are necessarily abstract and preliminary since the enabling legislation has not been drafted; we recommend that the constitutional issues be revisited after they are focussed in terms of a specific legislative proposal.

WILMER, CUTLER & PICKERING
1666 K STREET, N.W.
WASHINGTON, D.C. 20006

December 15, 1978

MEMORANDUM FOR THE
COMMISSIONER OF REVENUE
STATE OF ALASKA

Federal Constitutional Issues
Presented by Alaska's GSOC

You have asked us to review the federal constitutional issues raised by Alaska's creation of a general stock ownership corporation ("GSOC") as permitted by section 1391 of the Internal Revenue Code, enacted as section 601 of the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2892.[1/]

This memorandum concludes that, while there are several bases from which an attack on various aspects of the proposed GSOC could be launched, on the whole we believe

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1/ This memorandum does not cover issues of state constitutional law which are more appropriately addressed to Alaska counsel. In some instances the Alaska Supreme Court has interpreted provisions in the Alaska Constitution more restrictively than the Supreme Court has interpreted parallel provisions in the U.S. Constitution. See generally, Comment, Durational Residency Requirements: The Alaskan Experience, 6 U.C.L.A. - Alas. L. Rev. 50 (1976). In this regard, the outcome of the challenge to the Beirne initiative in the Alaska Supreme Court will be most instructive. See Bailey v. Thomas, No. 3AN-78-1592 (Alas. Super. Ct., Aug. 11, 1978), appeal pending.

that the GSOC can be organized and operated in a fashion that will minimize the likelihood that any constitutional challenge would be successful. We caution, however, that the ever-shifting application of constitutional principles by the courts precludes any absolute measure of certainty in this area. Moreover, until the state's enabling legislation is actually drafted, any discussion of constitutional problems is necessarily abstract and preliminary.

This memorandum will first describe the federally imposed definition of a GSOC and identify several constitutional issues raised by that definition as well as certain additional restrictions Alaska may wish to impose. It will then analyze the major constitutional doctrines relevant to our concerns. Finally it will focus on application of these constitutional principles to the questions raised by specific federal or state restrictions. Our conclusions and recommendations are set forth in the accompanying summary memorandum.

I. Introduction - the Nature of a GSOC and the Constitutional Issues It Presents

Section 1391 of the Internal Revenue Code provides special federal tax treatment for a GSOC whose shares are

owned by residents of the state which creates it. It is contemplated that a GSOC will acquire an interest in one or more business enterprises with borrowed funds, perhaps aided by state grants or guarantees. The cash flow from the acquired business interests will be used to repay loans and pay dividends to the residents of the state who are its shareholders. If the GSOC files the prescribed election, the corporation will be exempt from federal income tax and the shareholders will be taxed on their pro rata share of earnings whether or not distributed.

The GSOC legislation was structured with a minimum of federal restrictions in order to provide states with maximum flexibility to organize a GSOC on their own terms. However, the Internal Revenue Code requires that a GSOC must be chartered and organized after 1978 and before 1984 by an act of a state legislature or as a result of a statewide referendum. In addition, the GSOC's charter must provide that:

(1) Stock may be issued only to "eligible individuals." An eligible individual is "an individual who is, as of a date specified in the state's enabling legislation for the GSOC, a resident of the chartering

state and who remains a resident of such state between that date and the date of issuance." I.R.C. § 1391(c).

(2) Only one class of stock may be issued and at least one share must be issued to each eligible individual unless that individual elects within one year not to receive his share.

(3) No share may be transferable for five years after issuance, other than by will or by the laws of descent, except where the shareholder ceases to be a resident of the state.

(4) Shares may only be transferred to a resident of the state.

(5) Shares may not be transferred to any individual who would own more than ten shares of the GSOC after the transfer.

(6) The corporation must qualify as a GSOC under the Internal Revenue Code.

In addition, a GSOC may not hold a 20 percent or more interest in any subsidiary, may not acquire its business properties from an unwilling seller through the use of the state's power of eminent domain, and is

considered to be a private corporation and not a governmental unit for federal tax purposes.

Potential constitutional issues center on the statutory restrictions of GSOC ownership and transferability enumerated above. Those requirements are mandated by the Internal Revenue Code; other restrictions may be added, or these restrictions made more severe in application, by the state's enabling legislation or the articles of incorporation of the GSOC. Thus, constitutional questions may pertain either to the federal tax statute itself or to the GSOC program as implemented by the state.

There are three principal questions raised by the federal legislation which must be assessed under various constitutional provisions:

(1) May the initial issuance of GSOC shares be restricted to residents?

(2) May the issuance of GSOC shares be limited to a "closed class" of eligible individuals who are residents of the chartering state on a specified date without allowing persons who later qualify as residents to participate in the ownership of the GSOC?

(3) May various restrictions be imposed on the transferability of GSOC shares including (a) a temporary prohibition on the transfer of shares for five years after issuance, and (b) an absolute prohibition on transfers to non-residents, resident corporations (and other legal entities) and residents who would own more than ten shares after the transfer?

Two additional questions concern restrictions not mandated by the federal legislation which Alaska may wish to consider imposing:

(4) May Alaska require that GSOC shares be surrendered, redeemed or transferred when the owner ceases to be a resident?

(5) May Alaska restrict issuance of GSOC shares to a limited class of residents, such as residents over a certain age or residents of limited means?

II. Overview of Constitutional Issues

There are four constitutional provisions that may be pertinent to the questions presented above: (1) the equal protection clauses (U.S. Const. amends. V, cl. 3, and XIV, § 1); (2) the due process clauses (U.S. Const. amends. V, cl. 3, and XIV, § 1); (3) the privileges and

immunities clause (U.S. Const. art. IV, § 2); and (4) the commerce clause (U.S. Const. art. I, § 8, cl. 3). Each is discussed below.

A. Equal Protection of the Laws

The constitutional command that no person be denied equal protection of the laws sets a constitutional limit on classifications that can be made by the government in dispensing benefits or imposing burdens. Both the Fifth Amendment[2/] and the Fourteenth Amendment[3/] to the U.S. Constitution form the basis of the guaranty. Since the Internal Revenue Code requires that a GSOC be chartered by the state and sets forth certain provisions that must be included in the charter, any challenge would probably be directed both at the federal legislation and at the

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2/ The Fifth Amendment provides that no person shall "be deprived of life, liberty, or property, without due process of law." The Supreme Court interprets the due process clause of the Fifth Amendment to require it to test classifications arising from federal statutes under the same standard of review used against state legislation under the equal protection clause of the Fourteenth Amendment. *Bolling v. Sharpe*, 347 U.S. 497, 499 (1954).

3/ The Fourteenth Amendment, in relevant part, prohibits any state from "deny[ing] to any person within its jurisdiction the equal protection of the laws."

state's enabling legislation.[4/]

4/ Both sources of equal protection require that a person be deprived of equal treatment by "state action." It should be considered at the outset whether constitutional issues can be avoided by the argument that the various GSOC restrictions do not involve "state action." Probably not.

To the extent that GSOC restrictions are imposed by the Internal Revenue Code (a federal statute) as a condition for special tax treatment, there probably is "state action" by the federal government even though the Code specifies that the GSOC is a private corporation for tax purposes. A recognized ground for "state action" is governmental encouragement or compulsion of a private party to undertake the challenged practice. See Moose Lodge No. 107 v. Irvis, 407 U.S. 163 (1972). Compare Jackson v. Metropolitan Edison Co., 419 U.S. 345, 357 (1974); Flagg Bros. v. Brooks, 436 U.S. 149, 164-66 (1978). For the possibility that "state action" would also arise from the "special subsidy" of the federal tax exemption, see McGlotten v. Connally, 338 F. Supp. 448 (D.D.C. 1972). But see Bittker & Kaufman, Taxes and Civil Rights: "Constitutionalizing" the Internal Revenue Code, 82 Yale L.J. 51 (1972).

Moreover, a number of factors would support a finding of "state action" by the state of Alaska. First, §§ 1391(a)(3) and (4) of the IRC appear to require that the state's enabling legislation include the specific restrictions necessary for the GSOC's qualification for the tax exemption. Even if these provisions were interpreted to require only that the corporation include these restrictions in its articles of incorporation, § 1391(c) would still appear to require that the state specify in its enabling legislation the residency date that would determine eligibility for the receipt of GSOC shares. "State action" would exist if these restrictions were specified by the enabling legislation in compulsory terms.

In addition, a state loan or guarantee of loans to the GSOC would be a subsidy that could be viewed as state encouragement or participation sufficient to constitute "state action." See Norwood v. Harrison, 413 U.S. 455 (1973) (loan of books to private schools sufficient for state action); Gilmore v. City of Montgomery, 417 U.S. 556 (1974) (use of city facilities sufficient for state action). Finally, if GSOC dividends are intended to reduce the need for welfare payments, there would appear to be "state action" on the ground that the GSOC is performing a governmental function "traditionally

In deciding whether a particular restriction denies equal protection to some class of persons who are excluded or disadvantaged by the restriction, the federal courts look to the interest the federal or state government advances in support of the classification,[5/] the individual interests the challenger claims are adversely affected, and the nature of the statutory classification. The Supreme Court has developed more than one test under which to conduct its inquiry, depending on what interests are affected or what basis of classification is used. If a classification is based on suspect criteria (such as race) or if it impinges on a fundamental right (such as the right to travel or to vote), it can be upheld only if necessary

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[Footnote continued]
exclusively reserved to the State." Jackson, supra, 419 U.S. at 352.

Despite the above authorities there still remains the argument that there is no "state action" because the GSOC is essentially a private corporation. To the extent that the state wishes to incorporate additional restrictions on the operation of the GSOC that are not required by the Internal Revenue Code, consideration should be given to placing those restrictions in the articles of incorporation of the GSOC rather than in the enabling legislation to preserve the argument of no "state action."

5/ Since equal protection analysis is identical whether a restriction is imposed by the federal or state government, for convenience, in the remainder of this memorandum we refer to the interest of both the federal and state governments as "the government interest." In instances where the interests may not be identical, the interest of the state government will be separately described.

to promote a compelling state interest. This test is called "strict scrutiny." Otherwise, the "rational basis test" is used, and the classification will stand if it is rationally related to a legitimate government interest. The choice of which standard of review to apply is largely outcome determinative of the success of the challenge to the statute.[6/]

If a statute under challenge is economic or social welfare legislation, the Court will uphold it if the government is promoting a legitimate state interest and if the classification is "rationally related" to the accomplishment of legitimate government ends,[7/] at least

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6/ But see Antonio Independent School Dist. v. Rodriguez, 411 U.S. 1, 98-110 (1973) (Marshall, J., dissenting) and Massachusetts Bd. of Retirement v. Murgia, 427 U.S. 307, 318-21 (1976) (Marshall, J., dissenting), noting that it is somewhat simplistic to say that all of the Court's decisions fit neatly within the two tests, and that in practice the Court's method of analysis tends to be a balancing of the importance of the interest of the government and the interest of the individual.

7/ See, for examples of economic regulations, City of New Orleans v. Dukes, 427 U.S. 297, 303-04 (1976) (a city may prohibit pushcart sales except by those vendors who have been in business for eight years, to protect the character of the city); Hughes v. Alexandria Scrap Corp., 426 U.S. 794, 810-13 (1976) (state may make it easier for in-state businesses to receive a government bounty than out-of-state businesses, to rid the state of abandoned automobiles). The Dukes case expressly overruled the one Supreme Court decision which had applied the "strict scrutiny" test to an economic regulation (Morey v. Doud, 354 U.S. 457 (1957)).

See, for examples of social welfare legislation, Califano v. Aznavorian, 47 U.S.L.W. 4037, 4039 (U.S. Dec. 11, 1978) (upholding restricting SSI benefits to months when recipient

so long as an "inherently suspect" classification has not been used[8/] and a "fundamental right" of the challenger is not being seriously penalized.[9/] In addition, it should be noted that the Supreme Court has been especially deferential in its review of whether a classification appearing in tax legislation is justified by a legitimate governmental interest.[10/] The federal GSOC legislation,

[Footnote continued]
within United States); Maher v. Roe, 432 U.S. 464 (1977) (upholding state funding for childbirth but not abortion); Weinberger v. Salfi, 422 U.S. 749 (1975) (upholding duration of relationship test for widow and child to be eligible for social security benefits); Dandridge v. Williams, 397 U.S. 471 (1970) (upholding ceiling on AFDC grant based on family size). In the Aznavorian case, the Court noted that "[s]ocial welfare legislation, by its very nature, involves drawing lines among categories of people, lines that necessarily are sometimes arbitrary. This Court has consistently upheld the constitutionality of such classifications in federal welfare legislation, where a rational basis existed for Congress' choice."

8/ Inherently suspect classifications are, for example, those based on race or national origin. See, e.g., Brown v. Bd. of Educ., 347 U.S. 483 (1954); Korematsu v. United States, 323 U.S. 214 (1944).

9/ Fundamental rights are, for example, the right to marry (Zablocki v. Redhail, 434 U.S. 374 (1978)), the right to travel (Shapiro v. Thompson, 394 U.S. 618 (1969)), and the right to vote (Carrington v. Rash, 380 U.S. 89 (1965)).

10/ See, e.g., Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356, 359 (1973) (in denying equal protection challenge to Illinois statute subjecting corporations but not individuals to personal property tax, Court stated that "[w]here taxation is concerned and no specific federal right, apart from equal protection, is imperiled, the States have large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation"); Madden v. Kentucky, 309 U.S. 83, 88 (1940) ("in taxation, even more than in other fields,

which is part of the Internal Revenue Code, may receive an extra measure of protection from challenge for this reason.

If a fundamental right of the individual is significantly interfered with, however, economic and social welfare legislation may be subject to strict scrutiny. The right to economic benefits itself is not considered "fundamental," at least as long as the benefits cannot be considered "necessities of life."[11/] The Court has

[Footnote continued]
legislatures possess the greatest freedom in classification"); Mapes v. United States, 576 F.2d 896, 903-04 (Ct. Cl.), cert. denied, 47 U.S.L.W. 3405 (U.S. Dec. 11, 1978) (deference to congressional determination of tax policy noted in upholding the constitutionality of the IRC "marriage penalty"). Compare Austin v. New Hampshire, 420 U.S. 656 (1975) (deference to legislature on tax matters overridden in invalidating New Hampshire income tax on non-residents as violation of privileges and immunities clause).

11/ One court has distinguished the receipt of welfare benefits from the receipt of a subsidized education on this basis. Starns v. Malkerson, 326 F. Supp. 234, 238 (D. Minn. 1970), aff'd, 401 U.S. 985 (1971). However, the rational basis test has been applied even in grant of benefit situations in which one could argue that fundamental rights were being impacted by the classification. For example, in Dandridge v. Williams, 397 U.S. 471 (1970), the rational basis test was applied to test a dollar limit on welfare payments to a single family under which large families received less per child, even though the Court recognized that the "administration of public welfare assistance, by contrast [to regulation of business or industry], involves the most basic economic needs of impoverished human beings." Id. at 485.

However, even if the Court were to believe that GSOC benefits constituted necessities of life, we believe that a recent decision of the Supreme Court has substantially weakened

put the rule succinctly: "a noncontractual claim to receive funds from the public treasury enjoys no constitutionally protected status." Weinberger v. Salfi, 422 U.S. 749, 772, 774 (1975).

However, the right to interstate travel -- which is relevant to an evaluation of the GSOC legislation -- has been recognized as a "virtually unqualified" fundamental right. Califano v. Torres, 435 U.S. 1, 4 n.6 (1978); see also Shapiro v. Thompson, 394 U.S. 618, 634 (1969); United States v. Guest, 383 U.S. 745, 757-58 (1966).

Even though the right to travel is fundamental, residency has never been considered an "inherently suspect" distinction such as race, religion or alienage, so as to promote strict scrutiny for that reason alone.[12/] And

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[Footnote continued]
the possibility that the legislation would for this reason be subject to strict scrutiny. In Maher v. Roe, 432 U.S. 464 (1967), the Court upheld a state's decision to fund publicly those indigent pregnant women who elected to give birth, and deny funding to those who sought an abortion. The Court reasoned that by making such a distinction the state was not restricting the constitutionally guaranteed right to an abortion, but only choosing to encourage the alternative of childbirth by funding it; since women could still receive abortions by private financing, the right to receive an abortion had not been restricted. The Court dealt with an argument that poor women would be effectively foreclosed from the abortion alternative by responding that distinctions based on wealth have never been sufficient to create a suspect class which would necessitate strict scrutiny by the Court.

12/ City of New Orleans v. Dukes, 427 U.S. 297, 303 (1976).

courts have held that the right to travel is not violated when a state chooses to dispense benefits only to its residents, and thus have upheld the restriction of a wide range of public benefits to state residents under the rational basis test. See, e.g., McCarthy v. Philadelphia Civil Service Commission, 424 U.S. 645, 646 (1976) (city may restrict public municipal employment to residents); Hughes v. Alexandria Scrap Corp., 426 U.S. 794, 813 (1976) (state may prefer its residents in paying bounty); Starns v. Malkerson, 326 F. Supp. 234, 236 (D. Minn. 1970), aff'd, 401 U.S. 985 (1971) (upholding reduced tuition at a public university for state residents); Consumers Union of United States, Inc. v. Albright, 427 F. Supp. 840, 844 (S.D.N.Y. 1977), vacated and remanded sub nom. Consumers Union of United States, Inc. v. Heimann, 98 S. Ct. 3117 (1978) (state may restrict savings bank life insurance to state residents).

The primary situations in which statutory classifications have been subject to strict scrutiny as penalizing the fundamental right to interstate travel are the so-called durational residency cases, where states have refused state benefits to residents until they have lived within the state for a set period of time. In Shapiro v. Thompson, 394 U.S. 618 (1969), for example, state

statutes denying welfare benefits (deemed to be "necessities of life") to persons who had not lived in the jurisdiction for one year were held to deny equal protection of the laws after strict scrutiny as to whether the restriction was "necessary to promote a _compelling_ governmental interest." _Id_. at 634 (emphasis in original). The Court rejected various rationales offered by the states. The objective of reducing welfare costs by the one-year waiting period was held to be _per se_ unconstitutional because its very purpose was to deter the migration of indigents. The Court also rejected the concept that new and old residents could be distinguished on the basis of past tax contributions to the community since the equal protection clause prohibits the apportionment of state services based on tax contributions. Other justifications -- facilitating the planning of the welfare budget, providing an objective test of residency, minimizing welfare fraud and encouraging early entry of new residents into the labor force -- were dismissed as unfounded, solvable by less drastic means or simply not compelling.

While the _Shapiro_ decision sets the high standard of strict scrutiny for any durational residency restriction

to meet,[13/] later cases reflect application of a balancing test upholding reasonable restrictions that serve a very significant governmental interest which justifies a limitation on the travel right.[14/] In this regard, the courts have examined the degree of "penalty" imposed on the travel right in terms of the type of benefit that is restricted. For example, in Memorial Hospital v. Maricopa County, 415 U.S. 250 (1974), the Court struck down a one-year residency requirement for receipt of free non-emergency medical care, and noted that the right to travel had been penalized by denial of vital benefits:

13/ The Court left open the possibility that not all durational residency restrictions would fail to pass the test:

> We imply no view of the validity of waiting-period or residence requirements determining eligibility to vote, eligibility for tuition-free education, to obtain a license to practice a profession, to hunt or fish, and so forth. Such requirements may promote compelling state interests on the one hand, or, on the other, may not be penalties upon the exercise of the constitutional right of interstate travel. Id. at 638 n.21. (Emphasis supplied.)

14/ Compare Dunn v. Blumstein, 405 U.S. 330 (1972) (durational residency requirements of one year and three months for voting invalidated under strict scrutiny rationale) with Rosario v. Rockefeller, 410 U.S. 752 (1973) (requirement to enroll in party 30 days before a general election as a prerequisite to voting in the following primary - almost a year's delay - upheld as allowing state to discourage party raiding).

> In Shapiro, the Court found denial of the basic "necessities of life" to be a penalty. Nonetheless, the Court has declined to strike down state statutes requiring one year of residence as a condition to lower tuition at state institutions of higher education.
>
> Whatever the ultimate parameters of the Shapiro penalty analysis, it is at least clear that medical care is as much "a basic necessity of life" to an indigent as welfare assistance. And, governmental privileges or benefits necessary to basic sustenance have often been viewed as being of greater constitutional significance than less essential forms of governmental entitlements. 415 U.S. at 259. [Footnotes omitted.] 15/

As the Court in Memorial Hospital pointed out, prior cases had approved a one-year durational residency requirement for lower state university tuition. 16/ And more recently, in Sosna v. Iowa, 419 U.S. 393 (1975), the Court upheld a requirement of one year's residence before one was

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15/ The Court rejected what the state asserted as its compelling interests -- fiscal savings, inhibiting migration to obtain medical benefits, protection of past taxpayers, administrative convenience, budget predictability, and prevention of fraud. Id. at 262-69.

16/ Starns v. Malkerson, 401 U.S. 985 (1971), aff'g 326 F. Supp. 234 (D. Minn. 1970), cited with approval in Vlandis v. Kline, 412 U.S. 441, 452-53 n.9 (1973). The lower court in Starns distinguished tuition from the welfare payments in Shapiro v. Thompson in two ways -- first, that the restriction there had been intended to exclude poor persons from the state; and second, that denial of welfare had the effect of denying the necessities of life to needy residents. 326 F. Supp. at 237-38.

eligible to seek a divorce in state court. The Court reasoned that the restriction before it was "of a different stripe" since the plaintiff was not permanently foreclosed from receiving the benefit but merely suffered a temporary delay in access. Id. at 406.[17/]

Assuming that the rational basis test is to be applied to test restrictions on participation in a program implemented by both a federal and a state statute, the first step in equal protection analysis is to determine that the objectives of both governments in creating the program are the promotion of legitimate economic and social welfare goals.[18/] In addition to the primary goal of the

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17/ In addition, the interests urged by the state were more than merely budgetary considerations or administrative convenience. The state argued that the restriction allowed it to avoid becoming a divorce mill and protected its decrees from collateral attack. Id. at 406-09.

Compare "incidental" restrictions on other fundamental rights which have not resulted in strict scrutiny. E.g., Zablocki v. Redhail, 434 U.S. 374, 386 (1978) ("reasonable regulations" which may result in a mere incidental penalty on the fundamental right to marry do not require strict scrutiny).

18/ For example, the legislative history of the federal GSOC proposal indicates that it was designed to allow the states to experiment with new ways of expanding public participation in capitalism. S. Rep. No. 1263, 95th Cong., 2d Sess. 107 (1978); remarks of Senator Gravel, 124 Cong. Rec. S. 19,168-69 (daily ed. Oct. 14, 1978). We assume that such a rationale would be seen as the promotion of public welfare and therefore proper. Moreover, allowing states room for flexible experimentation has been approved as a valid congressional purpose under the rubric "cooperative federalism." Carroll v. Finch, 326 F. Supp. 891, 895 (D. Alas. 1971).

promotion of social welfare,[19] however, the courts will also consider preservation of the fisc,[20] alleviation of tax burdens[21] and administrative convenience[22] to be proper ancillary objectives under the rational basis test.

19/ In the present instance, it is our understanding that Alaska wishes to avail itself of the federally-granted opportunity to form a GSOC to broaden the base of ownership of in-state projects which have broad public impact and to encourage informed citizen participation in corporate decisions affecting vital state projects by spreading the opportunity to participate in capitalism more widely among its citizens. In addition, by giving state residents an interest in the profit-making resources of their state, Alaska hopes ultimately to pass on the economic benefits arising from development of state resource projects to residents within the state, and to spread the wealth more widely. We believe that all of these state interests will be considered consistent with the purposes of the federal legislation and valid objectives under the state's general power and duty to provide for the welfare of its citizens. (See, however, the discussion (infra at 25-27) of possible problems arising from allegations that some of these goals may impair the flow of interstate commerce.)

20/ See in a different context, City of Philadelphia v. New Jersey, 98 S. Ct. 2531, 2537 (1978) ("we assume New Jersey has every right to protect its residents' pocketbooks . . . ."); Geduldig v. Aiello, 417 U.S. 484, 495-96 (1974).

21/ Baldwin v. Fish & Game Comm'n, 436 U.S. 371, 388-90 (1978) (state's efforts to require non-residents to pay higher license fees to hunt elk upheld as rationally related to state's need to use tax dollars to support elk population).

22/ Weinberger v. Salfi, 422 U.S. 749, 777 (1975).

In the second step of analysis under the rational basis test, each restriction subject to attack must be shown to be rationally related to one or all of these proper government objectives. However, a statutory classification dealing only with economic matters which does not impinge on a fundamental interest need not be drawn with precision to fit the state's purposes. Hughes v. Alexandria Scrap Corp., 426 U.S. 794, 813 (1976); Williamson v. Lee Optical of Oklahoma, Inc., 348 U.S. 483, 489 (1955).

B. Privileges and Immunities Clause

The privileges and immunities clause of the Constitution provides: "The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States." Art. IV, § 2, cl. 1.[23/] The terms "citizens" and "residents" are interchangeable for purposes

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23/ A similar clause protecting the rights of national citizenship is found in the Fourteenth Amendment, which states that "[n]o State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States." U.S. Const. amend. XIV, § 1. The privileges and immunities clause of article IV is broader in that it is not restricted in its language to actions by the states, and thus arguably applies to the federal government as well. The applicability of the clause to federal statutes need not be debated at this time, however, since the state in chartering the GSOC will adopt the basic restrictions against non-residents required in the federal legislation as a condition to special tax treatment.

of the clause.[24/] The origins of the clause indicate that its purpose was to "fuse into one Nation a collection of independent, sovereign States. It was designed to insure to a citizen of State A who ventures into State B the same privileges which the citizens of State B enjoy." Toomer v. Witsell, 334 U.S. 385, 395 (1948).

While the clause does not enumerate the privileges which may not be infringed, early decisions have made it clear that the clause gives an out-of-stater the right to "pass into any other State of the Union for the purpose of engaging in lawful commerce, trade, or business without molestation; to acquire personal property . . . and to be exempt from any higher taxes or excises than are imposed by the State upon its own citizens." Ward v. Maryland, 79 U.S. (12 Wall.) 418, 430 (1870). In any event, the protections of the clause are not absolute. When a state can show substantial, valid justifications for discrimination against out-of-staters, the discrimination will sometimes stand if it is closely related to the state's needs, especially if important interests of the individual are not infringed. The method of analysis becomes much

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24/ Hicklin v. Orbeck, 98 S. Ct. 2482, 2487 n.8 (1978); Austin v. New Hampshire, 420 U.S. 656, 662 n.8 (1975).

like the balancing of interests conducted under the equal protection clause and, like that clause, there appear to be at least two articulated tests.

Two recent Supreme Court decisions illuminate the different approaches toward the application of the clause to a state preference for residents over non-residents in dispensing state benefits. In Baldwin v. Fish and Game Commission, 436 U.S. 371 (1978), the Court upheld a provision of Montana law providing for stiffer license fees for the hunting of elk for non-residents than those required for residents of the state. The Court's analysis followed a line of cases limiting application of the privileges and immunities clause to the protection of those rights which historically had been "fundamental" and which bear "upon the vitality of the Nation as a single entity." The Court reasoned that as a "sport," "not basic to the maintenance or well-being of the Union" and not affecting a means of livelihood or access to travel to any part of the state, the hunting of elk was not sufficiently "fundamental" so as to invoke the clause. Id. at 383, 388.

C. Commerce Clause

The commerce clause of the Constitution[28/] preserves to the federal Congress the power to regulate commerce among the several states. State statutes which interfere with the flow of commerce from state to state are subject to invalidation under this clause. There are again two tests which the Supreme Court has developed to evaluate such state statutes. If the statute is simply economic protectionism on the part of the state, the statute is *per se* invalid; but if the statute evenhandedly acts to effectuate a legitimate local public interest and only incidentally affects interstate commerce, a balancing test is applied and the statute will be upheld unless the burdens on interstate commerce outweigh the local interest, in light of less burdensome alternatives available to promote that local interest. *City of Philadelphia v. New Jersey*,

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[Footnote continued]
no violation of the privileges and immunitites clause when a state law preferred its residents in protecting its ownership interest in its resources. 565 P.2d 159, 167-69 (Alaska 1977). The United States Supreme Court rejected the ownership rationale as an exemption from operation of the privileges and immunities clause, and held that state "ownership" of natural resources was only one factor acting to strengthen a state's interest in preferring its residents. 98 S. Ct. at 2492.

28/ Art. I, § 8, cl. 3.

The second case is Hicklin v. Orbeck, 98 S. Ct. 2482 (1978). There, a unanimous Court invalidated an Alaska statute ("Alaska Hire") requiring all oil or gas leases, right-of-way permits or similar contracts to which the state was a party to include a clause favoring the employment of qualified Alaska residents, as opposed to non-residents. The statute was struck down under a method of analysis derived from two prior cases[25] where the inquiry was not centered on whether the plaintiff's right was "fundamental," but rather whether non-citizens constituted a particular source of the evil at which the statute was aimed and whether the statute was carefully drawn to meet that evil.[26] The Court found that Alaska had not proven that unemployment in Alaska (the "evil") was substantially caused by non-residents seeking in-state jobs, and noted that in any event the regulation was not sufficiently well-tailored to the "particular evil" asserted.[27]

25/ Toomer v. Witsell, 334 U.S. 385 (1948), and Mullaney v. Anderson, 342 U.S. 415 (1952).

26/ Of course the "evil" the statute is aimed at must be a legitimate goal for the state to pursue. See the discussion of possible commerce clause problems, infra.

27/ The Alaska Supreme Court in Hicklin had held that the one year residency provision of Alaska Hire violated the equal protection clause of the federal and state constitutions but upheld the remainder of the statute. The Alaska court found

98 S. Ct. 2531, 2537 (1978); Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

Commerce clause principles may impact other constitutional doctrines, however. In Hicklin v. Orbeck, 98 S. Ct. 2482 (1978), the Court addressed the interrelation between the privileges and immunities clause and the commerce clause. Although the commerce clause had not been raised by plaintiffs in Hicklin, the Court found that the expected impact on commerce from a law favoring residents for jobs on the Alaska pipeline acted to minimize the state's legitimate interest in favoring its residents for employment:

> [T]he Commerce Clause circumscribes a State's ability to prefer its own citizens in the utilization of natural resources found within its borders, but destined for interstate commerce. . . . Although the fact that a state owned resource is destined for interstate commerce does not, of itself, disable the State from preferring its own citizens in the utilization of that resource, it does inform analysis under the Privileges and Immunities Clause as to the permissibility of the discrimination the State visits upon nonresidents based on its ownership of the resource. Here, the oil and gas upon which Alaska hinges its discrimination against nonresidents are of profound national importance. On the other hand, the breadth of the discrimination mandated by Alaska Hire goes far beyond the degree of resident bias Alaska's ownership of

> the oil and gas can justifiably support.
> Id. at 2492 (footnote omitted).29/

Hence, reasoning traditionally applied to invalidate state statutes as impermissibly burdening interstate commerce may lead a court to hold that a government's interest is illegitimate or insufficiently strong to justify a classification or restriction under the tests applied under the privileges and immunities clause or the equal protection clause.30/

29/ See also Baldwin v. Fish & Game Comm'n, 436 U.S. 371, 392 (1978) (concurring opinion of Burger, J.).

30/ There is good authority to argue that commerce clause reasoning is not applicable to the GSOC proposal. First, Alaska can argue as a factual matter that its GSOC is not designed to impact nor will it negatively influence the flow of interstate commerce. Our understanding is that the GSOC will not monopolize the opportunity to invest in any particular projects. In addition, the Supreme Court has recently openly declined to express a view as to whether a state's decision to restrict to residents state benefits or the spending of state funds would survive an attack under the commerce clause. City of Philadelphia v. New Jersey, 96 S. Ct. 2531, 2537, n.6 (1978). We believe that on the authority of Hughes v. Alexandria Scrap Corp., 426 U.S. 794 (1976), the Court would uphold such state action. In Hughes, the Court ruled that the commerce clause is not involved when a state enters into the market for abandoned automobiles by offering a bounty favoring state residents; the Court distinguished the usual commerce clause case as involving state prohibitions or burdensome regulations interfering with the natural functioning of the interstate market. Although the Maryland statute in question had burdened out-of-state participation in a pre-existing bounty program, the Court rejected any constitutional implication of this kind of "burden":

> We would hesitate to hold that the Commerce Clause forbids state action reducing or eliminating a flow of commerce dependent

D. Due Process

Both federal and state action[31/] must comport with the constitutional guaranty of due process of law as set forth in the Fifth and Fourteenth Amendments to the Constitution. The tests employed to evaluate whether statutory limitations on a benefit comply with due process are substantially equivalent to those used to test

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[Footnote continued]

> for its existence upon state subsidy instead of private market forces . . . Nothing in the purposes animating the Commerce Clause prohibits a State . . . from participating in the market and exercising the right to favor its own citizens over others. 426 U.S. at 809 n.18 & 810.

See also the strong concurring opinion of Justice Stevens:

> . . . the Commerce Clause surely does not impose on the States any obligation to subsidize out-of-state business. Nor, in my judgment, does that Clause inhibit a State's power to experiment with different methods of encouraging local industry. Whether the encouragement takes the form of a cash subsidy, a tax credit, or a special privilege intended to attract investment capital, it should not be characterized as a "burden" on commerce. 426 U.S. 815-16.

31/ The possibility exists that Alaska may be able to insulate some restrictions from a nexus of governmental "action," and thus avoid due process problems as well as those arising under the equal protection clause. See supra at n.4.

classifications under the equal protection clause, and therefore a repetition of that analysis is unnecessary here. At the least, legislation must advance legitimate government goals and cannot be totally arbitrary and totally lacking in rational relationship to the legislative objectives. Weinberger v. Salfi, 422 U.S. 749, 767-77 (1975). As with equal protection analysis, unless there is no conceivable legitimate basis for a statutory provision, it will be upheld. For example, in Richardson v. Belcher, 404 U.S. 78 (1971), the Court looked to what "Congress could rationally [have concluded]" in upholding under the rational basis test an allegedly arbitrary Social Security Act provision which resulted in a reduction in benefits. 404 U.S. at 84.

In addition, in certain situations it has been held to be a violation of the due process clause for a legislature to dispense benefits by classifications based on irrebuttable presumptions. See, for example, Vlandis v. Kline, 412 U.S. 441 (1973), where the presumption

involved the concept of residency.[32/] It appears, however, that the Vlandis rule, which applied what amounts to "strict scrutiny" to invalidate a residency presumption, has been cut back substantially in later cases.[33/]

32/ In Vlandis, the Supreme Court invalidated as a denial of due process an irrebuttable statutory presumption that a student at the University of Connecticut would always be a resident of the place where he resided at the time of application to the university, and that he could not prove that he later became a resident of Connecticut for purposes of obtaining the lower tuition charged in-state students. The Court was not moved by Connecticut's justification for the presumption (primarily that it needed an administrative mechanism to restrict the tuition subsidy to in-state students, and that it was rational to favor long-time residents whose tax contributions to the state had been higher).

Moreover, the Court in Vlandis indicated that the tax rationale would run afoul of the equal protection clause and cited Shapiro for the proposition that the tax-based rationale would:

> logically permit the State to bar new residents from schools, parks, and libraries or deprive them of police and fire protection. . . . The Equal Protection Clause prohibits such an apportionment of state services. 412 U.S. at 450 n.6 (quoting Shapiro v. Thompson, 394 U.S. at 632-33).

In quoting Shapiro, the Court indicated that its evaluation under the due process clause was similar to strict scrutiny under the equal protection clause; the taxpayer rationale has been accepted under the rational basis test of the equal protection clause.

Irrebuttable presumptions in the form of residency requirements for voting purposes have also been invalidated after strict scrutiny under the equal protection clause, on the theory that voting is a fundamental right. See Dunn v. Blumstein, 405 U.S. 330, 349-52 (1972); Carrington v. Rash, 380 U.S. 89, 96-97 (1965).

33/ In Sosna v. Iowa, 419 U.S. 393 (1975), the Court upheld a state's requirement that a divorce petitioner be a resident of the state for one year before she could file for divorce. The Court rejected an argument, based

III. Application of Constitutional Principles to Specific Restrictions

A. MAY THE INITIAL ISSUANCE OF GSOC SHARES BE RESTRICTED TO RESIDENTS?

The federal legislation provides that only "eligible individuals" will be issued[34/] GSOC shares. To be eligible, an individual must be "as of a date specified in the State's enabling legislation for the GSOC, a resident of the chartering State and who remains a resident of such State between that date and the date of issuance." 26 I.R.C.

[Footnote continued]
on Vlandis, that such a showing was an irrebuttable presumption and that the petitioner had a due process right to make an individualized showing of good-faith residency without waiting for one year. The Court stressed the importance of the state's interests in not becoming a divorce mill and in avoiding collateral attack on its decrees, and distinguished Vlandis in that there the court had indicated that a reasonable durational residency requirement was permissible as one element in establishing bona fide residency. And in Weinberger v. Salfi, 422 U.S. 749, 771-73 (1975), the court refused to apply the Vlandis rule to invalidate an irrebuttable presumption that denied social security insurance benefits to wives and stepchildren of deceased wage-earners who had not been in that relationship for at least nine months prior to the wage-earner's death. The court reasoned that due process had not been denied as long as it was rational that the presumption prevented the abuse of straw marriages to receive death benefits.

34/ Although the federal legislation appears to allow a state the option of selling GSOC shares to its residents, our understanding is that Alaska plans to issue shares to all Alaska residents at no charge. See remarks of Senator Gravel, 124 Cong. Rec. S. 19,168 (daily ed. Oct. 14, 1978).

§ 1391(c). Hence, to qualify for federal tax benefits, each recipient must be a resident (as defined by state law)[35/] on date of issuance, and Alaska apparently has some latitude to set an earlier date at which time the recipient must also be a resident.

1. Equal Protection of the Laws

The rational basis test will be applied to test the limitation that only a resident can initially receive a GSOC share. As noted above, laws restricting distribution of benefits to state residents have been uniformly subject to this test since the right to travel is not penalized, and the chance to receive a GSOC share should not be viewed as one of the "necessities of life" requiring stricter scrutiny.[36/]

35/ The legislative history of the federal statute provides that "[a] State may define a resident for purposes of its GSOC so long as such definition is consistent with constitutional principles." S. Rep. No. 1263, 95th Cong., 2d Sess. 108 (1978)..

36/ It seems improbable that opportunity to participate in the Alaska GSOC will be considered to be a more fundamental right than the welfare payments discussed in Dandridge v. Williams, supra. We note, however, that one of the asserted purposes behind the federal GSOC legislation is to reduce the need for various government transfer payments. The Senate Finance Committee stated that "[t]he committee believes that an experimental program permitting States to form such private corporations for the benefit of their citizens may enable Congress to study a method of replacing transfer payments with dividend income." S. Rep. No. 1263, 95th Cong., 2d Sess. 107 (1978).

The first step in applying the rational basis test will be to search the federal and state legislative records to determine whether the residency restriction is consistent with the goals of the GSOC program. It seems beyond question that restricting the original issuance of GSOC shares to each state's residents is rationally related to the substantive purposes of the GSOC. If each state were required to set up a corporation whose shares would be freely distributed to residents of all states, a state would have little incentive to undertake such an experiment. Of course, each state also would want to restrict the benefits flowing from expenditure of state funds in establishing and initially administering its GSOC to residents whose past taxes will initially support the GSOC operation and to reduce the administrative difficulties which would ensue if the GSOC ownership were nationwide. As with limitations on the receipt of subsidized college tuition, restrictions on eligibility for government jobs, and receipt of a state bounty -- all of which have been

[Footnote continued]

At least at the time of its initial issue the value of a GSOC share will be minimal. However, we believe it will help to insulate the Alaska GSOC from successful constitutional challenge if the welfare rationale is not stressed in the state legislative record and if normal levels of transfer payments are maintained to eligible residents who are not residents at the time of the issuance of GSOC shares.

upheld against challenges that favoring residents for those benefits denied non-residents equal protection of the laws[37/] -- we conclude that the provision in the GSOC legislation restricting issuance of shares to residents should survive an equal protection challenge.

However, the question remains as to how Alaska should set the dates on which a person must be a resident in order to become an individual eligible to receive a GSOC share. If Alaska in its enabling legislation sets an eligibility date (when a recipient must be a resident) that substantially precedes the issuance date (when a recipient must also be a resident), it could be argued that the time lapse between the two dates acts as a durational residency requirement which penalizes those who have recently traveled interstate. Since such travel is a fundamental right, the statute might be subjected

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37/ Starns v. Malkerson, supra; McCarthy v. Philadelphia Civil Serv. Comm'n, supra; Hughes v. Alexandria Scrap Corp., supra.

See also Consumers Union of United States, Inc. v. Albright, 427 F. Supp. 840, 844 (S.D.N.Y. 1977), wherein an equal protection challenge to a restriction on the sale of savings bank life insurance to state residents failed. But see Hicklin v. Orbeck, 98 S. Ct. 2482 (1978), calling into question the results in the McCarthy and Albright situations in the face of an attack under the privileges and immunities clause; Albright was vacated and remanded by the Supreme Court for reconsideration in light of Hicklin. 98 S. Ct. 3117 (1978).

to the strict scrutiny test. See Dunn v. Blumstein, 405 U.S. 330, 335 (1972); Shapiro v. Thompson, 394 U.S. 618 (1969). For this reason, we recommend that Alaska seek to minimize the time gap between the two dates.[38/]

2. Privileges and Immunities Clause

It appears that Alaska's plans for a one-time gift of a GSOC share to each of its residents should pass muster under either the "fundamental" right test of Baldwin v. Fish & Game Commission, supra, or under the "source of the evil" analysis of Hicklin v. Orbeck, supra. Under the Baldwin analysis, it seems unlikely that the gift of a share of stock will be considered a fundamental national right.[39/] However, if the Hicklin analysis is applied,

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38/ We note in addition that under rulings of the Alaska Supreme Court apparently Alaska cannot under state law require a person to have lived in Alaska for more than thirty days in order to be considered a "resident," lacking a compelling state interest and no reasonable, less drastic alternative to promote that interest. Hicklin v. Orbeck, 565 P.2d 159, 171 (Alaska 1977), rev'd on other grounds, 98 S. Ct. 2482 (1978).

Moreover, if the federal courts apply strict scrutiny, it will be relevant to the analysis -- and detrimental to Alaska's defense of the challenge -- if Alaska defines residency more broadly for other state purposes without dire results to the state. See, e.g., Evans v. Cornman, 398 U.S. 419, 421 (1970), Carrington v. Rash, 380 U.S. 89, 95-96 (1965).

39/ Indeed, the GSOC is a novel idea and hardly a right which has -- in the words of one early case on which the Baldwin court relies -- "at all times, been enjoyed by the citizens of the several states which compose this Union, from the time

it will become crucial how the government describes its purposes in enacting the limitations in the legislation.[40/]

The answer to the Hicklin line of analysis is that neither the GSOC legislation nor any of its provisions is really aimed at any "evil." Issuance of GSOC shares is a one-time benefit, and it is a benefit initially supported by the state government as an experiment to broaden popular participation in the ownership of state investment opportunities. Dispensing such a benefit is different from imposing a penalty or restriction on non-

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[Footnote continued]
of their becoming free, independent, and sovereign." Corfield v. Coryell, 6 F. Cas. 546, 551 (C.C.E.D. Pa. 1823).

40/ For example, one could argue that the legislative history of the federal legislation contemplates that the "evil" the GSOC is aimed at is the monopolization of the opportunities of capitalism by the wealthy. If so, limiting GSOC ownership to residents of the chartering state is not aimed at such an "evil." But the states could respond that by choosing to charter a GSOC the initial shares of which will be issued only to its residents, each state aims to avoid the "evil" of dilution of the financial opportunity the state hopes to present to its residents by the gratuitous participation of out-of-staters. As long as this purpose is legitimate, out-of-staters are by definition the source of the "evil" and the restriction is aimed precisely at it.

The Supreme Court has noted that preserving a state's financial resources from dilution is a "presumably legitimate goal" as long as it is not done by means that violate the commerce clause (or, presumably, any other constitutional guarantee). City of Philadelphia v. New Jersey, 98 S. Ct. 2531, 2537 (1978). For reasons set forth supra at 25-27, we do not believe that commerce clause reasoning should lead to the invalidation of the GSOC restriction.

residents, as was the case in Hicklin. For this reason, we think the GSOC concept can be distinguished from the Hicklin case and can survive an attack based on denial of the privileges of citizenship.[41/]

3. Commerce Clause

The restriction on initial issuance to residents of the chartering state is made by a federal statute; the only role of the state legislature is to set the date (or dates) as of which the recipient must be a resident. Hence, if the restriction restrains the flow of commerce out of the state of Alaska,[42/] it does so at the express direction of Congress, which has plenary power to regulate interstate commerce.[43/]

41/ One lower court case decided before Hicklin makes use of the distinction described above. Consumers Union of United States v. Albright, 427 F. Supp. 840, 846 n.10 (S.D.N.Y. 1977) (when non-residents are denied the right to purchase savings bank life insurance, they are not penalized; they are merely deprived of a benefit). The fact that the Albright case has been vacated and remanded for reexamination in light of Hicklin v. Orbeck (98 S. Ct. 3117 (1978)) diminishes somewhat the likelihood of sustaining the benefit/penalty distinction.

42/ State statutes which restrain commerce within the state are as vulnerable under the clause as those that prohibit entry of items of commerce. City of Philadelphia v. New Jersey, 98 S. Ct. 2531, 2538 (1978).

43/ To avoid commerce clause problems, however, it is advisable that Alaska fashion the least restrictive definition of "residency" possible, to avoid a charge that, in implementing the federal legislation by state law, Alaska has impermissibly

4. Due Process

To invalidate the restriction of issuance of GSOC shares to residents of Alaska under the due process clause, one would have to show that the government was acting either on behalf of improper goals or that the decision to exclude non-residents was totally arbitrary. Moreover, the government is given broad latitude in prescribing criteria for eligibility for public funds. Weinberger v. Salfi, supra. Giving non-residents an original GSOC share would dilute the primary purpose behind the statute -- allowing a state to choose to provide a stake in capitalism for its residents. Seen from this perspective, the limitation is hardly arbitrary.

[Footnote continued]
burdened interstate commerce. For example, in addition to our suggestion that the time between two dates which the legislature sets to define "eligible individuals" be as short as practicable, we suggest that Alaska define "residency" for GSOC purposes as liberally as possible, with an explicit recognition that such a definition has been drafted to avoid incidental effects on interstate commerce (and the right to travel).

B. MAY ALASKA CREATE A "CLOSED CLASS" OF PERSONS TO RECEIVE GSOC SHARES, AND REFUSE TO ISSUE A GSOC SHARE TO A PERSON WHO BECOMES A BONA FIDE RESIDENT AFTER THE DATE OF INITIAL ISSUANCE?

The federal legislation provides that the GSOC's charter shall provide for the issuance of shares to "each eligible individual." An "eligible individual" is defined as "an individual who is, as of a date specified in the State's enabling legislation for the GSOC, a resident of the chartering State and who remains a resident of such State between that date and the date of issuance." On its face the federal statute would appear to require that a GSOC issue shares only to a closed class of persons who are residents on one certain set date (or dates) and issue no shares to persons who later become bona fide residents of Alaska. However, it also may be possible to read the federal legislation to allow the state in its enabling legislation to set a number of dates on which new state residents would become "eligible" to be issued a GSOC share.[44/] To avoid the problems discussed below, Alaska might wish to consider opening GSOC ownership to new residents,

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44/ We had recommended (by letter of October 12, 1978) that the definition of "eligible individual" in the federal legislation be left to state law definition so that a measure of flexibility to avoid constitutional confrontation would be available, but that suggestion was not adopted by Congress.

although we realize that such a solution creates administrative problems; if chosen, this solution should be cleared with the Internal Revenue Service as being consistent with the federal statute.

On the assumption that Alaska does not desire to follow such a course, what will be the impact on a person who moves to Alaska after the original issuance date? He has missed the one-time issuance of GSOC shares. But, at some point in time, he will become a bona fide "resident" as that concept is defined under Alaska law. If the state legislation provides no authority for the GSOC to issue him a share, the only mechanisms by which he could acquire GSOC ownership are (1) if he receives a share "by will or the laws of descent and distribution" from an Alaskan who has received a share, 26 U.S.C. § 1391(a)(4)(D)(i);[45/] or (2) if the state legislation provides for trading in GSOC shares after the five-year trading proscription set forth in the federal legislation, and an Alaskan sells

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45/ Although the federal legislation leaves some room for doubt, it appears that to receive a share by will or descent, a person must be a "resident individual" of Alaska at the time of receipt as defined by general concepts of residency under Alaska law. The state legislation should clarify what becomes of a GSOC share willed to an out-of-stater or to one which would pass under the Alaska law of intestate succession to a non-resident of Alaska.

him a share. Does this deprivation give rise to a constitutional claim by the new resident under the precedents discussed above?

1. Equal Protection of the Laws

A restriction on the grant of an economic or social benefit should ordinarily be evaluated under the rational basis test. However, if the closed class penalizes the fundamental right to travel, a stricter standard of review is appropriate. Alaska must distinguish the GSOC situation from the denial of welfare benefits in Shapiro v. Thompson to escape the strict scrutiny test. Alaska can do so by arguing that, in Shapiro, the plaintiff was denied welfare benefits which others who had not recently traveled interstate were then being granted. In contrast, the new resident of Alaska would be advancing the unprecedented notion that the state has an obligation to treat him equally with persons resident at an earlier date in time when the GSOC shares were given away. Moreover, even if denying a new resident a GSOC share may theoretically penalize him for having recently been resident elsewhere and subsequently moving to Alaska, the penalty he has suffered does not rise to the level of deprivation of a necessity of life.

It may help to sustain the closed class concept even if strict scrutiny is applied if Alaska takes advantage of what appears to be room in the federal legislation to allow residents leaving the state to transfer their shares to new residents. Under section 1391(a)(4)(D)(i), no shareholder may transfer a share for five years after issuance "except where the shareholder ceases to be a resident of the State." It appears that the federal statute leaves room for Alaska to allow (or perhaps even require) departing residents to sell their GSOC shares to newcomers who satisfy Alaska's state law definition of "residency."[46/] In this way, any "penalty" placed on persons who do not meet the tests of "eligible individual" at the time of the original GSOC issue is made less onerous. Under this suggestion, new residents would be burdened only by some measure of delay in obtaining their shares (assuming more persons come to Alaska than leave), and by being required to pay fair value for their shares.[47/] These burdens

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46/ Problems of the proper valuation to place on a GSOC share in this event and problems under the securities laws which may be accelerated due to the earlier creation of a trading market should be carefully considered in the state legislation.

47/ See infra at 51-57. Under the analysis of Maher v. Roe, supra, this provision would enhance the argument that an equal protection attack should be unsuccessful.

probably amount to at best a slight interference with the right to travel which the courts would uphold in light of the legitimate state interests advanced.

Assuming that the Shapiro rationale does not apply and that the closed class concept is properly evaluated under the rational basis test, it is important that the state legislative record list with as great a particularity as possible the reasons why the "closed class" restriction is highly useful to meet the legislative goals. Presumably the administrative burdens would be greatly reduced by the closed class. In addition, Alaska could recognize the possibility that it might charter additional GSOC's if the experiment is successful. Moreover, the closed class would avoid the problem of dilution of GSOC benefits by newcomers moving to Alaska merely to profit from Alaska's experiment. Finally, Alaska should point out that it reads section 1391(c) of the Internal Revenue Code to require the closed class.

2. Privileges and Immunities Clause

It is under the equal protection clause that disparate treatment given various classes of Alaska residents would be tested. The privileges and immunities clause is designed to rectify unreasonable state

discriminations between its residents and non-residents. Hicklin v. Orbeck, 98 S. Ct. 2482, 2485 (1978); Toomer v. Witsell, 334 U.S. 385, 395-96 (1948). Any harm which the new Alaska resident asserts should be tested under the equal protection guaranty.

3. Due Process

Alaska can argue that the closed class does not constitute a presumption of non-residency which excludes the new resident from state benefits. In Vlandis v. Kline, supra, the new resident was precluded by the presumption under attack from showing he was a Connecticut resident and thus receiving ongoing state benefits for all of his student years.[48/] In the GSOC situation, unless the Alaska legislature sets a series of eligibility dates or permits GSOC sales by departing residents to new residents, the new resident presumably is barred for five years after issuance from purchasing a GSOC share. But the benefit from which he is excluded -- a GSOC share -- is not one other residents of Alaska are currently receiving.

48/ 412 U.S. at 452-53 n.9. The Court noted that in Starns v. Malkerson, 326 F. Supp. 234 (D. Minn. 1970), aff'd mem., 401 U.S. 985 (1971), it had approved a tuition situation in which the student after one year in the state was allowed to prove bona fide residency.

Presumably, the ongoing benefit denied the new resident is the dividend income which is generated by the GSOC shares previously given to older residents. And this income is a benefit generated and distributed by the GSOC itself and arguably is not a product of "action" by the state of Alaska.

Moreover, even if the closed-class restriction is viewed as being mandated by the federal legislation and as creating a presumption of non-residency for GSOC purposes, Sosna and Weinberger teach that such presumptions can be upheld if they are rationally designed to prevent abuses and to secure important state goals. Presumably, there are no easy administrative means by which Alaska could admit new residents into the GSOC program; Vlandis largely rested on the fact that individual determinations could easily have been made. Alaska should rely on the language of Weinberger:

> The question is whether Congress, its concern having been reasonably aroused by the possibility of an abuse which it legitimately desired to avoid, could rationally have concluded both that a particular limitation or qualification would protect against its occurrence, and that the expense and other difficulties of individual determinations justified the inherent imprecision of a prophylactic rule. 422 U.S. at 777.

In sum, to the extent that there are valid administrative reasons to support the necessity to proceed on a closed class basis, there are strong defenses to any constitutional challenge. Nevertheless the closed class concept remains a troubling feature of the legislation from a constitutional standpoint.

C. MAY VARIOUS RESTRICTIONS BE IMPOSED ON THE TRANSFERABILITY OF GSOC SHARES INCLUDING (a) A TEMPORARY PROHIBITION ON THE TRANSFER OF SHARES FOR FIVE YEARS AFTER ISSUANCE, AND (b) AN ABSOLUTE PROHIBITION ON TRANSFERS TO NON-RESIDENTS, RESIDENTS WHO WOULD OWN MORE THAN TEN SHARES AFTER THE TRANSFER AND RESIDENT CORPORATIONS (AND OTHER LEGAL ENTITIES)?

The federal legislation provides various limitations on the powers of residents receiving GSOC shares to transfer their shares to others. Among those restrictions are: (1) a holder may not transfer his share for five years (except by will or descent) except where he ceases to be a resident of Alaska (§ 1391(a)(4)(D)(i)); (2) a holder may not transfer shares at any time to anyone not a resident of Alaska (§ 1391(a)(4)(D)(ii)); (3) a holder may not sell to any resident who, after the transfer, would own more than 10 GSOC shares (§ 1391(a)(4)(D)(iii)); and (4) a holder may not sell to a legal entity as opposed to an individual (§ 1391(a)(4)(D)(ii)).

Each of these restraints is required by the Internal Revenue Code as a condition of special tax treatment.[49/] While it could be argued that the restraints are a deprivation of substantive due process, on the ground that they unreasonably infringe on the holder's right to alienate his property, it is extremely unlikely that such an argument would be successful.[50/] State residents would certainly have no "fundamental right" to alienate their GSOC shares free of all restrictions. Rational bases for each restriction -- which are not set forth in the federal legislative history -- can and should be adduced in the state legislative record. For example, the five-year prohibition on transfer will greatly simplify the early administration of the GSOC. If shares could be transferred to non-residents, the administrative burden would expand, and one purpose of the GSOC -- to increase the participation of state residents in the development of the state -- would be hindered by sales out of state which would dilute the

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49/ Similar restrictions on alienation are imposed in other sections of the Internal Revenue Code as a condition to receiving tax benefits. For example, Section 422(a)(1) provides special treatment for qualified stock options provided that shares received upon exercise of the option are not disposed of for three years.

50/ We have not addressed the issue of whether these restraints on alienation present any problem under state law.

holdings of residents. To the extent that GSOC shares are expected to steadily increase in value, each state which chooses to implement a GSOC could reasonably desire to confer this benefit on its own residents. If ownership were not restricted to 10 shares per person, concentrated holdings of GSOC shares would hinder achievement of the purpose of widespread participation in capitalism. And if shares could be transferred to legal entities, such transfers could be used by residents holding ten GSOC shares, or by non-residents, to avoid the other alienation restrictions; in addition, holdings by legal entities would not be in furtherance of the avowed Congressional purpose of increasing individual participation in the free enterprise system.

D. MAY ALASKA REQUIRE HOLDERS OF GSOC SHARES TO SURRENDER (OR SELL) THOSE SHARES WHEN THEY LEAVE THE STATE?

While the federal law does not explicitly require that a GSOC holder surrender or sell his shares when leaving Alaska, it provides that no share of a GSOC may be transferable for five years after issuance "except where the shareholder ceases to be a resident of the State." (§ 1391(a)(4)(D)(i)). The federal law is thus silent as

to whether a shareholder must remain a resident in order to continue as a shareholder.

Presumably, Alaska will wish to clarify what is to become of a GSOC share when its owner leaves Alaska and ceases to be a resident. Of course, Alaska could merely allow the holder to retain his share and continue to receive dividends. Three alternatives come to mind: (1) that the GSOC share could cease to earn dividends when the holder leaves Alaska; (2) the holder could be obliged to surrender his share to the GSOC when leaving the state; and (3) the holder could be obliged to sell his share (at some value) to the GSOC or to another resident when leaving the state.

Each of these alternatives is fraught with problems of administration and enforcement, and each has important practical effects on the GSOC's operations. What legal complaints could a holder who moves out of the state make if Alaska chose one of these "recapture" provisions?

1. Equal Protection of the Laws

A former resident of Alaska may assert that in being obliged to surrender (or sell) his GSOC share or to be deprived of its earning ability merely because he has left the state, he has been penalized for exercising

his fundamental right to travel interstate and thus denied equal protection of the laws. Although one might think that strict scrutiny could be applied if involuntary deprivation of a GSOC share or its income could be seen as comparable to a denial of the necessities of life,[51/] a similar claim has been rejected by the Supreme Court. In Califano v. Torres, 435 U.S. 1 (1978) the Court analyzed and rejected under the rational basis test a claim that to cut off welfare benefits when a recipient moved to Puerto Rico penalized his right to travel.[52/] The Court stated that to require a person who travels to Puerto Rico to be given benefits superior to those enjoyed by other residents of Puerto Rico simply because he enjoyed them in the state from which he came "would require a State to continue to pay those benefits indefinitely to any persons who had once resided there." Id. at 4. Of course, whatever "penalty" on the travel right could be found in the GSOC situation after application of the Court's reasoning in Torres will be lessened if any Alaska recapture

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51/ Presumably in the future substantial value could be involved.

52/ Since Puerto Rico is not a state, a less fundamental right to international travel was probably involved. Cf. Califano v. Aznavorian, 47 U.S.L.W. 4037, 4039 (U.S. Dec. 11, 1978).

provision requires full payment of the value of the GSOC share.[53/]

Assuming the rational basis test is applied, administrative and policy reasons for restricting ownership to each state's residents set forth above probably would suffice to justify a GSOC provision that merely requires a departing resident to exchange his GSOC interest for fair market value. However, a more formidable problem would be presented by a provision that forfeited the share or the dividends of any resident departing the state. Justifications for such a provision could be made, however. For example, it could be asserted that it is reasonable for the GSOC to avoid both the depletion of cash reserves on account of direct cash payments and the administrative burden of establishing and regulating a market for the trading of this very limited number of shares, in light of the lack of a trading market for the shares in the early years and the difficulty of establishing a fair value. Perhaps, Alaska could also assert the need to qualify for the intrastate exemption from the Securities Act of 1933 and/or whatever conditions the Securities and Exchange

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53/ Presumably, it would also be less if the state into which the plaintiff moves has also established a GSOC with a policy of entry for new residents.

Commission imposes on whatever exemptions it grants the Alaska GSOC.[54/] In addition, it could be argued that the purpose of the GSOC is to establish long-term investment holdings by state residents, not to give cash windfalls to former residents. Nonetheless, these justifications are much weaker than the justifications for mere restraints on alienation, and the injury to affected individuals much greater. There is a substantial likelihood that a rational basis challenge to such a provision would be successful, and since it is possible that the strict scrutiny test would be applied due to the penalty on the travel interest involved, we believe inclusion of any confiscatory provision would be at the risk of invalidation.

1. Privileges and Immunities

A GSOC owner who ceases to be a resident may argue that Alaska is treating him differently from its residents in requiring him to surrender or sell his shares in violation of his privileges and immunities of state citizenship.

54/ See our Memorandum, Application of Federal Securities Laws to General Stock Ownership Corporations, dated November 2, 1978.

While involuntary relinquishment of a GSOC share which may by the time in question have substantial value and value-producing capacity is more substantial than the elk hunting restriction in Baldwin, a provision for Alaska's recapture of GSOC shares may nevertheless satisfy the Baldwin test if Alaska can assert rational policy reasons for the provision. Under the Hicklin analysis, presumably the evil which the recapture measure seeks to avoid is the dilution of the investment by Alaskans in Alaskan projects, as well as what may be an overwhelming administrative burden. In addition, if the former resident is either given fair value for his share or allowed to sell it, a strong argument can be made that since rational reasons support the decision to limit GSOC shares to state residents, and because he is being given "substantial equality of treatment" in comparison with residents, Austin v. New Hampshire, 420 U.S. 656, 665 (1975), a provision requiring the transfer of shares from all departing residents should be upheld in the face of a privileges and immunities challenge.

2. Commerce Clause

If a recapture provision is inserted in an Alaska statute, the commerce clause itself provides a basis for

attack.[55/] Presumably, the recapture provision, as one small part of a large and complex legislative program, would not be characterized as simple economic protectionism and *per se* invalid. Alaska would argue that any effect on commerce would be merely incidental and therefore permissible under the balancing test applied under the clause. In addition, Alaska can assert that a commerce clause challenge should be barred by operation of the *Hughes* decision, which held that the commerce clause was not violated when a state entered the market to increase commerce and in so doing favored its residents.

3. Due Process

Could a provision requiring the surrender by former residents of GSOC shares or their dividends be challenged successfully on the ground that it is an unconstitutional taking of property without payment of fair compensation? It is possible that the "taking" problem could be avoided by the statement on each GSOC share that it remains outstanding only as long as its holder remains an Alaskan resident, with the share either reverting to the state

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55/ For this reason, placing any such restriction in the GSOC's articles of incorporation would be preferable.

or losing its dividends if the holder moves out of state.[56/] There would be no taking of property without compensation to the extent that the alleged property interest infringed never existed.

A second possible due process problem is presented by a resident temporarily moving out of state who wishes to retain his state citizenship; he may claim he is entitled to procedural due process before he can be forced to sell or surrender his GSOC share. Assuming "state action" were found, the procedures that should be afforded in this situation could be modeled after procedures which must be afforded by universities in deciding whether a person is a resident for the purposes of in-state tuition.[57/]

On balance, we believe that if Alaska can assert strong reasons for its need for one or the other recapture provision, the provision should be enforceable; chances of survival are increased if the provision is placed in

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56/ This provision could be eternal, or could be limited to the first five years. Presumably after five years, a private market will have been established in which the former resident could receive fair value if forced to sell.

57/ See, e.g. Vlandis v. Kline, 412 U.S. at 451-53 (1973).

the GSOC's articles of incorporation and the former resident is fairly compensated.[58/]

E. MAY ALASKA RESTRICT ISSUANCE OF GSOC SHARES TO A LIMITED CLASS OF RESIDENTS, SUCH AS RESIDENTS OVER A CERTAIN AGE OR RESIDENTS OF LIMTED MEANS?

As a matter of statutory interpretation, we do not believe that the federal GSOC legislation leaves room for Alaska to restrict issuance of GSOC shares to a class more narrow than "eligible individuals" as defined in the tax legislation. Section 1391(a)(4)(C) specifies that the GSOC charter shall provide "for the issuance of at least one share to each eligible individual . . . ." (emphasis added). Section 1391(c) defines an "eligible individual" as a resident of the state on a date to be specified by the state, who remains a resident until share issuance. Read together, we believe these provisions simply leave no latitude for the state to issue GSOC shares to less than all eligible individuals as defined in the federal statute. Since the consequence of departing from the requirements imposed by the Internal Revenue Code is the

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58/ See footnote 4, *supra*.

We believe further analysis of the recapture problem is warranted once Alaska has decided it wishes to follow one or another of the alternatives.

loss of special tax benefits availabe to a GSOC, no attempt should be made to narrow the definition of "eligible individuals" without first receiving a ruling from the Internal Revenue Service that such action is consistent with the federal legislation.

If Alaska were permitted by the Service to restrict the class of eligible individuals, the choice to restrict GSOC ownership to adults or to those of limited means probably could not be successfully attacked on constitutional grounds.[59/]

59/ Age classification has not been recognized as constitutionally "suspect" and subject to strict scrutiny, Massachusetts Board of Retirement v. Murgia, 427 U.S. 307, 312-314 (1976), and the rational basis test would thus be applied in the review of a provision of Alaska law that GSOC shares be distributed only to residents over a certain age. If Alaska should desire to impose an age classification, it appears that sufficient rational bases exist to justify it. For example, Alaska could accept the traditional view that children of minority age do not have sufficient sense of responsibility to manage their own financial affairs; Alaska thus may desire to provide GSOC benefits only to those who will prudently use them. And Alaska may desire to give approximately the same GSOC benefit to each family, rather than to give a windfall to those families that include many children.

Furthermore, a wealth classification (for example, a restriction to families of limited means) would certainly not be consitititutionally "suspect" and subject to strict scrutiny. Wealth has never been a suspect class, and there would be no problem formulating a rational basis for aid to the poor. However, it should be noted that were Alaska to decide to restrict issuance of shares to residents of limited means, and obtained a revenue ruling which permitted this, GSOC dividends would have the character of welfare payments with the consequence of strengthening the argument that, because necessities of life may be involved, various GSOC restrictions penalize the exercise of the right to travel. See Shapiro, supra.

Conclusion

Although legal challenges to the GSOC concept and its particulars may occur, there are substantial arguments to be made in defense of the constitutionality of the salient features of the GSOC proposal as outlined in this memorandum.

WILMER, CUTLER & PICKERING

FEDERAL SECURITIES LAWS

The following memorandum, prepared by the firm of Wilmer, Cutler and Pickering, Washington, D.C., is a summary of recommendations regarding possible application of Federal securities laws and regulations to Alaska General Stock Ownership Corporation (AGSOC).

It appears that in all probability AGSOC will be subject to the provisions of the Securities Exchange Act of 1934.

It is contemplated that representatives of the Legislative Finance Division of the U.S. Senate, Kelso & Co., Incorporated and Wilmer, Cutler and Pickering will meet with the appropriate Division heads of the Securities and Exchange Commission to discuss the possibility of a private ruling or "no action letter" to simplify the paperwork which might otherwise be required of AGSOC under the 1934 Act.

WILMER, CUTLER & PICKERING
1666 K STREET, N.W.
WASHINGTON, D.C. 20006

November 2, 1978

MEMORANDUM

Summary of Recommendations Regarding
Federal Securities Regulation of
General Stock Ownership Corporations

A general stock ownership corporation ("GSOC") that is formed pursuant to the Revenue Act of 1978 potentially will be subject to at least three federal securities laws: (1) the Securities Act of 1933 (the "33 Act"), (2) the Securities Exchange Act of 1934 (the "34 Act") and the Investment Company Act of 1940 (the "40 Act"). The attached memorandum describes the operation of these provisions.

The 33 Act makes it unlawful to sell certain securities unless a registration statement for those securities has been filed with the Securities and Exchange Commission (the "SEC") and prohibits misleading information in registration or sale documents.

The 34 Act requires filing of a registration statement by companies whose securities are widely held, requires periodic reporting to the SEC of financial and other information, and sets forth rules governing the solicitation of proxies allowing one to vote shares of

other investors at an annual meeting or to effect other corporate action requiring a shareholder vote.

The 40 Act requires the registration of companies which primarily invest in the securities of other companies, regulates certain conduct of such companies, and sets disclosure standards for them.

Because of the unique nature of the GSOC, we believe that a special application of the federal securities laws may be warranted.

We propose that representatives of the State, on behalf of a proposed Alaskan GSOC, promptly formulate for presentation to the SEC a program of related applications for administrative exemption from the various federal securities laws, conditioned on the undertaking that a GSOC would comply with disclosure and proxy rules specially tailored to circumstances in Alaska and to the unique nature of a GSOC. In particular, we recommend that the GSOC:

(1) Apply for a "no action" letter from the SEC that the 33 Act does not apply to a GSOC on the alternative grounds that the initial offer and sale of GSOC shares (a) will not be "for value" or (b) will qualify for the intrastate exemption;

(2) Seek a conditional and temporary exemption from the 34 Act and 40 Act patterned after the Alaska Native Claims Settlement Act. Under this proposal a GSOC would be required to provide an annual report to shareholders containing substantially all the information required in annual reports under the 34 Act, but no other information. The annual report required by the Revenue Act of 1978 to be submitted to the Treasury Department might be used for this purpose. The exemption period proposed would correspond with the five-year period when shares of a GSOC are generally nontransferable.

(3) Utilize the five-year exemption period to continue discussions with the SEC concerning the extent to which the unique character of the GSOC warrants special treatment under or exemption from other provisions of the federal securities laws. For example, since the shareholders of the GSOC will be state voters, it may be desirable to explore utilizing the state's ballot process as a proxy machinery. Other problems may require innovative techniques in this case of a corporation owned by a large number of investors who in many cases may be less sophisticated than the usual investor for whom existing proxy and disclosure rules were designed.

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

WILMER, CUTLER & PICKERING

WILMER, CUTLER & PICKERING
1666 K STREET, N.W.
WASHINGTON, D.C. 20006

November 2, 1978

MEMORANDUM FOR THE
COMMISSIONER OF REVENUE
STATE OF ALASKA

Application of Federal Securities
Laws to General Stock Ownership
Corporations

You have asked our advice with respect to the application of the federal securities laws to the organization and operation of a general stock ownership corporation ("GSOC").

Introduction -- the Nature of a GSOC.

A GSOC is defined in section 601 of the Revenue Act of 1978 (the "Act"). Under the Act, a state is authorized to charter a private corporation whose shares will be owned entirely by individuals who are residents of the state. Although the legislation does not specify whether the shares will be distributed with or without charge, its primary sponsor (Senator Gravel) has stated his intention that the shares will be issued without charge.*/

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*/ 124 Cong. Rec. S19,168 (daily ed. Oct. 14, 1978).

It is contemplated that a GSOC will acquire an interest in one or more business enterprises with borrowed funds, perhaps aided by state grants or guarantees. The cash flow from the acquired business interests will be used to repay loans and pay dividends to the residents of the state who are its shareholders.

Under the Act, the GSOC will not be subject to corporate tax; instead the shareholders will be taxed currently on their pro rata share of the corporation's taxable income whether or not distributed. A GSOC will be required to distribute 90 percent of its taxable income each year to its shareholders.

The GSOC legislation was structured with a minimum of federal restrictions in order to provide states with maximum flexibility to organize a GSOC on their own terms. However, the corporate charter must provide that: (1) only one class of stock may be issued; (2) each resident will receive at least one share of the GSOC (unless a resident elects within one year not to receive his share); (3) shares may be owned only by individuals as opposed to legal entities; (4) shares may not be transferred for a five-year period, other than by will or by the laws of descent, except where the shareholder ceases to be a resident of the state; (5) shares may not be transferred to non-

residents; and (6) ownership is limited to ten shares. In addition, a GSOC may not hold a 20 percent or more interest in any subsidiary, may not acquire its business properties from an unwilling seller through the use of the state's power of eminent domain and is required to file an annual report with the Secretary of the Treasury summarizing its operations for the year.

The precise mechanisms by which ownership will be restricted to residents of the chartering state and details of distribution, redemption and trade in shares of the GSOCs will be determined by a state's enabling legislation. Principles of federal constitutional law which may be relevant to choices among the various alternatives will be examined in a separate memorandum. This memorandum addresses the applicability of the federal securities laws to a GSOC and reviews legislative and administrative alternatives by which federal regulation may be avoided or minimized.

Application of the Federal Securities Laws.

There are eight federal statutes which comprise the "federal securities laws." */ In a variety of ways, each of these statutes appears designed to protect the investing public by regulating the activities of companies that raise capital by sale of their shares to the public, by monitoring the practices of persons in the business of trading in such "securities" or the business of managing the investments of others, and by ensuring public disclosure of accurate and relevant information. At least three of the eight statutes which are administered by the Securities and Exchange Commission (the "SEC" or the "Commission") may apply to a GSOC. **/

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*/ These are the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Investor Protection Act of 1970, and certain aspects of the National Bankruptcy Act.

/ The Trust Indenture Act, regulating trust indentures covering particular types of debt securities, the Securities Investor Protection Act, providing certain protection for customers of brokers and dealers in securities who are forced to liquidate, and certain SEC responsibilities with respect to reorganizations under Chapter X of the Bankruptcy Act have no foreseeable application to the GSOCs. As will be explained infra at 17 n., the Investment Advisers Act and the Public Utility Holding Company Act may become relevant depending on the nature of GSOC operations, and should be explored at the appropriate time.

a) <u>Securities Act of 1933.</u>

i) <u>The statute and its application.</u>

The Securities Act of 1933 (the "33 Act") requires the disclosure of material information concerning companies when securities are sold to the public. The primary disclosure device is the Act's requirement that a company or other seller of securities file a detailed registration statement with the SEC and deliver the prospectus contained therein to prospective investors, in connection with the offer or sale of the securities to them. Registration statements are scrutinized by the SEC staff and must be declared "effective" by the SEC before sales of the securities registered may be made. Misleading or incomplete information in such materials or other selling communications is made unlawful by the antifraud provisions of the 1933 legislation and its implementing rules.*/

There are two reasons why the registration requirement of the 33 Act likely may not apply to a GSOC:

(i) <u>No-sale theory.</u>

The 33 Act's registration requirement is keyed to the sale (or offer for sale) of securities by

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*/ In addition, the 33 Act gives a person acquiring a security covered by a misleading registration statement or oral communication a civil cause of action against the directors of the company and others involved in preparation of the statement or communication.

any issuer. A "sale" is defined as "every . . . disposition of a security . . . for value."*/ If a GSOC issues its shares without charge, it would not appear to be selling (or offering for sale) shares "for value".**/ A no-action letter issued by the SEC in the case of corporations created under the Alaska Native Claims Settlement Act confirms our view.***/ See The Native Alaska Federation of Natives, Inc. (Jan. 28, 1974).****/

(ii) Intrastate offering exemption.

Even if a GSOC were to establish a subscription price for its shares, the GSOC may avoid the

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*/ 1933 Act, §§ 2(3), 4(1), and 5(a) and (c).

**/ It is possible, however, that the SEC could take the position that "value" inures to a GSOC from the ultimate creation of a trading market in GSOC shares. Cf. SEC v. Harwyn Indus. Corp., 326 F. Supp. 943 (S.D.N.Y. 1971).

***/ A no-action letter, although informative, is not an official interpretation by the SEC. It is nothing more than a representation of the SEC staff that, based upon the particular facts involved, they will not recommend to the Commission that it take enforcement action against the party seeking the advice. Thus, while we here and elsewhere discuss no-action letters, we are not talking about formal action by the Commission.

****/ A discussion of the legislative approach to securities laws problems in the Alaska Native Claims legislation is included at pp. 23-26.

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

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

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

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

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

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

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

ii) Possibilities for legislative exemption.

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

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

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

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

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

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

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

b) Securities Exchange Act of 1934.

i) The statute and its application.

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

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

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

ii) Possibilities for exemption -- administrative.

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

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

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

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

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

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

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

iii) Trading Alternatives.

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

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

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

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

iv) Possibilities of exemption -- legislative.

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

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

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

c) <u>Investment Company Act of 1940</u>

i) <u>The statute and its application.</u>

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

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

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

business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities*/ having a value exceeding 40 per centum of the value of such issuer's total assets . . . ." 40 Act §§ 3(a)(1) and (3).**/ If a GSOC falls within the definition, it is subject to registration and regulation under the 40 Act.

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

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

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

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

[Footnote continued on following page]

ii) Possibilities for exemption -- administrative.

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

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

[Footnote continued]

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

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

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

iii) Possibilities for exemption -- legislative.

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

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*/ See, e.g., Associated Life Ins. Investors Corp., SEC Investment Company Act Rel. No. 4574 (April 22, 1966); United Life Ins. Sec. Corp., SEC Investment Company Act Rel. No. 4193 (March 17, 1965); I.B.T., Inc., SEC Investment Company Act Rel. No. 3369 (November 28, 1961).

Our Recommendations

a) Questions of Policy.

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

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

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

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

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

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

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

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

b) The Alternative of Legislative Relief.

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

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

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

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

In 1975, the Settlement Act was amended to provide for total exemption of the Regional Corporations from operation of the 33 Act, 34 Act and 40 Act for the years during which shares in the Regional Corporations could not be transferred except by divorce, separation or death. 43 U.S.C. § 1625 provides:

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

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

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

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

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

c) The Alternative of Administrative Relief.

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

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

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

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

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

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

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

WILMER, CUTLER & PICKERING

INTERNAL REVENUE CODE SECTIONS

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

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

Internal Revenue Code Section 1504

[¶ 4911]

DEFINITIONS

'54 Code

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

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

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

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

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

(1) Corporations exempt from taxation under section 501.

(2) Insurance companies subject to taxation under section 802 or 821.

(3) Foreign corporations.

(4) Corporations with respect to which an election under section 936 (relating to possession tax credit) is in effect for the taxable year.

(5) Corporations organized under the China Trade Act, 1922 [repealed for taxable years beginning after December 31, 1977].

(6) Regulated investment companies and real estate investment trusts subject to tax under subchapter M of chapter 1.

(7) A DISC or former DISC (as defined in section 992(a)).

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

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

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

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

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

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

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

(i) section 243(b)(6) and the exception provided under section 243 (b)(5) with respect to subsections (b)(2) and (c) of this section,

(ii) section 542(b)(5), and

(iii) subsection (a)(4) and (b)(2)(D) of section 1563, and the reference to section 1563(b)(2)(D) contained in section 1563(b)(3)(C),

shall not be effective for such taxable year.

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

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

[¶ 4911]—Continued

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

Committee Reports on P. L. 94-455

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

Reasons for change

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

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

The committee amendment deals with this problem by permitting consolidated returns to be filed by life companies and nonlife companies, subject to the restriction that (1) the life company's taxable income cannot be reduced by more than one-half as a result of the consolidation, and (2) no more than one-half of a nonlife company's losses can be applied against a life company's income in any year. Any nonlife company losses not absorbed in this manner will still be available as carryovers of the nonlife companies to subsequent years. This preserves the concept sought by Congress in the past to the effect that some tax will be paid with respect to the life insurance company's investment income (except where the company itself has an overall loss from operations), but at the same time provides substantial relief in the future for casualty companies with losses.

Explanation of provision

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

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

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

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

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

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

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

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

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

Another special rule makes it clear that the enactment of the new provisions is not to result in the termination of an affiliated group. For example, assume that a life company owns 100 percent of a subsidiary which in turn owns 100 percent of a second subsidiary. Assume further that the first and second subsidiaries are not life companies but elect to file consolidated returns under this provision. If the life company also elects to join in the filing of a consolidated return, then the affiliated group of the two subsidiaries would not be treated as having been terminated (as a result, any deferred intercompany transactions between the subsidiaries would not be treated as giving rise to taxable income).

Effective date

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

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

House bill.—No provision.

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

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

[¶ 4911.06]—Continued

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

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

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

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

.09 Committee Reports on P. L. 86-69 are at 1959-2 CB 829.

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

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

Internal Revenue Code Section 248

[¶ 2165] **ORGANIZATIONAL EXPENDITURES**

'54 Code

Sec. 248 [1954 Code]. (a) ELECTION TO AMORTIZE.—The organizational expenditures of a corporation may, at the election of the corporation (made in accordance with regulations prescribed by the Secretary), be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the corporation (beginning with the month in which the corporation begins business).

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

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

(2) is chargeable to capital account; and

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

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

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

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

Internal Revenue Code Section 38

[¶ 582] INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY

'54 Code

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

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

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

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

[¶ 586] **AMOUNT OF CREDIT**

'54 Code

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

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

(A) the investment credit carryovers carried to such taxable year,

(B) the amount of the credit determined under paragraph (2) for such taxable year, plus

(C) the investment credit carrybacks carried to such taxable year.

(2) AMOUNT OF CREDIT.—

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

(i) the regular percentage,

(ii) in the case of energy property, the energy percentage, and

(iii) the ESOP percentage.

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

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

'54 Code

[¶ 586]—Continued

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

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

(ii) zero with respect to any other period.

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

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

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

(ii) with respect to the period beginning on January 1, 1977, and ending on December 31, 1983,[**] an additional percentage (not in excess of ½ of 1 percent) which results in an amount equal to the amount determined under section 48(n)(1)(B).

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

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

'54 Code

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

'54 Code

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

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

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

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

(i) 50 percent, plus

'54 Code

[¶ 586]—Continued

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

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

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

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

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

'54 Code

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

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

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

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

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

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

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

(i) 50 percent, plus

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

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

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

'54 Code

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

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

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

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

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(i) 50 percent, plus

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

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

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

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

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

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

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

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

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

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

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

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

(i) 50 percent, plus

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

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

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

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

[¶ 586]—Continued

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

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

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

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

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

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

(i) 50 percent, plus

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

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

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

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

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

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

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

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

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

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

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

(i) paragraph (3)(C) shall be applied by substituting "100 percent" for "50 percent",[*]

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

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

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

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

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

(b) CARRYBACK AND CARRYOVER OF UNUSED CREDITS.—

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

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

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

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

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

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

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[*] The amendment of subparagraph (B)(i) by Sec. 301(c) of the 1978 Energy Act (P. L. 95-618) failed to take into account the changes made to Code Sec. 46(a)(3) by Sec. 312(a) of the 1978 Revenue Act. Since the Revenue Act amendments to Code Sec. 46(a)(3) are effective for tax years ending after 1978, the references in subparagraph (B)(i) for years ending after 1978 should probably be to paragraph (3)(B) rather than (3)(C) and to "the percentage appropriate for the taxable year" rather than to "50 percent.".—CCH.

[¶ 586]—Continued

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

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

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

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

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

(c) QUALIFIED INVESTMENT.—

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

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

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

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

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

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

(3) PUBLIC UTILITY PROPERTY.—

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

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

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

(ii) gas through a local distribution system, or

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

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other communication services (other than international telegraph service),

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[¶ 586]—Continued

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

(6) SPECIAL RULE FOR COMMUTER HIGHWAY VEHICLES.—

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

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

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

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

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

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

(d) QUALIFIED PROGRESS EXPENDITURES.—

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

(2) PROGRESS EXPENDITURE PROPERTY DEFINED.—

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[¶ 586]—Continued

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

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

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

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

or for any taxable year thereafter.

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

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

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

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

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

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

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

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

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

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

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

(e) LIMITATIONS WITH RESPECT TO CERTAIN PERSONS.—

(1) IN GENERAL.—In the case of—

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(A) an organization to which section 593 applies, and

(B) a regulated investment company or a real estate investment trust subject to taxation under subchapter M (sec. 851 and following),

the qualified investment and the $25,000 amount specified under subparagraphs (A) and (B) of subsection (a)(3) shall equal such person's ratable share of such items.

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

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

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

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

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

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

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

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

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

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

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

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

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

[¶ 586]—Continued

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

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

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

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

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

(4) LIMITATION.—

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[¶ 586]—Continued

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Committee Reports on P. L. 95-618

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

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

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

In determining whether employees are transported from their homes to their places of employment, it is not necessary that the employees be picked up at, and transported to, their homes. It is sufficient to meet this requirement if the employees are transported to and from some central pickup point (or points) or intermediate location between the employees' residences and places of employment. * * *.—**Conference Committee Report.**

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

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

[¶ 586.0285]—Continued

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

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

Committee Reports on P. L. 95-600

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

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

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

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

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

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

A limitation is provided where five-year amortization is elected and the pollution control facility has also been financed in whole or in part by tax-exempt industrial development bonds. In order to reduce the duplication of tax incentives in such situations, the bill limits the amount of credit to, in effect, one-half of the full credit. In cases where the proceeds of industrial development bonds have been used to partially finance the construction of a plant or factory, including a pollution control facility for which the taxpayer elects five-year amortization, a pro-rata portion of the tax-exempt financing should be allocated to the pollution control facility for purposes of applying this limitation.

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

.0293 *House bill.*—No provision.

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

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

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

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

Committee Reports on P. L. 94-455

EXTENSION OF 10 PERCENT CREDIT AND USED PROPERTY LIMITATION

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

FIRST-IN-FIRST-OUT TREATMENT OF INVESTMENT CREDITS

.032 *House bill.*—No provision.

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

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

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

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

ESOP INVESTMENT CREDIT PROVISIONS

.034 *House bill.*—No provision.

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

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

Conference agreement.—The conference agreement follows the Senate amendment but limits the additional credit program to qualified investments made before January 1, 1981, and limits the additional credit generally to 1 percentage point. An additional one-half percentage point is available only if the first percentage point is contributed to the ESOP, and only to the extent the one-half percent is matched by employee contributions to the ESOP. Under the conference agreement, separate accounting would be required for matching employee and employer contributions continuing present law treatment, an employer contribution for a taxable year in excess of the amount attributable to the additional credit allowed for such year is deductible for that year, subject to the usual rules for deduction of contributions to employee plans.

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

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

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

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

[¶ 586.034]—Continued

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

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

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

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

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

INVESTMENT CREDIT LIMITATION FOR RAILROADS

.036 *House bill.*—No provision.

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

The Senate amendment allows railroads to take credits up to 100 percent of tax liability for 1976 and 1977 with annual reductions of 10 percentage points thereafter until the limitation returns to 50 percent in 1982. The amendment applies to tax years ending after December 31, 1975.

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

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

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

There are no comparable provisions in the House bill.

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

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

INVESTMENT CREDIT LIMITATION FOR AIRLINES

.038 *House bill.*—No provision.

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

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

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

POLLUTION CONTROL FACILITIES

.039 *House bill.*—No provision.

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

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

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

INVESTMENT CREDIT FOR CERTAIN VESSELS

.041 *House bill.*—No provision.

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

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

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

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

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

[¶ 586.041]—Continued

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

Committee Reports on P. L. 94-12

INCREASE IN INVESTMENT CREDIT

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

PROGRESS PAYMENTS

.0495 *Progress payments.*—Under present law, a tax credit may be taken for investment in qualified property at the time the property is placed in service and therefore is ready for use. As indicated previously, the committee concluded that in cases where taxpayers pay for long lead time property as it is being constructed and substantially before the property can be placed in service, to wait for the allowance of the investment credit until the property is placed in service represented too long a delay in the claiming of the credit. The bill overcomes this problem in present law by allowing an investment credit for what are called "progress payments."

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

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

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

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

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

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

[¶ 586.0495]—Continued

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

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

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

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

For this purpose, "progress" will generally be the percentage of completion, measured in terms of the manufacturer's incurred cost, as a fraction of his anticipated cost (as adjusted from year to year) based upon cost accounting records or in some cases on engineer or architect certificates.[6]

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

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

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

To prevent a possible abuse situation, where a manufacturer might certify unrealistic amounts of progress in connection with a project, the committee bill contains a "pro rata" rule. Under this rule, it will be presumed that generally progress will not occur with respect to a project more rapidly than ratably over the expected construction period for the property.[7] However, this presumption could be rebutted if the taxpayer shows by clear and convincing evidence that progress had, in fact, been more rapid.

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

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

If, on the other hand, the manufacturer had incurred only $5,000 of costs in connection with the property in 1980, the taxpayer would be allowed to treat only 50 percent of his $11,000 payment as qualified investment in 1980 ($5,500) because there had been only 5 percent "progress" in that year. However, in that case, if the manufacturer incurred an additional $5,000 of cost in connection with the property in 1981, the taxpayer could treat the $5,500 of unused 1980 payment as qualified investments for 1981 (receiving, in effect, a carryover of his unused 1980 payment) even if no further payments were made to the manufacturer in 1981.

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

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

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

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

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

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

As discussed above, progress expenditure treatment is to be allowed only in the case of property which has an estimated useful life (measured from the time the property is placed in service by the taxpayer) of seven years or more. If the estimated useful life of the property is less than seven years at the time it is placed in service (even if previous estimates were for a longer useful life and were reasonable when made) any excess credits previously allowed under the progress payment rules are to be subject to recapture.[10]

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

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

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

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

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

[9] For example, sale of the property, or of the contract rights to the property before the property is placed in service, is to be treated as a disposition. A similar result is to follow if the contract for the property is cancelled, or if the project is abandoned by the taxpayer. Conveyance of the property by gift is also to be treated as a disposition. However, there would be no recapture in the event of a transfer by death, or pursuant to a sec. 381 transaction, but the decedent, or corporation (as the case may be) would be treated as a "predecessor" of the person receiving the sec. 38 property, and progress payments of the predecessor would have to be taken into account in reducing the qualified investment of the successor.

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

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

[¶ 586.0495]—Continued

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

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

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

For example, assume that a progress expenditure of $10,000 were made in 1975. Two thousand dollars of this amount would be treated as a qualified investment in that year, and $2,000 would be available to be treated as qualified investment in each of the next 4 years. On the other hand, if a $10,000 progress expenditure were to be made in 1977 then $6,000 of that payment would be treated as a qualified investment in that year, and the remaining $4,000 woud be taken into account ratably in 1978 and 1979.

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

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

.05 **Committee Reports on P. L. 92-178 are at 1972-1 CB 504, 568 and 645.**

.055 **Committee Reports on P. L. 91-172 are at 1969-3 CB 199, 423 and 644.**

.057 **Committee Reports on P. L. 90-225 are at 1968-1 CB 640.**

.07 **Committee Reports on P. L. 89-800 are at 1966-2 CB 649.**

.08 **Committee Report on P. L. 89-389 is at 1966-1 CB 527.**

.09 **Committee Report on P. L. 89-384 is at ¶ 4844.10.**

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

[¶ 589] CERTAIN DISPOSITIONS, ETC., OF SECTION 38 PROPERTY

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

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

(2) PROPERTY BECOMES PUBLIC UTILITY PROPERTY.—If during any taxable year any property taken into account in determining qualified investment becomes public utility property (within the meaning of section 46(c)(3)(B)), then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from treating the property, for purposes of determining qualified investment, as public utility property (after giving due regard to the period before such change in use). If the application of this paragraph to any property is followed by the application of paragraph (1) to such property, proper adjustment shall be made in applying paragraph (1).

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

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

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

[¶ 589]—Continued

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

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

(4) SPECIAL RULES FOR COMMUTER HIGHWAY VEHICLES.—

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

(B) CHANGE IN USE.—If less than 80 percent of the mileage use of any commuter highway vehicle by the taxpayer during that portion of any taxable year which is within the first 36 months of the operation of such vehicle by the taxpayer meets the requirements of section 46(c)(6)(B), then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from treating such vehicle, for purposes of determining qualified investment, as not being a commuter highway vehicle. If the application of this subparagraph to any property is followed by the application of paragraph (1) to such property, proper adjustment shall be made in applying paragraph (1).

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

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

(A) GENERAL RULE.—Any aircraft which was new section 38 property for the taxable year in which it was placed in service and which is used outside the United States under a qualifying lease or leases shall be treated as not ceasing to be section 38 property by reason of such use until such aircraft has been so used for a period or periods exceeding 3½ years in total. For purposes of the preceding sentence, the registration of such aircraft under the laws of a foreign country shall be treated as used outside the United States.

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

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

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

(7) MOTION PICTURE FILMS AND VIDEO TAPES.—

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

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

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

(1) a transfer by reason of death,

(2) a transaction to which section 381(a) applies, or

(3) a transfer to which subsection (c) of section 374 (relating to exchanges under the final system plan for ConRail) applies.

For purposes of subsection (a), property shall not be treated as ceasing to be section 38 property with respect to the taxpayer by reason of a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as section 38 property and the taxpayer retains a substantial interest in such trade or business.

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

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

Committee Report on P. L. 95-618

.018 • • •

Under the normal investment credit rules, as applied to this provision, the credit will be recaptured if the commuter highway vehicle is disposed of within 3 years after it is placed in service. The conference agreement adds a recapture rule which provides, in effect, that recapture will occur if the full investment credit is claimed under this provision with respect to a vehicle, and within the first 36 months of the operation of the vehicle, the vehicle ceases to be a commuter highway vehicle. In applying the 80 percent of mileage use test to determine whether a vehicle ceases to be a commuter highway vehicle, the test shall be applied on the

[¶ 589.018]—Continued

basis of the entire portion of the 36 month period which falls within the taxable year. If recapture results from a change in use from vanpooling to other business use, the amount of credit which will be recaptured will be two-thirds of the investment credit claimed (assuming the vehicle has a useful life of 3 or 4 years). If recapture results from a change from a vanpooling use to a personal use, the entire amount of the investment credit will be recaptured.—**Conference Committee Report.**

Committee Report on P. L. 95-600

.0181 The bill adds an exception to the investment credit recapture rules (sec. 47(b)) so that a transferor railroad will not be subject to additional tax on its transfer of rail properties to ConRail. However, the committee intends that investment credits which are not subject to recapture because of this provision shall be treated as "other benefits" to the same extent that any other tax benefits are so treated for purposes of the special court's determination of compensation to the transferor railroads under sections 303 and 306 of the Regional Rail Reorganization Act of 1973.

The House bill did not contain a comparable provision.

This amendment applies to taxable years ending after March 31, 1976.—**Senate Committee Report.**

.0183 The Committee Reports on P. L. 94-455 are at ¶ 592.015.

.0185 Committee Reports on P. L. 94-12 are at ¶ 586.049.

.019 Committee Reports on P. L. 92-178 are at 1972-1 CB 504, 568 and 645.

Committee Report on P. L. 91-676

I. Summary

.02 In general, H. R. 17988 provides that there is not to be a recapture of an investment credit previously allowed with respect to an airplane by reason of the use of the airplane outside the United States, if the airplane is not used in this manner for more than one-half the time period taken into account in determining the amount of the investment credit originally allowed (that is, 4 to 6, 6 to 8, or 8 or more years). This treatment is to be available, however, only with respect to airplanes leased from U. S. air carriers after April 18, 1969, under leases which comply with the applicable Federal aviation statutes. Under present law, a previously allowed investment credit generally is recaptured if in any one taxable year the airplane is used outside the United States for more than half of the year.

The Treasury Department has indicated that it has no objection to the enactment of this bill.

II. Reasons for Bill

The amount of the 7-percent investment tax credit previously allowed to a taxpayer with respect to investment credit property when it was placed in service was determined with reference to the length of time the property would be used by the taxpayer.[1] The full 7-percent credit was allowed if the period was 8 or more years, two-thirds of a full credit was allowed if the period was 6 to 8 years, and one-third of a full credit was allowed if the period was 4 to 6 years. If property with respect to which the investment credit was previously allowed is disposed of, or ceases to be qualified investment credit property, before the end of the period (that is, in 0 to 4, in 4 to 6, or in 6 to 8 years) used in determining the amount of the credit originally allowed, then the previously allowed credit is recaptured in whole or in part. The amount recaptured is the excess of the credit previously allowed over the amount of the credit which would have been allowed if it had been determined on the basis of the period of time it was actually used in the specified manner by the taxpayer.

For an airplane to qualify initially as investment credit property and to continue to qualify, it must be principally used in the United States or (if it is registered with the Federal Aviation Agency) operated either to and from the United States or under contract with the United States. This requirement has been interpreted by the Treasury Department to mean that the plane must be used in the specified manner for more than half of each taxable year. If an airplane with respect to which an investment credit was previously allowed ceases to be used in the manner specified above for a taxable year before the end of the expected period of use, then the airplane ceases to qualify as investment credit property and the investment credit previously allowed is recaptured in whole or in part.

In recent years, U. S. air carriers have acquired (or are under binding obligations to acquire) airplanes based on a projected demand which took into account to a significant degree governmental airlift requirements, particularly those associated with Southeast Asia. Governmental airlift needs, however, have been decreasing from past levels and, as a result, a number of U. S. airlines find they have excess equipment. The only practical use of the excess airplanes at the present time, other than letting them remain idle, is to lease them on a temporary basis for use outside the United States. If this were done, however, there could be a recapture of the investment credit previously allowed with respect to the airplane.

It is possible at the present time to avoid the application of the recapture rules by rotating the individual aircraft used outside the United States so that in any 1 taxable year an airplane is used more than one-half the time in the United States. This procedure, however, generally is quite expensive and in some cases may not be possible—for example, where the airplane is leased for a temporary period of more than one-half a year to a foreign air carrier and the lease does not permit the substitution of airplanes.

Since a large part of the excess equipment which U. S. air carriers presently have (or have on order) was acquired in view of governmental needs which no longer exist, the committee agrees with the House that it is not appropriate to require U. S. air carriers, in order to preserve the investment credit they previously received with respect to the airplanes, either

[1] Although, as a result of the repeal of the investment credit, an investment credit generally is not available with respect to property acquired after Apr. 18, 1969, in some cases property acquired after that date qualifies for the investment credit by reason of one or more of the transition rules which were adopted in connection with the repeal of the credit.

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

III. Explanation of Bill

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

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

As indicated above, the basic concept of the bill is that an airplane may not be used outside the United States for more than half the period taken into account in determining for recapture purposes the amount of the investment credit allowable with respect to the airplane. Accordingly, the bill provides that if an airplane which is used outside the United States in the manner described above is disposed of or otherwise ceases to qualify as investment credit property before the end of the period taken into account in determining the amount of the credit originally allowed, then the amount of the investment credit to be recaptured is to be determined in the manner specified below. In computing the period of time the aircraft is considered to have been actually used by the taxpayer, the calendar months during any part of which it was used outside the United States under the type of lease described above may be taken into account only to the extent of the number of calendar months during all the days of which the plane was used in the United States (or was operated to and from the United States or under contract with the United States). The plane also must have been registered with the Federal Aviation Agency during these months. (However, the bill provides that an aircraft (after it is placed in service) for any calendar month in a taxable year ending before 1971 is to be treated as used in the United States if the plane was qualified investment credit property under present law for that year.)

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

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

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

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

Internal Revenue Code Section 48

[¶ 592] DEFINITIONS; SPECIAL RULES

'54 Code

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

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

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

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

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

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

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

(C) elevators and escalators, but only if—

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

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

(D) single purpose agricultural or horticultural structures, or

[¶ 592]—Continued

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

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

(2) PROPERTY USED OUTSIDE THE UNITED STATES.—

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(i) such property was completed outside the United States, or

(ii) less than 50 percent of the basis of such property is attributable to value added within the United States.

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

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

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

[¶ 592]—Continued

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

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

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

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

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

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

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

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

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

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

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

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

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

(10) BOILERS FUELED BY OIL OR GAS.—

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

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

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

(i) use in an apartment, hotel, motel, or other residential facility,

(ii) use in a vehicle, aircraft, or vessel, or in transportation by pipeline,

(iii) use on a farm for farming purposes (within the meaning of section 6420(c)),

(iv) use in—

(I) a shopping center,

(II) an office building,

(III) a wholesale or retail establishment,

(IV) any other facility which is not an integral part of manufacturing, processing, or mining, or

(V) any facility for the production of electric power having a heat rate of less than 9,500 Btu's per kilowatt hour and which is capable of converting to synthetic fuels (as certified by the Secretary),

(v) use in the exploration for, or the development, extraction, transmission, or storage of, crude oil, natural gas, or natural gas liquids, and

(vi) use in Hawaii.

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

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

(1) the construction, reconstruction, or erection of which is completed by the taxpayer after December 31, 1961, or

(2) acquired after December 31, 1961, if the original use of such property commences with the taxpayer and commences after such date.

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

(c) USED SECTION 38 PROPERTY.—

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

(2) DOLLAR LIMITATION.—

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

[¶ 592]—Continued

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

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

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

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

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

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

(C) CONTROLLED GROUP.—The term "controlled group" has the meaning assigned to such term by section 1563(a), except that the phrase "more than 50 percent" shall be substituted for the phrase "at least 80 percent" each place it appears in section 1563(a)(1).

(d) CERTAIN LEASED PROPERTY.—

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

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

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

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

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

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

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

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

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

(A) is new section 38 property,

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

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

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

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

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

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

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

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

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

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

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

[¶ 592]—Continued

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

(1) QUALIFIED REHABILITATED BUILDING DEFINED.—

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

(i) which has been rehabilitated,

(ii) which was placed in service before the beginning of the rehabilitation, and

(iii) 75 percent or more of the existing external walls of which are retained in place as external walls in the rehabilitation process.

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

(i) the date the physical work on this rehabilitation of the building began, and

(ii) the later of—

(I) the date such building was first placed in service, or

(II) the date such building was placed in service in connection with a prior rehabilitation with respect to which a credit was allowed by reason of subsection (a)(1)(E).

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

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

(2) QUALIFIED REHABILITATION EXPENDITURE DEFINED.—

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

(i) for property (or additions or improvements to property) with a useful life of 5 years or more, and

(ii) in connection with the rehabilitation of a qualified rehabilitated building.

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

(i) PROPERTY OTHERWISE SECTION 38 PROPERTY.—Any expenditure for property which constitutes section 38 property (determined without regard to subsection (a)(1)(E)).

(ii) COST OF ACQUISITION.—The cost of acquiring any building or any interest therein.

(iii) ENLARGEMENTS.—Any expenditure attributable to the enlargement of the existing building.

(iv) CERTIFIED HISTORIC STRUCTURES.—Any expenditure attributable to the rehabilitation of a certified historic structure (within the meaning of section 191(d)(1)), unless the rehabilitation is a certified rehabilitation (within the meaning of section 191(d)(4)).

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

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

(h) SUSPENSION OF INVESTMENT CREDIT.—For purposes of this subpart—

(1) GENERAL RULE.—Section 38 property which is suspension period property shall not be treated as new or used section 38 property.

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

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

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

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

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

(4) EQUIPPED BUILDING RULE.—If—

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

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

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

(5) PLANT FACILITY RULE.—

(A) GENERAL RULE.—If—

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

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

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

'54 Code

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

[¶ 592]—Continued

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

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

(i) a self-contained, single operating unit or processing operation,

(ii) located on a single site, and

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

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

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

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

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

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

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

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

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

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

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

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

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

(9) CERTAIN TRANSFERS TO BE DISREGARDED.—

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

(i) a transfer by reason of death, or

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

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

(B) If—

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

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

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

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

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

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

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

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

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

[¶ 592]—Continued

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

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

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

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

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

(12) WATER AND AIR POLLUTION CONTROL FACILITIES.—

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

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

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

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

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

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

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

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

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

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

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

(B) stolen,

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

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

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

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

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

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

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

(k) MOVIE AND TELEVISION FILMS.—

(1) ENTITLEMENT TO CREDIT.—

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

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

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

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

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

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

(3) ELECTION OF 90-PERCENT RULE.—

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

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

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

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

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

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

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

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

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

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

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

(5) QUALIFIED UNITED STATES PRODUCTION COSTS.—

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

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

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

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

(i) a reasonable allocation of general overhead costs,

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

(iii) costs of "first" distribution of prints,

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(A) which is—

(i) alternative energy property,

(ii) solar or wind energy property,

(iii) specially defined energy property,

(iv) recycling equipment,

(v) shale oil equipment, or

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

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

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

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

(3) ALTERNATIVE ENERGY PROPERTY.—

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

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

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

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

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

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

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

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

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

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

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

(i) oil and natural gas, and

(ii) any product of oil and natural gas.

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

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

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

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

(A) to generate electricity, or

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

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

(A) a recuperator,

(B) a heat wheel,

(C) a regenerator,

(D) a heat exchanger,

(E) a waste heat boiler,

(F) a heat pipe,

(G) an automatic energy control system,

(H) a turbulator,

(I) a preheater,

(J) a combustible gas recovery system,

(K) an economizer, or

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

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

(6) RECYCLING EQUIPMENT.—

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

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

(ii) in the recycling of solid waste.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(12) INDUSTRIAL INCLUDES AGRICULTURAL.—The term "industrial" includes agricultural.

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

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

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

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

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

(n) REQUIREMENTS FOR ALLOWANCE OF ESOP PERCENTAGE.—

(1) IN GENERAL.—

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

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

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

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

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

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

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

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

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

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

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

(i) first by treating the credit or carryover or carryback as attributable to the regular percentage,

(ii) second by treating the portion (not allocated under clause (i)) of such credit or carryover or carryback as attributable to the basic ESOP percentage, and

(iii) finally by treating the portion (not allocated under clause (i) or (ii)) as attributable to the matching ESOP percentage.

(2) QUALIFIED MATCHING EMPLOYEE CONTRIBUTION DEFINED.—

(A) IN GENERAL.—For purposes of this subsection, the term "qualified matching employee contribution" means, with respect to any taxable year, any contribution made by an employee to an ESOP maintained by the taxpayer if—

(i) each employee who is entitled to an allocation of employer securities transferred to the ESOP under paragraph (1)(A) is entitled to make such a contribution,

(ii) the contribution is designated by the employee as a contribution intended to be taken into account under this subparagraph for the taxable year,

(iii) the contribution is paid in cash to the employer or plan administrator not later than 24 months after the close of the taxable year, and is invested forthwith in employer securities, and

(iv) the ESOP meets the requirements of subparagraph (B).

(B) PLAN REQUIREMENTS.—For purposes of subparagraph (A), an ESOP meets the requirements of this subparagraph if—

(i) participation in the ESOP is not required as a condition of employment and the ESOP does not require matching employee contributions as a condition of participation in the ESOP,

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

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(ii) employee contributions under the ESOP meet the requirements of section 401(a)(4), and

(iii) the ESOP provides for allocation of all employer securities transferred to it or purchased by it (because of the requirements of paragraph (1)(B)) to the account of each participant in an amount equal to such participant's matching employee contributions for the year.

(3) CERTAIN CONTRIBUTIONS OF CASH TREATED AS CONTRIBUTIONS OF EMPLOYER SECURITIES.—For purposes of this subsection, a transfer of cash shall be treated as a transfer of employer securities if the cash is, under the ESOP, used within 30 days to purchase employer securities.

(4) ADJUSTMENTS IF ESOP CREDIT RECAPTURED.—If any portion of the ESOP credit is recaptured under section 47 or the ESOP credit is reduced by a final determination—

(A) the employer may reduce the amount required to be transferred to the ESOP under paragraph (1) for the current taxable year or any succeeding taxable year by an amount equal to such portion (or reduction), or

(B) notwithstanding the provisions of paragraph (5) and to the extent not taken into account under subparagraph (A), the employer may deduct an amount equal to such portion (or reduction), subject to the limitations of section 404.

(5) DISALLOWANCE OF DEDUCTION.—No deduction shall be allowed under section 162, 212, or 404 for amounts required to be transferred to an ESOP under this subsection.

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

(A) EMPLOYER SECURITIES.—The term "employer securities" has the meaning given to such term by section 409A(1).

(B) VALUE.—The term "value" means—

(i) in the case of securities listed on a national exchange, the average of closing prices of such securities for the 20 consecutive trading days immediately preceding the due date for filing the return for the taxable year (determined with regard to extensions), or

(ii) in the case of securities not listed on a national exchange, the fair market value as determined in good faith and in accordance with regulations prescribed by the Secretary.

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

(o) CERTAIN CREDITS DEFINED.—For purposes of this title—

(1) REGULAR INVESTMENT CREDIT.—The term "regular investment credit" means that portion of the credit allowable by section 38 which is attributable to the regular percentage.

(2) ENERGY INVESTMENT CREDIT.—The term "energy investment credit" means that portion of the credit allowable by section 38 which is attributable to the energy percentage.

(3) ESOP CREDIT.—The term "ESOP credit" means the sum of—

(A) the basic ESOP credit, and

(B) the matching ESOP credit.

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(4) BASIC ESOP CREDIT.—The term "basic ESOP credit" means that portion of the credit allowable by section 38 which is attributable to the basic ESOP percentage.

(5) MATCHING ESOP CREDIT.—The term "matching ESOP credit" means that portion of the credit allowable by section 38 which is attributable to the matching ESOP [percentage].

(6) BASIC ESOP PERCENTAGE.—The term "basic ESOP percentage" means the 1-percent ESOP percentage set forth in section 46(a)(2)(E)(i).

(7) MATCHING ESOP PERCENTAGE.—The term "matching ESOP percentage" means the additional ESOP percentage (not to exceed ½ of 1 percent) set forth in section 46(a)(2)(E)(ii).

(p) SINGLE PURPOSE AGRICULTURAL OR HORTICULTURAL STRUCTURE DEFINED.—For purposes of this section—

(1) IN GENERAL.—The term "single purpose agricultural or horticultural structure" means—

(A) a single purpose livestock structure, and

(B) a single purpose horticultural structure.

(2) SINGLE PURPOSE LIVESTOCK STRUCTURE.—The term "single purpose livestock structure" means any enclosure or structure specifically designed, constructed, and used—

(A) for housing, raising, and feeding a particular type of livestock and their produce, and

(B) for housing the equipment (including any replacements) necessary for the housing, raising, and feeding referred to in subparagraph (A).

(3) SINGLE PURPOSE HORTICULTURAL STRUCTURE.—The term "single purpose horticultural structure" means—

(A) a greenhouse specifically designed, constructed, and used for the commercial production of plants, and

(B) a structure specifically designed, constructed and used for the commercial production of mushrooms.

(4) STRUCTURES WHICH INCLUDE WORK SPACE.—An enclosure or structure which provides work space shall be treated as a single purpose agricultural or horticultural structure only if such work space is solely for—

(A) the stocking, caring for, or collecting of livestock or plants (as the case may be) or their produce,

(B) the maintenance of the enclosure or structure, and

(C) the maintenance or replacement of the equipment or stock enclosed or housed therein.

(5) SPECIAL RULE FOR APPLYING SECTION 47.—For purposes of section 47, any single purpose agricultural or horticultural structure shall be treated as meeting the requirements of this subsection for any period during which such structure is held for the use under which it qualified under this subsection.

(6) LIVESTOCK.—The term "livestock" includes poultry.

(q) CROSS REFERENCE.—

For application of this subpart to certain acquiring corporations, see section 381(c)(23).

'54 Code

.01 Added by P. L. 87-834. Amended by P. L. 95-618, P. L. 95-600, P. L. 94-455, P. L. 94-12, P. L. 92-178, P. L. 91-172, P. L. 90-26, P. L. 89-809, P. L. 89-800 and P. L. 88-272. For details, see the Code Volumes.

Committee Reports on P. L. 95-618

.0135 A. Additional Investment Tax Credit for Alternative Energy Property.

House Bill.—The bill provides for an additional 10-percent investment credit which is not

[¶ 592.0135]—Continued

available to taxpayers who claim credit against the user tax. The credit is limited to 100 percent of tax liability, and this additional credit rate is 5 percent for property financed with tax-exempt industrial development bonds. Utilities will receive the credit for new boilers only to the extent that an existing oil- or gas-fired boiler is phased down to less than 1,500 hours of use per year. The credit is available only to persons engaged in a trade or business, and the credit is recaptured according to the rules for the regular investment credit.

Qualifying property includes equipment which uses a fuel or feedstock other than oil or gas or their products, i. e., an alternate substance. Equipment must be new and must be used in connection with a building or structure located in the United States and is eligible even if considered a structural component or used in connection with lodging facilities.

Alternative energy property includes:

(1) Boilers;

(2) Burners for combustors other than boilers;

(3) Nuclear and hydroelectric power equipment, not including turbines or generators;

(4)(a) Geothermal power equipment, not including turbines or generators;

(b) Geothermal equipment to provide heating, cooling and electricity used in connection with an existing building and an existing commercial or industrial process;

(5) Equipment for producing synthetic gas;

(6)(a) Equipment for modifying existing equipment so that an alternate substance is at least 25 percent of the fuel or feedstock;

(b) Equipment for modifying an existing boiler in an existing electric generating facility so that an alternate substance is at least 25 percent of the fuel; the rate of credit depends on fuel savings percentage;

(7) Pollution control equipment required by Federal, State, and local regulations to be installed in connection with equipment in categories (1), (2), (5), and (6);

(8) Equipment used to handle, store, and prepare an alternate substance, at the point of use as a fuel or feedstock, for use in equipment in categories (1), (2), (3), (4)(a), (5), (6) and (7); facilities to manufacture coke are excluded;

(9) Equipment which uses solar and wind energy to provide heat, cooling or electricity in connection with an existing building and existing industrial or commercial process, and

(10) Plans and designs for equipment in the above categories.

The credit is available for investments after April 19, 1977, and before January 1, 1983.

Conference Agreement.—The conference agreement follows the House bill with the following modifications.

The eligible equipment includes the Senate provision of equipment for producing synthetic liquid, gaseous or solid fuel, but not coke or coke gas, and equipment which uses coal (including lignite) as a feedstock for the manufacture of chemicals or other products, except coke or coke gas. Geothermal equipment is defined as in the Senate bill.

Hydroelectric and nuclear equipment, structures and dams are excluded.

Solar and wind energy equipment are included, as defined in the Senate amendment, and are eligible for a refundable credit. The definition of solar equipment does not include so-called "passive solar" equipment.

The additional investment credit for alternative energy property is not available to the tax-exempt organizations that were included in the Senate amendment: State and local governments and organizations exempt under sections 501(c)(3) and (12). In addition, the credit is not available to public utility property, as defined in section 46(f)(5): property used predominantly in the trade or business of the furnishing or sale of:

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

(ii) gas through a local distribution system,

(iii) telephone service, telegraph service by means of domestic telegraph operations or other communication services, or

(iv) steam through a local distribution system or the transportation of gas or steam by pipeline.

The additional credits, except those for solar and wind energy equipment, are not refundable, but may be used to offset 100 percent of tax liability. The rules for applying the limitations based on tax liability to the use of the investment credit in combination with the energy credits provided in the conference agreement will operate under the following stacking order. A taxpayer first will apply the credits attributable to section 38 property (not including the energy credits provided in this agreement) against tax liability to the extent allowed under current law. The first-in-first-out rule of section 46(a) will continue to apply with respect to the stacking of credits within the limitation. Next, a taxpayer will apply the credits attributable to the application of the energy percentage to energy property to the remaining tax liability, up to 100 percent of that tax liability. Finally, if the energy credits exceed tax liability and any of the excess is attributable to solar and wind energy credit, these latter amounts will be treated as an overpayment of tax[,] i. e., as if the amounts were allowed by section 39.

The credits are available for eligible property acquired and placed in service after September 30, 1978, and before January 2, 1983, to the extent of basis attributable to this period.

B. Specially Defined Energy Property Tax Credit.

House Bill.—An additional 10-percent investment credit is provided for this category of energy property. The credit is limited to 50 percent of tax liability. Qualifying property is required to be new depreciable property, with a useful life of at least 3 years, used in connection with a structure located in the United States. All categories of qualifying property must satisfy performance and quality standards prescribed by the Secretary. The recapture rules under the regular investment credit also apply to this credit. The credit is reduced to 5 percent for property financed by industrial development bonds.

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Eligible property includes: (1) a recuperator, (2) a heat wheel, (3) a regenerator, (4) a heat exchanger, (5) a waste heat boiler, (6) a heat pipe, (7) an automatic energy control system, (8) a turbulator, (9) a preheater, (10) a combustible gas recovery system, (11) an economizer, or (12) any other property of a kind specified by the Secretary by regulations, the principal purpose of which is reducing the amount of energy consumed in any existing industrial or commercial process and which is installed in connection with an existing industrial or commercial facility.

The additional credit applies to investments in qualifying property after April 19, 1977, and before January 1, 1983.

Senate Amendment.—The Senate made available the same 10-percent credit as the House bill, but amended the House bill in several other respects.

The credit is refundable, under the same terms applicable to alternative energy property (No. 27 above).

The list of eligible property was expanded to include industrial heat pumps; energy efficient replacement electric motors; fuel cells, gas turbines and external combustion engines with demonstrated fuel efficiency; fluorescent replacement lighting systems; and silicone controlled rectifier units.

In addition, the Secretary's administrative authority has been extended to equipment that reduces the amount of heat wasted, and equipment in this category of energy property may be installed in connection with utility and agricultural facilities.

This credit applies to investments in qualifying property after April 19, 1977, and before January 1, 1986.

Conference Agreement.—The conference agreement generally follows the House bill, but the credit may be applied against 100 percent of tax liability as in the Senate amendment. The Secretary is authorized to specify other similar items of energy conservation equipment eligible for this credit, including modifications which are made to existing industrial processes, the principal purpose of which is the reduction in the amount of energy consumed or heat wasted. The conferees expect the Secretary to consult with [the] Department of Energy and the Bureau of Standards in determining additional items to be eligible as specially defined energy property. The credit will be available for qualifying property placed in service after September 30, 1978, and before January 1, 1983, and for qualified expenditures incurred during this period.

C. Energy Property Tax Credit.

House Bill.—The additional nonrefundable 10-percent investment credit is available for two additional types of energy property:

(1) Cogeneration property for the production of steam, heat or other forms of useful energy and also electric energy; and

(2) Recycling equipment which is used exclusively in the recycling of solid waste or to sort and prepare solid waste for recycling.

This credit is limited to 50 percent of tax liability and the additional credit is reduced to 5 percent if the property is financed in whole or in part with industrial development bonds.

The credit applies to qualifying property placed in service after April 19, 1977, and before January 1, 1983.

Senate Amendment.—Under the Senate amendment, the credit is an additional 10 percent, applicable up to 100 percent of tax liability. Eligible property includes:

(1) Cogeneration property defined as in the House bill plus cogeneration for agricultural purposes, and water purification and desalination.

(2) Recycling equipment defined as in the House bill, but the exclusive use requirement is modified to permit use of up to 10 percent virgin materials; in addition, eligible equipment includes recycling equipment to the point where a marketable product has been produced, e. g., newsprint, paperboard, metal ingots, or textile fibers.

(3) Shale oil equipment which is used to mine, extract or produce oil from oil-bearing shale rock;

(4) Transportation equipment which includes commuter vans and equipment designed to reduce energy consumption when added to existing motor vehicles and commercial carriers;

(5) Equipment used to produce natural gas from geopressured brine;

(6) On-site electrical heat processing equipment which is replacement equipment and which uses electricity produced with an alternate substance; and

(7) Electric motor vehicles, primarily for use on public streets, roads and highways, when purchased for use in a trade or business.

The credit applies to eligible equipment placed in service after April 19, 1977, and before January 1, 1986.

Conference Agreement.—The conference agreement provides that the additional 10 percent credit will be available to be applied against 100 percent of tax liability. Eligible property includes (1) recycling equipment defined as in the Senate bill except that in the iron and steel industry, the credit is limited to equipment used before the solid waste is reduced to a molten state, (2) shale oil equipment, as in the Senate amendment, and (3) equipment to produce natural gas from geopressured brine, as in the Senate amendment. For the latter equipment, the rules of the Federal Energy Regulatory Commission will be applied to determine which well qualifies as a well producing natural gas from geopressured brine under the terms of the definition in the Natural Gas Pricing Act, but the Secretary of the Treasury will determine whether the equipment used in connection with that well is eligible for the credit.

The additional credit will be available for eligible equipment acquired or placed in service after September 30, 1978, and before January 1, 1983, and for qualified expenditures in this period.—**Conference Committee Report.**

[*Air conditioning and space heating units*]

.0137 Under the committee bill, several tax incentives would be repealed for new investments in certain energy property. In particular, the committee bill deletes air conditioning and space heating units (that is, those not considered structural components) from the definition of tangible personal property so that such property no longer will be eligible for the regular

[¶ 592.0137]—Continued

investment tax credit. Boilers or other combustors fueled by oil or natural gas also would be denied the regular (or any additional) investment tax credit, unless the use of coal or another alternate substance is precluded by existing Federal or State air pollution regulations, or unless the use of such a boiler or other combustor is an exempt use under sec. 4992(b) of the bill.

An exempt use of oil or natural gas is defined by sec. 4992(b) as a use in a residential facility, in transportation (including by pipeline), on a farm for farming purposes, in a shopping center, office building or wholesale or retail establishment, in any other facility which is not an integral part of manufacturing, processing or mining, or use in the exploration or development, extraction, transmission or storage of crude oil, natural gas, or natural gas liquids, and an exempt process use.

In addition, new oil or natural gas boilers would be required to use straight-line depreciation, rather than any accelerated depreciation method, and the useful life of such property must equal the class life prescribed by the Secretary, without regard to the 20 percent variance in class life available under sec. 167(m)(1) of the Code.

The denial of the investment tax credit would apply to property placed in service after June 20, 1977, but the denial would not apply to property which is constructed, reconstructed, erected or acquired under the terms of a binding contract to which the taxpayer was a party on June 20, 1977, and at all times thereafter. This provision would pertain only to contracts in which the construction, reconstruction, erection, or acquisition of property is itself the subject matter of the contract and would not apply to a contract with a person other than the builder or supplier under which the taxpayer becomes obligated to construct, reconstruct, erect or acquire property. A contract which is binding on the taxpayer on June 19, 1977, would not be considered binding at all times thereafter if it is substantially modified after that date.—**House Committee Report.**

.0138 The conference agreement generally follows the House provision, modified to apply only to portable air conditioners, portable space heaters and boilers fueled by oil or gas. Other combustors fueled by oil or natural gas will not be subject to the investment tax credit and accelerated depreciation denial rules under the conference agreement. In addition, the conference agreement includes the range of exempt uses under the House bill, which generally exempt from the provision those uses which are not part of manufacturing, production or mining. In addition, the credit is not available to public utility property, as defined in section 46(f)(5): property used predominantly in the trade or business of the furnishing or sale of:

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

(ii) gas through a local distribution system,

(iii) telephone service, telegraph service by means of domestic telegraph operations or other communication services, or

(iv) steam through a local distribution system or the transportation of gas or steam by pipeline.

The provision applies to property placed in service after September 30, 1978, except for property for which a binding contract was in effect on that date.—**Conference Committee Report.**

Committee Reports on P. L. 95-600

.014 * * * The conference agreement modifies the Senate amendment to specifically extend the investment credit to special purpose structures used for livestock and horticultural products and to adopt the general conditions and requirements of H. R. 12846, as passed by the House of Representatives on October 13, 1978.

In order to be included under this provision, a livestock structure must be specifically designed, constructed, and used for the housing, raising and feeding of livestock and their produce. The term "livestock" for this purpose includes poultry. The full range of livestock breeding, raising and production activities is intended to be included so that special purpose structures will qualify for credit if used, for example, to breed chickens or hogs, to produce milk from dairy cattle, or to produce feeder cattle or pigs, broiler chickens, or eggs. In addition, the structure or enclosure must be designed and used to house equipment necessary to feed and care for the livestock. As a result, such facilities must include, as an integral part of the structure or enclosure, equipment to contain the livestock and to provide water, feed and temperature control, if necessary.

Similarly, a horticultural structure is made specifically eligible for the credit under this provision if it has been designed, constructed, and used for the commercial production of plants, including mushrooms.

The issues which have arisen concerning allowance of the credit under present law are also resolved by providing that the life of the structure need not be contemporaneous with the equipment it houses. In addition, working space is permitted within an eligible structure. Under this latter rule, the property will be eligible for the credit even if working space is provided for caring for the livestock or plants or for gathering their produce (such as eggs, tomatoes or flowers). In addition, working space may be provided to maintain the structure and to maintain or replace the equipment within the structure.

It should be emphasized that the structure must be used exclusively for the purpose for which it was specifically designed and constructed. As a result of this requirement, a hog structure will not be eligible property, for example, if it is used for the housing and feeding of poultry or cattle or if more than incidental use of a structure is made to store feed or machinery. (However, mere vacancy of the facility will not violate this usage test.) Similarly, the use of part of a greenhouse for the purpose of selling plants or their produce, such as by installation of a check-out stand, will make the greenhouse ineligible for the credit. If a single purpose structure becomes ineligible because of this usage test within seven years from the time it was placed in service, investment credits claimed on the structure may be partially or entirely recaptured under the investment credit recapture rules in present law. In addition, the conferees wish to emphasize that the specific provisions concerning the eligibility of these structures for the investment credit are not to create a negative inference regarding the eligibility of other special purpose agricultural and productive structures for

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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 ⅔'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.

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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 re-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.[6] 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. Sixty 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

	$00
40 pct. of compensation paid to [illegible] U. S. citizens	

[6] 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 under 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.

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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 38 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 inference 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.

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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.

Internal Revenue Code Section 301(a)

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.

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[¶ 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.

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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.

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.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 earnings. 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 further 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.)

[¶ 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

[¶ 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.

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→ 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.

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.

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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,

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.

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.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

[¶ 9915] INTEREST ON UNDERPAYMENT, NONPAYMENT, OR EXTENSIONS OF TIME FOR PAYMENT, OF TAX

'54 Code

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.

[¶ 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.

'54 Code

(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

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(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

[¶ 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 de 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.

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[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

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(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—

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(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 witholding 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 deducted and withheld to be governed by such estimation year, shall be determined under regulations prescribed by the Secretary.

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[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,

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[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.

'54 Code

.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 persons. 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

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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 interpretation 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 relates 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 than 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-

[¶ 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.

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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 exemption 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.

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Internal Revenue Code Section 1016(a)

[¶ 4534] ADJUSTMENTS TO BASIS

'54 Code

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;

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(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

[¶ 5009] **PERSONS REQUIRED TO MAKE RETURNS OF INCOME**

—'54 Code—

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,

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(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

'54 Code

(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.**

.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.

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Representative Duncan

DESIGN OF AN ALASKAN

GENERAL STOCK OWNERSHIP PLAN

VOLUME I

A REPORT TO THE ALASKA STATE LEGISLATURE

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KELSO & CO., INCORPORATED

SAN FRANCISCO, CALIFORNIA

FEBRUARY 15, 1979

STATE OF ALASKA

THE LEGISLATURE

BUDGET AND AUDIT COMMITTEE

FINANCE DIVISION
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February 21, 1979

All Members
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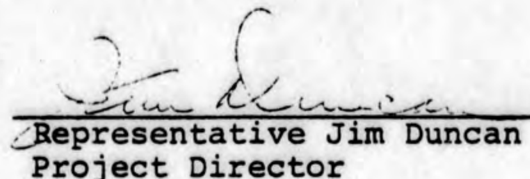
Pursuant to an appropriation to the Legislative Finance Division contained in Chapter 163, SLA 1978, the Budget and Audit Committee entered into a contract with Kelso & Co., Inc. of San Francisco to provide a legal and financial design of a corporation which would (1) be owned by all Alaskan citizens; (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

31-Q1LH

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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, <u>pro rata</u>, 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 <u>to the extent of income applied to purchase productive capital assets</u> 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, be 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 <u>physical</u> 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 <u>all</u> 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 <u>must</u> 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 through 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 our 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

asset power. The lender may look to the debt repayment power of the purchaser's present business, the business to be acquired (bootstrap), or the combined earning power of both (partial bootstrap).

Debt Capital from the Seller

In situations where the purchaser is unable to raise debt capital from his own or third-party resources, the seller may effectuate the deal by consenting to an installment payment of the sales price. This is another form of bootstrap. Another technique which may be applicable to AGSOC is the assumption of the debt of the acquired company. In addition to making a deal possible at all, an installment sale or assumption of debt is not without other advantages to the seller.

1) Versus payment in full, an installment sale with not more than 30% payment in the first year spreads out the tax payment on the capital gain.
2) The seller may receive a high interest return on the unpaid installment, possibly his best investment opportunity.

The principal disadvantage to the seller is his continued assumption of business risk for future installment payments or the possibility of default on assumed debt.

The problems of buying a going business are most complicated. They go to every aspect of the transaction. The

problems of investigation, valuation, and method of financing are challenges to management which require not only keen business judgment, but technical answers. There are many questions which AGSOC management must consider in a most careful way if it is to make the proper decision. The end product will be a financing proposal to be presented to the Legislature and, if approved, and if it involves the general credit of the State, submitted to a vote of the people. Each potential acquisition candidate will have different characteristics and require separate financing techniques.

START-UP COST

The appropriate way to obtain funds for AGSOC's start-up costs and expenses until it generates income would appear to be by way of a fiscal bill which would be separate from the enabling legislation.

Such a bill should provide sufficient funds in the nature of a short-term loan or otherwise to cover the organizational and start-up expenses of AGSOC, including but not limited to: organization and qualification as a domestic corporation; contracting for legal, accounting, investment banking counsel, analysts, and other professional services; employment of management and staff personnel to search out, analyze and evaluate potential investments and to create effective liaison with appropriate departments and agencies of the Federal and State Governments; arranging financing for acquisition of appropriate investments; identifying the persons who will be eligible to become stockholders of the corporation; preparing a data base of stockholders eligible for initial issuance of AGSOC shares; establishing or arranging for appropriate trust and escrow departments or services; arranging for banking, stock registrar and other appropriate services; paying directors' fees and expenses; obtaining necessary licenses and paying fees and taxes, if any; procuring office facilities, equipment and supplies, travel, communication expense, and all other expenses

normally expended in starting up a new enterprise.

The term, amount and rate of interest of such a loan would presumably be established by the Commissioner of Revenue of the State of Alaska. We recommend that an initial installment of $2,500,000 be immediately loaned to AGSOC to allow the Board of Directors to proceed with the recruitment, selection and employment of the management group.

A BILL

FOR AN ACT ENTITLED "AN ACT ESTABLISHING ALASKA GENERAL STOCK OWNERSHIP CORPORATION; AMENDING CERTAIN ALASKA STATUTES; AND PROVIDING FOR AN EFFECTIVE DATE."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

Section 1. ALASKA GENERAL STOCK OWNERSHIP CORPORATION ORGANIZATION. The Governor of the State of Alaska be, and hereby is, authorized and directed to cause the incorporation of Alaska General Stock Ownership Corporation (AGSOC), by the filing of appropriate Articles of Incorporation with the Division of Banking and Securities of the Department of Commerce and to appoint as incorporators and as the first Board of Directors of AGSOC nine (9) individuals, at least five (5) of whom are residents of Alaska.

Section 2. GENERAL STOCK OWNERSHIP CORPORATION UNDER INTERNAL REVENUE CODE. AGSOC shall be organized as a General Stock Ownership Corporation under Title VI of the Internal Revenue Code of 1954, as amended, and under this Act.

Section 3. ORGANIZED AS A DOMESTIC CORPORATION. AGSOC shall be a domestic corporation for profit under the laws of the State of Alaska, and shall not be an agency or political subdivision of the State of Alaska for any purpose.

Section 4. INITIAL BOARD OF DIRECTORS.

(a) The initial Board of Directors of AGSOC (hereinafter referred to as the "Board") shall consist of nine (9) members, at least five (5) of whom shall at all times during their terms as members of the Board be residents of the State of Alaska.

(b) Members of the initial Board shall be divided into three (3) classes, each class consisting of three (3) individuals, designated as Class One directors, each with a term of one (1) year and until their successors are elected and qualified; Class Two directors, each with a term of two (2) years and until their successors are elected and qualified; and Class Three directors, each with a term of three (3) years and until their successors are elected and qualified.

Section 5. ISSUE AND TRANSFER OF STOCK. Alaska General Stock Ownership Corporation is hereby authorized and directed:

(a) to issue only one (1) class of stock;

(b) to issue shares only to residents (eligible individuals) of Alaska as defined herein;

(c) to initially issue at least one (1) share of its stock to each resident of Alaska, unless such resident elects within one (1) year after the date of such issuance not to receive such share;

(d) to provide that no share of stock shall be sold, pledged, assigned, mortgaged, subjected to encumbrance, voluntarily or involuntarily, or otherwise transferred --

(i) by a shareholder other than by will or the applicable laws of descent and distribution until after the expiration of five (5) years from the date such stock is issued by AGSOC except in the event the shareholder ceases to be a resident of the State of Alaska and thereupon elects to make such transfer;

(ii) to any person other than an individual who is at the time of such transfer an individual resident of Alaska as defined herein;

(iii) to any individual who, after the transfer, would own more than ten (10) shares of the stock of AGSOC;

(iv) by any shareholder until such shareholder shall reach the age of majority, as defined by Alaska law;

(e) to perform all acts and conform to all legal requirements to qualify and thereafter to continue to qualify as a General Stock Ownership Corporation under the Internal Revenue Code of 1954, as amended, and under this Act, unless the Board, with the consent of the Secretary in accordance with applicable provisions of the Internal Revenue Code and regulations thereunder, shall elect to terminate such qualification; and

(f) not to invest in or acquire any interest in properties acquired by it or for its benefit through exercise of the right of eminent domain.

Section 6. RIGHT OF FIRST REFUSAL TO PURCHASE OWN STOCK. AGSOC shall have a right of first refusal to purchase any shares of stock of AGSOC offered to be transferred by the holder thereof. Such shares may be held by AGSOC in the general escrow or trust account of its trust or escrow division, in which event such stock shall continue its status as issued and outstanding stock of AGSOC for all purposes, except that such shares, while so held, shall not be voted nor shall they be entitled to dividends declared on shares of AGSOC stock. The Board of Directors by resolution shall have the power to cancel such reacquired shares and such shares shall thereupon return to the status of authorized and unissued shares.

Section 7. ESCROW OF STOCK BY AGSOC. AGSOC shall have the power to make and enforce reasonable rules and regulations with respect to the establishing of escrow accounts either within its own trust and escrow department or otherwise for each stockholder of the corporation; for releasing shares of stock to the owner or buyer thereof subject to the continuing restrictions set forth in this Act at the expiration of the period of five (5) years following date of issue thereof, or the date upon which the shareholder shall reach the age of majority, as defined by Alaska law, or the date when the shareholder shall have complied with all reasonable rules and regulations of AGSOC pertaining to the release of such shares from escrow, whichever

of said events shall be the last to occur, except in the event of death of the shareholder or upon the shareholder ceasing to be a resident of the State of Alaska and thereupon electing to transfer such shares to an eligible transferee; for the operation of its trust and escrow division; for the transfer and recording of transfers of its stock if it determines to act as its own transfer agent; for the operation of its trust and escrow division if it determines to establish a trust and escrow division, and with respect to the issue, transfer, repurchase and other handling or dealing with its stock as its Board of Directors may adopt and promulgate. All such rules and regulations shall be published to the stockholders of AGSOC and shall be available in suitable form to any stockholder at any time upon request during regular business hours.

Section 8. DEFINITION OF RESIDENT.

(a) For purposes of original issue of shares of AGSOC stock under this Act, the terms "resident", "eligible individual", or "qualified individual" shall have the same and identical meaning, and shall mean an individual, born prior to 12:00 o'clock midnight on January 1, 1979, regardless of age, who as of 12:00 o'clock midnight on January 1, 1979, was a resident of and was domiciled in the State of Alaska and who remains a resident of Alaska through the date determined by the Board of Directors of AGSOC and publicly announced as such, to be the date the shares of stock of AGSOC are initially issued.

(b) For purposes of transfer of AGSOC shares subsequent to

initial issuance, "resident" shall mean an individual, regardless of age, who is a resident and is domiciled in the State of Alaska on the date such transfer is made effective.

Section 9. IDENTIFICATION OF RESIDENTS OF ALASKA ELIGIBLE TO BECOME AGSOC SHAREHOLDERS.

(a) Prior to issuing any shares of stock, AGSOC shall take all reasonable measures, by public advertising, radio and television broadcasting, and otherwise, to make known to all residents of the State of Alaska its intention to issue stock to each person eligible to become a shareholder and to similarly notify all Alaska residents of the eligibility requirements to become a registered shareholder of AGSOC. Such efforts shall be made from time to time and shall continue for a period of at least ninety (90) days prior to the date for issuance of stock of AGSOC, and shall be made at least once each month over the next eleven (11) months, and as frequently thereafter as the Board of Directors of AGSOC may deem appropriate. The procedural details pertaining to the identification of such persons as shareholders, either in person, or if they are minors represented by a parental or legal guardian, or if they be incompetent persons by a legal guardian, shall be fully provided to each person making inquiry at a properly designated office by a representative of AGSOC.

(b) The duty and responsibility, however, of each qualified resident to make application for registration as a shareholder of AGSOC shall rest solely and exclusively upon such

qualified resident and upon the parental and legal guardians of qualified residents, and AGSOC shall not be liable for any loss, loss of income, disadvantage or inconvenience resulting directly or indirectly from the failure of such qualified resident to make such timely application except as herein specifically provided.

(c) AGSOC shall have no obligation to reimburse any eligible individual who may incur income tax liability as the result of failure to make timely application for registration as a shareholder of AGSOC, nor shall AGSOC be liable for reimbursing previously declared or paid dividends to which an applicant for registration as a shareholder would have been entitled had timely application therefor been made. Subject to these limitations, however, an eligible resident who would have been entitled to the issuance of a share or shares of stock of AGSOC, had application been made prior to the time of such issuance, or a transferee by will, or by the laws of descent and distribution, or other legal transferee, and had such qualification continued through the date of such issuance, may at any time thereafter make such application and receive the stock (or escrow certificate representing such stock) to which he shall thus be established as being entitled.

Section 10. CIVIL AND CRIMINAL PENALTIES FOR MISREPRESENTATION OF FACTS DETERMINING ELIGIBILITY TO BECOME AGSOC SHAREHOLDER.

(a) Any individual who shall have received stock upon orig-

inal issue by AGSOC through fraudulent or misleading representations shall, upon demand therefor in writing being made by or on behalf of AGSOC, return all certificates or other evidence of the ownership of such shares and the full amount of dividends, whether in cash, in stock or otherwise, received thereon, together with interest at the rate of eight percent (8%) per annum from the date that such dividend or dividends were received to the date of such repayment. In the event of failure of such illegal holder of shares of AGSOC to make such restitution in full, AGSOC shall be entitled by civil action in any Superior Court in the State of Alaska to enforce such recovery, together with payment of all legal fees and court costs incurred by AGSOC in effecting such recovery.

(b) Any person who shall obtain for himself or for a person as to whom he is or has represented that he is a parental or legal guardian the issuance of shares of AGSOC through fraud, misrepresentation or by any deceitful or illegal means, shall be guilty of a Class C felony.

Section 11. SPECIAL SESSION TO APPROVE FINANCING. It is the intent of the legislature 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. However, no special session need be called if the legislature is scheduled to meet within sixty (60) days of the date of such request. In the event the legislature shall determine that financing or the guaranty of financing for an AGSOC project is necessary or desirable, the legislature shall at the

earliest convenient time call a special election (unless an election is scheduled to be held within sixty (60) days) for voting on the approval of the extension of credit to AGSOC by the State of Alaska, or the guarantying by the State of Alaska or by any agency or instrumentality thereof of the credit of AGSOC.

Section 12. TRUST ACCOUNT WITH DEPARTMENT OF REVENUE. There is hereby established a trust account within the Department of Revenue which account shall be used solely and exclusively for purposes of guarantying loans, public or private, to AGSOC for the accomplishment of its purposes.

Section 13. The following amendments shall be and hereby are made to the Alaska Statutes:

(a) Title 10, Section 10.05.012, is hereby amended by inserting prior to the first word in the second sentence thereof the words: "Except with respect to General Stock Ownership Corporations,".

(b) The last sentence of Title 10, Section 10.05.186, is hereby amended to read: "Except with respect to General Stock Ownership Corporations, no classification of directors is effective prior to the first annual meeting of shareholders."

(c) Title 10, Section 10.05.204, is hereby amended by adding a new Subsection (7) at the end thereof as follows:

"(7) Notwithstanding the foregoing or any other pro-

visions of Title 10 of the Alaska Statutes, dividends may be declared and paid by a General Stock Ownership Corporation, organized under AS __________, at any time and from any source to the extent deemed by the Board of Directors thereof necessary to comply with the distribution requirements of the laws of Alaska and of the United States, except that no dividend shall be declared when such General Stock Ownership Corporation is insolvent or which would cause it to become insolvent."

(d) Title 45 is hereby amended by adding a new Section 45.55.141 thereto to read:

"Section 45.55.141. The stock of a General Stock Ownership Corporation organized under the Alaska General Stock Ownership Corporation Act (AS ____.____) is not a security and the issue or sale of stock under that Act shall not be construed as a sale of a security for purposes of this chapter."

Section 14. AGSOC SHALL BE EXEMPT FROM PROVISIONS OF TITLE 6, CHAPTER 25, OF ALASKA STATUTES. AGSOC shall be authorized to engage in trust and escrow activities with respect only to matters involving its own stock and to such extent AGSOC shall be exempt from compliance with the provisions of Title 6, Chapter 25, of Alaska Statutes.

EXPLANATORY FOOTNOTES TO PROPOSED "BILL FOR AN ACT ENTITLED 'AN ACT ESTABLISHING ALASKA GENERAL STOCK OWNERSHIP CORPORATION; AMENDING CERTAIN ALASKA STATUTES; AND PROVIDING FOR AN EFFECTIVE DATE'"

Set forth below is a copy of the proposed Bill, to which footnotes have been added at appropriate places above the particular words to which the footnotes are pertinent. Thus the preceding draft of proposed Bill and the following draft of proposed Bill are identical except that in the following draft the footnote references have been added. The footnotes themselves appear immediately following the second draft.

A BILL

FOR AN ACT ENTITLED "AN ACT ESTABLISHING ALASKA GENERAL STOCK OWNERSHIP CORPORATION; AMENDING CERTAIN ALASKA STATUTES; AND PROVIDING FOR AN EFFECTIVE DATE."(1)

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

Section 1. ALASKA GENERAL STOCK OWNERSHIP CORPORATION ORGANIZATION. The Governor of the State of Alaska be, and hereby is, authorized and directed to cause the incorporation of Alaska General Stock Ownership Corporation (AGSOC), by the filing of appropriate Articles of Incorporation with the Division of Banking and Securities of the Department of Commerce(2) and to appoint as incorporators and as the first Board of Directors of AGSOC nine (9) individuals, at least five (5) of whom are residents of Alaska.(3)

Section 2. GENERAL STOCK OWNERSHIP CORPORATION UNDER INTERNAL REVENUE CODE. AGSOC shall be organized as a General Stock Ownership Corporation under Title VI of the Internal Revenue Code of 1954, as amended, and under this Act.(4)

Section 3. ORGANIZED AS A DOMESTIC CORPORATION. AGSOC shall be a domestic corporation for profit under the laws of the State of Alaska, and shall not be an agency or political subdivision of the State of Alaska for any purpose.(5)

Section 4. INITIAL BOARD OF DIRECTORS.

(a) The initial Board of Directors of AGSOC (hereinafter referred to as the "Board") shall consist of nine (9) members, at least five (5) of whom shall at all times during their terms as members of the Board be residents of the State of Alaska.

(b) Members of the initial Board shall be divided into three (3) classes, each class consisting of three (3) individuals, designated as Class One directors, each with a term of one (1) year and until their successors are elected and qualified; Class Two directors, each with a term of two (2) years and until their successors are elected and qualified; and Class Three directors, each with a term of three (3) years and until their successors are elected and qualified.[6]

Section 5. ISSUE AND TRANSFER OF STOCK. Alaska General Stock Ownership Corporation is hereby authorized and directed:

(a) to issue only one (1) class of stock;[7]

(b) to issue shares only to residents (eligible individuals) of Alaska as defined herein;[8]

(c) to initially issue at least one (1) share of its stock to each resident of Alaska, unless such resident elects within one (1) year after the date of such issuance not to receive such share;[9]

(d) to provide that no share of stock shall be sold, pledged, assigned, mortgaged, subjected to encumbrance, voluntarily or involuntarily, or otherwise transferred --

(i) by a shareholder other than by will or the applicable laws of descent and distribution until after the expiration of five (5) years from the date such stock is issued by AGSOC except in the event the shareholder ceases to be a resident of the State of Alaska and thereupon elects to make such transfer;[10]

(ii) to any person other than an individual who is at the time of such transfer an individual resident of Alaska as defined herein;[11]

(iii) to any individual who, after the transfer, would own more than ten (10) shares of the stock of AGSOC;[12]

(iv) by any shareholder until such shareholder shall reach the age of majority, as defined by Alaska law;[13]

(e) to perform all acts and conform to all legal requirements to qualify and thereafter to continue to qualify as a General Stock Ownership Corporation under the Internal Revenue Code of 1954, as amended, and under this Act, unless the Board, with the consent of the Secretary in accordance with applicable provisions of the Internal Revenue Code and regulations thereunder, shall elect to terminate such qualification;[14] and

(f) not to invest in or acquire any interest in properties acquired by it or for its benefit through exercise of the right of eminent domain.[15]

Section 6. RIGHT OF FIRST REFUSAL TO PURCHASE OWN STOCK. AGSOC shall have a right of first refusal to purchase any shares of stock of AGSOC offered to be transferred by the holder thereof.[16] Such shares may be held by AGSOC in the general escrow or trust account of its trust or escrow division, in which event such stock shall continue its status as issued and outstanding stock of AGSOC for all purposes, except that such shares, while so held, shall not be voted nor shall they be entitled to dividends declared on shares of AGSOC stock.[17] The Board of Directors by resolution shall have the power to cancel such reacquired shares and such shares shall thereupon return to the status of authorized and unissued shares.

Section 7. ESCROW OF STOCK BY AGSOC. AGSOC shall have the power to make and enforce reasonable rules and regulations with respect to the establishing of escrow accounts either within its own trust and escrow department or otherwise for each stockholder of the corporation; for releasing shares of stock to the owner or buyer thereof subject to the continuing restrictions set forth in this Act at the expiration of the period of five (5) years following date of issue thereof, or the date upon which the shareholder shall reach the age of majority, as defined by Alaska law, or the date when the shareholder shall have complied with all reasonable rules and regulations of AGSOC pertaining to the release of such shares from escrow, whichever

of said events shall be the last to occur, except in the event of death of the shareholder or upon the shareholder ceasing to be a resident of the State of Alaska and thereupon electing to transfer such shares to an eligible transferee;[18] for the operation of its trust and escrow division; for the transfer and recording of transfers of its stock if it determines to act as its own transfer agent;[19] for the operation of its trust and escrow division if it determines to establish a trust and escrow division, and with respect to the issue, transfer, repurchase and other handling or dealing with its stock as its Board of Directors may adopt and promulgate. All such rules and regulations shall be published to the stockholders of AGSOC and shall be available in suitable form to any stockholder at any time upon request during regular business hours.

Section 8. DEFINITION OF RESIDENT.

(a) For purposes of original issue of shares of AGSOC stock under this Act, the terms "resident", "eligible individual", or "qualified individual" shall have the same and identical meaning, and shall mean an individual, born prior to 12:00 o'clock midnight on January 1, 1979, regardless of age, who as of 12:00 o'clock midnight on January 1, 1979,[20] was a resident of and was domiciled in the State of Alaska and who remains a resident of Alaska through the date determined by the Board of Directors of AGSOC and publicly announced as such, to be the date the shares of stock of AGSOC are initially issued.

(b) For purposes of transfer of AGSOC shares subsequent to

initial issuance, "resident" shall mean an individual, regardless of age, who is a resident and is domiciled in the State of Alaska on the date such transfer is made effective.

Section 9. IDENTIFICATION OF RESIDENTS OF ALASKA ELIGIBLE TO BECOME AGSOC SHAREHOLDERS.

(a) Prior to issuing any shares of stock, AGSOC shall take all reasonable measures, by public advertising, radio and television broadcasting, and otherwise, to make known to all residents of the State of Alaska its intention to issue stock to each person eligible to become a shareholder and to similarly notify all Alaska residents of the eligibility requirements to become a registered shareholder of AGSOC.[21] Such efforts shall be made from time to time and shall continue for a period of at least ninety (90) days prior to the date for issuance of stock of AGSOC, and shall be made at least once each month over the next eleven (11) months, and as frequently thereafter as the Board of Directors of AGSOC may deem appropriate. The procedural details pertaining to the identification of such persons as shareholders, either in person, or if they are minors represented by a parental or legal guardian, or if they be incompetent persons by a legal guardian, shall be fully provided to each person making inquiry at a properly designated office by a representative of AGSOC.

(b) The duty and responsibility, however, of each qualified resident to make application for registration as a shareholder of AGSOC shall rest solely and exclusively upon such

qualified resident and upon the parental and legal guardians of qualified residents, and AGSOC shall not be liable for any loss, loss of income, disadvantage or inconvenience resulting directly or indirectl_ from the failure of such qualified resident to make such timely application except as herein specifically provided.(22)

(c) AGSOC shall have no obligation to reimburse any eligible individual who may incur income tax liability as the result of failure to make timely application for registration as a shareholder of AGSOC, nor shall AGSOC be liable for reimbursing previously declared or paid dividends to which an applicant for registration as a shareholder would have been entitled had timely application therefor been made. Subject to these limitations, however, an eligible resident who would have been entitled to the issuance of a share or shares of stock of AGSOC, had application been made prior to the time of such issuance, or a transferee by will, or by the laws of descent and distribution, or other legal transferee, and had such qualification continued through the date of such issuance, may at any time thereafter make such application and receive the stock (or escrow certificate representing such stock) to which he shall thus be established as being entitled.(23)

Section 10. CIVIL AND CRIMINAL PENALTIES FOR MISREPRESENTATION OF FACTS DETERMINING ELIGIBILITY TO BECOME AGSOC SHAREHOLDER.

(a) Any individual who shall have received stock upon orig-

inal issue by AGSOC through fraudulent or misleading representations shall, upon demand therefor in writing being made by or on behalf of AGSOC, return all certificates or other evidence of the ownership of such shares and the full amount of dividends, whether in cash, in stock or otherwise, received thereon, together with interest at the rate of eight percent (8%) per annum from the date that such dividend or dividends were received to the date of such repayment. In the event of failure of such illegal holder of shares of AGSOC to make such restitution in full, AGSOC shall be entitled by civil action in any Superior Court in the State of Alaska to enforce such recovery, together with payment of all legal fees and court costs incurred by AGSOC in effecting such recovery.

(b) Any person who shall obtain for himself or for a person as to whom he is or has represented that he is a parental or legal guardian the issuance of shares of AGSOC through fraud, misrepresentation or by any deceitful or illegal means, shall be guilty of a Class C felony.

Section 11. SPECIAL SESSION TO APPROVE FINANCING. It is the intent of the legislature 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. However, no special session need be called if the legislature is scheduled to meet within sixty (60) days of the date of such request. In the event the legislature shall determine that financing or the guaranty of financing for an AGSOC project is necessary or desirable, the legislature shall at the

earliest convenient time call a special election (unless an election is scheduled to be held within sixty (60) days) for voting on the approval of the extension of credit to AGSOC by the State of Alaska, or the guarantying by the State of Alaska or by any agency or instrumentality thereof of the credit of AGSOC.[24]

Section 12. TRUST ACCOUNT WITH DEPARTMENT OF REVENUE. There is hereby established a trust account within the Department of Revenue which account shall be used solely and exclusively for purposes of guarantying loans, public or private, to AGSOC for the accomplishment of its purposes.

Section 13. The following amendments shall be and hereby are made to the Alaska Statutes:

(a) Title 10, Section 10.05.012, is hereby amended by inserting prior to the first word in the second sentence thereof the words: "Except with respect to General Stock Ownership Corporations,".[25]

(b) The last sentence of Title 10, Section 10.05.186, is hereby amended to read: "Except with respect to General Stock Ownership Corporations, no classification of directors is effective prior to the first annual meeting of shareholders."[26]

(c) Title 10, Section 10.05.204, is hereby amended by adding a new Subsection (7) at the end thereof as follows:

"(7) Notwithstanding the foregoing or any other provisions of Title 10 of the Alaska Statutes, dividends may be declared and paid by a General Stock Ownership Corporation, organized under AS __________, at any time and from any source to the extent deemed by the Board of Directors thereof necessary to comply with the distribution requirements of the laws of Alaska and of the United States, except that no dividend shall be declared when such General Stock Ownership Corporation is insolvent or which would cause it to become insolvent."[27]

(d) Title 45 is hereby amended by adding a new Section 45.55.141 thereto to read:

"Section 45.55.141. The stock of a General Stock Ownership Corporation organized under the Alaska General Stock Ownership Corporation Act (AS ____._____) is not a security and the issue or sale of stock under that Act shall not be construed as a sale of a security for purposes of this chapter."[28]

Section 14. AGSOC SHALL BE EXEMPT FROM PROVISIONS OF TITLE 6, CHAPTER 25, OF ALASKA STATUTES. AGSOC shall be authorized to engage in trust and escrow activities with respect only to matters involving its own stock and to such extent AGSOC shall be exempt from compliance with the provisions of Title 6, Chapter 25, of Alaska Statutes.[29]

FOOTNOTES

1. The proposed State legislation is intended to create a corporation conforming to the requirements of the Federal legislation adopted as part of the Revenue Act of 1978. This legislation (H.R. 13511) was enacted into law as Title VI of the Internal Revenue Code of 1954, as amended. That law is reproduced herein under the title "Federal Law" and its provisions are explained in footnotes under the title "Footnotes" following the text of the Federal law.

2. Section 1391(a)(3) of the Federal enabling law requires that the corporation be chartered "by an Act of a State legislature". We believe this Bill is such an Act, even though the procedure specifically directed to be used in bringing the corporation into existence is a direction by the Legislature to the Governor specifying, to the degree required by the Federal enabling Act and by expression of intent of the Alaskan Legislature concerning certain of the details of the Alaska law and resulting special corporation. For simplicity, this contemplates that the Alaska General Business Corporation laws shall apply where not inconsistent with the provisions of this Act.

3. It is assumed that it may be regarded as either necessary or desirable by the Governor, in appointing the incorporators, who, under the provisions of the Bill would become the initial Board of Directors, to go outside the State for certain expertise and experience that may not be available within the State. The Act does not preclude all directors being residents of the State of Alaska if such be the result of the Governor's appointment of the initial Board and the result of subsequent elections by the stockholders. This tracks the Federal enabling Act. (Section 1391(a)(4)(E).)

4. The General Stock Ownership Corporation Act, which became law on November 6, 1978, as part of the 1978 tax revision legislation, was the extraordinary accomplishment of Senator Mike Gravel of Alaska. Notwithstanding the absolute newness of the concept, he managed to convince Congress (and the President) of the soundness of tax legislation that made it possible for states to help the non-capital owning many among their citizens to buy capital ownership and pay for it out of what the newly acquired capital produced. This Bill is intended to take advantage of that pioneering law.

5. This tracks the Federal enabling Act. (Section 1391(a)(3) and Paragraph (d) of that section.)

6. The Federal enabling legislation is silent on both the question of the number of members of the Board of Directors of a GSOC and the question of whether such directors may be divided into classes. However, since Alaskan law permits such division of directors into classes, this has been provided for

in order to assure greater continuity of experience and policy once AGSOC becomes operational. Stockholders would elect three directors, each to a term of three years, at AGSOC's regular annual meeting of stockholders, or at a special meeting held in lieu thereof.

7. This tracks the Federal enabling law. (See Section 1391 (a)(4)(A).)

8. This tracks the Federal enabling law. (See Section 1391 (a)(4)(B).)

9. This tracks the Federal enabling law. (See Section 1391 (a)(4)(C).)

10. This tracks the Federal enabling law. (See Section 1391 (a)(4)(D).) It should be noted that the Federal enabling statute does not prohibit a stockholder of AGSOC from changing his residence from the State of Alaska to another jurisdiction after his eligibility to be a stockholder has been established by residence and domicile in the State of Alaska on the date specified by the Legislature and on the date of issuance of the stock. However, as drawn, the Alaska enabling Act would prevent such non-resident stockholder of AGSOC from transferring his AGSOC stock, either within the initial five year period when transfers in general are prohibited, or thereafter, to any person not a qualified resident of the State of Alaska.

11. This tracks the Federal enabling Act. (See Section 1391 (a)(4)(B)(ii).)

12. This tracks the Federal enabling law. (See Section 1391 (a)(4)(D)(iii).)

13. This provision is inserted in conformity to the general policy that property transactions by minors are either void or voidable. It also provides a measure of assurance that although a parental or legal guardian of a minor stockholder may spend the dividends income accruing to such minor stockholder from his holding of AGSOC stock on his maintenance, education, etc., the stock itself is, in effect, subject to a spendthrift clause that assures the minor stockholder's receipt of his share or shares of AGSOC stock intact upon reaching the age of majority.

14. The theory of the Federal enabling legislation is designed to facilitate the acquisition of stock by all eligible residents of a state adopting a General Stock Ownership Corporation law by eliminating Federal income taxes on the corporation at the corporate level. Under Alaskan law, this has the effect of eliminating State corporate income taxes on AGSOC as well. Certainly the acquisition of ownership of capital stock in a corporation primarily out of the earnings produced by the capital represented by that stock is made easier by the elimination of one level of income taxes. Each stockholder's share of the

corporate income is included in the stockholder's individual income for Federal income tax purposes (and, unless the Alaska Legislature should determine otherwise, for State individual income tax purposes). (Federal enabling law, Section 1393(a).)

The requirement of the Federal enabling law that a General Stock Ownership Corporation distribute at least 90% of its taxable income for any taxable year by January 31st following the close of such taxable year is intended to insure, so far as possible, that no stockholder shall have taxable income attributed to him without cash dividends to pay such tax. See the Federal enabling law, Section 1396(a). See Footnote 23 in the annotations in this report to the Federal enabling legislation.

15. This tracks the Federal law. (See Section 1391(a)(5) and Footnote 14 in the annotations to the Federal enabling law.)

16. Since a right of first refusal is merely a privilege which may or may not be exercised by AGSOC, the existence of such a privilege does not in itself impose any burden upon AGSOC but does permit the corporation to provide a substitute market, particularly during the initial five year period after issuance of AGSOC's shares when the only permitted transfers are incidental to death or, as the Bill is presently drafted, by stockholders who cease to be residents and elect to transfer their shares.

17. By authorizing AGSOC to establish an escrow and trust division, into which shares of its stock acquired pursuant to its right of first refusal, or otherwise, could be transferred, without causing such shares to automatically return to the status of authorized but unissued shares, many details in connection with transfers of stock to existing shareholders, who may acquire up to ten shares of AGSOC stock, or persons who become residents of Alaska in the sense required for eligibility as AGSOC stockholders except for the fact that they were not such on the date of original issue, the establishment of such a trust and escrow division could serve a valuable function. As the remainder of Section 6 indicates, the Board of Directors could cancel such reacquired shares, assuming that no individual rights with respect thereto were outstanding, causing them to return to the status of authorized and unissued shares.

18. Section 7 of the Bill is drawn to give the Board of Directors a variety of options with respect to establishing "in-house" facilities for handling the escrow accounts and stock transfer activities of its stockholders, or for employing outside facilities, such as those of a bank or trust company, for this purpose. It would seem that the maintaining of shares of stock in escrow accounts established for each stockholder during the initial five year period when, under the Federal enabling law as well as under the provisions of this Bill, the shares of AGSOC's stock are not generally transferable

would be desirable. Each AGSOC stockholder, in such case, would receive an impressively embossed escrow receipt showing that stock is held in his name. It would also permit the holding of AGSOC shares in escrow for minors until they reach the age of majority, and the establishment by the Board of Directors of reasonable rules and regulations relating to the release of shares from escrow. Such rules and regulations might, for example, establish the criteria by which a stockholder identifies himself as the individual entitled to issuance of his share or shares.

19. This provision authorizes the Board of Directors to have stock transfer functions handled either internally or externally as careful analysis of the merits of those alternatives are evaluated by the Board.

20. The Federal enabling law, Section 1391(c), requires that "eligible individual" means an individual who is, "as of a date specified in the State's enabling legislation" a resident and "who remains a resident of such State between that date and the date of issuance". (See the Federal enabling law and Footnote 16 thereto.) As pointed out in Footnote 16 to the Federal enabling legislation, the term "resident" is not a specific term, and is considerably narrower than the term "domiciliary". A domiciliary is an individual who, by the weight of all evidence pertinent to identification of the place that one regards as his main geographical home, is held to be domiciled in that place. "Residence" is merely one of the types of evidence indicating domicile. Since the question of the identity of the place that one regards as his domicile is a question of intent as evaluated by all pertinent evidence, the Bill has been drawn to require both "residence" and "domicile" to determine eligibility for original issue of AGSOC stock, or for acquisition by subsequent transfer of AGSOC stock. Doubtless the rules and regulations of the Board of Directors will lay down some prima facie criteria for determining who is a "resident", "eligible individual", or "qualified individual", having in mind that the provisions of Section 8 of the Bill intend each of these terms to be equivalent to domicile as well. Ultimately, in case of a dispute, such facts must be determined by the appropriate court.

21. The Bill contemplates that all reasonable efforts will be made by AGSOC to alert all eligible residents of Alaska of its intent to issue shares and to come forward, under such rules and regulations as the Board of Directors may establish, to demonstrate their eligibility and to have their stockholder accounts set-up. Rules and regulations, to be adopted by the Board of Directors, will lay down the appropriate procedures, including the right of parental guardians and legal guardians -- on behalf of minors or incompetent persons -- to establish eligibility for registration as a stockholder of AGSOC.

22. It is intended by the provisions of Paragraph (b) of Section 8 of the Bill to relieve AGSOC from legal liability for

failure to identify and register as a shareholder every person who is eligible to be so registered. The legal burden to get registered is on the eligible stockholder.

23. Paragraphs (b) and (c) of Section 8 of the Bill are intended to establish just and equitable provisions for eligible individuals, who initially fail to identify themselves at the time of the initial issuance of stock by AGSOC and who later seek to do so. The eligible individual can establish his eligibility at any subsequent time and receive his share or shares as the case may be. However, since AGSOC must pay out substantially all its earnings, and cannot be charged with unexpected liabilities for any substantial number of individuals who, through negligence or otherwise, fail to establish their entitlement to AGSOC stock and who thus have had income which otherwise might have been received by them distributed to other shareholders.

24. Implicit in the Bill for a proposed enabling Act permitting the establishment of AGSOC is the idea that economic activities of such magnitude that if their ownership is spread over the entire body of eligible residents (as of a particular time) will be capable of connecting each such stockholder with sufficient capital to provide a significant addition to his annual income. Thus, in effect, one clearly contemplated approach is to use the credit of the State of Alaska for the purpose of bettering the economic status and economic lives of all of its residents. Thus the timeliness of State action to authorize the establishment of private enterprise organizations capable of using the credit of the State for the purpose of building capital ownership into the citizens of the State or acquiring such capital ownership for them, would seem to be not only proper, but long overdue. The State in so doing would be seeking to increase the size of its tax base -- the property and incomes of its citizens -- but also to diminish the incidence of poverty.

It is inevitable that, by separate appropriation Bill or Bills, funds or lines of credit will have to be made available, either by grant or by loan, to the initial Board of Directors for the purpose of organizing the corporation, employing and paying an initial staff, both managerial and clerical and technical, establishing headquarters, reviewing and analyzing investment opportunities, employing accountants, lawyers, investment banking advisors and consultants, and consultants having appropriate expertise in the area of investments deemed by the Board of Directors worthy of investigation for possible acquisition. Our estimate of the funds required would be in the area of $2.5 to $3 million.

Since it is intended that AGSOC function as a private enterprise institution, such initial organizational funding would seem most appropriately provided by loan, either from the State, or through guaranty by the State or by a State agency, or in other appropriate manner.

Once a suitable project for initial investment has been ascertained and such investment determined by adequate analysis of qualified experts, feasibility and investment memoranda prepared and approved by the Board of Directors and by potential loan sources, either during a General Session of the Legislature or at a Special Session of the Legislature, action necessary to finance the project acquisition and to provide necessary working capital will be required.

It should be noted that one of the major tasks of the newly organized corporation, should the legislation be adopted, will be the establishment, either within AGSOC or within some contracting organization, such as a major banking firm, of the data bank identifying the eligible residents who are entitled to become its first shareholders. A sizeable amount of clerical work, legal work, development of computer software, development of stock issuance, escrow, and transfer rules and regulations, will precede or need to be carried on simultaneously with the search for suitable investment or investments.

25. Title 10, Section 10.05.012, of the Alaska Business Corporation Act should be amended to exempt a General Stock Ownership Corporation from the provision that "Purchase by a corporation of its own shares, whether direct or indirect, may be made only to the extent that earned surplus is available for the purchase, *** ". Because of the requirement that AGSOC pay out 90% of its income at all times there may not be earned surplus available for purchase of its own shares even though circumstances may convince the Board in a particular case that it do so.

26. Title 10, Section 10.05.186, should be amended to exempt AGSOC from prohibition against classifying directors prior to the first annual meeting of shareholders as it seems desirable to arrange for the initial Board to be divided into three classes with staggered terms to assure a continuity of directorship during the initial start-up period.

27. Title 10, Section 10.05.204, should be amended to provide that AGSOC may pay dividends at any time or from any source to comply with requirements of the Federal law that a GSOC pay out 90% of its income each year.

28. This new section added to Title 45 of the Alaskan Securities Act would provide that shares of AGSOC will not be a security, and the sale of such shares will not be the sale of a security which would require registration under that Act.

29. Title 6, Chapter 25, of Alaska Statutes provides for formation and operation of trust companies. AGSOC should be exempted from the provisions of these laws dealing with and regulating trust businesses generally so long as its trust and escrow activities involve its own stock.

ANALYSIS RECOMMENDED FOR INCLUSION IN THE
LEGISLATIVE FINANCIAL COMMITTEE REPORT
TO ACCOMPANY THE AGSOC BILL

1. THERE ARE TWO SOURCES OF INDIVIDUALLY PRODUCED INCOME: JOBS AND CAPITAL

An individual may generate personal income either through his labor or through his privately-owned capital. Most people are familiar with both types of income, but rely primarily on employment related income. Most Americans receive only minimal amounts of capital income: a small dividend on some corporate stock or a few dollars interest from a savings account. But, for a few capital related income comprises most of their income. Indeed, for a very few capital income is so large that they cannot consume it all and they reinvest the surplus to create new capital. This generates even larger amounts of capital related surplus income in later years.

There is an important difference between capital and job related income. Job related income is subject to a finite limit based on the number of hours a person can work, his education, health, experience and other personal factors. Capital related income is subject only to the availability of profitable investments and has, in some cases, grown to extremes.

Recognizing that most Americans rely on wages and salaries for survival, efforts have been taken to assure high levels of employment. Government "creates" jobs in the public and private

sectors to insure that the otherwise unemployed have income to purchase the necessities of life.

2. TECHNOLOGY DISPLACES LABOR WITH CAPITAL

Capital and labor both contribute to the production of goods and services. However, labor unaided by capital has very definite limits to its productiveness. Unaided, a laborer will not accomplish much when set to dig an irrigation ditch. Add a small amount of capital in the form of a shovel and the worker can accomplish much more in a given amount of time. As technology progresses and the laborer is equipped with a power shovel, production is increased greatly. The increase in production is attributable to the addition of increasing amounts of capital.

Income reflects the value of the products created by the two components of production, labor and capital. As labor is replaced with capital the flow of income shifts from labor to capital. But, the owners of labor and the owners of capital are quite different. Labor power is broadly owned by the great majority of American workers, while the ownership of capital is highly concentrated. Thus, as the earnings shift from labor to capital, without government interference, more and more income will flow to fewer and fewer people. It is the shifting of income as a result of technology which threatens the foundations of our society. It means that fewer and fewer people

will own an even larger portion of our productive power and the income accompanying it while labor receives an ever decreasing portion.

There are only two solutions to the crisis which we are facing. One would be to simply appropriate income from the wealthy and give it to those who can no longer earn enough income to survive or be comfortable. Under our democratic government the great labor owning majority may be shifting income toward artifically evaluated labor and away from capital through such things as the minimum wage, feather bedded contracts, unemployment compensation, and welfare. An alternative would be to bring those wage earners into the system of capital ownership so that if their labor income should be insufficient income from capital ownership will supplement or replace it.

3. NEW CAPITAL MAY BE ACQUIRED WITH CREDIT

Conventional methods of financing economic development and the creation of new capital rely heavily upon the use of credit. Borrowed money is used to purchase assets which produce income to pay off the loan. Once the loan is retired the asset continues to generate income enriching its owner. The credit route to wealth is used by most corporations and many individuals and may be illustrated by the following example:

> Mr. Adams, a man of considerable wealth, wants to build a fourplex which will cost \$200,000. He takes a personal loan from his bank for that amount and builds the apartments. For simplicity assume that no interest is charged on his loan and payments are \$20,000 per year for 10 years. Mr. Adams rents his fourplex for \$2,000 per month or \$24,000 per year leaving him \$4,000 per year for maintenance and other expenses after loan payments of \$20,000. At the end of 10 years Mr. Adams owns the fourplex free and clear of the loan and it continues to generate \$24,000 (or more) per year in income which he is free to spend.

In the example Mr. Adams did not invest his own assets in the fourplex, but used borrowed funds to acquire an asset which would pay for itself. Why doesn't everyone invest the way Mr. Adams does? Because access to credit is limited.

4. ACCESS TO CREDIT IS LIMITED

Access to credit for the acquisition of income producing capital is limited primarily to those who already own some capital. Lenders do not like to take risks. They want

assurance that borrowed money will be repaid even if it is lost in an unsuccessful venture. To assure repayment they look not only to the investment to be undertaken, but to the financial strength of the borrower. Wealthy borrowers are more likely to receive loans because they have other assets on which the bank may call if the investment by the borrower generates insufficient income to retire the loan. This is what leads to the incongruity that those who need most to borrow funds to invest in productive capital are least able, under conventional financing methods to do so, and vice versa.

In more abstract terms existing capital is put "at risk" to assure the lender against the possibility that the new capital will not pay for itself. This means existing capital is a major component, along with the debt, in generating new capital. But, what about the broad group of Americans with no existing capital, what lies in store for them?

5. OUR INSTITUTIONS FOSTER CAPITAL CONCENTRATION

Existing capital is a key to new capital under our present institutions, fostering concentrations of wealth. New capital tends to be generated by those who own existing capital and "the rich get richer." Structural components in our laws encourage capital formation by those who already own capital: the income tax interest deduction encourages debt financing of

growth by corporations making existing shareholders richer; distributions of earnings are discouraged by taxing them as ordinary income preventing leveraged acquisition of corporate stock with repayment through dividends; government loans are made to corporations with assets sufficient to guarantee the loans making the existing shareholders more wealthy.

The concentration of capital in America has been the subject of a number of studies which indicate that the top 5% of Americans own more than half of all our productive wealth. This means that much of the capital related income in our economy flows to a very small group of people. Our existing structure fosters capital concentration in such a way that one would think it a desirable and intended governmental objective.

6. HIGHLY CONCENTRATED CAPITAL OWNERSHIP IS UNHEALTHY

Large concentrations of capital accrue large concentrations of income. There is a finite limit to the amount of income a family can consume and beyond which income is reinvested to increase capital accumulation. The income poured into new capital is not available for consumption. Thus, high concentrations of capital reduce total consumption.

The reduction of total consumption might not be unhealthy if all the needs and wants of our citizens were satisfied.

But, such is not the case and we tax away excess income for transfer payments to those whose labor income is insufficient and who have no capital-related income. We pump up demand by transferring income to the unemployed, the welfare recipients the elderly.

If capital were widely owned the income from capital would supply the needs of those who earn insufficient income from labor. This group's demand for goods and services would finally be satisfied from an income source independent of transfer payments. This demand would stimulate the need for more capital goods to supply the demand and the additional capital, if owned by the same group, would throw off more income to the group.

7. BROADENING OWNERSHIP CAN BE DONE THROUGH CAPITAL FORMATION

Capital ownership can be broadened without reducing the wealth of the rich. Our system of capital formation, biased in favor of the wealthy, can be weighted in favor of everyone. New capital can be formed in a way so that everyone participates in the process without affecting the ownership of existing capital.

The key to broadened capital ownership without confiscation is credit. Credit is a major element in the creation of new capital. Access to credit gives the wealthy access to the new capital created in our economy. New capital is created every

day in the form of pipelines, plants, machinery and equipment. It is estimated that our existing net national wealth of nearly six trillion dollars will double in the next 20 years in much the same way that the wealth of Alaska doubled with the construction of the Trans Alaska Pipeline. If the typical citizen can be given access to credit for capital formation he can share in the economic growth of our society and develop a capital estate for himself.

The average citizen does not have effective access to credit for capital formation because he does not have existing wealth to guarantee the lender's risk. However, joined together with his fellow citizens through his State government he has tremendous borrowing power. The security of a State guarantee can perform the same guarantee function for the average citizen which existing capital does for the wealthy. Through the power of State government the typical citizen can leverage himself into a capital asset which will pay for itself and throw off income to him and his neighbors and his children.

8. LIMITED CAPITAL OWNERSHIP CONTRIBUTES TO POVERTY

Poverty stems from a lack of income. Poverty makes no distinction between sources of income and one is just as poor without capital as he is without a job. Conversely, if one has capital income he may not be destitute even without a job.

Since capital is one of the two available sources of income the lack of widespread capital ownership has ramifications for the level of income within a State. To the extent that capital ownership is widespread, citizens need not rely solely on labor income for survival. Unemployment may require a reduced standard of living, but may not require government support to insure the necessities of life.

For years governments have addressed only one aspect of poverty: jobs. Where jobs were unavailable or could not be created the only solution was to transfer income to the poor from those who had income. But, there is another way to address the roots of poverty and that is through the ownership of capital. If the average citizen can be involved in capital ownership he will have an additional source of income if his job fails. Governments have tinkered with our system to create jobs so people will have income; it is now time to adjust the process of capital formation so that the people will have capital and capital related income as well.

9. A BETTER LIVING STANDARD FOR ALL CITIZENS IS AN APPROPRIATE GOVERNMENT GOAL

It has long been a tradition in America that eradication of poverty and improvement of the general standard of living are appropriate goals for government to pursue. These goals

have been the center piece of many major legislative programs in both Federal and State governments. These goals have been endorsed by the State of Alaska and, having been tested in our courts, found to be proper objectives toward which the power of the State may be exercised.

10. BROADENED CAPITAL OWNERSHIP IS AN APPROPRIATE GOVERNMENT GOAL

Restrictive capital ownership is an impediment to the eradication of poverty and the improvement of the general standard of living, both of which are appropriate government objectives. The broadening of capital ownership contributes to the achievement of those objectives through increasing income available to the groups involved. Therefore, broadening capital ownership is a proper governmental activity undertaken to achieve these goals and becomes a proper goal in and of itself.

The State objectives of broadening capital ownership must be balanced by other State interests such as the protection of private property interests and the maintenance of acceptable levels of state revenues and risks. Thus, it would not be appropriate for the State to redistribute existing privately held wealth. However, the creation of a General Stock Ownership Corporation balances the competing goals and obligations of the State while broadening the ownership of capital.

11. DILUTION OF CAPITAL IS INCOMPATIBLE WITH BROADENED OWNERSHIP

Dilution of capital occurs when a corporation increases the number of shares outstanding without increasing the amount of capital in the corporation. For example a corporation with $100 of capital and 100 shareholders has net equity per shareholder of $1.00. If the number of shareholders is increased to 200 without increasing the corporation's capital each original shareholder's book value falls to 50¢. The addition of new shareholders has reduced the value of original shareholder's stock. If the new shareholders are mandated by law the government has effectively appropriated half the value of the original shareholder's stock for the benefit of the new shareholders. Such an appropriation of capital is a violation of the concept of private property and beyond the proper exercise of a State's authority.

12. A CLOSED CLASS IS APPROPRIATE TO THE OBJECTIVE OF BROADENED CAPITAL OWNERSHIP

In the development of a General Stock Ownership Corporation it is necessary to identify certain persons who, within the limits set forth under Federal law, qualify as shareholders. To assure proper functioning of the corporation as a private for profit business enterprise it is necessary to issue stock which shall have all the rights and privileges of private property. Inherent in the concept of stock as private property is the

right of a shareholder to be free from dilution of his stock except upon a majority vote of the shareholders. Therefore, it is appropriate to the objective of broadening capital ownership through the creation of a General Stock Ownership Corporation to close the class of individuals eligible to become shareholders as of a specific date established by the State in the authorizing legislation.

But of course, if the number of Alaskan residents without shares in the Alaska General Stock Ownership Corporation becomes substantial, the Legislature can again address itself to this problem, authorizing another class of stock for all then-qualified residents (with permissive changes in State and Federal laws), and arrange further financing for the development of additional capital assets to support the issuance of additional shares.

FEDERAL ENABLING LAW

REVENUE ACT OF 1978 [1]

(H.R. 13511)

ENACTING TITLE VI, INTERNAL REVENUE CODE OF 1954, AS AMENDED

GENERAL STOCK OWNERSHIP CORPORATIONS

NOTE: Numbers in parenthesis above the text refer to the explanatory annotations immediately following the text of the legislation.

Sec. 601. ESTABLISHMENT AND TAXATION OF GENERAL STOCK OWNERSHIP CORPORATIONS AND THEIR SHAREHOLDERS.

(a) IN GENERAL - Chapter 1 [2] (relating to normal taxes and surtaxes) is amended by adding at the end thereof the following new subchapter:

"Subchapter U [3] - General Stock Ownership Corporations

"Sec. 1391. Definitions.
"Sec. 1392. Election by general stock ownership corporation.
"Sec. 1393. Corporation taxable income taxed to shareholders.
"Sec. 1394. Rules applicable to distributions of electing general stock ownership corporations.
"Sec. 1395. Adjustments to basis of stock of shareholders.
"Sec. 1396. Minimum distribution.
"Sec. 1397. Special rules applicable to earnings and profits of an electing general stock ownership plan.

"Sec. 1391. DEFINITIONS.

"(a) GENERAL STOCK OWNERSHIP CORPORATION. - For purposes of this subchapter, the term 'general stock ownership corporation' (hereinafter referred to as a 'GSOC') means a domestic [4] corporation which -

"(1) is not a member of an affiliated group (as defined in section 1504), [5] and

"(2) is chartered and organized after December 31, 1978, and before January 1, 1984;(6)

"(3) is chartered by an act of a State legislature(7) or as a result of a State-wide referendum;

"(4) has a charter providing -

"(A) for the issuance of only 1 class of stock,

"(B) for the issuance of shares only to eligible individuals(8) (as defined in subsection (c));

"(C) for the issuance of at least one share to each eligible individual,(9) unless each eligible individual elects within one year after the date of issuance not to receive such share;

"(D) that no share of stock shall be transferable -

"(i) by a shareholder other than by will or the laws of descent and distribution until after the expiration of 5 years from the date such stock is issued by the GSOC except where the shareholder ceases to be a resident of the State;(10)

"(ii) to any person other than a resident individual of the chartering State;(11)

"(iii) to any individual who, after the transfer, would own more than 10 shares of the GSOC;(12)

"(E) that such corporation shall qualify as a GSOC under the Internal Revenue Code;(13)

"(5) is empowered to invest in properties (but not in properties acquired by it or for its benefit through the right of eminent domain.(14)

For purposes of this subsection, section 1504

(a) shall be applied by substituting '20 percent' for '80 percent' wherever it appears.

"(b) ELECTING GSOC. - For purposes of this subchapter, the term 'electing GSOC' means a GSOC which files an election under section 1392 which, under section 1392, is in effect for such taxable year.(15)

"(c) ELIGIBLE INDIVIDUALS. - For purposes of subsection (a), the term 'eligible individual' means an individual who is, as of a date specified in the State's enabling legislation for the GSOC, a resident of the chartering State and who remains a resident of such State between that date and the date of issuance.(16)

"(d) TREATED AS PRIVATE CORPORATION. - For purposes of this title, a GSOC shall be treated as a private corporation and not as a governmental unit.(17)

"(e) STUDY OF GENERAL STOCK OWNERSHIP CORPORATIONS. - The staff of the Joint Committee on Taxation shall prepare a report on the operation and effects of this subchapter relating to GSOC's. An interim report shall be filed within two years after the first GSOC is formed and a final report shall be filed by September 30, 1983.

"Sec. 1392. ELECTION BY GSOC.

"(a) ELIGIBILITY. - Except as provided in section 1393, any GSOC may elect, in accordance with the provisions of this section, not to be subject to the taxes imposed by this chapter.[18]

"(b) EFFECT. - If a GSOC makes an election under subsection (a) then -

"(1) with respect to the taxable years of the GSOC for which such election is in effect, such corporation shall not be subject to the taxes imposed by this chapter and, with respect to such taxable years and all succeding taxable years, the provisions of section 1396 shall apply to such GSOC,[19] and

"(2) with respect to each such taxable year, the provisions of section 1393, 1394, and 1395 shall apply to the shareholders of such GSOC.[20]

"(c) WHERE AND HOW MADE. - An election under subsection (a) may be made by a GSOC at such time and in such manner as the Secretary shall prescribe by regulations.

"(d) YEARS FOR WHICH EFFECTIVE. - An election under subsection (a) shall be effective for the taxable year of the GSOC for which it is made and for all succeeding taxable years of the GSOC, unless it is terminated under subsection (f).

"(e) TAXABLE YEAR. - The taxable year of a GSOC shall end on October 31 unless the Secretary consents to a different taxable year.".[21]

"(f) TERMINATION. - The election of a GSOC under subsection (a) shall terminate for any taxable year during which it ceases to be a GSOC and for all succeeding taxable years.[22] The election of a GSOC under subsection (a) may be terminated at any other time with the consent of the Secretary, effective for the first taxable year with respect to which the Secretary consents and for all succeeding taxable years.[23]

"Sec. 1393. TAXABLE INCOME TAXED TO SHAREHOLDERS.

"(a) GENERAL RULE. - The taxable income of an electing GSOC for any taxable year shall be included in the gross income of the shareholders of such GSOC in the manner and to the extent set forth in this subsection.(24)

"(1) AMOUNT INCLUDED IN GROSS INCOME. - Each shareholder of an electing GSOC on any day of a taxable year of such GSOC shall include in his gross income for the taxable year with or within which the taxable year of the GSOC ends the amount he would have received if, on each day of such taxable year, there had been distributed pro rata to its shareholders by such GSOC an amount equal to the taxable income of the GSOC for its taxable year divided by the number of days in the GSOC's taxable year.(25)

"(2) TAXABLE INCOME DEFINED. - For purposes of this section, the term 'taxable income' of a GSOC shall be determined without regard to the deductions allowed by part VIII of subchapter B (other than deductions allowed by section 248, relating to organizational expenditures).(26)

"(b) SPECIAL RULE FOR INVESTMENT CREDIT.(27) - The investment credit of an electing GSOC for any taxable year shall be allowed as a credit to the shareholders of such corporation in the manner and to the extent set forth in this subsection.

"(1) CREDIT. - There shall be apportioned among the shareholders a credit equal to the amount each shareholder would have received if, on each day of such taxable year, there had been distributed pro rata to the shareholders the electing GSOC's net investment credit divided by the number of days in the GSOC's taxable year.

"(2) NET INVESTMENT CREDIT. - For purposes of this paragraph the term 'net investment credit' means the investment credit of the electing GSOC for its taxable year less any tax from recomputing a prior year's investment credit in accordance with section 47.

"(3) RECAPTURE. - There shall be apportioned among the shareholders of a GSOC, in the manner described in paragraph (1), an additional tax equal to the excess of any tax resulting from recomputing a prior year's investment credit in accordance with section 47 over the investment credit of the GSOC for it's taxable year.

"Sec. 1394. RULES APPLICABLE TO DISTRIBUTIONS OF AN ELECTING GSOC'S[28]

"(a) SHAREHOLDER INCOME ACCOUNT. - An electing GSOC shall establish and maintain a shareholder income account[29] which account shall be -

"(1) increased at the close of the GSOC's taxable year by an amount equal to the GSOC's taxable income for such year,[30] and

"(2) Decreased, but not below zero, on the first day of the GSOC's taxable year by the amount of any GSOC distribution to the shareholders of such GSOC made or treated as made during the prior taxable year.[31]

"(b) TAXATION OF DISTRIBUTION. - Distributions by an electing GSOC shall be treated as -

"(1) a distribution of previously taxed income to the extent such distribution does not exceed the balance of the shareholder income account as of the close of the taxable year of the GSOC,[32] and

"(2) a distribution to which section 301(a) applies but only to the extent such distribution exceeds the balance of the shareholder income account as of the close of the taxable year of the GSOC.[33]

"(c) DISTRIBUTIONS NOT TREATED AS A DIVIDEND. - Any amounts includible in the gross income of any individual by reason of ownership of stock in a GSOC shall not be considered as a dividend for purposes of section 116.[34]

"(d) REGULATIONS. - The Secretary shall have authority to prescribe by regulation, rules for treatment of distribution in respect of shares of stock of the GSOC that have been transferred during the taxable year."[35]

"Sec. 1395. ADJUSTMENT TO BASIS OF STOCK OF SHAREHOLDERS.[36]

"The basis of a shareholder's stock in an electing GSOC shall be increased by the amount includible in the gross income of such shareholder under section 1393, but only to the extent to which such amount is actually included in the gross income of such shareholder.

"Sec. 1396. MINIMUM DISTRIBUTIONS.

"(a) GENERAL RULE. - A GSOC shall distribute at least 90 percent of its taxable income for any taxable year by January 31 following the close of such taxable year.[37] Any distribution made on or before

January 31 shall be treated as made as of the close of the preceding taxable year.

"(b) IMPOSITION OF TAX IN CASE OF FAILURE TO MAKE MINIMUM DISTRIBUTION.[38] - If a GSOC fails to make the minimum distribution requirements described in subsection (a), there is hereby imposed on the GSOC a tax equal to 20 percent of the excess of the amount required to be distributed over the amount actually distributed.

"Sec. 1397. SPECIAL RULES APPLICABLE TO AN ELECTING GSOC.[39]

"(a) GENERAL RULE. - The current earnings and profits of an electing GSOC as of the close of its taxable year shall not include the amount of taxable income for such year which is required to be included in the gross income of the shareholders of such GSOC under section 1393(a).[40]

"(b) SPECIAL RULE FOR AUDIT ADJUSTMENTS.[41] -

"(1) TAXABLE INCOME. - Taxable income of an electing GSOC shall, in the year of final determination, be increased or decreased, as the case might be, by any adjustment to taxable income for a prior taxable year.

"(2) INVESTMENT CREDIT. - The investment credit of an electing GSOC shall, in the year of final determination, be increased or decreased, as the case might be, by any adjustment to the net investment credit for a prior taxable year.

"(3) METHOD OF MAKING ADJUSTMENTS. - An electing GSOC shall include in gross income for the year of an adjustment the amount described in paragraph (1) and shall take into account the adjustment described in paragraph (2), and shall be liable for payment of interest in the amount that would have been payable by the GSOC under section 6601 (relating to interest on underpayment, nonpayment or extensions of time for payment, of tax) or receivable by the GSOC under section 6611 (relating to interest on overpayments) if such GSOC had been a corporation other than an electing GSOC.

(b) TECHNICAL AMENDMENTS. -

(1) NET OPERATING LOSS DEDUCTION.[42] - Paragraph (1) of section 172(b) (relating to net operating loss carrybacks and carryovers) is amended by adding at the end thereof the following new subparagraph:

"(H) In the case of an electing GSOC which has a net operating loss for any taxable year such loss shall not be a net operating loss carry-

back to any taxable year preceding the year of such loss, but shall be a net operating loss carryover to each of the 10 taxable years following the year of such loss."

(2) INCOME TAX COLLECTED AT SOURCE.[43] - Section 3402 (relating to income collected at source) is amended by adding at the end thereof the following new subsection:

"(r) EXTENSION OF WITHHOLDINGS TO GSOC DISTRIBUTIONS. -

"(1) GENERAL RULE. - An electing GSOC making any distribution to its shareholders shall deduct and withhold from such payment a tax in an amount equal to 25 percent of such payment.

"(2) 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, distributions of an electing GSOC to any shareholder which are subject to withholding shall be treated as if they were wages paid by an employer to an employee."

(3) ADJUSTMENTS TO BASIS.[44] - Section 1016(a) (relating to adjustments of basis) is amended by redesignating pargraph (23) as (22) and by inserting after paragraph (20) the following new paragraph:

"(21) to the extent provided in section 1395 in the case of stock of shareholders of a general stock ownership corporation (as defined in section 1391) which makes the election provided by section 1392; and".

(4) RETURN OF GENERAL STOCK OWNERSHIP CORPORATION.[45] - Subpart A of part III of subchapter A of Chapter 61 (relating to information returns) is amended by adding at the end thereof the following new section:

"Sec. 6039B. RETURN OF GENERAL STOCK OWNERSHIP CORPORATION.

"Every general stock ownership corporation (as defined in section 1391) which makes the election provided by section 1392 shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable by subtitle A, the amount of investment credit or additional tax, as the case may be, the names and addresses of all persons owning stock in the corporation at any time during the taxable year, the number of shares of stock owned by each shareholder at all times during the taxable year, the amount of money and other property distributed by the corporation during the taxable year to each shareholder, the date of each such distribution, and such other information, for the purpose of carrying out the provisions of subchapter U of chapter 1, as the Secretary may by regulation

prescribe. Any return filed pursuant to this section shall, for purposes of chapter 66 (relating to limitations), be treated as a return filed by the corporation under section 6012.[46] Every GSOC shall file an annual report with the Secretary summarizing its operations for such year."[47]

(c) CLERICAL AMENDMENTS.[48] -

(1) The table of subchapters for chapter 1 is amended by adding at the end thereof the following:

"SUBCHAPTER U. - General stock ownership plans."

(2) The table of sections for subpart A of part III of subchapter A of chapter 61 is amended by adding at the end thereof the following:

"Sec. 6039B. Return of general stock ownership corporation."

(d) EFFECTIVE DATE.[49] - The amendments made by this section shall apply with respect to corporations chartered after December 31, 1978, and before January 1, 1984.

1. The Revenue Bill of 1978 was passed by the Congress of the United States on October 14, 1978, and signed into law by President Carter on November 6, 1978. The General Stock Ownership Corporation provisions were included as a Senate amendment to that Bill (H.R. 13511) and appear in the legislation as Title VI.

2. The Internal Revenue Code is organized into chapters, subchapters, sections, and subsections. Chapter 1 of the Internal Revenue Code deals generally with the income tax provisions of the Federal law covering both personal and corporate taxes.

3. The Revenue Act of 1978 amends Chapter 1 of the Internal Revenue Code to add a new subchapter designated as Subchapter U. This subchapter, containing seven sections (Sections 1391-1397), sets forth the Federal tax law regarding General Stock Ownership Corporations.

4. A domestic corporation is a corporation which is organized under the laws of the United States or a state thereof.

5. The Internal Revenue Code, Section 1504, defines an affiliated group for purposes of determining which corporations are eligible to file consolidated returns. Generally, an affiliated group is formed when one corporation acquires 80% or more of the voting stock of one or more other corporations. The 80% or more definition in Section 1504 is to be read as 20% or more for purposes of the GSOC legislation.

Since GSOC stock may not be owned by a corporation or other non-individual, the limitation on membership in affiliated groups applies only to ownership by the GSOC of stock in other corporations. The GSOC, in order to avoid being a member of an affiliated group, may not own 20% or more of the stock in another corporation. Failure to comply with this requirement would appear to jeopardize the special tax treatment available to the GSOC under Federal law.

This limitation was included in the GSOC provisions in order to prevent the GSOC from becoming a holding company for other corporations' stock. Because of the special nature of the GSOC tax advantages this limitation is not particularly significant. The elimination of corporate income taxes for the GSOC may not be extended to corporations owned by the GSOC. Therefore, any subsidiary corporation would be fully subject to the Federal income tax, and dividends paid by such a corporation to the GSOC would be net of Federal taxes. The special tax advantage of the GSOC in eliminating the Federal corporate income tax would therefore be defeated by significant ownership of subsidiary corporations.

6. In keeping with the experimental nature of the General Stock Ownership Corporation legislation, a five year period was provided during which such corporations may be formed. Any corporation not formed within the dates set forth in the Act

will not be eligible for treatment under Federal tax law as a General Stock Ownership Corporation. However, any corporation formed and qualifying under these provisions during the five year period will continue to receive the special tax treatment provided GSOCs indefinitely. There is no limitation on the tax advantages once a corporation is established within the designated time frame.

7. The term charter is used in its broadest sense and means that the corporation must have a special grant of powers from either the State Legislature or a statewide referendum. It would not appear to be acceptable for a state to generally authorize the creation of GSOCs. But, it also does not appear necessary for a state to adopt into the law the actual Articles of Incorporation for the GSOC. Indeed, it may be unacceptable for a Legislature to enact the Articles of Incorporation into law and subsequently allow the stockholders of the corporation to amend the Articles. Amendment of the Articles of Incorporation in such a case would appear to effectively amend the statutes of the authorizing state and this would seem to be an unconstitutional delegation of the power of a State Legislature. Conversely, if the Articles of Incorporation could not be amended by its stockholders, it would not appear to be a private business corporation as Congress contemplates by this law.

8. Eligible individual is defined in Section 1391(c) and will be further discussed in Footnote 16 below.

9. At least one share of stock in the General Stock Ownership Corporation must be issued to each eligible individual unless that individual elects within the first year of ownership not to receive the stock. This language does not appear to preclude charging a purchase price for the stock, but in such an event would seem to require that some accommodation be made for those eligible individuals who are not in a position or who are unwilling to pay for the stock. Generally, the drafters of the legislation contemplated the simple distribution of the stock without charge to eligible individuals, with corporate operations and purchases thereafter financed initially through debt instruments only. This would enable the stockholders to build an equity in the stock through amortization of debt with the earnings of corporate investments.

10. In order to qualify as a General Stock Ownership Corporation, the transfer of corporate stock must be restricted during the first five years following its issuance. Since it was contemplated that stockholders in a General Stock Ownership Corporation would be limited to the residents of the authorizing state, an exception is provided so that if an individual ceases to be a resident or dies during the first five years, his stock may be sold or transferred.

The five year transfer restriction was included in order to give shareholders a period of time during which to become familiar with the benefits of stock ownership. It is hoped that

during the first five years of corporate operations the GSOC would be in a position to distribute dividends, giving its shareholders some experience with the income generating capabilities of capital and giving those interested in the formation of these particular corporations an opportunity to study the reactions of shareholders to this new type of investment.

In order to discourage shareholders from emigrating in order to sell their stock prior to the end of the five year period, it may be necessary to provide for some controlled purchase price. This could be done in the form of an option on the part of the corporation to repurchase stock from an individual emigrating from the authorizing state at a value below either the fair market value or income stream valuation approach. Such a repurchase would be consistent with the private capital nature of the GSOC stock and could return to the shareholder his book equity. Book equity valuation for purposes of a mandatory repurchase during the five year nontransferability period might be appropriate in that this represents the shareholder's share of cash invested in acquiring the asset. This is the case because the distribution of stock was cost free to the shareholder and his only investment at the time of sale will be in the form of what would otherwise be cash distributions applied to the repayment of the debt incurred to buy the underlying assets. Thus the shareholder is paying for his capital out of the income it produces.

In the event that a shareholder whose shares are repurchased at book value has incurred tax liability in excess of his distributions of cash from the corporation, his basis in the stock will be increased accordingly and he will receive a capital loss deduction for the difference between the book value purchase price and his adjusted basis. This loss deduction will offset his future additional income from the GSOC, insuring that he remains whole once the transaction is concluded if the assets purchased by the GSOC have thrown off in income their purchase costs and necessary interest.

11. Transfers of GSOC stock may not be made to individuals who are not "residents" of the authorizing state. This limitation is designed to assure that the GSOC, which must begin life as a corporation owned by the residents of a single state, either continues to be owned by those residents or, if they are permitted to take it out of state and cease to be residents, they must at or before their death transfer their GSOC stock to a qualified resident. Thus, while a holder of GSOC stock may sell or otherwise dispose of his stock, he may not do so to a corporation, trust, partnership, or other artificial person nor to any individual who is not a resident of the authorizing state.

12. This limitation on transfers was included in order to assure that great concentrations of GSOC stock do not develop. The GSOC was conceived as a means of broadening capital ownership and thereby spreading more widely the income benefits from capital. This transfer limitation implements these goals.

13. The requirements of Section 1391(4)(A)-(E) are limitations which must be included in both the GSOC authorizing legislation adopted by the State Legislature and the Articles of Incorporation for the GSOC. The limitation set forth in (E) simply makes it clear that both the authorizing Legislature and the incorporators of the General Stock Ownership Corporation intend to qualify under the provisions of Subchapter U of the Internal Revenue Code.

14. There are generally no limitations on the types of investments which GSOCs may undertake. However, because of the unique relationship between GSOCs and the authorizing State Legislatures, certain members of Congress felt it necessary to clarify that GSOCs may not be used as vehicles through which ownership of existing capital assets can be transferred from one group to another through the exercise of the state's powers of eminent domain. Therefore, this limitation was added to prevent the power of state condemnation from being used to transfer unwillingly ownership of an existing business to a General Stock Ownership Corporation. This language does not preclude the condemnation of a pipeline right of way or the purchase by a General Stock Ownership Corporation of an asset a component of which is acquired by the sellers through condemnation. It is designed only to preclude the direct condemnation of existing business assets and a resale thereof to the GSOC.

15. The General Stock Ownership Corporation, in order to avail itself of the special tax treatment provided under Subchapter U, must file an election with the Secretary of the Treasury under the terms of Section 1392, discussed below at Footnote 18.

16. Eligible individuals are those individuals to whom stock must be issued under the provisions of Section 1391(a)(4)(B). Stock must be issued to individuals who are, as of a specific date set forth in the state's GSOC enabling legislation, residents of the state and who remain residents of the state until the date the stock is actually issued. The statutory language with respect to a specific date was included to allow a State Legislature to select a date certain upon which residency could be determined. It was contemplated that such a date might be one prior to the date of the enabling legislation in order to assure that a flood of immigrants to the state would not be encouraged.

The term resident may be defined by the State Legislature for purposes of the GSOC legislation in any constitutional and acceptable manner. The term resident itself is a legal term of uncertain meaning, the definition of which varies with the use. For purposes of general stock ownership legislation it may be appropriate to use a definition of resident which equates that term with the legal term of "domiciliary". This would give a definition of resident dependent not only upon present mailing address or physical location within the state, but intent, however evidenced, to establish and maintain primary geographical living situs within the State of Alaska.

17. The GSOC is to be treated as a private corporation and therefore is not eligible to issue securities or levy taxes as a governmental unit or municipal corporation.

18. To take advantage of the special provisions of Subchapter U, the General Stock Ownership Corporation must file an election under the provisions of Section 1392. The election is to be made at the time and in the manner described by the Secretary of the Treasury. Section 1392(b) is effective for the taxable year of the GSOC for which it is filed and for all later taxable years unless the election is terminated.

19. If the GSOC makes an election under Section 1392, the GSOC corporation itself is exempt from all the income taxes imposed by Chapter 1 of the Internal Revenue Code for the year in which the election is made and all following years until the election is terminated. The GSOC is, however, subject to the limitations of Section 1396 which requires minimum distributions of GSOC income and imposes a penalty tax in the event of a failure to distribute income in accordance with Section 1396 requirements.

20. While the electing GSOC is exempt from Federal income tax, the income of the corporation is taxed to the shareholders under Sections 1393, 1394 and 1395. These sections set out the rules under which the shareholders are attributed the income of the General Stock Ownership Corportion, provide for tax treatment of GSOC distributions, and establish rules for determining the basis of a shareholder's stock.

21. In order to assure that significant deferral of income does not occur, the General Stock Ownership Corporation is required to operate on a taxable year ending on October 31st. This allows the corporation sufficient time to determine its taxable income for the year and to provide that information to the shareholders prior to the April 15th regular filing deadline for shareholders' returns.

22. It appears that under the Federal legislation there is at least one event which could involuntarily terminate the special tax status of the General Stock Ownership Corporation, and that event would be membership in an affiliated group which is prohibited under the terms of Section 1391(a)(1). Depending on interpretations of the general law, other events might involuntarily terminate the special status of the GSOC, such as a revocation by the State Legislature of a corporation's charter or amendments to the Articles of Incorporation which remove the conditions required by Section 1391(4) and (5).

23. The election of the General Stock Ownership Corporation to qualify under Subchapter U may be terminated at any time with the consent of the Secretary of the Treasury. Voluntary termination of GSOC status under Subchapter U might be sought in the event that a General Stock Ownership Corporation were to incur taxable income, perhaps from recapture on the sale of an asset, substantially in excess of cash available for distribution. At

this point the Board of Directors might elect to terminate GSOC status so that the taxable income of the corporation did not flow through to the shareholders, but remained, under the normal rules of corporate taxation, with the corporation. While it is not expected that such an event is likely to occur, it was felt that an option should be provided to allow voluntary termination of elections.

24. This provision makes it clear that the income of the General Stock Ownership Corporation is to be taxed directly to the shareholders.

25. If an individual is a shareholder of a General Stock Ownership Corporation at any point during the GSOC's taxable year, that individual will be attributed a share of the corporation's income for that taxable year. The income must be included in the return of the shareholder for the shareholder's tax year during which the GSOC year ends. Thus, if an individual is a shareholder of a GSOC at any time during the corporation's fiscal year beginning on November 1, 1980, and ending on October 31, 1981, the shareholder would be required to include his share of GSOC income on his personal return for calendar year 1981.

If an individual is a shareholder of a General Stock Ownership Corporation throughout the entire taxable year of the corporation, his share of GSOC income is determined by dividing the total amount of GSOC income for the year by the number of shares of stock outstanding and then multiplying this per share earnings figure by the number of shares owned by the shareholder. If, however, the shareholder should dispose of his stock during the corporation's taxable year, he will be attributed income from the corporation on the basis of the number of days during the corporation's taxable year during which he was a shareholder. The per share income of the corporation for the entire year would be divided by 365 to determine the per share daily earnings of the corporation and this amount would be multiplied by the number of days during the year which the shareholder owned his stock. The product of this formula would give the earnings attributable to shareholder's part year ownership interest and this amount would be included in the shareholder's taxable year during which the GSOC year ends.

26. The term taxable income is a clearly defined term for the purposes of the Internal Revenue Code. The taxable income of the General Stock Ownership Corporation is to be determined under the normal rules for corporations, although the General Stock Ownership Corporation is not required to pay tax on this income. The General Stock Ownership Corporation is not allowed to deduct those items normally allowed to corporations under Part 8 of Subchapter B. These deductions include the dividend received deduction, the foreign corporation dividend received deduction, public utilities dividends deduction, and other minor tax deductions. The General Stock Ownership Corporation is allowed to deduct the organizational expenses allowed by Section 248 under

Part 8 of Subchapter B of the Internal Revenue Code. Section 248 provides an option to corporations to deduct organizational expenses over a period of not less than sixty months.

27. The Internal Revenue Code allows a tax credit equal to 10% of the purchase price of certain types of new and used property. This 10% credit is a dollar for dollar offset against taxes due rather than a deduction from gross income in arriving at taxable income. The property eligible for the investment tax credit is generally depreciable tangible personal property, excluding buildings and structural components, used by an individual or corporation engaged in a trade or business and having a useful life of at least three years. The investment tax credit may be taken on the taxpayer's return during the year in which the taxpayer places such an asset into use in his trade or business. In the event that the taxpayer disposes of an asset on which he has taken an investment tax credit prior to the required seven year holding period, he is subject to recapture by the Federal Government of all or a portion of the investment tax credit in the form of additional tax liability. The sections of the Internal Revenue Code applicable to investment tax credits and investment tax credit recapture include Sections 38, 46, 47, and 48.

The 10% investment tax credit is not allowed to a General Stock Ownership Corporation. This is unimportant, however, since the General Stock Ownership Corporation has no tax liability and therefore could not avail itself of the tax credit in any event. Section 1393(b) provides that the investment tax credit to which a General Stock Ownership Corporation would be entitled if it were taxable shall flow through to the shareholders in much the same manner as income. The investment tax credit and any recapture of investment tax credit generated by the sale of corporate assets will be netted at the corporate level. If there is a net investment tax credit, that amount will be prorated to the shareholders in the same manner as income. If there is a net investment tax credit recapture, this amount will be prorated as well, but will be characterized as additional tax liability to the shareholders. It is not expected that the corporation will operate in such a way as to generate any significant amount of net investment credit recapture.

28. Distributions of corporate income are normally taxed as ordinary income to the extent that they constitute dividends paid out of the earnings of the corporation. Distributions in excess of the accumulated earnings of the corporation are treated as a reduction in the shareholder's basis in his stock and to the extent they exceed the shareholder's basis are taxed at capital gains rates. Additional rules are necessary for distributions from General Stock Ownership Corporations since the distributions do not bear direct relationship to the amount of tax which the shareholders may pay. The rules of Section 1394 are designed to indicate whether a distribution of cash from a General Stock Ownership Corporation is a distribution of

income which has already been taxed to the shareholders, a distribution of capital reducing the shareholder's basis in his shares, or a capital gain.

29. The shareholder income account is simply a bookkeeping entry of the corporation designed to keep track of the relationship between taxable income of the GSOC attributed to the shareholders and cash distributions by the GSOC to its shareholders.

30. The shareholder income account is increased at the close of each GSOC taxable year by an amount equal to the GSOC's taxable income in order to indicate the total amount of taxable income which has been attributed to the shareholders and is taxable to them.

31. The shareholder income account is decreased to a minimum balance of zero at the beginning of each GSOC taxable year by the amount of distributions made to the shareholders from the GSOC during the prior year. Thus the account which has been increased by the amount of GSOC taxable income for the prior year is immediately decreased by the amount of distributions made from the GSOC during the same year. Any balance remaining in the GSOC income account after these entries have been made will show the amount of GSOC income in excess of cash distributions on which the GSOC shareholders have paid tax. A General Stock Ownership Corporation is required by Section 1396 to distribute at least 90% of its taxable income for any taxable year ending October 31st by January 31st of the following year. Any distribution made on or before January 31st is to be treated as if it were made as of the close of the preceding taxable year ending October 31st. This means that distributions made within three months of the close of the GSOC's taxable year will be treated as made during the preceding taxable year for purposes of the shareholder income account.

32. To the extent that distributions of the General Stock Ownership Corporation do not exceed the amount in the shareholder income account as of the close of the taxable year (the taxable income of the GSOC for the current year and any taxable income in excess of the distributions from prior years), the distribution will be treated as a distribution of income which has already been taxed to the shareholders and therefore will come to the shareholders tax free.

33. If the distribution should exceed the balance of the shareholder income account, the account would be netted out at zero and distributions in excess of the account would be dealt with under Section 301(a) of the Internal Revenue Code. Section 301 provides that distributions which are not a dividend within the meaning of Code Section 316 (which such GSOC distributions would not be) are treated first as a reduction of the shareholder's basis in his stock and, to the extent the distribution exceeds the shareholder's basis, the distribution is treated as a capital gain. Distributions which are treated as a capital gain will

either be treated as a short term or long term capital gain depending on the time period during which the shareholder has owned his stock.

34. Section 116 of the Internal Revenue Code provides a $100.00 exclusion for individuals receiving dividends on corporate stock. This provision is a simplified way of eliminating the double taxation of dividends for the recipients of small dividend amounts. Since the double taxation of dividends has been completely eliminated for all shareholders in a General Stock Ownership Corporation, it was felt that this additional tax concession was unnecessary. Therefore, the income attributable to an individual taxpayer from a General Stock Ownership Corporation is not eligible for the $100.00 dividend exclusion provided by Section 116.

35. Distributions from the General Stock Ownership Corporation of cash or other property may not directly parallel the tax liability of the respective owners of stock in a situation where a sale of stock occurred during the taxable year. It was felt appropriate to provide the Secretary of the Treasury with regulatory authority to determine the best means of adjusting the relative tax statuses of the seller and buyer and to establish rules for the allocation of distribution rights between the two parties.

36. Generally, in a conventional corporation, the basis of a shareholder in his corporate stock equals the price paid for that stock. Upon a sale of the stock, the shareholder determines his taxable gain by deducting his basis from the sale's proceeds. It is this amount which is referred to in the tax laws as a capital gain. The shareholder in a General Stock Ownership Corporation which distributes its stock free of charge to the shareholders will have a basis in his stock at the time of receipt equal to zero. In the event that distribution of the stock should result in a tax liability to the shareholder because the Internal Revenue Service has imputed income to him from the receipt of stock, the shareholder would receive a basis in the stock equal to the value at which the stock is assessed for purposes of Federal income taxation.

Section 1395 provides a special rule for determining the basis of stock in General Stock Ownership Corporations. Assuming that no income is imputed to the shareholder upon receipt of his shares, he will have a zero basis in the stock at the time of receipt. The basis in his stock will then be increased for the amount of GSOC income which is attributed to him for tax purposes. This means that as he pays tax on General Stock Ownership Corporation income the basis in his stock will increase. The basis will be decreased for distributions from the General Stock Ownership Corporation reflecting the shareholder's receipt of income on which he has paid tax. In the normal course of events, a General Stock Ownership Corporation shareholder will have a basis in his stock which reflects the difference between the income of the corporation on which he has been taxed

less the cash distributions which he has received from the corporation. If the corporation distributes all of its taxable income, the shareholder will continue to have a zero basis in his stock and the entire proceeds of any sale thereof will be treated for tax purposes as a capital gain.

37. In order to assure that the shareholders of the General Stock Ownership Corporation have cash on hand sufficient to cover the tax liability generated by the income attributed to them from the General Stock Ownership Corporation, the corporation is required to distribute to its shareholders at least 90% of its taxable income for the year ending October 31st on or before the following January 31st. This distribution would normally allow the shareholders to have cash on hand to pay their personal taxes for the year ending December 31st on the following April 15th when those taxes become due.

38. In order to insure that the General Stock Ownership Corporation makes the distributions required by Section 1396, a penalty is provided for failure to do so. This penalty is an additional tax (deductible by the General Stock Ownership Corporation) equal to 20% of the amount which the GSOC failed to distribute on a timely basis. Thus, if the General Stock Ownership Corporation had taxable income for the year of $100.00 and distributed only $80.00 by January 31st of the following year, it would fail to comply with the requirements of Section 1396. Section 1396 requires a 90% distribution of taxable income and would have required the corporation to distribute $90.00 to its shareholders by January 31st of the following year rather than $80.00. A 20% tax would be levied on the difference between the amount which should have been distributed ($90.00) and the amount which was in fact distributed ($80.00). Thus, the tax would be 20% of $10.00 or $2.00.

39. Section 1397 sets forth special rules applicable to a General Stock Ownership Corporation and a number of technical amendments to other sections of the Internal Revenue Code necessary to the operation of the GSOC provisions.

40. Earnings and profits is a technical term under the Internal Revenue Code and is composed essentially of the undistributed retained earnings of the corporation. Current earnings and profits are determined on an annual basis and if undistributed are added to earnings and profits generally. Distributions by a corporation are treated as dividends and taxed as ordinary income to the extent of a corporation's earnings and profits. Therefore, it is important in dealing with a General Stock Ownership Corporation, whose income is taxed to the shareholders, to assure that income which is so taxed is not included in earnings or profits. This general rule sets forth that position and assures that current earnings and profits for a General Stock Ownership Corporation do not include income of the corporation which is taxed to its shareholders.

41. When the Internal Revenue Service audits a taxpayer, it may find that an overpayment to the government has been made by the taxpayer or that the taxpayer owes additional taxes to the government. It may be several years before an audit of a taxpayer is completed and a final determination of his tax status for a particular year is determined. Normally an adjustment is made in the taxpayer's tax liability for the year being audited and that adjustment is paid by the taxpayer or the government in the year in which the audit is completed.

In the case of a General Stock Ownership Corporation, audit adjustments are treated in a modified manner. Since the shareholders of the General Stock Ownership Corporation are taxed directly on the income of the corporation, any error in the corporation's tax status for a particular year will be reflected on the individual returns of each shareholder. It would be very clumsy and complicated to adjust the tax status of each GSOC shareholder for such an error. If audit adjustments were handled in this manner, it might well happen that hundreds of thousands of shareholders would find themselves being audited by the Internal Revenue Service because of the tax treatment of a particular item by the General Stock Ownership Corporation. To avoid this result, audit adjustments for General Stock Ownership Corporations are to be made at the corporate level and reflected in the income of the corporation for the year in which a final determination of the tax audit is completed. This means that if the General Stock Ownership Corporation understated its income for a particular year due to the error in the tax treatment of a particular item, the adjustment for that error would be made in the year of the final determination and the corporation would have additional income in that year as a result of the adjustment. In addition, the corporation may be liable for interest payments and penalties which will be computed in the normal manner under Section 6601 of the Code. In the event that the General Stock Ownership Corporation overstated its income and therefore the shareholders had tax liability in excess of the correct amount, adjustments would be made in the form of a reduction to the current year General Stock Ownership Corporation income and a cash payment by the government equal to the interest due on overpayments under Internal Revenue Code Section 6611.

42. This provision amends the net operating loss deduction provisions of Section 172(b) to provide for a ten year carryover of net operating losses for General Stock Ownership Corporations. This means that if the General Stock Ownership Corporation for any year should incur a net operating loss (total deductible costs of operation in excess of the current year's income) the corporation can carry this loss omer and use it as a deduction against future years' income for a period of ten years from the year in which the loss was incurred.

43. Section 3402 of the Internal Revenue Code provides for the withholding of taxes by employers directly from employees' paychecks. In order to assure that the shareholders of a General

Stock Ownership Corporation are not attributed income on which they are unable to pay the tax, the GSOC is required to withhold from each cash distribution to its shareholders an amount equal to 25% of the cash payment. This amount will be paid to the Federal Government and be credited to the shareholders as an advance payment of the tax due. This provision creates a new Section 3402(r) which sets forth the general rule on withholding and ties the GSOC withholding provisions into the general rules dealing with withholding on wages. Of particular note is the provision in Section 3402(n) which provides an exemption from the withholding provisions for individuals who have filed a withholding exemption certificate with the General Stock Ownership Corporation certifying that the shareholder incurred no tax liability for the preceding taxable year and anticipates that he will incur no tax liability for the current year.

44. This provision simply cross-references the basic provisions for the General Stock Ownership Corporation set forth in Section 1395 back into the general basis provisions in the capital gains sections of the Code at Section 1016(a).

45. This provision sets forth requirements for an information return to be filed by the General Stock Ownership Corporation with the Internal Revenue Service. This return is an information return only as the GSOC itself is exempt from Federal income taxes. The information on the return must include a statement of the General Stock Ownership Corporation's income for the year, investment credits, the names and addresses of the shareholders, the number of shares owned by each, the amount of GSOC distributions to each shareholder, the date of each distribution, and any other information which the Secretary of the Treasury may prescribe by regulation.

46. For purposes of the statute of limitations on income tax audits and crimes, the return of a General Stock Ownership Corporation is to be treated as a return filed under Code Section 6012, which sets forth who must file income tax returns. Other procedural provisions of the Internal Revenue Code are tied into Code Section 6012 so that the General Stock Ownership Corporation will be covered by the normal rules regarding filing requirements, audits and the rights of taxpayers.

47. In addition to filing an annual information return with the Internal Revenue Service, the General Stock Ownership Corporation is required to file its annual report with the Secretary of the Treasury. It is contemplated that this annual report would be significantly more detailed than a normal corporate annual report and would address such questions as the effect of the GSOC on distributions of income and wealth, the level of transfer payments made or required, the social and demographic profiles of GSOC shareholders, the level of economic understanding of GSOC shareholders, and possible beneficial revisions of General Stock Ownership Corporation legislation.

48. This provision simply amends the index and tables of the Internal Revenue Code to provide for the inclusion of Subchapter U.

49. The operative dates for Subchapter U are set forth in this provision which makes it clear that the Subchapter U changes apply to corporations formed within the December 31, 1978 - January 1, 1984 time frame. It is clear from the language in this provision that the tax benefits of Subchapter U will continue after January 1, 1984, for any corporation formed within this time frame and continuing to comply with the provisions of Subchapter U.

ARTICLES OF INCORPORATION
OF
ALASKA GENERAL STOCK OWNERSHIP CORPORATION

We, the undersigned natural persons, each being over the age of nineteen (19) years, having been appointed as incorporators by the Hon. Jay Hammond, Governor of the State of Alaska, under the provisions of the Alaska General Stock Ownership Corporation Act of said State, (the "Alaska GSOC Act"), and the Alaska Business Corporation Act, as amended by said Alaska GSOC Act, and as it may be amended from time to time, (the "Corporation Act"), do hereby adopt the following Articles of Incorporation:

ARTICLE I

NAME

Section 1.01. The name of this Corporation (the "Corporation") is: ALASKA GENERAL STOCK OWNERSHIP CORPORATION, but the Corporation may with equal propriety be identified as "AGSOC" or "Alaska GSOC".

ARTICLE II

DURATION

Section 2.01. The period of duration of the Corporation is perpetual.

ARTICLE III

PURPOSES

Section 3.01. The purposes for which the Corporation is organized are:

(a) to qualify as a General Stock Ownership Corporation under Subchapter U of the Internal Revenue Code of 1954, as amended; and

(b) to further and carry out the purposes and achieve the objectives of the Alaska GSOC Act; and

(c) to do everything necessary, desirable, advisable, or convenient for the furtherance and accomplishment of such purposes; and

(d) to engage in any lawful act or activity authorized by the Alaska GSOC Act and the Corporation Act except, however, that the Corporation may not invest in properties acquired by it or for its benefit through the right of eminent domain.

ARTICLE IV

SHARES

Section 4.01. The aggregate number of shares which the Corporation shall have authority to issue is five million (5,000,000). Such shares shall be common stock of a single class, shall be without par value, and shall be deemed fully paid and non-assessable upon issuance.

ARTICLE V

ISSUANCE AND TRANSFER OF SHARES

Section 5.01. The rights, preferences, limitations, and terms and conditions for the issuance and transferability of the common stock of the Corporation are as follows:

(a) shares of the Corporation may be issued only to eligible individuals as defined by the Alaska GSOC Act;

(b) shareholders of the Corporation must be natural persons;

(c) initial issuance of shares of the Corporation will be made on the basis of at least one (1) share to each eligible individual who qualified as such on the date of issuance;

(d) each such eligible individual will have a period of one (1) year from the date of issuance to elect not to receive the share(s) allocated to him;

(e) shares registered in the name of each eligible individual upon original issue will be held in escrow by the Corporation for a period of five (5) years from the date of issuance or until the shareholder shall reach the age of majority, as defined by Alaska law, or until the shareholder shall have complied with all reasonable rules and regulations of AGSOC pertaining to the release of such shares from escrow, whichever of said events shall be the last to occur, except in the event of death of the shareholder or upon the shareholder ceasing to be a resident of the State of Alaska. Shares acquired by each eligible individual upon original issue by AGSOC shall not be sold, pledged, assigned, mortgaged, subjected to encumbrance, voluntarily or involuntarily, or otherwise transferable by the shareholder prior to the expiration of the five (5) year period after initial issuance, nor until the shareholder shall reach the age of majority, as defined by Alaska law, or until the shareholder shall have complied with all reasonable rules and regulations of AGSOC pertaining to the release of such shares from escrow, whichever of said events shall be the last to

occur, except in the event of death of the shareholder or upon the shareholder ceasing to be a resident of the State of Alaska;

(f) during the first five (5) years following initial issuance, the Corporation shall have a right of first refusal to purchase any shares of the Corporation proposed to be transferred, other than by gift, by will, or by the laws of descent and distribution, at a price exercisable in the manner set forth in the By-Laws of the Corporation;

(g) no share of the Corporation may be transferred by a shareholder:

(1) to any individual who, as of the date of transfer, is not a resident of the State of Alaska;

(2) to any individual who, after the transfer, would own more than ten (10) shares of the Corporation;

(h) upon the death of a shareholder, after the first five (5) years following issuance or in the event the Corporation does not exercise its right of first refusal to purchase during said five (5) year period, ownership of his shares shall be transferred in accordance with his last will and testament or under the applicable laws of intestacy, except that:

(1) shares may be transferred only to a resident of the State of Alaska; and

(2) in the event a deceased shareholder fails to dispose of his share or shares by will and has no heirs who are natural persons under the applicable laws of intestacy who are residents of Alaska, such share or shares shall escheat to the Corporation;

(i) no shareholder shall have a preemptive right to acquire additional or treasury shares of the Corporation;

(j) except in the case of shares owned by minors and as may be otherwise provided in the By-Laws of the Corporation as to shares purchased and held in general account escrow by the Corporation, each share of common stock shall be entitled to one (1) vote on each matter submitted to a vote at a meeting of shareholders. No share of common stock shall be entitled to vote at any meeting of shareholders if such share, at the time of such meeting, is owned or held in violation of the provisions of the Alaska GSOC Act, or in violation of these Articles or the By-Laws as established by the Board of Directors, or of any rule or regulation promulgated by the Corporation thereunder;

(k) the presence in person or by proxy of the holders of one-third (1/3rd) (or such greater number as may be fixed by statute or by the By-Laws in any case) of the outstanding shares of stock of the Corporation entitled to vote shall be necessary to, and shall, constitute a quorum at any meeting of shareholders. When a quorum is present, the affirmative vote of a majority of shares represented at the meeting, in person or by proxy, and entitled to vote on the subject matter shall be the act of the shareholders. Provided, however, that these Articles can only be amended by the affirmative vote of two-thirds (2/3rds) of the shares present or represented by proxy at a meeting and entitled to vote thereat; and

(l) the shares of stock of the Corporation may not be cumulatively voted.

Section 5.02. The holders of the Corporation's shares shall be entitled to receive, when and as declared by the Board of Directors, dividends either in cash, in property, or in shares of stock of the Corporation.

Section 5.03. Each share of common stock shall vest in the holder all rights of a shareholder in a business corporation organized under the Alaska Business Corporation Act and the Alaska GSOC Act.

ARTICLE VI

MANAGEMENT

Section 6.01. The management of the Corporation shall be vested in a Board of Directors. Subject to the provisions of the Alaska GSOC Act respecting qualifications of directors, the number, terms and method of election of directors shall be as prescribed in the By-Laws of the Corporation.

ARTICLE VII

DIRECTORS

Section 7.01. The number of directors constituting the initial Board of Directors of the Corporation shall be nine (9). The directors shall be divided into three (3) classes, Class One, Class Two, and Class Three, each consisting of three (3) directors. Class One directors shall each have a term of one (1) year and until their successors are elected and qualified; Class Two directors shall have a term of two (2) years and until their successors are elected and qualified, and Class Three directors shall each have a term of three (3) years and until their successors are elected and qualified. The names and addresses of the persons who are to serve as the initial directors until their successors are elected and qualified are:

1.

2.

3.

4.

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ARTICLE VIII

OFFICE AND AGENT

Section 8.01. The address of the Corporation's initial registered office shall be:

Section 8.02. The name of the Corporation's initial registered agent is:

ARTICLE IX

AMENDMENTS

Section 9.01. Subject to the Alaska GSOC Act, these Articles may be amended, restated or repealed from time to time in accordance with the Corporation Act.

ARTICLE X

Section 10.01. The names and addresses of the incorporators are:

1.

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9.

IN WITNESS WHEREOF, the incorporators have hereunto set their hands this _____ day of ____________________, 1979.

____

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____

____

BY-LAWS

OF

ALASKA GENERAL STOCK OWNERSHIP CORPORATION

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BY-LAWS
OF
ALASKA GENERAL STOCK OWNERSHIP CORPORATION

ARTICLE I

OFFICES

Section 1.01. Registered Office. The registered office of the Corporation shall be in the City of ________________, Alaska.

Section 1.02. Other Offices. The Corporation may also have offices at such other places, either within or without the State of Alaska, as the Board of Directors may from time to time authorize.

ARTICLE II

SHAREHOLDERS

Section 2.01. Meetings. Annual and special meetings of the shareholders entitled to vote shall be held at the Corporation's principal place of business in ________________, Alaska, or at such other place within or without the State of Alaska as the Board of Directors may from time to time determine.

Section 2.02. Annual Meeting. The annual meeting of the shareholders for the election of directors shall be held at __________ local time at the place of meeting on the __________ after the first ____________ in ______________ of each year, or if that day shall be a holiday at the place of the meeting, then on the next succeeding business day. Failure to hold the annual meeting at the designated time shall not work any forfeiture or dissolution of the Corporation, but if the meeting shall not be called and held within three (3) months after the time therefor as above provided, five percent (5%) of the shareholders by written petition filed with the Secretary of the Corporation at least thirty (30) days before the date proposed for such meeting may call such meeting in ________________, Alaska.

Section 2.03. Special Meetings. A special meeting of the shareholders may be requested at any time by the Chairman of the Board, the President, or the Board of Directors, or by holders of not less than one-fifth (1/5th) of all the shares of stock of the Corporation outstanding and entitled to vote at such meeting. Upon any such request, it shall be the duty of the Secretary promptly to call such special meeting to be held on such date as the Secretary may fix, giving notice thereof in accordance with Section 2.05 of these By-Laws. If the Secretary shall neglect or refuse to issue such call, the Chairman of the Board, the President, or the Board of Directors, or

the person or persons making the request, may so do.

Section 2.04. Adjournments. Any annual or special meeting of shareholders may be adjourned from time to time by a majority of the votes of the shareholders present in person or represented by proxy at the meeting and entitled to vote thereat.

Section 2.05. Notice or Waiver of Notice. Except as hereinafter otherwise provided, notice of each meeting of the shareholders, whether annual or special, shall be given to each shareholder of record entitled to vote at such meeting by delivering a written or printed notice thereof to him personally or by mailing or telegraphing such notice to him, charges prepaid, addressed to him at his address as it appears on the books of the Corporation, not less than ten (10) days (or such greater period as may be required by law in a particular case) and not more than fifty (50) days before the day on which the meeting is to be held. Every such notice shall state the place, day and hour of the meeting and, in the case of special meetings, state the business to be transacted at, and the purpose of, the meeting. Attendance by any shareholder, in person or by proxy, at any meeting of which he is entitled to notice shall constitute a waiver by him of notice of such meeting except where such attendance is for the express purpose of objecting to the transaction of any business because the meeting was not lawfully called or convened. A written waiver of notice of any meeting signed by a person or persons entitled to such notice, whether before or after the time stated therein, shall be deemed equivalent to giving of such notice to such person or persons. When a meeting is adjourned it shall not be necessary except when required by law to give any notice of the adjourned meeting or of the business to be transacted thereat otherwise than by announcement at the meeting at which such adjournment is taken.

Section 2.06. Quorum. A shareholders' meeting shall not be organized for the transaction of business unless a quorum is present. The presence in person or by proxy of the holders of one-third (1/3rd) of the outstanding shares of stock of the Corporation entitled to vote shall be necessary to, and shall, constitute a quorum. Provided, however, that if a quorum is found to exist at any duly organized meeting, a quorum shall be deemed to continue to exist until final adjournment of such meeting, whether on the same day or a later day, notwithstanding the withdrawal of the holders of enough shares to leave less than the number necessary to constitute a quorum.

Section 2.07. Organization. At each meeting of the shareholders the Chairman of the Board or the President, or in the absence of the Chairman of the Board and the President, a chairman chosen by a majority of the votes of the shareholders present in person or represented by proxy at the meeting and entitled to vote thereat shall act as chairman of such meeting and preside thereat. The Secretary of the Corporation, or in his absence, an Assistant Secretary, shall act as secretary at all meetings of the shareholders. In the absence from any such meeting of

the Secretary and all the Assistant Secretaries, the chairman of the meeting may appoint any person to act as secretary of the meeting.

Section 2.08. Order of Business. The order of business to be followed at any meeting at which a quorum is present shall be as established by the chairman of the meeting, unless objection thereto shall be made by a shareholder, in which event the order of business shall be established by a majority of the votes of the shareholders present in person or represented by proxy at the meeting and entitled to vote thereat.

Section 2.09. Voting - Voting List - Proxies.

(a) Except as in the Articles of Incorporation or these By-Laws or by applicable law otherwise provided, every shareholder of record entitled to vote shall have the right at every shareholders' meeting to one (1) (non-cumulative) vote for each share entitled to be voted standing in his name on the books of the Corporation at the time determined in accordance with Section 6.07 of these By-Laws. At an election for directors every shareholder entitled to vote may vote the number of shares owned by him for as many persons as there are directors to be elected and for whose election he has a right to vote. At least five (5) days before each meeting of shareholders, the Secretary shall make a complete list of the shareholders entitled to vote at the meeting arranged in alphabetical order with the address of and the number of shares held by each. Such list shall be kept on file at the principal place of business of the Corporation or at the registered office of the Corporation, and shall be subject to inspection, for any proper purpose, at any time during usual business hours, by any shareholder entitled to vote. The original share ledger or transfer book, or a duplicate thereof, shall be *prima facie* evidence as to who are the shareholders entitled to examine such lists or to vote at any meeting of the shareholders.

(b) Any shareholder may vote either in person or by proxy. A proxy may authorize the casting of votes in any manner authorized by the Articles of Incorporation, as the holder of such proxy may determine in his discretion, or may require that such votes be cast in a particular manner. Every proxy shall be executed in writing by the shareholder or by his duly authorized attorney-in-fact and filed with the Secretary or, if the Secretary shall so direct, with the Inspectors of Election. No proxy shall be valid after eleven (11) months from the date of its execution, unless a longer period is expressly provided therein. Each proxy shall be revocable at the pleasure of the person executing it or his personal representatives or assigns.

(c) Upon the written demand of not less than five percent (5%) of the shareholders present at any meeting either in person or represented by proxy, the vote upon any matter shall be by ballot. On a vote by ballot, each ballot shall be signed by the shareholder voting or by the holder of his proxy, and shall

state the number of shares voted. At all meetings of the shareholders, all matters (except the election of directors and matters the manner of deciding which is especially regulated by statute, the Articles of Incorporation or these By-Laws) shall be decided by a majority of the votes of the shareholders of the Corporation present in person or represented by proxy and entitled to vote at such meeting. Shares owned by the Corporation or held in general account escrow for the benefit of the Corporation shall not be voted and shall not be counted in determining the existence of a quorum or in determining the total number of outstanding shares for voting purposes.

Section 2.10. Inspectors of Election. The Board of Directors, in advance of any meeting of shareholders, shall appoint three (3) Inspectors of Election to act at the meeting or any adjournment thereof. In case any person appointed fails to appear or act, the vacancy may be filled by appointment made by the Board of Directors in advance of the meeting or at the meeting by the chairman of the meeting. Each Inspector of Election shall, promptly upon his appointment, subscribe an oath or affirmation faithfully to execute his duties with strict impartiality. The Inspectors of Election shall determine all questions touching the qualifications of votes and, with respect to each vote by ballot, shall collect and count the ballots and report in writing to the secretary of the meeting the result of the vote. The Inspectors of Election need not be shareholders of the Corporation. No person who is an officer or director of the Corporation, or who is a candidate for election as director, shall be eligible to be an Inspector of Election.

Section 2.11. Election of Directors.

(a) At each annual meeting, or special meeting of shareholders held in lieu thereof, the shareholders entitled to vote shall elect three (3) directors, in the manner provided in the Articles of Incorporation, to serve until the expiration of the term for which they are elected or until their successors are elected and qualified.

(b) No vote may be counted for the election of any person as a director unless such person shall have been proposed for nomination to be a candidate for election by a written notice signed by a shareholder and mailed by registered or certified mail to the Secretary not less than ten (10) nor more than fifty (50) days before the date of the meeting, provided that in the event of the death or incapacity of any person so proposed the proposer shall be entitled to make a substitute nomination at the meeting. The Secretary shall, upon the written request of any shareholder entitled to vote at any meeting, give to such shareholder a list of the names of those proposed for nomination and their proposers.

(c) No vote may be counted for the election of any person as a director unless each written solicitation, by him or by his proposer, of proxies to vote shares in favor of his election as

a director shall have included a statement of his interests in the General Stock Ownership Corporation in such reasonable detail as the Board of Directors may require. No vote may be counted for the election of any person as a director unless such a statement shall have been filed with the Secretary. Such statements shall be produced and kept open at the time and place of the meeting, and during the whole time of the meeting shall be subject to inspection by any shareholder entitled to vote.

Section 2.12. Appointment of Independent Public Accountants. At each annual meeting, the shareholders, after receiving a recommendation of the Board of Directors, shall appoint Independent Public Accountants for the purpose of auditing and certifying the annual financial statements of the Corporation for its current fiscal year, as sent to shareholders or otherwise published by the Corporation. In case the shareholders shall fail to appoint such Independent Public Accountants or if the Independent Public Accountants so appointed by the shareholders shall decline to act, or shall resign, or for some other reason shall be unable to perform their duties, the Board of Directors shall appoint other Independent Public Accountants to perform the duties herein provided.

ARTICLE III

BOARD OF DIRECTORS

Section 3.01. General Powers. The property, affairs and business of the Corporation shall be managed by the Board of Directors.

Section 3.02. Number, Term of Office and Qualifications. The Board of Directors shall consist of nine (9) members, at least five (5) of whom shall be residents of Alaska at the time of appointment or election and at all times while holding office as such director. The Board shall be divided into three (3) classes consisting of three (3) directors each and shall hold office as follows:

(a) The initial Board of Directors consisting of nine (9) members of three (3) classes, of three (3) each, whether appointed by the Governor pursuant to the Alaska GSOC Act or appointed to fill vacancies by the directors so appointed by the Governor, shall serve for the term for which they were appointed, and until their successors have been duly elected and qualified, with the term of office of the Class One directors to expire at the first annual meeting of shareholders held after the initial issuance of the common stock, or at any special meeting of shareholders held in lieu thereof, that of Class Two directors shall expire at the second annual meeting, or at any special meeting of shareholders held in lieu thereof, and that of Class Three directors shall expire at the third annual meeting, or at any special meeting of shareholders held in lieu thereof.

(b) At each annual meeting thereafter, the number of directors equal to the number of directors whose terms expire shall be elected to serve for a period of three (3) years and until their successors are elected and qualified.

Section 3.03. The Chairman of the Board. At the meeting of the Board of Directors specified in Section 5.02 of these By-Laws, the Board, by a vote of a majority of all of the members thereof, shall elect from among its members a Chairman of the Board of Directors, to serve in such capacity at the pleasure of the Board. He shall, if present, preside at all meetings of the Board. He shall perform such other duties as from time to time may be assigned to him by the Board. In his capacity as Chairman of the Board, he shall not be an officer of the Corporation, but he shall be eligible to serve, in addition, as an officer of the Corporation, including President, pursuant to Article V of these By-Laws. The President of the Corporation, in the absence of the Chairman of the Board, shall in all respects act in the stead of the Chairman of the Board during such absence.

Section 3.04. Organization of Directors' Meetings. At all meetings of the Board of Directors the Chairman of the Board, or, in his absence, the President, or in the absence of the Chairman of the Board and the President, a chairman chosen by a majority of the directors present shall act as chairman of such meeting and preside thereat. The Secretary, or in his absence, an Assistant Secretary, shall act as secretary at all meetings of the Board. In the absence from any such meeting of the Secretary and all the Assistant Secretaries, the chairman may appoint any person to act as secretary of the meeting.

Section 3.05. Resignations. Any director of the Corporation may resign at any time by giving written notice of his resignation to the Corporation. Such resignation shall take effect at the time received unless another time is specified therein. The acceptance of such resignation shall not be necessary to make it effective.

Section 3.06. Regular Meetings. Regular meetings of the Board of Directors shall be held within the State of Alaska or elsewhere at such regular intervals as may be fixed by resolution adopted by a majority of the whole Board and upon such notice, or without notice, as shall be specified in said resolution.

Section 3.07. Special Meetings. Special meetings of the Board of Directors shall be held whenever called by the Chairman of the Board, the President or any three (3) of the directors. Notice of each such meeting shall be mailed to each director at his address appearing on the books of the Corporation or supplied by him to the Corporation for the purpose of notice, at least five (5) days before the day on which the meeting is to be held, or shall be sent to him at such place by telegraph, charges pre-

paid, or delivered to him personally not later than the third (3rd) day before the day on which the meeting is to be held. Every such notice shall specify the place, day and hour of the meeting and the general nature of the business to be transacted. A waiver of notice of any meeting in writing signed by the director entitled to such notice, whether before or after the time stated therein, shall be deemed equivalent to the giving of such notice. Attendance of a director at any meeting shall constitute a waiver by him of notice of such meeting except where a director attends for the express purpose of objecting to the transaction of any business because the meeting was not lawfully called or convened. Whenever a meeting of the Board of Directors shall be adjourned it shall not be necessary to give any notice of the adjourned meeting or of the business to be transacted thereat otherwise than by announcement at the meeting at which such adjournment is taken.

Section 3.08. Quorum, Manner of Acting and Adjournment. At each meeting of the Board of Directors the presence of five (5) directors shall be necessary to constitute a quorum for the transaction of business; provided that, if a quorum is found to exist at any time during the course of any such meeting, a quorum shall be deemed to continue to exist until final adjournment of such meeting. Except as otherwise specifically provided by statute, the Articles of Incorporation or these By-Laws, the acts of a majority of the directors present at a meeting at which a quorum has been found to exist for the purpose of transacting business shall be the acts of the Board of Directors. A majority of the directors present at any meeting may adjourn the meeting from time to time. Except as otherwise provided in the Articles of Incorporation, each director shall be entitled to one (1) vote. Voting rights of directors may not be exercised by proxy. Notwithstanding the foregoing, during an emergency period following a national catastrophe, a majority of the surviving members of the Board of Directors who have not been rendered incapable of acting or attending shall constitute a quorum.

Section 3.09. Special Meetings for Filling Vacancies in Board. Any vacancy among the directors, shall be filled at a meeting of the remaining directors. Such a meeting shall be held whenever called by the Chairman of the Board, the President, or three (3) of the directors. Notice of any such meeting shall be given to, or may be waived by, each director in accordance with the provisions of Section 3.07 of these By-Laws. A majority of the directors remaining in office shall be necessary to constitute a quorum at any such meeting, and the affirmative vote of a majority of the directors remaining in office shall be necessary to fill the vacancy. A majority of the directors present at any such meeting, whether or not they shall constitute a quorum, may adjourn the meeting from time to time, and it shall not be necessary to give any notice of the adjourned meeting otherwise than by announcement at the meeting at which such adjournment is taken.

Section 3.10. Compensation. Directors shall receive such reasonable compensation for their services as members of the Board or of any committee thereof, and such reimbursement for expenses incurred in connection with such services (including attendance at meetings), as the Board of Directors may by resolution from time to time prescribe; provided, however, that nothing herein contained shall preclude any director from serving the Corporation in any other capacity or from receiving compensation for any such services.

Section 3.11. Outside Interests of Directors. Pursuant to procedures to be established by the Board of Directors from time to time, each director, upon assuming office and at least annually thereafter, shall file with the Secretary a statement identifying any entity (individual proprietorship, partnership, association, corporation or other business entity) with which the Corporation to his knowledge does or contemplates doing a substantial volume of business, and of which he is a director, officer, trustee or employee, or in which he has a substantial financial interest. For purposes of this Section, the term "substantial financial interest" shall mean any financial interest with a fair value in excess of $10,000, or any ownership interest in excess of five per centum (5%) without regard to value, including any such interest known to the director, officer or employee, as the case may be, of his spouse or minor child.

ARTICLE IV

COMMITTEES

Section 4.01. Executive Committee. The Board of Directors, by resolution adopted by a majority of the whole Board, may designate three (3) of the directors then in office to constitute an Executive Committee. To the extent specifically provided by resolution adopted by a majority of the whole Board, the Executive Committee shall have and may exercise the authority of the Board of Directors in the management of the property, affairs and business of the Corporation, and may authorize the seal of the Corporation to be affixed to all papers which may require it. The Board may designate one (1) member of the Committee to act as its chairman.

Section 4.02. Committee on Conflicts of Interest. The Board of Directors, by resolution adopted by a majority of the whole Board, may designate not less than three (3) nor more than five (5) of the directors then in office as a Committee on Conflicts of Interest. The Committee, if established, shall (i) consult with the directors and officers of the Corporation concerning the establishment and administration of policies and programs in respect of conflicts of interest (including the establishment of procedures pursuant to Section 3.11 of these By-Laws and the adoption of rules and regulations pursuant to Section 5.13 of these By-Laws), (ii) consider and make recommendations to the Board upon matters relating to such policies and

programs and the administration thereof, and (iii) exercise such authority as may from time to time be granted to it by resolution adopted by the Board upon matters pertaining to conflicts of interest. The Board may designate one (1) member of the Committee to act as its chairman. A director who is also an officer or employee of the Corporation shall not be eligible to serve as a member of the Committee.

Section 4.03. Committee on Compensation and Employee Benefit Arrangements. The Board of Directors, by resolution adopted by a majority of the whole Board, may designate not less than three (3) nor more than five (5) of the directors then in office to constitute a Committee on Compensation and Employee Benefit Arrangements. The Committee, if established, shall (i) consider and make recommendations to the Board with respect to the rates and manner of payment of the compensation to be paid to officers of the Corporation, (ii) after receiving the recommendations of the principal officers of the Corporation, consider and make recommendations to the Board as to the rates and manner of payment of the compensation to be paid to employees of the Corporation (other than officers) whose rate of compensation shall exceed such rate as shall be fixed from time to time by the Board, (iii) upon request, consult with the principal officers of the Corporation upon matters of policy relating to the compensation of employees of the Corporation, (iv) consider and make recommendations to the Board with respect to the adoption, modification or termination of any employee stock ownership plan, pension plan, profit-sharing plan, stock bonus plan, stock option plan or other incentive or benefit plan or arrangement applicable to any or all of the officers and employees of the Corporation, (v) exercise the authority which may be granted to the Committee by any such plan. The Board may designate one (1) member of the Committee to act as its chairman. A director who is also an officer of the Corporation shall not be eligible to serve as a member of the Committee.

Section 4.04. Audit Committee. The Board of Directors, by resolution adopted by a majority of the whole Board, may designate not less than three (3) nor more than five (5) of the directors then in office to constitute an Audit Committee. The Committee, if established, shall (i) consider and make recommendations to the Board with respect to the employment of a firm of Independent Public Accountants; which recommendation if accepted by the Board, shall be subject to the provisions of Section 2.12 of these By-Laws, (ii) confer with the Corporation's Independent Public Accountants to determine the scope of the audit that such accountants will perform, (iii) receive reports from the Independent Public Accountants and transmit such reports to the Board, and after the close of the fiscal year, transmit to the Board the financial statements certified by such accountants, (iv) inquire into, examine and make comments on the accounting procedures of the Corporation and the reports of the Independent Public Accountants, and (v) consider and make recommendations to the Board upon matters presented

to it by the officers of the Corporation pertaining to the audit practices and procedures adhered to by the Corporation. The Board may designate one (1) member of the Committee to act as its chairman.

Section 4.05. Committees in General. The Board of Directors may appoint such other committees, and chairmen thereof, as it may deem appropriate to perform such functions as it may designate, provided that no committee shall be appointed or disbanded unless notice of such proposed action shall have been given to, or waived by, each director in accordance with the provisions of Section 3.07 of these By-Laws.

Section 4.06. Committee Procedure. Each member of any committee shall continue to be a member of that committee only during the pleasure of the Board of Directors, provided that no existing member of a committee shall be removed from such membership and no new member shall be appointed unless notice of such proposed action shall have been given to, or waived by, each director in accordance with the provisions of Section 3.07 of these By-Laws. Except as otherwise provided by the Board of Directors, a majority of a committee shall constitute a quorum thereof, and the act of a majority of those present at a meeting at which a quorum is present shall be the act of the committee, provided that any committee may, by unanimous approval of its members, take action without a meeting of the committee. Meetings of each committee shall be called by the secretary at the request of the chairman of the committee or any two (2) members of the committee. Each committee shall keep minutes of its meetings and shall render to the Board of Directors at its next ensuing regular meeting, a report of all action taken by the committee since the last meeting of the Board at which a report was made, or if no such previous report was made, since the appointment of the committee. Each committee shall also render such other reports, at such other times, as the Board may request.

ARTICLE V

OFFICERS

Section 5.01. Officers. The officers of the Corporation shall be a President, such Vice Presidents as may from time to time be elected by the Board of Directors, a Secretary, a Treasurer and a Comptroller. The Board of Directors may elect such other officers, including assistant officers, as it may deem necessary, each of whom shall have such authority and perform such duties as the Board of Directors may from time to time determine.

Section 5.02. Election, Term of Office and Qualifications. The officers of the Corporation shall be elected at least annually by vote of a majority of the whole Board of Directors. Such annual election shall be held at the first meeting of the Board of Directors following the annual election of directors.

Each officer shall hold his office until his successor shall have been duly elected and qualified in his stead or until he shall resign or shall have been removed in the manner hereinafter provided. Except as may be provided otherwise by law, any two (2) or more offices may be held by the same person.

Section 5.03. Removal. Any officer elected by the Board of Directors may be removed by vote of a majority of the whole Board of Directors whenever in its judgment the best interest of the Corporation will be served thereby, but such removal shall be without prejudice to the contract rights, if any, of the person so removed.

Section 5.04. Resignation. Any officer of the Corporation may resign at any time by giving written notice of his resignation to the Corporation. Such resignation shall take effect at the time received unless another time is specified therein. The acceptance of such resignation shall not be necessary to make it effective.

Section 5.05. Vacancies. Any vacancy in any office because of death, resignation, removal, disqualification or any other cause may be filled by the Board of Directors at any regular or special meeting thereof.

Section 5.06. The President. The President shall have all the authority and perform all the duties normally incident to the office of President and such other duties as from time to time may be assigned to him by the Board of Directors.

Section 5.07. The Vice Presidents. Each Vice President shall have such powers and perform such duties as from time to time may be assigned to him by the Board of Directors.

Section 5.08. The Secretary. The Secretary shall (a) see that all notices are duly given in accordance with law and these By-Laws; (b) be custodian of the seal of the Corporation and affix such seal to all certificates of stock of the Corporation prior to their issue and to all documents the execution of which, on behalf of the Corporation under its seal, is authorized by the Board of Directors or the Executive Committee, if any, or by any officer or agent of the Corporation to whom power to authorize the affixing of such seal shall have been delegated; (c) keep, or cause to be kept, in books provided for the purpose, minutes of the meetings of the shareholders, of the Board of Directors, and of each committee of the Board; (d) keep or arrange to be kept registers of the shareholders of stock in accordance with Section 6.01 of these By-Laws; (e) see that the books, reports, statements, certificates, voting lists and all other documents and records required by law are properly kept and filed; (f) sign such instruments as require the signature of the Secretary; and (g) in general perform all the duties incident to the Office of Secretary, and such other duties as from time to time may be assigned to him by the Board of Directors.

Section 5.09. The Treasurer. The Treasurer shall (a) have charge and custody of, and be responsible for, all funds and securities of the Corporation and deposit all such funds in such banks, trust companies or other depositories as shall be selected in accordance with the provisions of these By-Laws; (b) receive, and give receipts for, monies due and payable to the Corporation from any source whatsoever; (c) sign such documents as shall require the signature of the Treasurer; and (d) perform such other duties as from time to time may be assigned to him by the Board of Directors. The Treasurer shall give a bond for the faithful discharge of his duties in such sum and with such sureties as the Board of Directors shall determine.

Section 5.10. Comptroller. The Comptroller shall keep, or cause to be kept at such office of the Corporation as the Board of Directors shall from time to time by resolution designate, and shall be responsible for the keeping of, correct records of the business and transactions of the Corporation and at all reasonable times shall exhibit such records to any of the directors of the Corporation upon application at the office of the Corporation where such records are kept. The Comptroller shall perform such other duties as from time to time may be assigned to him by the Board of Directors.

Section 5.11. Duties of Officers May Be Delegated. Subject to the approval of the Board of Directors, which approval may be of a general or specific nature, any officer of the Corporation may delegate to any employee of the Corporation, for the period set forth in such delegation, but not to exceed the term of office of the person making such delegation, any authority or duty of his office; provided, however, that any such delegation shall not be effective until such delegation and the approval relating thereto are evidenced in writing and filed in the Office of the Secretary of the Corporation.

Section 5.12. Compensation. The compensation of the officers shall be fixed from time to time by the Board of Directors. No officer of the Corporation shall, without prior full disclosure in writing to the Board of Directors and express approval thereof by the Board of Directors, receive any salary from any source other than the Corporation during his period of employment by the Corporation.

Section 5.13. Outside Interests of Officers and Employees. The Board of Directors from time to time may adopt rules and regulations governing the conduct of officers or key employees with respect to matters in which they have a financial interest adverse to the interests of the Corporation. Such rules and regulations may forbid officers or key employees from participating personally and substantially in corporate action with respect to any contract, transaction or other matter in which, to the knowledge of any such officer or employee, he or any member of his immediate family has a financial interest, unless (a) such officer or employee makes full disclosure of the cir-

cumstances to the Board or its delegate and the Board or its delegate determines that the interest is not adverse, or is not so substantial as to affect the integrity of the services of such officer or employee, or (b) on the basis of standards to be established in such rules or regulations, the financial interest is too remote or too inconsequential to affect the integrity of such services. Such rules and regulations may also prohibit, or establish appropriate limits upon, the ownership by such officer or employee, or member of his immediate family, of securities of any firm or corporation doing a substantial volume of business with the Corporation.

ARTICLE VI

SHARES AND THEIR ISSUANCE AND TRANSFER

Section 6.01. Certificates for Shares.

(a) Shares of stock of the Corporation shall be represented by certificates for shares in such form, including the form of electronically-stored data, as the Board of Directors may from time to time prescribe. No certificate representing any share shall be issued initially to anyone except a qualified individual as defined by the Alaska GSOC Act. Each certificate representing shares of common stock shall state that the transfer of the shares represented thereby is subject to the provisions of the Alaska GSOC Act, the Articles of Incorporation, and the By-Laws of this Corporation. Shares of common stock shall be held in trust (escrow) for the account of each eligible individual for a period of five (5) years from initial issuance pursuant to the Alaska GSOC Act and for such additional period or periods of time as the Articles of Incorporation, By-Laws, or escrow and stock transfer regulations adopted pursuant to the By-Laws of the Corporation may provide. Certificates for shares of stock of the Corporation shall be numbered and registered in the order in which they shall be issued.

(b) A record shall be kept of the name of the person in which each certificate for shares of stock of the Corporation shall be issued, the number of shares represented thereby, the date thereof, and, in case of cancellation, the date of the cancellation thereof. A record shall also be kept of the declarations made as provided in Section 6.02 of these By-Laws by each person, in whose name a certificate for shares of common stock is issued.

(c) No certificate for shares of stock of the Corporation shall be valid unless it shall have been signed by the President or a Vice President and by the Secretary or an Assistant Secretary and shall have been impressed with the corporate seal; provided, however, that to the extent permitted by law, the signatures of such officers or any of them and such corporate seal may be facsimile, and such certificates may be in the form of stored electronic data.

Section 6.02. Declarations Required. No issue or transfer of shares of common stock shall be registered on the books of the Corporation, and no certificate for shares shall be issued, except after execution and delivery to the Corporation, by or on behalf of the person in whose name such shares are to be registered and in whose name the certificate for such shares is to be issued, of an application containing declarations, in such form as may be prescribed by rules or regulations of the Board of Directors, with reference to the limitations on ownership of shares set forth in Section 5.01 of the Articles of Incorporation and to the qualifications of persons to whom shares may be issued set forth in the Alaska GSOC Law, the Articles of Incorporation, or in the By-Laws or in the stock transfer regulations adopted pursuant thereto.

Section 6.03. Transfer of Stock. Except as otherwise provided by law, transfer of shares of stock of the Corporation shall be made on the books of the Corporation only by the holder thereof, or by his attorney thereunto authorized by a power of attorney duly executed and filed with the Secretary, and on surrender of the certificate or certificates, if issued, for such shares properly endorsed and the payment of all taxes on the transfer thereof. The Corporation shall have the right to treat the person whose name is registered upon its books as the holder of any shares of its stock as the absolute owner of such shares, and, except as otherwise provided in the By-Laws or in regulations duly adopted pursuant thereto, such person shall have the exclusive right to vote and to receive dividends thereon.

Section 6.04. Right of First Refusal by Corporation. As provided in Section 5.01 of the Articles of Incorporation, before any initial shareholder can sell or transfer his initial share(s) of common stock, during the first five (5) years after issuance, such initial shareholder shall first offer said share(s) to the Corporation and the Corporation may exercise its right of first refusal in the following manner: (a) The initial shareholder shall deliver a notice in writing by mail or otherwise to the Secretary of the Corporation stating his intention to sell or transfer such share(s). (b) Within thirty (30) days thereafter, the President or his delegate shall, subject to any limitations imposed by the Articles of Incorporation or by law, have the prior right to purchase such share(s) on the following terms and conditions: (i) Purchase will be at book value as determined by the Corporation's Independent Public Accountants as of the end of the quarter immediately preceding offer to sell or transfer either for cash or in installments over a period not to exceed five (5) years. (ii) Should the Corporation fail to purchase such share(s) at the expiration of the thirty (30) day period, or prior thereto decline to purchase such share(s), the shareholder may dispose of his share(s) to any person qualified as a resident as of the date of transfer to hold shares of the Corporation.

Section 6.05. Lost, Destroyed and Mutilated Certificates. The holder of any shares of stock of the Corporation shall immediately notify the Corporation of any loss, destruction or mutilation of the certificate therefor, and the Board of Directors may, in its discretion, cause a new certificate or certificates to be issued to him, upon the surrender of the mutilated certificate, or in the case of loss or destruction of the certificate, upon satisfactory proof of such loss or destruction, and the deposit of a bond, in such form and amount and with such sureties as the Board of Directors may require.

Section 6.06. Regulations. The Board of Directors may make such rules and regulations as it may deem expedient concerning the issue, escrow, transfer and registration of certificates for shares of stock of the Corporation. It may appoint one or more transfer agents and one or more registrars of transfers, and may require all certificates of stock to bear the signature of either a transfer agent or a registrar or both. The Corporation may act as its own transfer agent, and, through the internally established trust and escrow department or division, as the escrow holder or trustee for its own shares. It may not, however, act both as transfer agent and as registrar for its own shares.

Section 6.07. Closing Transfer Books - Fixing Record Date, Etc. Insofar as permitted by law, the Board of Directors shall have power to close the stock transfer books of the Corporation for a period not exceeding fifty (50) days preceding the date of any meeting of the shareholders, or the date fixed for the payment of any dividend or distribution, or the date for the allotment of rights, or the date when any change or conversion or exchange of shares will be made or go into effect. If the stock transfer books are so closed for the purpose of determining shareholders entitled to notice of or vote at a meeting of shareholders, such books shall be closed for at least ten (10) days immediately preceding the date of such meeting. If the stock transfer books are so closed for any purpose, written or printed notice of the closing shall be mailed at least ten (10) days before the closing to each shareholder of record of the Corporation at his address appearing on the records of the Corporation, or supplied by him to the Corporation for the purpose of notice. While the stock transfer books of the Corporation are closed, no transfer of shares shall be made thereon. In lieu of closing the stock transfer books as aforesaid, the Board of Directors may, in its discretion, fix a time, not more than fifty (50) days prior to the date of any meeting of shareholders or the date fixed for the payment of any dividend or distribution, or the date for the allotment of rights, or the date when any change or conversion or exchange of shares will be made or go into effect, and, in the case of a meeting of shareholders, not less than ten (10) days before the date of the meeting, as a record date for the determination of shareholders entitled to notice of, or to vote at any such meeting, or entitled to receive payment of any such dividend or distribu-

tion, or to receive any such allotment of rights, or to exercise the rights in respect of any such change, conversion or exchange of shares. If a record date shall be fixed as aforesaid, such persons as shall be shareholders of record on the date so fixed, and only such persons, shall be entitled to notice of, or to vote at, such meeting, or to receive payment of such dividend, or to receive such allotment of rights, or to exercise such rights, as the case may be, notwithstanding any transfer of any shares on the books of the Corporation after any record date so fixed as aforesaid. If the stock transfer books of the Corporation shall not be closed as herein provided and if a record date for the determination of shareholders entitled to receive notice of, or to vote at, any shareholders' meeting shall not be fixed as herein provided, the date on which notice of the meeting is given shall be in accordance with Section 2.05 of these By-Laws and shall be the record date for such determination.

Section 6.08. Corporate Records. The Corporation shall keep at its principal place of business (a) the original or a duplicate record of the proceedings of the shareholders and directors, (b) the original or a copy of its By-Laws, including all amendments or alterations thereto to date, certified by the Secretary, and (c) appropriate, correct and complete books and records of account. The Corporation shall keep at its principal place of business or at the registered office of the Corporation in ____________________, Alaska, the original or a duplicate share register of shares.

ARTICLE VII

SEAL

The Corporation shall have a corporate seal, which shall be in the form of a circle and shall bear the full name of the Corporation and the words and figures "Incorporated __________ ______________, Alaska", or words and figures of similar import.

ARTICLE VIII

INDEMNIFICATION

Section 8.01.

(a) The Corporation may indemnify each and every person against any and all expenses and liabilities incurred by him or imposed on him in connection with any claim, action, suit or proceeding (whether actual or threatened, brought by or in the right of the Corporation or otherwise, civil, criminal, administrative or investigative, including appeals) to which he may be or is made a party by reason of his being or having been a director, officer or employee of the Corporation, or at its request of any other corporation in which it owns shares of stock or of which it is a creditor; provided, however, that there shall be no indemnification (i) as to amounts paid in settlement or

other disposition of any threatened or pending action, or in satisfaction of a judgment rendered in an action, by or in the right of the Corporation or such other corporation, or (ii) as to matters in respect of which it shall be adjudged in such action, suit or proceeding that such person was liable for negligence or misconduct in the performance of his duty to the Corporation or such other corporation and, in the case of any criminal action or proceeding, that he had reasonable cause to believe that his conduct was unlawful.

(b) Any such person shall be entitled to indemnification as of right (i) if he has been wholly successful, on the merits or otherwise, with respect to any claim, action, suit or proceeding, or (ii) except as hereinabove provided, in respect of matters as to which the Board of Directors, acting by a quorum consisting of directors not parties to such claim, action, suit or proceeding, or a court or independent legal counsel shall have determined that he acted in good faith for a purpose which he reasonably believed to be in the best interests of the Corporation or such other corporation and, in addition, in the case of any criminal action or proceeding, had no reasonable cause to believe that his conduct was unlawful. The Board of Directors or such court or independent counsel shall have the power to determine that such person is entitled to indemnification as to some matters even though he is not so entitled as to others. The termination of any claim, action, suit or proceeding by judgment, settlement, conviction or upon a plea of _nolo contendere_ or its equivalent, shall not in itself create a presumption that any such person did not act in good faith for a purpose which he reasonably believed to be in the best interests of the Corporation and, in the case of any criminal action or proceeding, that he had reasonable cause to believe that his conduct was unlawful.

(c) Amounts paid in indemnification of expenses and liabilities may include, but shall not be limited to, counsel fees and other fees, costs and disbursements, and judgments, fines or penalties against and amounts paid in settlement by such person. The Corporation may advance expenses to, or where appropriate may itself at its expense undertake the defense of, any such person; provided, however, that he shall have undertaken to repay or to reimburse such expenses if it should be ultimately determined that he is not entitled to indemnification under this Article.

(d) Payments of indemnification made pursuant to this Article shall be reported to the stockholders in the next proxy statement or otherwise, except that no such payments need be reported if such person has been wholly successful on the merits or otherwise.

(e) The provisions of this Article shall be applicable to claims, actions, suits or proceedings made or commenced after the adoption hereof, whether arising from acts or omissions to act occuring before or after the adoption hereof.

(f) The rights of indemnification provided for in this Article shall not be deemed to exclude any rights to which any such person may otherwise be entitled by any provision of law, Articles of Incorporation, By-Law, contract, vote of stockholders or otherwise; and all such rights shall enure to the benefit of the heirs, executors, administrators, or other legal representatives of such persons.

(g) If any part of this Article shall be found, in any action, suit or proceeding, to be invalid or ineffective, the validity and the effectiveness of the remaining parts shall not be affected.

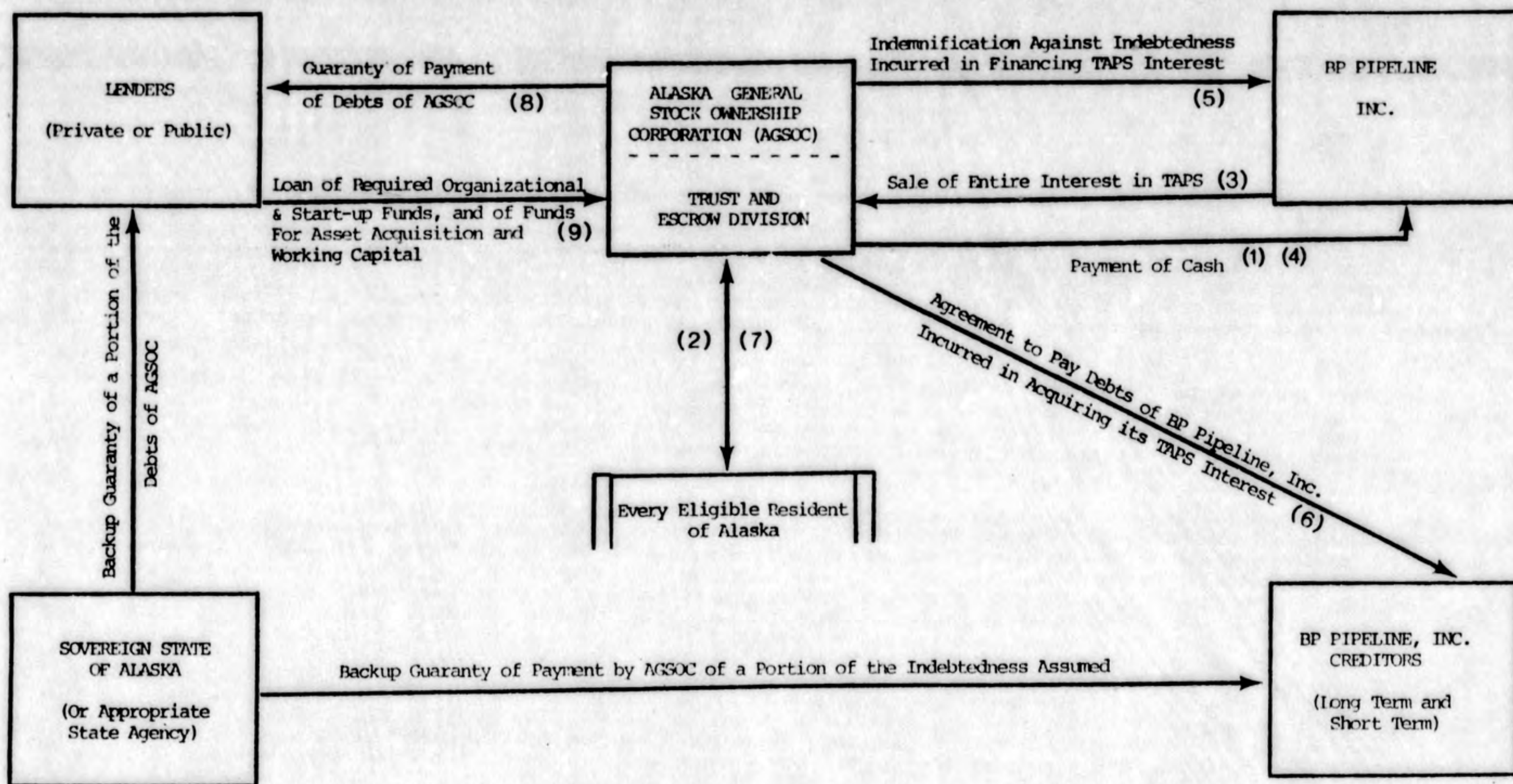
ARTICLE IX

AMENDMENTS

Any of these By-Laws may be altered, amended or repealed, and new By-Laws may be adopted, by the affirmative vote of a majority of the whole Board; provided that (a) such action may be taken only at a meeting of the Board called for such purpose; (b) the notice of such meeting shall state the substance of the By-Law to be made or repealed, or of the alteration or amendment; and (c) the notice of such meeting shall be mailed, telegraphed or delivered personally to each director, at least five (5) days before the date of which the meeting is to be held.

ILLUSTRATIVE DIAGRAM

ILLUSTRATIVE APPLICATION OF THE PURCHASE BY ALASKA GENERAL STOCK OWNERSHIP CORPORATION (AGSOC) OF A PARTICULAR ASSET, NAMELY THE INTEREST OF BP PIPELINE, INC. IN THE TRANS-ALASKA PIPELINE



(1) Payment by AGSOC of the cash initially required to close the transaction. This would provide AGSOC with the cash necessary to pay BP Pipeline, Inc. its cash requirement for the assets to be acquired by AGSOC and would enable AGSOC to retain necessary working capital.

(2) It is tentatively proposed that one share of the stock of AGSOC would be issued to the AGSOC TRUST AND ESCROW DIVISION for each eligible individual prior to its acquisition of any operating assets or anything of net asset value, so that the initial issuance in escrow would merely be the acquisition of a right of indefinite future value and thus not constitute an income taxable event to the shareholder. A U.S. Treasury ruling to this effect will doubtless be sought prior to the issue of stock. All shares issued by AGSOC would be held in escrows established for each individual resident as of the time of such purchase, as "resident" shall be defined by the State Legislature. As valuable assets are acquired by AGSOC, presumably the shares beneficially or directly owned by stockholders would acquire value. The term of the escrow would presumably be established by By-laws of AGSOC or by rules and regulations adopted pursuant thereto. The escrow of initially issued stock presumably would continue at least until expiration of the non-transferability period of five years established by Title VI of the Internal Revenue Code, and until the age of majority under Alaskan law (presently age 19) for under-age stockholders, and until compliance by the shareholders with reasonable rules and regulations of AGSOC covering release of the stock from escrow. While full details can only be developed by the Board of Directors of AGSOC, we presume that AGSOC could function to facilitate transfers of stock between individuals for stock ultimately released from escrow. It is, of course, a political question as to how qualified residents, for purposes of the plan, will be defined. The character of the Federal GSOC law is such that presumably AGSOC could operate much like a closed-end investment fund.

(3) This diagram is based upon the assumption that the entire interest of BP Pipeline, Inc. in TAPS will be purchased by AGSOC. There is also evidence that the seller would be willing to negotiate a sale of 12.5% interest in TAPS rather than 15.84%. Many considerations will enter into the Board of Director's decision whether to buy 12.5% or a greater amount. Among these considerations would be the relationship of the Alaskan oil interest to the resulting AGSOC carrier capacity, the economics of transporting for others, the resulting markeing problems for AGSOC, etc.

(4) The preliminary financial data suggest that the seller would sell its interest at a price that will make it whole, assuming that preferential rights of other TAPS owners are not exercised. Presumably this figure would be adjusted, depending upon negotiations and upon the closing date.

(5) AGSOC under this financial design, would agree to hold the seller harmless from liability for any of the presently outstanding debt of $1.212 billion.

(6) AGSOC would assume the obligation to pay the debts outstanding of the seller incurred in connection with the seller's acquisition of its interest in TAPS.

(7) These hatch-marks are intended to represent, in the aggregate, each of the qualified residents of the State of Alaska whose eligibility would be defined by the Alaska General Stock Ownership enabling law. Each resident would have an individual escrow account in the escrow facility built in AGSOC by its enabling legislation and By-laws. It should not be an objection to the plan as a whole that the purchase of a single asset, although a substantial one, or even of several substantial assets for a defined body of qualified residents, does not solve all of the economic problems of everyone (in the State of Alaska) forever.

(8) AGSOC would directly guarantee the repayment to lenders of funds loaned to AGSOC initially and from time to time.

(9) The lenders would initially loan AGSOC the cash required for organization, staffing and start-up of operations, as well as funds for the acquisition of operating assets and initial working capital. This illustration assumes the making of guaranties, within the limitations set forth in the Alaska GSOC law and in other applical law pledging the general credit of the State of Alaska, and thus a minimum interest rate should be available. While the guarantee by the State of Alaska of up to twenty-five percent (25%) of the funding, upon proper vote of the citizen shareholders, is contemplated by this proposal, the general credit of AGSOC would, of course, stand behind the entire debt.