# EXPLANATION OF FINANCE COMMITTEE AMENDMENT TO S. 2238

## (TECHNICAL CORRECTIONS ACT OF 1988, AS REPORTED)

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Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION



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## INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Finance committee amendment to S. 2238 (Technical Corrections Act of 1988) as previously reported by the Senate Committee on Finance on August 3, 1988.[2] The Finance Committee amendment was approved on September 8, 1988.[3]

Part I describes additional technical corrections and modifications of previously adopted technicals. Part II describes revenue-increase provisions to close certain loopholes. Part III includes certain noncontroversial, low-cost provisions. Part IV describes extensions of expiring tax provisions and certain other substantive provisions. Part V describes other, nontax provisions in the Committee amendment.

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[1] This document may be cited as follows: Joint Committee on Taxation, Explanation of Finance Committee Amendent to S. 2238 (Technical Corrections Act of 1988, as Reported) (JCX-28-88), September 12, 1988.

[2] See S. Rept. 100-445.

[3] For estimated revenue effects of the Finance Committee amendment to S. 2238, see JCX-27-88, September 9, 1988.

## I. ADDITIONAL TECHNICAL CORRECTIONS AND MODIFICATIONS TO TECHNICAL CORRECTIONS

### Corporate Tax Provisions

1. Outbound liquidations. Provide that the technical correction relating to transfers of property to a foreign corporation that would otherwise qualify as a tax-free reorganization would apply only to transactions occurring after June 21, 1988, except that such technical correction would not apply to reorganizations for which a plan of reorganization had been adopted before June 22, 1988.

2. Mirror subsidiary transition rule. Clarify that, for purposes of the exception from the effective date provision concerning mirror subsidiary transactions in cases where 80 percent of the stock of the distributing corporation is acquired by the distributee, the ownership of distributees which are members of the same affiliated group may be aggregated in certain cases.

3. Section 384 and common control exception. Provide that if the gain corporation, the loss corporation or both were not in existence throughout the five year period, the exception will be applied by substituting the shorter of the periods during which the gain corporation, the loss corporation, or both were in existence.

4. Section 384 and treatment of affiliated corporations. Clarify in legislative history that not only post-affiliation gains or losses, but also pre-affiliation gains or losses which were not limited under section 384, are not subject to the limitations of section 384 upon the merger of members of the same affiliated group.

5. General Utilities repeal and reorganizations of RICs and REITs. Provide that the technical correction clarifying that the Treasury's regulatory authority to ensure that the purposes of General Utilities repeal is not circumvented through the use of REITs or RICs would not apply to any reorganization involving a RIC or REIT if by June 10, 1987: 1) the board of directors of one of the parties to the reorganization adopted a resolution to solicit shareholder approval for the transaction; or 2) the shareholders or the board of directors of one of the parties to the reorganization approved the transaction.

6. General Utilities repeal and reorganizations involving RICs and REITs. The Internal Revenue Service announced that it intends to issue regulations which would require, as of June 10, 1987, that a RIC or REIT disposing of built-in gain assets would not only have to pay a corporate-level tax on the built in gain but also distribute the proceeds in excess of the corporate-level tax to

shareholders. Provide legislative history indicating that the Committee expects the Internal Revenue Service to use its section 7805(b) authority to provide relief to adversely affected taxpayers.

7. Special rule relating to 1976 Act net operating loss limitations. Clarify that warrants would not be treated as stock under section 382 of the 1976 Act.

8. Real Estate Investment Trusts. The provision in the bill treating certain interest rate swap and cap agreements as giving rise to income qualifying under the 95 percent test and as securities under the 30 percent test would not be treated as creating a negative inference as to whether other interest rate swap and cap agreements should be similarly treated.

**Capital Cost Provisions**

1. Delete technical correction. Delete a provision in the technical corrections bill relating to the Riverwalk project in New York City.

2. Offset of investment tax credit refunds. Clarify that refunds payable under section 212 of the 1986 Act (providing for cash-out of investment tax credits) generally may not be offset by the IRS with the excise tax imposed by section 4971 for failure to meet minimum funding rules for qualified plans.

**Minimum Tax Provisions**

1. Incentive Stock Options. The bill clarifies that for all purposes of the individual minimum tax, stock acquired pursuant to the exercise of an incentive stock option will be treated as a nonqualified stock option. Provide that the provision in the bill applies only to options exercised after December 31, 1987 (as opposed to October 16, 1987).

**Accounting Provisions**

1. Taxable years of common trust funds. The amendment would clarify that the effective date rules applicable to entities required by the 1986 Act to adopt a calendar year would also apply to common trust funds for taxable years beginning after December 31, 1987.

**Financial Institutions**

1. Limitations on bad debt reserves. Delete the technical correction which provides that, in the case of a large bank, an election made by a member of a parent-subsidiary controlled group concerning the method of

recapturing an existing bad debt reserve is binding on all banks that are members of such parent-subsidiary controlled group for the taxable year of the election. Instead, the amendment provides that each such member of a parent-subsidiary controlled group may make a separate election concerning the method of recapturing its existing bad debt reserve.

**Insurance Provisions**

1. Property and Casualty Insurance Companies. Clarify that the rule of former section 825(g), eliminating loss carryovers of corporations electing to be taxed only on investment income, continues to apply. The provision is effective as if enacted with the Tax Reform Act of 1986.

**Pensions and Deferred Compensation**

1. Retirement bond distribution rules. Under the amendment, permissible rollovers from retirement bonds (sec. 409) could be delayed under rules similar to temporary Treasury rules delaying the application of the required distribution rules to IRAs. (Title XI of the 1986 Act)

2. Reporting of dependent care assistance. The bill modifies an employer's obligation to report dependent care assistance. Under the bill, the amount required to be reported for a year with respect to an employee is the amount such employee incurs for dependent care assistance during the year. Under the amendment, an employer may treat an amount electively contributed by an employee under a cafeteria plan for dependent care assistance for a year as an amount incurred for dependent care assistance by such employee for such year. (Revenue Act of 1987)

3. Treatment of plan spin-offs, transfers, etc. The bill provides that, in the case of plan spin-offs and similar transactions (within a controlled group) involving defined benefit plans, assets in excess of the benefits that would have been provided immediately before the transaction (if the plan then terminated) are allocated on a proportional basis. The amendment would provide two exceptions to this rule. First, if pursuant to the plan spin-off or similar transaction, one or more of the defined benefit plans is terminated, such plan or plans would be treated like a plan transferred outside the controlled group and thus would be exempt from the proportional allocation rule. Second, the proportional allocation rule would not apply to a plan that is spun off from a multiple employer plan if, after the spin-off, no employer (or member of the same controlled group) maintaining the multiple employer plan maintains the spun-off plan. (Revenue Act of 1987)

4. Variable rate premium. Under the bill, if the deductible contributions cannot be made to a plan for a plan year because of the full funding limitation, no additional PBGC premium would be required with respect to the plan in the following plan year. The amendment would limit this relief from the additional PBGC premium to situations in which no deductible contributions can be made because of the new 150 percent of current liability component of the full funding limitation. (Pension Protection Act)

5. ERISA, etc., amendments. Under the amendment, generally technical amendments to Titles I and IV of the Employee Retirement Income Security Act of 1974 (ERISA) or to the Public Health Service Act, as well as corresponding amendments to the Internal Revenue Code, and a correction of a date in a transition rule with respect to the effective date of the Multiemployer Pension Plan Amendments Act of 1980 would be deleted from the bill.

**Foreign Provisions**

1. Liquidation of possession corporation. Clarify the technical correction in the bill which treats gains derived from the liquidation of certain possession corporations as foreign source, so that the three-year testing period would be applied by reference to the year in which the liquidating distribution occurs, rather than the year in which the liquidation is deemed to occur.

2. Effective date of qualified electing fund election. Provides that, notwithstanding the normal deadline provided in the Code by which a passive foreign investment company must make a qualified electing fund election, the period for making the election will in no event expire before the date 60 days after the date of the enactment of the bill. This technical correction was in the introduced version of S. 2238 and was inadvertently ommitted from the committee-passed bill.

3. Retroactive qualified electing fund election. Provide regulatory authority to allow a passive foreign investment company (PFIC) to make a late qualified electing fund election where the foreign corporation reasonably believed, as of the normal due date for making the election with respect to an earlier taxable year, that it was not a PFIC in that year. This technical correction was in the introduced version of S. 2238 and was inadvertently ommitted from the committee-passed bill.

**Tax Exempt Bond Provisions**

1. Deletion of Technical Correction. The amendment would delete section 113(g)(3)(C) from the bill.

**Estate and Gift Taxes**

A. Estate Freezes

1. Qualified debt. The provision in the bill requiring that the fixed maturity date of qualified debt be within 15 years of the date of issue would be eliminated. In addition, the requirement that qualified debt not grant voting rights would be clarified so as to permit voting rights when there is a default as to payment of interest or principal.

2. Consideration. The provision directing that appropriate adjustments be made for the value of the retained interest would be clarified to provide for adjustments for consideration received by the transferor. In addition, the Secretary of the Treasury would be directed to study how such adjustments should best be made.

3. Exceptions. The bill would be amended to allow taxpayers to modify (prior to 1/1/90) their debt instruments, agreements, or other retained interests in order to fall within the statutory exceptions.

4. Right of contribution. The bill would be amended so that there would be no right of contribution against a charitable remainder trust for gift and estate tax attributable to the operation of the provision. In addition, there would be no right of contribution if a decedent lacking a will so directs in a provision of a trust which serves as a substitute for a will.

5. Deemed gift. The amount of a gift deemed by virtue of a later transfer by either the original transferor or transferee would be reduced by the value of the original transferor's right to recover such tax from the transferee. A subsequent failure to recover such tax would give rise to a gift even if recovery is impossible.

B. Generation Skipping Transfer Tax

1. Definition of executor. If there is no executor or administrator appointed, qualified and acting within the United States, then any person in actual or constructive possession of any property of the decedent would be treated as the executor for generation-skipping transfer tax purposes.

Compliance

1. Section 6323. Provide that State legislation merely conforming to or reenacting Federal law establishing a national filing system for instruments affecting interests in personal property does not constitute a second office

designated by the State for filing notices of Federal tax liens.

2. Section 6332. Extend the immunity from liability of a person honoring an IRS levy to apply not only with respect to the delinquent taxpayer but also any other person.

3. Section 6503. Conform the statute of limitations rule for levies to that for liens so that if a timely proceeding in court for the collection of tax is commenced, the period during which such tax may be collected by levy shall not expire as long as the tax is still collectible.

**Excise Taxes**

1. Aviation fuel used in international flights not subject to LUST tax. Under the Superfund Reauthorization and Amendments Act of 1986, aviation fuel used as supplies in an aircraft in foreign trade was exempt from the LUST tax. The provisions relating to the collection of the diesel fuel excise tax in the Revenue Act of 1987 inadvertently terminated this exemption. The amendment would restore this exemption.

**Miscellaneous Provisions**

1. Treatment of payments from certain mining reclamation programs. Section 118(q)(6) of the bill clarifies the present law exclusion from gross income, under section 126 of the Code, of certain payments received under environmental and conservation programs. The amendment would delete this provision.

2. Basis adjustment for market discount currently included in income. Taxpayers electing to include market discount currently in income would be allowed a basis adjustment for amounts so included.

## II. PROVISIONS THAT CLOSE LOOPHOLES

### A. Corporate Estimated Tax Speedup (Sec. 700)[1]

Under present law, corporations are required to make estimated tax payments four times a year. For small corporations, each installment is required to be based on an amount equal to the lesser of (1) 90 percent of the tax shown on the return or (2) 100 percent of the tax shown on the preceding year's return. For large corporations, each installment is required to be based on an amount equal to 90 percent of the tax shown on the return (except that the first payment may be based on 100 percent of the tax shown on the preceding year's return). For both large and small corporations, the amount of any payment is not required to exceed an amount which would be due if the total payments for the year up to the required payment equal 90 percent of the tax which would be due if the income already received during the current year were placed on an annual basis. Any reduction in a payment resulting from using this annualization rule must be made up in the subsequent payment if the corporation does not use the annualization rule for that subsequent payment. However, if the subsequent payment makes up at least 90 percent of the earlier shortfall, no penalty is imposed.

The provision would require a corporation that uses the annualization method for a prior payment to make up the entire shortfall (rather than 90 percent of the shortfall) in the subsequent payment in order to avoid an estimated tax penalty. This provision would change the provision relating to corporate estimated taxes included in S. 2238 as reported by the Finance Committee. The provision would be effective for estimated tax payments required to be made after September 30, 1988.

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[1] Sections refer to the committee amendment (e.g., additional, nontechnical tax provisions are in new title VII).

## B. Treatment of Single Premium and Other Investment-Oriented Life Insurance Contracts (Sec. 701)

Under present law, the undistributed investment income earned on premiums credited under a contract that satisfies a statutory definition of life insurance is not subject to current taxation to the owner of the contract. Death benefits under a life insurance contract are excluded from the gross income of the recipient. Amounts received under a life insurance contract prior to the death of the insured generally are not includible in gross income to the extent that the amounts received are less than the taxpayer's investment in the contract. Amounts borrowed under a life insurance contract generally are not treated as received under the contract and, consequently, are not includible in gross income.

The provision would modify the treatment of loans and other amounts received under a class of life insurance contracts that are statutorily defined as modified endowment contracts. First, amounts received under modified endowment contracts would be treated first as income and then as recovered basis. In addition, loans under modified endowment contracts and loans secured by modified endowment contracts would be treated as amounts received under the contract. An additional 10-percent income tax would be imposed on certain amounts received that are includible in gross income.

Under the provision, a modified endowment contract would be defined as any contract meeting the present-law definition of life insurance but failing to satisfy a 7-pay test. A modified endowment contract would also include any life insurance contract received in exchange for a modified endowment contract. A contract that is materially changed would be considered a new contract that is subject to the 7-pay test as of the date that the material change takes effect.

The provision would apply to contracts that are entered into or that are materially changed on or after June 21, 1988.

The provision is the same as the provision contained in H.R. 4333 as passed by the House with the following clarifications and modifications:

### 1. Distribution rules

a. The assignment or pledge of a modified endowment contract would not be treated as an amount received under the contract if the assignment or pledge is solely to cover the payment of burial expenses or prearranged funeral expenses and the policyholder does not receive cash directly or indirectly in connection with the assignment.

b. Any amount payable or borrowed under a modified endowment contract would not be included in gross income to the extent that the amount is retained by the insurance company as a premium or other consideration paid for the contract or as interest or principal paid on a loan under the contract.

c. For purposes of the distribution rules, the cash surrender value of a modified endowment contract would be reduced by the amount of any loan that is treated as received under the contract under the revised income inclusion rules. In addition, the investment in the contract and the cash surrender value of the contract would be increased by the amount of payments on a loan to the extent attributable to loans treated as received under the contract under the revised income inclusion rules.

d. A contract would be considered a modified endowment contract for (1) distributions that occur during the contract year that the contract fails (whether due to a death benefit reduction or otherwise) to satisfy the 7-pay test and all subsequent contract years, and (2) distributions that are made in anticipation of the contract failing to satisfy the 7-pay test as determined by the Treasury Department.

2. 7-pay test

a. The mortality charges taken into account in computing the 7-pay premiums would equal the mortality charges specified in the prevailing commissioners' standard table (as defined in sec. 807(d)(5)) at the time the contract is issued or materially changed (currently 1980 CSO) except to the extent provided otherwise by the Treasury Department (e.g., with respect to substandard risks).

b. In the case of a contract that provides an initial death benefit of $10,000 or less and that requires at least 20 nondecreasing annual premium payments, the amount of the 7-pay premium for each year would be increased by an expense charge of $75. All contracts issued by the same insurance company would be treated as a single contract for purposes of applying this rule.

c. Riders to contracts would be considered part of the base insurance contract for purposes of the 7-pay test.

d. The complete surrender of a life insurance contract during the first 7 years of the contract would not in itself cause the contract to be treated as a modified endowment contract.

e. The lapse of a contract resulting in paid-up insurance in a reduced amount due to the nonpayment of premiums would not be considered in applying the 7-pay test if the contract is reinstated to the original face amount within 180 days after the lapse.

f. The amount paid under a contract would be reduced by nontaxable distributions to which section 72(e) applies whether or not attributable to a reduction in the originally scheduled death benefit.

**3. Material change rules**

a. The rule that a death benefit increase must be required in order to satisfy the statutory definition of life insurance would be eliminated.

b. The definition of necessary premium for guideline premium contracts would be modified to allow aggregate premium payments equal to the greater of (1) the guideline single premium or (2) the sum of the guideline level premiums to date (without regard to the deemed cash value). For this purpose, the guideline single premium and the guideline level premiums would be based on the lowest death benefit payable during the first 7 contract years.

c. A decrease in future benefits under a contract would not be considered a material change.

d. Policyholder dividends would be considered other earnings that may increase the death benefit without triggering a material change.

e. The Treasury Department would be granted authority to provide circumstances under which a de minimis death benefit increase is not a material change (e.g., a death benefit increase that is attributable to a reasonable cost of living adjustment determined under an established index specified in the contract).

f. In the case of a contract that is materially changed, the new 7-pay premium would be adjusted to take into account only the cash surrender value of the contract as of the date of the material change.

**4. Effective date**

a. The provision would apply to contracts entered into on or after June 21, 1988. A contract would be considered entered into on or after June 21, 1988, if (1) on or after June 21, 1988, one or more of the future benefits under the contract are increased or a qualified additional benefit is increased or added to the contract and, prior to June 21, 1988, the owner of the contract did not have a unilateral right under the contract to obtain such increase or addition without providing additional evidence of insurability, or (2) the contract has been converted from a term life insurance contract into a life insurance contract providing coverage other than term insurance coverage after June 20, 1988, without regard to any right of the owner under the contract to obtain such conversion.

b. A modified endowment contract that is entered into on or after June 21, 1988, and before the date of enactment and that is exchanged (within 3 months after the date of enactment) for a life insurance contract that satisfies the 7-pay test would not be considered a modified endowment contract if gain (if any) is recognized on the exchange.

### C. Repeal of Special Rules Allowing Loss Transfers by Alaska Native Corporations (Sec. 702)

Corporations established under the Alaska Native Claims Settlement Act may, for taxable years beginning before 1992, file consolidated returns with subsidiary corporations under rules more liberal than the generally applicable rules. In addition, during this period no provision or principle of law may be applied to prevent use of losses or credits of an Alaska Native Corporation by its consolidated group. The effect of these provisions is to allow Alaska Native Corporations to transfer the benefit of their tax losses and credits to other corporations, which use the losses or credits to reduce their tax liability.

Under the provision, the special consolidation rules applicable to Alaska Native Corporations (including the rule prohibiting denial of the use of losses or credits through application of any provision or principle of law) would be repealed.

The provision would be effective for losses and credits arising after April 26, 1988. In addition, losses and credits of an Alaska Native Corporation arising before that date could not be used to offset income assigned (or attributable to property contributed) on or after that date, unless such use would be allowable without regard to the special consolidation rules.

In addition, if an Alaska Native Corporation has not engaged in any loss transfer transaction prior to April 26, 1988, up to $5 million of losses and credits of such Alaska Native Corporation arising on or before December 31, 1988, may be used to offset income assigned (or attributable to property contributed) on or before December 31, 1988. The intention is to provide a period during which Alaska Native Corporations that have never undertaken a loss transfer transaction under the special rules may do so, subject to a limitation on the amount of losses that may be transferred.

### D. Modification of Distilled Spirits Flavors Credit (Sec. 703)

Credit is allowed against the distilled spirits excise tax for the alcohol content of a taxable beverage that is derived from wine or from flavor components (sec. 5010). The wine credit is equal to the difference between the distilled spirits tax rate ($12.50 per proof gallon) and the tax rate applicable to wine (based on alcohol content). The flavors credit may not exceed 2.5 percent of the alcohol content of the beverage, and is equal to the amount of the distilled spirits tax. The provision would limit the flavors credit to cases where the flavors remain in the distilled spirits beverage after completion of all distillation. (No change would be made to the wine credit.)

The provision would be effective for distilled spirits removed after the date of enactment.

### E. Denial of Deduction for Certain Residential Telephone Service (Sec. 704)

Under the provision, any otherwise allowable deduction would not be allowed to an individual taxpayer for any charge (including any sales or excise taxes imposed on such charge) required to be paid by the taxpayer in order to obtain local telephone service with respect to the first telephone line in a taxpayer's residence (whether or not the taxpayer's principal residence). The provision would not affect the deductibility of charges for long-distance calls, nor would it affect the deductibility of charges for equipment rental, optional services offered by the telephone company (e.g., call waiting or call forwarding), or charges attributable to additional telephone lines to a taxpayer's residence other than the first telephone line.

The provision would be effective for taxable years beginning after December 31, 1988.

### F. Update IRS Valuation Tables (Sec. 705)

The IRS publishes tables that are used to value annuities, life estates, terms of years, remainders and reversions. Last published in 1984, these tables assume a 10 percent interest rate and are based on mortality assumptions published in 1969-71. On a monthly basis, the IRS publishes an applicable Federal rate, which is based on the average market yield of obligations of the United States.

The provision would require the value of any annuity, interest for life or term of years, remainder or reversionary interest to be determined under tables (or formulas) prescribed by the Secretary of the Treasury and by using an interest rate (rounded to the nearest 2/10ths of one percent) equal to 120 percent of the Federal mid-term rate in effect under section 1274(d)(1) for the month in which the valuation date falls. At the taxpayer's election, such property would be valued by reference to the Federal mid-term rate in effect for either of the two months preceding the valuation date.

The provision would apply to interests valued after the first date of the sixth calendar month beginning after the date of enactment.

## III. NONCONTROVERSIAL, LOW-COST PROVISIONS

### A. Corrections Affecting Agriculture

**1. Special use valuation of farm property for estate tax purposes (sec. 706)**

Under present law, if the executor so elects, the value of real property used as a farm or in another trade or business is its value in such use. A recapture tax is imposed if the property ceases to be used in its qualified use within 10 years (15 years for individuals dying before 1982) after the death of the person in whose estate the property was specially valued. Under the provision, a surviving spouse's cash rental of specially valued real property to a member of the spouse's family would not result in imposition of the recapture tax.

The provision would be effective for rentals occurring after December 31, 1976.

**2. Discharge of indebtedness income of rural mutual or cooperative utility companies (sec. 707)**

Under present law, a mutual or cooperative telephone, electric or water company qualifies for exemption from Federal income taxation if at least 85 percent of its gross income consists of amounts collected from members for the sole purpose of meeting losses and expenses of providing service to its members. Gross income of a taxpayer generally includes income from discharge of indebtedness (sec. 61(12)).
Under the provision, the 85-percent test of section 501(c)(12) is to be determined without regard to any discharge of indebtedness income arising pursuant sales of indebtedness under section 1001 of the Budget Reconciliation Act of 1986.

**3. Treatment of livestock sold on account of drought (sec. 708)**

Under present law, a cash method taxpayer whose principal trade or business is farming and who is forced to sell certain livestock due to drought conditions may elect to include any income from the sale of the livestock in the taxable year following the taxable year of the sale. This one-year elective deferral of income is available only if the livestock would not have been sold in the taxable year but for the drought and the drought conditions resulted in the area being designated as eligible for Federal assistance. The provision would extend the present-law provision to cattle, horses, and other livestock held for draft, breeding, dairy or sporting purposes.

The provision would apply to sales and exchanges occurring after December 31, 1987.

**4. Exemption from payroll tax for certain agricultural workers**

(sec. 709)

The provision would exclude wages paid to certain individuals who are paid less than $150 in annual cash wages by an agricultural employer. The provision would be effective as if included in the Omnibus Budget Reconciliation Act of 1987.

To be eligible for the FICA tax exclusion the individual must (1) be employed in agriculture, (2) be a hand harvest laborer, (3) be paid on a piece-rate basis, (4) be paid piece-rates in an operation which has been, and is customarily and generally recognized as having been paid on a piece-rate basis in the region of employment, (5) commutes daily from his permanent residence to the farm on which he is so employed, and (6) has been employed in agriculture less than 13 weeks during the preceding calendar year.

## B. Pensions and Employee Benefits

### 1. Employee benefit nondiscrimination rule modifications: church plans and cafeteria plans (sec. 710)

The Tax Reform Act of 1986 provided nondiscrimination rules applicable to statutory employee benefit plans maintained by any employer, including an employer that is a tax-exempt organization (sec. 89). The proposal would provide that the nondiscrimination requirements of section 89 do not apply to statutory employee benefit plans maintained by a church for church employees. For purposes of this proposal, the definition of a church would be the same definition that applies for purposes of exclusion from FICA taxes (sec. 3121(w)(3)). Thus, the term "church" would include (1) a convention or association of churches, (2) an elementary or secondary school that is controlled, operated, or principally supported by a church or by a convention or association of churches, and (3) any church-controlled tax-exempt organization that does not receive substantial support from governmental sources or sales of goods or services. The proposal would be effective as if included in the Tax Reform Act of 1986.

Under present law, life insurance that is funded prior to retirement under a cafeteria plan but provided after retirement is tested for discrimination when provided. Under the proposal, such life insurance would be tested for discrimination when it is funded, based on the amount of life insurance that could at that time be purchased (assuming section 79(c) table costs) with the cafeteria plan elective contributions. This proposal would be effective as if it were part of the provision added by the Tax Reform Act of 1986 allowing post-retirement life insurance to be funded under a cafeteria plan.

Under present law, available elective contributions under a cafeteria plan may not be taken into account for purposes of the 90-percent/50-percent test under section 89. The prior committee amendment allows an employer, under certain circumstances, to take into account all available elective contributions for this purpose. The requirement that an employer either take into account all available elective contributions or none of such contributions can create unintended difficulties in certain situations. Thus, under the proposal, an employer may establish a limit on the amount of available elective contributions taken into account with respect to each employee covered under a cafeteria plan. This is consistent with the original intent of the 90-percent/50-percent test, i.e., that it be focused on available nonelective contributions. This provision would be effective as if it were enacted as part of section 89 in the Tax Reform Act of 1986.

The bill provides that for purposes of applying the nondiscrimination rules of section 89, an employer generally may treat the contribution it makes to a multiemployer plan on behalf of an employee as the benefit provided to the employee under such multiemployer plan. Under the proposal, it would be clarified that an employer may value benefits provided under a multiemployer plan under the generally applicable valuation rules without regard to the special rule provided under the prior committee amendment. This provision would be effective as if it were enacted as part of section 89 in the Tax Reform Act of 1986.

The provision would clarify in legislative history that under present law the nondiscrimination tests that apply to dependent care assistance programs, other than the concentration test (sec. 129(d)(4)) and the benefits test (sec. 129(d)(8)), apply only to the availability of the program, not to the utilization of the program. This provision would be a clarification of present law retroactive to the addition of the relevant nondiscrimination tests.

**2. Modification of section 403(b) nondiscrimination rules (sec. 711)**

The Tax Reform Act of 1986 generally applied the qualified pension plan coverage and nondiscrimination rules to the nonelective and matching contributions or benefits of tax-sheltered annuity programs, generally effective for plan years beginning after December 31, 1988. The provision would modify these nondiscrimination rules in the following manner: (1) student employees who are not taken into account for employment tax purposes may be disregarded; (2) adjunct professors and other part-time employees could be disregarded if they normally work less than 20 hours per week; and (3) the nondiscrimination tests could be applied by testing at the level of the institution that maintains the plan, as long as the institution functions as, and has been historically recognized as, a separate employer. The provision also would clarify that the special rules applicable to multiple employer pension plans (sec. 413(c)) for purposes of determining whether certain rules are required to be satisfied on an employer-by-employer or on an aggregate basis are applicable to multiple employer tax-sheltered annuity programs. In addition, for plan years beginning before January 1, 1992, the nondiscrimination rules could be applied by testing with respect to a statistically valid sample of employees.

The provision would be effective as if included in the Tax Reform Act of 1986.

**3. Provide that plans of police or firefighters are tested separately for purposes of the minimum participation rule (sec. 712)**

Under present law, a pension plan is not a tax-qualified plan unless it benefits no fewer than the lesser of (1) 50 employees of the employer, or (2) 40 percent of all employees of the employer. Under the provision, a plan maintained by a governmental employer for police or firefighters, which is structured generally to take into account the early retirement ages of such employees, would satisfy the minimum participation rule if the plan satisfied the rule taking into account only the employees of the employer who are police or firefighters. Similarly, police or firefighters would not be taken into account in applying the minimum participation rule to coverage of employees of the employer who are not police or firefighters.

The provision would be effective as if included in the Tax Reform Act of 1986.

4. Gift tax treatment of joint and survivor annuities (sec. 713)

Under present law, a taxable gift occurs with respect to a joint and survivor annuity when the donor irrevocably designates a beneficiary. A gift of such an annuity to a spouse may not qualify for the marital deduction because the spouse's interest may terminate and pass to the donor without incurring transfer tax. Under the provision, the transfer to a spouse of an interest in a joint and survivor annuity in which no person other than a spouse has the right to receive any payments prior to the death of the last spouse to die would, unless otherwise elected, qualify for a marital deduction for Federal estate and gift tax purposes under the rules governing qualified terminable interest property.

The provision generally would be effective for decedents dying, and transfers made, after December 31, 1981.

**5. Allow rural telephone cooperatives to establish section 401(k) plans (sec. 714)**

Under present law, State and local governments and other tax-exempt organizations (other than rural electric cooperatives) may not maintain section 401(k) plans (cash or deferred arrangements). The provision would permit rural telephone cooperatives to maintain section 401(k) plans on the same basis as rural electric cooperatives, effective for years beginning after the date of enactment.

**6. Employee leasing safe harbor rule (sec. 715)**

Under present law, certain employees of a leasing organization are considered employees of the service recipient for purposes of certain pension and employee benefit rules. Under a safe harbor rule, a service recipient is not required to maintain records with respect to leased employees if, among other things, less than 5 percent of the recipient's workforce are leased employees (determined in a simplified manner). Under the provision, certain individuals would not be considered leased employees of a service recipient that would satisfy the 5-percent test if the percentage were raised from 5 percent to 10 percent. The exempted individuals would include any individual who (1) is credited with less than 3,000 hours of service for the service recipient over any two consecutive calendar years, and (2) did not perform services (as an employee or otherwise) for the service recipient within the same geographic area at any time within the calendar year immediately preceding the two-calendar-year period.

The provision would be effective as if included in the Tax Reform Act of 1986.

**7. Limitations on contributions and benefits under qualified pension plans maintained by public employers (sec. 716)**

Present law (sec. 415) provides overall limits on contributions and benefits under qualified pension plans maintained by any private or public employer or by related employers. Present law provides special rules applicable to a governmental pension plan and special rules applicable to benefits provided to police and firefighters. Under the provision, in the case of a plan maintained by a State or local government, the limitation on benefits under a defined benefit pension plan would be the greater of (1) the normal limit on benefits (sec. 415(b)) or (2) the accrued benefit of a participant determined without regard to any benefit increases adopted after October 14, 1987. The provision would only apply to individuals who are participants before January 1, 1990. In addition, to qualify for this special limitation, the employer maintaining the plan would be required to elect to satisfy the general requirements of section 415 without regard to the special rules for public plans (other than the special rules for police and firefighters). This election could be made indirectly through the modification of the plan maintained by governmental employers.

The provision would be effective with respect to years beginning after December 31, 1982, and the employer's election would be required by the close of the first plan year beginning after December 31, 1989.

**8. Treatment of church self-insured death benefit plans as life insurance (sec. 717)**

The definition of life insurance created as part of the Deficit Reduction Act of 1984 called into question the income tax exclusion for death benefits that some churches provide for their ministers and lay workers. Under the provision, the term life insurance generally includes certain church self-funded death benefit arrangements otherwise satisfying the definition of life insurance, even if the arrangements do not constitute life insurance under applicable State law.

The provision would be effective as if included in the Deficit Reduction Act of 1984.

**9. Study of effects of minimum participation rule (sec. 718)**

Under the Tax Reform Act of 1986, a qualified retirement plan must cover at least the lesser of (1) 50 employees, or (2) 40 percent of the employees of the employer (sec. 401(a)(26)). Federal law requires government contractors to provide certain employees specified retirement benefits or make a specified level of contributions to retirement plans. In some cases where these requirements apply, such as the construction industry, individuals change employers frequently. In order to provide the specified benefits and address the problem of frequent job changes, some employers have established a multiple employer plan covering the affected employees, while maintaining other qualified retirement plans for employees not subject to the Federal requirements. The provision would require the Treasury Department to perform a study of the effects of the new minimum participation rule on arrangements of this type. The study should consider (1) the Federal requirements with respect to employee benefits for employees of government contractors, (2) whether a special minimum participation rule should apply to multiple employer plans where such Federal requirements apply, and (3) ways in which the plans of employers subject to such requirements could be modified to satisfy the minimum participation rule.

The study would be required to be completed by September 1, 1989.

**10. Permit IRA acquisitions of State-issued coins (sec. 719)**

Under present law, the acquisition by an individual retirement account (IRA) of any collectible is treated as a distribution from the IRA equal to the cost of the collectible and is includible in the IRA owner's income for the year in which the cost is deemed distributed. Under the Tax Reform Act of 1986, coins issued by the United States government are not treated as collectibles.

Under the provision, coins issued under the laws of any State would not be treated as collectibles for purposes of the IRA prohibition on investments in collectibles, as long as the coins are held by a person independent of the IRA owner. The provision would be effective for State coins acquired by an IRA after the date of enactment.

**11. Age 70-1/2 required beginning date for qualified plan distributions (sec. 720)**

The Tax Reform Act of 1986 provides that distribution of benefits under all qualified plans (secs. 401(a) and 403(a)), individual retirement arrangements (IRAs), tax-sheltered annuities and custodial accounts (sec. 403(b)), and eligible deferred compensation plans of State and local governments and tax-exempt employers (sec. 457 plans) is required to commence by April 1 of the calendar year following the calendar year in which the participant or owner attains age 70-1/2, without regard to the actual date of separation from service. This required beginning date is effective with respect to years beginning after December 31, 1988, with a special effective date for collectively bargained plans. Prior to the Tax Reform Act of 1986, the required beginning date generally was the April 1 of the calendar year following the later of (1) the calendar year in which the participant or owner attains age 70 1/2, or, in the case of an employer-maintained plan (2) the calendar year in which the participant retires.

Under the provision, there would be a one-year delay in the general effective date of the required beginning date under the Tax Reform Act for distributions from plans maintained by State or local governments, or tax-exempt organizations that are described in section 501(c)(3).

12. Application of funding rules to multiple employer plans (sec. 721)

Under present law, the minimum funding requirement with respect to a multiple employer plan and the maximum permissible deductible contribution to a multiple employer plan are calculated at the plan level.

The provision would provide that, for purposes of calculating the required or permissible contribution to a pension plan pursuant to the minimum funding rules and the full funding limitation, each employer participating in a multiple employer pension plan is deemed to be maintaining a separate plan. The assets and liabilities of each such plan are deemed to be those that would be transferred to a successor plan if the employer were to withdraw from the multiple employer plan, determined in accordance with section 414(l) and the terms governing the multiple employer plan.

The provision would be effective on the date of enactment, with respect to plans established after December 31, 1988. In the case of a multiple employer plan established on or before December 31, 1988, the plan administrator is permitted to elect to have the new rule apply to the plan. The election is required to be made on or before the last day of the first plan year beginning after the date of enactment and applies to the plan year during which the election is made and all subsequent plan years. The election may be revoked only with the consent of the Secretary.

## 13. Liability for withdrawal from a multiemployer plan in the case of an illegal strike (sec. 722)

Under present law, an employer may be liable to a multiemployer plan for withdrawal liability even though the withdrawal was the result of action by employee representatives rather than by the employer.

Under the provision, the Pension Benefit Guaranty Corporation (PBGC) would be required to study whether withdrawal liability should be triggered by an illegal strike or other illegal bargaining by an employee representative. The report to Congress pursuant to the study would be required to be issued by March 1, 1989. This provision would be effective on the date of enactment.

In addition, under the provision, and notwithstanding any other provision of law, certain withdrawal liability that has not been paid as of September 8, 1988, or that arises after such date would not be payable prior to January 1, 1990. The affected withdrawal liability is liability related directly or indirectly to striking or picketing in violation of the National Labor Relations Act, as determined by the National Labor Relations Board.

## 14. Study of employment tax treatment of certain technical services personnel (sec. 723)

Under present law, in general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a common law test. Under this test, an employer-employee relationship generally exists if the person contracting for services has the right to control not only the result of the services, but also the means by which that result is accomplished. Section 530 of the Revenue Act of 1978 generally allows a taxpayer to treat a worker as not being an employee, regardless of the individual's actual status under the common law test, unless the taxpayer has no reasonable basis for such treatment. Section 1706 of the Tax Reform Act of 1986 provided that section 530 of the Revenue Act of 1978 does not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.

Under the provision, the Treasury Department would be required to conduct a study of section 1706 and report to the House Committee on Ways and Means and the Senate Committee on Finance by September 1, 1989. The study is to include evaluation of the following issues: (1) the difficulty of administration of the provisions of section 1706; (2) whether there are any abuses in the reporting of income by independent contractors that justify the adoption of section 1706 (including any evidence of greater noncompliance with the tax laws by independent contractors as compared to employees); (3) the effect that section 1706 has had on the ability of technical services personnel to get work; (4) the administrability of the present-law standards for determining whether an individual is an employee or an independent contractor; and (5) the equity of providing rules that distinguish between independent contractors who work through brokers and those who do not. The provision would be effective on the date of enactment.

## C. Exempt Organizations

### 1. Effective date for UBIT treatment of income from certain games of chance (sec. 724)

The Deficit Reduction Act of 1984 provided that the unrelated business income tax (UBIT) does not apply to income of a tax-exempt organization derived from conducting a game of chance in a State having a statute, in effect as of October 5, 1983, providing that only nonprofit organizations could conduct such activities; this provision applied to such income derived after June 30, 1981. However, the technical corrections title of the Tax Reform Act of 1986 specified that the only State law to which the 1984 Act provision was intended to apply was a particular North Dakota law. Accordingly, such income derived in other States that tax-exempt organizations had treated as not subject to UBIT pursuant to the 1984 Act was retroactively treated as taxable.

The provision would make the 1986 Act technical correction effective beginning October 22, 1986 (the date of enactment of the technical correction). As a result, the treatment of income derived by tax-exempt organizations from games of chance conducted prior to that date would be governed by the provision of the 1984 Act as originally enacted.

### 2. Purchasing of insurance by tax-exempt hospital service organizations (sec. 725)

Section 501(e) provides tax-exempt status for hospital service organizations operated solely to perform, on a centralized basis, one or more specifically enumerated services. The specifically enumerated services are: data processing, purchasing, warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel services.

The provision would clarify that purchasing by a hospital service organization includes the acquisition, on a group basis, of insurance (such as malpractice and general liability insurance) for its hospital members. The provision would apply to such purchases made before, on, or after the date of enactment.

### 3. Exempt charitable relief cargo from harbor maintenance tax (sec. 726)

Under present law, the harbor maintenance tax is 0.04 percent of the value of the commercial cargo loaded or unloaded at a U.S. port. Under the provision, there would be an exemption from the harbor maintenance tax for cargo donated for humanitarian and development assistance overseas, where such cargo is owned or financed by a non-profit organization or cooperative and where the Customs Service certifies that the cargo is, in fact, intended for donation overseas.

The provision would be effective on April 1, 1987 (the effective date of the tax).

**4. Exemption from BATF distilled spirits occupational tax for certain persons receiving spirits tax-free for research purposes (sec. 727)**

An annual occupational tax of $250 is imposed on persons dealing in specially denatured distilled spirits (and ethyl alcohol), including persons using these distilled spirits for research purposes. The provision would exempt from this occupational tax State and local government and section 501(c)(3) educational organizations that purchase 25 gallons or less of these spirits in the year for which tax otherwise would be due.

The provision would be effective on July 1, 1989.

**5. Treatment of certain payments to colleges for right to purchase athletic tickets (sec. 728)**

Pursuant to IRS guidelines, if a payment to or for a college (e.g., to the college's athletic scholarship program) entitles the payor to purchase seating at the college's athletic stadium, the payment is not deductible as a charitable contribution if such tickets would not have been readily available to the taxpayer without making the payment.

Under the provision, if a taxpayer makes a payment to or for a college that would be deductible as a charitable contribution but for the fact that the taxpayer thereby receives (directly or indirectly) the right to purchase seating in the college's athletic stadium, 80 percent of such payment would be treated as a charitable contribution, whether or not tickets would have been readily available to the taxpayer without making the payment. No amount paid for the actual purchase of tickets would be deductible as a charitable contribution; the provision would not apply if the taxpayer receives tickets or seating (rather than the right to purchase tickets) in return for the payment.

The provision would apply to amounts paid in taxable years beginning after December 31, 1983 (i.e., beginning with the year in which the original IRS ruling on this issue was published).

## D. Administrative Provisions

### 1. Definition of manufacturing for retail excise tax on trucks (sec. 729)

A 12-percent excise tax is imposed on the first retail sale or use after manufacture, production, or importation of any heavy truck, tractor, or trailer. Extensive repairs on a truck or trailer after it has been in use for several years can trigger the tax because the repairs are considered to have resulted in manufacture of a new vehicle.

The provision clarifies that the criteria, related to three categories of repair operations, presently employed by the Treasury to determine whether manufacture of a new truck has occurred is consistent with the intent of the statute. The committee, however, wishes to emphasize that in cases of the third category, i.e., repair or manufacture that extends the useful life of a vehicle, a higher ratio of repair costs to the full retail price of a comparable new truck should be applied. Thus, a ratio of 75 percent is to be used as a safe harbor, but the IRS is to administer the criterion with caution so that ordinary repairs to a two or three year old vehicle are not treated as having extended its useful life. On the other hand, the provisions of Code section 4051(b) are to apply in the case of a vehicle that has been repaired. In applying this section, the IRS is to aggregate the costs of nonemergency repairs, modifications, or upgrades to a vehicle over any 6-month period, and to use the total cost of such repairs in determining whether the 75 percent test is met.

### 2. Certain tolerances permitted in determination of wine excise tax (sec. 730)

An excise tax ranging from $0.17 cents per wine gallon to $3.40 per wine gallon is imposed on wine. The applicable rate depends on the alcohol content of the beverage. The provision would authorize the Treasury Department to prescribe de minimis tolerances for the amount of wine contained in commercial containers. If the amount of wine in a container was within these tolerances, tax would not be collected for any excess wine actually in the container. (An identical rule currently applies to the beer excise tax.)

The provision would be effective on January 1, 1989.

### 3. Gasoline wholesalers permitted to claim refunds on behalf of certain exempt users (sec. 731)

The gasoline excise tax is imposed on removal of gasoline blend stocks from the refinery or bonded pipeline terminal. Exemptions from the tax generally are realized by means of refunds (or credits against other taxes) following tax-paid sales. Refiners and terminal operators (as taxpayers) are allowed to claim the refunds on behalf of many exempt users.

The provision would allow wholesale distributors (defined as under the diesel fuel tax provisions) to claim gasoline tax refunds for exempt users on the same basis as refiners and terminal operators may do under present law.

The provision would be effective after September 30, 1988.

### 4. Election to treat passive foreign investment company (PFIC) stock as stock in a qualified electing fund (sec. 732)

A taxpayer's gain from the sale of stock in a passive foreign investment company (PFIC) and certain income received from a PFIC are generally treated as if earned over the period that the stock was held by the taxpayer. An interest charge is imposed on any deferred taxes: that is, taxes attributable to income that is treated as earned in previous years. Under present law, income and gains with respect to PFIC stock are not subject to deferred tax and interest rules if the PFIC has elected to be treated as a qualified electing fund and certain other requirements are met.

Under the provision, the election to be subject to the qualified electing fund rules would be made at the U.S. shareholder level, on a shareholder by shareholder basis, rather than at the company level. The shareholder election would be available, however, only where the PFIC complied with appropriate requirements (as prescribed by regulation) to determine the income of the company and other information necessary to carry out the PFIC provisions.

The provision would be effective for taxable years beginning after December 31, 1986.

### 5. Election by parent to claim unearned income of dependent on return (sec. 733)

Under present law, the unearned income of a child under the age of 14 in excess of a specified amount is taxed to the child at the top marginal rate of his or her parents. A dependent child with any unearned income must file a tax return if his or her total income exceeds $500. Under the provision, a parent generally would be permitted to elect to include certain unearned income of a child under the age of 14 on the parent's income tax return if the income of the child is less than $5,000 and consists entirely of specified types of unearned income (interest, dividends, and Alaska Permanent Fund dividends). The election could not be made if estimated tax payments for the taxable year are made in the child's name and social security number.

The provision would be effective for taxable years beginning after December 31, 1988.

**6. Change in due date of GAO trade study (sec. 734)**

Section 8008 of the Omnibus Trade Act of 1988 requires the General Accounting Office (GAO) to complete a study of four aspects of the Small Business Innovation Research Program by December 31, 1988. The provision would give the GAO six additional months, until July 1, 1989, to complete this study.

**7. Disclosure of return information to certain cities (sec. 735)**

Present law provides that the IRS can disclose otherwise confidential tax returns and return information to local tax administrators of any city with a population in excess of 2 million that imposes an income (or wage) tax. The provision would apply this provision to cities that impose an income (or wage) tax with populations in excess of 250,000. The provision would be effective on the date of enactment.

**8. Study of cigarette excise tax and effects of smoking on health care costs (sec. 736)**

Excise taxes are imposed on cigars, cigarettes, cigarette paper and tubes, and on snuff and chewing tobacco. The excise tax on small cigarettes is 16 cents per pack of 20 cigarettes. Most taxable cigarettes are small cigarettes.

The provision would require an ongoing study by the Secretary of the Treasury Department, after consulting with the Surgeon General, of:

(1) The public and private health care costs incurred (with respect to smokers, their spouses, and others) as a result of cigarette smoking in the United States;

(2) The incidence of cigarette smoking in the U.S. by teenage and younger children; and

(3) The impact of the rate of the cigarette excise tax on smoking by adults and by teenage and younger children.

Reports of the results of the study would be required to be submitted every two years to the House Committee on Ways and Means and the Senate Committee on Finance, with the first such report to be submitted by January 1, 1989.

## E. Tax-Exempt Bonds

### 1. Calculation of qualified mortgage bond purchase price limit for residences located on certain land subject to ground leases (sec. 737)

Residences financed with tax-exempt qualified mortgage bonds must have purchase prices of 90 percent or less of the average area purchase price, determined including the acquisition cost of land. The value of land held subject to a ground lease is determined by capitalizing the value of the lease payments, discounted by the yield on the underlying tax-exempt bonds.

The provision would direct the Treasury Department to amend its regulations to provide a method of determining a capitalized value for ground leases where the lease term has at least 35 years remaining and the rent is known for at least the first 10 years of the remaining term, but not the entire term.

The provision would be effective on the date of the bill's enactment, for bonds issued after the date of the bill's enactment.

### 2. Application of the security interest test to bond financing of hazardous waste clean-up funds

State and local governments may issue tax-exempt bonds to finance governmental activities, but may issue tax-exempt private activity bonds only for specified purposes. Several States are considering issuance of tax-exempt bonds to finance hazardous waste clean-up activities. Present law is unclear as to when these bonds are governmental bonds if the proceeds are used to finance activities on private property and if reimbursement may be sought from private parties. The provision would direct the Treasury Department to issue guidance concerning the application of the private activity bond test to tax-exempt bond financing for State programs. The guidance would be provided before January 1, 1989.

### 3. Calculation of income limits for qualified mortgage bond financed homes in high housing cost areas (sec. 738)

Purchasers of houses financed with tax-exempt qualified mortgage bonds must have incomes of 115 percent or less of the higher of area or State median income in statistical areas other than targeted areas of economic distress.

The provision would provide a third alternative for establishing the income limit in high housing cost areas. In these areas, this alternative would adjust the income limit upward from 115 percent of area median income by one percent for each percent that the ratio of local housing cost to income exceeds 120 percent of the same ratio determined nationally. The maximum adjusted income limit would be 140 percent of area median income.

The provision would apply to bonds issued after December 31, 1988.

**4. Tax-exempt financing for certain high-speed rail facilities (sec. 739)**

Exempt-facility bonds are tax-exempt bonds issued to finance airports, docks and wharves, mass commuting facilities, and sewage facilities among other facilities. With the exception of bonds for airports and docks and wharves, exempt-facility bonds are subject to State private activity volume limitations.

The provision would create a new category of exempt-facility bonds: bonds to finance intercity high-speed rail facilities. These bonds would receive treatment similar to that currently accorded to bonds issued for airports. The proceeds of such bonds could be used to finance the construction or purchase of terminal facilities, roadbed, rails or other fixed guideway, and any necessary right of way. The proceeds could not be used to purchase rolling stock or other facilities for which tax-exempt bonds are prohibited for airports, ports, and mass commuting facilities.

To qualify as a high-speed rail facility it would have to be reasonably expected that trains carrying passengers on the financed property will be able to operate at average speeds in excess of 150 miles per hour between scheduled stops. The provision defines a high-speed rail facility to include high-speed ground transportation systems which employ magnetic levitation technology. Twenty-five percent of the bonds issued must receive State private activity volume cap allocation. Also, high-speed rail facilities need not be governmentally owned, but any private owner would have to make an irrevocable election not to claim depreciation or any tax credit with respect to the bond financed property. In addition, any proceeds not spent within three years of the date of issue would have to be used to redeem outstanding bonds.

The provision would be effective for bonds issued after the date of the bill's enactment.

**5. Application of arbitrage rebate requirement to bona fide debt service funds (sec. 740)**

Issuers of tax-exempt bonds are required to rebate to the Federal Government arbitrage earnings on investments unrelated to the purpose of the borrowing. At the election of the issuer, no rebate is required with respect to arbitrage earnings on certain small current debt service funds (i.e., funds where gross earnings are less than $100,000).

The provision would eliminate the $100,000 earnings limit for fixed-rate governmental bonds having a weighted average maturity of five years or more. Additionally, the present-law elective provision for small current debt service funds would be made mandatory.

The provision would apply to bonds issued after the date of the bill's enactment. Issuers of outstanding governmental fixed rate bonds would be allowed a one-time election to apply the new rule in the provision to amounts deposited after the date of the bill's enactment in bona fide debt service funds issued after August 31, 1986.

## F. Miscellaneous Provisions

### 1. Net operating loss rules for bankruptcy: certain ownership changes not counted (sec. 741)

The net operating loss limitations of the 1986 Act do not apply to an ownership change resulting from certain bankruptcy reorganizations or proceedings if a petition in the case was filed with a court before August 14, 1986. When stock of a corporation is acquired during the pendency of a bankruptcy, an ownership change may occur and losses may be limited. Under the provision, under regulations to be prescribed by the Treasury, if any stock that was acquired by shareholders during the proceeding in a transaction that triggered an ownership change does not in fact represent more than 50 percent of the value of the corporation (based on the value of the stock immediately after the completion of the bankruptcy proceeding), an amended return could generally be filed with respect to prior years for which losses were limited (without regard to the otherwise applicable statute of limitations).

The provision would be effective as if included in the Tax Reform Act of 1986.

### 2. Reserves for losses on loans of banks: Exception for small banks (sec. 742)

Under present law, a large bank is not allowed a deduction for an addition to a reserve for bad debts. A bank is a large bank if for the taxable year, or any preceding taxable year beginning after December 31, 1986, the bank (or the parent-subsidiary controlled group of which it was a member) exceeds a certain size. The provision would provide that, if a bank which is a member of an affiliated group is sold to persons who did not, directly or indirectly, own any interest in any member of the affiliated group, the determination of whether a bank is a large bank for this purpose would be made without regard to the size of the bank before such sale.

The provision would be effective as if included in the Tax Reform Act of 1986.

### 3. Personal holding company income: Application to broker-dealers (sec. 743)

Under present law, personal holding company income of a broker-dealer includes interest income. The provision would exclude from the definition of personal holding company income interest received by broker-dealers with respect to: (1) any securities or money market instruments held as inventory; (2) margin accounts; or (3) any financing for a customer secured by securities or money market instruments.

The provision would be effective with respect to interest received after the date of enactment of the Act.

4. **Foreign currency transactions (sec. 744)**

Under present law, uniform residence-based sourcing and ordinary income and loss characterization rules apply to certain gains and losses on foreign currency-related forward contracts, futures contracts, options, and similar financial instruments, unless those instruments are marked to market under section 1256 at year-end. At the taxpayer's election, gain or loss on a forward, futures, or option which is a capital asset in the hands of the taxpayer, is not part of a straddle, and is identified by the taxpayer before the close of the day on which it is entered into, is capital, and not ordinary.

Under the provision, foreign currency gains and losses from transactions in forwards, futures, options, and similar financial instruments would be sourced on the basis of the taxpayer's residence, and unless the capital gain election were applicable, would be treated as ordinary income, without regard to whether the instruments are or would be marked to market under section 1256 if held at year end. The provision would relax the identification and anti-straddle conditions on making the capital gain election in the case of certain traders.

The provision would be effective for transactions acquired or entered into after September 8, 1988.

5. **Dual resident companies (sec. 745)**

Prior to the 1986 Act, certain U.S. corporations subject to income tax in a foreign country on their income without regard to its source or on a residence basis (so-called "dual resident companies") could consolidate with one set of affiliates in the United States and another set in a foreign country simultaneously. In these cases, a dual resident company with a net loss could use that loss to reduce the taxes on two separate streams of income.

The 1986 Act prevents the double use of losses that prior law allowed. Thus, a loss of a dual resident company may in some cases be used to reduce the taxes on income of other members of its foreign affiliated group, but not of its U.S. affiliated group. Under U.S. and U.K. law, however, there are cases in which the loss of a dual resident company with U.K. residence may not be used to offset the income of any other affiliate, U.S. or foreign. In order to restore the use of its losses in the United Kingdom, such a company must reorganize as a U.K. corporation. However, such a reorganization may be a taxable event if the U.S. parent of the dual resident company has an "excess loss account" with respect to the stock of the dual resident company. An excess loss account is created in the stock of a U.S. corporation when losses derived by, and distributions from, that U.S. corporation are in excess of its parent's basis in its stock.

Under the provision, a U.S. corporation with respect to whose stock there is an excess loss account which arose prior to January 1, 1988 and while the corporation was a dual resident company would be allowed to reorganize as a new foreign corporation without triggering the potential tax associated with the excess loss account. Instead, the excess loss account would be suspended until the stock in the new foreign corporation is disposed of outside of the affiliated group. In addition, rules would be provided so that the new foreign corporation's income is subject to full U.S. tax jurisdiction until the excess loss account is reduced to zero or is recaptured.

The provision would be effective for transactions occurring after date of enactment.

**6. Controlled foreign corporations: chain deficit rule (sec. 746)**

Under present law, deficits generated by a controlled foreign corporation cannot reduce the subpart F income of any other controlled foreign corporation. S. 2238 as reported by the committee contains a "chain deficit rule" under which deficits would be so usable in limited circumstances. This treatment would not be available for deficits attributable to categories of business activities the income from which is not subject to current tax under Subpart F, or for deficits from categories of business activities that are not carried on by the corporation whose subpart F income is sought to be reduced by the chain member's deficit. Insurance income is subject to current tax under subpart F unless it is attributable to the insurance of risks in the same country in which the corporation is organized. Under S. 2238, subpart F income of one controlled foreign corporation remains ineligible for reduction by insurance deficits of a related controlled foreign corporation if either corporation is not a "qualified insurance company."

Under the provision, a per-country election would be available to treat same-country insurance income as subpart F income eligible for reduction under the deficit rules of subpart F. The deficit rules of subpart F would be applied by characterizing certain investment income as if it were derived by a qualified insurance company. The provision would be effective as if included in the 1986 Act.

**7. Qualified possession source investment income (sec. 747)**

Under present law, a possession tax credit is available on qualified possession source investment income (QPSII) of certain electing domestic corporations engaged in a trade or business in Puerto Rico or the U.S. Virgin Islands. In order to be QPSII, investment income generally must be, among other things, attributable to investment in a possession where a trade or business is conducted, for use in that possession.

Under the 1986 Act, investments in certain financial intermediaries are treated as investments for use in Puerto Rico if the intermediary makes appropriate investments in qualified Caribbean Basin countries. Qualified Caribbean Basin countries are those "beneficiary countries" under the Caribbean Basin Economic Recovery Act that have entered into tax information exchange agreements with the United States and whose tax laws have not been found by the Treasury to discriminate against conventions held in the United States. The U.S. Virgin Islands do not constitute a beneficiary country under the Caribbean Basin Economic Recovery Act.

Under the provision, the U.S. Virgin Islands would be treated as a qualified Caribbean Basin country for purposes of determining whether investments in financial intermediaries give rise to QPSII. The provision would be effective for investments made after date of enactment.

**8. Treatment of foreign branch as controlled foreign corporation (sec. 748)**

Subject to exceptions, income earned by a U.S.-controlled foreign corporation is not taxed by the United States until that income is distributed to the U.S. persons owning the stock of the foreign corporation. Under present law, such deferral of current U.S. tax is not available for insurance income derived by U.S.-controlled foreign corporations, except in the case of underwriting income attributable to risks of property or activities in, or the lives or health of residents of, the country in which the controlled foreign corporation is organized.

Under the provision, a qualified insurance branch of a controlled foreign corporation would be treated as a separate corporation for purposes of applying the same-country exception to insurance income derived by controlled foreign corporations. Rules would be provided to treat remittances by the branch to its head office as a dividend for purposes of imposing current U.S. tax on the remitted earnings. The provision would be effective for taxable years of foreign corporations beginning after December 31, 1988.

**9. Banks organized in possessions (sec. 749)**

Under present law, certain non-Guamanian possession banks are subject to net-basis U.S. income tax and to branch level taxes with respect to interest from U.S. government obligations, regardless of whether such banks have an actual trade or business in the United States. By contrast, other foreign banks without U.S. trades or businesses are generally not subject to U.S. tax on interest from U.S. government obligations.

Under the provision, effective for taxable years beginning after December 31, 1988, possession banks would not be subject to net-basis U.S. tax on U.S. government interest they receive, and possession banks would not be subject to branch level taxes on earnings that arise from, and interest expense that is allocated against, interest income from U.S. obligations derived by those banks (unless those banks are engaged in a U.S. trade or business and the interest is actually effectively connected therewith).

10. Carryover of nonconventional fuels credit under minimum tax (sec. 750)

Under present law, the nonconventional fuels credit (sec. 29) may not reduce the taxpayer's net income tax to less than the amount of the minimum tax. Carryovers of unused credits are not allowed. Under the provision, the minimum tax credit allowable in future years against the regular tax will be increased by the amount of the nonconventional fuels credit not allowed for the taxable year solely by reason of the limitation based on the taxpayer's minimum tax liability.

The provision would apply to taxable years beginning after December 31, 1986.

11. **One-year extension of placed in service rule for nonconventional fuels production credit (sec. 751)**

Qualified fuels are eligible for the production credit for nonconventional fuels, if the fuel is produced from a well drilled after December 31, and before January 1, 1990, or produced from a facility placed in service after December 31, 1979, and before January 1, 1990.

The provision would be amended to extend eligibility for the production credit to qualified fuels that are produced from a facility placed in service or a well drilled before January 1, 1991.

12. **Exception from distilled spirits occupational tax for certain small plants producing exclusively for fuel uses (sec. 752)**

An annual occupational tax of $1,000 per premise is imposed on each proprietor of a distilled spirits plant. The tax is $500 per year for businesses with gross receipts of less than $500,000 in the preceding taxable year (taxable year is July 1-June 30 for the occupational tax).

The provision would exempt from the annual distilled spirits producer occupational tax plants which (1) produce distilled spirits exclusively for fuel use and (2) produce no more than 10,000 proof gallons per year.

The provision would be effective on July 1, 1989.

**13. Treatment of certain pledged installment obligations (sec. 753)**

Under present law, if any indebtedness is secured directly by an installment obligation that arises out of the sale of non-farm real property that is used in a taxpayer's trade or business or that is held for the production of rental income where the selling price of the real property exceeds $150,000 (a "nondealer real property installment obligation"), the net proceeds of the secured indebtedness are treated as a payment on the installment obligation. This rule generally applies to nondealer real property installment obligations that are pledged as security for a loan after December 17, 1987.

Under the provision, the refinancing of an indebtedness that was outstanding on December 17, 1987, and that was secured by a nondealer real property installment obligation on such date is to be treated as a continuation of the indebtedness and, consequently, will not result in a deemed payment with respect to the installment obligation if (1) the taxpayer is required by the creditor to refinance the loan, and (2) the refinancing is provided by a person other than the creditor or a person related to the creditor. This exception to the deemed payment rule would not apply to the extent that the principal amount of the indebtedness resulting from the refinancing exceeds the principal amount of the refinanced indebtedness immediately before the refinancing. In addition, if the term of the indebtedness resulting from the refinancing exceeds the term of the refinanced indebtedness, upon the expiration of the term of the refinanced indebtedness, the outstanding balance of the indebtedness resulting from the refinancing is to be treated as a deemed payment with respect to the installment obligation.

**14. Treatment of stock held in trust in determining whether certain corporations may use the cash method of accounting (sec. 754)**

Under present law, qualified personal service corporations are excepted from the general rule denying the use of the cash method of accounting to a C corporation or a partnership with a C corporation as a partner. A qualified personal service corporation is a corporation that satisfies both a function test and an ownership test. The ownership test is satisfied if substantially all (i.e., 95 percent or more) of the value of the outstanding stock is owned, directly or indirectly, by certain employees, certain retired employees, the estates of such employees or retired employees, and other persons who acquire stock in the corporation by reason of the death of such employees or retired employees.

The provision would require the Treasury Department to issue regulations that provide to what extent stock owned by non-grantor trusts is to be treated as indirectly owned by the beneficiaries of the trust for purposes of the ownership test.

The provision would be effective as if included in the Tax Reform Act of 1986.

15. Above-the-line deduction for jury pay that employee must surrender to employer (sec. 755)

Under present law, unreimbursed employee business expenses generally are allowed only as itemized deductions. Also, the total of all miscellaneous itemized deductions, including such unreimbursed employee business expenses, is deductible only to the extent exceeding two percent of the taxpayer's adjusted gross income. If an employer requires its employees to surrender to the employer amounts received as jury pay, in return for continuing the employee's normal salary while on jury service, the amount of surrendered jury pay is deductible only by itemizers, and only to the extent exceeding the two-percent floor.

The provision would provide an above-the-line deduction for jury pay surrendered to the employer as described above. Thus, the deduction would be available to both itemizers and nonitemizers, and would not be subject to the two-percent floor.

The provision would be effective for taxable years beginning after December 31, 1986 (the effective date of the 1986 Act provisions relating to employee business expenses).

**16. Minimum tax treatment of structured settlement arrangements (sec. 756)**

Under present law, the income earned on annuity contracts that are qualified funding assets under structured settlement arrangements is included in the adjusted current earnings of a corporation, under the corporate alternative minimum tax. Under the provision, an exclusion from the adjusted current earnings of a corporation would be provided for income on annuity contracts that are qualified funding assets (without regard to whether there is a qualified assignment).

The provision would be effective for taxable years beginning after December 31, 1989.

**17. Repeal of general creditor requirement for certain personal injury liability assignments (sec. 757)**

Under present law, an exclusion from gross income is provided for amounts received for agreeing to a qualified assignment to the extent that the amount received does not exceed the aggregate cost of any qualified funding asset. The terms of the liability assignment are required to satisfy certain qualifications, for the assignment to be a qualified assignment. The qualifications include, among others, the requirement that the assignee does not provide to the recipient of the periodic payments under the liability assignment any rights against the assignee which are greater than those of a general creditor.

Under the provision, a liability assignment is treated as a qualified assignment notwithstanding that the recipient is provided creditor's rights against the assignee greater than those of a general creditor. The provision provides that no amount is currently includible in the recipient's income solely because the recipient is provided creditor's rights that are greater than the rights of a general creditor.

The provision would be effective for liability assignments after the date of enactment.

18. Phase-in of property and casualty insurance company discounting rules for certain hospital insurers (sec. 758)

Present law limits the deduction for unpaid losses of property and casualty insurance companies to the amount of discounted unpaid losses. The amount of discounted unpaid losses is determined by applying a discount factor, which is calculated on a line of business basis by applying a historical loss payment pattern for the line of business and the applicable interest rate. The applicable interest rate is 100 percent of the average of the applicable Federal mid-term rates effective as of the beginning of each of the calendar months in the most recent 60-month period. The discounting rules are effective for taxable years beginning after December 31, 1986, with a fresh start transition rule.

The provision provides an elective phase-in of the discounting rules for taxable years beginning in 1987 and 1988 for qualified nonprofit hospital insurers. A qualified nonprofit hospital insurer is any domestic insurance company other than a life insurance company if, for the taxable year for which an election is in effect, (1) at least 75 percent of the value and voting power of the company is owned by nonprofit health care facilities or trade associations of such facilities, (2) a majority of the insurance or reinsurance provided by the company covers risks of nonprofit health care facilities, and (3) at least 75 percent of the insurance provided by the company is medical malpractice or general liability insurance.

Under the phase-in, the amount of the discounted unpaid losses of an electing company is to be increased by 20 percent of the amount of the discount for a taxable year beginning in 1987. For a taxable year beginning in 1988, the amount of the discounted unpaid losses of an electing company is to be increased by 10 percent of the amount of the discount. The fresh start and reserve strengthening provisions contained in the Tax Reform Act of 1986 apply for each taxable year of an electing company beginning in 1987, 1988, and 1989.

19. Cost of living allowances for judicial branch employees (sec. 759)

Under present law, civilian officers or employees of the U.S. government stationed outside the contiguous 48 states and the District of Columbia can exclude from gross income cost-of-living allowances received in accordance with regulations approved by the President. Cost-of-living allowances paid to federal court employees of the U.S. government (after October 12, 1987) are not received under regulations approved by the President and are not excludable from gross income.

Under the provision, judicial branch employees stationed outside the contiguous 48 states and the District of Columbia would exclude from gross income cost-of-living allowances received after October 12, 1987, if they were received either under regulations approved by the President or under certain other approved pay scales or salary plans.

20. Business use of automobiles by rural letter carriers (sec. 760)

An employee of the U.S. Postal Service could compute his or her deduction for business use of an automobile in performing services involving the collection and delivery of mail on a rural route by using, for all business use mileage, 150 percent of the standard mileage rate applicable to the first 15,000 miles of business use of an automobile that is not fully depreciated. However, this computation method could not be used if the taxpayer claimed depreciation deductions for the automobile for any taxable year beginning after December 31, 1987.

The provision would apply to taxable years beginning after December 31, 1987.

**21. Medical expense deduction for costs of service animals to assist handicapped individuals**

IRS rulings specifically provide that amounts paid to acquire, train, and maintain a dog for the purpose of assisting a blind or deaf taxpayer or dependent are eligible for the itemized deduction for medical expenses (Rev. Rul. 55-261, 1955-1 C.B. 307; Rev. Rul. 68-295, 1968-1 C.B. 92). The legislative history of the bill would clarify that under present law, similar costs incurred with respect to a dog or other service animal in order to assist individuals with other physical disabilities similarly would be eligible for the medical expense deduction.

**22. Retroactive application of IRS change of position relative to employer pickups of retirement contributions**

The 1983 Social Security Amendments provided that the payment by a State and local employer of employee contributions under a State or local retirement plan would be treated as wages subject to social security tax. The Deficit Reduction Action of 1984 modified this provision to allow the exclusion from wages for social security tax purposes of any such "pickups" by the employer of employee contributions unless the pickups were made pursuant to a salary reduction agreement. On the basis of this 1984 change in the legislation, some States undertook to implement pickups of this type after obtaining letter rulings from the Internal Revenue Service to the effect that the pickups would not be considered as wages. A subsequent review of the issue, in the light of statement of managers language in the conference report on the 1984 Act, led the Internal Revenue Service to reverse its position and to revoke the earlier letter rulings. In revoking the earlier letter rulings, the Service indicated that the States affected could apply for relief from liability for FICA taxes on the pickups with respect to the retroactive period prior to the issuance of the letter ruling.

The provision would relieve States from FICA liability for employer pickups subsequent to the effective date of the 1984 amendments to the extent that the State did not pay the FICA taxes in good faith reliance on a letter ruling of the Internal Revenue Service. The relief would apply only to pickups for which taxes were not paid and only for the period ending with the earlier of the date of enactment of this provision or the receipt by the State from the Internal Revenue Service of a notice of revocation of the letter ruling.

**23. Limitation on CBI ethanol imports**

Section 1910 of the Omnibus Trade Act of 1988 permits five companies to import 20 million gallons apiece of ethanol that does not meet the rules of origin of the Caribbean Basin Economic Recovery Act, as amended, in that the ethanol dehydrated in those plants is not fermented from vegetable matter grown in the region at plants located in the region.

The provision would bar the application of the provisions of the Trade Act after the enactment of this bill until the Secretaries of Agriculture, Energy, and the Treasury acting jointly certify that the domestic ethanol industry is not fully meeting domestic demand for ethyl alcohol and that imported ethanol is necessary to maintain adequate supplies for consumers.

## IV. EXTENSION OF EXPIRING TAX PROVISIONS AND OTHER SUBSTANTIVE PROVISIONS

### A. Taxpayer Bill of Rights (Secs. 763-785)[2]

(1) Disclosure of rights of taxpayers

Under present law, there is no statutory requirement that the IRS provide a written explanation of the rights of the taxpayer and the obligations of the IRS during the tax dispute resolution process. The provision would require the IRS, when it contacts a taxpayer concerning the determination or collection of any tax, to provide a written explanation of the rights of the taxpayer and the obligations of the IRS during the audit, appeals, refund, and collection processes. The IRS would be required to prepare the written explanation not later than 180 days after enactment.

(2) Procedures involving taxpayer interviews

Under present law, the IRS is required to select a reasonable time and place for an examination of a taxpayer (but no regulations have been promulgated elaborating on this provision), and there is no statutory provision governing audio recordings of IRS interviews. The provision would require the IRS to publish within one year of enactment regulations enumerating standards for determining whether the selection of a time and place for interviewing a taxpayer is reasonable. Prior to initial audit or collection interviews, IRS employees would be required to explain the audit or collection process and taxpayers' rights under that process. A taxpayer would be permitted, upon advance notice to the IRS, to make an audio recording of any in-person interview at the taxpayer's own expense. Taxpayers also would be permitted to be represented during an interview by any attorney, certified public accountant, enrolled agent, enrolled actuary, or any other person currently permitted to represent the taxpayer before the IRS. If a taxpayer clearly states during an interview that he or she wishes to consult with a representative, the interview would have to be suspended to afford the taxpayer a reasonable opportunity to consult with the representative. Absent an administrative summons, a taxpayer could not be required to accompany the representative to an interview. The provision would apply to interviews conducted on or after 30 days after enactment.

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[2] These provisions are modifications to S. 2223 as reported by the Finance Committee. The Finance Committee held markup sessions on the Taxpayer Bill of Rights (S. 2223) on March 18 and 21, 1988, and reported the bill on March 29, 1988 (S. Rept. 100-309).

(3) Taxpayers may rely on written advice of the IRS

Under present law, the IRS may abate administratively some penalties. The provision would require the IRS to abate any portion of any penalty that is attributable to erroneous written advice furnished by the IRS to a taxpayer, where such advice was specifically requested in writing by the taxpayer and reasonably relied upon, unless the taxpayer failed to provide adequate or accurate information when requesting the advice. The provision would be effective for advice requested on or after enactment.

(4) Taxpayer assistance orders

The Taxpayer Ombudsman administers the IRS Problem Resolution Program, which is designed to resolve a wide range of tax administration problems that are not remedied through normal operating procedures or administrative channels. The provision would provide the Taxpayer Ombudsman with statutory authority to issue a taxpayer assistance order (e.g., requiring release from levy of property of the taxpayer) if, in the determination of the Ombudsman, the taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the IRS is administering the internal revenue laws. The provision would be effective upon enactment.

(5) Office of Inspector General

The Treasury Department has a nonstatutory Inspector General with internal audit and investigative responsibilities for the Department, except for its four law enforcement agencies: IRS, Secret Service, Customs Service, and the Bureau of Alcohol, Tobacco, and Firearms. These functions are performed at the IRS by the Inspection Division, which reports directly to the IRS Commissioner. The provision would establish a statutory Inspector General within the IRS. It would in addition establish a separate statutory Inspector General within the Treasury Department (with oversight responsibility over all other agencies within the Department). The provision would be effective upon enactment. (The provision was passed by the Senate on February 2, 1988, as part of S. 908, The Inspector General Act Amendments of 1988. The House of Representatives passed a modified version of this legislation on July 26, 1988.)

(6) Basis for evaluation of IRS employees

The IRS Manual prohibits the use of production quotas or goals based upon sums collected to evaluate IRS enforcement officers, appeals officers, and reviewers. The provision would statutorily prohibit the IRS from using records of tax enforcement results to evaluate enforcement officers, appeals officers, and reviewers or to impose or suggest production quotas or goals. The provision would be effective for evaluations conducted on or after enactment.

(7) Procedures relating to IRS regulations

Under present law, the IRS publishes all regulations in the Federal Register. Before final regulations are promulgated, proposed regulations are issued and comments are invited from the public and Government agencies. The IRS also issues some regulations as temporary regulations, which generally are effective upon publication and remain in effect until replaced by final regulations. The provision would require the IRS to solicit comments from the Small Business Administration (SBA) after the publication of proposed regulations or before the promulgation of final regulations. The SBA would be allowed four weeks to provide its comments on the impact of the regulations on small businesses. Each time the IRS issued temporary regulations, it would be required to simultaneously issue those regulations in proposed form. Temporary regulations would be permitted to remain in effect for no more than two years after issuance. The provision would be effective for regulations issued after enactment.

(8) Explanation of tax liability and penalties

The IRS currently is not required to explain the basis for assessing penalties. The provision would require that all tax due notices or deficiency notices contain both a description of the basis for, and an identification of the amounts (if any) of, tax due, interest, and penalties. The provision would apply to mailings made after 180 days after enactment.

(9) Installment payment of tax liability

Under present law, the IRS is not required to enter into installment payment agreements with taxpayers, but generally does so if a taxpayer who is unable to pay the delinquency in full is able to make payments on the delinquent taxes and pay current taxes as they become due. The provision would grant the IRS statutory authority to enter into a written installment payment agreement if the IRS determines that an agreement will facilitate collection of tax owed. The IRS would have authority to modify or terminate an installment payment agreement if the IRS determines that the financial condition of the taxpayer has significantly changed and if notice is given to the taxpayer at least 30 days prior to the date of action. The provision would apply to installment agreements entered into after enactment.

(10) Assistant Commissioner for Taxpayer Services

There is currently within the IRS an Assistant Commissioner (Taxpayer Services and Returns Processing). This position is not provided by statute. The provision would establish an Assistant Commissioner for Taxpayer Services who, jointly with the Taxpayer Ombudsman, would be required to report annually to Congress concerning the quality of taxpayer services provided by the IRS. The provision would be effective upon enactment.

(11) Levy and distraint

Notice to taxpayers.--Present law provides that, at least 10 days before collecting a tax by levy, the IRS must provide the taxpayer written notice of its intent to levy. If the IRS finds that collection of tax is in jeopardy, it may collect the tax by levy without providing notice or waiting 10 days. The provision would extend the 10-day notice and waiting period to 30 days. As under present law, the notice and waiting period requirements would not apply if the collection of tax is in jeopardy.

Property subject to levy.--Property subject to levy includes any property belonging to the taxpayer, except property specifically excluded, which includes (1) fuel, provisions, furniture, and personal household effects, not exceeding $1,500 in aggregate value; and (2) books and tools necessary for the trade, business, or profession of the taxpayer, not exceeding $1,000 in aggregate value. The provision would index for inflation through 1990 the dollar value of both of these exclusions. The provision also would exempt from levy a taxpayer's principal residence and tangible personal property essential to the taxpayer's trade or business, unless an IRS district director or assistant director personally approves the levy in writing or the collection of tax is found to be in jeopardy. The provision also would prohibit levies in cases where the estimated expenses of levy and sale exceed the fair market value of the property.

Levy on wages.--Present law provides that the IRS may instruct the taxpayer's employer to pay directly to the IRS wages payable to the taxpayer, except (1) wages necessary to comply with a prior judgment of a court for support of minor children, and (2) a minimum amount of wages or other income (in general, $75 per week plus $25 per week for each dependent). The provision would increase the amount of wages exempt from levy for each week to an amount equal to the taxpayer's standard deduction and personal exemptions allowable for the taxable year in which the levy occurs, divided by 52.

Release of levy.--The IRS currently has authority to release a levy if it determines that this will facilitate the collection of tax. The provision would require the IRS to release a levy on property if (1) the liability for which the levy was made is satisfied, (2) the IRS determines that release will facilitate the collection of the liability, (3) an installment payment agreement has been executed with respect to such liability, (4) the IRS has determined that the levy is creating an economic hardship due to the taxpayer's financial condition, or (5) the fair market value of the property exceeds the liability and partial release would not hinder collection of the tax and related costs owed to the IRS. The provision would be effective for levies issued more than 90 days after enactment.

(12) Review of jeopardy levy and assessment procedures

Present law provides special rules relating to administrative review and judicial review (by Federal district courts) of jeopardy assessments. These rules do not apply to jeopardy levies. The provision would extend the existing rules relating to review of jeopardy assessments to review of jeopardy levies. The Tax Court would be provided jurisdiction concurrent with Federal district courts with respect to the challenges to a jeopardy assessment or jeopardy levy if the taxpayer has filed a petition with the Tax Court prior to the making of the assessment or levy with respect to any deficiency covered by the jeopardy assessment or jeopardy levy notice. The provision would apply to jeopardy levies issued and jeopardy assessments made after enactment.

(13) Administrative appeal of liens

Under present law, although a taxpayer can obtain a review within the IRS of an initial determination of tax deficiency, there is no statutory procedure for the administrative appeal of IRS decisions concerning the collection of a tax liability. The provision would require the IRS to promulgate regulations within 180 days after enactment that provide taxpayers with an administrative procedure to obtain review of the filing of a notice of lien in the public record and an opportunity to petition for the release of such lien.

(14) Awarding of costs and certain fees in administrative and civil actions

Recoverable costs.--Under present law, any person who is a prevailing party in a tax case in any Federal court may be awarded reasonable litigation costs if the position of the United States was not substantially justified, but costs incurred during the IRS administrative process generally are not recoverable. The provision would provide that any person who substantially prevails in any tax case brought by or against the United States may be awarded reasonable litigation costs incurred in connection with any court proceeding and reasonable administrative costs incurred before the IRS, but only if such administrative costs were incurred after the earlier of (1) the date of the first notice of proposed deficiency that allows the person an opportunity for administrative review in the IRS Office of Appeals, or (2) the date of the notice of deficiency described in section 6212 of the Code.

Burden of proof.--Under present law, in order to obtain reasonable litigation costs, the taxpayer must establish that the position of the United States in the case was not substantially justified. The provision would shift the burden of proof to the Government to establish that its position was substantially justified in order to prevent a prevailing taxpayer from recovering costs.

Position of the United States.--Under present law, in determining whether the position of the United States was substantially justified, the position is determined beginning with the position in the civil proceeding, or, if applicable, the position taken by the IRS district counsel administratively. This generally does not include positions taken in the audit or appeals process. The provision would provide that in determining whether the position of the United States was substantially justified, the position of the United States is any position taken after the later of (1) the date of the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the IRS Appeals Office, or (2) the date by which the relevant evidence under the control of the taxpayer, as well as relevant legal arguments, with respect to such action have been presented by the taxpayer to IRS examination or Service Center personnel.

Administrative settlement of claims for litigation costs.--The Code presently does not provide explicit authority to the IRS to settle administratively claims for litigation costs prior to the commencement of the civil action. The provision would provide the IRS with authority to settle claims for administrative costs and litigation costs. The provision would apply to actions commenced after enactment.

(15) Civil cause of action for damages due to failure to release lien

Under present law, the Code does not grant taxpayers a right to bring an action for damages resulting from the wrongful failure to remove a lien on a taxpayer's property. The provision would grant taxpayers the right to sue the Federal Government in Federal district court or Tax Court if any IRS employee knowingly or negligently fails to release a lien on the taxpayer's property as required under the Code. Taxpayers would be permitted to recover the costs of the action and damages equal to the greater of (1) the actual direct economic damages sustained by the taxpayer which, but for the actions of the IRS, would not have been sustained, or (2) $100 per day (up to $1000) for each day the failure continues during the period that begins ten days after the taxpayer provides written notice to the IRS of the failure to release the lien. The provision would apply to taxpayer notices provided and damages arising after enactment.

(16) Civil cause of action for damages due to unreasonable

<u>action by the IRS</u>

Under present law, taxpayers do not have a specific right to bring an action against the Government for damages sustained due to unlawful actions taken by an IRS employee. The provision would grant taxpayers the right to sue the Federal Government in Federal district court or Tax Court for damages if in connection with the determination or collection of any Federal tax, an officer or employee of the IRS carelessly, recklessly, or intentionally disregards any provision of Federal law or any regulation promulgated under the Internal Revenue Code. The taxpayer could recover the costs of the action plus actual direct economic damages sustained by the taxpayer as a proximate result of the unlawful actions or inaction of the IRS employee. The provision would apply to actions of IRS officers or employees that occur after enactment.

(17) <u>Jurisdiction to restrain certain premature assessments</u>

Under present law, jurisdiction to restrain IRS assessment and collection of tax rests solely with the Federal district courts. The provision grants the Tax Court jurisdiction (concurrent with Federal district courts) to restrain the assessment and collection of any tax by the IRS if the tax is the subject of a timely filed petition pending before the Tax Court. The provision would apply to orders entered after enactment.

(18) <u>Jurisdiction to enforce overpayment determinations</u>

Under present law, if the IRS fails to refund an overpayment determined by the Tax Court, the taxpayer must seek relief in another court. The provision would grant the Tax Court jurisdiction to order the refund of an overpayment plus interest if, within 120 days after a Tax Court decision has become final, the IRS fails to refund to a taxpayer an overpayment determined by the Tax Court. The provision would apply to overpayments determined by the Tax Court which have not been refunded by the 90th day after enactment.

(19) <u>Jurisdiction to review certain sales of seized property</u>

Under present law, if a taxpayer wishes to contest an IRS determination to sell property seized pursuant to a jeopardy assessment, the only recourse is to bring suit in Federal district court. The provision would grant the Tax Court jurisdiction during the pendency of proceedings before it to review the IRS' determination to sell property seized pursuant to a jeopardy assessment. The provision would be effective on the 90th day after enactment.

(20) <u>Jurisdiction to redetermine interest on deficiencies</u>

Under present law, if, following a decision by the Tax Court, a taxpayer disagrees with the IRS' interest computation, the Tax Court does not have jurisdiction to resolve that dispute. The provision would permit a taxpayer, within one year from the date the Tax Court decision becomes final, to move to reopen the Tax Court proceeding for a determination of interest due. The provision would apply to assessments of deficiencies made after enactment.

(21) Jurisdiction to modify decisions in certain estate tax cases

Under present law, certain estates which consist largely of an interest in a closely held business may elect to pay Federal estate tax over an extended-payment period. If such an election is made, the amount of the estate tax deduction for interest to which an estate is entitled cannot be determined until the interest is paid, and the Tax Court may not enter a final judgment in the case until the extended-payment period has expired. The provision would grant the Tax Court authority to enter a final decision in an estate tax case in which an extended-payment period is elected and subsequently, if necessary, modify the decision at the end of the extended-payment period to reflect interest actually paid by the estate. The provision would apply to Tax Court cases for which the decision is not final on the date of enactment.

(22) Refund jurisdiction for the Tax Court

Under present law, the Tax Court has no jurisdiction to determine whether a taxpayer has made an overpayment except in the context of a deficiency proceeding. If the IRS rejects a taxpayer's refund claim, or does not act within six months, then the taxpayer may bring an action for refund in Federal district court or the United States Claims Court, but not in the Tax Court. The provision would grant the Tax Court jurisdiction over tax refund actions against the IRS where there is already pending and awaiting submission for disposition by a judge a deficiency action in the Tax Court, and where the issue in the refund action is related by subject matter to the deficiency action or the result in either of the two actions will affect the amount in controversy in the related action. All proceedings in the Tax Court would be stayed for 180 days if a refund action is filed in the Tax Court and there is a showing by the IRS that there has been no audit of the taxpayer's return for the period or type of tax involved in the refund action. The general prerequisites governing the commencement of tax refund actions would apply to refund actions filed in the Tax Court. A taxpayer would continue to have the option of filing a claim for refund in the appropriate Federal district court or the United States Claims Court. The provision would apply to proceedings commenced in the Tax Court six months after enactment.

### B. Modification of Low-Income Housing Credit Provisions (Sec. 786)

In general, a building must be placed in service in the year in which a credit allocation is received from the applicable State housing agency. The provision permits the building to be placed in service in the year in which the credit allocation is received or in either of the two succeeding years provided that at least 10 percent of the project costs were paid by the end of the year in which the credit allocation was received. The provision defines project costs to include the total costs budgeted to acquire and develop the project. The provision applies only to credit allocations for new construction and substantial rehabilitations (as defined under current law). The provision is effective for all credit allocations made after December 31, 1987.

## C. Extend Mortgage Revenue Bonds Through June 30, 1989 (Sec. 787)

Qualified mortgage bonds (QMBs) are tax-exempt bonds the proceeds of which generally are used to make mortgage loans to first-time homebuyers. QMBs are issued subject to the State private activity volume limitations. As an alternative to QMBs, States and local governments may elect to trade bond authority available under the State's private activity volume limitation and issue mortgage credit certificates (MCCs). MCCs may be issued to the same persons who qualify for QMB financing. Authority to issue QMBs and to trade bond authority to issue MCCs expires after December 31, 1988. The provision would extend the QMB and MCC for six months, through June 30, 1989.

The provision would be effective on the date of the bill's enactment.

## D. Extension of Exclusion for Employer-Provided Educational Assistance Through 1988 (Sec. 788)

Under present law, an individual may (subject to the two-percent floor on nonreimbursed employee expenses) deduct from income amounts expended for education if the education is job-related (sec. 162). Education generally is job-related if it (1) maintains or improves skills required for the employee's job, or (2) meets the express requirements of the individual's employer that are imposed as a condition of continued employment in the same job. Job-related education expenses that are reimbursed by an individual's employer are excludable from gross income. Educational assistance provided by the employer that is not job-related is includible in income.

Under prior law (taxable years beginning before January 1, 1988), an employee's gross income for income and employment tax purposes did not include amounts paid or incurred by the employer for educational assistance provided to the employee (without regard to whether the education was job-related) if such amounts were paid or incurred pursuant to an educational assistance program that met certain requirements (sec. 127). This exclusion, which expired for taxable years beginning after December 31, 1987, was limited to $5,250 of educational assistance with respect to an individual during a calendar year and did not apply to education involving sports, games, or hobbies.

Under the provision, the exclusion under section 127 for educational assistance would be restored retroactively to the date of expiration and would be extended so that it would expire for taxable years beginning after December 31, 1988. However, the exclusion under section 127 would not apply to any payment for, or the provision of any benefits with respect to, any graduate level courses of a kind normally taken by an individual pursuing a program leading to a law, business, medical, or similar advanced academic or professional degree. For this purpose, the phrase "graduate-level course" means a course taken by an individual who (1) has received a bachelor's degree (or the equivalent thereof), or (2) is receiving credit toward a more advanced degree. This graduate education rule would not apply to graduate teaching or research assistants who receive tuition reduction under section 117(d), i.e., the scholarship rules. This graduate education rule also would not affect an employee's ability to exclude from income employer-provided job-related educational assistance.

In addition, the provision would clarify the definition of education ineligible for the section 127 exclusion--i.e., education involving sports, games, or hobbies. Under this clarification, education with respect to a subject commonly considered a sport, game, or hobby, such as photography or gardening, would be ineligible for the exclusion unless such education (1) has a reasonable relationship to an activity maintained by the employee for profit; (2) has a reasonable relationship to the business of the employer; or (3) is required as part of a degree program. Of course, education meeting these criteria may fail to be eligible for the exclusion for other reasons (such as the graduate education rule described above).

Also, it was unclear under prior law whether the prohibition on providing employees with a choice between nontaxable educational assistance benefits under section 127 and other remuneration includible in gross income prohibited the provision of taxable and nontaxable educational assistance benefits from a single trust. The provision would clarify in legislative history the prior-law rules so that it is permissible to pay taxable and nontaxable educational assistance benefits from the same trust.

The provision generally would be effective as of the date of the expiration of the exclusion. However, the provisions with respect to hobbies and payments from the same trust would be considered retroactive clarifications of prior law.

## E. Extension of Exclusion for Employer-Provided Group Legal Services Through 1988 (Sec. 789)

Under prior law, amounts contributed by an employer to a qualified group legal services plan for an employee (or the employee's spouse or dependents) were excluded from the employee's gross income for income and employment tax purposes (sec. 120). The exclusion also applied to any services received by an employee (or the employee's spouse or dependents) or any amounts paid to an employee under such a plan as reimbursement for the cost of legal services for the employee (or the employee's spouse or dependents). In order for the exclusion to apply, the group legal services plan was required to fulfill certain requirements. The exclusion for group legal services benefits expired for taxable years ending after December 31, 1987.

In addition, under prior law, an organization, the exclusive function of which was to provide legal services or indemnification against the cost of legal services as part of a qualified group legal services plan, was entitled to tax-exempt status (sec. 501(c)(20)). The tax exemption for such an organization expired for taxable years ending after December 31, 1987.

Under the provision, the exclusion for group legal services and the section 501(c)(20) exemption would be restored retroactively to the date of expiration and would be extended so that they would expire for taxable years ending after December 31, 1988. However, under the provision, the exclusion of the premium value of any insurance-type protection against legal expenses for any individual in a taxable year would be limited to $70. This limit would apply to the premium value of a plan (whether insured or self-insured) but not to the reimbursements or services provided under the plan.

In addition, under the provision, the provision under a tax-exempt trust of group legal services benefits that are in excess of the $70 limit and taxable solely for that reason would not cause the trust to lose its tax-exempt status.

Also, for taxable years ending before January 1, 1989, the provision under a cafeteria plan of a group legal services benefit that is taxable solely because of the $70 cap would be considered the provision of a qualified benefit (sec. 125(e)) and thus would not disqualify the cafeteria plan.

The provision would be effective as of the date of the expiration of the exclusion and exemption.

### F. Extension of Special Student Loan Bond Arbitage Rules through June 30, 1989 (Sec. 790)

Generally, arbitrage profits earned on nonpurpose investments acquired with the gross proceeds of any tax-exempt bond must be rebated to the United States. In addition, temporary periods when bond proceeds may be invested in higher yielding investments are statutorily limited for pooled financing bonds. The Tax Reform Act of 1986 provided an exemption from these requirements for certain qualified student loan bonds issued before January 1, 1989.

The provision would provide a 6-month extension of these special rules, for bonds issued before July 1, 1989. The provision would be effective on the date of the bill's enactment.

### G. Extension of Business Energy Tax Credits for Solar, Geothermal and Ocean Thermal Property Through June 30, 1989 (Sec. 791)

Under present law, three business energy tax credits are scheduled to expire after December 31, 1988:

(1) Business solar--10% credit
(2) Geothermal--10% credit
(3) Ocean thermal--15% credit.

These credits were extended in the Tax Reform Act of 1986 through 1988, with the tax credit rates effective in 1988 as shown above.

Under the provision, these credits would be extended through June 30, 1989, at the present (1988) tax credit rates. The extension of the present energy tax credit rates would become effective on January 1, 1989.

### H. Extension Of Modified Targeted Jobs Tax Credit Through June 30, 1989 (Sec. 792)

The present-law targeted jobs tax credit provides a tax credit to employers for hiring individuals from nine targeted groups. The credit is 85 percent of the first $3000 of wages paid to disadvantaged summer youth employees, and 40 percent of the first $6000 of wages paid to all other qualified individuals. The credit is available for individuals who begin work before January 1, 1989.

The provision would extend the credit for individuals who begin work before July 1, 1989. In addition, the provision would reduce the disadvantaged summer youth credit percentage from 85 percent to 40 percent.

The provision would be effective for individuals who begin work after December 31, 1988 and before July 1, 1989.

### I. Extension of Tax Credit for Research Expenditures (Sec. 793)

The present-law research credit (including the university basic research credit), which is scheduled to expire after December 31, 1988, would be extended for three additional months, i.e., through March 31, 1989. A pro rata rule would apply for purposes of computing the extended credit, pursuant to which the taxpayer's qualified research expenditures (or basic research payments) for January 1, 1989 through March 31, 1989 would be deemed equal to one-quarter of the taxpayer's qualified research expenditures (or basic research payments) for calendar year 1989.

### J. Financially Troubled Thrift Institutions: Reorganizations, NOLs, and FSLIC Assistance Payments (Sec. 794)

Under present law, three special rules enacted in the Economic Recovery Tax Act of 1981, and repealed as of December 31, 1988, by the Tax Reform Act of 1986, apply to financially troubled thrift institutions:

(1) Under section 597 of the Code, gross income of a domestic savings and loan association does not include amounts received from the Federal Savings and Loan Insurance Corporation ("FSLIC") under its financial assistance program, and no basis reduction is required on account of the receipt of such assistance payments;

(2) Under section 368(a)(3)(D) of the Code, certain FSLIC assisted acquisitions of financially troubled thrift institutions are permitted to qualify as tax-free reorganizations, without regard to the continuity of interest requirement; and

(3) Under section 382(l)(5)(F), special rules apply to the carryover of net operating losses, built-in losses, and excess credits of a thrift institution that has a certain ownership changes.

The provision would generally extend the special present law rules for financially troubled thrift institutions for six months, through June 30, 1989, and would expand these provisions to include financially troubled banks and payments made to such banks by the Federal Deposit Insurance Corporation ("FDIC").

In general, assistance payments made by FSLIC and FDIC would be tax exempt by reason of section 597. However, to the extent of 50 percent of such assistance payments, there would be a reduction in deductions for net operating losses existing at the time of the regulatory assistance, interest expense, and loan portfolio built-in losses.

In the case of taxable asset acquisitions, there will be no reduction in any deductions on account of any payments made to make up the difference between the fair market value of the assets transferred and the liabilities assumed. However, in all other cases involving FSLIC or FDIC assistance payments, including, for example, periodic maintenance payments and lump sum payments made in the context of a reorganization, there would be a reduction of the losses or the interest deduction equal to 50 percent of the assistance payments.

The provision would be effective as follows:

(1) The extension of section 368(a)(3)(D) would apply to acquisitions after December 31, 1988, and before July 1, 1989;

(2) The extension of section 597 and the 50 percent cutback would apply to assistance payments made pursuant to acquisitions occurring after December 31, 1988 and before July 1, 1989; and

(3) The extension of section 382(l)(5)(F) would apply to any equity structure shifts or transactions occurring after December 31, 1988, and before July 1, 1989.

## K. Repeal Uniform Capitalization Rules for Free-Lance Authors, Photographers, and Artists (Sec. 795(a))

Under present law, uniform capitalization rules generally apply to the production of all tangible personal property and to the purchase and holding of property for resale. The provision would exempt from the uniform capitalization rules any otherwise deductible expense that is paid or incurred by an individual engaged in the business of being a writer, photographer, or artist. The exemption would apply only to the individual whose personal efforts create or may reasonably be expected to create a literary manuscript, musical composition, dance score, photograph, photographic negative or transparency, picture, painting, sculpture, statue, etching, drawing, cartoon, graphic design, or original print edition. The exemption would also apply to expenses of a personal service corporation that directly relate to the activities of a qualified employee-owner if such expenses would qualify for the exemption had they been paid or incurred directly by the employee-owner.

The provision would be effective as if included in the Tax Reform Act of 1986.

## L. Repeal Uniform Capitalization Rules for Certain Producers of Animals; Depreciation of Certain Farm Property

### 1. Uniform capitalization rules for producers of animals (sec. 795(b))

Under present law, the uniform capitalization rules apply to the production of an animal in a farming business if (1) the animal has a preproductive period of more than two years or (2) the taxpayer engaged in the farming business is a corporation, partnership or tax shelter that is required to use an accrual method of accounting. The provision would exempt from the uniform capitalization rules otherwise deductible expenses that are incurred by a taxpayer in connection with the production of animals in any farming business other than a farming business of a corporation, partnership or tax shelter that is required to use an accrual method of accounting.

The provision would apply to costs incurred after December 31, 1988.

### 2. Depreciation of certain farm property (sec. 795(b))

Under present law, property with recovery periods of less than 15 years may be depreciated using the 200 percent declining balance method. A special rule for farming businesses subject to the capitalization rules on pre-productive expenses which elect to deduct these pre-productive expenses requires them to depreciate assets using the alternative depreciation system. Also, single-purpose agricultural structures are assigned a 7-year recovery period. The provision would make the 150-percent declining balance method the applicable depreciation method for property used in a farming business. The exception requiring farming businesses still subject to the pre-productive capitalization rules which elect to deduct these expenses to use the alternative depreciation system would still apply. In addition, the recovery period for single-purpose agricultural structures would be ten-and-one-half years.

The provision would generally apply to property placed in service after December 31, 1988. An exception is provided for any property placed in service before January 1, 1990 if such property (1) is constructed, reconstructed, or acquired by the taxpayer pursuant to a written contract that was binding on September 8, 1988, or (2) is constructed or reconstructed by the taxpayer and such construction or reconstruction began by July 14, 1988.

### M. Extension and Modification of Allocation and Apportionment Rules for R&D Expenses (Sec. 796)

The degree to which a U.S. taxpayer that pays foreign income taxes can take advantage of the foreign tax credit depends, in part, on the proportion of its entire worldwide taxable income that is from foreign sources. Expenses that may relate to both U.S. source and foreign source gross income (such as R&D expenses) must be allocated and apportioned among U.S. and foreign sources in order to arrive at the relevant proportion of foreign source taxable income to worldwide taxable income. For certain taxable years beginning before August 14, 1981 and for taxable years beginning after August 1, 1987, R&D expenses were and are allocated under detailed Treasury regulations promulgated for this purpose in 1977. The regulation is designed to allocate and apportion R&D expenses on the basis of their respective contributions to U.S source and foreign source net income.

For the intervening taxable years indicated above, R&D expenses were allocated and apportioned under statutory rules designed with particular emphasis on encouraging the conduct of R&D in the United States. This result was accomplished by enacting temporary rules that generally allocated more U.S. incurred R&D expenses to U.S. source gross income than would have been allocated under the 1977 regulation. The statutory methods thus tended to boost any taxpayer's proportion of foreign source taxable income to worldwide taxable income, in many cases allowing the foreign tax credit for foreign income taxes that otherwise would not have been creditable.

Under the provision, a new statutory allocation method, designed to provide an additional tax incentive to perform R&D in the United States, would be temporarily effective for the first four months of the taxpayer's first taxable year beginning after August 1, 1987. (In determining which R&D expenses were incurred in which four-month period of that taxable year, R&D expenses would be treated as if incurred ratably throughout the taxable year.) The proposed method would allow U.S. persons to allocate 64 percent of U.S. R&D expenses (other than any such amounts allocated to one geographical source because of legal requirements) to U.S. source income. Similarly, U.S. persons would allocate 64 percent of expenses for R&D conducted outside the United States (other than any such amount allocated to one geographical source because of legal requirements) to foreign source income. The remainder of U.S. and foreign R&D expenses would be allocated on the basis of gross sales or (subject to a limit) gross income. The amount of R&D expense allocated to foreign source income on the basis of gross income would in all cases be at least 30 percent of the amount allocated to foreign source income on the basis of gross sales.

## N. Controlled Foreign Insurance Corporations Owned by U.S. Persons (Sec. 797)

Under present law, foreign corporations engaged in the insurance business in the United States are subject to the branch level taxes even where those corporations are controlled by U.S. persons. If such corporations were reorganized as U.S. corporations they could avoid the branch tax, but would potentially be subject to a tax on accumulated earnings and profits. This tax results from the general rule that when a U.S.-controlled foreign corporation is reorganized as a U.S. corporation, certain accumulated earnings and profits of the foreign corporation must be taxed in order for the reorganization to be considered a nonrecognition event.

Under the provision, controlled foreign corporations engaged in the insurance business could make an election to be treated as a U.S. corporation, thereby avoiding the branch level taxes, so long as certain conditions and requirements are met. Dividends paid by an electing corporation would be eligible for the dividends received deduction to the extent paid out of earnings and profits for periods that the election is in effect. In lieu of paying an immediate U.S. tax on earnings and profits accumulated prior to the election, the provision would provide for a tax equal to three-quarters of one percent of capital and surplus (but limited to $1,500,000.) of any foreign corporation that elects to be treated as a U.S. corporation.

The provision would be effective for taxable years beginning after December 31, 1987.

### O. Elimination of Treasury Authority to Lengthen Depreciable Lives (Sec. 798)

Under present law, the Treasury Department generally has the authority to establish or change the class lives of depreciable assets. The Tax Reform Act of 1986 established an office in Treasury to monitor and analyze actual experience of tangible depreciable assets and to report its findings to the Secretary who can then prescribe new depreciable lives for these assets. Certain assets may not have their lives adjusted or lengthened before January 1, 1992.

The provision would remove Treasury's authority to lengthen the depreciable life of an asset. Treasury would still retain authority to shorten an asset's depreciable life. The Committee expects the Treasury to continue to undertake and expeditiously to complete studies of the actual experience of tangible depreciable assets. The provision would require the findings of these studies to be reported to Congress. The provision would be effective on the date of enactment.

### P. Pension Reversions of Qualified Plan Assets (Sec. 799)

Under present law, a 10-percent excise tax is imposed on an employer reversion from a qualified plan (sec. 4980). The provision would temporarily increase the excise tax from 10 percent to 60 percent. Present-law exceptions to the excise tax, such as the exception for certain transfers of reversions to an employee stock ownership plan, would continue to be exempt from the increased excise tax. In addition, the provision would require that the excise tax be paid by the employer by the end of the month following the month in which the reversion occurs.

The increase in the excise tax would apply with respect to reversions received after July 26, 1988, and before May 1, 1989. However, the increase in the excise tax would not apply to reversions pursuant to a plan termination if (1) with respect to plans subject to Title IV of ERISA, a notice of intent to terminate required under section 4041(b) of ERISA was provided to participants before July 27, 1988, or, if there are no participants, a notice of intent to terminate was provided to the PBGC before July 27, 1988, (2) with respect to plans subject to Title I of ERISA, a notice of intent to reduce future accruals required under section 204(h) of ERISA was provided to participants in connection with the termination before July 27, 1988, or (3) with respect to plans not subject to Title I or Title IV of ERISA, the board of directors of the employer approved the termination or the employer took similar binding action before July 27, 1988. The acceleration of time for payment of the tax would apply to reversions received on or after May 1, 1989.

## TITLE VIII -- MEDICARE AND MEDICAID MINOR AND TECHNICAL AMENDMENTS

### HOSPITAL PAYMENTS FOR CATASTROPHIC ILLNESS

(Section 801 of the Amendment)

Prior to the enactment of the Medicare Catastrophic Coverage Act of 1988, Medicare beneficiaries were eligible for a limited number of hospital days each year; charges for hospital days beyond the limits were the responsibility of the beneficiary. The catastrophic legislation makes beneficiaries eligible for 365 days of hospital care annually.

Medicare payments to most hospitals are made under the prospective payment systen (PPS), which pays hospitals a fixed amount for each case. Some hospitals (long-term care, childrens', rehabilitation and psychiatric) are exempt from PPS and are paid their costs, subject to target rate-of-increase limits created in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and can receive bonuses if their costs remain below the limits. Payments to both types of hospitals are based on the average costs of providing Medicare covered services during a base year, indexed forward. These costs did not include the costs of caring for patients beyond their available Medicare days.

Under the catastrophic legislation, hospitals will no longer be paid by patients for very long hospital stays, but by Medicare. However, Medicare's current rates do not accomodate the costs of newly available days. The catastrophic legislation requires the Secretary of HHS to make certain changes in Medicare hospital payment rules to reflect lower beneficiary payments to hospitals resulting from the elimination of a day limit on Medicare hospital services. These requirements are meant to ensure that hospitals are not adversely affected by the expansion of Medicare benefits.

For PPS hospitals, the Secretary is required to take into account as appropriate reduced beneficiary cost-sharing for hospital services under the Act in setting payment rules. For PPS-exempt (TEFRA) hospitals, the Secretary is required to adjust the cost limits for each hospital.

The amendment clarifies that adjustments in cost limits for TEFRA hospitals should be made beginning January 1, 1989. As drafted, the conference agreement compensates TEFRA hospitals during hospital fiscal years beginning on or after October 1, 1988; some hospitals would receive compensation before they incurred additional costs and others would receive no compensation for as long as nine months. The amendment also clarifies that TEFRA hospitals must be protected, not only from exceeding the cost limits as a result of catastrophic, but also from any reduction in bonus payments.

# TREATMENT OF CERTAIN HOSPITALS AS RURAL HOSPITALS FOR CERTAIN PURPOSES

(Section 802 of the Amendment)

Under the Prospective Payment system (PPS), Medicare pays different rates to urban and rural hospitals. A hospital is urban, and qualifies for higher rates, if it is located in a Metropolitan Statistical Area (MSA) as defined by the Office of Management and Budget. Under the Omnibus Budget Reconciliation Act of 1987, hospitals in rural counties meeting certain criteria are considered to be located in an adjacent urban area and qualify for higher Medicare rates, beginning October 1, 1988. Under OBRA, higher payments to hospitals in these redesignated counties are to be financed through an across-the-board payment reduction to rates for all urban hospitals.

The Department of Health and Human Services has issued proposed rules setting Medicare hospital payment policy for FY1989. As a result of the changes described above, some hospitals located in urban areas (prior to OBRA) to which new urban hospitals have been added, as well as some rural hospitals, will experience payment reductions (above and beyond the across-the-board adjustment described above) beginning October 1st, 1988.

This effect occurs in areas where the addition of new hospitals to an urban area, or the deletion of hospitals from a rural area, substantially changed the calculation of the area wage index used in computing PPS payments.

The amendment requires the Secretary, effective October 1, 1989, to compute the area wage index as though hospitals who qualify for urban status under OBRA's redesignation were still paid as rural hospitals.

## DEMONSTRATION PROJECTS WITH RESPECT TO CHRONIC VENTILATOR-DEPENDENT UNITS IN HOSPITALS (Section 803 of the Amendment)

The Medicare Catastrophic Coverage Act of 1988 requires the Secretary of HHS to conduct up to five demonstration projects, for up to three years each, of the appropriateness of classifying hospital units that treat chronic ventilator-dependent patients as rehabilitation units for the purposes of the prospective payment system (PPS). (Rehabilitation units are exempt from PPS and are reimbursed on a reasonable cost basis.)

The amendment clarifies that the Secretary is required to conduct at least five demonstration projects for at least three years each.

## ELECTION OF PERSONNEL POLICY FOR COMMISSION EMPLOYEES (Section 804 of the Amendment)

The Omnibus Budget Reconciliation Act of 1987 provided that employees of the Prospective Payment Assessment Commission (PROPAC) and the Physician Payment Review Commission (PHYSPRC) should be treated as Senate employees for administrative purposes.

The amendment clarifies that, with respect to PROPAC, this provision is effective only for employees hired on or after December 22, 1987. Personnel hired before this date would have the option to elect to continue under personnel policies in effect previously. All personnel would be required to make a one-time election no later than 60 days after enactment of this amendment.

Increase in Authorization for the Patient Outcome Assessment Research Program. (Section 805 of the Amendment)

The Omnibus Budget Reconciliation Act of 1986 authorized a program of research on patient outcomes of selected medical treatments and surgical procedures for the purpose of assessing their appropriateness, necessity, and effectiveness. The amounts authorized to be appropriated from the Medicare Trust Funds for the program are $6 million for fiscal year 1987, and $7.5 million for each of the fiscal years 1988 and 1989.

The amendment increases the authorization to $10 million for fiscal year 1989, and authorizes $20 million for fiscal year 1990 and $30 million for fiscal year 1991.

Payment Adjustments to Organizations With Risk-sharing Contracts. (Section 806 of the Amendment)

When Medicare contracts with a health maintenance organization (HMO) on a risk sharing basis, the amount of the Medicare payment to the HMO is determined prospectively, based on the estimated average cost of providing all covered Medicare services to a beneficiary in the area. Risk sharing contracts are annual contracts. During the calendar year 1988, the Secretary issued a guideline that changed the eligibility guidelines for extended care services. As a result of the change, more individuals were eligible for extended care services than had been anticipated at the time the payment levels for 1988 were established.

The amendment provides that any HMO that experiences increased costs in 1988 due to the change in the extended care benefit eligibility criteria, may submit to the Secretary a revised adjusted community rate for 1988. The Secretary shall review the revised rate within 90 days of submittal, and if he approves the revision he shall make additional payments to the HMO equal to the increase in the adjusted community rate.

While this amendment applies only to the change in the extended care criteria, the Committee urges the Secretary to take steps to modify the HMO contracting process and cycle to allow HMOs some relief in similar situations in the future. Because HMOs are locked into a pre-established rate, the Secretary must be sensitive to their special needs when actions are taken that may have an impact on the cost of providing Medicare services.

Fee Schedule for Payments to Certified Registered Anesthetists. (Section 807 of the Amendment)

Payment for the services of a certified registered nurse anesthetist (CRNA) are currently made under part A on a cost passthrough basis to hospitals who employ or contract with them, or under part B to physicians who employ or contract with them. The Omnibus Budget Reconciliation Act of 1986 provided for direct Medicare reimbursement for the services of a CRNA, beginning January 1, 1989. Payment would be made only under part B and would be equal to 80% of a fee schedule established by the Secretary. The Secretary was directed to establish the fee schedule at a level such that the total amount paid under the Medicare program for CRNA services, plus applicable coinsurance, would be the same as total payments under the Medicare program would have been under the reimbursement rules as in effect in 1986. The Secretary was further directed to reduce the fee schedule, or the payments to physicians for medical direction of CRNAs, or both, to the extent necessary to ensure that total Medicare payments plus applicable coinsurance for CRNA services and medical direction would be the same as total Medicare payments for those services would have been under the reimbursement rules as in effect in 1986.

The amendment clarifies that the comparison between payment levels under the fee schedule and the 1986 reimbursement rules for payment for medical direction and CRNA services should take coinsurance into account on both sides of the equation. Thus the second comparison described above would be between (A) total Medicare payments, plus applicable coinsurance, for CRNA services and medical direction under the 1986 rules, and (B) total Medicare payments for CRNA services and medical direction, plus applicable coinsurance, under the new 1989 rules.

Clarification of Covered Certified Nurse Midwife Services. (Section 808 of the Amendment)

Section 4073 of the Omnibus Budget Reconciliation Act of 1987 provided coverage under the Medicare program for services furnished by a certified nurse-midwife. Covered services are defined as services that are authorized under State law to be furnished by a certified nurse-midwife, and that would be covered by Medicare if furnished by a physician. The definition of a nurse-midwife refers to a nurse who "performs services in the area of management of the care of mothers and babies throughout the maternity cycle". The proposed regulations promulgated by the Health Care Financing Administration to implement this provision limit covered services to services furnished during the maternity cycle, although some State laws allow nurse-midwives to furnish other gynecological services that are not within the maternity cycle.

The amendment clarifies that the definition of who qualifies as a nurse-midwife does not limit the covered services to those furnished during the maternity cycle.

Coverage of Psychologist Services When Provided On-site at a Community Mental Health Center or Off-site as Part of a Treatment Plan. (Section 809 of the Amendment)

The Omnibus Budget Reconciliation Act of 1987 provided for direct payment under the Medicare program for the services of a psychologist furnished at a community mental health center.

The amendment clarifies that services of a psychologist will be covered under the OBRA 87 provision when provided on-site at the community mental health center, and when provided necessarily off-site under the auspices of the clinic as part of the treatment plan. Services provided by a psychologist at his private office away from the clinic would not be covered.

Trip Fees for Clinical Laboratories. (Section 810 of the Amendment)

Section 1833(h)(3) of the Social Security Act requires the Secretary to make special payments with respect to lab specimens that must be collected and brought to the lab. A fee is authorized under 1833(h)(3)(A) for the cost of collecting the specimen, and a trip fee is authorized under 1833(h)(3)(B) for travel expenses of trained personnel who must travel to collect a specimen. Trip fees are allowed only for specimens collected from a patient who is homebound or an inpatient in a nursing facility. Most carriers have established trip fees based on average costs, or on the number of miles, or a combination of the two methods.

The amendment requires that, in establishing trip fees, all carriers that use a flat fee per trip must also allow the lab the option to bill on the basis of actual mileage. Each carrier would have to implement this requirement in a budget neutral manner.

Requirement of Physician Care and Plan with Respect to Outpatient Physical Therapy Services Limited to the Provision of Such Sercices to Medicare Beneficiaries. (Section 811 of the Amendment)

Medicare covers outpatient physical and occupational therapy services provided by a provider of services, clinic, rehabilitation agency, or public health agency, and services by a physical or occupational therapist in his office or at the patient's home. The statute requires that the services be provided to individuals who are under the care of a physician, and that the physician establish and periodically review a plan for furnishing the services. The regulations implementing the provision require that the entity furnishing the services must meet the requirements relating to physician care and to the establishment and review of the plan of care by a physician for all its patients, not just for Medicare beneficiaries.

Some States have enacted physical therapy and occupational therapy practice laws that allow a therapist to provide services independently, without a physician referral. However, because the Medicare requirements apply to all patients, the State laws have been in effect superceded by the Medicare requirements.

The amendment clarifies that the requirements relating to physician care and establishment and review of the plan of care by a physician apply only to Medicare beneficiaries, and State law would apply to other patients.

Delay in Issuance of Final Regulations Concerning the Use of Voluntary Contributions or Provider-paid Taxes by States to Receive Federal Matching Funds. (Section 812 of the Amendment)

The Medicaid program is a Federal-State program under which federal matching funds are available to States for medical assistance programs that meet specified federal requirements. The federal matching rate varies by State based on State per capita income. Under current law, some States use donated funds to provide a portion of the State share, which are then matched by federal funds. Some States also use funds that are generated from taxes on health care providers to draw federal matching funds.

In the President's proposed budget for fiscal year 1989, the administration indicated that it would issue regulations to limit the use of donated funds as part of the State share. The regulations have not yet been published.

The amendment prohibits the Secretary from issuing final regulations that change the policy governing the use of donated funds or the use of revenues generated from provider taxes until after February 15, 1989. Proposed regulations could be published before that date.

Formula Modification for Determining State Expenditures Under the Medicaid Long-term Care Waiver Program. (Section 813 of the Amendment)

Section 1915(d) of the Social Security Act provides States an option to receive Medicaid funding for home and community-based services for the elderly, subject to limits based on long-term care expenditures (including nursing facility services) during a base year. The base year amount is updated to take into account growth in the elderly population and increases in the cost of services. However, the base year amount is not adjusted to take into account new mandated services or program expansions, such as the spousal impoverishment protections enacted in the Medicare Catastrophic Coverage Act of 1988.

The amendment provides that the base year amounts would be adjusted to take into account new services and program expansions mandated by Federal law.

Extension of Time Period for Certain Intermediate Care Facilities for the Mentally Retarded to Submit Plans of Correction or Reduction. (Section 814 of the Amendment)

Section 9516 of the Consolidated Omnibus Budget Reconciliation Act of 1985 allowed an intermediate care facility for the mentally retarded (ICF/MR) that was subject to a termination action under the Medicaid program to submit a 6-month plan of correction or 36-month plan of reduction as an alternative to decertification. The Department of Health and Human Services did not issue regulations implementing the section until January 25, 1988. The provision is scheduled to sunset on April 6, 1989, three years after the date of enactment of COBRA. The final regulations did not allow the use of the plan of correction or reduction in the case of a facility that was subject to decertification because of failure to provide active treatment.

The amendment provides that the option to submit a plan of correction or reduction would be available in any case where there was no immediate threat to the health or safety of the facility residents, including failure to provide active treatment. However, during a plan of reduction, active treatment would have to be provided for the residents who remain in the facility. The sunset date would be extended to January 25, 1991, three years after the final regulations were actually issued.

Nursing Facility Decertification Hearing Procedures.
(Section 815 of the Amendment)

Section 1910 of the Social Security Act provides that a nursing facility that is a party to a decertification proceeding based on a federal look-behind review may continue to participate in the Medicaid program while a hearing on the issue is pending. The Department of Health and Human Services has taken the position that evidence of compliance based on a later federal or State survey may not be admitted at such hearing. Thus a facility may be terminated on the basis of noncompliance that has subsequently been corrected.

The amendment provides that in a decertification proceeding, nursing facilities would be allowed to submit evidence of correction of deficiencies based on federal or State surveys conducted after the initial finding of noncompliance. This provision would not apply in the case of intermediate sanctions. While the amendment allows the results of a subsequent survey to be admitted as evidence, such evidence does not preclude a decertification finding. The ALJ would also take into account the facility's record of noncompliance and the extent and likely duration of the compliance exhibited in such subsequent survey.

**Charter for the National Academy of Social Insurance**
(Sections 901-916 of the Amendment)

The amendment authorizes the granting of a Federal charter for the National Academy of Social Insurance. The National Academy is a nonprofit, nonpartisan organization devoted to furthering knowledge and understanding of Social Security and related programs. The provision requires the Academy, as a condition of maintaining its charter, to meet various qualifications generally required of Federally chartered institutions such as maintaining its status as a nonprofit corporation and operating within the scope of the powers granted to it by its bylaws and articles of incorporation in the State or States in which it is incorporated. (The National Academy is incorporated in the District of Columbia.)

**Foster Care Independent Living Initiatives** (Section 921 of the Amendment)

The Consolidated Omnibus Budget Reconciliation Act of 1985 (P.L. 99-272) authorized funds for State independent living programs for fiscal year 1987 and fiscal year 1988. These programs are to provide services to help children age 16 or over in the AFDC foster care program make the transition from foster care to independence. Children eligible for services under the program are those who are receiving assistance under the Title IV-E foster care program (which provides Federal assistance for foster care maintenance payments). Title IV-E assistance is limited to those foster care children who would have been eligible for AFDC before they were removed from their home and placed in foster care.
The Secretary of Health and Human Services is required to provide Congress with a report on the program by July 1, 1988. The authorization level for this entitlement is $45 million for each of the two fiscal years. States did not begin receiving funds under the program until July 1987.

Under the amendment, the current authority for State independent living initiatives is extended for one year (through fiscal year 1989), with an authorization level of $45 million. The following additional changes are made:

1. States will be permitted to spend fiscal year 1987 carry-over funds in fiscal years 1988 and 1989.
2. States will be permitted to use funds under the foster care independent living program for services for two groups of children in addition to those authorized under current law (i.e., children who are receiving assistance under the Title IV-E foster care maintenance payment program): any or all children in foster care who are at least age 16; and, for up to 6 months after foster care payments or foster care ends, children previously in foster care and whose care or payments ended after the child attained age 16.
3. Independent living initiative funds may not be used for the provision of room and board.
4. The definition of case review system under Title IV-E is modified to clarify that the 18-month dispositional hearing also must include, with respect to a child who has reached age 16, the services needed to assist the child in making the transition from foster care to independent living.
5. State reports would be due on January 1, 1989, and a Federal report would be due on March 1, 1989.

The authority for States to include non-AFDC foster care children in the independent living program and the prohibition on the use of funds for room and board are effective on enactment. The remaining provisions take effect on October 1, 1988 contigent upon appropriation of funds.