[JOINT COMMITTEE PRINT]

EXPLANATION OF H.R. 2775 RELATING TO ADDITIONAL TAX SIMPLIFICATION

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides an explanation of H.R. 2775. H.R. 2775 (relating to additional tax simplification) was introduced by Mr. Rostenkowski on June 26, 1991.

The bill includes four titles:

Title I—Individual Tax Provisions;
Title II—Tax-Exempt Bond Provisions;
Title III—Administrative Provisions; and
Title IV—Estate and Gift Tax Provision.

[1] This document may be cited as follows, Joint Committee on Taxation, *Explanation of H.R. 2775 Relating to Additional Tax Simplification* (JCS-11-91), June 28, 1991.

EXPLANATION OF H.R. 2775

Title I.—Individual Tax Provisions

1. Repeal supplemental young child credit portion of earned income tax credit and increase family size adjustment for earned income tax credit (sec. 101 of the bill and sec. 32 of the Code)

Present Law

Eligible low-income workers are able to claim a refundable earned income tax credit (EITC) of up to 16.7 percent (17.3 percent for taxpayers with more than one qualifying child) of the first $7,140 of earned income for 1991. The maximum amount of credit for 1991 is $1,192 ($1,235 for taxpayers with more than 1 qualifying child), and this maximum is reduced by 11.93 percent (12.36 percent for taxpayers with more than one qualifying child) of earned income (or adjusted gross income, if greater) in excess of $11,250. The EITC is totally phased out for workers with earned income (or adjusted gross income, if greater) over $21,245. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

The credit rates for the EITC change over time under present law, as shown in the following table.

Year	One qualifying child—		Two or more qualifying children—	
	Credit rate	Phaseout rate	Credit rate	Phaseout rate
1992	17.6	12.57	18.4	13.14
1993	18.5	13.21	19.5	13.93
1994 and after	23.0	16.43	25.0	17.86

The maximum amount of earned income on which the EITC may be claimed and the income threshold for the phaseout of the EITC are indexed for inflation.

A supplemental young child credit is available for qualifying children under the age of one year. This young child credit rate is 5 percent and the phase-out rate is 3.57 percent. It is computed on the same base as the ordinary EITC. The maximum supplemental young child credit for 1991 is $357. If a taxpayer claims the supplemental young child credit, the child that qualifies the taxpayer for such credit is not a qualifying individual under the dependent care tax credit (sec. 21).

Reasons for Simplification

The existence of a supplemental credit as part of the EITC increases the number of computations required of taxpayers who may be eligible for the credit. In addition, the limitation imposed on taxpayers who may also be able to claim the dependent care tax credit essentially requires that these taxpayers compute the tax benefits from both credits and then choose the alternative that provides the larger tax benefit. The compliance burden of these additional computations may be substantial for many taxpayers.

Explanation of Provision

The bill repeals the supplemental young child credit and increases the basic EITC rate for families with 2 or more qualifying children to 21.7 percent in 1992, to 22.8 percent in 1993 and to 28.3 percent in 1994 and thereafter. The phaseout rates for the EITC for families with 2 or more qualifying children will be 15.5 percent for 1992, 16.28 percent for 1993, and 20.22 percent for 1994 and thereafter.

Effective Date

The provision is effective for tax years beginning after December 31, 1991.

2. Rollover of gain on sale of principal residence in case of divorce or separation (sec. 102 of the bill and sec. 1034 of the Code)

Present Law

No gain is recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence is purchased and used by the taxpayer as his or her principal residence within a specified period of time (sec. 1034). This replacement period generally begins two years before and ends two years after the date of sale of the old residence. The basis of the replacement residence is reduced by the amount of any gain not recognized on the sale of the old residence by reason of section 1034.

The determination whether property is used by a taxpayer as a principal residence depends upon all the facts and circumstances in each case, including the good faith of the taxpayer. No safe harbor is provided for sales of principal residences incident to divorce or marital separation.

Reasons for Simplification

In the case of a divorce or marital separation, the determination of principal residence for one or both spouses may be unduly complex for both the taxpayer and the Internal Revenue Service. The creation of a safe-harbor rule for certain sales pursuant to a divorce or marital separation will ease administration of the law while still preserving the policy that the rollover is available only for the sale of an individual's principal residence.

Explanation of Provision

The bill provides a safe harbor in the determination of principal residence in certain cases incident to divorce or marital separation. Specifically, the bill provides that a residence is treated as the taxpayer's principal residence at the time of sale if (1) the residence is sold pursuant to a divorce or marital separation, and (2) the taxpayer used such residence as his or her principal residence at any time during the two-year period ending on the date of sale.

Effective Date

The provision applies to sales of old residences (within the meaning of section 1034) after the date of enactment.

3. De minimis exception to passive loss rules (sec. 103 of the bill and sec. 469 of the Code)

Present Law

The passive loss rules limit deductions and credits from passive trade or business activities. Deductions from passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not from a passive activity. Deductions that are suspended under this rule are carried forward and treated as deductions from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of the entire interest in the passive activity to an unrelated person.

Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. Material participation requires a taxpayer to be involved in the operations of the activity on a regular, continuous and substantial basis.

Rental activities are also included in the definition of passive activities. A special rule permits the deduction of up to $25,000 of losses from certain rental real estate activities in which the taxpayer actively participates (even though the activities are considered passive) for taxpayers with adjusted gross incomes of $100,000 or less. This deduction is phased out for taxpayers with adjusted gross incomes between $100,000 and $150,000. A rental activity is defined as any activity where payments are principally for the use of tangible property.

Reasons for Simplification

A taxpayer who has a very small amount of passive losses that is disallowed for the year is required to carry forward the disallowed losses to the next year. In the case of certain small amounts of passive losses that cannot otherwise be deducted in the current taxable year, the bill permits the deduction and eliminates the need to keep records of the carryforward.

Explanation of Provision

The bill creates a $200 de minimis exception to the rule disallowing net passive activity losses. Under the exception, a taxpayer who

is an individual and whose total net passive activity losses for the year do not exceed $200 for the taxable year generally may deduct such losses for the year. The exception also applies to estates for the first two taxable years following the decedent's death. Similarly to the present-law rules applicable to the $25,000 exception, the amount under the exception provided in the bill is $100 in the case of a married taxpayer filing a separate return, and the exception is not available in the case of a married taxpayer filing a separate return who does not live apart from his spouse at all times during the taxable year.

The $200 exception is available only for taxpayers with net passive activity losses totalling $200 or less; a taxpayer with $300 of passive losses for the year, for example, is not eligible for the $200 exception. The $200 exception is applied after determining the taxpayer's net passive activity loss for the year (which includes taking into account suspended losses from prior years), but before taking the $25,000 allowance for rental real estate. Thus, for example, if a taxpayer has $500 of losses from rental real estate, he is not eligible for the $200 exception but may be eligible for the $25,000 exception (assuming he otherwise meets the requirements of the $25,000 exception). In all other respects, the $200 exception is applied after applying all other applicable rules under the passive loss rule.

The $200 exception does not apply with respect to passive activity credits.

The $200 exception does not apply with respect to items from publicly traded partnerships, to which the passive loss rule has separate application under present law.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

Title II.—Tax-Exempt Bond Provisions

1. Overview

Interest on State and local government bonds generally is excluded from gross income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units (Code sec. 103).

Unlike the interest on governmental bonds, described above, interest on private activity bonds generally is taxable. A private activity bond is a bond issued by a State or local governmental unit acting as a conduit to provide financing for private parties in a manner violating either (a) a private business use and payment test or (b) a private loan restriction. However, interest on private activity bonds is not taxable if (a) the financed activity is specified in the Code and (b) at least 95 percent of the net proceeds of the bond issue are used to finance the specified activity.

Issuers of State and local government bonds must satisfy numerous other requirements, including arbitrage restrictions (for all such bonds) and annual State volume limitations (for most private activity bonds) for the interest on their bonds to be excluded from gross income.

2. Provisions of the bill

a. Repeal of unrelated and disproportionate use limit (sec. 201 of the bill and sec. 141(b) of the Code)

Present Law

Bonds issued by States and local governmental units are private activity bonds if (1) more than ten percent of the proceeds of the issue of which they are part satisfy a private business use and payment test or (2) more than five percent ($5 million, if less) of the proceeds are used to finance loans to persons other than States or local governments. The ten-percent private business limits are reduced to five percent in the case of certain use that is unrelated to a governmental use also being financed with the proceeds of the issue (the "unrelated and disproportionate use limit").

Reasons for Simplification

Whether a private business use is related to a governmental activity also being financed with a bond issue may be a complex facts and circumstances determination. In light of the general ten-percent limit on private business use, the private loan restriction, and the State volume limit requirement for larger governmental bond issues, the complexity associated with this determination may be eliminated without sacrificing the Federal policy of strictly limiting

use of governmental bond proceeds to finance private activities not specifically approved by the Congress.

Explanation of Provision

The bill repeals the five-percent unrelated and disproportionate use limit.

Effective Date

This provision applies to bonds issued after the date of enactment.

b. Simplification of arbitrage rebate requirement for smaller issuers of governmental bonds (sec. 202 of the bill and sec. 148 of Code)

Present Law

Subject to limited exceptions, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. The rebate requirement does not apply to governmental bonds issued by issuers with general taxing powers if they issue $5 million or fewer of such bonds during the calendar year when the bonds are issued.

Reasons for Simplification

The Federal policy addressed by the arbitrage rebate requirement is the elimination of earlier and larger issuance of tax-exempt bonds to obtain a financial advantage by investing funds borrowed at lower tax-exempt rates in higher yielding taxable investments. Compliance with the rebate requirement may necessitate adherence to accounting practices different from those used generally for governmental operations.

The exception from the arbitrage rebate requirement for governmental bonds issued by smaller governmental units reflects a balancing of the policy of preventing arbitrage-motivated bond issuance with the desire to make the administrative responsibilities necessary to comply with the rebate requirement easily manageable. Increasing the current $5 million annual issuance limit defining eligible governments to $10 million is appropriate.

Explanation of Provision

The bill increases the $5 million annual issuance limit for small issuers whose governmental bonds are not subject to rebate to $10 million.

Effective Date

This provision applies to bonds issued in calendar years beginning after the date of enactment.

c. Repeal of 150-percent of debt service limit (sec. 203 of the bill and sec. 148 of the Code)

Present Law

Issuers of all tax-exempt bonds generally are subject to two sets of arbitrage restrictions on investment of their bond proceeds. The first set requires that tax-exempt bond proceeds not be invested at a yield materially higher (generally defined as 0.125 percentage points) than the bond yield. Exceptions are provided to this restriction for investments during any of several "temporary periods" pending use of the proceeds and, throughout the term of the issue, for proceeds invested as part of a reasonably required reserve or replacement fund or a "minor" portion of the issue proceeds.

Except for temporary periods and amounts held pending use to pay current debt service, present law also limits the amount of the proceeds of private activity bonds (other than qualified 501(c)(3) bonds) that may be invested at any time at materially higher yields during a bond year to 150 percent of the debt service for that bond year. This restriction affects primarily investments in reasonably required reserve or replacement funds. Present law further restricts the amount of proceeds from the sale of bonds that may be invested in reserve funds to ten percent of such proceeds.

The second set of arbitrage restrictions requires that generally all arbitrage profits earned on investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. Arbitrage profits include all earnings (in excess of bond yield) derived from the investment of bond proceeds (and subsequent earnings on any such earnings).

Reasons for Simplification

The 150-percent of debt service limit was enacted before enactment of the arbitrage rebate requirement and the ten-percent limit on the size of reasonably required reserve or replacement funds. It was intended to eliminate arbitrage-motivated activities available from investment of such reserve funds. Provided that comprehensive yield restriction and rebate requirements and the overall present-law size limit on reserve funds are maintained, the 150-percent of debt service yield restriction limit could be viewed as duplicative.

Explanation of Provision

The bill repeals the 150-percent of debt service yield restriction.

Effective Date

This provision applies to bonds issued after the date of enactment.

d. Election to terminate most post-initial temporary period rebate liability for certain bonds (sec. 204 of the bill and sec. 148 of the Code)

Present Law

Issuers of all tax-exempt bonds generally are subject to two sets of arbitrage requirements with respect to investment of their bond proceeds. First, tax-exempt bond proceeds may not be invested at a yield materially higher (generally defined as 0.125 percentage points) than the bond yield. Exceptions are provided to this restriction for investments during any of several "temporary periods" pending use of the proceeds and, throughout the term of the issue, for proceeds invested as part of a reasonably required reserve or replacement fund or a "minor" portion of the issue proceeds.

Second, generally all arbitrage profits earned on investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. Arbitrage profits generally include all earnings (in excess of bond yield) derived from the investment of bond proceeds (and subsequent earnings on any such earnings).

Reasons for Simplification

Arbitrage-motivated bond issuance may be expected to occur as a result of lower tax-exempt borrowing costs relative to higher yielding taxable investments if issuers are allowed to earn and retain profits on substantial amounts of bond proceeds during extended periods. Tax-exempt bond issuers have been subject to a yield restriction requirement since 1969. The arbitrage rebate requirement was first enacted in 1980 (qualified mortgage bonds) and 1984 (most industrial development bonds). The requirement was extended to all other bonds in 1986.

Familiarity with the long-standing yield restriction requirement by bond issuers may make compliance with that requirement easier than compliance with the newer rebate requirement. If periods when arbitrage profits may be earned on substantial amounts of bond proceeds and retained by issuers are eliminated or substantially curtailed through an expanded yield restriction requirement, the arbitrage rebate requirement likewise may be eliminated or substantially curtailed. Such a provision should simplify administrative compliance with the arbitrage restrictions without increasing Federal revenue loss from unnecessary issuance of tax-exempt bonds.

Statutorily limiting periods when rebate liability exists also relieves issuers of the administrative complexity associated with calculating arbitrage payments. Under present law, issuers must perform these calculations even if they restrict the yield on investments so that no arbitrage profits are earned (or rebate owed).

Explanation of Provision

The bill allows issuers of bonds (other than tax and revenue anticipation notes and advance refunding bonds) to elect to terminate prospective application of the arbitrage rebate requirement to cer-

tain bond proceeds, and to comply instead with a yield restriction requirement similar to that which applies to the bonds under present law.[2]

The election generally applies to all proceeds of an issue other than proceeds invested in a bona fide debt service fund or a reserve or replacement fund (e.g., a "4R" fund). However, issuers may elect to apply the provision to proceeds invested in reserve or replacement funds.[3]

The current refunding of bonds with respect to which an election has been made does not terminate the election with respect to the refunded bonds; rather, the current refunding bonds "step into the shoes" of the refunded bonds.[4]

The election (including the election for reserve or replacement funds) must be made no later than 90 days after the expiration of the initial temporary period applicable to the bonds. If the election is made, these issuers will be liable for rebate of arbitrage profits earned through the end of the 90-day period after expiration of that initial three- or five-year temporary period, or if earlier, substantial completion of the governmental spending purposes of the issue.

Issuers will make a final payment of their rebate liability on proceeds subject to the election 60 days after the date on which the election is effective.

After the election is effective, issuers must forego any further periods of unrestricted yield (i.e., further temporary periods) and, except as described below, restrict the yield on nonpurpose investments of bond proceeds to a yield that does not exceed the yield on the issue of which the bonds are a part. The yield restriction requirement does not apply to proceeds invested during the following newly prescribed, exclusive temporary periods:

(1) Proceeds held during the minimum notice period prescribed by the Treasury Department State and local government series ("SLGS") obligation program immediately preceding their use to purchase SLGS;

(2) Proceeds invested during a period not exceeding ten days immediately preceding their use to redeem bonds; and

(3) In the case of other proceeds, periods not exceeding five consecutive days, subject to a maximum of 15 days during any 12-month period.

Effective Date

This provision applies to bonds issued after the date of enactment.

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[2] In the case of pooled financing bonds, the election is made separately by the issuer of the pooled financing bonds and by borrowers from the pool.

[3] This election is not available to construction bond issues with respect to which an election to pay penalties in lieu of rebate is made (sec. 148(f)(4)(C)(vii) and (viii)).

[4] In the case of a high-to-low refunding, the yield restriction requirement is adjusted to reflect the lower yield on the refunding bonds.

Title III.—Administrative Provisions

1. Simplify payroll tax deposit requirements (sec. 301 of the bill and sec. 6302 of the Code)

Present Law

The Code provides that the Secretary of the Treasury ("Secretary") may establish the mode or time for collecting any tax that is not specified in the Code (sec. 6302(a)). In general, Treasury regulations have established the system under which employers deposit income taxes withheld from employees' wages and FICA taxes. The frequency with which these taxes must be deposited increases as the amount required to be deposited increases.

Employers are required to deposit these taxes as frequently as eight times per month, provided that the amount to be deposited equals or exceeds $3,000. These deposits must be made within three banking days after the end of each eighth-monthly period. Monthly or quarterly deposits are required for smaller amounts.

In addition, the Code requires employers who are on this eighth-monthly system to deposit income taxes withheld from employees' wages and FICA taxes by the close of the next banking day (instead of by the close of the third banking day) after any day on which the business cumulates an amount to be deposited equal to or greater than $100,000 (regardless of whether that day is the last day of an eighth-monthly period).

Reasons for Simplification

Many employers find the present-law deposit requirements extremely confusing and complex. A large number of employers have difficulty dealing with the eighth-monthly system, in part because the day of the week on which the last day of each eighth-monthly period falls varies from month to month. In addition, a number of employers have difficulty in determining with certainty and with sufficient lead time which of the four deposit schemes of present law they are required to utilize.

Explanation of Provision

In general

The bill replaces the entire payroll tax deposit system with a new system that is clearer and easier to understand. In general, the new system consists of three basic deposit timetables. The first, which is most generally applicable (and replaces the eighth-monthly system), requires deposits twice a week, on Tuesdays and Fridays. The second, which applies to large depositors, retains the requirement of present law that cumulations of an amount to be deposited of $100,000 or more must be deposited on the next day. The

third, which applies to many small depositors, provides generally that if the amount required to be deposited was $3,500 or less per quarter for a previous two-year base period, deposits must be made only once a quarter, on or before the last day of the first month of the following quarter.

Tuesday/Friday deposit rule

The Tuesday/Friday rule operates in the following manner. Amounts attributable to wage payments made on Wednesday, Thursday, or Friday are to be deposited on or before the following Tuesday. Amounts attributable to wage payments made on Saturday, Sunday, Monday, or Tuesday are to be deposited on or before the following Friday. Utilizing Tuesday and Friday as both the final days of the portion of the week with respect to which amounts to be deposited are cumulated as well as the days on which deposits must be made will provide a simple, easily remembered rule that will simplify the administration of these deposit requirements for both employers and the IRS.

Small depositor rules

The small depositor rules operate as follows. If an employer is a small depositor, deposits of employment taxes attributable to wage payments during a calendar quarter must be made on or before the last day of the first month of the following quarter. Thus, for example, a small depositor must deposit employment taxes attributable to the January through March calendar quarter no later than April 30.

A person is a small depositor for a calendar quarter if, for each calendar quarter in the base period, the amount of employment taxes attributable to payments in each of those calendar quarters was $3,500 or less. The base period is defined to be the eight calendar quarters ending with the second preceding calendar quarter before the quarter with respect to which the deposit requirements are being determined. For example, the base period for the calendar quarter of April through June 1993 is January 1991 through December 1992. If with respect to each of the calendar quarters in that two-year period, the amount of employment taxes was $3,500 or less, then the employer is a small depositor for the April through June 1993 calendar quarter and is required to make one deposit of employment taxes for that quarter, on or before July 31, 1993. This is true regardless of the amount of employment taxes for the April through June 1993 quarter. The only exception to this is that the $100,000 rule applies to all depositors, including small depositors. This application of the $100,000 rule should have no impact on small employers; it is designed to prevent very large new companies from making deposits only once for each quarter.

New companies will initially be treated as small depositors. For purposes of performing the base period determination, a company is considered to have employment taxes of zero for any calendar quarter in which a company did not exist. Consequently, new companies will, for at least the first two calendar quarters of their existence, be required to deposit only once for each quarter (unless they fall within the $100,000 rule).

The small depositor rule is designed to provide certainty to small employers with respect to their current deposit requirements. Most employers will be able to examine their quarterly employment tax returns (Form 941) for the two years in the base period and readily determine on that basis whether they are small depositors or must deposit on the Tuesday/Friday system. The "second preceding quarter" provision is designed to provide employers with ample lead time to make this determination prior to the start of a calendar quarter.

Safe harbor

The bill provides a statutory safe harbor with respect to certain shortfalls in deposits. An employer will be treated as having deposited the required amount of employment taxes in any deposit if the shortfall does not exceed the greater of $150 or two percent of the amount of employment taxes otherwise required to be deposited. A shortfall is the excess of the amount required to be deposited (without regard to this rule) over the amount actually deposited on or before the last day on which that deposit is required. Any shortfall is to be deposited as required by Treasury regulations.

Definitions and other rules

The bill provides that deposits are required only on banking days. (This rule is also contained in present law.) If a deposit is required to be made on or before a day that is not a banking day, the deposit is considered to have been made on a timely basis if it is made on or before the close of the next banking day. It is anticipated that the substance of Treasury regulations defining the term "banking day" will not be changed. For example, if a deposit is required to be made on a Friday, which is also the July 4 holiday, that deposit would be considered to be made on a timely basis if it is made on or before the following Monday.

The bill defines "employment taxes" to mean FICA taxes (both the employer and employee portions), Railroad Retirement Tax Act taxes, and withheld income taxes (as well as similar withheld taxes under chapter 24 of the Code).

These provisions generally do not apply to employment taxes that are not required to be deposited pursuant to Treasury regulations issued pursuant to section 6302. Under present law, employers with less than $500 of employment taxes for a calendar quarter are not required to deposit those taxes. They are instead permitted to remit those taxes with the quarterly employment tax return (Form 941). It is anticipated that a similar system permitting remittance (rather than requiring deposit) of these small amounts will be continued.

Treasury regulations

The bill provides that the Secretary may prescribe regulations relating to specific issues (in addition to the general authority to issue regulations with respect to collecting tax in sec. 6302 or generally in sec. 7805). First, the regulations may specify alternate employment tax requirements for employers who fail to comply with the requirements of this provision. This would enable the IRS to continue its practice (currently authorized by regulations issued

pursuant to sec. 6302(a)) of specifying more frequent deposit requirements or alternate payment mechanisms for employers who have seriously violated the established deposit requirements.

The bill also permits Treasury to issue regulations specifying the additional circumstances (beyond those provided in the bill) under which an employer may be treated as a small depositor. This in effect permits the Treasury to expand (but not contract) the definition of small depositors.

In addition, the bill permits Treasury to issue regulations modifying these provisions for end-of-quarter periods. This is designed to permit the IRS to require appropriate treatment of amounts that overlap two quarters. For example, assume that a quarter ends on Wednesday. The deposit normally required to be made on or before the following Tuesday could include amounts attributable to the previous quarter (with respect to Wednesday) as well as amounts attributable to the current quarter (with respect to Thursday and Friday). Treasury regulations can specify an alternate rule to distinguish amounts relating to the two quarters.

Finally, the bill permits Treasury to issue regulations establishing different deposit requirements for amounts withheld pursuant to the backup withholding requirements of section 3406. Under present law, these amounts are treated the same as amounts withheld from income taxes. Because amounts withheld pursuant to the backup withholding requirements are often relatively small and are not generally handled by payroll offices, it is appropriate for Treasury to provide alternate deposit rules with respect to these amounts.

This simplified payroll tax deposit system will be significantly easier to understand and to administer for both businesses and the IRS. This should reduce materially the number of businesses who are subject to the penalty for failure to make timely deposits (sec. 6656) due to inadvertent errors. It is intended that, for purposes of this penalty, reasonable cause also apply to any failure to make deposits if the employer's total employment tax liability is $3,500 or less for any quarter. Thus, employers who are certain that they will have less than that amount to be deposited in a quarter will only need to be concerned with the quarterly deposit rule for that quarter. If, however, an employer is uncertain to whether the amount required to be deposited will be $3,500 or less for the quarter, and the employer is not a small depositor (as defined above), the employer should make deposits under the Tuesday/Friday rule.

Effective Date

The provision is effective for amounts attributable to payments made after December 31, 1992. This will permit employers and the IRS to have adequate time to implement this new system with minimal difficulty.

2. Simplify estimated tax payment rules for small corporations (sec. 311 of the bill and sec. 6655 of the Code)

Present Law

A corporation is subject to an addition to tax for any underpayment of estimated tax. A corporation does not have an underpayment of estimated tax if it makes four timely estimated tax payments each equal to at least 22.5 percent of its tax liability for the current taxable year. In addition, a corporation that is not a "large corporation" may avoid the addition to tax if it makes four timely estimated tax payments each equal to at least 25 percent of its tax liability for the preceding taxable year, so long as the preceding year was not a short taxable year and the corporation filed a return showing a tax liability for such year. A large corporation may use this second rule only with respect to its estimated tax payment for the first quarter of its current taxable year. A large corporation is one that had taxable income of $1 million or more for any of the three preceding taxable years.

Reasons for Simplification

The calculation of estimated tax payments may be difficult for a corporation (particularly a small corporation) that had no tax liability in the preceding taxable year because it must use the current taxable year rule; it is not allowed to use a safe harbor that is available to a corporation with a tax liability in the preceding taxable year.

Explanation of Provision

The bill provides that a small corporation (i.e., a corporation that is not a "large corporation" under present law) with no tax liability in the preceding taxable year may avoid the addition to tax if it makes four timely estimated tax payments each equal to at least 25 percent of its tax liability for the second preceding taxable year.[5] This rule will apply so long as (1) neither the preceding taxable year nor the second preceding taxable year was a short tax year, and (2) the corporation filed tax returns for both years. If the corporation satisfies these two requirements and did not have a tax liability for either of the two preceding taxable years, the corporation will not be required to make estimated tax payments for the current taxable year.

A large corporation may use this expanded safe harbor with respect to its estimated tax payment for the first quarter of its taxable year, as under present law.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

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[5] As under present law, a small corporation may continue to use the current taxable year rule for estimated tax purposes.

3. Interest rate on large corporate underpayments (sec. 321 of the bill and sec. 6621(c) of the Code)

Present Law

The interest rate on a large corporate underpayment of tax is the Federal short-term rate plus five percentage points. A large corporate underpayment is any underpayment by a subchapter C corporation of any tax imposed for any taxable period, if the amount of such underpayment for such period exceeds $100,000. The large corporate underpayment rate generally applies to periods beginning 30 days after the earlier of the date on which the first letter of proposed deficiency, a statutory notice of deficiency, or a nondeficiency letter or notice of assessment or proposed assessment is sent. For this purpose, a letter or notice is disregarded if the taxpayer makes a payment equal to the amount shown on the letter or notice within that 30 day period.

Reason for Simplification

The large corporate underpayment rate generally applies if the underpayment of tax for a taxable period exceeds $100,000, even if the initial letter or notice of deficiency, proposed deficiency, assessment, or proposed assessment is for an amount less than $100,000. Thus, for example, under present law, a nondeficiency notice relating to a relatively minor mathematical error by the taxpayer may result in the application of the large corporate underpayment rate to a subsequently identified income tax deficiency.

Explanation of Provision

For purposes of determining the period to which the large corporate underpayment rate applies, any letter or notice will be disregarded if the amount of the deficiency, proposed deficiency, assessment, or proposed assessment set forth in the letter or notice is not greater than $100,000 (determined by not taking into account any interest, penalties, or additions to tax).

Effective Date

The provision is effective for purposes of determining interest for periods after December 31, 1990.

Title IV.—Estate and Gift Tax Provisions

Include fractional share of property qualifying for the marital deduction in the gross estate (sec. 401 of the bill and secs. 2056(b) and 2523 of the Code)

Present Law

A marital deduction against the estate and gift tax generally is permitted for the value of property passing between spouses. No marital deduction is permitted, however, if, upon termination of the spouse's interest, possession or enjoyment of the property passes to another person (the "terminable interest rule"). Certain exceptions to this rule may apply if the spouse receives a general power of appointment over, or an income interest in, a "specified portion" of property (sec. 2056(b)(5), (6), (7)). The spouse is subject to estate and gift tax on property over which he or she holds a general power of appointment.

A Treasury regulation defines a "specified portion" to be a fractional or percentile share of a property interest (Treas. Reg. sec. 20.2056(b)-5(c)). Finding this regulation invalid, courts have held that the term "specified portion" includes a fixed dollar amount. (See *Northeastern Pennsylvania National Bank & Trust Co. v. United States*, 387 U.S. 213 (1967); *Estate of Alexander v. Commissioner*, 82 T.C. 34 (1984), *aff'd*, No. 8401600 (4th Cir. April 3, 1985).) Under the court holdings, appreciation in certain marital deduction property may be includible in neither spouse's estate.

Reasons for Simplification

The marital deduction postpones the imposition of the estate or gift tax until the property is transferred outside the marital unit. The exceptions to the terminable interest rule insure that the present value of property qualifying for the marital deduction is subject to transfer tax in the hands of the recipient spouse. By invalidating the Treasury regulation having this effect, the court holdings create uncertainty. Reversal of the holdings makes the law more certain by clearly implementing the policy underlying the marital deduction.

Explanation of Provision

The bill provides that, for purposes of the marital deduction, a "specific portion" only includes a portion determined on a fractional or percentage basis. Thus, a trust does not qualify under the exceptions to the terminable interest rule unless the required income interest and general power of appointment are expressed as a fraction or a percentage of the property. The bill thereby reverses the

court holdings and codifies the position of the Treasury Regulations.

It is intended that no inference be drawn from the provision with respect to the definition of "specified portion" under present law.

Effective Date

The provision generally applies to gifts made, and decedents dying, after date of enactment. The provision exempts a transfer under a will or revocable trust executed before the date of enactment if either (1) on that date the decedent was under a mental disability to change the disposition of his property and did not regain his competence to dispose of such property before the date of death, or (2) the decedent dies within three years after the date of enactment. The exemption does not apply if the will or trust is amended after the date of enactment in any respect that increases the amount of the transfer or alters the terms by which the interest passes.

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