DESCRIPTION OF REVENUE RECONCILIATION PROPOSAL

PART ONE: REVENUE-RAISING PROVISIONS

Scheduled for Markup

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SENATE COMMITTEE ON FINANCE

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Prepared by the Staff

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of Part One of a revenue reconciliation proposal for consideration by the Senate Committee on Finance at a markup scheduled for October 3, 1989.[2] Part One describes revenue-raising provisions.

A separate document provides estimated budget effects of the specific provisions.

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1 This document may be cited as follows: Description of Revenue Reconciliation Proposal: Part One (Revenue-Raising Provisions) (JCX-57-89), October 3, 1989.

2 Part Two of the revenue reconciliation proposal is in a separate document, which includes expiring provisions, child care initiative (from S. 5), individual retirement accounts (IRAs), and other provisions.

Also, see separate document (JCX-56-89) for a description of technical corrections provisions.

DESCRIPTION OF REVENUE RECONCILIATION PROPOSAL

PART ONE: REVENUE-RAISING PROVISIONS[1]

A. Repeal of Special Rules Applicable to Financially Troubled Financial Institutions in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (P.L. 101-73)

Prior Law

Under prior law, special rules provided as follows:

(1) certain mergers involving financially troubled thrift institutions and financially troubled banks could qualify as tax-free reorganizations, without regard to the continuity of interest requirement;

(2) relaxed rules applied to the carryforward of net operating losses, built-in losses, and excess credits in the case of tax-free reorganizations involving financially troubled thrift institutions and financially troubled banks;

(3) gross income did not include assistance payments from the Federal Savings and Loan Insurance Corporation in the case of thrift institutions, or the Federal Deposit Insurance Corporation in the case of banks, and no basis reduction was required on account of such payments although there may have been a reduction in certain tax attributes.

These provisions were scheduled to expire after December 31, 1989.

Explanation of Present Law

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (P.L. 101-73), enacted on August 9, 1989, repealed these special rules.

Effective Date

The repeal is effective for transactions on or after May 10, 1989.

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[1] See also separate document for Part Two: Expiring Provisions, Child Care Initiative, IRAs, and Other Provisions.

B. Corporate Provisions

1. Defer interest deduction on certain high-yield original issue discount (OID) obligations until interest is paid

Present Law

Original issue discount (OID) is the excess of the stated redemption price at maturity over the issue price of a debt instrument. The issuer of a debt instrument with OID generally accrues and deducts the discount, as interest, over the life of the obligation even though the amount of such interest is not paid until the debt matures. The holder of such a debt instrument also generally includes the OID in income as interest on an accrual basis.

Explanation of Proposal

The interest deduction for OID with respect to certain instruments, including instruments allowing for the payment of interest with additional instruments of the issuer (e.g., so-called "payment-in-kind (PIK)" bonds), would be deferred until actually paid. The holder, however, would continue to include such discount, as interest, in income as it accrues.

The provision would apply to OID on any debt instrument issued by a C corporation that has a term of more than five years, significant OID, and a yield in excess of 5 percentage points over the applicable Federal rate. An instrument has significant OID if in any accrual period ending more than five years after issuance, the aggregate taxable income with respect to the instrument exceeds (1) the aggregate cash interest to be paid under the instrument plus (2) the yield on the instrument in the first year.

The Secretary of the Treasury would be granted authority to prescribe regulations appropriate to carry out the purpose of the provision and to prevent its avoidance, including regulations governing the treatment of complex instruments.

Effective Date

The provision would be effective for instruments issued after July 10, 1989. The provision would not apply to an instrument issued after July 10, 1989, in connection with an acquisition completed (or for which there was a commitment to complete) before July 11, 1989, so long as the significant terms of such instrument were determined before July 11, 1989, in a written document transmitted to a government regulatory agency or prospective party to the issuance or acquisition. The provision also would not apply to an instrument issued after July 10, 1989, so long as the significant terms of the instrument do not exceed the terms contained in the last bankruptcy reorganization plan filed before that date. For these purposes, a maturity date not otherwise determined is considered determined so long as the actual term of the instrument does not exceed ten years.

In addition, the provision would not apply to instruments issued as interest payments on a grandfathered instrument. Finally, a grandfathered instrument could be refinanced without being subject to the provision so long as its term, issue price, and redemption price are not increased (and periodic interest payments not reduced) by the refinancing.

2. Limit dividends received deduction with respect to certain nontaxed income of consolidated subsidiaries

Present Law

A distribution to a shareholder is generally treated as a dividend to the extent of the distributing corporation's current or accumulated earnings and profits. Corporate recipients of dividends generally are entitled to a dividends received deduction equal to at least 70 percent of the dividend. (An 80-percent or 100-percent deduction is permitted if the recipient has sufficient ownership of the stock of the distributing corporation.) The dividends received deduction serves to reduce substantially or eliminate multiple taxation with respect to income earned and corporate-level tax paid by distributing corporations on distributions to corporate shareholders.

If a group of corporations files a consolidated return, taxable income is determined by reference to the income and deductions of all members of the group and is, in substance, computed as if the group operated as a single corporation. No income is separately attributed to minority owners of a subsidiary that joins in filing a consolidated return. Thus, for example, income of a subsidiary bears no corporate-level tax if its parent corporation or other members of the group have losses sufficient to offset that income, even though the subsidiary may have taxable income economically attributable to minority ownership. If the minority owner and the parent or other group members had been joint venturers with respect to the subsidiary's business, then the income attributable to minority ownership could not be sheltered by losses of other members of the group but would be fully taxed to the minority owners.

In order to be eligible to file a consolidated return, a subsidiary generally must be related to the rest of the group through the group's ownership of at least 80 percent of the vote and value of all classes of subsidiary stock. However, stock described in section 1504(a)(4) (generally, nonvoting preferred stock that does not participate in corporate growth to any significant extent) is not counted for this purpose. Thus, minority shareholders holding nonvoting preferred stock may be entitled to virtually all the subsidiary's earnings without preventing consolidation. In this situation, the earnings to which the preferred shareholders are entitled can be sheltered by the losses of other members of the group without limitation. The subsidiary can pay these non-taxed earnings to the minority corporate shareholders as dividends eligible for the 70-percent dividends received deduction. Such earnings thus bear no corporate-level tax to the distributing corporation and bear a maximum tax to the recipient corporation of only 10.2 percent (34 percent of the

30 percent that is taxable after the dividends received deduction).

Explanation of Proposal

The dividends received deduction would not be allowed for a portion of dividends paid out of current earnings and profits with respect to stock described in section 1504(a)(4) (generally, nonvoting preferred stock) in certain circumstances.

The provision would apply only to dividends paid from a subsidiary of a group filing a consolidated return.

The portion of dividends received deduction disallowed would be calculated as a fraction, the numerator of which is the amount of consolidated losses (other than those of the distributing corporation) and the deduction equivalent of consolidated credits (other than foreign tax credits) attributable to other members of the group that reduce the distributing corporation's separately computed taxable income, and the denominator of which is the distributing corporation's separately computed taxable income. The amount of distributions limited with respect to the dividends received deduction shall not exceed the amount of the consolidated losses and the deduction equivalent of consolidated credits attributable to other members of the group that are treated as reducing the distributing corporation's separately computed taxable income.

The Treasury Department would be authorized to exempt taxpayers from the limitation to the extent they can establish that the distributions in question were made out of earnings that were taxed to the distributing corporation or the consolidated group of which it is a member.

The Treasury Department would also be authorized to provide antiabuse rules. It is expected that regulations would prevent avoidance of the rules through the contribution of built-in loss assets or other direction of losses to the subsidiary by other members of the group. It is also expected that regulations would prevent avoidance of the rules through delaying distributions until later years or through the use of tiered subsidiaries or similar devices.

Effective Date

The provision is generally effective for distributions after October 2, 1989. However, it does not apply to distributions with respect to subsidiary stock issued on or before that date, or issued after that date pursuant to a binding written contract in effect on that date and at all times thereafter before such stock is issued, so long as the subsidiary is not transferred outside the group of which it was a member on October 2, 1989.

Auction rate preferred stock is treated for this purpose as issued when the contract requiring the auction became binding and is not considered issued at the time of each auction conducted pursuant to such commitment.

3. Repeal nonrecognition treatment when securities are received in section 351 transactions

Present Law

No gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control of the corporation (sec. 351). Accordingly, a transferor may transfer appreciated property to a controlled corporation in exchange for stock and a debt obligation of the corporation that is a security, without recognition of gain.

Different rules apply for debt obligations that are not considered to be "securities" under section 351. Such other debt obligations are treated as "boot." A transferor who receives boot is taxed on the lesser of the amount of the boot or the gain realized on the exchange generally as if the transferred property had been sold.

Under the corporate reorganization provisions, a taxpayer who transfers property in a reorganization and who receives securities with a principal amount in excess of any securities surrendered is taxable on the excess as "boot."

The receipt of any debt obligation constituting boot generally qualifies for installment sale treatment. Under the installment sale rules, taxpayers generally report gain on the installment method but must pay interest on the deferred tax liability in certain circumstances. However, the installment method is not available in certain circumstances (for example, if the property transferred is stock or securities traded on an established market, or in the case of certain transfers between related parties). In addition, in certain circumstances, a taxpayer will accelerate gain if the installment note is pledged as security for an indebtedness (sec. 453A).

Explanation of Proposal

Securities received in a section 351 transaction would be treated as boot. The provision would not apply, however, to: (1) any exchange that is pursuant to a plan of reorganization in which the securities are subject to section 354(a); or (2) any exchange where the stock or securities received in the exchange are distributed as part of a section 355 transaction and are subject to section 355(a)(3).

The provision is not intended to alter the ability of the Internal Revenue Service to recharacterize transactions to which the provision does not apply.

Effective Date

The provision would apply to transfers made by corporations after July 11, 1989 (other than transfers made by S corporations, and other than transfers where the corporate transferor, immediately after the transfer, owns stock in the transferee that meets the 80-percent vote and value test of section 1504(a)(2)), unless the transfer was pursuant to a written binding contract in effect on July 11, 1989 and at all times thereafter before such transfer.

The provision would apply to transfers made by individuals, other noncorporate entities, corporations (but only where the corporate transferor, immediately after the transfer, owns stock in the transferee that meets the 80-percent vote and value test of section 1504(a)(2)), and S corporations after October 2, 1989, unless the transfer was pursuant to a written binding contract in effect on that date and at all times thereafter before such transfer.

4. Reduce built-in gain or loss threshold for sections 382 and 384

Present Law

Sections 382 and 384 of the Code restrict the use of built-in losses and built-in gains of a corporation when there are certain changes in the control of the corporation. These rules apply only if the net unrealized built-in loss or built-in gain exceeds 25 percent of the fair market value of the assets of the company.

The consolidated return regulations also contain rules that restrict the use of built-in losses of a corporation in certain circumstances. These rules apply only if a 15 percent threshold is exceeded.

Under the minimum tax adjusted current earnings regime, if there is a change of ownership under section 382, all built-in losses are limited without a threshold.

Explanation of Proposal

The restrictions in Code sections 382 and 384 on the use of built-in gains and built-in losses of a corporation would apply if the built-in loss or built-in gain exceeds the lesser of (1) 15 percent of the fair market value of the assets of the company or (2) $25 million.

A corresponding threshold would be provided under the minimum tax adjusted current earnings regime.

Effective Date

The proposal generally would be effective for changes in control of a corporation subject to section 382 or 384 after October 2, 1989, unless pursuant to a binding written contract in effect on or before October 2, 1989 and at all times thereafter. However, in the case of a reorganization described in subparagraph (G) of section 368(a)(1) of the Internal Revenue Code of 1986, as amended, or an exchange of debt for stock in a title 11 or similar case, as defined in section 368(a)(3) of such Code, the provision would not apply to any ownership change resulting from such a reorganization or proceeding if a petition in such case was filed with the court before October 3, 1989.

5. Require basis reduction for nontaxed portion of dividends on self-liquidating stock

Present Law

In general, corporations are entitled to a deduction equal to 70 percent of the dividends received from a domestic corporation. An 80-percent dividends received deduction is allowable if the corporate shareholder owns 20 percent or more of the stock of the domestic corporation and a 100-percent dividends received deduction is allowable if the corporate shareholder owns at least 80 percent of the stock of the domestic corporation.

A corporate shareholder's basis in stock is reduced by the portion of a dividend eligible for the dividends received deduction if the dividend is "extraordinary." In general, a dividend is extraordinary if the amount of the dividend equals or exceeds 10 percent (5 percent in the case of preferred stock) of the shareholder's adjusted basis in the stock and the shareholder has not held the stock, subject to a risk of loss, for at least 2 years prior to the date the amount or payment of the dividend is declared, announced, or agreed to, whichever is the earliest (sec. 1059).

Explanation of Proposal

Dividends with respect to certain preferred stock would be treated as extraordinary dividends under section 1059 (regardless of holding period), thus requiring reduction in stock basis. The provision would apply to dividends with respect to preferred stock if (1) when issued, such stock has a dividend rate which declines (or reasonably can be expected to decline) in the future, (2) the issue price of such stock exceeds its liquidation rights or its stated redemption price, or (3) such stock is otherwise structured to enable corporate shareholders to reduce tax through a combination of dividend received deductions and loss on the disposition of the stock. The provision would not apply to dividends on preferred stock whose dividend rate declines due to an unforeseen economic downturn in the issuer's business.

The Secretary of the Treasury would be authorized to prescribe regulations that would apply the provision to dividends with respect to stock other than preferred stock in appropriate cases.

Effective Date

The provision would apply to stock issued after July 10, 1989, unless issued pursuant to a written binding contract in effect on July 10, 1989, and at all times thereafter before the stock is issued.

6. Modify excess loss account recapture rules to prevent prevent shifting of basis to debt

Present Law

Under consolidated return regulations, in general, a parent corporation must reduce its basis in the stock of a subsidiary with which it files a consolidated return by the amount of distributions the parent receives from the subsidiary and the amount of any deficit in earnings and profits of the subsidiary. The parent increases its basis in the stock of a subsidiary by the amount of contributions to the subsidiary and earnings and profits of the subsidiary. In general, when distributions and losses from the subsidiary exceed the contributions to and earnings of the subsidiary, an "excess loss account" is created. This amount is generally recaptured by the parent on certain dispositions of the stock of the subsidiary.

Under the present consolidated return regulations, a parent corporation that has an excess loss account in the stock of the subsidiary can defer recapture of such excess loss account on dispositions of the subsidiary's stock by electing to apply the excess loss account to reduce the basis of other stock or debt held by the parent in the subsidiary.

Explanation of Proposal

The proposal would modify the excess loss account recapture rules to prevent the reallocation of the excess loss account to reduce the basis of subsidiary debt held by the parent. Thus, on disposition of the stock of a subsidiary, gain attributable to an excess loss account would be required to be recognized rather than deferred through a reduction in the basis of debt held by the parent corporation.

The Treasury Department would be directed to reexamine the rules permitting reallocation of the excess loss account to reduce the basis of the other stock held in the subsidiary.

Effective Date

The provision would be effective for dispositions after July 10, 1989, unless pursuant to a binding written contract in effect on that date and at all times thereafter.

7. Clarify Treasury regulation authority relating to debt/equity (section 385)

Present Law

The characterization of an investment in a corporation as debt or equity for Federal income tax purposes generally is determined by reference to numerous factors that are deemed to reflect aspects of the economic substance of the investor's interest in the corporation. There presently is no definition in the Internal Revenue Code or the income tax regulations which can be used to determine whether an interest in a corporation constitutes debt or equity for Federal income tax purposes. Such a determination is made under principles developed in case law. Courts have approached the issue of distinguishing debt and equity by analyzing and weighing the relevant facts and circumstances of each case.

In 1969, Congress granted the Secretary of the Treasury the authority to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated as stock or as indebtedness for Federal income tax purposes (sec. 385). The regulations were to prescribe factors to be taken into account in determining, with respect to particular factual situations, whether a debtor-creditor relationship or a corporation-shareholder relationship existed. Proposed regulations under section 385 were issued in 1980 and 1981, although they were withdrawn in 1983. To date, no additional regulations have been issued.

Explanation of Proposal

Section 385 would be amended to allow the Treasury Department to characterize an instrument having significant debt and equity characteristics as part debt and part equity. In addition, the Treasury Department would continue to be authorized, although not required, to issue comprehensive debt-equity regulations under section 385. However, the Treasury Department would be directed to increase the issuance of IRS published rulings on debt-equity issues.

No inference is intended that the Internal Revenue Service could not characterize an instrument as part debt and part equity under present law.

Effective Date

The Treasury Department's regulatory authority to characterize an instrument as part debt and part equity would apply only on a prospective basis. Such authority could be exercised only with respect to instruments issued after public guidance is published, whether by regulation, ruling, or otherwise, stating the position of the Treasury Department with respect to the characterization of such instruments.

8. Require reporting to IRS of acquisitions and recapitalizations

Present Law

There is no requirement under present law that the parties to an acquisition or recapitalization transaction report information to the Treasury Department or the Internal Revenue Service with respect to such transaction, except as incident to the filing of Federal income tax returns.

Explanation of Proposal

The Treasury Department would be directed to require reporting with respect to corporate acquisition and recapitalization transactions. The information to be reported would include the identity of the parties to the transaction, the fees involved, and the change in the capital structure of the corporation. Penalties would apply for non-compliance with these reporting rules.

Effective Date

The proposal would be effective on date of enactment for transactions after March 31, 1990.

9. Require Treasury study of "debt vs. equity" and integration issues

Present Law

Interest on debt is generally deductible by the issuer and is includible in the income of the holder. However, in the case of tax exempt or foreign holders, the interest is not taxable with the result that neither the issuer nor the holders pay any tax on amounts distributed as interest.

The U.S. income tax system is not integrated, i.e., corporations and their shareholders are generally separate taxable entities. Thus, income earned by a corporation and distributed to shareholders may be taxed twice: once at the corporate level and again at the shareholder level when such income is distributed to shareholders.

Explanation of Proposal

The Treasury Department would be required to study whether the present-law distinctions between debt and equity are meaningful and whether there are cases in which it would be appropriate to limit interest deductions.

The Treasury Department would also be required to study the policy and revenue implications of proposals which would integrate the corporate and individual income tax systems, including a deduction for dividends paid by a corporation and a shareholder credit or exclusion for such dividends.

In addition, the Treasury Department would be directed to consider the policy and revenue implications of the tax treatment of corporate distributions with respect to debt and equity held by tax-exempt entities and foreign persons.

The Treasury Department would be required to report its findings and recommendations to the House Committee on Ways and Means, the Senate Committee on Finance, and the Joint Committee on Taxation no later than one year following the date of enactment of this proposal.

Effective Date

The provision would be effective on the date of enactment.

10. Restrict ability of C corporations to carry back certain net operating losses

Present Law

A corporation that incurs net operating losses (NOLs) generally can carry the NOLs back 3 taxable years and forward 15 taxable years. Carrying the NOLs back against prior taxable income allows a corporation to recognize currently the benefit of those losses by obtaining a refund.

Explanation of Proposal

The ability of C corporations to carry back NOLs would be limited in cases where the NOLs were created by interest deductions allocable to certain corporate equity-reducing transactions (CERTs). A CERT would be either a major stock acquisition (of at least 50 percent of the vote or value of another corporation) or an excess distribution (defined generally as the excess of the aggregate distributions and redemptions made by a corporation with respect to its stock over 150 percent of the average of such distributions for the previous 3 years).

The portion of the NOL carryback that would be limited would be the lesser of (1) the corporation's interest expense that is allocable to the CERT, or (2) the excess of the corporation's interest expense in the loss limitation year over the average of the corporation's interest expense for the 3 taxable years prior to the taxable year in which the CERT occurred. The provision would not apply if the lesser of these two amounts was less than $1 million.

Effective Date

The proposal generally would apply to CERTs occurring after August 2, 1989, in taxable years ending after that date.

In determining whether a CERT has occurred after August 2, 1989, the following would not be taken into account: (1) acquisitions or redemptions of stock, or distributions with respect to stock, occurring on or before August 2, 1989; (2) acquisitions or redemptions of stock after August 2, 1989, pursuant to a written binding contract (or tender offer filed with the SEC) in effect on August 2, 1989, and at all times thereafter before such acquisition or redemption; or (3) any distribution with respect to stock after August 2, 1989, which was declared on or before August 2, 1989.

11. **Require mutual funds to distribute 98 percent of ordinary income**

Present Law

In order to avoid a penalty excise tax, regulated investment companies, commonly called "mutual funds," must distribute before January 1 of any year at least 97 percent of their ordinary income earned during the prior calendar year and 98 percent of their capital gain net income for the twelve month period ending on October 31 of that year.

Explanation of Proposal

The distribution required to avoid the penalty excise tax would be increased to 98 percent of ordinary income.

Effective Date

The provision would be effective for taxable years ending after July 10, 1989.

12. Require continued capitalization of mutual fund load charges in the case of certain switches within a family of funds

Present Law

A shareholder's basis in shares purchased in a regulated investment company (mutual fund) is the cost of acquiring the shares. This cost includes expenses incurred in connection with the purchase. Upon sale or exchange of the shares, the shareholder's gain is reduced, or loss is increased, by the amount of such expenses.

Some mutual fund sponsors impose an advance charge for sales fees (load charge) upon purchase of shares. Sometimes, a load charge is imposed when shares of a fund are purchased but is waived if the shares are received in exchange for those of another fund within a family of funds. Under present law, a shareholder can purchase shares of a fund, immediately exchange them for shares of a fund for which the load charge is waived, and increase loss or reduce gain by an amount equal to the load charge.

Explanation of Proposal

A load charge would not be taken into account in determining a shareholder's basis in mutual fund shares which are sold or exchanged within six months in a transaction that does not terminate the shareholder's reinvestment right. A reinvestment right is the right to reinvest the proceeds from the sale or exchange of the shares at a reduced charge in one or more mutual funds.

Effective Date

The provision would apply to load charges incurred after October 3, 1989, in taxable years ending after such date.

13. **Require mutual funds to include dividend income on the ex-dividend date**

Present Law

Dividends from stock owned by a regulated investment company (RIC), commonly called a "mutual fund," are includible in the company's income when received.

Explanation of Proposal

Dividends received by a mutual fund would be includible in income when the stock becomes ex-dividend with respect to the dividend. If a mutual fund receiving a dividend did not own the stock when the stock became ex-dividend, the dividend is includible in income on the date the fund acquired the stock.

Effective Date

The provision is effective for dividends on stock becoming ex-dividend after date of enactment.

C. Employee Benefit Provisions

1. Provisions relating to employee stock ownership plans (ESOPs)

Present Law

ESOPs in general

An employee stock ownership plan (ESOP) is a qualified stock bonus plan or a combination of a stock bonus plan and money purchase pension plan that meets certain requirements and under which employer securities are held for the benefit of employees. Present law generally prohibits loans between a qualified plan and a disqualified person (sec. 4975). An exception to this rule is provided in the case of an ESOP.

If employer securities are acquired by an ESOP with loan proceeds, the ESOP is referred to as a leveraged ESOP. The ESOP may borrow directly from a financial institution (typically with a guarantee from the employer), or the employer may borrow from a financial institution and in turn lend the funds to the ESOP which then uses them to acquire employer securities. The employer securities are typically pledged as security for the loan. The employer makes contributions to the ESOP which are then used to repay the acquisition loan. Shares that are acquired with an acquisition loan are allocated to the accounts of ESOP participants as the loan is repaid.

In general, the type of employer securities that may be held by an ESOP are (1) common stock of the employer that is readily tradable on an established securities market, or (2) if there is no such common stock, common stock issued by the employer having a combination of voting power and dividend rights at least equal to that class of common having the greatest voting power and that class of common having the greatest dividend power. Noncallable preferred stock is treated as employer securities if such stock is convertible into stock that meets the requirements of (1) or (2), whichever is applicable.

ESOPs are required to pass through to plan participants certain voting rights with respect to employer securities. If the employer has a registration-type class of securities, the ESOP is required to permit each participant to direct the plan as to the manner in which employer securities allocated to the account of the participant are entitled to vote. If the employer does not have a registration-type class of securities, the plan is required to permit each particpant to direct the plan as to the manner in which voting rights are to be exercised only with respect to certain enumerated corporate issues, such as the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, and similar transactions as prescribed by the Secretary.

Partial interest exclusion for ESOP loans

A bank, an insurance company, a corporation actively engaged in the business of lending money, or a regulated investment company may exclude from gross income 50 percent of the interest received with respect to a "securities acquisition loan" used to acquire employer securities for an ESOP (sec. 133). A "securities acquisition loan" is generally defined as (1) a loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities for the ESOP, or (2) a loan to a corporation to the extent that the corporation transfers an equivalent amount of employer securities to the ESOP and such securities are allocable to accounts of ESOP participants within 1 year of the date of the loan (an "immediate allocation loan").

Explanation of Proposal

The proposal limits the circumstances in which the partial interest exclusion applies. In general under the proposal, the partial interest exclusion does not apply to a securities acquisition loan unless (1) immediately after the acquisition of the securities acquired with the loan the ESOP owns at least 30 percent of each class of outstanding stock of the corporation issuing the employer securities or 30 percent of the total value of all outstanding stock of the corporation, (2) the term of the loan does not exceed 15 years, and (3) each participant is entitled to direct the plan as to the manner in which shares allocated to the participant's account that were acquired with a section 133 loan are to be voted. These requirements apply to transfers of stock with respect to an immediate allocation loan as well as other types of securities acquisition loans.

The 30-percent requirement is designed to ensure that the ESOP holds a substantial percentage of the company's stock. After the sale of the stock to the ESOP, the ESOP must generally hold the employer securities for at least 3 years. An excise tax is imposed on the employer sponsoring the ESOP if, within 3 years after the acquisition of the employer securities with a loan to which section 133 applies, the ESOP disposes of employer securities and the total number of employer securities held by the ESOP is less than the total number held after the acquisition or the value of the employer securities held by the plan after the disposition is less than 30 percent of the value of the outstanding securities. The excise tax does not apply to certain distributions, such as distributions to plan participants and distributions with respect to certain corporate reorganizations.

An excise tax is also imposed if the ESOP disposes of the employer securities before the securities are allocated to accounts of participants and the proceeds from such disposition are not so allocated.

The amount of each excise tax is 10 percent of the amount realized on the disposition. The excise tax rules are similar to those that apply in situations where there has been a sale of stock to an ESOP that entitles the seller to defer recognition of gain on the sale (sec. 1042) or an estate tax deduction (sec. 2057).

The voting requirements of the proposal apply to all shares acquired with the loan to which the partial interest exclusion applies. This requirement applies to all issues and applies regardless of whether the employer has a registration-type class of securities. In addition, if the shares are convertible preferred stock, the participants must be entitled to direct the voting of such stock as if the preferred stock had the voting rights of the common stock of the employer having the greatest voting power.

Effective Date

The proposal would generally be effective with respect to loans made after June 6, 1989, including (except as provided below) loans made after June 6, 1989, to refinance loans made on or before June 6, 1989. The proposal would not apply to any loan (1) pursuant to a binding written commitment to make a securities acquisition loan in effect on June 6, 1989, and at all times thereafter before the loan is made, (2) the proceeds of which are use to acquire employer securities pursuant to a written binding contract (or tender offer registered with the Securities and Exchange Commission) in effect on June 6, 1989, and at all times thereafter before such securities are acquired, (3) to the extent made to finance the acquisition of employer securities by an ESOP pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified on or before June 6, 1989, or agreed to on or before such date and ratified within a reasonable period of time after such agreement and which agreement which sets forth the material terms of the ESOP, or (4) with respect to which a filing was made with an agency of the United States on or before June 6, 1989, which specified the aggregate principal amount of the loan or debt obligations, and (a) such filing specifies that the loan is intended to be a securities acquisition loan (as defined in sec. 133) and is for registration required to permit the offering of such loan, or (b) such filing is for approval required in order for the ESOP to acquire more than a certain percentage of the stock of the employer. The grandfather in item (4) relates only to governmental filings required in order for the ESOP debt to be issued or the employer securities to be acquired by the ESOP and, thus, for example, does not apply to requests for a determination letter from the Internal Revenue Service that the ESOP is a qualified plan.

In addition, the proposal would not apply to loans made after June 6, 1989, to refinance loans made on or before such date (or to refinance loans described in the preceding paragraph), if (1) such refinanced loan meets the requirements of section 133 (as in effect before the amendments made by the proposal), (2) the outstanding principal amount of the loan is not increased, and (3) the term of such loan does not extend beyond the later of (a) the last day of the term of the original securities acquisition loan, or (b) the last day of the 7-year period beginning on the date the original securities acquisition loan was made.

It is intended that the refinancing rules described above also apply in the case of a securities acquisition loan that consists of a loan to the employer with a corresponding loan to the ESOP (a "back-to-back" or "mirror" loan) (see sec. 133(b)(3)), if the loan is restructured so that the loan is directly from the financial institution to the ESOP with a guarantee from the employer rather than a loan from the employer.

With respect to the grandfather rule for certain loans made after June 6, 1989, the legislative history would provide that the existence of a written binding loan commitment can be demonstrated, for example, by a combination of documentation by the lender, written communications by the borrower or the borrower's agent (e.g., an investment banker or a broker), and documentation of the borrower showing that the loan was approved by the lender and that the offer to make the loan was received by the borrower. Such documentation would have to include the principal terms of the loan, such as the principal amount, interest rate or spread or formula pursuant to which the interest rate will be set, and maturity of the loan. The binding contract rules apply to all types of securities acquisition loans, including immediate allocation loans.

2. Transfer of excess pension plan assets to pay current retiree health benefits

Present Law

Under present law, pension plan assets may not revert to an employer prior to the termination of the plan and the satisfaction of all plan liabilities. Any assets that revert to the employer upon such termination are included in the gross income of the employer and are subject to a 15-percent excise tax (sec. 4980).

Subject to certain limitations, an employer may under present law make deductible contributions to a defined benefit pension plan up to the full funding limitation. The full funding limitation is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan or (b) 150 percent of the plan's current liability, over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the actuarial value of the plan's assets. Special deduction rules apply in the case of contributions to plans established before January 1, 1954, as a result of an agreement between employee representatives and the Government of the United States during a period of Government operation of a major part of the productive facilities of the industry in which such employer is engaged (sec. 404(c)).

Under present law, a pension plan may provide medical benefits to retirees through a section 401(h) account. These medical benefits, when added to any life insurance protection provided under the plan, are required to be incidental or subordinate to the retirement benefits provided under the plan. Under Treasury regulations, the medical benefits are considered incidental or subordinate to the retirement benefits if, at all times, the aggregate of employer contributions (made after the date on which the plan first includes such medical benefits) to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions made after such date, other than contributions to fund past service credits.

The assets of a pension plan may not be transferred to a section 401(h) account without disqualifying the pension plan and subjecting the amounts transferred to income tax and the 15-percent excise tax.

Explanation of Proposal

Permitted transfer of certain excess assets

Under the proposal, a transfer of certain assets is permitted from the pension assets in a defined benefit pension plan to the section 401(h) account that is a part of such plan. The assets transferred are not includible in the gross income of the employer and are not subject to the 15-percent excise tax on reversions. The defined benefit pension plan does not fail to satisfy the qualification requirements (sec. 401(a)) solely on account of the transfer and does not violate the present-law requirement that medical benefits under a section 401(h) account be subordinate to the retirement benefits under the plan.

The transfer of assets to a section 401(h) account may be made only once in any taxable year of the employer. Transfers may be made in taxable years beginning after December 31, 1989, and before December 31, 1994.

Under the proposal, accrued retirement benefits under the plan must be nonforfeitable (i.e., vested).

The amount of excess pension assets that may be transferred and used for retiree health benefits is limited to the amount reasonably estimated to be the amount the employer will pay for qualified current retiree health liabilities. "Excess pension assets" are those assets in excess of those necessary to meet the full funding limitation. That is, excess pension assets are those in excess of the lesser of (1) 150 percent of the plan's current liability, or (2) the accrued liability (including normal cost) under the plan (as determined under sec. 412(c)(7)).

The amount transferred under this proposal is generally treated as a contribution except that no deduction is available with respect to the transfer. Under the proposal, for purposes of determining the maximum deductible contribution to the defined benefit pension plan, the amounts held in the section 401(h) account are considered in determining whether the plan is at the full funding limitation.

Qualified current retiree health liabilities are defined as the amount of retiree health benefits (including administrative expenses) expended by the employer or reasonably estimated to be paid by the employer during the employer's taxable year in which such transfer occurs and with respect to those employees who have retired on or before the date of the transfer. In determining the amount that may be transferred, the employer is to consider earnings that will be attributable to such assets subsequent to the transfer. The amount of qualified current retiree health liabilities is also reduced to the extent that the employer has previously made a contribution to a section 401(h) account or a welfare benefit fund (e.g., voluntary employees' beneficiary association (VEBA)) relating to the same liabilities. No deduction is allowed with respect to amounts expended by the employer and subsequently reimbursed from the section 401(h) account.

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The retired employees who may be taken into account in calculating qualified current retiree health liabilities are limited to those who are eligible for retirement benefits under the defined pension benefit plan containing the separate account. Retiree health benefits of key employees (sec. 416(i)(1)) may not be paid out of transferred assets. Transferred amounts are generally required to benefit all participants in the pension plan who are entitled upon retirement to receive retiree medical benefits (other than key employees) through the section 401(h) account.

A special rule applies with respect to an employer's taxable year beginning in 1989. Under this rule, an employer may transfer to a section 401(h) account the amount expended by the employer for qualified retiree health benefits during the employer's 1989 taxable year. The transfer may be made after the end of the 1989 taxable year and before the time for filing the employer's tax return for such year (including extensions). The employer may make a single transfer for both 1989 and 1990 qualified current retiree health benefits. Alternatively, an employer may make 2 transfers in an employer's 1990 taxable year, if one of the transfers is made to reimburse 1989 liabilities.

An employer that makes a transfer to a section 401(h) account under the proposal is to maintain employer-provided retiree health expenditures for covered employees at a minimum dollar level for the year of the transfer and the following 4 years. The minimum level is equal to the highest average employer cost per employee for retiree health benefits for the pension plan participants in the 2 years preceding the year of the transfer.

The amounts transferred to the section 401(h) account are required to be paid out for qualified current retiree health liabilities. Amounts that are not expended within the taxable year of the employer in which the transfer occurs are to be returned at the end of such year to the general assets of the plan.

The employer is noc entitled to a deduction when amounts are transferred into the section 401(h) account or when such amounts (or income on such amounts) are used to pay retiree health benefits. No deduction or contribution is allowed the employer for the provision of retiree health benefits (whether directly, through a 401(h) account, or a welfare benefit fund) except to the extent that the total of such payments for qualified current retiree health liabilities exceed the amount transferred to the section 401(h) account (including any income thereon).

<u>Special rule for certain negotiated plans</u>

The proposal would provide that surplus assets in certain retirement plans may be transferred to retiree health benefit plans. Assets so transferred would not be includible in the income of the employer, nor would they be subject to the 15-percent excise tax. A plan qualifies as a transferor plan under the proposal if it is a plan described in section 404(c) or a continuation of such a plan and participation in the plan is substantially limited to individuals who retired before January, 1976. A plan qualifies as a transferee plan under the proposal if it is a plan described in section 404(c) or a continuation of such a plan and it provides health benefits to retirees and beneficiaries of the industry that maintained the transferor plan.

In addition, the proposal would provide that any employer that had an obligation to contribute to a plan that qualifies as a transferee plan under the proposal as of January 1, 1988, (including a contingent obligation to contribute) shall have a continuing obligation to contribute to the plan.

Requirement that medical benefits be incidental or subordinate

Under the proposal, the medical benefits described in section 401(h) are considered subordinate to the retirement benefits only if the aggregate of actual contributions (made after the date on which the plan first includes such medical benefits) to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions actually made after such date (rather than the cost related to benefit accruals) other than contributions to fund past service credits. This rule does not apply to a transfer of excess assets permitted under the temporary rule described above.

Under this rule, for example, if a section 401(h) retiree medical benefits plan was established at a time when the plan was fully funded (as determined under section 412), the employer is precluded from making contributions to fund the section 401(h) account unless and until the plan falls below the full funding limit. This is because the permissible level of contributions is measured by actual contributions to the pension plan after the date the medical benefit is established.

Internal Revenue Service General Counsel Memorandum, 39785, issued on April 3, 1989, is rejected to the extent it concludes that contributions to a section 401(h) account may be based on plan costs rather than actual contributions to the plan. No inference is intended as to whether a contribution to a section 401(h) account prior to the effective date of this proposal met the requirement that the medical benefits be subordinate to the retirement benefits of the plan where the determination as to whether such requirement was met was based on plan costs rather than on actual contributions to the plan.

Effective Date

The proposal would generally apply to years beginning after December 31, 1989. However, no transfer under the general rule would be allowed with respect to any year beginning after December 31, 1994.

The special rule applicable to certain negotiated plans would be effective on the date of enactment, except that the continuing obligation to contribute would be effective as of January 1, 1988.

The proposal relating to the subordination requirement (i.e., the 25-percent rule) for purposes of determining the permissible contribution to a section 401(h) account would be effective with respect to contributions after the date of committee action.

D. Foreign Provisions

1. Conform tax years of certain controlled foreign corporations and foreign personal holding companies to tax years of certain U.S. shareholders

Present Law

A controlled foreign corporation is deemed to distribute certain earnings and profits to its U.S. shareholders on the last day of the controlled foreign corporation's taxable year. Similar rules apply to a foreign personal holding company. There is no requirement that the taxable year end of such foreign corporations conform to the taxable year end of their U.S. shareholders. By contrast, the ability of taxpayers to defer income inclusions by manipulating the taxable years of other pass-through entities was significantly curtailed by the 1986 Act.

Explanation of Proposal

The proposal would generally require the taxable year of a controlled foreign corporation to conform to the taxable year of any U.S. shareholder that directly, indirectly, or by attribution owns more than fifty percent of the outstanding stock of the controlled foreign corporation. Alternatively, the controlled foreign corporation would be allowed to use a taxable year end which provides no more than one month of income deferral to such majority U.S. shareholder. For example, if the majority U.S. shareholder has a taxable year end of December 31, then under the proposal, the controlled foreign corporation would be permitted to use either November 30 or December 31 as its year end. If, as a result of attribution of stock ownership, more than one such majority U.S. shareholder exists (or there is a U.S. shareholder that is not a majority U.S. shareholder but that owns stock in the controlled foreign corporation, and that stock is regarded as owned by a majority U.S. shareholder), then the controlled foreign corporation would generally be required to use the year which results in the least aggregate amount of deferral of income to such U.S. shareholders as its taxable year.

In the case of a foreign personal holding company that is not also a controlled foreign corporation, the proposal would require the company to adopt the taxable year of its shareholder who is a U.S. person and who directly, indirectly, or by attribution owns more than fifty percent of the outstanding stock of the foreign personal holding company. If, by attribution, there is more than one such majority U.S. shareholder (or there is a U.S. shareholder that is not a majority U.S. shareholder but that owns stock in the foreign personal holding company, and that stock is regarded as owned by a majority U.S. shareholder), then the foreign personal holding company would generally be required to use as its taxable year the year which results in the least aggregate amount of deferral to such U.S. shareholders.

The proposal to require taxable year conformity would not apply to a controlled foreign corporation or a foreign personal holding company that does not have a U.S. shareholder who is considered to own under applicable ownership attribution rules more than fifty percent of the value of the outstanding stock of such corporation.

The proposal additionally would allow a foreign personal holding company two and one-half months beyond the close of its taxable year to distribute its undistributed foreign personal holding company income for such year. The distribution would be treated as paid during such year and would be required to be included in the income of the recipient U.S. shareholder (under the principles of section 551(f)) for its taxable year in which the taxable year of the foreign personal holding company ends.

Effective Date

The proposal would be effective for taxable years beginning after July 10, 1989. In the case of a controlled foreign corporation or foreign personal holding company that would be required by this proposal to change its taxable year for its first taxable year beginning after July 10, 1989, each shareholder that would otherwise be required to include income from more than one taxable year of such corporation in any one of its taxable years would take into account the income for the short taxable year of the corporation ratably over a period not to exceed four years, beginning with its taxable year with which or within which the short taxable year of the corporation ends.

2. Resourcing income to prevent avoidance of foreign tax credit limitation rules relating to foreign losses

Present Law

Members of an affiliated group of corporations may file (or be required to file) consolidated returns. To be a member of an affiliated group for this purpose, a corporation must be an "includible corporation," and a controlling percentage of the stock of the corporation (unless it is the common parent) must be owned by an "includible corporation." Under section 1504(b), foreign corporations and certain other types of corporations do not qualify as includible corporations.

Each foreign tax credit limitation to which a consolidated group is subject varies directly with the ratio of (1) the foreign source taxable income of the group subject to that limitation, to (2) the entire taxable income of the group. Under foreign tax credit limitation rules relating to foreign losses, a net loss in a separate foreign tax credit limitation category, or in the general limitation category, reduces positive foreign source taxable income in each of the other categories.

Explanation of Proposal

The proposal gives the Treasury authority to resource the income of any member of an affiliated group of corporations (defined to include certain groups that would otherwise not be treated as affiliated because stock of includible corporations is owned indirectly, rather than directly, by other includible corporations), or to modify the consolidated return regulations, to the extent such resourcing or modification is necessary to prevent avoidance of the purposes of the foreign tax credit limitation rules relating to foreign losses. For example, where an includible corporation indirectly controls another includible corporation through a corporation that is not includible, the Treasury would be authorized to recharacterize by regulation foreign source income of the includible corporations as U.S. source income, so that the aggregate U.S. tax liability of those corporations is no less than the tax that would be imposed if, for foreign tax credit purposes, the includible corporations had joined in filing a consolidated return.

Effective Date

The provision would be effective for taxable years beginning after July 10, 1989.

3. Improve information reporting by U.S. subsidiaries and branches of foreign corporations

Present Law

The Treasury is authorized to distribute, apportion or allocate gross income, deductions, credits, or allowances between or among commonly controlled organizations, trades, or businesses as necessary to prevent the evasion of taxes or to clearly reflect income (sec. 482). Any corporation (U.S. or foreign) that conducts a trade or business in the United States and that is controlled by a foreign person must file an information return reporting all transactions with related foreign persons (sec. 6038A). Failure to comply with this reporting requirement carries a monetary penalty that can reach a maximum of $25,000. "Control" for purposes of section 6038A requires 50-percent ownership by a single foreign person (including ownership attributed to that person).

The IRS is authorized to summon certain persons to produce books, papers, records, and other data that may be relevant to the examination of any return (sec. 7602). However, such summonses may not be practically or legally enforceable in all appropriate cases, especially where summoned materials are in the possession of a foreign person.

Explanation of Proposals

Requirements imposed on taxpayers

1. Apply the reporting requirements of section 6038A to corporations that are owned by 25-percent foreign shareholders, and to transactions involving such shareholders.

2. Require certain books, papers, records and other data (generally as specified in Treasury regulations) that are necessary to determine the tax liability of a corporation that is subject to the reporting requirements of section 6038A ("reporting corporation") to be maintained in the United States for each transaction that is required to be reported under section 6038A ("reportable transaction"). Treasury would be authorized to limit the categories of records required to be maintained in the United States. Translation of any such documents into English, where necessary to determine the tax liability of the reporting corporation, will not be required until the time specified in Treasury regulations. Treasury would be authorized to modify the generally applicable requirements that it prescribes under this provision in appropriate specific cases, including by entering into record-retention agreements that accomplish the purposes of this provision.

3. Require any foreign person that is a related party of any reporting corporation to designate such corporation as its agent to accept service of process in connection with IRS summonses related to any reportable transaction, solely for the purpose of determining the tax liability of the reporting corporation. It is contemplated that where records of the related party are obtainable on a timely and efficient basis under a procedure in a treaty, the Service would make use of that procedure before issuing a summons to the designated agent.

Penalties for noncompliance

1. Increase the existing $1,000 penalty for failure to meet the requirements of section 6038A (as expanded by the proposal) to $10,000, and remove the current $24,000 ceiling on additions to that penalty.

2. Authorize the Secretary to (1) reduce or disallow deductions claimed by the reporting corporation for amounts paid or incurred to the related party in connection with reportable transactions, and (2) reduce or eliminate the cost (including all components of the cost of goods sold) to the reporting corporation of property acquired from or transferred to the related party in connection with a reportable transaction, in the event that the reporting corporation and the related party fail to satisfy information availability requirements specified by this provision. Failures that the Secretary may take into account include (a) the failure by a related party to designate a reporting corporation as its agent to accept service of summonses related to reportable transactions (for purposes of determining the tax liability of the reporting corporation), and (b) the failure by a reporting corporation or a foreign person related thereto to produce books, papers, records, or other data that are properly required by the IRS in the examination of a reportable transaction. Treasury would be authorized to disregard certain de minimis failures.

Report to Congress

Require the IRS to report to Congress on its efforts to audit U.S. subsidiaries and branches of foreign-based multinationals.

Effective Date

The provisions would apply to taxable years beginning after July 10, 1989.

E. Excise Tax Provisions

1. Repeal Airport and Airway Trust Fund tax reduction — trigger

Present Law

The tax rates of certain of the excise taxes which fund the Airport and Airway Trust Fund (AATF) generally will be reduced by 50 percent as of January 1, 1990, because AATF appropriations for fiscal years 1989 and 1990 for airport improvement, facilities and equipment, and research, engineering and development programs were 79 percent, instead of at least 85 percent, of the amounts authorized for those fiscal years. The tax rate reductions are required under provisions of the Airport and Airway Revenue Act of 1987, because of the expressed concern by the Congress that the trust fund programs cited above were not being funded adequately.

The present levels of AATF excise taxes are scheduled to expire after December 31, 1990.

The AATF excise tax rates which will be reduced by 50 percent are: (1) 8 percent tax on air passenger transportation; (2) 5 percent tax on air freight; and (3) 14 cents-per-gallon tax on jet fuel used in noncommercial aviation. The 3 cents-per-gallon additional tax on gasoline used in noncommercial aviation (in addition to the basic 9 cents-per-gallon tax under section 4081) would be eliminated and 3 cents of the 9 cents-per-gallon gasoline tax would be refunded or credited to ultimate purchasers using the gasoline in noncommercial aviation. The $3 per person international departure tax would not be reduced.

Explanation of Proposal

The 1990 reduction in AATF excise tax rates would be repealed. Present law excise tax rates relating to air passenger transportation, air freight transportation, and gasoline and other fuels used in noncommercial aviation would remain unchanged.

Administration position

The Administration proposed, in its budget recommendations, that the trigger be repealed. It also indicated, in a letter to the Chairman of the Committee on Ways and Means of the House of Representatives, its support for increased spending for the airport improvement program, with concern for capacity and security projects. The Committee on Finance understands that the Administration continues to endorse that position.

Effective Date

The proposal would be effective beginning on January 1, 1990.

2. Increase international air passenger departure tax

Present Law

The international air passenger departure tax is $3 per person. The tax is imposed when the air passenger ticket is purchased.

Revenues from this tax are deposited in the Airport and Airway Trust Fund. The tax is scheduled to expire after December 31, 1990.

Explanation of Proposal

The departure tax on international air passenger transportation would be increased by $3 per person to $6 per person.

Effective Date

The proposal would become effective on January 1, 1990, with respect to international departures on and after that date.

3. Ship passengers international departure tax

Present Law

There are no Federal taxes or fees currently imposed on cruise ship passengers. Cruise ships using U.S. ports are subject to a .04 percent excise tax on the value of commercial cargo and passenger fares (sec. 4461). Revenues from this tax are deposited in the Harbor Maintenance Trust Fund.

Under special rules, no harbor maintenance tax applies to cruise ships loading or unloading with respect to cruises to or from Alaska, Hawaii, or a U.S. possession, unless the Alaska, Hawaii, or U.S. possession port is only a stopover to a foreign destination.

Explanation of Proposal

There would be imposed a tax of $3 per passenger on a covered voyage on a passenger vessel having berth or stateroom accommodations for more than 16 passengers that embarks from a United States port on a voyage that extends over one or more nights. The tax also would be imposed on a vessel transporting passengers engaged in gambling aboard the vessel beyond the territorial sea of the United States. The tax would be assessed only once for each passenger on a covered voyage, either when a passenger first embarks or disembarks in the U.S.

The tax would not be imposed on a vessel on a voyage of less than 12 hours between two points in the United States, or a vessel owned and operated by a State or a political subdivision of a State.

Effective Date

The proposal would be effective on January 1, 1990.

4. Petroleum Excise Tax for Oil Spill Liability Trust Fund

Present Law

Present law (Code sec. 4611) establishes an excise tax at the rate of 1.3 cents per barrel on domestic crude oil and imported petroleum products (including imported crude oil) for the purpose of funding the Oil Spill Liability Trust Fund. However, the tax will not be imposed until the enactment of qualified authorizing legislation.[1] Although the tax itself was enacted in 1986, qualified authorizing legislation has not yet been enacted. Consequently, this tax has never been collected.

The tax on domestic crude oil would be imposed on the operator of any United States refinery receiving such crude oil, while the tax on imported petroleum products would be imposed on the person entering the product into the United States for consumption, use, or warehousing. If domestic crude oil were used in, or exported from, the United States before imposition of the tax on the operator of a refinery, the tax would be imposed on the user or exporter of the oil.

Repayable advances could be made to the Trust Fund from the general fund of the Treasury in a maximum outstanding amount of $500 million. The maximum amount which could be paid from the Trust Fund for any single incident is $500 million, no more than $250 million of which could be used to pay for natural resource damage claims (sec. 9509(c)). Certain costs incurred by the Federal Government for oil spill removal are authorized by the Federal Water Pollution Control Act and the Intervention on the High Seas Act and are permissible Trust Fund expenditure purposes which, although subject to appropriation, do not require the enactment of the qualified authorizing legislation which is necessary to commence collection of the 1.3-cents-per-barrel excise tax.

The Oil Spill Liability Trust Fund excise tax is scheduled to expire on December 31, 1991. The tax will terminate earlier than that date if the Secretary of the Treasury determines that $300 million has been credited to the Trust Fund before January 1, 1992.

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[1] The Code (sec. 4611(f)) requires that the authorizing legislation must be substantially identical to subtitle E of title VI, or subtitle D of title VIII, of H.R. 5300 of the 99th Congress as passed the House of Representatives.

Explanation of Proposal

The proposal would modify present law to impose the tax at a rate of 3 cents per barrel and to commence collection of the tax for the Trust Fund expenditure purposes which under present law do not require the enactment of qualified authorizing legislation. Upon the enactment of qualified authorizing legislation, Trust Fund amounts could be available for additional expenditure purposes. The proposal specifies that qualified authorizing legislation includes S. 686, "The Oil Pollution Liability and Compensation Act of 1989" as passed by the Senate August 4, 1989, for this purpose. As under present law, collection of the tax would cease December 31, 1991, or earlier if $300 million had been credited to the Trust Fund.

Effective Date

The provision would require the collection of the tax to commence on January 1, 1990.

5. Excise tax on ozone-depleting chemicals

Present Law

The use or manufacture of chemicals which deplete the ozone layer is not subject to Federal tax under present law.

Explanation of Proposal

The proposal would assess an excise tax on the sale or use by a manufacturer of certain ozone-depleting chemicals and on the import into the United States of such chemicals or products containing such chemicals. Ozone-depleting chemicals include: chlorofluorocarbons ("CFCs") (which generally are used as refrigerants, foam blowing agents, and solvents) and halons. Those chemicals subject to tax would be those chemicals subject to production and consumption restrictions under the Montreal protocol.

The amount of tax would be determined by multiplying a base tax amount by an "ozone-depleting factor." The ozone-depleting factor would reflect the potential ozone depletion which would result from one kilogram of a given chemical compared to the ozone depletion which results from one kilogram of CFC-11 (trichlorofluoromethane).[1]

For the period beginning January 1, 1990, and ending December 31, 1990, the provision would not apply in the case of the manufacture or sale of halons or the sale or use by a manufacturer of ozone-depleting chemicals for the purpose of manufacturing or selling rigid foam insulation, or the import into the United States of chemicals or products containing such chemicals for such purposes. For calendar years 1991, 1992, and 1993, a credit against the excise tax would be provided for halons and rigid foam insulation in a credit percentage that equates the tax per pound of qualifying chemical to a net tax of 25 cents per pound of ozone-depleting chemical, prior to any adjustment for inflation indexing.

The base tax rate on ozone-depleting chemicals would be $1.10 per pound for 1990 and 1991, $1.60 per pound for 1992, and $3.10 per pound for 1993 and beyond. The base tax amount would be indexed for inflation which occurs after 1989.

Effective Date

The provision would be effective for ozone-depleting chemicals produced in or imported into the United States after December 31, 1989. In addition, a floor stocks tax

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[1] CFC-11 is assigned an ozone depleting factor of 1.0.

would be imposed on ozone-depleting chemicals held by a dealer for sale on January 1, 1990, and on every subsequent January when the tax rate on taxed chemicals changes. For 1990, collection of the tax would not begin until April 1, 1990.

6. Excise tax for Coastal Wetlands Trust Fund

Present Law

Excise taxes are imposed under present law with respect to certain substances, such as crude oil, feedstock chemicals, and chemical derivatives. Receipts from these excise taxes are appropriated to trust funds to pay costs incurred in the cleanup of hazardous wastes, oil spills, and leaking underground storage facilities.

Internal Revenue Code section 4611 establishes an excise tax of 1.3 cents per barrel on domestic crude oil and imported petroleum products (including imported crude oil) for the purpose of funding the Oil Spill Liability Trust Fund (the "Oil Spill Fund"). However, under present law, the tax will not be imposed until qualified authorizing legislation is enacted. Oil Spill Fund expenditure purposes would include payment of removal costs of an oil spill and certain otherwise uncompensated claims. In addition, funds would be available to carry out specific provisions of other legislation relating to oil discharges and pollution. The Oil Spill Fund excise tax currently is scheduled to expire on December 31, 1991, or on an earlier date if the Secretary of the Treasury estimates that $300,000,000 will be credited to the Fund before January 1, 1992.

The Offshore Oil Pollution Compensation Fund (the "Offshore Pollution Fund") is established by Title 43 U.S.C. section 1812. The Offshore Pollution Fund is financed by a fee not to exceed 3 cents per barrel on oil obtained from the Outer Continental Shelf, which is imposed on the owner of the oil when it is produced, and by monies recovered by the Fund in actions against polluters. The Offshore Pollution Fund is available to pay for offshore (and adjoining shoreline) cleanups and for damages resulting from an oil spill where the owner or operator of a vessel or offshore facility is incapable of meeting its obligation. The 3-cent-per-barrel fee authorized by 43 U.S.C. section 1812 terminates when the amount in the Offshore Pollution Fund reaches $200,000,000.

Explanation of Proposal

An excise tax of 3 cents per barrel would be imposed on oil obtained from the Outer Continental Shelf (i.e., from offshore drilling) for the purpose of financing a Coastal Wetlands Trust Fund ("wetlands fund") to be used for the preservation and restoration of wetlands. In addition, an excise tax of 2 cents per thousand cubic feet would be imposed on natural gas obtained from the Outer Continental Shelf, also for the purpose of financing the wetlands fund. The excise taxes would be imposed on the owner of such oil or natural gas at the time it is produced.

Expenditures from the wetlands fund of receipts collected from excise taxes imposed on oil or natural gas obtained from the Outer Continental Shelf would be contingent upon the enactment of qualified authorizing legislation. The excise taxes provided for by this proposal would expire on December 31, 1994.

Effective Date

Imposition of the excise taxes provided for by the proposal would commence January 1, 1990.

7. Accelerate payment schedule for the gasoline excise tax

Present Law

Deposits of gasoline excise tax liability are made monthly or semi-monthly, depending on the amount of tax to be deposited.

Taxpayers must make monthly deposits of tax for any month in which they are liable for more than $100 of taxes, and the monthly deposits are due by the last day of the following month. Taxpayers liable for more than $2,000 of excise taxes for any month of a calendar quarter must make semi-monthly deposits in the following quarter 9 days after the end of a semi-monthly period which ends on the 15th or last day of a month. Taxpayers who deposit by electronic wire transfers to a government depositary have until 14 days after the end of a semi-monthly period to make the transfer.

Explanation of Proposal

Taxpayers which have more than $100 in any month of a calendar quarter of gasoline excise tax liability would make tax deposits four times in a month.

Nine day and 14 day depositors would make tax deposits at those same intervals after the end of the tax period, but there would be four tax periods in each month. The tax periods would end on the 7th, 14th, 21st, and last days of the month. Nine day taxpayers would deposit tax liabilities, with respect to the weekly tax periods on the 16th, 23rd, 30th days, respectively, of the same month and on the 9th day of the succeeding month. For the same tax periods, 14 day taxpayers would make their deposits on the 21st and 28th days, respectively, of the current month and on the 7th and 14th days of the succeeding month.

The table also sets forth the proposed payment schedules.

Days in tax period	9 day payers	14 day payers
1st - 7th	16th day current month	21st day current month
8th - 14th	23rd " " "	28th " " "
15th - 21st	30th " " "	7th " " "
22nd - last	9th " next "	14th " next "

Effective Date

The proposal would be effective on January 1, 1990.

8. Modify collection period for air passenger tax

Present Law

An 8 percent excise tax is imposed on the value of air passenger transportation. Revenues collected under this and other aviation taxes are deposited in the Airport and Airway Trust Fund. This tax is effective through December 31, 1990.

The air passenger tax is billed to the customer with the charge for air transportation and is considered to be collected from the customer during the second following semi-monthly period. The tax is collected by the air carrier (or its agent) which provides the transportation. The tax must be deposited in a Federal Reserve Bank or other authorized depositary within 3 banking days after the end of the semi-monthly period for which the tax is considered to be collected.

Explanation of Proposal

The air passenger tax collected during a semi-monthly period would be considered as collected during the first week of the second following semi-monthly period. It would be required that the tax be deposited within 3 banking days after the end of the week for which such tax is considered to be collected.

Effective Date

The proposal would be effective with respect to taxes considered collected for semi-monthly periods beginning after January 1, 1990.

F. Accounting Provisions

1. Repeal of the completed contract method of accounting for long-term contracts

Present Law

Taxpayers engaged in the production of property under a long-term contract generally must compute income from the contract under either the percentage of completion method or the percentage of completion-capitalized cost method. However, exceptions to these required accounting methods are provided for certain construction contracts of small businesses and certain home construction contracts.

Under the percentage of completion-capitalized cost method, a taxpayer generally must take into account 90 percent of the items under the contract under the percentage of completion method. The remaining 10 percent of the items under the contract must be taken into account under the taxpayer's normal method of accounting (e.g., the completed contract method of accounting). Exceptions to the 90/10 requirement are provided for certain ship construction contracts (40 percent under the percentage of completion method and 60 percent under the taxpayer's normal method of accounting) and certain residential construction contracts other than home construction contracts (70 percent under the percentage of completion method and 30 percent under the taxpayer's normal method of accounting).

Explanation of Proposal

The percentage of completion-capitalized cost method of accounting for long-term contracts would be repealed. The present-law special rules and exceptions for certain construction contracts of small businesses, qualified ship contracts, home construction contracts and residential construction contracts would be retained.

Effective Date

The proposal would apply to contracts entered into on or after July 11, 1989. However, the proposal would not apply to any contract entered into pursuant to a written bid or proposal submitted by a taxpayer to the other party to the contract before July 11, 1989, if the bid or proposal could not have been revoked or amended by the taxpayer at any time during the period after July 10, 1989, and ending on the date that the contract was entered into.

2. Treatment of amounts paid on account of the transfer of a franchise, trademark or trade name

Present Law

A taxpayer that purchases an intangible asset (such as a patent, know-how, or a contract right) is generally allowed a deduction for the purchase price over a period no shorter than the useful life of the asset. If the useful life is not determinable or is perpetual, no deduction is generally permitted. The useful life of an asset is a question of fact.

A taxpayer that leases an asset and pays continuing rents or royalties (*e.g.*, a recurring annual percentage of sales) is generally allowed a deduction as the rent or royalties are paid. If the lessee makes a payment of an initial fixed sum at the start of the lease, a deduction is generally allowed for the payment over the life of the lease. The life of a lease is a question of fact.

Section 1253(d) of the Code provides exceptions to these rules in the case of certain payments made on account of the transfer of a franchise, trademark or trade name. For example, in the case of a single payment made in discharge of a fixed-sum amount where the transferor is required to treat the payment as ordinary income rather than as capital gain, section 1253(d) provides that the payment is to be deducted ratably over a period of no more than 10 taxable years, regardless of the useful life of the franchise, trademark or trade name. In addition, section 1253(d) provides that any amount paid or incurred on account of the transfer of a franchise, trademark or trade name which is contingent on the productivity, use, or disposition of the asset transferred is allowed as an ordinary and necessary business expense deduction.

Explanation of Proposal

The special rules applicable to the deduction of fixed-sum payments and contingent payments that are made on account of the transfer of a franchise, trademark or trade name would be modified. First, the proposal would repeal the special treatment accorded fixed-sum payments where the total fixed-sum amount for any transaction exceeds $100,000. Second, contingent payments would not be allowed as a deduction for the taxable year in which paid or incurred unless (1) the payments are made at least annually throughout the period that the use of the franchise, trademark or trade name will occur, and (2) the payments are substantially equal in amount or payable pursuant to a fixed formula. Third, fixed-sum and contingent payments that are no longer deductible under the proposal would be chargeable to capital account and would be amortized over the actual useful of the franchise, trademark or trade name to the extent otherwise allowed under present law. Alternatively, a taxpayer would be allowed to elect to amortize over a 20-year period all fixed-sum payments and contingent payments (other than those deductible for the taxable year in which paid or incurred) that are part of the same transaction (or a series of related transactions).

The proposal would also repeal a provision of present law that prohibits a deduction for costs of acquiring trademarks and trade names and would provide that deductions for certain payments are to be recaptured on the disposition of the franchise, trademark or trade name.

Effective Date

The proposal would apply to transfers that occur after October 2, 1989, unless pursuant to a binding written contract in effect on that date and at all times thereafter until the transfer occurs.

G. Employment Tax Provisions

1. Income tax withholding on the wages of certain agricultural workers

Present Law

In general, wages paid by an employer to an employee are subject to income tax withholding. Wages paid for agricultural labor are, however, exempt from income tax withholding (sec. 3401(a)(2)).

Certain cash wages paid for agricultural labor are subject to withholding for Federal Insurance Contributions Act (FICA) taxes (sec. 3121(a)(8)). In general, agricultural workers are subject to FICA withholding if they earn at least $150 in annual cash remuneration or are covered because of the employer FICA withholding test. The employer FICA withholding test generally subjects employee wages to FICA withholding if the employer pays more than $2,500 during the year to all employees. Certain employees who are hand harvest laborers, are paid on a piece rate basis, commute daily to the farm from their permanent residence, and were employed in agriculture less than 13 weeks during the prior year, are exempt from FICA withholding.

Explanation of Proposal

If an agricultural worker's cash wages are subject to FICA withholding, the agricultural worker's cash wages also would be subject to income tax withholding. In addition, crew leader rules parallel to those utilized for FICA withholding purposes are to apply for income tax purposes (these rules specify who is the employer of certain agricultural workers).

Effective Date

The proposal would be effective for wages paid after December 31, 1989.

2. Payroll tax deposit speedup

Present Law

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 the eighth-monthly period.

Explanation of Proposal

Employers who are on the eighth-monthly system would be required 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 has an amount to be deposited equal to or greater than $250,000 (regardless of whether that day is the last day of an eighth-monthly period).

Effective Date

The proposal would be effective for amounts required to be deposited after July 31, 1990. A special rule would be effective for 1991 and 1992. For 1991 and 1992, amounts required to be deposited under this provision must be deposited by the close of the third banking day (instead of the next banking day). The Treasury Department is given authority to issue regulations for 1995 and succeeding years to provide for similar modifications to the date by which deposits must be made in order to minimize unevenness in the receipts effects of the provision.

H. Other Revenue-Raising Provisions

1. Tax pre-contribution gain on certain in-kind partnership distributions

Present Law

Under present law, income, gain, loss and deduction with respect to property contributed to a partnership by a partner is required to be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time when it was contributed (sec. 704(c)). If appreciated property that was contributed to a partnership is sold, the partnership's gain generally is required to be allocated to the contributing partner, to the extent that the partner has not theretofore recognized pre-contribution appreciation in the property.

Present law does not provide the same result in the case of a distribution (rather than sale) of the contributed property, however. In general, gain is recognized upon a distribution from a partnership only to the extent that cash is distributed in excess of the partner's basis in his partnership interest. Thus, under present law, the pre-contribution gain may not be recognized by the contributing partner if the contributed property is distributed to another partner instead of sold by the partnership.

Explanation of Proposal

In the case of a distribution of contributed property, the contributing partner would be treated as recognizing pre-contribution gain or loss. The amount of gain or loss recognized by the contributing partner would be the amount that he would have been required to take into account if the partnership had sold the property at its fair market value at the time of the distribution, to the extent he had not previously taken into account the pre-contribution gain or loss. Gain or loss recognition would not be required, however, to the extent property is distributed back to the partner or partners who contributed the property. In addition, gain or loss recognition would not be required when a distribution of contributed property (to a partner other than the contributor) is accompanied within six months by a distribution of section 1031 like-kind property to the contributing partner.

The legislative history would provide that a constructive termination of the partnership would not change the application of section 704(c) (as modified by the proposal) to pre-contribution gain or loss with respect to previously contributed property, and that a constructive termination would not cause gain or loss recognition under the proposal.

The provision would apply to distributions of contributed property within the three year period following the contribution of the property.

Effective Date

The provision would be effective for contributions of property to a partnership after July 10, 1989, in taxable years ending after such date.

2. Restrict basis shifting techniques between related parties in like-kind exchanges

Present Law

An exchange of property, like a sale, generally is a taxable transaction. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" which is to be held for productive use in a trade or business or for investment (sec. 1031).

If related parties engage in a like-kind exchange that qualifies for nonrecognition treatment under section 1031, a subsequent disposition of the property by the transferee generally will not affect the nonrecognition treatment of the original exchange. In contrast, present law prevents the use of related party sales to avoid current recognition of gain in the case of installment sales. Under section 453 (relating to the installment method of reporting gain), if an installment sale between related parties is followed by certain dispositions of the property by the transferee, the gain reportable by the original seller will be accelerated.

Explanation of Provision

If a taxpayer exchanges property with a related party (as defined for purposes of sec. 267) and the taxpayer would otherwise be eligible for nonrecognition treatment with respect to the exchange of such property under section 1031, and within two years of the date of the last transfer which was part of the exchange, either the related party disposes of such property or the taxpayer disposes of the like-kind property received in the exchange from the related party, then the original exchange would not qualify for nonrecognition under section 1031. Any gain or loss not recognized by the taxpayer as of the date of the original exchange would, subject to the loss limitation rules of section 267, be recognized as of the date of the subsequent disposition. A disposition of the property would not invalidate the nonrecognition treatment of the original exchange if such disposition is due to the death of either party or the involuntary conversion of the property, or if it is established to the satisfaction of the Secretary of the Treasury that neither the exchange nor the disposition had as one of its principal purposes the avoidance of Federal income tax. It is intended that the non-tax avoidance exception generally would apply to: (i) a transaction involving an exchange of undivided interests in different properties that results in each taxpayer holding the entire interest in a single property; and (ii) dispositions of property in nonrecognition transactions.

Nonrecognition would not be accorded to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of this provision. For example, if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within two years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party would not be entitled to nonrecognition treatment under section 1031.

The running of the two-year holding period would be suspended during any period with respect to which a party's risk of loss with respect to the property is substantially diminished.

Effective Date

The provision would apply to transfers after July 10, 1989, other than transfers pursuant to a written binding contract in effect on July 10, 1989 and at all times thereafter before the transfer. For this purpose, a written contract which, on July 10, 1989, and at all times thereafter before the transfer, obligates the taxpayer to transfer the property to another party would not fail to qualify as a binding contract solely because it provides in the alternative for an exchange or a sale, or solely because the property to be received in the exchange was not identified on or before July 10, 1989.