DESCRIPTION OF REVENUE PROVISIONS OF AMENDMENT TO S. 1028

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April 18, 1996

JCX-11-96

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the revenue provisions contained in an amendment to be offered by Senators Dole and Roth in connection with the consideration by the Senate of S. 1028, "Health Insurance Reform Act." The Senate is scheduled to begin consideration of S. 1028 on April 18, 1996.

The provisions in the amendment include: (1) a phased-in increase in the deduction for health insurance expenses of self-employed individuals, (2) clarification of the tax treatment of long-term care insurance and benefits, (3) clarification of the tax treatment of accelerated death benefits under life insurance contracts for terminally and chronically ill individuals, (4) preferential tax treatment for medical savings accounts, (5) an exemption from Federal income tax for State-sponsored organizations providing health coverage to high-risk individuals, (6) a provision permitting penalty-free withdrawals from Individual Retirement Arrangements ("IRAs") for certain medical expenses, (7) rules clarifying the tax treatment of individuals who relinquish their U.S. citizenship or permanent residence, (8) a provision to disallow the interest deduction for corporate-owned life insurance policy loans, (9) a provision relating to the treatment of bad debt deductions of thrift institutions, and (10) certain earned income credit compliance provisions.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Revenue Provisions of Amendment to S. 1028 by Senators Dole and Roth*, (JCX-11-96), April 18, 1996.

1. Increase in Deduction for Health Insurance Expenses of Self-Employed Individuals

The proposal would phase up the 30-percent deduction for health insurance expenses of self-employed individuals to 80 percent as follows: 35 percent in 1997, 40 percent in 1998, 45 percent in 1999, 50 percent in 2000, 55 percent in 2001, 60 percent in 2002, 65 percent in 2003, 70 percent in 2004, 75 percent in 2005, and 80 percent in 2006 and thereafter.

The proposal is similar to a provision in the Balanced Budget Act of 1995 and a provision in the Health Coverage Availability and Affordability Act of 1996 as passed by the House of Representatives, except that those proposals would phase up the deduction to 50 percent.

The proposal would be effective for taxable years beginning after December 31, 1996.

2. Treatment of Long-Term Care Insurance

Tax treatment and definition of long-term care insurance contracts and qualified long-term care services

Favorable tax treatment would be provided for long-term care insurance and services meeting the requirements of the proposal.

Exclusion of long-term care proceeds

A long-term care insurance contract generally would be treated as an accident and health insurance contract. Amounts (other than policyholder dividends or premium refunds) received under a long-term care insurance contract generally would be excludable as amounts received for personal injuries and sickness, subject to a cap of $175 per day, or $63,875 annually, on per diem contracts only. If the aggregate payments under all per diem contracts with respect to any one insured exceed $175 per day, then the excess would not be excludable from gross income. The dollar cap would be indexed by the medical care cost component of the consumer price index.

Exclusion for employer-provided long-term care coverage

A plan of an employer providing coverage under a long-term care insurance contract generally would be treated as an accident and health plan. Employer-provided coverage under a long-term care insurance contract would not, however, be excludable by an employee if provided through a cafeteria plan; similarly, expenses for long-term care services cannot be reimbursed under a flexible spending arrangement (FSA).[2]

Definition of long-term care insurance contract

A long-term care insurance contract would be defined as any insurance contract that provides only coverage of qualified long-term care services and that meets other requirements. The other requirements would be that (1) the contract is guaranteed renewable, (2) the contract does not provide for a cash surrender value or other money that can be paid, assigned, pledged or borrowed, (3) refunds (other than refunds on the death of the insured or complete surrender or cancellation of the contract) and dividends under the contract may be used only to reduce future premiums or increase future benefits, and (4) the contract generally does not pay or reimburse expenses reimbursable under Medicare (except where Medicare is a secondary payor, or the

[2] The proposal would not otherwise modify the requirements relating to FSAs. An FSA is defined as a benefit program providing employees with coverage under which specified incurred expenses may be reimbursed (subject to maximums and other reasonable conditions), and the maximum amount of reimbursement that is reasonably available to a participant is less than 500 percent of the value of the coverage.

contract makes per diem or other periodic payments without regard to expenses).

A contract would not fail to be treated as a long-term care insurance contract solely because it provides for payments on a per diem or other periodic basis without regard to expenses incurred during the period.

Medicare duplication rules

The proposal would provide that no provision of law shall be construed or applied so as to prohibit the offering of a long-term care insurance contract on the basis that the contract coordinates its benefits with those provided under Medicare.

Definition of qualified long-term care services

Qualified long-term care services would mean necessary diagnostic, preventive, therapeutic, curing, treating, mitigating and rehabilitative services, and maintenance or personal care services that are required by a chronically ill individual and that are provided pursuant to a plan of care prescribed by a licensed health care practitioner.

A chronically ill individual would be one who has been certified within the previous 12 months by a licensed health care practitioner as (1) being unable to perform (without substantial assistance) at least 2 activities of daily living for at least 90 days[3] due to a loss of functional capacity, (2) having a similar level of disability as determined by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services, or (3) requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment. Activities of daily living would be eating, toileting, transferring, bathing, dressing and continence.[4]

It would be intended that an individual who is physically able but has a cognitive impairment such as Alzheimer's disease or another form of irreversible loss of mental capacity be treated similarly to an individual who is unable to perform (without substantial assistance) at least 2 activities of daily living. Because of the concern that eligibility for the medical expense deduction not be diagnosis-driven, the proposal would require the cognitive impairment to be severe. It would be intended that severe cognitive impairment mean a deterioration or loss in

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[3] The 90-day period would not be a waiting period. Thus, for example, an individual could be certified as chronically ill if the licensed health care practitioner certifies that the individual will be unable to perform at least 2 activities of daily living for at least 90 days.

[4] Nothing in the proposal would require the contract to take into account all of the activities of daily living. For example, a contract could require that an individual be unable to perform (without substantial assistance) 2 out of any 5 such activities, or for another example, 3 out of the 6 activities.

intellectual capacity that is measured by clinical evidence and standardized tests which reliably measure impairment in: (1) short- or long-term memory; (2) orientation to people, places or time; and (3) deductive or abstract reasoning. In addition, it would be intended that such deterioration or loss place the individual in jeopardy of harming self or others and therefore require substantial supervision by another individual.

A licensed health care practitioner would be a physician (as defined in sec. 1861(r)(l) of the Social Security Act) and any registered professional nurse, licensed social worker, or other individual who meets such requirements as may be prescribed by the Secretary of the Treasury.

Expenses for long-term care services treated as medical expenses

Unreimbursed expenses for qualified long-term care services provided to the taxpayer or the taxpayer's spouse or dependent would be treated as medical expenses for purposes of the itemized deduction for medical expenses (subject to the present-law floor of 7.5 percent of adjusted gross income). For this purpose, amounts received under a long-term care insurance contract (regardless of whether the contract reimburses expenses or pays benefits on a per diem or other periodic basis) would be treated as reimbursement for expenses actually incurred for medical care.

For purposes of the deduction for medical expenses, qualified long-term care services would not include services provided to an individual by a relative, including the individual's spouse (directly, or through a partnership, corporation, or other entity), unless the relative is a licensed professional with respect to such services, or by a related corporation (within the meaning of Code section 267(b) or 707(b)).[5]

Long-term care insurance premiums treated as medical expenses

Long-term care insurance premiums that do not exceed specified dollar limits would be treated as medical expenses for purposes of the itemized deduction for medical expenses.[6] The limits would be as follows:

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[5] The rule limiting such services provided by a relative or a related corporation would not apply for purposes of the exclusion for amounts received under a long-term care insurance contract, whether the contract is employer-provided or purchased by an individual. The limitation would be unnecessary in such cases because it is anticipated that the insurer will monitor reimbursements to limit opportunities for fraud in connection with the performance of services by the taxpayer's relative or a related corporation.

[6] Similarly, within certain limits, in the case of a rider to a life insurance contract, charges against the life insurance contract's cash surrender value that are includible in income would be treated as medical expenses (provided the rider constitutes a long-term care insurance contract).

In the case of an individual with an attained age before the close of the taxable year of:	The limitation on premiums paid for such taxable years is:
Not more than 40	$ 200
More than 40 but not more than 50	375
More than 50 but not more than 60	750
More than 60 but not more than 70	2,000
More than 70	2,500

For taxable years beginning after 1997, these dollar limits would be indexed for increases in the medical care component of the consumer price index. The Secretary of the Treasury, in consultation with the Secretary of Health and Human Services, would be directed to develop a more appropriate index to be applied in lieu of the foregoing. Such an alternative might appropriately be based on increases in skilled nursing facility and home health care costs. The intent would be that the Treasury Secretary annually publish the indexed amount of the limits as early in the year as they can be calculated.

Deduction for long-term care insurance of self-employed individuals

The present-law 30 percent deduction for health insurance expenses of self-employed individuals would be phased up to 80 percent under another provision of the proposal. Because this proposal treats payments of eligible long-term care insurance premiums in the same manner as medical insurance premiums, the self-employed health insurance deduction would apply to eligible long-term care insurance premiums under the proposal.

Long-term care riders on life insurance contracts

In the case of long-term care insurance coverage provided by a rider on or as part of a life insurance contract, the requirements applicable to long-term care insurance contracts would apply as if the portion of the contract providing such coverage were a separate contract. The term "portion" would mean only the terms and benefits that are in addition to the terms and benefits under the life insurance contract without regard to long-term care coverage. As a result, if the applicable requirements are met by the long-term care portion of the contract, amounts received under the contract as provided by the rider would be treated in the same manner as long-term care insurance benefits, whether or not the payment of such amounts causes a reduction in the contract's death benefit or cash surrender value. The guideline premium limitation applicable under section 7702(c)(2) would be increased by the sum of charges (but not premium payments) against the life insurance contract's cash surrender value, the imposition of which reduces premiums paid for the contract (within the meaning of sec. 7702(f)(1)). In addition, the intent would be that Treasury regulations provide for appropriate reduction in premiums paid (within the meaning of sec. 7702(f)(1)) to reflect the payment of benefits under the rider that reduce the cash surrender value of the life insurance contract. A similar rule should apply in the case of a contract governed by section 101(f) and in the case of the payments under a rider that are excludable under section 101(g) of the Code (as added by the accelerated death benefits provision of the proposal).

Health care continuation rules

The health care continuation rules would not apply to coverage under a long-term care insurance contract.

Life insurance company reserves

In determining reserves for insurance company tax purposes, the proposal would provide that the Federal income tax reserve method applicable for a long-term care insurance contract issued after December 31, 1996, would be the method prescribed by the National Association of Insurance Commissioners (or, if no reserve method has been so prescribed, a method consistent with the tax reserve method for life insurance, annuity or noncancellable accident and health insurance contracts, whichever is most appropriate). The method currently prescribed by the NAIC for long-term care insurance contracts is the one-year full preliminary term method. As under present law, however, in no event could the tax reserve for a contract as of any time exceed the amount which would be taken into account with respect to the contract as of such time in determining statutory reserves.

Exchanges of life insurance and other contracts for long-term care insurance contracts

The exchange of a life insurance contract or an endowment or annuity contract for a qualified long-term care insurance contract would not be taxable under the proposal.

Certain distributions from IRAs and retirement plans for long-term care insurance

The proposal would permit certain plans to make distributions to pay premiums for long-term care insurance for the individual or the individual's spouse and would provide that the 10-percent tax on early withdrawals does not apply to such distributions. The proposal would apply to distributions from individual retirement arrangements (IRAs) and distributions attributable to elective deferrals to qualified cash or deferred arrangements (sec. 401(k) plans), tax-sheltered annuities (sec. 403(b) plans), nonqualified deferred compensation plans of governmental or tax-exempt employers (sec. 457 plans), and section 501(c)(18) plans used to pay premiums for long-term care insurance for the individual or the individual's spouse. Such distributions would be includable in income (as under present law).

Inclusion of excess long-term care benefits

In general, the proposal would provide that the maximum annual amount of long-term care benefits under a per diem type contract that is excludable from income with respect to an insured who is chronically ill (not including amounts received by reason of the individual being terminally ill)[7] could not exceed the equivalent of $175 per day for each day the individual is chronically ill. Thus, for per diem type contracts, the maximum annual exclusion for long-term care benefits with respect to any chronically ill individual (not including amounts received by reason of the individual being terminally ill) would be $63,875 (for 1997). If payments under such contracts exceed the dollar limit, then the excess would be excludable only to the extent the individual has incurred actual costs for long-term care services. If the insured is not the same as the holder of the contract, the insured could assign some or all of this limit to the contract holder at the time and manner prescribed by the Secretary.

This $175 per day limit would be indexed for inflation after 1997 for increases in the medical care component of the consumer price index. The Treasury Secretary, in consultation with the Secretary of Health and Human Services, would be directed to develop a more appropriate index, to be applied in lieu of the foregoing. Such an alternative might appropriately be based on increases in skilled nursing facility and home health care costs. The intent would be that the Treasury Secretary annually publish the indexed amount of the limit as early in the year as it can be calculated.

A payor of long-term care benefits (defined for this purpose to include any amount paid under a product advertised, marketed or offered as long-term care insurance) would be required to report to the IRS the aggregate amount of such benefits paid to any individual during any calendar year, and the name, address and taxpayer identification number of such individual. A copy of the report would have to be provided to the payee by January 31 following the year of payment, showing the name of the payor and the aggregate amount of benefits paid to the individual during the calendar year. Failure to file the report or provide the copy to the payee would be subject to the generally applicable penalties for failure to file similar information reports.

Consumer protection provisions

Under the proposal, long-term care insurance contracts, and issuers of contracts, would have to satisfy certain provisions of the long-term care insurance model Act and model regulations promulgated by the National Association of Insurance Commissioners (as adopted as of January 1993). The policy requirements relate to disclosure, nonforfeitability, guaranteed renewal or noncancellability, prohibitions on limitations and exclusions, extension of benefits, continuation or conversion of coverage, discontinuance and replacement of policies, unintentional lapse, post-claims underwriting, minimum standards, inflation protection, preexisting conditions, and prior hospitalization. The proposal also would provide disclosure

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[7] Terminally ill would be defined as under the provision of the proposal relating to accelerated death benefits. In general, under that provision, an individual would be considered to be terminally ill if he or she is certified as having an illness or physical condition that reasonably can be expected to result in death within 24 months of the date of the certification.

and nonforfeiture requirements. The nonforfeiture provision would give consumers the option of selecting reduced paid-up insurance, extended term insurance, or a shortened benefit period in the event a policyholder who elects a nonforfeiture provision is unable to continue to pay premiums. The requirements for issuers of long-term care insurance contracts relate to application forms, reporting requirements, marketing, appropriateness of purchase, format, delivering a shopper's guide, right to return, outline of coverage, group plans, policy summary, monthly reports on accelerated death benefits, and incontestability period. A tax would be imposed equal to $100 per policy per day for failure to satisfy these requirements.

Nothing in the proposal would prevent a State from establishing, implementing or continuing standards related to the protection of policyholders of long-term care insurance policies, if such standards are not inconsistent with standards established under the proposal.

Legislative background

The proposal is generally the same as the provisions relating to long-term care insurance and services in the Balanced Budget Act of 1995, except that the definition of a chronically ill individual is expanded to include an individual with severe cognitive impairment and the effective dates generally are changed from December 31, 1995 to December 31, 1996.

Effective date

The provisions defining long-term care insurance contracts and qualified long-term care services would apply to contracts issued after December 31, 1996. Any contract issued before January 1, 1997, that met the long-term care insurance requirements in the State in which the policy was sitused at the time it was issued would be treated as a long-term care insurance contract, and services provided under or reimbursed by the contract would be treated as qualified long-term care services.

A contract providing for long-term care insurance could be exchanged for a long-term care insurance contract (or the former cancelled and the proceeds reinvested in the latter within 60 days) tax free between the date of enactment and January 1, 1998. Taxable gain would be recognized to the extent money or other property is received in the exchange.

The issuance or conformance of a rider to a life insurance contract providing long-term care insurance coverage would not be treated as a modification or a material change for purposes of applying sections 101(f), 7702 and 7702A of the Code.

The provisions relating to treatment as a medical expense of qualified long-term care insurance services and eligible long-term care premiums would be effective for taxable years beginning after December 31, 1996.

The provision relating to tax-free exchanges of life insurance, endowment and annuity contracts for long-term care insurance contracts would be effective for taxable years beginning after December 31, 1997.

The change in treatment of reserves for long-term care insurance contracts would be effective for contracts issued after December 31, 1996. If, after that date, a company changes its tax reserve method for long-term care insurance contracts issued after that date, the amount of any adjustment arising from the change with respect to those contracts would be spread over a 10-year period as provided in section 807(f).

The provision relating to certain distributions from IRAs and elective deferrals used to pay long-term care insurance premiums would be effective for payments and distributions after December 31, 1996.

The provisions relating to the maximum exclusion for certain long-term care benefits and reporting would be effective for taxable years beginning after December 31, 1996. Thus, the initial year in which reports will be filed with the IRS and copies provided to the payee would be be 1998, with respect to long-term care benefits paid in 1997.

3. Tax Treatment of Accelerated Death Benefits Under Life Insurance Contracts

The proposal would provide an exclusion from gross income as an amount paid by reason of the death of an insured for (1) amounts received under a life insurance contract and (2) amount received for the sale or assignment of a life insurance contract to a qualified viatical settlement provider, provided that the insured under the life insurance contract is either terminally ill or chronically ill.

The proposal would not apply in the case of an amount paid to any taxpayer other than the insured, if such taxpayer has an insurable interest by reason of the insured being a director, officer or employee of the taxpayer, or by reason of the insured being financial interested in any trade or business carried on by the taxpayer.

A terminally ill individual would be defined as one who has been certified by a physician as having an illness or physical condition that reasonably can be expected to result in death within 24 months of the date of certification. A physician would be defined for this purpose in the same manner as under the long-term care insurance rules of the proposal.[8]

A chronically ill individual would be defined under the long-term care rules of the proposal.[9] In the case of amounts received with respect to a chronically ill individual (but not amounts received by reason of the individual being terminally ill), the $175 per day ($63,875 annual) limitation on excludable benefits that applies for per diem type long-term care insurance contracts also would limit amounts that could be excluded with respect to such contracts under this provision. A reporting requirement would apply to payments to a chronically ill individual.

A qualified viatical settlement provider would be any person that regularly purchases or

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[8] A physician would be defined for these purposes as in section 1861(r)(1) of the Social Security Act, which provides that a physician means a doctor of medicine or osteopathy legally authorized to practice medicine and surgery by the State in which he performs such function or action (including a physician within the meaning of section 1101(a)(7) of that Act). Section 1101(a)(7) of that Act provides that the term physician includes osteopathic practitioners within the scope of their practice as defined by State law.

[9] Thus, a chronically ill individual would be one who has been certified witin the previous 12 months by a licensed health care practitioner as (1) being unable to perform (without substantial assistance) at least 2 activities of daily living for at least 90 days due to a loss of functional capacity, (2) having a similar level of disability as determined by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services, or (3) requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment. Activities of daily living would be eating, toileting, transferring, bathing, dressing and continence. Nothing in the proposal would require the contract to take into account all of the activities of daily living.

takes assignments of life insurance contracts on the lives of terminally ill individuals and either: (1) is licensed for such purposes in the State in which the insured resides; or (2) if the person is not required to be licensed by that State, meets the requirements of the sections 8 and 9 of the Viatical Settlements Model Act (issued by the National Association of Insurance Commissioners (NAIC)), and also meets the section of the NAIC Viatical Settlements Model Regulation relating to standards for evaluation of reasonable payments, including discount rates, in determining amounts paid by the viatical settlement provider.

For life insurance company tax purposes, the proposal would provide that a life insurance contract is treated as including a reference to a qualified accelerated death benefit rider to a life insurance contract (except in the case of any rider that is treated as a long-term care insurance contract under section 7702B, as added by the proposal). A qualified accelerated death benefit rider would be any rider on a life insurance contract that provides only for payments of a type that are excludable under this provision.

The proposal is the same as the provision relating to accelerated death benefits that was included in the Balanced Budget Act of 1995, except that the effective dates are changed from December 31, 1995, to December 31, 1996.

The proposal would apply to amounts received after December 31, 1996. The provision treating a qualified accelerated death benefit rider as life insurance for life insurance company tax purposes would take effect on January 1, 1997. The issuance of a qualified accelerated death benefit rider to a life insurance contract, or the addition of any provision required to conform an accelerated death benefit rider to these provisions, would not be treated as a modification or material change of the contract (and would not affect the issue date of any contract under section 101(f)).

4. Medical Savings Accounts

In general

Under the proposal, within limits, individuals covered by a high deductible health plan could make tax deductible contributions to a medical savings account ("MSA"). Similarly, within limits, contributions to an MSA would be excludable from income (and wages for social security purposes) if made by the employer of an individual covered under a high deductible health plan. Earnings on amounts in an MSA would not be currently taxable. Distributions from an MSA for medical expenses would not be taxable. Distributions not used for medical expenses would be taxable. In addition, distributions not used for medical expenses would be subject to an additional 10-percent tax unless the distribution is made after age 59-1/2, death, or disability.

Eligible individuals

An individual (including a self-employed individual) would be eligible to make a deductible contribution to an MSA (or to have employer contributions made on his or her behalf) if the individual is covered under a high deductible health plan and is not covered under another health plan (other than a plan that provides certain permitted coverage).[10] An individual would not be eligible to make contributions to an MSA for a year if any employer contributions are made to an MSA on behalf of the individual for the year.

Tax treatment of and limits on contributions

Under the proposal, individual contributions to an MSA would be deductible (within limits) in determining AGI. Subject to the same limits, employer contributions to an MSA would be excludable from gross income and wages for employment tax purposes, except that this exclusion would not apply to contributions made through a cafeteria plan. If the high deductible plan covers only the individual, the maximum amount of contributions that could be deducted or excluded for a year would be equal to the lesser of (1) the deductible under the high deductible plan or (2) $2,000. If the high deductible plan covers the individual and a spouse or a dependent, the maximum that could be excluded or deducted for a year would be the lesser of (1) the annual limit under the plan on the aggregate amount of deductibles required to be paid with respect to

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[10] An individual with other coverage in addition to a high deductible plan would still be eligible for an MSA if such other coverage is certain permitted insurance or is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care. Permitted insurance would be: (1) Medicare supplemental insurance; (2) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such other similar liabilities as the Secretary may prescribe by regulations; (3) insurance for a specified disease or illness; and (4) insurance that provides a fixed payment for hospitalization.

all individuals, and (2) $4,000. The dollar limits would be indexed for medical inflation and rounded to the nearest multiple of $50.

Definition of high deductible plan

A high deductible health plan would be a health insurance plan with a deductible of at least $1,500 in the case of single coverage and $3,000 in the case of coverage of more than one individual. These dollar limits would be indexed for medical inflation, rounded to the nearest multiple of $50.

Taxation of distributions

Under the proposal, distributions from an MSA for the unreimbursed medical expenses of the individual (including a self-employed individual) and his or her spouse or dependents would be excludable from income.

Medical expenses would be defined as under the rules relating to the itemized deduction for medical expenses, except that medical expenses for this purpose would not include insurance premiums other than (1) premiums for long-term care insurance; (2) premiums for health care continuation coverage under any Federal law; and (3) premiums while the individual is receiving unemployment.[11]

Distributions that are not for medical expenses would be included in income. In addition, such distributions would be subject to an additional 10-percent tax unless made after age 59-1/2, death, or disability.

Upon death, if the beneficiary of the MSA is the individual's surviving spouse, the spouse could continue the MSA as his or her own. If the beneficiary is not the surviving spouse, the beneficiary would have to include the MSA balance in income in the year of death. If there is no beneficiary, the MSA balance would be includible on the final return of the decedent. In all cases, no estate tax applies.

Definition of an MSA

In general, an MSA would be a trust or custodial account created exclusively for the benefit of the account holder and would be subject to rules similar to those applicable to individual retirement arrangements.

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[11] The long-term care provisions of the proposal would provide that expenses for long-term care services are treated as medical expenses for purposes of the itemized deduction for medical expenses. Thus, an individual could use amounts in an MSA to pay expenses for long-term care insurance or services.

Prior legislation

The proposal is the same as a proposal contained in the Balanced Budget Act of 1995, and the Health Coverage Availability and Affordability Act of 1996, as passed by the House.

Effective date

The proposal would be effective for taxable years beginning after December 31, 1996.

5. Exemption from Income Tax for State-Sponsored Organization Providing Health Coverage for High-Risk Individuals

The proposal would provide tax-exempt status to any membership organization that is established by a State exclusively to provide coverage for medical care on a nonprofit basis to certain high-risk individuals, provided certain criteria are satisfied.[12] The organization may provide coverage for medical care either by issuing insurance itself or by entering into an arrangement with a health maintenance organization ("HMO").

High-risk individuals eligible to receive medical care coverage from the organization would be required to be residents of the State who, due to a pre-existing medical condition, are either unable to obtain health coverage for such condition through insurance or an HMO, or are able to acquire such coverage only at a rate that is substantially higher than the rate charged for such coverage by the organization. The State would be required to determine the composition of membership in the organization. For example, a State could mandate that all organizations that are subject to insurance regulation by the State must be members of the organization.

The proposal further would require the State or members of the organization to fund the liabilities of the organization to the extent that premiums charged to eligible individuals are insufficient to cover such liabilities. Finally, no part of the net earnings of the organization could inure to the benefit of any private shareholder or individual.

The proposal is identical to a provision contained in the Health Coverage Availability and Affordability Act of 1996, as passed by the House of Representatives.

The proposal would apply to taxable years beginning after December 31, 1996.

[12] No inference would be intended as to the tax treatment of other types of State-sponsored organizations.

6. Penalty-Free Withdrawals from Individual Retirement Arrangements

The proposal would provide that distributions from an individual retirement arrangement ("IRA") for medical expenses in excess of 7.5 percent of adjusted gross income ("AGI") would not be subject to the 10-percent tax on early withdrawals. In addition, the 10-percent tax would not apply to distributions for medical insurance (without regard to the 7.5 percent floor) if the individual has received unemployment compensation under Federal or State law for at least 12 weeks.

The proposal is similar to a provision in the Balanced Budget Act of 1995.

The proposal would be effective for taxable years beginning after December 31, 1996.

7. Expatriation Tax Provisions

In general

The proposal would replace the present-law expatriation income tax rules with rules that generally subject certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who relinquish their U.S. residency to tax on the net unrealized gain in their property as if such property were sold for fair market value on the expatriation date. The proposal also would impose information reporting obligations on U.S. citizens who relinquish their citizenship and long-term residents whose U.S. residency is terminated.

Individuals covered

The proposal would apply the expatriation tax to certain U.S. citizens and long-term residents who terminate their U.S. citizenship or residency. For this purpose, a long-term resident would be any individual who was a lawful permanent resident of the United States for at least 8 out of the 15 taxable years ending with the year in which the termination of residency occurs. In applying this 8-year test, an individual would not be considered to be a lawful permanent resident of the United States for any year in which the individual is taxed as a resident of another country under a treaty tie-breaker rule. An individual's U.S. residency would be considered to be terminated when either the individual ceases to be a lawful permanent resident pursuant to section 7701(b)(6) (i.e., the individual loses his or her green-card status) or the individual is treated as a resident of another country under a tie-breaker provision of a tax treaty (and the individual does not elect to waive the benefits of such treaty).

The expatriation tax under the proposal would apply only to individuals whose average income tax liability or net worth exceeds specified levels. U.S. citizens who lose their citizenship and long-term residents who terminate U.S. residency would be subject to the expatriation tax if they meet either of the following tests: (1) the individual's average annual U.S. Federal income tax liability for the 5 taxable years ending before the date of such loss or termination is greater than $100,000, or (2) the individual's net worth as of the date of such loss or termination is $500,000 or more. The dollar amount thresholds contained in these tests would be indexed for inflation in the case of a loss of citizenship or termination of residency occurring in any calendar year after 1996.

Exceptions from the expatriation tax under the proposal would be provided for individuals in two situations. The first exception would apply to an individual who was born with citizenship both in the United States and in another country, provided that (1) as of the date of relinquishment of U.S. citizenship the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual was a resident of the United States for no more than 8 out of the 15 taxable years ending with the year in which the relinquishment of U.S. citizenship occurred. The second exception would apply to a U.S. citizen who relinquishes citizenship before reaching age 18-1/2, provided that the individual was a resident of the United States for no more than 5 taxable years before such relinquishment.

Deemed sale of property upon expatriation

Under the proposal, individuals who are subject to the expatriation tax generally would be treated as having sold all of their property at fair market value immediately prior to the relinquishment of citizenship or termination of residency. Gain or loss from the deemed sale of property would be recognized at that time, generally without regard to provisions of the Code that would otherwise provide nonrecognition treatment. The net gain, if any, on the deemed sale of all such property would be subject to U.S. tax at such time to the extent it exceeds $600,000 ($1.2 million in the case of married individuals filing a joint return, both of whom expatriate).

The deemed sale rule of the proposal generally would apply to all property interests held by the individual on the date of relinquishment of citizenship or termination of residency, provided that the gain on such property interest would be includible in the individual's gross income if such property interest were sold for its fair market value on such date. Special rules would apply in the case of trust interests (see "Interests in trusts", below). U.S. real property interests, which remain subject to U.S. taxing jurisdiction in the hands of nonresident aliens, generally would be excepted from the proposal. An exception also would apply to interests in qualified retirement plans and, subject to a limit of $500,000, interests in certain foreign pension plans as prescribed by regulations. The Secretary of the Treasury would be authorized to issue regulations exempting other property interests as appropriate. For example, an exclusion could be provided for an interest in a nonqualified compensation plan of a U.S. employer, where payments from such plan to the individual following expatriation would continue to be subject to U.S. withholding tax.

Under the proposal, an individual who is subject to the expatriation tax would be required to pay a tentative tax equal to the amount of tax that would be due for a hypothetical short tax year ending on the date the individual relinquished citizenship or terminated residency. Thus, the tentative tax would be based on all the income, gain, deductions, loss and credits of the individual for the year through such date, including amounts realized from the deemed sale of property. The tentative tax would be due on the 90th day after the date of relinquishment of citizenship or termination of residency.

Deferral of payment of tax

Under the proposal, an individual would be permitted to elect to defer payment of the expatriation tax with respect to the deemed sale of any property. Under this election, the expatriation tax with respect to a particular property, plus interest thereon, would be due when the property is subsequently disposed of. For this purpose, except as provided in regulations, the disposition of property in a nonrecognition transaction would constitute a disposition. In addition, if an individual holds property until his or her death, the individual would be treated as having disposed of the property immediately before death. In order to elect deferral of the expatriation tax, the individual would be required to provide adequate security to ensure that the deferred expatriation tax and interest ultimately will be paid. A bond in the amount of the deferred tax and interest would constitute adequate security. Other security mechanisms also would be permitted provided that the individual establishes to the satisfaction of the Secretary of the Treasury that the security is adequate. In the event that the security provided with respect to a particular property subsequently becomes inadequate and the individual fails to correct such situation, the deferred expatriation tax and interest with respect to such property would become due. As a further condition to making this election, the individual would be required to consent to the waiver of any treaty rights that would preclude the collection of the expatriation tax.

Interests in trusts

In general

Under the proposal, special rules would apply to trust interests held by the individual at the time of relinquishment of citizenship or termination of residency. The treatment of trust interests would depend upon whether the trust is a qualified trust. For this purpose, a "qualified trust" would be a trust that is organized under and governed by U.S. law and that is required by its instruments to have at least one U.S. trustee.

Constructive ownership rules would apply to a trust beneficiary that is a corporation, partnership, trust or estate. In such cases, the shareholders, partners or beneficiaries of the entity would be deemed to be the direct beneficiaries of the trust for purposes of applying these provisions. In addition, an individual who holds (or who is treated as holding) a trust interest at the time of relinquishment of citizenship or termination of residency would be required to disclose on his or her tax return the methodology used to determine his or her interest in the trust, and whether such individual knows (or has reason to know) that any other beneficiary of the trust uses a different method.

Nonqualified trusts

If an individual holds an interest in a trust that is not a qualified trust, a special rule would apply for purposes of determining the amount of the expatriation tax due with respect to such trust interest. The individual's interest in the trust would be treated as a separate trust consisting of the trust assets allocable to such interest. Such separate trust would be treated as having sold its assets as of the date of relinquishment of citizenship or termination of residency and having distributed all proceeds to the individual, and the individual would be treated as having recontributed such proceeds to the trust. The individual would be subject to the expatriation tax with respect to any net income or gain arising from the deemed distribution from the trust. The election to defer payment would be available for the expatriation tax attributable to a nonqualified trust interest.

A beneficiary's interest in a nonqualified trust would be determined on the basis of all facts and circumstances. These would include the terms of the trust instrument itself, any letter of wishes or similar document, historical patterns of trust distributions, and the role of any trust protector or similar advisor.

Qualified trusts

If the individual has an interest in a qualified trust, a different set of rules would apply. Under these rules, the amount of unrealized gain allocable to the individual's trust interest would be calculated at the time of expatriation. In determining this amount, all contingencies and discretionary interests would be resolved in the individual's favor (i.e., the individual would be allocated the maximum amount that he or she potentially could receive under the terms of the trust instrument). The expatriation tax imposed on such gains generally would be collected when the individual receives distributions from the trust, or, if earlier, upon the individual's death. Interest would be charged for the period between the date of expatriation and the date on which the tax is paid.

If an individual has an interest in a qualified trust, the individual would be subject to expatriation tax upon the receipt of any distribution from the trust. Such distributions could also be subject to U.S. income tax. For any distribution from a qualified trust made to an individual after he or she has expatriated, expatriation tax would be imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates, but in no event would the tax imposed exceed the deferred tax amount with respect to such trust interest. The "deferred tax amount" would be equal to (1) the tax calculated with respect to the unrealized gain allocable to the trust interest at the time of expatriation, (2) increased by interest thereon, and (3) reduced by the tax imposed under this provision with respect to prior trust distributions to the individual.

If an individual's interest in a trust is vested as of the expatriation date (e.g., if the individual's interest in the trust is non-contingent and non-discretionary), the gain allocable to the individual's trust interest would be determined based on the trust assets allocable to his or her trust interest. If the individual's interest in the trust is not vested as of the expatriation date (e.g., if the individual's trust interest is a contingent or discretionary interest), the gain allocable to his or her trust interest would be determined based on all of the trust assets that could be allocable to his or her trust interest, determined by resolving all contingencies and discretionary powers in the individual's favor. In the case where more than one trust beneficiary is subject to the expatriation tax with respect to trust interests that are not vested, the rules are intended to apply so that the same unrealized gain with respect to assets in the trust would not be taxed to both individuals.

If the individual disposes of his or her trust interest, the trust ceases to be a qualified trust, or the individual dies, expatriation tax would be imposed as of such date. The amount of such tax would equal to the lesser of (1) the tax calculated under the rules for nonqualified trust interests applied as of such date or (2) the deferred tax amount with respect to the trust interest as of such date.

If the individual agrees to waive any treaty rights that would preclude collection of the tax, the tax would be imposed under this provision with respect to distributions from a qualified trust to the individual deducted and withheld from distributions. If the individual does not agree to such a waiver of treaty rights, the tax with respect to distributions to the individual would be imposed on the trust, the trustee would be personally liable therefor, and any other beneficiary of the trust would have a right of contribution against such individual with respect to such tax. Similarly, in the case of the tax imposed in connection with an individual's disposition of a trust interest, the individual's death while holding a trust interest or the individual's holding of an interest in a trust that ceases to be qualified, the tax would be imposed on the trust, the trustee would be personally liable therefor, and any other beneficiary of the trust would have a right of contribution against such individual with respect to such tax.

Election to be treated as a U.S. citizen

Under the proposal, an individual would be permitted to make an irrevocable election to continue to be taxed as a U.S. citizen with respect to all property that otherwise is covered by the expatriation tax. This election would be an "all-or-nothing" election; an individual would not be permitted to elect this treatment for some property but not other property. The election, if made, would apply to all property that would be subject to the expatriation tax and to any property the basis of which is determined by reference to such property. Under this election, the individual would continue to pay U.S. income taxes at the rates applicable to U.S. citizens following expatriation on any income generated by the property and on any gain realized on the disposition of the property, as well as any excise tax imposed with respect to the property (see, e.g., sec. 1491). In addition, the property would continue to be subject to U.S. gift, estate, and generation-skipping transfer taxes. However, the amount of any transfer tax so imposed would be limited to the amount of income tax that would have been due if the property had been sold for its fair market value immediately before the transfer or death. The $600,000 exclusion provided with respect to the expatriation tax under the proposal would be available to reduce the tax imposed by reason of this election. In order to make this election, the taxpayer would be required to waive any treaty rights that would preclude the collection of the tax. The individual also would be required to provide security to ensure payment of the tax under this election in such form, manner, and amount as the Secretary of the Treasury requires.

Date of relinquishment of citizenship

Under the proposal, an individual would be treated as having relinquished U.S. citizenship on the date that the individual first makes known to a U.S. government or consular officer his or her intention to relinquish U.S. citizenship. Thus, a U.S. citizen who relinquishes citizenship by formally renouncing his or her U.S. nationality before a diplomatic or consular officer of the United States would be treated as having relinquished citizenship on that date, provided that the renunciation is later confirmed by the issuance of a certificate of loss of nationality (CLN). A U.S. citizen who furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act with the requisite interest to relinquish his or her citizenship would be treated as having relinquished his or her citizenship on the date the statement is so furnished (regardless of when the expatriating act was performed), provided that the voluntary relinquishment is later confirmed by the issuance of a CLN. If neither of these circumstances exist, the individual would treated as having relinquished citizenship on the date a CLN is issued or a certificate of naturalization is canceled. The date of relinquishment of citizenship determined under the proposal would apply for all tax purposes.

Effect on present-law expatriation provisions

Under the proposal, the present-law income tax provisions with respect to U.S. citizens who expatriate with a principal purpose of avoiding tax (sec. 877) and certain aliens who have a break in residency status (sec. 7701(b)(10)) would not apply to U.S. citizens who are treated as relinquishing their citizenship on or after February 6, 1995 or to long-term U.S. residents who terminate their residency on or after such date. The special estate and gift tax provisions with respect to individuals who expatriate with a principal purpose of avoiding tax (secs. 2107 and 2501(a)(3)), however, would continue to apply; a credit against the tax imposed solely by reason of such special provisions would be allowed for the expatriation tax imposed with respect to the same property.

Treatment of gifts and inheritances from an expatriate

Under the proposal, the exclusion from income provided in section 102 would not apply to the value of any property received by gift or inheritance from an individual who was subject to the expatriation tax (i.e., an individual who relinquished citizenship or terminated residency and to whom the expatriation tax was applicable). Accordingly, a U.S. taxpayer who receives a gift or inheritance from such an individual would be required to include the value of such gift or inheritance in gross income and would be subject to U.S. income tax on such amount.

Required information reporting and sharing

Under the proposal, an individual who relinquishes citizenship or terminates residency would be required to provide a statement which includes the individual's social security number, forwarding foreign address, new country of residence and citizenship and, in the case of individuals with a net worth of at least $500,000, a balance sheet. In the case of a former citizen, such statement would be due not later than the date the individual's citizenship is treated as relinquished and would be provided to the State Department (or other government entity involved in the administration of such relinquishment). The entity to which the statement would be provided by former citizens would be required to provide to the Secretary of the Treasury copies of all statements received and the names of individuals who refuse to provide such statements. In the case of a former long-term resident, the statement would be provided to the Secretary of the Treasury with the individual's tax return for the year in which the individual's U.S. residency is terminated. An individual's failure to provide the statement required under this provision would result in the imposition of a penalty for each year the failure continues equal to the greater of (1) 5 percent of the individual's expatriation tax liability for such year or (2) $1,000.

The proposal would require the State Department to provide the Secretary of the Treasury with a copy of each CLN approved by the State Department. Similarly, the proposal would require the agency administering the immigration laws to provide the Secretary of the Treasury with the name of each individual whose status as a lawful permanent resident has been revoked or has been determined to have been abandoned.

Further, the proposal would require the Secretary of the Treasury to publish in the Federal Register the names of all former U.S. citizens with respect to whom it receives the required statements or whose names it receives under the foregoing information-sharing provisions.

Treasury report

The proposal would direct the Treasury Department to undertake a study on the tax compliance of U.S. citizens and green-card holders residing outside the United States and to make recommendations regarding the improvement of such compliance. The findings of such study and such recommendations would be required to be reported to the House Committee on Ways and Means and the Senate Committee on Finance within 90 days of the date of enactment.

During the course of the 1995 Joint Committee on Taxation staff study on expatriation (see Joint Committee on Taxation, Issues Presented by Proposals to Modify the Tax Treatment of Expatriation (JCS-17-95), June 1, 1995), a specific issue was identified regarding the difficulty in determining when a U.S. citizen has committed an expatriating act with the requisite intent, and thus no longer has the obligation to continue to pay U.S. taxes on his or her worldwide income due to the fact that the individual is no longer a U.S. citizen. Neither the Immigration and Nationality Act nor any other Federal law requires an individual to request a CLN within a specified amount of time after an expatriating act has been committed, even though the expatriating act terminates the status of the individual as a U.S. citizen for all purposes. Accordingly, it is anticipated that the Treasury report, in evaluating whether improved coordination between executive branch agencies could improve compliance with the requirements of the Internal Revenue Code, would review the process through which the State Department determines when citizenship has been lost, and make recommendations regarding changes to such process to recognize the importance of such date for tax purposes. In particular, it is anticipated that the Treasury Department would explore ways of working with the State Department to insure that the State Department will not issue a CLN confirming the commission of an expatriating act with the requisite intent necessary to terminate citizenship in the absence of adequate evidence of both the occurrence of the expatriating act (e.g., the joining of a foreign army) and the existence of the requisite intent.

Legislative background

The proposal is substantially similar to the expatriation tax provisions passed by the Senate in connection with the Balanced Budget Act of 1995.

Effective date

The proposal would be effective for U.S. citizens whose date of relinquishment of citizenship (as determined under the proposal, see "Date of relinquishment of citizenship" above) occurs on or after February 6, 1995. Similarly, the proposal would be effective for long-term residents who terminate their U.S. residency on or after February 6, 1995.

U.S. citizens who committed an expatriating act with the requisite intent to relinquish their U.S. citizenship prior to February 6, 1995, but whose date of relinquishment of citizenship (as determined under the proposal) does not occur until after such date, would be subject to the expatriation tax under the proposal as of date of relinquishment of citizenship. However, the individual would not be subject retroactively to worldwide tax as a U.S. citizen for the period after he or she committed the expatriating act (and therefore ceased being a U.S. citizen for tax purposes under present law). Such an individual would continue to be subject to the expatriation tax imposed by present-law section 877 until the individual's date of relinquishment of citizenship (at which time the individual would be subject to the expatriation tax of the proposal). The rules described in this paragraph would not apply to an individual who committed an expatriating act prior to February 6, 1995, but did not do so with the requisite intent to relinquish his or her U.S. citizenship.

The tentative tax would not be required to be paid, and the reporting requirements would not be required to be met, until 90 days after the date of enactment. Such provisions would apply to all individuals whose date of relinquishment of U.S. citizenship or termination of U.S. residency occurs on or after February 6, 1995.

8. Disallow Interest Deduction for Corporate-Owned Life Insurance Policy Loans

Under the proposal, no deduction would be allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance policies or annuity or endowment contracts owned by the taxpayer covering any individual who is (1) an officer or employee of, or (2) financially interested in any trade or business carried on by the taxpayer, regardless of the aggregate amount of debt with respect to policies or contracts covering the individual.

An exception would be provided retaining present law for interest on indebtedness with respect to life insurance policies covering up to 10 key persons. A key person would be an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that could be treated as key persons may not exceed the greater of (1) five individuals, or (2) the lesser of 5 percent of the total number of officers and employees of the taxpayer, or 10 individuals. Interest paid or accrued on debt with respect to a life insurance contract covering a key person would be deductible only to the extent the rate of interest does not exceed Moody's Corporate Bond Yield Average - Monthly Average Corporates for each month interest is paid or accrued.

The proposal is the same as the provision relating to disallowance of the interest deduction for corporate-owned life insurance policy loans that was included in the Balanced Budget Act of 1995.

Effective date.--The proposal generally would be effective with respect to interest paid or accrued after December 31, 1995 (subject to a phase-in rule).

The phase-in rule would provide that with respect to debt incurred before January 1, 1996, any otherwise deductible interest paid or accrued after October 13, 1995, and before January 1, 1999, would be allowed to the extent the rate of interest does not exceed the lesser of (1) the borrowing rate specified in the contract as of October 13, 1995, or (2) a percentage of Moody's Corporate Bond Yield Average - Monthly Average Corporates for each month the interest is paid or accrued. For interest paid or accrued after October 13, 1995, and before January 1, 1996, the percentage of the Moody's rate would be 100 percent; for interest paid or accrued in 1996, the percentage would be 90 percent; for interest paid or accrued in 1997, the percentage would be 80 percent; for 1998, the percentage would be 70 percent; for 1999 and thereafter, the percentage would be 0 percent. Only interest that would have been allowed as a deduction but for the provision would be allowed under the phase-in. Interest that is deductible under the phase-in rules would not include interest on borrowings by the taxpayer with respect to contracts on the lives of more than 20,000 insured individuals, effective for interest paid or accrued after December 31, 1995. For this purpose, all persons treated as a single employer would be treated as one taxpayer.

An exception would be provided under the effective date with respect to any life insurance contract entered into during 1994 or 1995. In the case of such contracts, with respect to debt incurred before January 1, 1997, no deduction would be allowed for interest except with respect to policies that satisfy the key person exception, and except as provided under the phase-in rule.

The proposal generally would not apply to interest on debt with respect to contracts purchased on or before June 20, 1986 (thus generally continuing the effective date provision of the $50,000 limitation enacted in the 1986 Act). If the policy loan interest rate under such a contract provides for a fixed rate of interest, then interest on such a contract paid or accrued after October 13, 1995, would be allowable only to the extent the fixed rate of interest does not exceed Moody's Corporate Bond Yield Average--Monthly Average Corporates for the month in which the contract was purchased. If the policy loan interest rate under such a contract does not provide for a fixed rate of interest, then interest on such a contract paid or accrued after October 13, 1995, would be allowable only to the extent the rate of interest for each fixed period selected by the taxpayer does not exceed Moody's Corporate Bond Yield Average--Monthly Average Corporates, for the month immediately preceding the beginning of the fixed period. The fixed period must be 12 months or less.

Any amount included in income during 1996, 1997, or 1998, that is received under a contract described in the proposal on the complete surrender, redemption or maturity of the contract or in full discharge of the obligation under the contract that is in the nature of a refund of the consideration paid for the contract, would be includable ratably over the first four taxable years beginning with the taxable year the amount would otherwise have been includable. Utilization of this 4-year income-spreading rule would not cause interest paid or accrued prior to January 1, 1999, to be nondeductible solely by reason of (1) failure to meet the 4-out-of-7 rule, or (2) causing the contract to be treated as a single premium contract within the meaning of section 264(b)(1) (i.e., a contract in which substantially all of the premiums are paid within 4 years after the date of purchase). In addition, the lapse of a contract after October 13, 1995, due to nonpayment of premiums, would not cause interest paid or accrued prior to January 1, 1999, to be nondeductible solely by reason of (1) failure to meet the 4-out-of-7 rule, or (2) causing the contract to be treated as a single premium contract within the meaning of section 264(b)(1).

In the case of an insurance company, the unamortized balance of policy expenses attributable to a contract with respect to which the 4-year income-spreading treatment would be allowed to the policyholder would be deductible in the year in which the transaction giving rise to income-spreading occurs.

No inference would be intended as to the treatment of interest paid or accrued under present law.

9. Treatment of Bad Debt Deductions of Thrift Institutions

The proposal would repeal the section 593 reserve method of accounting for bad debts by thrift institutions, effective for taxable years beginning after 1995. Thrift institutions that qualify as small banks would be allowed to use the experience method applicable to such banks, while thrift institutions that are treated as large banks are required to use the specific charge-off method.

A thrift institution required to change its method of computing reserves for bad debts under the proposal would treat such change as a change in a method of accounting, initiated by the taxpayer, and having been made with the consent of the Secretary of the Treasury. Any section 481(a) adjustment required to be taken into account with respect to such change generally is be determined solely with respect to the "applicable excess reserves" of the taxpayer. The amount of applicable excess reserves would be taken into account ratably over a 6-taxable year period, beginning with the first taxable year beginning after 1995, subject to the residential loan requirement described below. In the case of a thrift institution that becomes a "large bank" (as determined under sec. 585(c)(2)), the amount of the institution's applicable excess reserves generally would be the excess of (1) the balance of its reserves described in section 593(c)(1) (other than its supplemental reserve for losses on loans) as of the close of its last taxable year beginning before January 1, 1996, over (2) the balance of such reserves as of the close of its last taxable year beginning before January 1, 1988 (i.e., the "pre-1988 reserves"). Similar rules would be provided for "small banks" and for small banks that subsequently become large banks.

The pre-1988 reserves of a thrift institution would be restored to income ratably if the institution ceased to be a bank. A thrift institution that becomes a credit union would be not be treated as a bank and any reserves required to be included in income by the credit union would be treated as unrelated trade or business income.

The balance of the pre-1988 reserves would continue to be subject to the provisions of present-law section 593(e) (requiring recapture in the case of certain excess distributions to, and redemptions of, shareholders). Section 593(e) would not apply to certain internal restructurings of an affiliated group of banks.

Under a special rule, if the taxpayer meets the "residential loan requirement" for a taxable year, the recapture of the applicable excess reserves otherwise required to be taken into account as a section 481(a) adjustment for such year would be suspended. A taxpayer would meet the residential loan requirement if, for the taxable year, the principal amount of residential loans made by the taxpayer during the year is not less than its base amount. The "base amount" of a taxpayer would be the average of the principal amounts of the residential loans made by the taxpayer during the six most recent taxable years beginning before January 1, 1996. At the election of the taxpayer, the base amount could be computed by disregarding the taxable years within that 6-year period in which the principal amounts of loans made during such years were highest and lowest. The test would be applied on a controlled group basis. The residential loan requirement would be applicable only for taxable years that begin after December 31, 1995, and before January 1, 1998, and must be applied separately with respect to each such year. Thus, all taxpayers would be required to recapture their applicable excess reserves within six, seven, or eight years after the effective date of the provision.

The proposal is substantially similar to a provision in the Balanced Budget Act of 1995, and is the same as a provision in the Health Coverage Affordability and Availability Act of 1996 as passed by the House of Representatives.

The proposal generally would be effective for taxable years beginning after December 31, 1995. Taxpayers with applicable excess reserves that make distributions with respect to preferred stock within a specified period of time would treat such distributions in a manner similar to the treatment provided under present-law section 593(e).

10. Earned Income Credit Proposals

Under the proposal, individuals would not be eligible for the earned income credit if they do not include their taxpayer identification number (and, if married, their spouse's taxpayer identification number) on their tax return. Solely for these purposes and for purposes of the present-law identification test for a qualifying child, a taxpayer identification number would be defined as a social security number issued to an individual by the Social Security Administration other than a number issued under section 205(c)(2)(B)(i)(II) (or that portion of sec. 205(c)(2)(B)(i)(III) relating to it) of the Social Security Act (regarding the issuance of a number to an individual applying for or receiving Federally funded benefits).

If an individual fails to provide a correct taxpayer identification number, such omission would be treated as a mathematical or clerical error. If an individual who claims the credit with respect to net earnings from self-employment fails to pay the proper amount of self-employment tax on such net earnings, the failure would be treated as a mathematical or clerical error for purposes of the amount of credit allowed.

The proposal is identical to a provision contained in the Health Coverage Availability and Affordability Act of 1996 as passed by the House of Representatives. The proposal was also included in the Balanced Budget Act of 1995.

The proposal would be effective for taxable years beginning after December 31, 1995.