[JOINT COMMITTEE PRINT]

TECHNICAL EXPLANATION OF THE TAX SIMPLIFICATION ACT OF 1993 (H.R. 13)

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the "Tax Simplification Act of 1993" (H.R. 13). H.R. 13 was introduced by Ways and Means Committee Chairman Rostenkowski on January 5, 1993.

The Tax Simplification Act of 1993 includes nine titles:

Title I—Individual Tax Provisions;
Title II—Pension Simplification;
Title III—Treatment of Large Partnerships;
Title IV—Foreign Provisions;
Title V—Treatment of Intangibles;
Title VI—Other Income Tax Provisions;
Title VII—Estate and Gift Tax Provisions;
Title VIII—Excise Tax Simplification; and
Title IX—Administrative Provisions.

Most of the provisions of H.R. 13 were included in Title IV of the Conference Agreement on H.R. 11 ("Revenue Act of 1992," 102nd Cong.), as passed by the House and the Senate but vetoed by President Bush.

[1] This pamphlet may be cited as follows: *Technical Explanation of the Tax Simplification Act of 1993 (H.R. 13)* (JCS-1-93), January 8, 1993.

TECHNICAL EXPLANATION OF THE BILL

(TAX SIMPLIFICATION ACT OF 1993)

TITLE I. PROVISIONS RELATING TO INDIVIDUALS

1. Simplification of earned income tax credit (sec. 101 of the bill and sec. 32 of the Code)

Present Law

Eligible low-income workers are able to claim a refundable earned income tax credit (EITC) of up to 18.5 percent of the first $7,750 of earned income for 1993 (19.5 percent for taxpayers with more than one qualifying child). The maximum amount of credit for 1993 is $1,434 ($1,511 for taxpayers with more than one qualifying child). This maximum credit is reduced by 13.21 percent of earned income (or adjusted gross income, if greater) in excess of $12,200 (13.93 percent for taxpayers with more than one qualifying child). The EITC is totally phased out for workers with earned income (or adjusted gross income, if greater) over $23,050. The maximum amount of earned income on which the EITC may be claimed and the income threshold for the phaseout of the EITC are indexed for inflation. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

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

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

A supplemental young child credit is available to taxpayers with qualifying children under the age of one year. This young child credit rate is 5 percent and the phase-out rate is 3.57 percent. It is computed on the same income base as the basic EITC. The maximum supplemental young child credit for 1993 is $388. If a taxpayer claims the supplemental young child credit, the child that qualifies the taxpayer for such credit is not a qualifying individual for purposes of the dependent care tax credit (sec. 21).

A supplemental health insurance credit is available to taxpayers who provide health insurance coverage for their qualifying children. This health insurance credit rate is 6 percent and the phase-

out rate is 4.285 percent. It is computed on the same income base as the basic EITC, with the limitation that the credit claimed cannot exceed the out-of-pocket cost of the health insurance coverage. In addition, the taxpayer is denied an itemized deduction for medical expenses of qualifying insurance coverage up to the amount of credit claimed. The maximum supplemental health insurance credit for 1993 is $466.

Reasons for Simplification

The supplemental young child credit and supplemental health insurance credit components of the EITC complicate the tax filing and compliance process for lower-income taxpayers. Moreover, rules to prevent taxpayers who claim these supplemental credits from receiving a double tax benefit for the same expenses are complex. (For example, a taxpayer cannot claim both the supplemental young child credit and the dependent care tax credit for expenses relating to the same child.) These rules often cause taxpayers to compute the tax benefits for several alternatives to determine which is most beneficial before they file their return. The compliance burden on taxpayers of these additional computations may be substantial. The elimination of the need to perform these additional computations will simplify the EITC.

Providing a higher basic EITC credit rate for taxpayers with two or more qualifying children recognizes the equity of providing larger tax benefits to those with a lesser ability to pay taxes. A larger gap between the two basic credit rates than currently exists is appropriate in light of the larger financial resources required to maintain larger families.

Explanation of Provision

The bill repeals the supplemental young child credit and the supplemental health insurance credit and increases the basic EITC rate for taxpayers with two or more qualifying children as shown in the following table.

Year	One qualifying child—		Two or more qualifying children—	
	Credit rate	Phaseout rate	Credit rate	Phaseout rate
1993	18.5	13.21	23.3	16.64
1994 and after	23.0	16.43	28.8	20.58

Effective Date

The provision is effective for taxable years beginning after December 31, 1992.

2. Rollover of gain on sale of a principal residence (secs. 111–112 of the bill and sec. 1034 of the Code)

Present Law

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

In general, nonrecognition treatment is available only once during any two-year period. In addition, if the taxpayer purchases more than one residence during the replacement period and such residences are each used as the taxpayer's principal residence within two years after the date of sale of the old residence, only the last residence so used is treated as the replacement residence.

Special rules apply, however, if residences are sold in order to relocate for employment reasons. First, the number of times nonrecognition treatment is available during a two-year period is not limited. Second, if a residence is sold within two years after the sale of the old residence, the residence sold is treated as the last residence used by the taxpayer and thus as the only replacement residence.

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

Reasons for Simplification

It is believed that the rollover provision governing the sale of a principal residence is unnecessarily complex, in part due to the different set of rules that applies depending on whether the sale is work-related. The bill simplifies the rollover provision by applying only one set of rules to the sale of a principal residence regardless of whether the sale is work-related.

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

Explanation of Provisions

Multiple rollovers

Under the bill, gain is rolled over from one residence to another residence in the order the residences are purchased and used, regardless of the taxpayer's reasons for the sale of the old residence. In addition, gain may be rolled over more than once within a two-

year period. Thus, the rules that formerly applied only if a taxpayer sold his residence in order to relocate for employment purposes will apply in all cases. As under present law, the basis of each succeeding residence is reduced by the amount of gain not recognized on the sale of the prior residence.

Rollovers in the case of divorce or separation

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

Effective Date

The provisions apply to sales of old residences (within the meaning of sec. 1034) after the date of enactment.

3. De minimis exception to passive loss rules (sec. 121 of the bill and sec. 469 of the Code)

Present Law

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

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

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

Reasons for Simplification

A taxpayer who has a very small amount of passive losses that are disallowed for the year is required to carry forward the disallowed losses to the next year. In the case of certain small amounts of passive losses that cannot otherwise be deducted in the current

taxable year, the bill permits the deduction and eliminates the need to keep records of the carryforward.

Explanation of Provision

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

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

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

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

Effective Date

The provision applies to taxable years beginning after December 31, 1992.

4. Permit payment of taxes by credit card (sec. 122 of the bill and sec. 6311 of the Code)

Present Law

Payment of taxes may be made by checks or money orders, to the extent and under the conditions provided by regulations.

Reasons for Simplification

Credit cards are a commonly used and reliable form of payment. Some taxpayers may find paying taxes by credit card more convenient than paying by check or money order.

Explanation of Provision

In general

The Internal Revenue Service (IRS) is engaged in a long-term modernization of its information systems, the Tax Systems Modernization (TSM) Program. This modernization is intended to address deficiencies in the current IRS information systems and to plan effectively for future information system needs and requirements. The systems changes are designed to reduce the burden on taxpayers, generate additional revenue through improved voluntary compliance, and achieve productivity gains throughout the IRS. One key element of this program is electronic filing of tax returns.

At the present time, increasing reliance is being placed upon electronic funds transfers for payment of obligations. In light of this, the IRS seeks to integrate these payment methods in its TSM program, including electronic filing of returns, as well as into its traditional collection functions. The bill allows the IRS to accept electronic funds transfers, including those arising from credit cards and debit cards, for the payment of taxes. The IRS contemplates that it will proceed to negotiate contracts for these purposes with one or more private sector card systems.

Billing error resolution

In the course of processing these transactions, it will be necessary to resolve billing errors and other disputes. The Internal Revenue Code contains mechanisms for the determination of tax liability, defenses and other taxpayer protections, and the resolution of disputes with respect to those liabilities. The Truth-in-Lending Act contains provisions for determination of credit card liabilities, defenses and other consumer protections, and the resolution of disputes with respect to these liabilities.

The bill excludes credit card issuers and processing mechanisms from the resolution of tax liability, but makes IRS subject to the Truth-in-Lending provisions insofar as those provisions impose obligations and responsibilities with regard to the "billing error" resolution process. It is not intended that consumers obtain additional ways to dispute their tax liabilities under the Truth-in-Lending provisions.

The bill also specifically includes the use of debit cards in this provision and provides that the corresponding defenses and "billing error" provisions of the Electronic Fund Transfer Act will apply in a similar manner.

The bill adds new section 6311(d)(3) to the Code. This section describes the circumstances under which section 161 of the Truth-in-Lending Act ("TILA") and section 908 of the Electronic Fund Transfer Act ("EFTA") apply to disputes that may arise in connection with payments of taxes made by credit card or debit card. Subsections (A) through (C) recognize that "billing errors" relating to the credit card account, such as an error arising from a credit card transaction posted to a cardholder's account without the cardholder's authorization, an amount posted to the wrong cardholder's account, or an incorrect amount posted to a cardholder's account as a result of a computational error or numerical transposition, are governed by the billing error provisions of section 161 of TILA. Simi-

larly, subsections 6311(d)(3)(A)-(C) provide that errors such as those described above which arise in connection with payments of internal revenue taxes made by debit card, are governed by section 908 of EFTA.

The Internal Revenue Code provides that refunds are only authorized to be paid to the person who made the overpayment (generally the taxpayer). Subsection 6311(d)(3)(E), however, provides that where a taxpayer is entitled to receive funds as a result of the correction of a billing error made under section 161 of TILA in connection with a credit card transaction, or under section 908 of EFTA in connection with a debit card transaction, the IRS is authorized to utilize the appropriate credit card or debit card system to initiate a credit to the taxpayer's credit card or debit card account. The IRS may, therefore, provide such funds through the taxpayer's credit card or debit card account rather than directly to the taxpayer.

On the other hand, subsections 6311(d)(3)(A)-(C) provide that any alleged error or dispute asserted by a taxpayer concerning the merits of the taxpayer's underlying tax liability or tax return is governed solely by existing tax laws, and is not subject to section 161 or section 170 of TILA, section 908 of EFTA, or any similar provisions of State law. Absent the exclusion from section 170 of TILA, in a collection action brought against the cardholder by the card issuer the cardholder might otherwise assert as a defense that the IRS had incorrectly computed his tax liability. A collection action initiated by a credit card issuer against the taxpayer/cardholder would be an inappropriate vehicle for the determination of a taxpayer's tax liability, especially since the United States would not be a party to such an action.

Similarly, without the exclusion from section 161 of TILA and section 908 of EFTA, a taxpayer could contest the merits of his tax liability by putting the charge which appears on the credit card bill in dispute. Pursuant to TILA or EFTA, the taxpayer's card issuer would have to investigate the dispute, thereby finding itself in the middle of a dispute between the IRS and the taxpayer. It is believed that it is improper to attempt to resolve tax disputes through the billing process. It is also noted that the taxpayer retains the traditional, existing remedies for resolving tax disputes, such as resolving the dispute administratively with the IRS, filing a petition with the Tax Court after receiving a statutory notice of deficiency, or paying the disputed tax and filing a claim for refund (and subsequently filing a refund suit if the claim is denied or not acted upon).

Creditor status

The TILA imposes various responsibilities and obligations on creditors. Although the definition of the term "creditor" set forth in 15 U.S.C. sec. 1602 is limited, and would generally not include the IRS, in the case of an open-end credit plan involving a credit card, the card issuer and any person who honors the credit card are, pursuant to 15 U.S.C. sec. 1602(f), creditors.

In addition, 12 CFR sec. 226.12(e) provides that the creditor must transmit a credit statement to the card issuer within 7 business days from accepting the return or forgiving the debt. There is a

concern that the response deadlines otherwise imposed by 12 CFR sec. 226.12(e), if applicable, would be difficult for the IRS to comply with (given the volume of payments the IRS is likely to receive in peak periods). This could subject the IRS to unwarranted damage actions. Consequently, the bill generally provides an exception to creditor status for the IRS.

Privacy protections

The bill also addresses privacy questions that arise from the IRS' participation in credit card processing systems. It is believed that taxpayers expect that the maximum possible protection of privacy will be accorded any transactions they have with the IRS. Accordingly, the bill provides the greatest possible protection of taxpayers' privacy that is consistent with developing and operating an efficient tax administration system. It is expected that the principle will be fully observed in the implementation of this provision.

A key privacy issue is the use and redisclosure of tax information by financial institutions for purposes unrelated to the processing of credit card charges, i.e., marketing and related uses. To accept credit card charges by taxpayers, the IRS will have to disclose tax information to financial institutions to obtain payment and to resolve billing disputes. To obtain payment, the IRS will have to disclose, at a minimum, information on the "credit slip," i.e., the dollar amount of the payment and the taxpayer's credit card number.

The resolution of billing disputes may require the disclosure of additional tax information to financial institutions. In most cases, providing a copy of the credit slip and verifying the transaction amount will be sufficient. Conceivably, financial institutions could require some information regarding the underlying liability even where the dispute concerns a "billing dispute" matter. This additional information would not necessarily be shared as widely as the initial payment data. In lieu of disclosing further information, the IRS may elect to allow disputed amounts to be charged back to the IRS and to reinstate the corresponding tax liability.

Despite the language in most cardholder agreements that permits redisclosure of credit card transaction information, the public may be largely unaware of how widely that information is shared. For example, some financial institutions may share credit, payment, and purchase information with private credit bureaus, who, in turn, may sell this information to direct mail marketers, and others. Without use and redisclosure restrictions, taxpayers may discover that some traditionally confidential tax information might be widely disseminated to direct mail marketers and others.

It is intended that credit or debit card transaction information will generally be restricted to those uses necessary to process payments and resolve billing errors, as well as other purposes that are specified in the statute. The bill directs the Secretary to issue published procedures on what constitutes authorized uses and disclosures. It is anticipated that the Secretary's published procedures will prohibit the use of transaction information for marketing tax-related services by the issuer or any marketing that targets only those who use their credit card to pay their taxes. It is also antici-

pated that the published procedures will prohibit the sale of transaction information to a third party.

Effective Date

The provision is effective nine months after the date of enactment. The IRS may, in this interim period, conduct internal tests and negotiate with card issuers, but may not accept credit or debit cards for payment of tax liability.

5. Election by parent to claim unearned income of certain children on parent's return (sec. 123 of the bill and secs. 1 and 59(j) of the Code)

Present Law

The net unearned income of a child under 14 years of age is taxed to the child at the parents' statutory rate. Net unearned income means unearned income less the sum of $600 and the greater of: (1) $600 or, (2) if the child itemizes deductions, the amount of allowable deductions directly connected with the production of the unearned income. The dollar amounts are adjusted for inflation.

In certain circumstances, a parent may elect to include a child's unearned income on the parent's income tax return if the child's income is less than $5,000. A parent making this election must include the gross income of the child in excess of $1,000 in income for the taxable year. In addition, the parent must report an additional tax liability equal to the lesser of (1) $75 or (2) 15 percent of the excess of the child's income over $500. The dollar amounts for the election are not adjusted for inflation.

A person claimed as a dependent cannot claim a standard deduction exceeding the greater of $600 or such person's earned income. For alternative minimum tax purposes, the exemption of a child under 14 years of age generally cannot exceed the sum of such child's earned income plus $1,000. The $600 amount is adjusted for inflation but the $1,000 amount is not.

Reasons for Simplification

The election by a parent to include a child's unearned income on a return is intended to eliminate the need to file a separate return for a child without reducing the family's total tax liability. Indexation of the underlying dollar amounts simplifies return preparation by making the election available to more taxpayers.

Explanation of Provision

The bill adjusts for inflation the dollar amounts involved in the election to claim unearned income on the parent's return. It likewise indexes the $1,000 amount used in computing the child's alternative minimum tax.

Effective Date

The provision applies to taxable years beginning after December 31, 1992.

6. Simplified foreign tax credit limitation for individuals (sec. 124 of the bill and sec. 904 of the Code)

Present Law

In order to compute the foreign tax credit, a taxpayer computes foreign source taxable income and foreign taxes paid in each of the applicable separate foreign tax credit limitation categories. In the case of an individual, this requires the filing of IRS Form 1116, designed to elicit sufficient information to perform the necessary calculations.

In many cases, individual taxpayers who are eligible to credit foreign taxes may have only a modest amount of foreign source gross income, all of which is income from investments (e.g., dividends from a foreign corporation subject to foreign withholding taxes or dividends from a domestic mutual fund that can pass through its foreign taxes to the shareholder (see sec. 853)). Taxable income of this type ordinarily is subject to the single foreign tax credit limitation category known as passive income. However, under certain circumstances, the Code treats investment-type income (e.g., dividends and interest) as income in several other separate limitation categories (e.g., high withholding tax interest income, general limitation income) designed to accomplish certain policy objectives or forestall certain abuses. For this reason, any taxpayer with foreign source gross income is required to provide sufficient detail on Form 1116 to ensure that foreign source taxable income from investments, as well as all other foreign source taxable income, is allocated to the correct limitation category.

Reasons for Simplification

The committee believes that a significant number of individuals are entitled to credit relatively small amounts of foreign tax imposed at modest effective tax rates on foreign source investment income. For taxpayers in this class, applicable foreign tax credit limitations typically exceed the amounts of taxes paid. Therefore, relieving these taxpayers from application of the full panoply of foreign tax credit rules may achieve significant reduction in the complexity of the tax law without significantly altering actual tax liabilities. At the same time, however, the committee believes that the benefits of simplified treatment should be limited to cover those cases where the taxpayer is receiving a payee statement showing the amount of the foreign source income and the foreign tax.

Explanation of Provision

The bill allows individuals with no more than $200 ($400 in the case of married persons filing jointly) of creditable foreign taxes, and no foreign source income other than income that is in the passive basket, to elect a simplified foreign tax credit limitation equal to the lesser of 25 percent of the individual's foreign source gross income or the amount of the creditable foreign taxes paid or accrued by the individual during the taxable year. (It is intended that an individual electing this simplified limitation calculation not be

required to file Form 1116 in order to obtain the benefit of the credit.) A person who elects the simplified foreign tax credit limitation is not allowed a credit for any foreign tax not shown on a payee statement (as that term is defined in sec. 6724(d)(2)) furnished to him or her. Nor is the person entitled to treat any excess credits for a taxable year to which the election applied as a carryover to another taxable year. Because the limitation for a taxable year to which the election applies can be no more than the creditable foreign taxes actually paid for the taxable year, it is also the case under the bill that no excess credits from another year can be carried over to the taxable year to which the election applies.

For purposes of the simplified limitation, passive income generally is defined to include all types of income that would be foreign personal holding company income under the subpart F rules, plus income inclusions from passive foreign corporations (as defined in title IV of the bill), so long as the income is shown on a payee statement furnished to the individual. Thus, for purposes of the simplified limitation, passive income includes all dividends, interest (and income equivalent to interest), royalties, rents, and annuities; net gains from dispositions of property giving rise to such income; net gains from certain commodities transactions; and net gains from foreign currency transactions that give rise to foreign currency gains and losses as defined in section 988. The statutory exceptions to treating these types of income as passive for foreign tax credit limitation purposes, such as the exceptions for high-taxed income and high-withholding-tax interest, are not applicable in determining eligibility to use the simplified limitation.

Although an estate or trust generally computes taxable income and credits in the same manner as in the case of an individual (Code sec. 641(b); Treas. Reg. sec. 1.641(b)-1), the simplified limitation does not apply to an estate or trust.

Effective Date

The provision applies to taxable years beginning after December 31, 1992.

7. Personal transactions by individuals in foreign currency (sec. 125 of the bill and sec. 988 of the Code)

Present Law

When a U.S. taxpayer with a U.S. dollar functional currency makes a payment in a foreign currency, gain or loss (referred to as "exchange gain or loss") arises from any change in the value of the foreign currency relative to the U.S. dollar between the time the currency was acquired (or the obligation to pay was incurred) and the time that the payment is made. Gain or loss results because foreign currency, unlike the U.S. dollar, is treated as property for Federal income tax purposes.

Exchange gain or loss can arise in the course of a trade or business or in connection with an investment transaction. Exchange gain or loss can also arise where foreign currency was acquired for personal use. For example, the IRS has ruled that a taxpayer who converts U.S. dollars to a foreign currency for personal use—while

traveling abroad—realizes exchange gain or loss on reconversion of appreciated or depreciated foreign currency (Rev. Rul. 74-7, 1974-1 C.B. 198).

Prior to the Tax Reform Act of 1986 (the "1986 Act"), most of the rules for determining the Federal income tax consequences of foreign currency transactions were embodied in a series of court cases and revenue rulings issued by the IRS. Additional rules of limited application were provided by Treasury regulations and, in a few instances, statutory bills. Pre-1986 law was believed to be unclear regarding the character, the timing of recognition, and the source of gain or loss due to fluctuations in the exchange rate of foreign currency. The result of prior law was uncertainty of tax treatment for many legitimate transactions, as well as opportunities for tax-motivated transactions. Therefore, in the 1986 Act, Congress determined that a comprehensive set of rules should be provided for the U.S. tax treatment of transactions involving "nonfunctional currencies;" that is, currencies other than the taxpayer's "functional currency."

However, the 1986 Act provisions designed to clarify the treatment of currency transactions, primarily found in section 988, apply to transactions entered into by an individual only to the extent that expenses attributable to such transactions would be deductible under section 162 (as a trade or business expense) or section 212 (as an expense of producing income, other than expenses incurred in connection with the determination, collection, or refund of taxes). Therefore, the principles of pre-1986 law continue to apply to personal currency transactions.[2]

Reasons for Simplification

An individual who lives or travels abroad generally cannot use U.S. dollars to make all of the purchases incident to ordinary daily life. Instead, the local currency must often be used, yet the individual will not be treated for tax purposes as having changed his or her functional currency to the local currency. If it were necessary to treat foreign currency in this instance as property giving rise to U.S. dollar income or loss every time it was, in effect, "bartered" for goods or services, the U.S. individual living in or visiting a foreign country would have a significant administrative burden that may bear little or no relation to whether U.S.-dollar measured income has increased or decreased. An analogous issue arises for a corporation that has a qualified business unit ("QBU") in a foreign country but nevertheless uses the U.S. dollar as its functional currency pursuant to section 986(b)(3). Complexity concerns aside, Congress could have required in that case that gain or loss be computed on each transaction carried out in the local currency. Instead, however, Congress directed the Treasury to adopt a method of translation of the QBU's results that merely approximates the results of determining exchange gain or loss on a transaction-by-

[2] See, e.g., Rev. Rul. 90-79, 1990-2 C.B. 187 (where the taxpayer purchased a house in a foreign country, financed by a foreign currency loan, and the currency appreciates before the house is sold and the loan is repaid, the taxpayer's exchange loss on repayment of the loan is not deductible under sec. 165 and does not offset taxable gain on the sale of the house).

transaction basis.[3] The committee believes that individuals also should be given relief from the requirement to keep track of gains on an actual transaction-by-transaction basis in certain cases.

Explanation of Provision

In a case where an individual acquires nonfunctional currency and then disposes of it in a personal transaction, and where exchange rates have changed in the intervening period, the bill provides for nonrecognition of an individual's resulting exchange gain not exceeding $200. The bill does not change the treatment of resulting exchange losses. It is understood that under other Code provisions, such losses typically are not deductible by individuals (e.g., sec. 165(c)).

Effective Date

The provision applies to taxable years beginning after December 31, 1992.

8. Expanded access to simplified income tax returns (sec. 126 of the bill)

Present Law

There are three principal Federal income tax forms that are utilized by individual taxpayers: Form 1040, Form 1040A, and Form 1040EZ.

Reasons for Simplification

Many individual taxpayers find the tax forms to be complex.

Explanation of Provision

The bill provides that the Secretary of the Treasury shall take such actions as may be appropriate to expand access to simplified individual income tax forms and otherwise to simplify the individual income tax returns. In addition, the bill specifies that the Secretary study expanding access to Form 1040A.

The bill also requires that the Secretary submit a report to the Congress on the actions undertaken pursuant to this bill, together with any recommendations deemed advisable.

Effective Date

The report is due no later than one year after the date of enactment.

9. Simplification of tax treatment of rural letter carriers' vehicle expenses (sec. 127 of the bill and sec. 162 of the Code)

Present Law

A taxpayer who uses his or her automobile for business purposes may deduct the business portion of the actual operation and main-

[3] See Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986,* at 1096 (1987); Treas. Reg. sec. 1.985-3.

tenance expenses of the vehicle, plus depreciation (subject to the limitations of sec. 280F). Alternatively, the taxpayer may elect to utilize a standard mileage rate in computing the deduction allowable for business use of an automobile that has not been fully depreciated. Under this election, the taxpayer's deduction equals the applicable rate multiplied by the number of miles driven for business purposes and is taken in lieu of deductions for depreciation and actual operation and maintenance expenses.

An employee of the U.S. Postal Service may compute his 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.

Rural letter carriers are paid an equipment maintenance allowance (EMA) to compensate them for the use of their personal automobiles in delivering the mail. The tax consequences of the EMA are determined by comparing it with the automobile expense deductions that each carrier is allowed to claim (using either the actual expenses method or the 150 percent of the standard mileage rate). If the EMA exceeds the allowable automobile expense deductions, the excess generally is subject to tax. If the EMA falls short of the allowable automobile expense deductions, a deduction is allowed only to the extent that the sum of this shortfall and all other miscellaneous itemized deductions exceeds two percent of the taxpayer's adjusted gross income.

Reasons for Simplification

The filing of tax returns by rural letter carriers can be complex. Under present law, those who are reimbursed at more than the 150 percent rate must report their reimbursement as income and deduct their expenses as miscellaneous itemized deductions (subject to the two-percent floor). Permitting the income and expenses to wash, so that neither will have to be reported on the rural letter carrier's tax return, will simplify these tax returns.

Explanation of Provision

The bill repeals the special rate for Postal Service employees of 150 percent of the standard mileage rate. In its place, the bill provides that the rate of reimbursement provided by the Postal Service to rural letter carriers is considered to be equivalent to their expenses. The rate of reimbursement that is considered to be equivalent to their expenses is the rate of reimbursement contained in the 1991 collective bargaining agreement, which may in the future be increased by no more than the rate of inflation.

Effective Date

The provision is effective for taxable years beginning after December 31, 1992.

10. Exemption from luxury excise tax for certain equipment installed on passenger vehicles for use by disabled individuals (sec. 128 of the bill and sec. 4004 of the Code)

Present Law

The Code imposes a 10-percent excise tax on the portion of the retail price of a passenger vehicle that exceeds $30,000. The tax also applies to separate purchases of component parts and accessories for such vehicles occurring within six months of the date the vehicle is placed in service. The tax was effective on January 1, 1991.

Reasons for Simplification

It is appropriate to reduce the compliance burdens on handicapped persons.

Explanation of Provision

The bill provides that the luxury excise tax does not apply to a part or accessory installed on a passenger vehicle to enable or assist an individual with a disability to operate the vehicle, or to enter or exit the vehicle, in order to compensate for the effect of the disability.

Persons entitled to a refund of excise tax previously paid on these components may obtain it through the dealer at which they purchased the taxed item, as provided under present-law Code section 6416.

Effective Date

The provision is effective for purchases after December 31, 1990.

11. Tax treatment of certain combat pay (sec. 129 of the bill and sec. 3401 of the Code)

Present Law

Exclusion for combat pay

Gross income does not include certain combat pay of members of the Armed Forces (Code sec. 112). If enlisted personnel serve in a combat zone during any part of any month, military pay for that month is excluded from gross income. In addition, if enlisted personnel are hospitalized as a result of injuries, wounds, or disease incurred in a combat zone, military pay for that month is also excluded from gross income; this exclusion is limited, however, to hospitalization during any month beginning not more than two years after the end of combat in the zone. In the case of commissioned officers, these exclusions from income are limited to $500 per month of military pay.

Income tax withholding

There is no income tax withholding with respect to military pay for a month in which a member of the Armed Forces of the United States is entitled to the benefits of section 112 (sec. 3401(a)(2)). With respect to enlisted personnel, this income tax withholding rule par-

allels the exclusion from income under section 112: there is total exemption from income tax withholding and total exclusion from income. With respect to officers, however, the withholding rule is not parallel: there is total exemption from income tax withholding, although the exclusion from income is limited to $500 per month.

Reasons for Simplification

In most instances, the wage withholding rules closely parallel the inclusion in income rules. Consequently, most individuals whose income is subject to withholding may essentially rely on withholding to fulfill their tax obligations. The differences between the withholding rules and the exclusion rules with respect to combat pay could cause affected taxpayers (primarily officers) to be faced with substantial additional tax liability at the time of filing their tax returns as a result of underwithholding. Paying the additional tax liability with their tax returns could lead to greater financial hardship than would withholding that is parallel to the exclusion rules.

Explanation of Provision

The bill makes the income tax withholding exemption rules parallel to the rules providing an exclusion from income for combat pay.

Effective Date

The provision is effective as of January 1, 1994.

TITLE II. PENSION SIMPLIFICATION

A. Simplified Distribution Rules (secs. 201–204 of the bill and secs. 72(d), 101(b), 401(a)(9), and 402(d) of the Code)

Present Law

In general

Under present law, a distribution of benefits from a tax-favored retirement arrangement generally is includible in gross income in the year it is paid or distributed under the rules relating to the taxation of annuities. A tax-favored retirement arrangement includes (1) a qualified pension plan (sec. 401(a)), (2) a qualified annuity plan (sec. 403(a)), and (3) a tax-sheltered annuity (sec. 403(b)). Special rules apply in the case of lump-sum distributions from a qualified plan, distributions that are rolled over to an individual retirement arrangement (IRA), and employer-provided death benefits.

Lump-sum distributions

Under present law, lump-sum distributions from qualified plans and annuities are eligible for special 5-year forward income averaging (sec. 402(d)). In general, a lump-sum distribution is a distribution within one taxable year of the balance to the credit of an employee that becomes payable to the recipient (1) on account of the death of the employee, (2) after the employee attains age 59½, (3) on account of the employee's separation from service, or (4) in the case of self-employed individuals, on account of disability. In addition, a distribution is treated as a lump-sum distribution only if the employee has been a participant in the plan for at least 5 years before the year of the distribution. Lump-sum treatment is not available for distributions from tax-sheltered annuity contracts.

A taxpayer is permitted to make an election with respect to a lump-sum distribution received on or after the employee attains age 59½ to use 5-year forward income averaging under the tax rates in effect for the taxable year in which the distribution is made. Only one such election on or after age 59½ may be made with respect to any employee.

Special transition rules adopted in the Tax Reform Act of 1986 are available with respect to an employee who attained age 50 before January 1, 1986. Under these rules, an individual, trust, or estate may elect to use 5-year forward income averaging (using present-law tax rates) or 10-year forward income averaging (using the tax rates in effect prior to the Tax Reform Act of 1986) with regard to a single lump-sum distribution, without regard to whether the employee has attained age 59½. In addition, an individual, trust, or estate receiving a lump-sum distribution with respect to such employee maelect to retain the capital gains character of the

pre-1974 portion of the lump-sum distribution (using a tax rate of 20 percent).

Employer-provided death benefits

Under present law, the beneficiary or estate of a deceased employee generally can exclude up to $5,000 in benefits paid by or on behalf of an employer by reason of the employee's death (sec. 101(b)).

Recovery of basis

Qualified plan distributions other than lump-sum distributions generally are includible in gross income in the year they are paid or distributed under the rules relating to taxation of annuities (sec. 402(a)). Amounts received as an annuity generally are includible in income in the year received, except to the extent they represent the return of the recipient's investment in the contract (i.e., basis) (sec. 72(b)). Under present law, a pro-rata basis recovery rule generally applies, so that the portion of any annuity payment that represents nontaxable return of basis is determined by applying an exclusion ratio equal to the employee's total investment in the contract divided by the total expected payments over the term of the annuity.

The total expected payments depend on the form of the payment, e.g., a single-life annuity, an annuity with payments guaranteed for a specified number of years, or a joint and survivor annuity. For example, if benefits are paid in the form of an annuity during the life of the employee, the expected payments are calculated by multiplying the annual payment amount by the employee's life expectancy on the annuity starting date. If benefits are paid in the form of a joint and survivor annuity, then the total expected return depends on the life expectancies of both the primary annuitant and the person who is to receive the survivor annuity. The IRS has issued tables of life expectancies that are used to calculate expected returns.

Under a simplified alternative method provided by the Internal Revenue Service (IRS) (Notice 88-118) for payments from or under qualified retirement arrangements, the taxable portion of qualifying annuity payments is determined under a simplified exclusion ratio method. Under the simplified method, the portion of each annuity payment that represents nontaxable return of basis is equal to the employee's total investment in the contract (including the $5,000 death benefit exclusion under section 101(b), to the extent applicable), divided by the number of anticipated payments listed in a table published by the IRS. The number of anticipated payments listed in the table is based on the employee's age on the annuity starting date. The simplified method is available if (1) the annuity payments depend on the life expectancy of the recipient (or the joint lives of the recipient and his or her beneficiary), and (2) the recipient is less than age 75 on the annuity starting date or there are fewer than 5 years of guaranteed payments under the annuity.

Under both the pro-rata and simplified alternative methods, in no event can the total amount excluded from income as nontaxable

return of basis be greater than the recipient's total investment in the contract.

Required distributions

Present law provides uniform minimum distribution rules generally applicable to all types of tax-favored retirement vehicles, including qualified plans and annuities, IRAs, and tax-sheltered annuities.

Under present law, a qualified plan is required to provide that the entire interest of each participant will be distributed beginning no later than the participant's required beginning date (sec. 401(a)(9)). The required beginning date is generally April 1 of the calendar year following the calendar year in which the plan participant or IRA owner attains age 70½. In the case of a governmental plan or a church plan, the required beginning date is the later of (1) such April 1, or (2) the April 1 of the year following the year in which the participant retires.

Reasons for Simplification

In almost all cases, the responsibility for determining the tax liability associated with a distribution from a qualified plan, tax-sheltered annuity, or IRA rests with the individual receiving the distribution. Under present law, this task can be burdensome. Among other things, the taxpayer must consider (1) whether special tax rules apply that reduce the tax that otherwise would be paid, (2) the amount of the taxpayer's basis in the plan, annuity, or IRA and the rate at which such basis is to be recovered, and (3) whether or not a portion of the distribution is excludable from income as a death benefit.

The number of special rules for taxing pension distributions makes it difficult for taxpayers to determine which method is best for them and also increases the likelihood of error. In addition, the specifics of each of the rules create complexity. For example, the present-law rules for determining the rate at which a participant's basis in a qualified plan is recovered often entail calculations that the average participant has difficulty performing. These rules require a fairly precise estimate of the period over which benefits are expected to be paid. The IRS publication on taxation of pension distributions (Publication 939) contains over 60 pages of actuarial tables used to determine total expected payments.

The original intent of the income averaging rules for pension distributions was to prevent a bunching of taxable income because a taxpayer received all of the benefits in a qualified plan in a single taxable year. Liberalization of the rollover rules in the Unemployment Compensation Amendments of 1992 increased taxpayers' ability to determine the time of the income inclusion of pension distributions, and eliminates the need for special rules such as 5-year forward income averaging to prevent bunching of income.

It is inappropriate to require all participants to commence distributions by age 70½ without regard to whether the participant is still employed by the employer. However, the accrued benefit of employees who retire after age 70½ generally should be actuarially

increased to take into account the period after age 70½ in which the employee was not receiving benefits.

Explanation of Provisions

In general

The bill eliminates 5-year averaging for lump-sum distributions from qualified plans, repeals the $5,000 death benefit exclusion, and simplifies the basis recovery rules applicable to distributions from qualified plans. In addition, the bill modifies the rule that generally requires all participants to commence distributions by age 70½.

Special rules for lump-sum distributions

The bill repeals the special 5-year forward income averaging rule. The bill preserves the transition rules adopted in the Tax Reform Act of 1986.

Employer-provided death benefits

The bill repeals the exclusion from gross income of up to $5,000 in employer-provided death benefits.

Recovery of basis

Under the bill, the portion of an annuity distribution from a qualified retirement plan, qualified annuity, or tax-sheltered annuity that represents nontaxable return of basis generally is determined under a method similar to the present-law simplified alternative method provided by the Internal Revenue Service. Under the simplified method provided in the bill, the portion of each annuity payment that represents nontaxable return of basis generally is equal to the employee's total investment in the contract as of the annuity starting date, divided by the number of anticipated payments determined by reference to the age of the participant listed in the table set forth in the bill. The number of anticipated payments listed in the table is based on the employee's age on the annuity starting date. If the number of payments is fixed under the terms of the annuity, that number is to be used instead of the number of anticipated payments listed in the table.

The simplified method does not apply if the primary annuitant has attained age 75 on the annuity starting date unless there are fewer than 5 years of guaranteed payments under the annuity. If in connection with commencement of annuity payments, the recipient receives a lump-sum payment that is not part of the annuity stream, such payment is taxable under the rules relating to annuities (sec. 72) as if received before the annuity starting date, and the investment in the contract used to calculate the simplified exclusion ratio for the annuity payments is reduced by the amount of the payment. As under present law, in no event will the total amount excluded from income as nontaxable return of basis be greater than the recipient's total investment in the contract.

Required distributions

The bill modifies the rule that requires all participants in qualified plans to commence distributions by age 70½ without regard to

whether the participant is still employed by the employer and generally replaces it with the rule in effect prior to the Tax Reform Act of 1986. Under the bill, distributions generally are required to begin by April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70½ or (2) the calendar year in which the employee retires. However, in the case of a 5-percent owner of the employer, distributions are required to begin no later than the April 1 of the calendar year following the year in which the 5-percent owner attains age 70½. Distributions from an IRA are required to begin no later that April 1 of the calendar year following the year in which the IRA owner attains age 70½.

In addition, in the case of an employee (other than a 5-percent owner) who retires in a calendar year after attaining age 70½, the bill generally requires the employee's accrued benefit to be actuarially increased to take into account the period after age 70½ in which the employee was not receiving benefits under the plan. Thus, under the bill, the employee's accrued benefit is required to reflect the value of benefits that the employee would have received if the employee had retired at age 70½ and had begun receiving benefits at that time.

The actuarial adjustment rule and the rule requiring 5-percent owners to begin distributions after attainment of age 70½ does not apply, under the bill, in the case of a governmental plan or church plan.

Effective Date

The provisions generally apply to years beginning after December 31, 1993. The modifications to the basis recovery rules apply with respect to annuity starting dates after December 31, 1993.

B. Increased Access to Pension Plans

1. Modification of simplified employee pensions (sec. 211 of the bill and sec. 408(k)(6) of the Code)

Present Law

Under present law, certain employers (other than tax-exempt and governmental employers) can establish a simplified employee pension (SEP) for the benefit of their employees under which the employees can elect to have contributions made to the SEP or to receive the contributions in cash (sec. 408(k)(6)). If an employee elects to have contributions made on the employee's behalf to the SEP, the contribution is not treated as having been distributed or made available to the employee. In addition, the contribution is not treated as an employee contribution merely because the SEP provides the employee with such an election. Therefore, an employee is not required to include in income currently the amounts the employee elects to have contributed to the SEP. Elective deferrals under a SEP are to be treated in the same manner as elective deferrals under a qualified cash or deferred arrangement and, thus, are subject to the $8,728 (for 1992) cap on elective deferrals.

The election to have amounts contributed to a SEP or received in cash is available only if at least 50 percent of the employees of the employer elect to have amounts contributed to the SEP. In addition, such election is available for a taxable year only if the employer maintaining the SEP had 25 or fewer eligible employees at all times during the prior taxable year.

Under present law, elective deferrals under SEPs are subject to nondiscrimination standards. The amount eligible to be deferred as a percentage of each highly compensated employee's compensation (i.e., the deferral percentage) is limited by the average deferral percentage (based solely on elective deferrals) for all nonhighly compensated employees who are eligible to participate. The deferral percentage for each highly compensated employee (taking into account only the first $228,860 (for 1992) of compensation) cannot exceed 125 percent of the average deferral percentage for all other eligible employees. Nonelective SEP contributions may not be combined with the elective SEP deferrals for purposes of this test. An employer may not make any other SEP contributions conditioned on elective SEP deferrals. If the 125-percent test is not satisfied, rules similar to the rules applicable to excess contributions to a cash or deferred arrangement are applied.

If any employee is eligible to make elective SEP deferrals, all employees satisfying the participation requirements must be eligible to make elective SEP deferrals. An employee satisfies the participation requirements if the employee (1) has attained age 21, (2) has performed services for the employer during at least 3 of the immediately preceding 5 years, and (3) received at least $374 (for 1992) in compensation from the employer for the year. An employee can participate even though he or she is also a participant in one or more other qualified retirement plans sponsored by the employer. However, SEP contributions are added to the employer's contribution to the other plans on the participant's behalf in applying the limits on contributions and benefits (sec. 415).

Reasons for Simplification

Further simplification and broadening of the rules applicable to plans of small employers should encourage more small employers to establish plans for their employees.

Explanation of Provision

The bill modifies the rules relating to salary reduction SEPs by providing that such SEPs may be established by employers with 100 or fewer employees. The bill also repeals the requirement that at least half of eligible employees actually participate in a salary reduction SEP.

Effective Date

The provision applies to years beginning after December 31, 1993.

2. Tax-exempt organizations eligible under section 401(k) (sec. 212 of the bill and sec. 401(k) of the Code)

Present Law

Under present law, if a tax-qualified profit-sharing or stock bonus plan meets certain requirements, then an employee is not required to include in income any employer contributions to the plan merely because the employee could have elected to receive the amount contributed in cash (sec. 401(k)). Plans containing this feature are referred to as cash or deferred arrangements. Tax-exempt organizations are generally prohibited from establishing qualified cash or deferred arrangements. Because of this limitation, many of such employers are precluded from maintaining broad-based, funded, elective deferral arrangements for their employees.

Reasons for Simplification

Nongovernmental tax-exempt entities should be permitted to maintain qualified cash or deferred arrangements for their employees on the same basis as other employers.

Explanation of Provision

The bill allows tax-exempt organizations (other than State and local governments and their agencies and instrumentalities) to maintain cash or deferred arrangements. Thus, any organization, including an Indian tribe, previously denied eligibility on the ground that they are a tax-exempt organization (and not because they are a State or local government or agency or instrumentality thereof) is eligible to maintain a cash or deferred arrangement for its employees under the bill. As under present law, the limitation on the amount that may be deferred by an individual participating in both a cash or deferred arrangement and another elective deferral arrangement applies.

Effective Date

The provision applies to nongovernmental tax-exempt organizations with respect to years beginning after December 31, 1993. The provision does not affect the ability of certain State and local government employers to maintain qualified cash or deferred arrangements that were adopted before May 6, 1986.

3. Duties of sponsors of certain prototype plans (sec. 213 of the bill)

Present Law

The Internal Revenue Service (IRS) master and prototype program is an administrative program under which trade and professional associations, banks, insurance companies, brokerage houses, and other financial institutions can obtain IRS approval of model retirement plan language and then make these preapproved plans available for adoption by their customers, investors, or association members. Rules regarding who can sponsor master and prototype programs, the prescribed format of the model plans, and other mat-

ters relating to the program are contained in revenue procedures and other administrative pronouncements of the IRS.

The IRS also maintains related administrative programs that authorize advance approval of model plans prepared by law firms and others, i.e., the regional prototype plan program and volume submitter program.

Reasons for Simplification

As the laws relating to retirement plans have become more complex, employers have experienced an increase in the frequency and cost of amending plans and the burdens of administering the plans. Master and prototype plans reduce these costs and burdens, particularly for small- to medium-sized employers, and improve IRS administration of the retirement plan rules. Today, the majority of employer-provided qualified retirement plans, including qualified cash or deferred arrangements (sec. 401(k) plans), simplified employee pensions (SEPs) and individual retirement arrangements (IRAs) are approved master and prototype plans. The Treasury and the IRS believe that the further expansion of the master and prototype program is desirable, but that statutory authority authorizing the IRS to define specifically the duties of master and prototype sponsors should be obtained before the program becomes more widely utilized.

Explanation of Provision

The bill authorizes the IRS to define the duties of organizations that sponsor master and prototype, regional prototype, and other preapproved plans, including mass submitters. These duties would become a condition of sponsoring preapproved plans. The bill is not intended to be interpreted as diminishing the IRS's administrative authority with respect to the master and prototype, regional prototype, or similar programs, including the authority to define who is eligible to sponsor prototype plans, or to create other rules relating to these programs. Rather, it is intended to create a system of sponsor accountability, subject to IRS monitoring, that will give adopters of master and prototype and other preapproved plans a level of protection, comparable to that in the regional prototype plan program, against failure of master and prototype and other plan sponsors to fulfill certain obligations.

The bill thus authorizes the IRS to prescribe duties of sponsors of prototype and other preapproved plans that include, but are not limited to, maintaining annually current lists of adopting employers and providing certain annual notices to adopting employers and to the IRS. While reflecting the IRS's own requirements in its regional prototype plan procedure, the bill does not require the IRS to mandate a master and prototype accountability system that is identical to the regional prototype plan procedure. The bill also authorizes the IRS to prescribe such other reasonable duties as are consistent with the objective of protecting adopting employers from a sponsor's failure to amend a plan in a timely manner or to communicate amendments or other notices required by the IRS's procedures.

The bill authorizes the IRS to define the duties of preapproved plan sponsors that relate to providing administrative services to the plans of adopting employers. This authorization is not intended to obligate sponsors to undertake the complete day-to-day administration of the plans they sponsor (although it does not preclude the IRS from mandating the performance of specific functions), but rather to protect employers against loss of qualification merely because they are unaware of the need to arrange for such services, or the unavailability of professional assistance from parties familiar with the sponsor's plan.

It is thus intended that, at a minimum, sponsors should (1) advise adopting employers that failure to arrange for administrative services to the plan may significantly increase the risk of disqualification and resulting sanctions, and (2) furnish employers with the name of firms that are familiar with the plan and can provide professional administrative service. This is not intended to preclude the sponsor from providing that service itself.

The bill should not be construed as creating fiduciary relationships or responsibilities under Title I of the Employee Retirement Income Security Act of 1974 (ERISA) that would not exist in the absence of the provision.

To the extent deemed reasonably necessary to carry out the purposes of this provision of the bill, the Secretary is authorized to issue regulations that permit the relaxation of the anti-cutback rules contained in ERISA (sec. 204(g)) and the Code (sec. 411(d)(6)) when employers replace an individually designed plan with an IRS model plan, provided that the rights of participants to accrued benefits under the individually designed plan are not significantly impaired. This discretion will facilitate the shift by employers from individually designed plans to IRS model plans.

Effective Date

The provision is effective on the date of enactment.

C. Nondiscrimination Provisions

1. Definition of highly compensated employee and family aggregation rules (sec. 221 of the bill and secs. 401(a)(17), 404(l), and 414(q) of the Code)

Present Law

In general

For purposes of the rules applying to qualified retirement plans under the Code, an employee, including a self-employed individual, generally is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee: (1) was a 5-percent owner of the employer; (2) received more than $93,518 (for 1992) in annual compensation from the employer; (3) received more than $62,345 (for 1992) in annual compensation from the employer and was one of the top-paid 20 percent of employees during the same year; or (4) was an officer of the employer who received compensation greater than $56,111 (for 1992). These dollar amounts are adjusted annually for inflation at the same time and

in the same manner as the adjustments to the dollar limit on benefits under a defined benefit pension plan (sec. 415(d)).

If, for any year, no officer has compensation in excess of $56,111 (for 1992), then the highest paid officer of the employer for such year is treated as a highly compensated employee. An employee is not treated as in the top-paid 20 percent, as an officer, or as receiving $93,518 or $62,345 (for 1992) solely because of the employee's status during the current year, unless such employee also is among the 100 employees who have received the highest compensation during the year.

Election to use simplified method

Employers are permitted to elect to determine their highly compensated employees under a simplified method. Under this method, an electing employer may treat employees who received more than $62,345 (for 1992) in annual compensation from the employer as highly compensated employees in lieu of applying the $93,518 (for 1992) threshold and without regard to whether such employees are in the top-paid group of the employer. This election is available only if at all times during the year the employer maintained business activities and employees in at least 2 geographically separate areas.

Treatment of family members

A special rule applies with respect to the treatment of family members of certain highly compensated employees. Under the special rule, if an employee is a family member of either a 5-percent owner or 1 of the top 10 highly compensated employees by compensation, then any compensation paid to such family member and any contribution or benefit under the plan on behalf of such family member is aggregated with the compensation paid and contributions or benefits on behalf of the 5-percent owner or the highly compensated employee in the top 10 employees by compensation. Therefore, such family member and employee are treated as a single highly compensated employee. An individual is considered a family member if, with respect to an employee, the individual is a spouse, lineal ascendant or descendant, or spouse of a lineal ascendant or descendant of the employee.

Similar family aggregation rules apply with respect to the $228,860 (for 1992) limit on compensation that may be taken into account under a qualified plan (sec. 401(a)(17)) and for deduction purposes (sec. 404(l)). However, under such provisions, only the spouse of the employee and lineal descendants of the employee who have not attained age 19 are taken into account.

Reasons for Simplification

Under present law, the administrative burden on plan sponsors to determine which employees are highly compensated can be great. The various categories of highly compensated employees require employers to perform a number of complex calculations that for many employers have largely duplicative results.

Explanation of Provisions

The bill provides that an employee is highly compensated with respect to a year if the employee (1) was a 5-percent owner of the employer at any time during the year or the preceding year, or (2) had compensation for the preceding year in excess of $50,000. The $50,000 threshold is adjusted for cost-of-living increases in the same manner and at the same time (and using the same base year) as the limitations on contributions and benefits (sec. 415(d)). Under the bill, as under present law, the dollar limit in effect for 1992 is $62,345. Thus, an employee would be highly compensated in 1993 if the employee's compensation for 1992 is in excess of $62,345.

Under the bill, if no employee is a 5-percent owner or had compensation for the preceding year in excess of $50,000 (indexed), then the highest paid officer for the year is treated as a highly compensated employee.

The bill repeals the family aggregation rules.

Effective Date

The provision is effective for years beginning after December 31, 1993.

2. Modification of additional participation requirements (sec. 222 of the bill and sec. 401(a)(26) of the Code)

Present Law

Under present law, a plan is not a qualified plan unless it benefits no fewer than the lesser of (a) 50 employees of the employer or (b) 40 percent of all employees of the employer (sec. 401(a)(26)). This requirements may not be satisfied by aggregating comparable plans, but may be applied separately to different lines of business of the employer. A line of business of the employer does not qualify as a separate line of business unless it has at least 50 employees.

Reasons for Simplification

The minimum participation rule was adopted in the Tax Reform Act of 1986 because the Congress believed that it was inappropriate to permit an employer to maintain multiple plans, each of which covered a very small number of employees. Although plans that are aggregated for nondiscrimination purposes are required to satisfy comparability requirements with respect to the amount of contributions or benefits, such an arrangement may still discriminate in favor of highly compensated employees.

However, it is appropriate to better target the minimum participation rule by limiting the scope of the rule to defined benefit pension plans and increasing the minimum number of employees required to be covered under very small plans.

Also, the arbitrary requirement that a line of business must have at least 50 employees requires application of the minimum participation rule on an employer-wide basis in some cases in which the employer truly has separate lines of business.

Explanation of Provision

The bill provides that the minimum participation rule (sec. 401(a)(26)) applies only to defined benefit pension plans. In addition, the bill provides that a defined benefit pension plan does not satisfy the rule unless it benefits no fewer than the lesser of (1) 50 employees or (2) the greater of (a) 40 percent of all employees of the employer or (b) 2 employees (1 employee if there is only 1 employee). The excludable employee rule applies as under present law.

The bill provides that the requirement that a line of business has at least 50 employees does not apply in determining whether a plan satisfies the minimum participation rule on a separate line of business basis.

Effective Date

The provision is effective for years beginning after December 31, 1993.

3. Nondiscrimination rules for qualified cash or deferred arrangements (sec. 223 of the bill and secs. 401(k) and (m) of the Code)

Present Law

A profit-sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual is $8,728 for 1992. This dollar limit is indexed annually for inflation. A special nondiscrimination test applies to cash or deferred arrangements.

The special nondiscrimination test applicable to elective deferrals under qualified cash or deferred arrangements is satisfied if the actual deferral percentage (ADP) for eligible highly compensated employees for a plan year is equal to or less than either (1) 125 percent of the ADP of all nonhighly compensated employees eligible to defer under the arrangement, or (2) the lesser of 200 percent of the ADP of all eligible nonhighly compensated employees or such ADP plus 2 percentage points. The ADP for a group of employees is the average of the ratios (calculated separately for each employee in the group) of the contributions paid to the plan on behalf of the employee to the employee's compensation.

Employer matching contributions and after-tax employee contributions under qualified defined contribution plans are subject to a special nondiscrimination test similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements.

The special nondiscrimination test is satisfied for a plan year if the actual contribution percentage (ACP) for eligible highly compensated employees does not exceed the greater of (1) 125 percent of the ACP for all other eligible employees, or (2) the lesser of 200

percent of the contribution percentage for all other eligible employees, or such percentage plus 2 percentage points. The ACP for a group of employees for a plan year is the average of the ratios (calculated separately for each employee in the group) of the sum of matching and employee contributions on behalf of each such employee to the employee's compensation for the year.

To determine the amount of excess contributions and the employees to whom they are allocated, the elective deferrals of highly compensated employees are reduced in the order of their actual deferral percentage beginning with those highly compensated employees with the highest actual deferral percentages.

Reasons for Simplification

The sources of complexity generally associated with the nondiscrimination requirements for qualified cash or deferred arrangements and matching contributions are the recordkeeping necessary to monitor employee elections, the calculations involved in applying the tests, and the correction mechanism, i.e., what to do if the plan fails the tests. None of these factors is new.

It is believed that the complexity of nondiscrimination requirements, particularly after the Tax Reform Act of 1986 changes that imposed a dollar cap ($8,728 in 1992) on elective deferrals, is not justified by the marginal additional participation of rank-and-file employees that might be achieved by the operation of these requirements. The result that the nondiscrimination rules are intended to produce can also be achieved by creating an incentive for employers to provide 100-percent matching contributions or nonelective contributions on behalf of rank-and-file employees. Such contributions should create a sufficient inducement to rank-and-file employee participation.

In addition, the significant simplification that a design-based safe harbor test achieves may reduce the complexity of the qualified cash or deferred arrangement requirements enough to encourage additional employers to establish such plans, thereby expanding employee access to voluntary retirement savings arrangements. The adoption of a nondiscrimination safe harbor that eliminates the testing of actual plan contributions removes a significant administrative burden that may act as a deterrent to employers who would not otherwise set up such a plan. Thus, the adoption of a simpler nondiscrimination test may encourage more employers, who do not now provide any tax-favored retirement plan for their employees, to set up such plans.

A design-based nondiscrimination test provides certainty to an employer and plan participants that does not exist under present law. Under such a test, an employer will know at the beginning of each plan year whether the plan satisfies the nondiscrimination requirements for the year.

Explanation of Provision

In general

The bill modifies the present-law nondiscrimination test applicable to elective deferrals and employer matching and after-tax em-

ployee contributions to provide that the maximum permitted actual deferral percentage for highly compensated employees for the year is determined by reference to the actual deferral percentage for nonhighly compensated employees for the preceding, rather than the current, year. In the case of the first plan year of a qualified cash or deferred arrangement, the actual deferral percentage of nonhighly compensated employees for the previous year is deemed to be 3 percent or, at the election of the employer, the actual deferral percentage for such first plan year.

In addition, the bill adds alternative methods of satisfying the special nondiscrimination requirements applicable to elective deferrals and employer matching contributions. Under these safe harbor rules, a cash or deferred arrangement is treated as satisfying the actual deferral percentage test if the plan of which the arrangement is a part (or any other plan of the employer maintained with respect to the employees eligible to participate in the cash or deferred arrangement) meets (1) one of two contribution requirements and (2) a notice requirement. A plan satisfies the safe harbor with respect to matching contributions if (1) the plan meets the contribution and notice requirements under the safe harbor for cash or deferred arrangements and (2) the plan satisfies a special limitation on matching contributions. These safe harbors permit a plan to satisfy the special nondiscrimination tests through plan design, rather than through the testing of actual contributions.

The bill also modifies the method of determining excess contributions under the present-law nondiscrimination test.

Safe harbor for cash or deferred arrangements

Contribution requirements.—A plan satisfies the contribution requirements under the safe harbor rule for qualified cash or deferred arrangements if the plan either (1) satisfies a matching contribution requirement or (2) the employer makes a nonelective contribution to a defined contribution plan of at least 3 percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to whether the employee makes elective contributions under the arrangement.

A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee's elective contributions up to 3 percent of compensation and (b) 50 percent of the employee's elective contributions from 3 to 5 percent of compensation; and (2) the level of match for highly compensated employees is not greater than the match rate for nonhighly compensated employees at any level of compensation.

Alternatively, if the matching contribution requirement is not satisfied at some level of employee compensation, the requirement is deemed to be satisfied if (1) the level of employer matching contributions does not increase as employee elective contributions increase and (2) the aggregate amount of matching contributions with respect to elective contributions up to that level of compensation at least equals the amount of matching contributions that would be made if matching contributions satisfied the percentage

requirements. For example, the alternative test is satisfied if an employer matches 125 percent of an employee's elective contributions up to the first 3 percent of compensation, 25 percent of elective deferrals from 3 to 4 percent of compensation, and provides no match thereafter. This is because the employer match does not increase and the aggregate amount of matching contributions is at least equal to the matching contributions required under the general safe harbor rule.

Under the safe harbor, an employee's rights to employer matching contributions or nonelective contributions used to meet the contribution requirements are required to be 100-percent vested.

An arrangement does not satisfy the contribution requirements unless the requirements are met without regard to the permitted disparity rules (sec. 401(l)) and contributions used to satisfy the contribution requirements are not taken into account for purposes of determining whether a plan of the employer satisfies the permitted disparity rules.

Employer matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules are nonforfeitable and subject to the restrictions on withdrawals that apply to an employee's elective deferrals under a qualified cash or deferred arrangement (sec. 401(k)(2)(B) and (C)).

The matching or nonelective contribution safe harbor requirements are deemed satisfied if the employer maintains another qualified plan that meets such requirements.

Notice requirement.—The notice requirement is satisfied if each employee eligible to participate in the arrangement is given written notice, within a reasonable period before any year, of the employee's rights and obligations under the arrangement. This notice must be sufficiently accurate and comprehensive to apprise the employee of his or her rights and obligations and must be written in a manner calculated to be understood by the average employee eligible to participate.

Alternative method of satisfying special nondiscrimination test for matching contributions

The bill provides a safe harbor method of satisfying the special nondiscrimination test applicable to employer matching contributions. Under this safe harbor, a plan is treated as meeting the special nondiscrimination test if (1) the plan meets the contribution and notice requirements applicable under the safe harbor method of satisfying the special nondiscrimination requirement for qualified cash or deferred arrangements, and (2) the plan satisfies a special limitation on matching contributions. After-tax employee contributions are tested separately under the ACP test.

The limitation on matching contributions is satisfied if (1) the matching contributions on behalf of any employee may not be made with respect to employee contributions or elective deferrals in excess of 6 percent of compensation and (2) the level of an employer's matching contribution does not increase as an employee's contributions or elective deferrals increase.

Distribution of excess contributions

Under the bill, the total amount of excess contributions is determined in the same manner as under present law, but the distribution of excess contributions is required to be made on the basis of the amount of contribution by, or on behalf of, each highly compensated employee. Thus, under the bill, excess contributions are deemed attributable first to those highly compensated employees who have made the greatest dollar amount of elective deferrals under the plan. This modified distribution method also applies to excess contributions that are treated as distributed to an employee and then contributed by the employee to the plan (recharacterization).

For example, assume that an employer maintains a qualified cash or deferred arrangement under section 401(k). Assume further that the actual deferral percentage (ADP) for the eligible nonhighly compensated employees is 2 percent. In addition, assume the following facts with respect to the eligible highly compensated employees:

Employee	Compensation	Deferral	Deferral (percent)
A	$200,000	$7,000	3.5
B	200,000	7,000	3.5
C	70,000	7,000	10.0
D	70,000	5,250	7.5
E	70,000	2,100	3.0
F	70,000	1,750	2.5

Under these facts, the highly compensated employees' ADP is 5 percent, which fails to satisfy the special nondiscrimination requirements.

Under present law, the highly compensated employees with the highest deferral percentages would have their deferrals reduced until the ADP of the highly compensated employees is 4 percent. Accordingly, C and D would have their deferrals reduced to $4,025 (i.e., a deferral percentage of 5.75 percent). The reduction thus is $2,975 for C and $1,225 for D, for a total reduction of $4,200.

Under the bill, the amount of the total reduction is calculated in the same manner as under present law so that the total reduction remains $4,200. However, this total reduction of $4,200 is allocated to highly compensated employees based on the employees with the largest contributions. Thus, A, B, and C would each be reduced by $1,400 from $7,000 to $5,600. The ADP test would not be performed again.

It is intended that the Secretary interpret and apply the section 401(k) and 401(m) nondiscrimination tests in a manner consistent with the modified distribution rule. For example, a plan will not fail to be a qualified cash or deferred arrangement merely because the plan fails to satisfy the section 401(k) nondiscrimination test after excess contributions are distributed or recharacterized under the modified distribution rule.

Effective Date

The provision is effective for plan years beginning after December 31, 1993.

D. Miscellaneous Pension Simplification

1. Treatment of leased employees (sec. 231 of the bill and sec. 414(n) of the Code)

Present Law

An individual (a leased employee) who performs services for another person (the recipient) may be required to be treated as the recipient's employee for various employee benefit provisions if the services are performed pursuant to an agreement between the recipient and a third person (the leasing organization) who is otherwise treated as the individual's employer (sec. 414(n)). The individual is to be treated as the recipient's employee only if the individual has performed services for the recipient on a substantially full-time basis for a year, and the services are of a type historically performed by employees in the recipient's business field.

An individual who otherwise would be treated as a recipient's leased employee will not be treated as such an employee if theindividual participates in a safe harbor plan maintained by the leasing organization meeting certain requirements. Each leased employee is to be treated as an employee of the recipient, regardless of the existence of a safe-harbor plan, if more than 20 percent of an employer's nonhighly compensated workforce are leased.

Reasons for Simplification

The leased employee rules are complex and have unexpected and sometimes indefensible results, especially as interpreted under regulations proposed by the Secretary. For example, under the "historically performed" standard, the employees and partners of a law firm may be the leased employees of a client of the firm if they work a sufficient number of hours for the client and if it is not unusual for employers in that business field to have in-house counsel. While arguably meeting the present-law leased employee definition, it is believed that situations such as this are outside the intended scope of the rules.

Explanation of Provision

The present-law "historically performed" test is replaced with a new rule defining who must be considered a leased employee. Under the bill, an individual is not considered a leased employee unless such services are performed under significant direction or control by the service recipient. As under present law, the determination of whether someone is a leased employee is made after determining whether the individual is a common-law employee of the service recipient. Thus, an individual who is not a common-law employee of the service recipient may nevertheless be a leased employee of the service recipient. Similarly, the fact that a person is or is not found to perform services under significant direction or

control of the recipient for purposes of the employee leasing rules is not determinative of whether the person is or is not a common-law employee of the recipient.

Whether services are performed by an individual under significant direction or control by the service recipient depends on the facts and circumstances. Factors that are relevant in determining whether significant direction or control exists include whether the individual is required to comply with instructions of the service recipient about when, where, and how he or she is to perform the services, whether the services must be performed by a particular person, whether the individual is subject to the supervision of the service recipient, and whether the individual must perform services in the order or sequence set by the service recipient. Factors that would generally not be relevant in determining whether such direction or control exists include whether the service recipient has the right to hire or fire the individual and whether the individual works for others.

For example, an individual who works under the direct supervision of the service recipient would be considered to be subject to significant direction or control of the service recipient even if another company hired and trained the individual, had the ultimate (but unexercised) legal right to control the individual, paid his wages, withheld his employment and income taxes, and had the exclusive right to fire him. Thus, for example, temporary secretaries, receptionists, word processing personnel and similar office personnel who are subject to the day-to-day control of the employer in essentially the same manner as a common law employee are treated as leased employees if the period of service threshold is reached.

On the other hand, an individual who is a common-law employee of Company A who performs services for Company B on the business premises of Company B under the supervision of Company A would generally not be considered to be under significant direction or control of Company B. The supervision by Company A must be more than nominal, however, and not merely a mechanism to avoid the literal language of the direction or control test.

An example of the situation in the preceding paragraph might be a work crew that comes into a factory to install, repair, maintain, or modify equipment or machinery at the factory, and that includes a supervisor who is an employee of the equipment (or equipment repair) company and who has the authority to direct and control the crew, and who actually does exercise such direction and control. In this situation, the supervisor and his or her crew are not the leased employees of the manufacturer, even if the supervisor is in frequent communication with the employees of the manufacturer and even if the supervisor and his or her crew are required to comply with the safety and environmental precautions of the manufacturer.

Under the direction or control test, clerical and similar support staff (e.g., secretaries and nurses in a doctor's office) generally would be considered to be subject to significant direction or control of the service recipient and would be leased employees provided the other requirements of section 414(n) are met. On the other hand, outside professionals who maintain their own businesses (e.g., lawyers and accountants) generally would not be considered to be sub-

ject to such primary control. However, the Secretary is encouraged to continue efforts to prevent abuses in the leased manager area.

In many cases, the "historically performed" test is overly broad, and results in the unintended treatment of individuals as leased employees. One of the principal purposes for changing the leased employee rules is to relieve the unnecessary hardship and uncertainty created for employers in these circumstances. However, it is not intended that the direction or control test enable employers to engage in abusive practices. Thus, it is intended that the Secretary interpret and apply the leased employee rules in a manner so as to prevent abuses. This ability to prevent abuses under the leasing rules is in addition to the present-law authority of the Secretary under section 414(o). For example, one potentially abusive situation exists where the benefit arrangements of the service recipient overwhelmingly favor its highly compensated employees, the employer has no or very few nonhighly compensated common-law employees, yet the employer makes substantial use of the services of nonhighly compensated individuals who are not its common-law employees.

Effective Date

The provision is effective for years beginning after December 31, 1993, except that the changes do not apply to relationships that have been previously determined by an IRS ruling not to involve leased employees. In applying the leased employee rules to years beginning before the effective date, it is intended that the Secretary use a reasonable interpretation of the statute to apply the leasing rules to prevent abuse. Relationships that would not be treated as involving leased employees under the standard adopted in the bill are conclusively presumed to be nonabusive.

2. Modification of cost-of-living adjustments (sec. 232 of the bill and sec. 415(d) of the Code)

Present Law

The rules relating to qualified plans contain a number of dollar limits that are indexed annually for cost-of-living adjustments (e.g., the dollar limit on benefits under a defined benefit plan (sec. 415(b)), the limit on elective deferrals under a qualified cash or deferred arrangement (sec. 402(g)), and the dollar amounts used in determining highly compensated employees (sec. 414(q))). The Secretary publishes annually a list of the amounts applicable under each provision for the year.

Reasons for Simplification

Due to the timing of the cost-of-living adjustments, the dollar amounts for each year are not known until after the start of the calendar year.

Explanation of Provision

The bill provides that the cost-of-living adjustment with respect to any calendar year is based on the increase in the applicable index as of the close of the calendar quarter ending September 30

of the preceding calendar year. Thus, adjusted dollar limits will be published before the beginning of the calendar year to which they apply.

In addition, the bill provides that the dollar limits determined after application of the cost-of-living adjustments are generally rounded to the nearest $1,000. Dollar limits relating to elective deferrals and to the compensation floor under the simplified employee pension (SEP) participation requirements are rounded to the nearest $100.

Effective Date

The provision is effective for years beginning after December 31, 1993.

3. Plans covering self-employed individuals (sec. 233 of the bill and sec. 401(d) of the Code)

Present Law

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) different rules applied to retirement plans maintained by incorporated employers and unincorporated employers (such as partnerships and sole proprietors). In general, plans maintained by unincorporated employers were subject to special rules in addition to the other qualification requirements of the Code. Most, but not all, of this disparity was eliminated by TEFRA. Under present law, certain special aggregation rules apply to plans maintained by owner-employees that do not apply to other qualified plans (sec. 401(d)(1) and (2)).

Reasons for Simplification

The remaining special aggregation rules for plans maintained by unincorporated employers are unnecessary and should be eliminated. Applying the same set of rules to all types of plans would make the qualification standards easier to apply and administer.

Explanation of Provision

The bill eliminates the special aggregation rules that apply to plans maintained by self-employed individuals that do not apply to other qualified plans.

Effective Date

The provision is effective for years beginning after December 31, 1993.

4. Elimination of special vesting rule for multiemployer plans (sec. 234 of the bill and sec. 411(a) of the Code)

Present Law

Under present law, except in the case of multiemployer plans, a plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under 1 of 2 alternative minimum vesting schedules. A plan satisfies the first schedule if a par-

ticipant acquires a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the participant's completion of 5 years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent at the end of 4 years of service, 60 percent at the end of 5 years of service, 80 percent at the end of 6 years of service, and 100 percent at the end of 7 years of service.

In the case of multiemployer plan, a participant's accrued benefit derived from employer contributions is required to be 100 percent vested no later than upon the participant's completion of 10 years of service. This special rule applies only to employees covered by the plan pursuant to a collective bargaining agreement.

Reasons for Simplification

The present-law vesting rules for multiemployer plans add to complexity because there are different vesting schedules for different types of plans, and different vesting schedules for persons within the same multiemployer plan. In addition, the present-law rule prevents some workers from earning a pension under a multiemployer plan. Conforming the multiemployer plan rules to the rules for other plans would mean that workers could earn additional benefits.

Explanation of Provision

The bill conforms the vesting rules for multiemployer plans to the rules applicable to other qualified plans.

Effective Date

The provision is effective for plan years beginning on or after the earlier of (1) the later of January 1, 1994, or the date on which the last of the collective bargaining agreements pursuant to which the plan is maintained terminates, or (2) January 1, 1996, with respect to participants with an hour of service after the effective date.

5. Full-funding limitation of multiemployer plans (sec. 235 of the bill and sec. 412(c)(7) of the Code)

Present Law

Under the Internal Revenue Code, subject to certain limitations, an employer may make deductible contributions to a defined benefit pension plan up to the full funding limitation. The full funding limitation is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 150 percent of the plan's current liability, over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the actuarial value of the plan's assets (sec. 412(c)(7)).

Plans subject to the minimum funding rules are required to make an actuarial valuation of the plan not less frequently than annually.

Reasons for Simplification

It is not necessary to apply the 150-percent of current liability full funding limit to multiemployer plans. The full funding limit is intended to limit employer deductions for liabilities that have not yet accrued. Employers who participate in multiemployer plans do not have the same incentive to make excessive contributions to the plan as is the case with single-employer plans.

Explanation of Provision

The bill amends the Internal Revenue Code to provide that the 150 percent of current liability limitation does not apply to multiemployer plans. In addition, the bill repeals the Internal Revenue Code annual valuation requirement for multiemployer plans and applies the prior-law rule that valuations generally be performed at least every 3 years.

Effective Date

The provision applies to years beginning after December 31, 1993.

6. Alternative full-funding limitation (sec. 236 of the bill and sec. 412(c) of the Code)

Present Law

Under present law, subject to certain limitations, an employer may make deductible contributions to a defined benefit pension plan up to the full funding limitation. The full funding limitation is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 150 percent of the plan's current liability, over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the actuarial value of the plan's assets (sec. 412(c)(7)).

The Secretary may, under regulations, adjust the 150-percent figure contained in the full funding limitation to take into account the average age (and length of service, if appropriate) of the participants in the plan (weighted by the value of their benefits under the plan). In addition, the Secretary is authorized to prescribe regulations that apply, in lieu of the 150 percent of current liability limitation, a different full funding limitation based on factors other than current liability. The Secretary may exercise this authority only in a manner so that in the aggregate, the effect on Federal budget receipts is substantially identical to the effect of the 150-percent full funding limitation.

Reasons for Simplification

The Secretary has not yet exercised his authority with respect to the full funding limitation. It is necessary to specify a revenue-neutral way of exercising such authority.

Explanation of Provision

In general

The bill provides that an employer may elect to disregard the 150-percent limitation if each plan in the employer's control group is not top-heavy and the average accrued liability of active participants under the plan for the immediately preceding 5 plan years is at least 80 percent of the plan's total accrued liability (the "alternative full funding limitation"). The Secretary is required to adjust the 150-percent full funding limitation (in the manner specified under the bill) for employers that do not use the alternative full funding limit to ensure that the election by employers to disregard the 150-percent limit does not result in a substantial reduction in Federal revenues for any fiscal year.

Notice requirement

Under the bill, employers electing to apply the alternative limitation generally must notify the Secretary by January 1 of the calendar year preceding the calendar year in which the election period begins.

Under a special transition rule, in the case of any election period beginning on or after July 1, 1993, and before January 1, 1994, the notice requirement is deemed satisfied if the Secretary is notified of the election by October 1, 1993. In addition, the Secretary is required, by January 1, 1994, to notify defined benefit plans that have not made an election to apply the alternative limitation of any adjustment to the 150-percent full funding limitation required under the provision.

To the extent a defined benefit plan sponsor makes a contribution to a defined benefit plan with respect to the transition period that exceeds the full-funding limitation, as adjusted by the Secretary for the transition period, the sponsor is required to offset the excess contribution against allowable contributions to the plan in subsequent quarters in the taxable year of the sponsor. If no subsequent contributions may be made for the taxable year, the trustee of the defined benefit plan must return the excess contribution to the sponsor in that taxable year or the subsequent taxable year.

Effective Date

The provision is effective on January 1, 1993.

7. Distributions under rural cooperative plans (sec. 237 of the bill and sec. 401(k)(7) of the Code)

Present Law

Under present law, a qualified cash or deferred arrangement can permit withdrawals by participants only after the earlier of (1) the participant's separation from service, death, or disability, (2) termination of the arrangement, (3) in the case of a profit-sharing or stock bonus plan, the attainment of age 59½, or (4) in the case of a profit-sharing or stock bonus plan to which section 402(a)(8) applies, upon hardship of the participant (sec. 401(k)(2)(B)). In the case of a rural cooperative qualified cash or deferred arrangement, which is

part of a money purchase pension plan, withdrawals by participants cannot occur upon attainment of age 59½ or upon hardship.

Reasons for Simplification

It is appropriate to permit qualified cash or deferred arrangements of rural cooperatives to permit distributions to plan participants under the same circumstances as other qualified cash or deferred arrangements.

Explanation of Provision

The bill provides that a rural cooperative plan that includes a qualified cash or deferred arrangement will not be treated as violating the qualification requirements merely because the plan permits distributions to plan participants after the attainment of age 59½.

Effective Date

The provision is effective for distributions after the date of enactment.

8. Treatment of governmental plans under section 415 (sec. 238 of the bill and secs. 415 and 457 of the Code)

Present Law

Present law imposes limits on contributions and benefits under qualified plans based on the type of plan (sec. 415). The limits apply to plans maintained by private and public employers. Certain special rules apply to governmental plans.

In the case of a defined contribution plan, the annual additions to the plan with respect to each plan participant are limited to the lesser of (1) 25 percent of compensation, or (2) $30,000. The limit on the annual benefits payable by a defined benefit pension plan is generally the lesser of (1) 100 percent of compensation, or (2) $112,221 for 1992. The dollar limit is increased annually for inflation. The dollar limit is reduced actuarially if payment of benefits is to begin before the social security retirement age, and increased if benefits are to begin after that age.

Under special rules for plans maintained by State or local governments, such plans may provide benefits greater than those permitted by the limits on benefits applicable to plans maintained by private employers.

Reasons for Simplification

The limits on contributions and benefits create unique problems for plans maintained by public employers.

Explanation of Provision

The bill makes the following modifications to the limits on contributions and benefits as applied to governmental plans: (1) compensation includes employer contributions to certain employee plans under a salary reduction arrangement; (2) the 100 percent of compensation limitation does not apply; and (3) the defined benefit

pension plan limitation does not apply to certain disability and survivor benefits. The bill also permits State and local government employers to maintain excess benefit plans (i.e., plans that provide benefits that cannot be provided under a qualified plan due to the limits on contributions and benefits) without regard to the limits on unfunded deferred compensation arrangements of State and local government employers (sec. 457). Benefits provided by such plans are subject to the same tax rules applicable to excess plans maintained by private employers (e.g., sec. 83).

Effective Date

The provision is effective for years beginning on or after the date of enactment. Governmental plans are treated as if in compliance with the requirements of section 415 for years beginning on or before the date of enactment.

9. Uniform retirement age (sec. 239 of the bill and sec. 401(a)(5) of the Code)

Present Law

A qualified plan generally must provide that payment of benefits under the plan must begin no later than 60 days after the end of the plan year in which the participant reaches age 65. Also, for purpose of the vesting and benefit accrual rules, normal retirement age generally can be no later than age 65. For purposes of applying the limits on contributions and benefits (sec. 415), social security retirement age is generally used as retirement age. The social security retirement age as used for such purposes is presently age 65, but is scheduled to gradually increase.

Reasons for Simplification

Many plans base benefits on social security retirement age so that the benefits under the plan complement social security. Under present law, plans that do so may fail applicable nondiscrimination tests. It is believed that the social security retirement age is an appropriate age for use under plans maintained by private employers.

Explanation of Provision

The bill provides that for purposes of the general nondiscrimination rule (sec. 401(a)(4)) the social security retirement age (as defined in sec. 415) is a uniform retirement age and that subsidized early retirement benefits and joint and survivor annuities are not treated as not being available to employees on the same terms merely because they are based on an employee's social security retirement age (as defined in sec. 415).

Effective Date

The provision is effective for years beginning after December 31, 1993.

10. Uniform penalty provision to apply to certain pension reporting requirements (sec. 240 of the bill and secs. 6652(i) and 6724(d) of the Code)

Present Law

Any person who fails to file an information report with the Internal Revenue Service on or before the prescribed filing date is subject to penalties for each failure. The general penalty structure provides that the amount of the penalty is to vary with the length of time within which the taxpayer corrects the failure, and allows taxpayers to correct a de minimis number of errors and avoid penalties entirely (sec. 6721). A different, flat-amount penalty applies for each failure to provide information reports to the IRS or statements to payees relating to pension payments (sec. 6652(e)).

Reasons for Simplification

Conforming the information-reporting penalties that apply with respect to pension payments to the general information-reporting penalty structure would simplify the overall penalty structure through uniformity and provide more appropriate information-reporting penalties with respect to pension payments.

Explanation of Provision

The bill incorporates into the general penalty structure the penalties for failure to provide information reports relating to pension payments to the IRS and to recipients. Thus, information reports with respect to pension payments would be treated in a similar fashion to other information reports. The bill also modifies the penalty for failure to provide the notice required under section 402(f).

Effective Date

The provision applies to returns and statements the due date (determined without regard to extensions) for which is after December 31, 1993.

11. Contributions on behalf of disabled employees (sec. 241 of the bill and sec. 415(c)(3) of the Code)

Present Law

Under present law, an employer may elect to continue deductible contributions to a defined contribution plan on behalf of an employee who is permanently and totally disabled. For purposes of the limit on annual additions (sec. 415(c)), the compensation of a disabled employee is deemed to be equal to the annualized compensation of the employee prior to the employee's becoming disabled. Contributions are not permitted on behalf of disabled employees who were officers, owners, or highly compensated before they became disabled.

Reasons for Simplification

It is appropriate to facilitate the provision of benefits for disabled employees, if it is done on a nondiscriminatory basis.

Explanation of Provision

The bill provides that the special rule for contributions on behalf of disabled employees is applicable without an employer election and to highly compensated employees if the defined contribution plan provides for the continuation of contributions on behalf of all participants who are permanently and totally disabled.

Effective Date

The provision applies to years beginning after December 31, 1993.

12. Affiliation requirements for employers jointly maintaining a VEBA (sec. 242 of the bill)

Present Law

A voluntary employees' beneficiary association (VEBA) that satisfies certain requirements is entitled to tax-exempt status. The Code generally describes a VEBA as an association that provides for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of the association inures (other than through such payments) to the benefit of any private shareholder or individual. The requirements a VEBA must comply with in order to be tax exempt are further specified in regulations.

Under Treasury regulations, membership in a VEBA is required to be limited to individuals whose eligibility is determined by reference to objective standards that constitute an employment-related common bond. Such a common bond exists if eligibility is determined by the following standards: (1) employment by a common employer (or affiliated employers); (2) coverage under one or more collective bargaining agreements; (3) membership in a labor union (or in one or more locals of a national or international labor union); or (4) employment by one or more employers in the same line of business in the same geographic locale.

Under proposed Treasury regulations, an area is a single geographic locale if it does not exceed the boundaries of three contiguous States. In addition, the Commissioner of the Internal Revenue Service may recognize certain other areas as a single geographic locale if (1) it would not be economically feasible to cover employees under two or more separate VEBAs each extending over fewer States, and (2) employment or population characteristics, or other regional factors, support the particular States included.

Reasons for Simplification

VEBAs offer an effective mechanism for affiliated employers, particularly small employers, to band together for the purpose of providing certain employee benefits at lower cost than would otherwise be possible. The requirement under Treasury regulations that participating employers be in the same geographic locale is an arbitrary restriction on the ability of certain affiliated employers to maintain VEBAs.

Explanation of Provision

Under the bill, employers are considered affiliated for purposes of the VEBA rules if substantially all such employers are section 501(c)(12) organizations of the same type.

For purposes of this provision, the term "section 501(c)(12) organization" means (1) any organization described in section 501(c)(12); (2) any organization providing a service that is the same type of service that is or could be provided by an organization described in clause (1); (3) any organization described in section 501(c)(4) or (6), provided that at least 80 percent of the members of the organization are section 501(c)(12) organizations described in clauses (1) or (2); and (4) any organization which is a national association of organizations described in clauses (1), (2), or (3).

An organization described in clause (2), but not in clause (1), will not be treated as a section 501(c)(12) organization with respect to a VEBA unless a substantial number of employers maintaining such VEBA are described in clause (1). Similarly, an organization described in clause (2) but not in clause (1) will not be considered to provide a service that is the same type of service as a service provided by an organization described in clause (1) unless that type of service is a primary function of the organization described in clause (1). Under clause (2), a service will not be considered one that could be provided unless there is a substantial likelihood that the same type of service would or could be provided by a section 501(c)(12) organization. Services are considered to be of the same type if they are the same or directly related to each other. For example, the generation of electricity is directly related to the provision of electricity to consumers.

Effective Date

The provision applies to years beginning after December 31, 1993. The provision is not intended to create any inference as to present law.

13. Special rules for plans covering pilots (sec. 243 of the bill and sec. 410(b) of the Code)

Present Law

Under present law, employees covered by a collective bargaining agreement are excluded from consideration in testing whether a qualified retirement plan satisfies the minimum coverage and nondiscrimination requirements (sec. 410(b)(3)(A)). Similarly, in the case of plan established pursuant to a collective bargaining agreement between airline pilots and one or more employers, all employees not covered by the collective bargaining agreement are disregarded for purposes of testing whether the plan satisfies the minimum coverage and nondiscrimination requirements (sec. 410(b)(3)(B)). This provision applies only in the case of a plan that provides contributions or benefits for employees whose principal duties are customarily performed aboard aircraft in flight. Thus, a collectively bargained plan covering only airline pilots is tested separately for purposes of the minimum coverage requirements.

Reasons for Simplification

Present law treats airline pilots covered by a collective bargaining agreement separately for purposes of testing whether a pension plan satisfies the minimum coverage requirements, but requires nonunion airline pilots to be considered with an employer's other employees for coverage purposes. It is understood that pilots are required to retire earlier than other workers under Federal regulations. Thus, all pilots should accrue their benefits over a shorter period of time, regardless of whether they are members of a union.

Explanation of Provision

The bill provides that, in the case of a plan established by one or more employers to provide contributions or benefits for air pilots employed by one or more common carriers engaged in interstate or foreign commerce or air pilots employed by carriers transporting mail for or under contract with the United States government, all employees who are not air pilots are excluded from consideration in testing whether the plan satisfies the minimum coverage requirements. In addition, the bill provides that this exception does not apply in the case of a plan that provides contributions or benefits for employees who are not air pilots or for air pilots whose principal duties are not customarily performed aboard aircraft in flight.

Effective Date

The provision is effective for years beginning after December 31, 1993.

14. Treatment of deferred compensation plans of State and local governments and tax-exempt organizations (sec. 244 of the bill and sec. 457(e) of the Code)

Present Law

Under a general principle of the Federal income tax system, individuals are taxed currently not only on compensation actually received, but also on compensation constructively received during the taxable year. An individual is treated as having constructively received compensation during the current taxable year if the compensation would have been payable during the current taxable year but for the individual's election to defer receipt of the compensation to a later taxable year.

An exception to this rule applies to compensation deferred under an eligible unfunded deferred compensation plan (a sec. 457 plan) of a tax-exempt or State or local governmental employer.

Under a section 457 plan, an employee who elects to defer the receipt of current compensation will be taxed on the amounts deferred when such amounts are paid or made available. The maximum annual deferral under such a plan is the lesser of (1) $7,500 or (2) 33⅓ percent of compensation (net of the deferral).

In general, amounts deferred under a section 457 plan may not be made available to an employee before the earlier of (1) the calendar year in which the participant attains age 70½, (2) when the participant is separated from service with the employer, or (3) when the participant is faced with an unforeseeable emergency.

Amounts that are made available to an employee upon separation from service are includible in gross income in the taxable year in which they are made available.

Under present law, benefits under a section 457 plan are not treated as made available if the participant may elect to receive a lump sum payable after separation from service and within 60 days of the election. This exception to the general rules is available only if the total amount payable to the participant under the plan does not exceed $3,500 and no additional amounts may be deferred under the plan with respect to the participant.

Reasons for Simplification

It is appropriate to index the dollar limits on deferrals under section 457 plans to maintain the value of the deferral and to provide two additional exceptions to the principle of constructive receipt with respect to distributions from such plans.

Explanation of Provision

The bill makes three changes to the rules governing unfunded deferred compensation plans of tax-exempt and governmental employers.

First, the bill permits in-service distributions of accounts that do not exceed $3,500 if no amount has been deferred under the plan with respect to the account for 2 years and there has been no prior distribution under this cash-out rule.

Second, the bill increases the number of elections that can be made with respect to the time distributions must begin under the plan. The bill provides that the amount payable to a participant under a section 457 plan is not to be treated as made available merely because the participant may elect to defer commencement of distributions under the plan if (1) the election is made after amounts may be distributed under the plan but before the actual commencement of benefits, and (2) the participant makes only 1 such additional election. This additional election is permitted without the need for financial hardship, and the election can only be to a date that is after the date originally selected by the participant.

Finally, the bill provides for indexing of the dollar limit on deferrals.

Effective Date

The provisions are effective for taxable years beginning after the date of enactment.

15. Treatment of employer reversions required by contract to be paid to the United States (sec. 245 of the bill and sec. 4980(c)(2) of the Code)

Present Law

Under present law, employer reversions from qualified pension plans are generally subject to an excise tax. In some cases, Federal regulations require that a portion of any reversion from a plan

maintained by a government contractor be paid to the United States. Such amounts are subject to the excise tax on reversions.

Reasons for Simplification

The excise tax was intended to apply to amounts received by an employer. Imposition of the tax is not appropriate if the reversion is payable to the Federal Government.

Explanation of Provision

The bill provides that, for purposes of the excise tax, an employer reversion does not include certain amounts paid to the Federal Government by reason of certain government contracting regulations.

Effective Date

The provision is effective on the date of enactment.

16. Continuation health coverage for employees of failed financial institutions (sec. 246 of the bill and sec. 4980B(f) of the Code)

Present Law

Under the health care continuation rules, persons who are covered under a group health plan are required to be offered the opportunity to continue to participate for a specified period of time in a group health plan of the employer (or a plan of a successor employer) despite the occurrence of a qualifying event that otherwise would terminate such participation. Qualified beneficiaries are employees covered by the plan and the spouse and dependent children of a covered employee.

Qualifying events include termination of employment of a covered employee, the divorce or death of a covered employee, the covered employee becoming entitled to Medicare, and, in the case of a retired employee, the commencement of a bankruptcy proceeding under title 11 of the United States Code.

The period for which coverage is required to be continued depends on the qualifying event, and is generally either 18 months or 36 months. Persons electing continuation coverage can be required to pay for the coverage.

The health care continuation provisions are enforced under the Code by means of an excise tax (sec. 4980B).

The Federal Deposit Insurance Corporation Improvement Act of 1991 contained a provision clarifying the application of the health care continuation rules in the case of failed depository institutions. In general, the provision provides that the Federal Deposit Insurance Corporation (FDIC), a bridge bank, or any successor of a failed depository institution is required to provide continuation health care coverage to former employees of the failed institution. This provision is effective for plan years beginning on or after the date of enactment of the Act, regardless of whether the qualifying event occurred before, on, or after such date.

Reasons for Simplification

The health care continuation provisions relating to successors of failed financial institutions were not included in the Internal Revenue Code. Administration of such rules would be simplified if the rules were added to the Code provisions regarding health care continuation. In doing so, certain clarifications of the provisions are appropriate.

Explanation of Provision

Under the bill, the obligations of bridge banks and successors to failed institutions are incorporated into the health care continuation provisions of the Code. The bill clarifies that the individuals eligible for continuation health care coverage include any individual who was provided coverage under a group health plan of the failed depository institution by reason of the performance of services for such institution, and the spouse and any dependent child of such individual. The bill also provides that former and retired employees of a failed depository institution are entitled to the same continuation coverage rights as retirees of a company in bankruptcy.

Under the bill, successors to failed institutions are not required to provide continuation health care coverage to former employees of the failed institution if the FDIC or the Resolution Trust Corporation (RTC) elects to relieve the acquirer from such obligation.

Coverage under the continuation plan maintained by the FDIC on June 25, 1992, and any other substantially similar plan maintained by the FDIC, is deemed to satisfy the obligations of the FDIC (and any acquirer) under the health care continuation provisions of the Code as well as section 451 of the FDIC Improvement Act of 1991 with respect to qualified individuals of failed depository institutions.

Effective Date

The provision is effective as if included in section 451 of the Federal Deposit Insurance Corporation Improvement Act of 1991. In the case of the FDIC or any acquirer from the FDIC, the amendments made by this provision apply only to failed depository institutions for which a receiver or conservator is appointed after the date of enactment.

17. Date for adoption of plan amendments (sec. 247 of the bill)

Present Law

Under regulations, plan amendments to reflect amendments to the Code generally must be made within the remedial amendment period. Such period generally ends at the time prescribed by law for filing the income tax return of the employer for the employer's taxable year in which the change in law occurs. The plan must be operated in accordance with the law at all times, and any plan amendment must apply retroactively to the period following the effective date of the change which it reflects.

Reasons for Simplification

Plan sponsors should have adequate time to amend plan documents.

Explanation of Provision

The bill provides that any plan amendments required by the bill are not required to be made before the first plan year beginning on or after January 1, 1995, if (1) the plan is operated in accordance with the applicable provision, (2) the plan is amended to comply with the required changes no later than the first day of the first plan year beginning after December 31, 1994, and (3) the amendment is retroactive to the effective date of the applicable provision.

Effective Date

The provision is effective on the date of enactment.

TITLE III. TREATMENT OF LARGE PARTNERSHIPS

A. General Provisions

1. Simplified flow-through for large partnerships (sec. 301 of the bill and new secs. 771–777 of the Code)

Present Law

Treatment of partnerships in general

A partnership generally is treated as a conduit for Federal income tax purposes. Each partner takes into account separately his distributive share of the partnership's items of income, gain, loss, deduction or credit. The character of an item is the same as if it had been directly realized or incurred by the partner. Limitations affecting the computation of taxable income generally apply at the partner level.

The taxable income of a partnership is computed in the same manner as that of an individual except that no deduction is permitted for personal exemptions, foreign taxes, charitable contributions, net operating losses, certain itemized deductions, or depletion. Elections affecting the computation of taxable income derived from a partnership are made by the partnership, except for certain elections such as those relating to discharge of indebtedness income and the foreign tax credit.

Capital gains

The net capital gain of an individual is taxed generally at the same rates applicable to ordinary income, subject to a maximum marginal rate of 28 percent. Net capital gain is the excess of net long-term capital gain over net short-term capital loss. Individuals with a net capital loss generally may deduct up to $3,000 of the loss each year against ordinary income. Net capital losses in excess of the $3,000 limit may be carried forward indefinitely.

A special rule applies to gains and losses on the sale, exchange or involuntary conversion of certain trade or business assets (sec. 1231). In general, net gains from such assets are treated as long-term capital gains but net losses are treated as ordinary losses.

A partner's share of a partnership's net short-term capital gain or loss and net long-term capital gain or loss from portfolio investments is separately reported to the partner. A partner's share of a partnership's net gain or loss under section 1231 generally is also separately reported.

Deductions

Miscellaneous itemized deductions (e.g., certain investment expenses) are deductible only to the extent that, in the aggregate, they exceed two percent of the individual's adjusted gross income.

In general, taxpayers are allowed a deduction for charitable contributions, subject to certain limitations. The deduction allowed an individual generally cannot exceed 50 percent of the individual's adjusted gross income for the taxable year. The deduction allowed a corporation generally cannot exceed 10 percent of the corporation's taxable income. Excess contributions are carried forward for five years.

A partner's distributive share of a partnership's miscellaneous itemized deductions and charitable contributions are separately reported to the partner.

Credits in general

Each partner is allowed his distributive share of credits against his taxable income. A refundable credit for gasoline used for exempt purposes is allowed. Nonrefundable credits for clinical testing expenses for certain drugs for rare diseases, for producing fuel from nonconventional sources, and for the general business credit are also allowed. The general business credit includes the investment credit (which in turn includes the rehabilitation credit), the targeted jobs credit, the alcohol fuels credit, the research credit, and the low-income housing credit.

The credits for clinical testing expenses and for the production of fuel from nonconventional sources are limited to the excess of regular tax over tentative minimum tax. Excess credits generally cannot be carried to another taxable year. The amount of general business credit allowable in a taxable year is limited to the excess of a partner's net income over the greater of (1) the tentative minimum tax for the year or (2) 25 percent of the taxpayer's net regular tax liability in excess of $25,000. The general business credit in excess of this amount is carried back three years and forward 15 years.

The benefit of the investment credit and the low-income housing credit is recaptured if, within a specified time period, the partner transfers his partnership interest or the partnership converts or transfers the property for which the credit was allowed.

Foreign taxes

The foreign tax credit generally allows U.S. taxpayers to reduce U.S. income tax on foreign income by the amount of foreign income taxes paid or accrued with respect to that income. In lieu of electing the foreign tax credit, a taxpayer may deduct foreign taxes. The total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income bears to the taxpayer's worldwide taxable income for the taxable year.

Unrelated business taxable income

Tax-exempt organizations are subject to tax on income from unrelated businesses. Certain types of income (such as dividends, interest and certain rental income) are not treated as unrelated business taxable income. Thus, for a partner that is an exempt organization, whether partnership income is unrelated business taxable income depends on the character of the underlying income. Income from a publicly traded partnership, however, is treated as unrelat-

ed business taxable income regardless of the character of the underlying income.

Special rules related to oil and gas activities

Taxpayers involved in the search for and extraction of crude oil and natural gas are subject to certain special tax rules. As a result, in the case of partnerships engaged in such activities, certain specific information is separately reported to partners.

A taxpayer who owns an economic interest in a producing deposit of natural resources (including crude oil and natural gas) is permitted to claim a deduction for depletion of the deposit as the minerals are extracted. In the case of oil and gas produced in the United States, a taxpayer generally is permitted to claim the greater of a deduction for cost depletion or percentage depletion. Cost depletion is computed by multiplying a taxpayer's adjusted basis in the depletable property by a fraction, the numerator of which is the amount of current year production from the property and the denominator of which is the property's estimated reserves as of the beginning of that year. Percentage depletion is equal to a specified percentage (generally, 15 percent in the case of oil and gas) of gross income from production. Cost depletion is limited to the taxpayer's basis in the depletable property; percentage depletion is not so limited. Once a taxpayer has exhausted its basis in the depletable property, it may continue to claim percentage depletion deductions (generally referred to as "excess percentage depletion").

Certain limitations apply to the deduction for oil and gas percentage depletion. First, percentage depletion is not available to oil and gas producers who also engage (directly or indirectly) in significant levels of oil and gas retailing or refining activities (so-called "integrated producers" of oil and gas). Second, the deduction for percentage depletion may be claimed by a taxpayer only with respect to up to 1,000 barrels-per-day of production. Third, the percentage depletion deduction may not exceed 100 percent of the taxpayer's net income for the taxable year from the depletable oil and gas property. Fourth, a percentage depletion deduction may not be claimed to the extent that it exceeds 65 percent of the taxpayer's pre-percentage depletion taxable income.

In the case of a partnership that owns depletable oil and gas properties, the depletion allowance is computed separately by the partners and not by the partnership. In computing a partner's basis in his partnership interest, basis is increased by the partner's share of any partnership-related excess percentage depletion deductions and is decreased (but not below zero) by the partner's total amount of depletion deductions attributable to partnership property.

Intangible drilling and development costs ("IDCs") incurred with respect to domestic oil and gas wells generally may be deducted at the election of the taxpayer. In the case of integrated producers, no more than 70 percent of IDCs incurred during a taxable year may be deducted. IDCs not deducted are capitalized and generally are either added to the property's basis and recovered through depletion deductions or amortized on a straight-line basis over a 60-month period.

The special treatment granted to IDCs incurred in the pursuit of oil and gas may give rise to an item of tax preference or (in the case of corporate taxpayers) an adjusted current earnings ("ACE") adjustment for the alternative minimum tax. The tax preference item is based on a concept of "excess IDCs." In general, excess IDCs are the excess of IDCs deducted for the taxable year over the amount of those IDCs that would have been deducted had they been capitalized and amortized on a straight-line basis over 120 months commencing with the month production begins from the related well. The amount of tax preference is then computed as the difference between the excess IDC amount and 65 percent of the taxpayer's net income from oil and gas (computed without a deduction for excess IDCs). For IDCs incurred in taxable years beginning after 1992, the ACE adjustment related to IDCs is repealed for taxpayers other than integrated producers. Moreover, beginning in 1993, the IDC tax preference generally is repealed for taxpayers other than integrated producers. In this case, however, the repeal of the excess IDC preference may not result in more than a 40 percent reduction (30 percent for taxable years beginning in 1993) in the amount of the taxpayer's alternative minimum taxable income computed as if that preference had not been repealed.

Passive losses

The passive loss rules generally disallow deductions and credits from passive activities to the extent they exceed income from passive activities. Losses not allowed in a taxable year are suspended and treated as current deductions from passive activities in the next taxable year. These losses are allowed in full when a taxpayer disposes of the entire interest in the passive activity to an unrelated person in a taxable transaction. Passive activities include trade or business activities in which the taxpayer does not materially participate. (Limited partners generally do not materially participate in the activities of a partnership.) Passive activities also include rental activities (regardless of the taxpayer's material participation).[4] Portfolio income (such as interest and dividends), and expenses allocable to such income, are not treated as income or loss from a passive activity.

The $25,000 allowance also applies to low-income housing and rehabilitation credits (on a deduction equivalent basis), regardless of whether the taxpayer claiming the credit actively participates in the rental real estate activity generating the credit. In addition, the income phaseout range for the $25,000 allowance for rehabilitation credits is $200,000 to $250,000 (rather than $100,000 to $150,000). For interests acquired after December 31, 1989 in partnerships holding property placed in service after that date, the $25,000 deduction-equivalent allowance is permitted for the low-income housing credit without regard to the taxpayer's income.

A partnership's operations may be treated as multiple activities for purposes of the passive loss rules. In such case, the partnership

[4] An individual who actively participates in a rental real estate activity and holds at least a 10-percent interest may deduct up to $25,000 of passive losses. The $25,000 amount phases out as the individual's income increases from $100,000 to $150,000.

must separately report items of income and deductions from each of its activities.

Income from a publicly traded partnership is treated as portfolio income under the passive loss rules. In addition, loss from such a partnership is treated as separate from income and loss from any other publicly traded partnership, and also as separate from any income or loss from passive activities.

REMICs

A tax is imposed on partnerships holding a residual interest in a real estate mortgage investment conduit ("REMIC"). The amount of the tax is the amount of excess inclusions allocable to partnership interests owned by certain tax-exempt organizations ("disqualified organizations") multiplied by the highest corporate tax rate.

Contribution of property to a partnership

In general, a partner recognizes no gain or loss upon the contribution of property to a partnership. However, income, gain, loss and deduction with respect to property contributed to a partnership by a partner must be allocated among the partners so as to take into account the difference between the basis of the property to the partnership and its fair market value at the time of contribution. In addition, the contributing partner must recognize gain or loss equal to such difference if the property is distributed to another partner within five years of its contribution (sec. 704(c)), or if other property is distributed to the contributor within the five year period (sec. 737).

Election of optional basis adjustments

In general, the transfer of a partnership interest or a distribution of partnership property does not affect the basis of partnership assets. A partnership, however, may elect to make certain adjustments in the basis of partnership property (sec. 754). Under a section 754 election, the transfer of a partnership interest generally results in an adjustment in the partnership's basis in its property for the benefit of the transferee partner only, to reflect the difference between that partner's basis for his interest and his proportionate share of the adjusted basis of partnership property (sec. 743(b)). Also under the election, a distribution of property to a partner in certain cases results in an adjustment in the basis of other partnership property (sec. 734(b)).

Terminations

A partnership terminates if either (1) all partners cease carrying on the business, financial operation or venture of the partnership, or (2) within a 12-month period 50 percent or more of the total partnership interests are sold or exchanged (sec. 708).

Reasons for Simplification

The requirement that each partner take into account separately his distributive share of a partnership's items of income, gain, loss, deduction and credit can result in the reporting of a large number

of items to each partner. The Schedule K-1, on which such items are reported, contains space for more than 40 items. Reporting so many separately stated items is burdensome for individual investors with relatively small, passive interests in large partnerships. In many respects such investments are indistinguishable from those made in corporate stock or mutual funds, which do not require reporting of numerous separate items.

In addition, the number of items reported under the current regime makes it difficult for the Internal Revenue Service to match items reported on the K-1 against the partner's income tax return. Matching is also difficult because items on the K-1 are often modified or limited at the partner level before appearing on the partner's tax return.

By significantly reducing the number of items that must be separately reported to partners, the provision eases the reporting burden of partners and facilitates matching by the IRS. Moreover, it is understood that the Internal Revenue Service is considering restricting the use of substitute reporting forms by large partnerships. Reduction of the number of items makes possible a short standardized form.

In addition, the rules governing allocations with respect to property contributed to a partnership and the rules regarding partnership terminations are ill-suited to large partnerships, whose interests are commonly transferred. By adopting a deferred sale approach for property contributions and by reducing the possibility of partnership terminations, the provision improves the administration of the tax rules governing large partnerships.

Explanation of Provisions

In general

The bill modifies the tax treatment of a large partnership (generally, a partnership with at least 250 partners, or an electing partnership with at least 100 partners) and its partners. The bill provides that each partner takes into account separately the partner's distributive share of the following items, which are determined at the partnership level: (1) taxable income or loss from passive loss limitation activities; (2) taxable income or loss from other activities (e.g., portfolio income or loss); (3) net capital gain or loss to the extent allocable to passive loss limitation activities and other activities; (4) tax-exempt interest; (5) net alternative minimum tax adjustment separately computed for passive loss limitation activities and other activities; (6) general credits; (7) low-income housing credit; (8) rehabilitation credit; (9) credit for producing fuel from a nonconventional source; and (10) creditable foreign taxes and foreign source items.[5]

Under the bill, the taxable income of a large partnership is computed in the same manner as that of an individual, except that the items described above are separately stated and certain modifica-

[5] In determining the amounts required to be separately taken into account by a partner, those provisions of the large partnership rules governing computations of taxable income are applied separately with respect to that partner by taking into account that partner's distributive share of the partnership's items of income, gain, loss, deduction or credit. This rule permits partnerships to make otherwise valid special allocations of partnership items to partners.

tions are made. These modifications include disallowing the deduction for personal exemptions, the net operating loss deduction and certain itemized deductions.[6] All limitations and other provisions affecting the computation of taxable income or any credit (except for the at risk, passive loss and section 68 itemized deduction limitations, and any other provision specified in regulations) are applied at the partnership (and not the partner) level. Thus, for example, any investment interest of the partnership is limited at the partnership level, and any carryover is made at that level.

All elections affecting the computation of taxable income or any credit generally are made by the partnership.

Capital gains

Under the bill, netting of capital gains and losses occurs at the partnership level. A partner in a large partnership takes into account separately his distributive share of the partnership's net capital gain or net capital loss. [7] Such net capital gain or loss is treated as long-term capital gain or loss.

Any excess of net short-term capital gain over net long-term capital loss is consolidated with the partnership's other taxable income and is not separately reported.

A partner's distributive share of the partnership's net capital gain is allocated between passive loss limitation activities and other activities. The net capital gain is allocated to passive loss limitation activities to the extent of net capital gain from sales and exchanges of property used in connection with such activities, and any excess is allocated to other activities. A similar rule applies for purposes of allocating any net capital loss.

Any gains and losses of the partnership under section 1231 are netted at the partnership level. Net gain is treated as long-term capital gain and is subject to the rules described above. Net loss is treated as ordinary loss and consolidated with the partnership's other taxable income.

Deductions

The bill contains two special rules for deductions. First, miscellaneous itemized deductions are not separately reported to partners. Instead, 70 percent of the amount of such deductions is disallowed at the partnership level;[8] the remaining 30 percent is allowed at the partnership level in determining taxable income, and is not subject to the two- percent floor at the partner level.

Second, charitable contributions are not separately reported to partners under the bill. Instead, the charitable contribution deduction is allowed at the partnership level in determining taxable income, subject to the limitations that apply to corporate donors.

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[6] A large partnership is allowed a deduction under section 212 for expenses incurred for the production of income, subject to 70-percent disallowance, as described below. No income from a large partnership is treated as fishing or farming income.

[7] The term "net capital gain" has the same meaning as in section 1222(11). The term "net capital loss" means the excess of the losses from sales or exchanges of capital assets over the gains from sales or exchanges of capital assets. Thus, the partnership cannot offset any portion of capital losses against ordinary income.

[8] The "70 percent" figure is intended to approximate the amount of such deductions that would be denied at the partner level as a result of the two-percent floor.

Credits in general

Under the bill, general credits are separately reported to partners as a single item. General credits are any credits other than the low-income housing credit, the rehabilitation credit and the credit for producing fuel from a nonconventional source. A partner's distributive share of general credits is taken into account as a current year general business credit. Thus, for example, the credit for clinical testing expenses is subject to the present law limitations on the general business credit. The refundable credit for gasoline used for exempt purposes and the refund or credit for undistributed capital gains of a regulated investment company are allowed to the partnership, and thus are not separately reported to partners.

In recognition of their special treatment under the passive loss rules, the low-income housing and rehabilitation credits are separately reported.[9] In addition, the credit for producing fuel from a nonconventional source is separately reported.

The bill imposes credit recapture at the partnership level and determines the amount of recapture by assuming that the credit fully reduced taxes. Such recapture is applied first to reduce the partnership's current year credit, if any; the partnership is liable for any excess over that amount. Under the bill, the transfer of an interest in a large partnership does not trigger recapture.

Foreign taxes

The bill retains present-law treatment of foreign taxes. The partnership reports to the partner creditable foreign taxes and the source of any income, gain, loss or deduction taken into account by the partnership. Elections, computations and limitations are made by the partner.

Tax-exempt interest

The bill retains present-law treatment of tax-exempt interest. Interest on a State or local bond is separately reported to each partner.

Unrelated business taxable income

The bill retains present-law treatment of unrelated business taxable income. Thus, a tax-exempt partner's distributive share of partnership items is taken into account separately to the extent necessary to comply with the rules governing such income.

Passive losses

Under the bill, a partner in a large partnership takes into account separately his distributive share of the partnership's taxable income or loss from passive loss limitation activities. The term "passive loss limitation activity" means any activity involving the conduct of a trade or business (including any activity treated as a trade or business under sec. 469(c)(5) or (6)) and any rental activity.

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[9] It is understood that the rehabilitation and low-income housing credits which are subject to the same passive loss rules (i.e., in the case of the low-income housing credit, where the partnership interest was acquired or the property was placed in service before 1990) could be reported together on the same line.

A partner's share of a large partnership's taxable income or loss from passive loss limitation activities is treated as an item of income or loss from the conduct of a trade or business which is a single passive activity, as defined in the passive loss rules. Thus, a large partnership generally is not required to separately report items from multiple activities.

A partner in a large partnership also takes into account separately his distributive share of the partnership's taxable income or loss from activities other than passive loss limitation activities. Such distributive share is treated as an item of income or expense with respect to property held for investment. Thus, portfolio income (e.g., interest and dividends) is reported separately and is reduced by portfolio deductions and allocable investment interest expense.

In the case of a partner holding an interest in a large partnership which is not a limited partnership interest, such partner's distributive share of any items are taken into account separately to the extent necessary to comply with the passive loss rules. Thus, for example, income of a large partnership is not treated as passive income with respect to the general partnership interest of a partner who materially participates in the partnership's trade or business.

Under the bill, income from a publicly traded partnership continues to be treated as portfolio income.

Alternative minimum tax

Under the bill, alternative minimum tax ("AMT") adjustments and preferences are combined at the partnership level. A large partnership would report to partners a net AMT adjustment separately computed for passive loss limitation activities and other activities. In determining a partner's alternative minimum taxable income, a partner's distributive share of any net AMT adjustment is taken into account instead of making separate AMT adjustments with respect to partnership items. The net AMT adjustment is determined by using the adjustments applicable to individuals (in the case of partners other than corporations), and by using the adjustments applicable to corporations (in the case of corporate partners). Except as provided in regulations, the net AMT adjustment is treated as a deferral preference for purposes of the section 53 minimum tax credit.

Discharge of indebtedness income

If a large partnership has income from the discharge of any indebtedness, such income is separately reported to each partner. In addition, the rules governing such income (sec. 108) are applied without regard to the large partnership rules. Thus, for example, the large partnership provisions do not affect section 108(d)(6), which provides that certain section 108 rules apply at the partner level, or section 108(b)(5), which provides for an election to reduce the basis of depreciable property.

REMICs

For purposes of the tax on partnerships holding residual interests in REMICs, all interests in a large partnership are treated as

held by disqualified organizations. Thus, a large partnership holding a residual interest in a REMIC is subject to a tax equal to the excess inclusions multiplied by the highest corporate rate. The amount subject to tax is excluded from partnership income.

Deferred sale treatment for contributed property

In general

For all partners contributing property to a large partnership (including partners who are disqualified persons, as described below), the bill replaces sections 704(c) and 737 with a "deferred sale" approach. Under the bill, a large partnership is treated as if it had purchased the property from the contributing partner for its then fair market value, thus taking a fair market value basis in the property. The contributing partner's gain or loss on the contribution (the "precontribution gain or loss") [10] is deferred until the occurrence of specified recognition events. In general, the character of the precontribution gain or loss is the same as if the property had been sold to the partnership by the partner at the time of contribution. The contributing partner's basis in his partnership interest is adjusted for precontribution amounts recognized under the provision. These adjustments generally are made immediately before the recognition event.

The bill effectively repeals the ceiling rule for large partnerships, i.e., the amount of precontribution gain or loss recognized by the contributing partner under the provision is not limited to the overall gain or loss from the contributed property recognized by the partnership. In addition, the amount of depreciation allowable to the partnership is not limited to the contributing partner's basis in the property.

Recognition events

Certain events occurring at either the partnership or partner level cause recognition of precontribution gain or loss. Loss is not recognized, however, by reason of a disposition to a person related (within the meaning of sec. 267(b) or sec. 707(b)(1)) to the contributing partner.

Transactions at partnership level.—The contributing partner recognizes precontribution gain or loss as the partnership claims an amortization, depreciation, or depletion deduction with respect to the property. The amount of gain (or loss) recognized equals the increase (or decrease) in the deduction attributable to changes in basis of the property occurring by reason of its contribution. Any gain or loss so recognized is treated as ordinary.

The contributing partner also generally recognizes precontribution gain or loss if the partnership disposes of the contributed property to a person other than the contributing partner. If such property is distributed to the contributing partner, its basis in the hands of the contributing partner equals its basis immediately before the contribution, adjusted for any gain or loss previously

[10] Precontribution gain is the excess of the fair market value of the contributed property at the time of contribution over the adjusted basis of such property immediately before such contribution. Precontribution loss is the excess of the adjusted basis of such property over its fair market value.

recognized on account of the deferred sale. No adjustment is made to the basis of undistributed partnership property on account of a distribution to the contributing partner.[11]

A contributing partner's deferred gain or loss is not recognized if the partnership disposes of the property in certain nonrecognition transactions: a like-kind exchange (sec. 1031); an involuntary conversion (sec. 1033); or a contribution to a partnership (sec. 721), provided the contributing partnership owns more than 50 percent of the recipient partnership.

Transactions at partner level.—A contributing partner recognizes precontribution gain or loss to the extent that he disposes of his partnership interest other than at death.[12] Such partner also recognizes precontribution gain or loss to the extent that the cash and fair market value of property (other than the contributed property) distributed to him exceeds the adjusted basis of his partnership interest immediately before the distribution (determined without regard to any basis adjustment under the deemed sale rules resulting from the distribution).

It is intended that the Secretary of the Treasury have regulatory authority to apply the deferred sale rules in the case of so-called "reverse 704(c)" situations, i.e., in cases where a partnership revalues its assets.[13]

Election of optional basis adjustments

Under the bill, a large partnership may still elect to adjust the basis of partnership assets with respect to transferee partners. The computation of a large partnership's taxable income is made without regard to the section 743(b) adjustment. As under present law, the section 743(b) adjustment is made only with respect to the transferee partner. In addition, a large partnership is permitted to adjust the basis of partnership property under section 734(b) if property is distributed to a partner, as under present law.

Terminations

The bill provides that a large partnership does not terminate for tax purposes solely because 50 percent of its interests are sold or exchanged within a 12-month period.

Partnerships and partners subject to large partnership rules

Definition of large partnership

A "large partnership" is any partnership with at least 250 partners in a taxable year beginning after December 31, 1993.[14] Any partnership treated as a large partnership for a taxable year is so treated for all succeeding years, even if the number of partners

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[11] Amounts recognized by reason of these recognition events are taken into account in the partner's taxable year in which or with which ends the partnership taxable year of the deduction or disposition.

[12] It is intended that a deceased partner's successor in interest would not recognize any remaining precontribution gain or loss.

[13] See Treas. Reg. sec. 1.704-1(b)(2)(iv)(f).

[14] The number of partners is determined by counting only persons directly holding partnership interests in the taxable year, including persons holding through nominees; persons holding indirectly (e.g., through another partnership) are not counted. It is not necessary for a partnership to have 250 or more partners at any one time in a taxable year for the partnership to constitute a large partnership.

falls below 250. Regulations may provide, however, that if the number of partners in any taxable year falls below 100, the partnership is not treated as a large partnership. Partnerships with at least 100 partners can elect to be treated as large partnerships. The election applies to the year for which made and all subsequent years and cannot be revoked without the Secretary's consent.

Special rules for certain service partnerships

A large partnership does not include any partnership if substantially all the partners are: (1) individuals performing substantial services in connection with the partnership's activities, or personal service corporations the owner-employees of which perform such services; (2) retired partners who had performed such services; or (3) spouses of partners who had performed such services. In addition, the term "partner" does not include any individual performing substantial services in connection with the partnership's activities and holding a partnership interest, or an individual who formerly performed such services and who held a partnership interest at the time the individual performed such services.

Exclusion for commodity partnerships

The large partnership rules do not apply to any partnership the principal activity of which is the buying and selling of commodities (not described in sec. 1221(1)), or options, futures or forwards with respect to commodities.

Special rules for partnerships holding oil and gas properties

Election to use simplified reporting

In general, a large partnership that otherwise meets the qualifications for simplified reporting is not required to report information to its partners under the rules of that regime if it is substantially engaged in oil and gas related activities. Rather, such a partnership continues to report information to its partners as under present law. The bill permits such a partnership, however, to elect to utilize the simplified reporting regime, as modified for oil and gas purposes. If an election is made for any taxable year, it will also apply for all subsequent taxable years unless revoked with the consent of the Secretary.

A partnership is considered to be substantially engaged in oil and gas activities if at least 25 percent of the average value of its assets during the taxable year consists of oil or gas properties.[15] In making this determination, a partnership is treated as owning its proportionate share of assets of any partnership in which it holds an interest.

Simplified reporting treatment of large partnerships with oil and gas activities

The bill provides special rules for large partnerships with oil and gas activities that operate under the simplified reporting regime (i.e., either (1) large partnerships that are substantially engaged in

[15] For this purpose, "oil or gas properties" means the mineral interests in oil or gas which are of a character with respect to which a deduction for depletion is allowable under section 611.

oil and gas activities and which elect to use the regime, or (2) large partnerships that are not substantially engaged in oil and gas operations, but do have some oil and gas activities). These partnerships are collectively referred to herein as "oil and gas large partnerships." Generally, the bill provides that an oil and gas large partnership reports information to its partners under the general simplified large partnership reporting regime described above. To prevent the extension of percentage depletion deductions to persons excluded therefrom under present law, however, certain partners are treated as disqualified persons under the bill.

The treatment of a disqualified person's distributive share of any item of income, gain, loss, deduction, or credit attributable to any partnership oil or gas property is determined under the bill without regard to the special rules applicable to large partnerships. Thus, an oil and gas large partnership reports information related to oil and gas activities to a partner who is a disqualified person in the same manner and to the same extent that it reports such information to that partner under present law. The simplified reporting rules of the bill, however, apply with respect to reporting such a partner's share of items not related to oil and gas activities.

The bill defines two categories of taxpayers as disqualified persons. The first category encompasses taxpayers who do not qualify for the deduction for percentage depletion under section 613A (i.e., integrated producers of oil and gas). The second category includes any person whose average daily production of oil and gas (for purposes of determining the depletable oil and natural gas quantity under section 613A(c)(2)) is at least 500 barrels for its taxable year in which (or with which) the partnership's taxable year ends. In making this computation, all production of domestic crude oil and natural gas attributable to the partner is taken into account, including such partner's proportionate share of any production of the large partnership.

A taxpayer that falls within a category of disqualified person has the responsibility of notifying any large partnership in which it holds a direct or indirect interest (e.g., through a pass-through entity) of its status as such. Thus, for example, if an integrated producer owns an interest in a partnership which in turn owns an interest in an oil and gas large partnership, it is responsible for providing the management of the large partnership information regarding its status as a disqualified person and details regarding its indirect interest in the large partnership.

Under the bill, an oil and gas large partnership computes its deduction for oil and gas depletion under the general statutory rules (subject to certain exceptions described below) under the assumptions that the partnership is the taxpayer and that it qualifies for the percentage depletion deduction. The amount of the depletion deduction, as well as other oil and gas related items, generally are reported to each partner (other than to partners who are disqualified persons) as components of that partner's distributive share of taxable income or loss from passive loss limitation activities. The bill provides that in computing the partnership's oil and gas percentage depletion deduction, the 1,000-barrel-per-day limitation does not apply. In addition, an oil and gas large partnership is allowed to compute percentage depletion under the bill without ap-

plying the 65-percent-of-taxable-income limitation under section 613A(d)(1).

As under present law, an election to deduct IDCs under section 263(c) is made at the partnership level. Since the bill treats those taxpayers required by the Code (sec. 291) to capitalize 30 percent of IDCs as disqualified persons, an oil and gas large partnership may pass through a full deduction of IDCs to its partners who are not disqualified persons. In contrast to present law, an oil and gas large partnership also has the responsibility with respect to its partners who are not disqualified persons for making an election under section 59(e) to capitalize and amortize certain specified IDCs. Partners who are disqualified persons are permitted to make their own separate section 59(e) elections under the bill.

Consistent with the general reporting regime for large partnerships, the bill provides that a single AMT adjustment (under either corporate or non-corporate principles, as the case may be) is made and reported to the partners (other than disqualified persons) of an oil and gas large partnership as a separate item. This separately-reported item is affected by the limitation on the repeal of the tax preference for excess IDCs. For purposes of computing this limitation, the bill treats an oil and gas large partnership as the taxpayer. Thus, the limitation on repeal of the IDC preference is applied at the partnership level and is based on the cumulative reduction in the partnership's alternative minimum taxable income resulting from repeal of that preference.

The bill provides that in making partnership-level computations, any item of income, gain, loss, deduction, or credit attributable to a partner who is a disqualified person is disregarded. For example, in computing the partnership's net income from oil and gas for purposes of determining the IDC preference (if any) to be reported to partners who are not disqualified persons as part of the AMT adjustment, disqualified persons' distributive shares of the partnership's net income from oil and gas are not to be taken into account.

Regulatory authority

The Secretary of the Treasury is granted authority to prescribe such regulations as may be appropriate to carry out the purposes of the provisions.

Effective Date

The provisions generally apply to partnership taxable years ending on or after December 31, 1993. The deferred sale provision applies to any contribution of property (other than cash) made on or after the date of enactment to a partnership which is, or is reasonably expected to become, a large partnership. It is intended that no inference be drawn as to the proper treatment of contributions of appreciated or depreciated property to a partnership made prior to the effective date.

2. Simplified audit procedures for large partnerships (sec. 302 of the bill and secs. 6240, 6241, 6242, 6245, 6246, 6247, 6249, 6251, 6252, 6255, and 6256 of the Code)

Present Law

In general

Prior to 1982, regardless of the size of a partnership, adjustments to a partnership's items of income, gain, loss, deduction, or credit had to be made in separate proceedings with respect to each partner individually. Because a large partnership sometimes had many partners located in different audit districts, adjustments to items of income, gains, losses, deductions, or credits of the partnership had to be made in numerous actions in several jurisdictions, sometimes with conflicting outcomes.

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") established unified audit rules applicable to all but certain small (10 or fewer partners) partnerships. These rules require the tax treatment of all "partnership items" to be determined at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, as provided by regulations.

Administrative proceedings

Under the TEFRA rules, a partner must report all partnership items consistently with the partnership return or must notify the IRS of any inconsistency. If a partner fails to report any partnership item consistently with the partnership return, the IRS may make a computational adjustment and immediately assess any additional tax that results.

The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. But the IRS must still assess any resulting deficiency against each of the taxpayers who were partners in the year in which the understatement of tax liability arose.

Any partner of a partnership can request an administrative adjustment or a refund for his own separate tax liability. Any partner also has the right to participate in partnership-level administrative proceedings. A settlement agreement with respect to partnership items binds all parties to the settlement.

Tax Matters Partner

The TEFRA rules establish the "Tax Matters Partner" as the primary representative of a partnership in dealings with the IRS. The Tax Matters Partner is a general partner designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year. If no Tax Matters Partner is designated, and it is impractical to apply the largest profits interest rule, the IRS may select any partner as the Tax Matters Partner.

Notice requirements

The IRS generally is required to give notice of the beginning of partnership-level administrative proceedings and any resulting ad-

ministrative adjustment to all partners whose names and addresses are furnished to the IRS. For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to any partner whose profits interest is less than one percent.

Adjudication of disputes concerning partnership items

After the IRS makes an administrative adjustment, the Tax Matters Partner (and, in limited circumstances, certain other partners) may file a petition for readjustment of partnership items in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court.

Statute of limitations

The IRS generally cannot adjust a partnership item for a partnership taxable year if more than 3 years have elapsed since the later of the filing of the partnership return or the last day for the filing of the partnership return.

Reasons for Simplification

Present audit procedures for large partnerships are inefficient and more complex than those for other large entities. The IRS must assess any deficiency arising from a partnership audit against a large number of partners, many of whom cannot easily be located and some of whom are no longer partners. In addition, audit procedures are cumbersome and can be complicated further by the intervention of partners acting individually.

Explanation of Provision

In general

The bill creates a new audit system for large partnerships. The bill defines "large partnership" the same way for audit and reporting purposes (generally partnerships with at least 250 partners) except that certain oil and gas partnerships exempted from the large partnership reporting requirements are large partnerships for the audit rules.

As under present law, large partnerships and their partners are subject to unified audit rules. Thus, the tax treatment of "partnership items" are determined at the partnership, rather than the partner, level. The term "partnership items" is defined as under present law.

Unlike present law, however, partnership adjustments generally will flow through to the partners for the year in which the adjustment takes effect. Thus, the current-year partners' share of current-year partnership items of income, gains, losses, deductions, or credits will be adjusted to reflect partnership adjustments that take effect in that year. The adjustments generally will not affect prior-year returns of any partners (except in the case of changes to any partner's distributive shares).

In lieu of flowing an adjustment through to its partners, the partnership may elect to pay an imputed underpayment. The imputed underpayment generally is calculated by netting the adjustments to the income and loss items of the partnership and multi-

plying that amount by the highest tax rate (whether individual or corporate). A partner may not file a claim for credit or refund of his allocable share of the payment.

Regardless of whether a partnership adjustment flows through to the partners, an adjustment must be offset if it requires another adjustment in a year after the adjusted year and before the year the offsetted adjustment takes effect. For example, if a partnership expensed a $1,000 item in year 1, and it was determined in year 4 that the item should have been capitalized and amortized ratably over 10 years, the adjustment in year 4 would be $700, apart from any interest or penalty. (The $900 adjustment for the improper deduction would be offset by $200 of adjustments for amortization deductions.) The year 4 partners would be required to include an additional $700 in income for that year. The partnership may ratably amortize the remaining $700 of expenses in years 4-10.

In addition, the partnership, rather than the partners individually, generally is liable for any interest and penalties that result from a partnership adjustment. Interest is computed for the period beginning on the return due date for the adjusted year and ending on the earlier of the return due date for the partnership taxable year in which the adjustment takes effect or the date the partnership pays the imputed underpayment. Thus, in the above example, the partnership would be liable for 4 years' worth of interest (on a declining principal amount).

Penalties (such as the accuracy and fraud penalties) are determined on a year-by-year basis (without offsets) based on an imputed underpayment. All accuracy penalty criteria and waiver criteria (such as reasonable cause, substantial authority, etc.) are determined as if the partnership were a taxable individual. Accuracy and fraud penalties are assessed and accrue interest in the same manner as if asserted against a taxable individual.

Any payment (for Federal income taxes, interest, or penalties) that a large partnership is required to make is non-deductible.

If a partnership ceases to exist before a partnership adjustment takes effect, the former partners are required to take the adjustment into account, as provided by regulations. Regulations are also authorized to prevent abuse and to enforce efficiently the audit rules in circumstances that present special enforcement considerations (such as partnership bankruptcy).

Administrative proceedings

Under the large partnership audit rules, a partner is not permitted to report any partnership items inconsistently with the partnership return, even if the partner notifies the IRS of the inconsistency. The IRS could treat a partnership item that was reported inconsistently by a partner as a mathematical or clerical error and immediately assess any additional tax against that partner. As under present law, the IRS could challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. Unlike under present law, however, partners will have no right individually to participate in settlement conferences or to request a refund.

Partnership representative

The bill requires each large partnership to designate a partner or other person to act on its behalf. If a large partnership fails to designate such a person, the IRS is permitted to designate any one of the partners as the person authorized to act on the partnership's behalf. After the IRS's designation, a large partnership could still designate a replacement for the IRS-designated partner.

Notice requirements

Unlike under present law, the IRS is not required to give notice to individual partners of the commencement of an administrative proceeding or of a final adjustment. Instead, the IRS is authorized to send notice of a partnership adjustment to the partnership itself by certified or registered mail. The IRS could give proper notice by mailing the notice to the last known address of the partnership, even if the partnership had terminated its existence.

Adjudication of disputes concerning partnership items

As under present law, an administrative adjustment could be challenged in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court. However, only the partnership, and not partners individually, can petition for a readjustment of partnership items.

If a petition for readjustment of partnership items is filed by the partnership, the court with which the petition is filed will have jurisdiction to determine the tax treatment of all partnership items of the partnership for the partnership taxable year to which the notice of partnership adjustment relates, and the proper allocation of such items among the partners. Thus, the court's jurisdiction is not limited to the items adjusted in the notice.

Statute of limitations

Absent an agreement to extend the statute of limitations, the IRS generally could not adjust a partnership item of a large partnership more than 3 years after the later of the filing of the partnership return or the last day for the filing of the partnership return. Special rules apply to false or fraudulent returns, a substantial omission of income, or the failure to file a return. The IRS would assess and collect any deficiency of a partner that arises from any adjustment to a partnership item subject to the limitations period on assessments and collection applicable to the year the adjustment takes effect (secs. 6248, 6501 and 6502).

Regulatory authority

The Secretary of the Treasury is granted authority to prescribe regulations as may be necessary to carry out the simplified audit procedure provisions, including regulations to prevent abuse of the provisions through manipulation. The regulations may include rules that address transfers of partnership interests, in anticipation of a partnership adjustment, to persons who are tax-favored (e.g., corporations with net operating losses, tax-exempt organizations, and foreign partners) or persons who are expected to be unable to pay tax (e.g., shell corporations). For example, if prior to

the time a partnership adjustment takes effect, a taxable partner transfers a partnership interest to a nonresident alien to avoid the tax effect of the partnership adjustment, the rules may provide, among other things, that income related to the partnership adjustment is treated as effectively connected taxable income, that the partnership adjustment is treated as taking effect before the partnership interest was transferred, or that the former partner is treated as a current partner to whom the partnership adjustment is allocated.

Effective Date

The provision applies to partnership taxable years ending on or after December 31, 1993.

3. Advance due date for furnishing information to partners (sec. 303 of the bill and sec. 6031(b) of the Code)

Present Law

A partnership required to file an income tax return with the Internal Revenue Service must also furnish an information return to each of its partners on or before the day on which the income tax return for the year is required to be filed, including extensions. Under regulations, a partnership must file its income tax return on or before the fifteenth day of the fourth month following the end of the partnership's taxable year (on or before April 15, for calendar year partnerships). This is the same deadline by which most individual partners must file their tax returns.

Reasons for Simplification

Information returns that are received on or shortly before April 15 (or later) are difficult for individuals to use in preparing their tax returns (or in computing their payments) that are due on that date.

Explanation of Provision

The bill provides that a large partnership must furnish information returns to partners by the first March 15 following the close of the partnership's taxable year. Large partnerships would be only those partnerships subject to the simplified reporting rules for large partnerships, as described above.

The bill also provides that, if the partnership is required to provide copies of the information returns to the Internal Revenue Service on magnetic media, each schedule (such as each Schedule K-1) with respect to each partner is treated as a separate information return with respect to the corrective periods and penalties that are generally applicable to all information returns.

Effective Date

The provision is effective for partnership taxable years ending on or after December 31, 1993.

4. Partnership returns on magnetic media (sec. 304 of the bill and sec. 6011 of the Code)

Present Law

Partnerships are permitted, but not required, to provide the tax return of the partnership (Form 1065), as well as copies of the schedules sent to each partner (Form K-1), to the Internal Revenue Service on magnetic media.

Reasons for Simplification

Most entities that file large numbers of documents with the Internal Revenue Service must do so on magnetic media. Conforming the reporting provisions for large partnerships to the generally applicable information reporting rules will facilitate integration of partnership information into already existing data systems.

Explanation of Provision

The bill authorizes the Internal Revenue Service to require large partnerships and other partnerships with 250 or more partners to provide the tax return of the partnership (Form 1065), as well as copies of the schedules sent to each partner (Form K-1), to the Internal Revenue Service on magnetic media.

Effective Date

For partnerships that are large partnerships (as defined in the preceding reporting and audit provisions), the provision is effective for partnership taxable years ending on or after December 31, 1993. For partnerships that are not large partnerships (as defined) but that have 250 or more partners, the provision is effective for partnership taxable years ending on or after December 31, 1998.

5. IRA filing requirements for income from certain unrelated trades and businesses (sec. 305 of the bill and sec. 6012 of the Code)

Present Law

Return filing requirements

An individual retirement account ("IRA") is a trust which generally is exempt from taxation except for the taxes imposed on income from an unrelated trade or business (sec. 408(e)(1)). Under regulations, a fiduciary of a trust that is exempt from taxation (but subject to the taxes imposed on income from an unrelated trade or business) generally is required to file a return on behalf of the trust for a taxable year if the trust has gross income of $1,000 or more included in computing unrelated business taxable income for that year (Treas. Reg. sec. 1.6012-3(a)(5)).

Unrelated business taxable income is the gross income (including gross income from a partnership) derived by an exempt organization from an unrelated trade or business, less certain deductions which are directly connected with the carrying on of such trade or business (sec. 512(a)(1)). In calculating unrelated business taxable

income, exempt organizations (including IRAs) generally also are permitted a specific deduction of $1,000 (sec. 512(b)(12)).

For purposes of determining whether income is from an unrelated trade or business, the character of a partner's distributive share of partnership income generally is the same as if the income had been directly realized by the partner (sec. 512(c)).

Unified audits of partnerships

All but certain small partnerships are subject to unified audit rules established by the Tax Equity and Fiscal Responsibility Act of 1982. These rules require the tax treatment of all "partnership items" to be determined at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, including such items as gross income and deductions of the partnership.

Reasons for Simplification

Under present law, tax returns often must be filed for IRAs that have no taxable income and, consequently, no tax liability. The filing of these returns by taxpayers, and the processing of these returns by the IRS, impose significant costs. Imposing this burden is unnecessary to the extent that the income of the IRA has been derived from an interest in a partnership that is subject to partnership-level audit rule. In these circumstances, the appropriateness of any deductions may be determined at the partnership level, and an additional filing is unnecessary to facilitate this determination.

Explanation of Provision

The bill modifies the filing threshold for an IRA with an interest in a partnership that is subject to the partnership-level audit rules. A fiduciary of such an IRA may treat the trust's share of partnership taxable income as gross income, for purposes of determining whether the trust meets the $1,000 gross income filing threshold. Thus, under the provision, a fiduciary of an IRA that receives taxable income from a partnership that is subject to partnership-level audit rules and gross income from any other unrelated trade or business will be required to file an income tax return where the sum of such taxable and gross income is $1,000 or more. A fiduciary of an IRA that receives taxable income from a partnership that is subject to partnership-level audit rules of less than $1,000 (before the $1,000 specific deduction) will not be required to file an income tax return if the IRA does not have any other income from an unrelated trade or business.

Effective Date

The provision applies to taxable years beginning after December 31, 1992.

B. Partnership Proceedings Under TEFRA [16]

1. Clarify the treatment of partnership items in deficiency proceedings (sec. 311 of the bill and sec. 6234 of the Code)

Present Law

TEFRA partnership proceedings must be kept separate from deficiency proceedings involving the partners in their individual capacities. Prior to the Tax Court's opinion in *Munro* v. *Commissioner*, 92 T.C. 71 (1989), the IRS computed deficiencies by assuming that all items that were subject to the TEFRA partnership procedures were correctly reported on the taxpayer's return. However, where the losses claimed from TEFRA partnerships were so large that they offset any proposed adjustments to nonpartnership items, no deficiency could arise from a non-TEFRA proceeding, and if the partnership losses were subsequently disallowed in a partnership proceeding, the non-TEFRA adjustments might be uncollectible because of the expiration of the statute of limitations with respect to nonpartnership items.

Faced with this situation in *Munro*, the IRS issued a notice of deficiency to the taxpayer that presumptively disallowed the taxpayer's TEFRA partnership losses for computational purposes only. Although the Tax Court ruled that a deficiency existed and that the court had jurisdiction to hear the case, the court disapproved of the methodology used by the IRS to compute the deficiency. Specifically, the court held that partnership items (whether income, loss, deduction, or credit) included on a taxpayer's return must be completely ignored in determining whether a deficiency exists that is attributable to nonpartnership items.

Reasons for Simplification

The opinion in *Munro* creates problems for both taxpayers and the IRS. For example, a taxpayer would be harmed in the case where he has invested in a TEFRA partnership and is also subject to the deficiency procedures with respect to nonpartnership item adjustments, since computing the tax liability without regard to partnership items will have the same effect as if the partnership items were disallowed. If the partnership items were losses, the effect will be a greatly increased deficiency for the nonpartnership items. If, when the partnership proceeding is completed, the taxpayer is ultimately allowed any part of the losses, the taxpayer will receive part of the increased deficiency back in the form of an overpayment. However, in the interim, the taxpayer will have been subject to assessment and collection of a deficiency inflated by items still in dispute in the partnership proceeding. In essence, a taxpayer in such a case would be deprived of a prepayment forum with respect to the partnership item adjustments. The IRS would be harmed if a taxpayer's income is primarily from a TEFRA partnership, since the IRS may be unable to adjust nonpartnership items such as medical expense deductions, home mortgage interest deductions or charitable contribution deductions because there

[16] Tax Equity and Fiscal Responsibility Act of 1982.

would be no deficiency since, under *Munro,* the income must be ignored.

Explanation of Provision

The bill is intended to overrule *Munro* and allow the IRS to return to its prior practice of computing deficiencies by assuming that all TEFRA items whose treatment has not been finally determined had been correctly reported on the taxpayer's return. This will eliminate the need to do special computations that involve the removal of TEFRA items from a taxpayer's return, and will restore to taxpayers a prepayment forum with respect to the TEFRA items. In addition, the bill provides a special rule to address the factual situation presented in *Munro.*

Specifically, the bill provides a declaratory judgment procedure in the Tax Court for adjustments to an oversheltered return. An oversheltered return is a return that shows no taxable income and a net loss from TEFRA partnerships. In such a case, the IRS is authorized to issue a notice of adjustment with respect to non-TEFRA items, notwithstanding that no deficiency would result from the adjustment. However, the IRS may only issue such a notice if a deficiency would have arisen in the absence of the net loss from TEFRA partnerships.

The Tax Court would be granted jurisdiction to determine the correctness of such an adjustment as well as to make a declaration with respect to any other item for the taxable year to which the notice of adjustment relates, except for partnership items and affected items which require partner-level determinations. No tax would be due upon such a determination, but a decision of the Tax Court would be treated as a final decision, permitting an appeal of the decision by either the taxpayer or the IRS. An adjustment determined to be correct would thus have the effect of increasing the taxable income that would be deemed to have been reported on the taxpayer's return. If the taxpayer's partnership items were then adjusted in a subsequent proceeding, the IRS would have preserved its ability to collect tax on any increased deficiency attributable to the nonpartnership items.

Alternatively, if the taxpayer chooses not to contest the notice of adjustment within the 90-day period, the bill provides that when the taxpayer's partnership items are finally determined, the taxpayer has the right to file a refund claim for tax attributable to the items adjusted by the earlier notice of adjustment for the taxable year. Although a refund claim is not generally permitted with respect to a deficiency arising from a TEFRA proceeding, such a rule is appropriate with respect to a defaulted notice of adjustment because taxpayers may not challenge such a notice when issued since it does not require the payment of additional tax.

In addition, the bill incorporates a number of provisions intended to clarify the coordination between TEFRA audit proceedings and individual deficiency proceedings. Under these provisions, any adjustment with respect to a non-partnership item that caused an increase in tax liability with respect to a partnership item would be treated as a computational adjustment and assessed after the conclusion of the TEFRA proceeding. Accordingly, deficiency proce-

dures would not apply with respect to this increase in tax liability, and the statute of limitations applicable to TEFRA proceedings would be controlling.

Effective Date

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

2. Permit the IRS to rely on partnership returns to determine the proper audit procedures (sec. 312 of the bill and sec. 6231 of the Code)

Present Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Reasons for Simplification

The IRS often finds it difficult to determine whether to follow the TEFRA partnership procedures or the regular deficiency procedures. If the IRS determines that there were fewer than 10 partners in the partnership but was unaware that one of the partners was a nonresident alien or that there was a special allocation made during the year, the IRS might inadvertently apply the wrong procedures and possibly jeopardize any assessment. Permitting the IRS to rely on a partnership's return would simplify the IRS' task.

Explanation of Provision

The bill permits the IRS to apply the TEFRA audit procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply. Similarly, the bill permits the IRS to apply the normal deficiency procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply.

Effective Date

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

3. Statute of limitations

a. Suspend statute when an untimely petition is filed (sec. 313(a) and sec. 6229 of the Code)

Present Law

In a deficiency case, section 6503(a) provides that if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, the period of limitations on assessment and collection is sus-

pended until the decision of the Tax Court becomes final, and for 60 days thereafter. The counterpart to this provision with respect to TEFRA cases is contained in section 6229(d). That section provides that the period of limitations is suspended for the period during which an action may be brought under section 6226 and, if an action is brought during such period, until the decision of the court becomes final, and for 1 year thereafter. As a result of this difference in language, the running of the statute of limitations in a TEFRA case will only be tolled by the filing of a timely petition whereas in a deficiency case, the statute of limitations is tolled by the filing of any petition, regardless of whether the petition is timely.

Reasons for Simplification

Under present law, if an untimely petition is filed in a TEFRA case, the statute of limitations can expire while the case is still pending before the court. To prevent this from occurring, the IRS must make assessments against all of the investors during the pendency of the action and if the action is in the Tax Court, presumably abate such assessments if the court ultimately determines that the petition was timely. These steps are burdensome to the IRS and to taxpayers.

Explanation of Provision

The provision is designed to conform the suspension rule for the filing of petitions in TEFRA cases with the rule under section 6503(a) pertaining to deficiency cases. Under the provision, the statute of limitations in TEFRA cases would be suspended by the filing of any petition under section 6226, regardless of whether the petition is timely or valid, and the suspension will remain in effect until the decision of the court becomes final, and for one year thereafter. Hence, if the statute of limitations is open at the time that an untimely petition is filed, the limitations period will no longer continue to run and possibly expire while the action is pending before the court.

Effective Date

The provision is effective with respect to all cases in which the period of limitations has not expired under present law as of the date of enactment.

b. Suspend statute of limitations during bankruptcy proceedings (sec. 313(b) of the bill and sec. 6229 of the Code)

Present Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6503(h) provides

for the suspension of the limitations period during the pendency of a bankruptcy proceeding. However, this provision only applies to the limitations periods provided in sections 6501 and 6502.

Under present law, because the suspension provision in section 6503(h) applies only to the limitations periods provided in section 6501 and 6502, some uncertainty exists as to whether section 6503(h) applies to suspend the limitations period pertaining to converted items provided in section 6229(f) when a petition naming a partner as a debtor in a bankruptcy proceeding is filed. As a result, the limitations period provided in section 6229(f) may continue to run during the pendency of the bankruptcy proceeding, notwithstanding that the IRS is prohibited from making an assessment against the debtor because of the automatic stay provisions of the Bankruptcy Code.

Reasons for Simplification

The ambiguity in present law makes it difficult for the IRS to adjust partnership items that convert to nonpartnership items by reason of a partner going into bankruptcy. In addition, any uncertainty may result in increased requests for the bankruptcy court to lift the automatic stay to permit the IRS to make an assessment with respect to the converted items.

Explanation of Provision

The bill clarifies that the statute of limitations is suspended for a partner who is named in a bankruptcy petition. The suspension period is for the entire period during which the IRS is prohibited by reason of the bankruptcy proceeding from making an assessment, and for 60 days thereafter. The provision is not intended to create any inference as to the proper interpretation of present law.

Effective Date

The provision is effective with respect to all cases in which the period of limitations has not expired under present law as of the date of enactment.

c. Extend statute of limitations for bankrupt TMPs (sec. 313(c) and sec. 6229 of the Code)

Present Law

Section 6229(b)(1)(B) provides that the statute of limitations is extended with respect to all partners in the partnership by an agreement entered into between the Tax Matters Partner (TMP) and the IRS. However, Temp. Treas. Reg. secs. 301.6231(a)(7)-1T(1)(4) and 301.6231(c)-7T(a) provide that upon the filing of a petition naming a partner as a debtor in a bankruptcy proceeding, that partner's partnership items convert to nonpartnership items, and if the debtor was the tax matters partner, such status terminates. These rules are necessary because of the automatic stay provision contained in 11 U.S.C. sec. 362(a)(8). As a result, if a consent to extend the statute of limitations is signed by a person who would be the TMP but for the fact that at the time that the agreement is execut-

ed the person was a debtor in a bankruptcy proceeding, the consent would not be binding on the other partners because the person signing the agreement was no longer the TMP at the time that the agreement was executed.

Reasons for Simplification

The IRS is not automatically notified of bankruptcy filings and cannot easily determine whether a taxpayer is in bankruptcy, especially if the audit of the partnership is being conducted by one district and the taxpayer resides in another district, as is frequently the situation in TEFRA cases. If the IRS does not discover that a person signing a consent is in bankruptcy, the IRS may mistakenly rely on that consent. As a result, the IRS may be precluded from assessing any tax attributable to partnership item adjustments with respect to any of the partners in the partnership.

Explanation of Provision

The bill provides that unless the IRS is notified of a bankruptcy proceeding in accordance with regulations, the IRS can rely on a statute extension signed by a person who would be the tax matters partner but for the fact that said person was in bankruptcy at the time that the person signed the agreement. Statute extensions granted by a bankrupt TMP in these cases will be binding on all of the partners in the partnership. The provision is not intended to create any inference as to the proper interpretation of present law.

Effective Date

The provision is effective for extension agreements entered into after the date of enactment.

4. Expand small partnership exception from TEFRA (sec. 314 of the bill and sec. 6231 of the Code)

Present Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Reasons for Simplification

The mere existence of a C corporation as a partner or of a special allocation does not warrant subjecting the partnership and its partners of an otherwise small partnership to the TEFRA procedures.

Explanation of Provision

The bill permits a small partnership to have a C corporation as a partner or to specially allocate items without jeopardizing its exception from the TEFRA rules. However, the bill retains the prohibition of present law against having a flow-through entity (other

than an estate of a deceased partner) as a partner for purposes of qualifying for the small partnership exception.

Effective Date

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

5. Exclude partial settlements from 1-year assessment rule (sec. 315 of the bill and sec. 6229(f) of the Code)

Present Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6231(b)(1)(C) provides that the partnership items of a partner for a partnership taxable year become nonpartnership items as of the date the partner enters into a settlement agreement with the IRS with respect to such items.

Reasons for Simplification

When a partial settlement agreement is entered into, the assessment period for the items covered by the agreement may be different than the assessment period for the remaining items. This fractured statute of limitations poses a significant tracking problem for the IRS and necessitates multiple computations of tax with respect to each partner's investment in the partnership for the taxable year.

Explanation of Provision

The bill provides that if a partner and the IRS enter into a settlement agreement with respect to some but not all of the partnership items in dispute for a partnership taxable year and other partnership items remain in dispute, the period for assessing any tax attributable to the settled items would be determined as if such agreement had not been entered into. Consequently, the limitations period that is applicable to the last item to be resolved for the partnership taxable year shall be controlling with respect to all disputed partnership items for the partnership taxable year. The provision is not intended to create any inference as to the proper interpretation of present law.

Effective Date

The provision is effective for settlements entered into after the date of enactment.

6. Extend time for filing a request for administrative adjustment (sec. 316 of the bill and sec. 6227 of the Code)

Present Law

If an agreement extending the statute is entered into with respect to a non-TEFRA statute of limitations, that agreement also extends the statute of limitations for filing refund claims (sec. 6511(c)). There is no comparable provision for extending the time for filing refund claims with respect to partnership items subject to the TEFRA partnership rules.

Reasons for Simplification

The absence of an extension for filing refund claims in TEFRA proceedings hinders taxpayers that may want to agree to extend the TEFRA statute of limitations but want to preserve their option to file a refund claim later.

Explanation of Provision

The bill provides that if a TEFRA statute extension agreement is entered into, that agreement also extends the statute of limitations for filing refund claims attributable to partnership items or affected items until 6 months after the expiration of the limitations period for assessments.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

7. Provide innocent spouse relief for TEFRA proceedings (sec. 317 of the bill and sec. 6230 of the Code)

Present Law

In general, an innocent spouse may be relieved of liability for tax, penalties and interest if certain conditions are met (sec. 6013(e)). However, existing law does not provide the spouse of a partner in a TEFRA partnership with a judicial forum to raise the innocent spouse defense with respect to any tax or interest that relates to an investment in a TEFRA partnership.

Reasons for Simplification

Providing a forum in which to raise the innocent spouse defense with respect to liabilities attributable to adjustments to partnership items (including penalties, additions to tax and additional amounts) would make the innocent spouse rules more uniform.

Explanation of Provision

The bill provides both a prepayment forum and a refund forum for raising the innocent spouse defense in TEFRA cases.

With respect to a prepayment forum, the bill provides that within 60 days of the date that a notice of computational adjust-

ment relating to partnership items is mailed to the spouse of a partner, the spouse may request that the assessment be abated. Upon receipt of such a request, the assessment will be abated and any reassessment will be subject to the deficiency procedures. If an abatement is requested, the statute of limitations will not expire before the date which is 60 days after the date of the abatement. If the spouse files a petition with the Tax Court, the Tax Court will only have jurisdiction to determine whether the requirements of section 6013(e) have been satisfied. In making this determination, the treatment of the partnership items that gave rise to the liability in question will be conclusive.

Alternatively, the bill provides that the spouse of a partner may file a claim for refund to raise the innocent spouse defense. The claim must be filed within 6 months from the date that the notice of computational adjustment is mailed to the spouse. If the claim is not allowed the spouse may file a refund action. For purposes of any claim or suit under this provision, the treatment of the partnership items that gave rise to the liability in question will be conclusive.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

8. Determine penalties at the partnership level (sec. 318 of the bill and sec. 6221 of the Code)

Present Law

Partnership items include only items that are required to be taken into account under the income tax subtitle. Penalties are not partnership items since they are contained in the procedure and administration subtitle. As a result, penalties may only be asserted against a partner through the application of the deficiency procedures following the completion of the partnership-level proceeding.

Reasons for Simplification

Many penalties are based upon the conduct of the taxpayer. With respect to partnerships, the relevant conduct often occurs at the partnership level. In addition, applying penalties at the partner level through the deficiency procedures following the conclusion of the unified proceeding at the partnership level increases the administrative burden on the IRS and can significantly increase the Tax Court's inventory.

Explanation of Provision

The bill provides that the partnership level proceeding is to include a determination of the applicability of penalties at the partnership level. However, the bill allows partners to raise any partner-level defenses in a refund forum.

Effective Date

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

9. Clarify jurisdiction of the Tax Court (sec. 319 of the bill and secs. 6225 and 6226 of the Code)

Present Law

Improper assessment and collection activities by the IRS during the 150-day period for filing a petition or during the pendency of any Tax Court proceeding, "may be enjoined in the proper court." Present law may be unclear as to whether this includes the Tax Court.

For a partner other than the Tax Matters Partner to be eligible to file a petition for redetermination of partnership items in any court or to participate in an existing case, the period for assessing any tax attributable to the partnership items of that partner must not have expired. Since such a partner would only be treated as a party to the action if the statute of limitations with respect to them was still open, the law is unclear whether the partner would have standing to assert that the statute of limitations had expired with respect to them.

Reasons for Simplification

Clarifying the Tax Court's jurisdiction simplifies the resolution of tax cases.

Explanation of Provision

The bill clarifies that an action to enjoin premature assessments of deficiencies attributable to partnership items may be brought in the Tax Court. The bill also permits a partner to participate in an action or file a petition for the sole purpose of asserting that the period of limitations for assessing any tax attributable to partnership items has expired for that person. Additionally, the bill clarifies that the Tax Court has overpayment jurisdiction with respect to affected items.

Effective Date

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

10. Treatment of premature petitions filed by certain partners (sec. 320 of the bill and sec. 6226 of the Code)

Present Law

The Tax Matters Partner is given the exclusive right to file a petition for a readjustment of partnership items within the 90-day period after the issuance of the notice of a final partnership administrative adjustment (FPAA). If the Tax Matters Partner does not file a petition within the 90-day period, certain other partners are permitted to file a petition within the 60-day period after the close

of the 90-day period. There are ordering rules for determining which action goes forward and for dismissing other actions.

Reasons for Simplification

A petition that is filed within the 90-day period by a person who is not the Tax Matters Partner is dismissed. Thus, if the Tax Matters Partner does not file a petition within the 90-day period and no timely and valid petition is filed during the succeeding 60-day period, judicial review of the adjustments set forth in the notice of FPAA is foreclosed and the adjustments are deemed to be correct.

Explanation of Provision

The bill treats premature petitions filed by certain partners within the 90-day period will be treated as being filed on the last day of the following 60-day period under specified circumstances, thus affording the partnership with an opportunity for judicial review that is not available under present law.

Effective Date

The provision is effective with respect to petitions filed after the date of enactment.

11. Clarify bond requirement for appeals from TEFRA proceedings (sec. 321 of the bill and sec. 7485 of the Code)

Present Law

A bond must be filed to stay the collection of deficiencies pending the appeal of the Tax Court's decision in a TEFRA proceeding. The amount of the bond must be based on the court's estimate of the aggregate deficiencies of the partners.

Reasons for Simplification

The Tax Court cannot easily determine the aggregate changes in tax liability of all of the partners in a partnership who will be affected by the Court's decision in the proceeding. Clarifying the calculation of the bond amount would simplify the Tax Court's task.

Explanation of Provision

The bill clarifies that the amount of the bond should be based on the Tax Court's estimate of the aggregate liability of the parties to the action (and not all of the partners in the partnership). For purposes of this provision, the amount of the bond may be estimated by applying the highest individual rate to the total adjustments determined by the Tax Court and doubling that amount to take into account interest and penalties.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

12. Suspend interest where there is a delay in computational adjustment resulting from TEFRA settlements (sec. 322 of the bill and sec. 6601 of the Code)

Present Law

Interest on a deficiency generally is suspended when a taxpayer executes a settlement agreement with the IRS and waives the restrictions on assessments and collections, and the IRS does not issue a notice and demand for payment of such deficiency within 30 days. Interest on a deficiency that results from an adjustment of partnership items in TEFRA proceedings, however, is not suspended.

Reasons for Simplification

Processing settlement agreements and assessing the tax due takes a substantial amount of time in TEFRA cases. A taxpayer is not afforded any relief from interest during this period.

Explanation of Provision

The bill suspends interest where there is a delay in making a computational adjustment relating to a TEFRA settlement.

Effective Date

The provision is effective with respect to adjustments relating to taxable years beginning after the date of enactment.

13. Extend time for filing a request for administrative adjustment relating to worthless securities and bad debt (sec. 323 of the bill and sec. 6227 of the Code)

Present Law

The non-TEFRA statute of limitations for filing a claim for credit or refund generally is the later of (1) three years from the date the return in question was filed or (2) two years from the date the claimed tax was paid, whichever is later (sec. 6511(b)). However, an extended period of time, seven years from the date the return was due, is provided for filing a claim for refund of an overpayment resulting from a deduction for a worthless security or bad debt (sec. 6511(d)).

Under the TEFRA partnership rules, a request for administrative adjustment ("RAA") must be filed within three years after the later of (1) the date the partnership return was filed or (2) the due date of the partnership return (determined without regard to extensions) (sec. 6227(a)(1)). In addition, the request must be filed before a final partnership administrative adjustment ("FPAA") is mailed for the taxable year (sec. 6227(a)(2)). There is no special provision for extending the time for filing an RAA that relates to a deduction for a worthless security or an entirely worthless bad debt.

Reasons for Simplification

Whether and when a stock or debt becomes worthless is a question of fact that may not be determinable until after the year in which it appears the loss has occurred. An extended statute of limitations allows partners in a TEFRA partnership the same opportunity to file a delayed claim for refund in these difficult factual situations as permitted other taxpayers.

Further, on past occasion, the IRS issued FPAAs that did not adjust the partnership's tax return. This action created wasteful paperwork, and may have, in some cases truncated the appeals rights of individual partners. A special rule is necessary to permit partners who may have been adversely impacted by this past practice of the IRS to avail themselves of the extended period irrespective of whether an FPAA has been issued.

Explanation of Provision

The bill extends the time for the filing of an RAA relating to the deduction by a partnership for a worthless security or bad debt. In these circumstances, in lieu of the three-year period provided in sec. 6227(a)(1), the period for filing an RAA will be seven years from the date the partnership return was due with respect to which the request is made (determined without regard to extensions). The RAA must still be filed before the FPAA is mailed for the taxable year.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

TITLE IV. FOREIGN PROVISIONS

1. Deferral of tax on income earned through foreign corporations and exceptions to deferral (secs. 401-404 of the bill and secs. 453, 532, 542, 543, 551-558, 563, 851, 954, 1246-1247, 1291-1297, and 4982 of the Code)

Present Law

Direct and indirect operations

U.S. citizens and residents and U.S. corporations (collectively, "U.S. persons") are taxed currently by the United States on their worldwide income, subject to a credit against U.S. tax on foreign income based on foreign income taxes paid with respect to such income. Income earned by a foreign corporation, the stock of which is owned in whole or in part by U.S. persons, generally is not taxed by the United States until the foreign corporation repatriates those earnings by payment to its U.S. stockholders. Therefore, two different sets of U.S. tax rules apply to U.S. taxpayers that control business operations in foreign countries; which rules apply depends on whether the business operations are conducted directly, for example, through a foreign branch, or indirectly through a separately incorporated foreign company.[17]

U.S. persons that conduct foreign operations directly (that is, not through a foreign corporation) include income (or loss) from those operations on the U.S. tax return for the year the income is earned or the loss is incurred. The United States taxes that income currently. The foreign tax credit may reduce or eliminate the U.S. tax on that income, however.

U.S. persons that conduct foreign operations through a foreign corporation generally pay no U.S. tax on the income from those operations until the foreign corporation repatriates its earnings to the United States. The income appears on the U.S. owner's tax return for the year it comes home, and the United States imposes tax on it then. The foreign tax credit may reduce the U.S. tax.[18]

In general, two kinds of transactions are repatriations that end deferral and trigger tax. First, in the case of any foreign corporation, an actual dividend payment ends deferral; any U.S. recipient must include the dividend in income. Second, in the case of a "controlled foreign corporation" (defined below), an investment in U.S. property, such as a loan to the lender's U.S. parent or the purchase of U.S. real estate, is also treated as a repatriation that ends deferral (Code sec. 956). In addition to these two forms of repatriation, a

[17] To the extent that foreign corporations operate in the United States rather than in foreign countries, they generally pay U.S. tax like U.S. corporations.

[18] The foreign corporation itself generally will not pay U.S. tax unless it has income effectively connected with a trade or business carried on in the United States, or has certain generally passive types of U.S. source income.

sale of shares of a foreign corporation may trigger tax, sometimes at ordinary income tax rates (secs. 1246, 1248, and 1291).

Since 1937, the Code has set forth one or more regimes providing exceptions to the general rule deferring U.S. tax on income earned indirectly through a foreign corporation. Today the Code sets forth the following anti-deferral regimes: the controlled foreign corporation rules (secs. 951-964); the foreign personal holding company rules (secs. 551-558); passive foreign investment company (PFIC) rules (secs. 1291-1297); the personal holding company rules (secs. 541-547); the accumulated earnings tax (secs. 531-537); and rules for foreign investment companies (sec. 1246) and electing foreign investment companies (sec. 1247). The operation and application of these regimes are discussed in the following sections.

Controlled foreign corporations

General definitions

A controlled foreign corporation is defined in the Code generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only) (sec. 957).[19] Stock ownership includes not only stock owned directly, but also all stock owned indirectly or constructively (sec. 958).

Deferral of U.S. tax on undistributed income of a controlled foreign corporation is not available for certain kinds of income (sometimes referred to as "subpart F income") under the Code's subpart F provisions. When a controlled foreign corporation earns subpart F income, the United States generally taxes the corporation's 10-percent U.S. shareholders currently on their pro rata share of the subpart F income. In effect, the Code treats those U.S. shareholders as having received a current distribution out of the subpart F income. In this case, also, the foreign tax credit may reduce the U.S. tax.

Subpart F income typically is income that is relatively movable from one taxing jurisdiction to another and that is subject to low rates of foreign tax. Subpart F income consists of foreign base company income (defined in sec. 954), insurance income (defined in sec. 953), and certain income relating to international boycotts and other violations of public policy (defined in sec. 952(a)(3)-(5)). Subpart F income does not include the foreign corporation's income that is effectively connected with the conduct of a trade or business within the United States, which income is subject to current tax in the United States (sec. 952(b)).

Foreign base company income

In general.—Foreign base company income includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income (sec. 954(a)). In computing foreign base company

[19] A controlled foreign corporation is defined differently in the case of a foreign corporation engaging in certain insurance activities (see secs. 953(c) and 957(b)).

income, amounts of income in these five categories are reduced by allowable deductions (including taxes and interest) properly allocable, under regulations, to such amounts of income (sec. 954(b)(5)).

Foreign personal holding company income.—One category of foreign base company income is foreign personal holding company income (sec. 954(c)). For subpart F purposes, foreign personal holding company income generally includes interest, dividends, and annuities; some rents and royalties; related party factoring income; net commodities gains; net foreign currency gains; and net gains from sales or exchanges of certain other property.

This last category of net gains from sales of property generally includes the excess of gains over losses from sales and exchanges of non-income producing property and property that gives rise to interest, dividends, rents, royalties, and annuities. Thus, foreign personal holding company income includes gain on the sale of property that was held for investment purposes, but does not include gain on the sale of land, buildings, or equipment that was used by the seller in an active trade or business of the seller (Temporary Reg. sec. 1.954-2T(e)(3)). Stock and securities gains generally are treated as foreign personal holding company income. However, foreign personal holding company income does not include gains on property sales that are realized by regular dealers. Gains from the sale or exchange of property which, in the hands of the seller, is inventory property (sec. 1221(1)) are also excluded from foreign personal holding company income.

Income received by a foreign insurance company, including income derived from its investments of funds, generally is subject to taxation under section 953. (See discussion at "Insurance income, in general," below.) Treasury regulations specify that taxation of an insurance company's income under section 953 takes precedence over taxation of that income as foreign personal holding company income under section 954 (Proposed Treas. Reg. sec. 1.953-6(g)). When dividends, interest, or securities gains derived by a controlled foreign insurance company are not taxed under section 953, they generally are taxed as foreign personal holding company income under section 954.

Foreign personal holding company income under subpart F does not include certain dividends and interest received from a related corporation organized and operating in the same foreign country as the recipient, and certain rents and royalties received from a related corporation for the use of property within the country in which the recipient was created or organized (sec. 954(c)(3)). This exclusion, however, is restricted by a rule that takes into account the subpart F income of related-party payors. Under this rule, interest, rent, and royalty payments do not qualify for the exclusion to the extent that such payments reduce subpart F income of the payor.

Other categories of foreign base company income.—Foreign base company income also includes foreign base company sales and services income, consisting respectively of income attributable to related party purchases and sales routed through the income recipient's country if that country is neither the origin nor the destination of the goods, and income from services performed outside the country of the corporation's incorporation for or on behalf of related persons. Foreign base company income also includes foreign base com-

pany shipping income. Finally, foreign base company income generally includes "downstream" oil-related income, that is, foreign oil-related income other than extraction income.

Insurance income

In general.—Subpart F insurance income is another category of income that is subject to current taxation under subpart F (sec. 953). Subpart F insurance income includes any income attributable to the issuing (or reinsuring) of any insurance or annuity contract in connection with risks in a country other than that in which the insurer is created or organized. [20] For this purpose, a qualified insurance branch of a controlled foreign corporation may be treated as a corporation created or organized in the country of its location (sec. 964(d)).

The amount of income subject to current tax under subpart F as insurance income is the amount that would be taxed under subchapter L of the Code if it were the income of a domestic insurance company (subject to the modifications provided in sec. 953(b)). In addition, as described above, investment income associated with same-country risk insurance is also included in subpart F income as foreign personal holding company income. Thus, for an insurance controlled foreign corporation, deferral generally is limited to underwriting income from same-country risk insurance.

For purposes of subpart F insurance income, a controlled foreign corporation is specially defined to include, in addition to any corporation that meets the usual test of 50-percent ownership by 10-percent shareholders (discussed above), any foreign corporation that satisfies a test of 25-percent ownership by 10-percent shareholders if more than 75 percent of the corporation's gross premium income is derived from the reinsurance or issuance of insurance or annuity contracts with respect to third-country risks (sec. 957(b)).

Related person (captive) insurance income.—In addition, subpart F insurance income that is related person insurance income generally is taxable under subpart F to an expanded category of U.S. persons (sec. 953(c)). For purposes of taking into account such income under subpart F, the U.S. ownership threshold for controlled foreign corporation status is reduced to 25 percent or more. Any U.S. person who owns (directly or indirectly) any stock in a controlled foreign corporation, whatever the degree of ownership, is treated as a U.S. shareholder of such corporation for purposes of this 25-percent U.S. ownership threshold and exposed to current tax on the corporation's related person insurance income.

Certain operating rules

Income inclusion.—When a controlled foreign corporation earns subpart F income, the United States generally taxes the corporation's U.S. shareholders currently on their pro rata share of the subpart F income (sec. 951). [21] In the case of a corporation that is a

[20] In addition, subpart F applies to income attributable to an insurance contract in connection with same-country risks as the result of an arrangement under which another corporation receives a substantially equal amount of premiums for insurance of other-country risks.

[21] Current taxation applies only if the foreign corporation is a controlled foreign corporation for an uninterrupted period of at least 30 days during the taxable year.

controlled foreign corporation for its entire taxable year, and a U.S. shareholder that owns the same proportion of stock in the corporation throughout the corporation's taxable year, the U.S. shareholder's pro rata share of subpart F income is the amount that would have been distributed with respect to the shareholder's stock if on the last day of the corporation's taxable year the controlled foreign corporation had distributed all of its subpart F income pro rata to all of its shareholders. The pro rata share definition provides for adjustments where the corporation is a controlled foreign corporation for less than the entire year or where actual distributions are made with respect to stock the shareholder owns for less than the entire year.

In addition, the United States generally taxes the corporation's U.S. shareholders currently on their pro rata share of the corporation's increase in earnings invested in U.S. property for the taxable year.

De minimis and full inclusion rules.—None of a controlled foreign corporation's gross income for a taxable year is treated as foreign base company income or subpart F insurance income if the sum of the corporation's gross foreign base company income and gross subpart F insurance income for the year is less than the lesser of 5 percent of its gross income, or $1 million (sec. 954(b)(3)(A)). The Code provides that if more than 70 percent of a controlled foreign corporation's gross income is foreign base company income and/or subpart F insurance income, then all of its income is treated as foreign base company income or insurance income (whichever is appropriate) (sec. 954(b)(3)(B)). This 70-percent full inclusion rule does not apply, however, to income of a company that is a controlled foreign corporation only for purposes of the captive insurance company provision. (See Proposed Treas. Reg. sec. 1.953-6(k).)

Exception for certain income subject to high foreign taxes.—Income otherwise subject to current taxation as foreign base company income can be excluded from subpart F if the income was not in fact routed through a controlled foreign corporation in which the income bore a materially lower tax than would be due on the same income earned directly by a U.S. corporation (sec. 954(b)(4)). Subpart F employs an objective test to determine whether income that has been earned through a controlled foreign corporation in fact has been subject to less tax than it would have borne if the income had been earned directly. Under this rule, subpart F income (other than foreign base company oil-related income) does not include items of income received by a controlled foreign corporation if the taxpayer establishes to the satisfaction of the Secretary that the income, measured under U.S. tax rules, was subject to an effective rate of foreign tax equal to at least 90 percent of the maximum U.S. corporate tax rate.

Section 954(b)(4) applies solely at the taxpayer's election. That is, the provision applies only if the taxpayer endeavors to establish to the Secretary's satisfaction that the income in question was subject to the requisite foreign tax, and the taxpayer succeeds in doing so. The Secretary may not apply the provision without the taxpayer's consent.

Treatment of investments in U.S. property.—As discussed above, a U.S. shareholder of a controlled foreign corporation generally is taxable on its pro rata share of the foreign corporation's subpart F income. In addition, a U.S. shareholder generally is taxable on its pro rata share of the foreign corporation's earnings and profits attributable to non-subpart F income to the extent of the increase for the year in such earnings that are invested in U.S. property (secs. 951(a)(1)(B) and 956). Such increase is measured by comparing the controlled foreign corporation's total amount of earnings invested in U.S. property at the close of the current taxable year with the corresponding amount at the close of the preceding taxable year.

The increase for the current taxable year in the earnings of a controlled foreign corporation invested in U.S. property generally is computed by subtracting the amount of the corporation's investment in U.S. property at the end of the prior year (to the extent that amount would have been a dividend if it had been distributed) from its investment in U.S. property at the end of the current year (to the extent that amount would have been a dividend if it had been distributed).

In addition, where earnings previously taxed under sections 951(a)(1)(B) and 956 are actually distributed, without reduction of the controlled foreign corporation's investment in U.S. property, subsequent earnings are included in the U.S. shareholder's income under sections 951(a)(1)(B) and 956 with no further increase in U.S. investment. This rule is intended to account for the fact that, in effect, new earnings are funding existing investments in U.S. assets, and should therefore be taxed.[22]

Distributions of previously taxed income.—Earnings and profits of a controlled foreign corporation that are (or previously have been) included in the incomes of the U.S. shareholders are not taxed again when such earnings are actually distributed to the U.S. shareholders (sec. 959(a)(1)). Similarly, such previously taxed income is not included in the incomes of the U.S. shareholders in the event that such earnings are invested in U.S. property (sec. 959(a)(2)). Previously taxed income actually distributed from a lower-tier controlled foreign corporation to a higher-tier controlled foreign corporation is disregarded in determining the subpart F income of the higher-tier controlled foreign corporation that is included in the income of the U.S. shareholders. In the event that stock in the controlled foreign corporation is transferred subsequent to the income inclusion but prior to the actual distribution of previously taxed income, the transferee shareholder is similarly exempt from tax on the distribution to the extent of the proven identity of shareholder interest.

Distributions by a controlled foreign corporation are allocated first to previously taxed income, then to other earnings and profits (sec. 959(c)). Therefore, a controlled foreign corporation may distribute its previously taxed income to its shareholders, resulting in no additional U.S. income taxation, before it makes any taxable divi-

[22] "If this were not done it would be possible to retain the [U.S.] investments in the corporation and make actual distributions out of other property to the shareholders which would not be taxable to them." H.R. Rep. No. 1447, 87th Cong., 2d Sess. 64 n.1 (1962).

dend distributions of any current or accumulated non-subpart F earnings and profits.

Allowance of foreign tax credit.—U.S. corporate shareholders of a controlled foreign corporation who include subpart F income in their own gross incomes are also treated as having paid the foreign taxes actually paid by the controlled foreign corporation on that income, to the same general extent as if they had received a dividend distribution of that income (sec. 960). Therefore, the U.S. corporate shareholders may claim foreign tax credits for those taxes to the same general extent as if they had received a dividend. Actual distributions by a controlled foreign corporation are not treated as dividends, and thus generally do not carry further eligibility for deemed-paid foreign tax credits, to the extent that the distributions are of previously taxed income.[23]

Individual U.S. shareholders of a controlled foreign corporation who include subpart F income in their own gross incomes may elect to be taxed as corporations on their subpart F income (sec. 962). Therefore, electing individual U.S. shareholders, like corporate shareholders, may claim foreign tax credits for the foreign taxes actually paid by the controlled foreign corporation on that income to the same general extent as if they had received a dividend.

Adjustments to basis and computation of earnings and profits.—The inclusion of an amount of a controlled foreign corporation's subpart F income in the gross income of a U.S. shareholder generally results in a corresponding increase in the shareholder's basis in the stock with respect to which the subpart F income was included (sec. 961(a)). In addition, the distribution of previously taxed income to a U.S. shareholder of a controlled foreign corporation generally results in a corresponding decrease in the shareholder's basis in the stock (sec. 961(b)).

The determination of the earnings and profits (or deficit in earnings and profits) of a controlled foreign corporation follows rules that are substantially similar to those applicable to domestic corporations (sec. 964(a)). One specific similarity is that any illegal bribes, kickbacks, or other payments that are not deductible under section 162(c) (such as payments that would be unlawful under the Foreign Corrupt Practices Act of 1977 if paid by a U.S. person) are not taken into account to reduce earnings and profits (or increase a deficit in earnings and profits).

Attribution of ownership.—In determining stock ownership for purposes of the controlled foreign corporation rules, a U.S. person generally is considered to own a proportionate share of stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or estate of which the U.S. person is a shareholder, partner, or beneficiary (sec. 958(a)).

Additional rules for constructive ownership apply for purposes of determining whether or not a U.S. person is a U.S. shareholder (within the meaning of sec. 951(b), as discussed above), whether or not the foreign corporation meets the relevant definition of control (within the meaning of secs. 957(a), 957(b), or 953(c)(1), as discussed

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[23] Certain actual distributions of previously taxed income can carry further eligibility for foreign tax credits (secs. 960(a)(3) and (b)).

above), and whether or not two persons are related (within the meaning of sec. 954(d)(3), as discussed above), but not for purposes of including amounts in a shareholder's gross income under section 951(a). These constructive ownership rules include, among other rules, provisions treating an individual as owning stock owned, directly or indirectly, by the individual's spouse, children, grandchildren, and parents; a 10-percent shareholder of a corporation as owning its proportionate share (100 percent, in the case of a more-than-50-percent shareholder) of stock owned, directly or indirectly, by the corporation; a partner or beneficiary as owning its proportionate share (100 percent, in the case of a more-than-50-percent partner or beneficiary) of stock owned, directly or indirectly, by the partnership or estate; a corporation as owning all stock owned, directly or indirectly, by 10-percent shareholders; a partnership or estate as owning all stock owned, directly or indirectly, by its partners or beneficiaries; and the holder of an option as owning the stock subject to the option (sec. 958(b)). However, these constructive ownership rules do not operate to treat stock owned by a nonresident alien individual as owned by a U.S. citizen or a resident alien individual (sec. 958(b)(1)).

Gain from certain sales or exchanges of stock in certain foreign corporations

If a U.S. person sells or exchanges stock in a foreign corporation, or receives a distribution from a foreign corporation that is treated as an exchange of stock, and, at any time during the five-year period ending on the date of the sale or exchange, the foreign corporation was a controlled foreign corporation and the U.S. person was a 10-percent shareholder (counting stock owned directly, indirectly, and constructively), then the gain recognized on the sale or exchange is included in the shareholder's income as a dividend, to the extent of the earnings and profits of the foreign corporation which were accumulated during the period that the shareholder held stock while the corporation was a controlled foreign corporation (sec. 1248).[24] For this purpose, earnings and profits of the foreign corporation do not include amounts that had already been subject to current U.S. taxation (whether imposed on the foreign corporation itself or the U.S. shareholders), such as amounts included in gross income under section 951, amounts included in gross income under section 1247 (applicable to foreign investment companies, which are discussed below), amounts included in gross income under section 1293 (applicable to certain passive foreign investment companies, which are discussed below), or amounts that were effectively connected with the conduct of a trade or business within the United States (sec. 1248(d)). The Code provides certain special rules to adjust the proper scope and application of section 1248 (sec. 1248(e)-(i)).

Amounts subject to treatment under section 1248, in accordance with their characterization as dividends, carry deemed-paid foreign tax credits that may be claimed by corporate taxpayers under section 902.

[24] A special limitation applies in the case of the sale or exchange by an individual of stock held as a long-term capital asset (sec. 1248(b)).

Foreign personal holding companies

In general

Congress enacted the foreign personal holding company rules (secs. 551-558) to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks." If five or fewer U.S. citizens or residents own, directly or indirectly, more than half of the outstanding stock (in vote or value) of a foreign corporation that has primarily foreign personal holding company income, that corporation will be a foreign personal holding company. In that case, all the foreign corporation's U.S. shareholders are subject to U.S. tax on their pro rata share of the corporation's undistributed foreign personal holding company income.

Operating rules

A foreign corporation is a foreign personal holding company if it satisfies both a stock ownership requirement (sec. 552(a)(2)) and a gross income requirement (sec. 552(a)(1)). The stock ownership requirement is satisfied if, at any time during the taxable year, more than 50 percent of either (1) the total combined voting power of all classes of stock of the corporation that are entitled to vote, or (2) the total value of the stock of the corporation, is owned (directly, indirectly, or constructively) by or for five or fewer individual citizens or residents of the United States. The gross income requirement is satisfied initially if at least 60 percent of the corporation's gross income is foreign personal holding company income. Once the corporation is a foreign personal holding company, however, the gross income threshold each year will be only 50 percent until the expiration of either one full taxable year during which the stock ownership requirement is not satisfied, or three consecutive taxable years for which the gross income requirement is not satisfied at the 50-percent threshold.

Foreign personal holding company income generally includes passive income such as dividends, interest, royalties (but not including active business royalties), and rents (if rental income does not amount to 50 percent of gross income) (sec. 553(a)). It also includes, among other things, gains (other than gains of dealers) from stock and securities transactions, commodities transactions, and amounts received with respect to certain personal services contracts. If a foreign personal holding company is a shareholder in another foreign personal holding company, the first company includes in its gross income, as a dividend, its share of the undistributed foreign personal holding company income of the second foreign personal holding company.

Excluded from characterization as foreign personal holding companies are corporations that are exempt from tax under subchapter F (sections 501 and following) of the Code, as well as certain corporations that are organized and doing business under the banking and credit laws of a foreign country (sec. 552(b)).

If a foreign corporation is a foreign personal holding company, all of its undistributed foreign personal holding company income is treated as distributed as a dividend on a pro-rata basis to all of its U.S. shareholders, including U.S. citizens, residents, and corporations (sec. 551(b)). That is, though only the five largest individual

shareholders count in the determination of foreign personal holding company status, all individual shareholders as well as persons other than individuals may be subject to current tax on their pro rata shares of the undistributed income of the foreign personal holding company. The undistributed foreign personal holding company income that is deemed distributed is treated as recontributed by the shareholders to the foreign personal holding company as a contribution to capital. Accordingly, the earnings and profits of the corporation are reduced by the amount of the deemed distribution (sec. 551(d)), and each shareholder's basis in his or her stock in the foreign personal holding company is increased by the shareholder's pro rata portion of the deemed distribution (sec. 551(e)).

Attribution of ownership for characterization as a foreign personal holding company

The foreign personal holding company provisions contain constructive ownership rules that determine whether a foreign corporation is more than 50 percent owned by five or fewer U.S. citizens or residents. These rules generally treat an individual as owning stock owned, directly or indirectly, by or for his or her partners, brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. However, ownership of stock actually owned by a nonresident alien is not attributed to the alien's U.S. brothers and sisters (whether by the whole or half blood), ancestors, and lineal descendants who do not own stock in the foreign corporation. For example, a foreign corporation 40 percent of whose shares belong to a U.S. citizen and 60 percent of whose shares belong to the nonresident alien sister of the U.S. citizen will be a foreign personal holding company if it meets the other criteria for foreign personal holding company status. Similarly, ownership of stock actually owned by a nonresident alien will not be attributed to the alien's U.S. partners if the alien's U.S. partners do not own, directly or indirectly, any stock in the foreign corporation and if the alien's partners do not include members of the same family as a U.S. citizen or resident who owns, directly or indirectly, any stock in the foreign corporation. For example, if the nonresident alien partner of a U.S. citizen owns 60 percent of a foreign corporation, while a second U.S. citizen (who is wholly unrelated to the first U.S. citizen and to the nonresident alien) owns the remaining 40 percent, the foreign corporation is not a foreign personal holding company.

These constructive ownership rules also apply to deem income to be foreign personal holding company income in two cases: (1) when a foreign corporation has contracted to furnish personal services that an individual who owns (or who owns constructively) 25 percent or more in value of the outstanding stock of the corporation has performed, is to perform, or may be designated to perform; and (2) when an individual who owns (or who owns constructively) 25 percent or more in value of the outstanding stock of the corporation is entitled to use corporate property and when the corporation in any way receives compensation for use of that property. This latter rule prevents foreign corporations from avoiding foreign personal holding company status by generating what appear to be large amounts of rental income.

Passive foreign investment companies

The 1986 Act established an anti-deferral regime for passive foreign investment companies (PFICs) and established separate rules for each of two types of PFICs. One set of rules applies to PFICs that are "qualified electing funds," where electing U.S. shareholders include currently in gross income their respective shares of a PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not qualified electing funds ("nonqualified funds"), whose U.S. shareholders pay tax on income realized from a PFIC and an interest charge which is attributable to the value of deferral.

Definition of passive foreign investment company

General definition.—A passive foreign investment company is any foreign corporation if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average fair market value of its assets consists of assets that produce, or are held for the production of, passive income (sec. 1296(a)).[25] Passive income for these purposes generally means income that satisfies the definition of foreign personal holding company income under subpart F (as discussed above); except as provided in regulations, however, passive income does not include certain active-business banking or insurance income, or certain amounts received from a related party (to the extent that the amounts are allocable to income of the related party which is not passive income, as discussed below) (sec. 1296(b)). Passive assets for this purpose are those assets that produce or are held for the production of passive income. Assets that are property which, in the hands of the foreign corporation, are inventory property (as defined in sec. 1221(1)), or are held by a regular dealer in that property, and are specifically identified as such inventory, are treated as nonpassive assets, even where that property generates foreign personal holding company income (as defined in sec. 954(c)), such as in the case of a securities broker-dealer that holds debt securities as inventory (Notice 88-22, 1988-1 C.B. 489, as modified by Notice 89-81, 1989-2 C.B. 399). In addition, transactions pursuant to certain securities sale and repurchase agreements (so-called "repos" and "reverses") may be characterized for tax purposes as loans rather than as sales and repurchases, and thus may give rise to interest income and expense for the parties to the transactions. The debt obligations deemed to be held, and the interest income deemed to be earned, pursuant to these agreements generally are treated as passive assets and income for purposes of the PFIC rules.

Look-through rules.—In determining whether foreign corporations that own subsidiaries are PFICs, look-through treatment is provided in certain cases (sec. 1296(c)). Under this look-through rule, a foreign corporation that owns, directly or indirectly, at least

[25] A foreign corporation can elect to apply the asset test using the adjusted bases of the corporation's assets rather than the fair market value of its assets. Thus, under this election, a foreign corporation with less than 50 percent passive assets by adjusted basis will not be a PFIC (assuming the income test is not met), even if its assets are 50 percent or more passive by fair market value. The election, once made, is revocable only with the consent of the Secretary.

25 percent of the value of the stock of another corporation is treated as owning a proportionate part of the other corporation's assets and income. Thus, amounts such as interest and dividends received from foreign or domestic subsidiaries are eliminated from the shareholder's income in applying the income test, and the stock or debt investment is eliminated from the shareholder's assets in applying the asset test.

In addition to the look-through rule applicable to 25-percent-owned subsidiaries, interest, dividends, rents, and royalties received from related persons that are not subject to section 1296(c) look-through treatment are excepted from treatment as passive income to the extent that, under regulations prescribed by the Secretary, those amounts are allocable to income of the payor that is not passive income (sec. 1296(b)(2)(C)).[26] As a corollary, the characterization of the assets that generate the income will follow the characterization of the income so that, for example, a loan to a related person will be treated as a nonpassive asset if the interest on the loan is treated as nonpassive income. Together, these rules provide that earnings of certain related corporations, which earnings would be excluded from foreign personal holding company income under the related-person same-country exception of subpart F (sec. 954(c)(3)) if distributed to the shareholders, are subject to look-through treatment whether or not the related party is 25-percent owned.

In addition, stock of certain U.S. corporations owned by another U.S. corporation which is at least 25-percent owned by a foreign corporation is treated as a nonpassive asset (sec. 1297(b)(8)). Under this rule, in determining whether a foreign corporation is a PFIC, stock of a regular domestic C corporation owned by a 25-percent owned domestic corporation is treated as an asset which does not produce passive income (and is not held for the production of passive income), and income derived from that stock is treated as income which is not passive income. Thus, a foreign corporation, in applying the look-through rule available to 25-percent owned corporations, is treated as owning nonpassive assets in these cases. This rule does not apply, however, if, under a treaty obligation of the United States, the foreign corporation is not subject to the accumulated earnings tax, unless the corporation agrees to waive the benefit under the treaty. This rule is designed to mitigate the potential disparate tax treatment between U.S. individual shareholders who hold U.S. stock investments through a U.S. holding company and those who hold those investments through a foreign holding company. If a foreign investment company attempts to use this rule to avoid the PFIC provisions, it will be subject to the accumulated earnings tax and, thus, the shareholders of that company essentially will be denied deferral on the earnings of the foreign company, with an effect in some ways similar to application of the PFIC provisions.

Special exceptions from PFIC classification apply to start-up companies (sec. 1297(b)(2)) and corporations changing businesses during the taxable year (sec. 1297(b)(3)). In both such cases, a corporation

[26] A related person is defined by reference to the related person definition in subpart F (that is, sec. 954(d)(3)).

may have a substantially higher proportion of passive assets (and passive income, in some cases) than at other times in its history.

General rule—nonqualified funds

General rule.—United States persons who are shareholders in PFICs that are not "qualified electing funds" (or have not been qualified electing funds for all PFIC years in the holding period of the taxpayer) pay U.S. tax and an interest charge based on the value of tax deferral at the time the shareholder disposes of stock in the PFIC or on receipt of an "excess" distribution (sec. 1291). Under this rule, gain recognized on disposition of stock in a nonqualified fund or income on receipt of an "excess" distribution from a nonqualified fund is treated as ordinary income and is treated as earned pro rata over the shareholder's holding period of his or her investment. The portion treated as earned before the current year during the post-1986 period during which the foreign corporation was a PFIC is taxed at the highest applicable tax rate in effect for each respective year, and is subject to an interest charge. The interest charge is treated as interest for tax purposes. The total of such tax and interest is referred to as the "deferred tax amount."

Availability of foreign tax credits.—Distributions from nonqualified funds are eligible for direct and deemed-paid foreign tax credits (under secs. 901 and 902) under the following method. The U.S. investor first computes the total amount of creditable foreign taxes with respect to the distribution it receives. This amount includes the amount of direct foreign taxes paid by the investor with respect to the distribution (for example, any withholding taxes) and the amount of the PFIC's foreign taxes deemed paid by the investor with respect to the distribution under section 902 (if any) to the extent the direct and indirect taxes are creditable under general foreign tax credit principles and the investor chooses to claim those taxes as a credit. The investor then determines the amount of the creditable foreign taxes that are attributable to the portion of the distribution that is an excess distribution (the "excess distribution taxes"). This determination is made by apportioning the total amount of creditable foreign taxes between the amount of the distribution that is an excess distribution and the amount of the distribution that is not an excess distribution on a pro rata basis. For purposes of determining the amount of the distribution from the PFIC (and the amount of the excess distribution), the gross-up under section 78 is included in the amount of money or other property received.

The U.S. investor then allocates the excess distribution taxes ratably to each day in the holding period of its stock. To the extent the taxes are allocated to days in taxable years prior to the year in which the foreign corporation became a PFIC and to the current taxable year, the taxes are taken into account for the current year under the general foreign tax credit rules. To the extent the taxes are allocated to days in any other taxable year (that is, to days in years on which the deferred tax amount is imposed), then the foreign tax credit limitation provisions of section 904 are applied separately to those taxes. Under this rule, the taxes allocable to a particular year can reduce the increase in tax for that year on which

interest is computed, but not below zero. In the event the taxes allocable to that year are in excess of any increase in tax, no interest will be due, but no carryover will be allowed since the foreign tax credit limitations are applied with respect to excess distributions occurring within each taxable year.

Definition of excess distribution.—An "excess" distribution is any current year distribution in respect of a share of stock that exceeds 125 percent of the average amount of distributions in respect of the share of stock received during the 3 preceding years (or, if shorter, the total number of years of the taxpayer's holding period prior to the current taxable year) (sec. 1291(b)). The determination of an excess distribution excludes from the 3-year average distribution base that part of a prior-year excess distribution that is considered attributable to deferred earnings (i.e., that part of the excess distribution that was not allocable to pre-1986 or pre-PFIC years or to the current year). Any gain from the sale or disposition of such stock is also treated as an excess distribution.

Anti-avoidance rules.—Regulatory authority is provided to disregard any nonrecognition provision of the Code on any transfer of PFIC stock (sec. 1291(f)). For example, regulations may treat a gift of stock in a nonqualified fund to a non-taxpaying entity, such as a charity or a foreign person, as a disposition for purposes of those rules in order that the deferred tax and interest charge attributable to that stock not be eliminated. Under proposed Treasury regulations, nonrecognition provisions may apply to the gain on a transfer of stock in a nonqualified fund that would otherwise qualify for the Code's nonrecognition provisions, but only to the extent that the transferee will be subject to the deferred tax and interest charge on a subsequent distribution by the PFIC or disposition of the PFIC stock.

Coordination with regulated investment company rules.—Proposed Treasury regulations permit a regulated investment company meeting certain requirements to mark to market its gain in PFIC stock of which it is a direct or indirect shareholder.

Qualified electing funds

General rule.—A U.S. person who owns stock in a PFIC may elect that the PFIC be treated as a "qualified electing fund" with respect to that shareholder (sec. 1295), with the result that the shareholder must include currently in gross income his or her pro rata share of the PFIC's total earnings and profits (sec. 1293). This inclusion rule generally requires current payment of tax, absent a separate election to defer tax.

Qualified fund election.—The election for treatment as a qualified electing fund, which is made at the shareholder level, is available only where the PFIC complies with the requirements prescribed in Treasury regulations to determine the income of the PFIC and to ascertain any other information necessary to carry out the purposes of the PFIC provisions. The effect of the election is to treat a PFIC as a qualified electing fund with respect to each electing investor so that, for example, an electing investor will not be subject to the deferred tax and interest charge rules of section 1291 on receipt of a distribution if the election has been in effect for each of the PFIC's taxable years for which the company was a

PFIC and which includes any portion of the investor's holding period.

Inclusion of income.—The amount currently included in the income of an electing shareholder is divided between a shareholder's pro rata share of the ordinary income of the PFIC and net capital gain income of the PFIC. The characterization of income, and the determination of earnings and profits, is made pursuant to general Code rules with two modifications. These modifications apply only when the qualified electing fund is also a controlled foreign corporation and the U.S. investor in the fund is also a U.S. shareholder in the controlled foreign corporation (as both terms are defined under subpart F).

Under the first modification, if the U.S. investor establishes to the satisfaction of the Secretary that an item of income derived by a fund was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of U.S. corporate tax, then that item of income is excluded from the ordinary earnings and net capital gain income of the fund for purposes of determining the U.S. investor's pro rata share of income.

Under the second modification, the qualified electing fund's ordinary earnings and net capital gain income do not include income from U.S. sources that is effectively connected with the conduct by the fund of a U.S. trade or business so long as that income is not exempt from U.S. taxation (or subject to a reduced rate of tax) pursuant to a treaty obligation of the United States.

Pro rata share of income.—Pro rata share of income generally is determined by aggregating a PFIC's income for the taxable year and attributing that income ratably over every day in the PFIC's year. Electing investors then include in income for the period in which they hold stock in the PFIC their daily ownership interest in the PFIC multiplied by the amount of income attributed to each day.

As a special rule, the Code permits that, to the extent provided in regulations, if a qualified electing fund establishes to the Secretary's satisfaction that it maintains records that determine investors' pro rata shares of income more accurately than allocating a taxable year's income ratably over a daily basis (for example, by allocating a month's income ratably over a daily basis), the fund can determine the investors' pro rata shares of income on that basis. This provision is designed to allow those funds that maintain appropriate records to more accurately determine U.S. investors' pro rata shares of income, which may be important in cases where the investors own their stock for only parts of a year.

Distributions and basis adjustments.—The distribution of earnings and profits that were previously included in the income of an electing shareholder under these rules is not treated as a dividend to the shareholder, but does reduce the PFIC's earnings and profits (sec. 1293(c)). The basis of an electing shareholder's stock in a PFIC is increased by amounts currently included in income under these rules, and is decreased by any amount that is actually distributed but treated as previously taxed under section 1293(c) (sec. 1293(d)).

Availability of foreign tax credit.—Foreign tax credits are allowed against U.S. tax on amounts included in income from a qualified electing fund to the same extent, and under the same

rules, as in the case of income inclusions from a controlled foreign corporation (sec. 1293(f)).

The Code provides special rules to characterize income inclusions from qualified electing funds for foreign tax credit purposes. In the case of a qualified electing fund that is also a controlled foreign corporation, where the U.S. person that has the income inclusion is a U.S. shareholder in the corporation (as defined under the subpart F rules), look-through treatment determines the foreign tax credit limitation characterization of the income inclusion. In addition, where the qualified electing fund is a noncontrolled section 902 corporation (as defined in sec. 904(d)(2)(E)) with respect to the taxpayer, the income inclusion is treated for foreign tax credit purposes as a dividend, and thus, is subject to the separate limitation applicable to those dividends. Where neither of the above conditions is satisfied, the income inclusion is characterized as passive income for foreign tax credit purposes.

Election to defer current payment of tax.—U.S. investors in qualified electing funds may generally, subject to the payment of interest, elect to defer payment of U.S. tax on amounts included currently in income but for which no current distribution has been received (sec. 1294). An election to defer tax is treated as an extension of time to pay tax for which a U.S. shareholder is liable for interest.

The disposition of stock in a PFIC generally terminates all previous extensions of time to pay tax with respect to the earnings attributable to that stock. Disposition for this purpose generally means any transfer of ownership, regardless of whether the transfer constitutes a realization or recognition event under general Code rules. For example, a transfer at death or by gift of stock in a qualified electing fund is treated as a disposition for these purposes.

Special rules applicable to both types of funds

Coordination of section 1291 with taxation of shareholders in qualified electing funds.—Gain recognized on disposition of stock in a PFIC by a U.S. investor, as well as distributions received from a PFIC in a year the PFIC is a qualified electing fund, are not taxed under the rules applicable to nonqualified funds (that is, sec. 1291) if the PFIC is a qualified electing fund for each of the fund's taxable years which begin after December 31, 1986 and which includes any portion of the investor's holding period (sec. 1291(d)(1)). Therefore, if for any taxable year beginning after December 31, 1986, a foreign corporation is a PFIC but is not a qualified electing fund with respect to the U.S. investor, gains and distributions in any subsequent year will be subject to the rules applicable to nonqualified funds. The section 1291 coordinating provision as it relates to distributions prevents a fund from retaining its annual income while it is not a qualified electing fund, and then distributing the accumulated income in a subsequent year after it becomes a qualified electing fund without incurring any interest charge.

Any U.S. person who owns stock (directly or indirectly under the attribution rules) in a PFIC which previously was not a qualified electing fund for a taxable year but which becomes one for the subsequent taxable year may elect to be taxed on the unrealized ap-

preciation inherent in his or her PFIC stock up through the first day of the subsequent taxable year, pay all prior deferred tax and interest, and acquire a new basis and holding period in his or her PFIC investment (sec. 1291(d)(2)). Thereafter, the shareholder is subject to the rules applicable to qualified electing funds.

An alternative election is available to shareholders in a controlled foreign corporation. Under this alternative, instead of recognizing the entire gain in the value of his or her stock, a U.S. person that holds stock (directly or indirectly under the attribution rules) in a controlled foreign corporation (as defined for subpart F purposes) that is a PFIC and that becomes a qualified electing fund can elect to include in gross income as a dividend his or her share of the corporation's earnings and profits accumulated after 1986 and since the corporation was a PFIC. Upon this election, the U.S. person's stock basis is increased by the amount included in income and the shareholder is treated as having a new holding period in his or her stock. Thereafter, the shareholder is subject to the rules applicable to qualified electing funds. The total amount treated as a dividend under the above election is an excess distribution and is to be assigned, for purposes of computing the deferred tax and interest charge, to the shareholder's stock interest on the basis of post-December 31, 1986 ownership.

Attribution of ownership.—In determining stock ownership, a U.S. person is considered to own his or her proportionate share of the stock of a PFIC owned by any partnership, trust, or estate of which the person is a partner or beneficiary (or in certain cases, a grantor), or owned by any foreign corporation if the U.S. person owns 50 percent or more of the value of the corporation's stock (sec. 1297(a)). However, if a U.S. person owns any stock in a PFIC, the person is considered to own his or her proportionate share of any lower-tier PFIC stock owned by the upper-tier PFIC, regardless of the percentage of his or her ownership in the upper-tier PFIC. Under regulations, any person who has an option to acquire stock may be treated as owning the stock.

Anti-avoidance rules.—The Code provides authority to the Secretary to prescribe regulations that are necessary to carry out the purposes of the PFIC provisions and to prevent circumvention of the interest charge (sec. 1297(d)). In addition, if a U.S. person is treated as owning stock in a PFIC by virtue of the attribution rules, regulations may treat any distribution of money or other property to the actual holder of the stock as a distribution to the U.S. person, and any disposition (whether by the U.S. person or the actual holder of the stock) which results in the U.S. person being treated as no longer owning the stock as a disposition by the U.S. person (sec. 1297(b)(5)).

Other anti-deferral regimes

Personal holding companies

In addition to the corporate income tax, the Code imposes a tax at the rate of 28 percent[27] on the undistributed income of a person-

[27] A proposed technical correction to the Omnibus Budget Reconciliation Act of 1990 would change the personal holding company tax rate to 31 percent, to conform to the increase in the top individual tax rate from 28 to 31 percent.

al holding company (sec. 541). This tax substitutes for the tax that would have been incurred by the shareholders on dividends actually distributed by the personal holding company. A personal holding company generally is defined as any corporation (with certain specified exceptions) if (1) at least 60 percent of its adjusted gross income for the taxable year is personal holding company income, and (2) at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals (sec. 542(a)).

This definition is very similar to that of a foreign personal holding company, discussed above, but does not depend on the U.S. citizenship or residence status of the shareholders. However, the specified exceptions to the definition of a personal holding company preclude the application of the personal holding company tax to, among others, any foreign personal holding company, most foreign corporations owned solely by nonresident alien individuals, and any PFIC (paragraphs (5), (7), and (10) of sec. 542(c)). Therefore, the personal holding company tax could apply to only a small class of foreign corporations, such as foreign corporations with at least 60 percent but less than 75 percent passive-type income, and majority owned by a group of five or fewer individuals of whom at least one is a U.S. person and at least one of whom is a nonresident alien.

Accumulated earnings tax

In addition to the corporate income tax, the Code also imposes a tax, at the rate of 28 percent, on the accumulated taxable income of any corporation (with certain exceptions) formed or availed of for the purpose of avoiding income tax with respect to its shareholders (or the shareholders of any other corporation), by permitting its earnings and profits to accumulate instead of being distributed (secs. 531, 532(a)). The specified tax-avoidance purpose generally is determined by the fact that the earnings and profits of the corporation are allowed to accumulate beyond the reasonable needs of the business (sec. 533). Like the personal holding company tax, the accumulated earnings tax acts as a substitute for the tax that would have been incurred by the shareholders on dividends actually distributed by the corporation.

The accumulated earnings tax does not apply to any personal holding company, foreign personal holding company, or PFIC (sec. 532(b)). These exceptions, along with the current inclusion of subpart F income in the gross incomes of the U.S. shareholders of a controlled foreign corporation, have resulted, in practice, in very limited application of the accumulated earnings tax to foreign corporations.

Foreign investment companies

A foreign investment company generally is defined as any foreign corporation that either is registered under the Investment Company Act of 1940 (as amended) as a management company or as a unit investment trust, or is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities or commodities or any interest (including a futures or forward contract or option) in securities or commodities, at a time when 50 percent or more of the vote or value of the stock

was held (directly or indirectly) by U.S. persons (sec. 1246(b)). In the case of the sale or exchange of stock in a foreign investment company, gain on the sale generally is treated as ordinary income to the extent of the taxpayer's ratable share of the undistributed earnings and profits of the foreign investment company (sec. 1246(a)). However, if a foreign investment company so elected by December 31, 1962, it can avoid the application of section 1246 to its shareholders by annually distributing at least 90 percent of its taxable income (determined as if the foreign corporation were a domestic corporation), and complying with other information-reporting and administrative requirements as the Secretary of the Treasury deems necessary (sec. 1247).

Coordination among anti-deferral regimes

The Code provides that, if an item of income of a foreign corporation would be includable in the gross income of a U.S. shareholder both under the controlled foreign corporation rules and under the foreign personal holding company rules, that item of income is included only under the controlled foreign corporation rules (sec. 951(d)). This rule of precedence operates only to the extent that the controlled foreign corporation rules and the foreign personal holding company rules overlap on an item-by-item basis. Income includible under only one set of rules (foreign personal holding company rules or subpart F rules) is includible under that set of rules. A taxpayer taxable under subpart F on amounts other than subpart F income (on such items as withdrawals from foreign base company shipping income and investments in U.S. property) is taxable under subpart F whether or not the taxpayer is also taxable on the undistributed foreign personal holding company income of the foreign corporation under the foreign personal holding company rules.

If an item of income of a foreign corporation would be includable in the gross income of a U.S. shareholder both under the controlled foreign corporation rules and under the rules relating to the current taxation of income from certain passive foreign investment companies, that item of income is included only under the controlled foreign corporation rules (sec. 951(f)). In addition, if an item of income of a foreign corporation would be includable in the gross income of a U.S. shareholder both under the controlled foreign corporation rules and under the rules relating to the current taxation of income from electing foreign investment companies, that item of income is included only under the foreign investment company rules (sec. 951(c)). Any amount that is taxable under only one set of rules is included in gross income pursuant to that set of rules.

In the case of a foreign corporation that is both a foreign personal holding company and a passive foreign investment company, to the extent that the income of the foreign corporation would be taxable to a U.S. person both under the foreign personal holding company rules and under section 1293 (relating to current taxation of income of certain passive foreign investment companies), that income is treated as taxable to the U.S. person only under the foreign personal holding company rules (sec. 551(g)).

In the case of a PFIC that is a qualified electing fund, the amount of income treated as a dividend on a sale or exchange of stock in a controlled foreign corporation (under sec. 1248) does not

include any amount of income included previously under the qualified electing fund rules to the extent that that amount of income has not been distributed from the PFIC prior to the sale or exchange of the stock. In addition, section 1248 does not apply to the sale or disposition of stock in a PFIC that is not a qualified electing fund.

In the case of a PFIC that is a qualified electing fund and that owns stock in a second-tier PFIC that is also a qualified electing fund, amounts distributed by the second-tier fund to the first-tier fund that have been included previously in income by U.S. investors—because they are deemed to own stock in the second-tier fund—are not to be included in the ordinary earnings of the first-tier fund. This rule prevents U.S. persons from including amounts in income twice. This relief provision also applies in the case of a second- (or lower-) tier PFIC that is a qualified electing fund and that is also a controlled foreign corporation. In this case, amounts that are included in a U.S. person's income under the subpart F provisions and that would have been included under the qualified electing fund provisions (but for the coordination provision of sec. 951(f)) are prevented from being included in income again under this relief provision.

In the case of a PFIC that is not a qualified electing fund, the Code eliminates the potential for double taxation by providing for proper adjustments to excess distributions for amounts that are taxed currently under the Code's other current inclusion rules. Thus, for example, excess distributions will not include any amounts that are treated as previously taxed income under section 959(a) when distributed by a controlled foreign corporation that is also a PFIC that is not a qualified electing fund.

As noted above, the personal holding company tax does not apply to any foreign personal holding company or PFIC, and the accumulated earnings tax does not apply to any personal holding company, foreign personal holding company, or PFIC.

Section 1246 does not apply to the earnings and profits of any foreign investment company for any year after 1986 if the company is a PFIC for that year (sec. 1297(b)(7)). In addition, an electing foreign investment company under section 1247 is excluded from the definition of a PFIC (sec. 1296(d)).

Reasons for Simplification

Some of the different anti-deferral regimes were enacted or modified at different times and reflect historically different Congressional policies. Different regimes provide different thresholds (either by type of income or asset at the foreign corporation level, or of U.S. stock ownership at the shareholder level) to their application. They provide for different mechanisms by which U.S. stockholders are denied the benefits of deferral. Some of the regimes have features directed at policy goals applicable to foreign corporations owned by U.S. corporations (e.g., the allowance of indirect foreign tax credits); others have features primarily directed at issues applicable to foreign corporations owned by U.S. individuals (e.g., the basis of property acquired from a decedent). Some regimes preserve the character of the income earned in the hands of a foreign

corporation while others do not. Some provide for movement of losses between years of a single foreign corporation or between multiple corporations while others do not. While a consistent theme of these regimes is to provide current taxation for certain types of interest, dividend, rental, royalty, and other similar income, the different regimes apply different criteria to these items of income to determine their current inclusion or noninclusion. Different regimes have different ordering rules for determining which dividends from foreign corporations subject to the regimes are subject to tax on repatriation and which are untaxed distributions of previously taxed income.

Simply because of the differences among the various anti-deferral regimes, U.S. taxpayers frequently are faced with the need to consult multiple sets of anti-deferral rules when they hold stock in a foreign corporation.

Moreover, the interactions of the rules cause additional complexity. There is significant overlap among the several regimes. This overlap requires the Code to provide specific rules of priority for income inclusions among the regimes, as well as additional coordination provisions pertaining to other operational differences among the several regimes. The overlapping or multiple application of anti-deferral regimes to a single corporation can result in significant additional complexity with little or no ultimate tax consequences.

Consolidation of the several anti-deferral regimes can achieve two major types of simplification. First, by reducing the number of separate definitions of entities among the anti-deferral regimes, taxpayers can be spared the burden of understanding and complying with a multiplicity of separate anti-deferral regimes with separate definitions and requirements. Moreover, where it is believed that operating rules of one current inclusion regime provide taxpayers with appropriate income measurement rules not contained in another regime (e.g., the qualified deficit rules present in subpart F but absent in the PFIC rules), consolidation of the operating rules permits more uniform extension of those benefits to all taxpayers subject to a current inclusion regime.

Second, from an operational perspective, the number of anti-deferral regimes that can apply to any one shareholder in a foreign corporation can be reduced to one. As discussed above, the operational differences, including the overlapping applicability of the six present-law anti-deferral regimes, is a source of complexity. Under a consolidated regime, however, deferral can be denied for many corporations (whether in full or in part) solely through the provisions of subpart F. In the case of a controlled foreign corporation, for example, being subject to the rules for full denial of deferral (such as the PFIC or foreign personal holding company provisions under present law) can, if only a single set of rules applies, result in fewer additional compliance burdens and less administrative and operational complexity.

Another source of complexity under present law is the need for shareholders of controlled foreign corporations to make "protective" current-inclusion elections in order to avoid adverse future consequences under the interest-charge method should the controlled foreign corporation also prove to be a PFIC. By replacing

elective current-inclusion treatment for PFICs that are also controlled foreign corporations by mandatory current inclusion through subpart F for passive foreign corporations that are also controlled foreign corporations, a consolidated regime can eliminate both the burdens of making protective elections and the risks of failing to do so.

It is understood that the interest-charge method of the present-law PFIC rules is a significant source of complexity both separately and in its interaction with other provisions of the Code. Even without eliminating the interest-charge method, significant simplification can be achieved by minimizing the number of taxpayers that may be subject to the method and by making certain modifications that may reduce the complexity engendered by the interest-charge method. Further, because some taxpayers have argued that they would have preferred choosing the current-inclusion method afforded by the qualified fund election, but were unable to do so because they could not obtain required corporate-level information, it is believed that the mark-to-market system provides a fair alternative method for measuring income and imposing an appropriate level of income tax.

Explanation of Provision

In general

The bill replaces the separate anti-deferral regimes of present law with a unified set of rules providing for either partial or full elimination of deferral depending on the circumstances. The bill preserves the present-law approach under which partial current taxation is a function of the type of income earned by the foreign corporation and a level of U.S. ownership in the corporation exceeding some threshold (as currently embodied in subpart F). The bill also preserves the present-law approach under which full current taxation is a function of a type of income or assets of the corporation exceeding some threshold (as currently embodied in subpart F, the PFIC rules, and the foreign personal holding company rules). The bill eliminates regimes that are redundant or marginally applicable, and ensures that no more than one set of rules generally will apply to a shareholder's interest in any one corporation in any one year.

Generally, the bill retains the subpart F rules as the foundation of its unified anti-deferral regime (with certain modifications described below and also in item 2., following, describing secs. 411-413 of the bill). It includes a modified version of the PFIC rules while eliminating the other regimes as redundant to one or the other. The bill's unified anti-deferral regime sets forth various thresholds for subjecting U.S. persons to full or partial inclusions of corporate income. In addition, where deferral is eliminated by U.S. shareholder inclusions of foreign corporate-level income, the bill applies a single set of rules (the subpart F rules) for basis adjustments, characterization of actual distributions, foreign tax credits, and similar issues. As under present law, the bill in some cases affords U.S. persons owning stock in foreign corporations a choice of technique for recognizing income from the elimination of deferral.

However, in a greater number of cases than under present law, the bill provides only one method of eliminating deferral.

Replacement of current law regimes for full elimination of deferral

The bill creates a single definition of a passive foreign corporation (PFC) that will unify and replace the foreign personal holding company and PFIC definitions. The rules applicable to PFCs represent a hybrid of characteristics of the foreign personal holding company rules, the PFIC rules, and the controlled foreign corporation rules (subpart F), plus a new mark-to-market regime, as well as a variety of simplifying or technical changes to rules under the existing systems. The following discussion explains the differences between the PFIC provisions of present law and the PFC provisions applicable under the bill.

A PFC is any foreign corporation if (1) 60 percent or more of its gross income is passive income, (2) 50 percent or more of its assets (on average during the year, measured by value) produce passive income or are held for the production of passive income, or (3) it is registered under the Investment Company Act of 1940 (as amended) either as a management company or as a unit investment trust.[28] As under the PFIC rules, the foreign corporation is permitted to elect to measure its assets based on their adjusted bases rather than their value.

As under present law, passive income for this purpose is defined in the bill generally as any income of a kind which would be foreign personal holding company income as defined in section 954(c), subject to the current law exceptions for banking and insurance income and the current look-through rules for certain payments from related persons (current sec. 1296(b)(2)).[29]

The bill adds a new exception to the definition of passive income. Under the bill, to the extent that any asset is properly treated as not held for the production of passive income (and therefore is treated as not a passive asset for purposes of the asset test), all income derived from the asset is treated as active income for purposes of the income test. Ordinarily the character of an asset as passive or active depends on the income generated by that asset. However, as explained above, some assets (for example, stocks or securities held for sale to customers in the ordinary course of business by a regular dealer in such property, and properly identified as inventory property) may be treated as active even though those assets generate, among other things, passive income. It is unclear whether this was intended when the PFIC rules were enacted.[30]

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[28] It is understood that a mutual insurance company can be treated under the bill and under present law as a passive foreign corporation, notwithstanding the fact that such a company does not actually issue "stock."

[29] Thus, the bill retains the exception for income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation. It is intended that in determining whether a corporation is "predominantly engaged" for this purpose, the Secretary may require a higher standard or threshold than the definition of an insurance company under Treasury Regulations section 1.801-3(a).

[30] Active asset treatment of certain securities held for sale to the public is confirmed in Notice 88-22, 1988-1 C.B. 489, 490, and S. Rep. No. 100-445, 100th Cong., 2d Sess. 281 (1988). The legislative history of the 1986 Act further suggested a view that all income from such inventory would be treated as active. "[S]ecurities held for sale to the public[] are assets that do not give

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The bill establishes that, to the extent an asset is properly treated as active, all of the income from that asset is treated as active for purposes of the income test. The bill is not intended to change the outcome of the application of the asset test under present law. For example, it is not intended to limit the IRS's authority to prescribe limits, as it did in Notice 88-22, on the cases in which assets generating what could be passive income are treated as active assets.[31] In addition, it is intended that where one item of property is properly viewed as two separate assets, a portion of the property can be treated as a passive asset that generates passive income while another portion of the same property can be treated as a nonpassive asset that generates nonpassive income. For example, assume that a taxpayer owns a six-story office building, and occupies two floors for use in its active business while renting out the other four floors. Assume that the two floors used in the active business are properly viewed as a nonpassive asset, while the four leased floors are properly viewed as a passive asset. It is intended that the rental income from the four leased floors in this example be treated as passive income.

Information has been presented that dealers in stocks and securities enter into securities sale and repurchase agreements (sometimes referred to as "repos" and "reverses"[32]) and engage in securities lending and borrowing transactions. For example, information has been presented that securities dealers may engage in offsetting repo and reverse transactions—i.e., may run a "matched book" with respect to such transactions. In addition, information has been presented that securities dealers enter into reverse repos and securities borrowing transactions to cover short sales and failed deliveries of securities for settlement of trades, and use repos and securities loans to finance inventory positions. As noted above, repos and reverses may be characterized for tax purposes as loans rather than as sales and repurchases, and thus may give rise to interest income and expense for the parties to the transactions.

The bill provides a netting rule with respect to repos and reverses, if entered into in connection with a "matched book" by a foreign corporation that is engaged in the active conduct of a trade or business as a dealer in securities. Under this rule, offsetting debt liabilities and assets resulting from matched repos and reverses are netted, and only the net asset position (if any) is treated as an asset held by a foreign corporation for purposes of applying the PFC definition. Similarly, the bill provides that the offsetting interest expense and income resulting from matched repos and reverses is netted and the net income, if positive, is treated as an item of gross income under the PFC definition. The reduction in

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rise to subpart F FPHC income by virtue of the dealer exception in sec. 954(c)...." Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986,* at 1025 (1987).

[31] Under the Notice, for example, the IRS conditioned active asset treatment of securities inventories on compliance with an identification requirement and a reasonable needs requirement. 1988-1 C.B. at 490.

[32] The use of industry shorthand terms such as "repo" and "reverse" in this explanation is not intended to limit the types of sale and repurchase transactions that, under the provision, may be within the scope of the Treasury's authority to treat as parts of a qualified matched transaction. It is not intended that the application of the provision be affected by the use of shorthand terms other than these to refer to transactions described herein.

gross income or assets that may result from application of this provision to a corporation does not apply for any purpose other than testing a foreign corporation for PFC status.

It is anticipated that Treasury regulations will provide guidance as to what constitutes a "matched book;" what repo and reverse transactions are considered to offset each other in a "matched book;" what constitutes the entry into matched book transactions in the active conduct of a trade or business of being a dealer in securities; and how the netting procedure will be carried out to arrive at amounts of gross income and assets for PFC definitional purposes.

It is intended that, in practice, the effect of this provision shall be only to mitigate the effect of the PFC rules on a company insofar as it is actively engaged in the business of providing the services of a financial intermediary to unrelated parties, rather than used as a vehicle for investment in stock, securities, or other financial products on behalf of its shareholders or other related parties. There are other instances in the Code and regulations where it is necessary to draw similar distinctions, and the Treasury is invited to consider whether any tests employed in those provisions are suitable in light of the purposes of this provision.

For example, rules under subpart F may require a determination whether a foreign corporation is a regular dealer within the meaning of section 954(c)(1)(B) in stocks, securities, or derivative financial products during its taxable year. As another example, under the PFIC rules of present law (as under the PFC rules in the bill) a foreign corporation, to the extent provided in regulations, may be exempted from passive characterization of its interest income from the active conduct of a banking business. Guidance has been issued under this provision analogous to the guidance that might be issued under the matched-book provision. As a third example, guidance has been issued under the foreign tax credit limitation regulations for identifying financial services entities.

As in the cases of the PFIC bank rules and the foreign tax credit limitation rules on financial services entities, it is believed that the Treasury could consider a variety of activities that may indicate the existence of an active securities business.[33]

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[33] Such activities might include: (a) purchasing or selling stock, debt obligations, commodity futures or other securities or derivative financial products (including notional principal contracts) from or to unrelated persons, and holding stock, debt obligations and other securities as inventory for sale to customers; (b) arranging notional principal contracts and other hedging transactions for, or entering into such transactions or any other derivative financial products with, unrelated persons who are customers; (c) arranging foreign exchange transactions for, or engaging in foreign exchange transactions with, unrelated persons who are customers; (d) underwriting issues of stocks, debt obligations or other securities under best-efforts or firm-commitment agreements with unrelated persons; (e) purchasing, selling, discounting, or negotiating on a regular basis for unrelated persons notes, drafts, checks, bills of exchange, acceptances or other evidences of indebtedness; (f) lending stocks or securities to unrelated persons; (g) providing finance leasing (which would not qualify as active leasing income under sec. 954(c)(2)(A)) to unrelated persons; (h) engaging in hedging activities directly related to bona fide securities activities described in items (a) through (g) of this list; (i) servicing mortgages; (j) investment banking activities; (k) providing financial or investment advisory services, investment management services, fiduciary services, trust services, or custodial services to unrelated persons; (l) providing margin or other financing for customers secured by securities or money market instruments, including repurchase agreements, or financing in connection with any of the bona fide securities activities described in items (a) through (k) of this list; (m) disposing of any property (whether tangible or intangible, personal or real) that was used in the active conduct of the securities

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In addition, in appropriate circumstances, the Treasury might consider it relevant that a foreign corporation is or is not registered or authorized in the country in which it conducts its principal securities dealer operations to conduct the bona fide securities activities that it performs in that country, and is subject to the appropriate securities regulatory authorities of that jurisdiction.

The foregoing list of possible approaches and factors to take into account is not intended to be exclusive of other approaches or factors not mentioned. Nor is it intended to suggest that the presence of any of the factors mentioned above, or the passing or failing of any test existing under present law, must be used by Treasury to determine the outcome of the question whether a foreign corporation is engaged in the active conduct of a trade or business as a dealer in securities. It is not intended to limit the Treasury's discretion to fashion rules suitable to the purposes of the provision.

The bill also requires that the Secretary of the Treasury conduct a study as to the tax treatment for purposes of the PFC rules of securities sale and repurchase transactions and securities lending and borrowing transactions. The Secretary is required, not later than one year after the date of the enactment of the bill, to submit to the House Ways and Means Committee and the Senate Finance Committee a report on the required study, together with such recommendations as the Secretary may deem advisable.

In addition, the bill provides two clarifications to present law. First, the bill clarifies that, as indicated in the legislative history of the 1988 Act, the same-country exceptions from the definition of foreign personal holding company income in section 954(c) do not apply in determining passive income for purposes of the PFIC definition.[34] Second, the bill clarifies that any foreign trade income of a foreign sales corporation does not constitute passive income for purposes of the PFIC definition (cf. sec. 951(e)).

The bill modifies the present law application of the asset test by treating certain leased property as assets held by the foreign corporation for purposes of the PFC asset test. This rule applies to tangible personal property with respect to which the foreign corporation is the lessee under a lease with a term of at least 12 months. Under the bill, the value of leased property for purposes of applying the asset test is the lesser of the fair market value of the property or the unamortized portion of the present value of the payments under the lease. Regulations are to provide for determining the unamortized portion of the present value of the payments. Present value is to be determined, under regulations, as of the beginning of the lease term, and, except as provided in regulations, by using a discount rate equal to the applicable Federal rate determined under the rules applicable to original discount instruments (sec. 1274(d)), substituting under those rules the term of the lease for the term of the debt instrument. In applying those rules, options to renew or extend the lease are not to be taken into account.

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business, but only to the extent that the property was held in connection with a bona fide securities activity; and (n) any other activity that the Secretary may determine to be a bona fide securities activity that is commonly conducted by active foreign securities dealers in the ordinary course of their securities business.

[34] H.R. Rep. No. 100-795, 100th Cong., 2d Sess. 272 (1988); S. Rep. No. 100-445, 100th Cong., 2d Sess. 285 (1988).

Also, the special rule to be applied under section 1274(d)(2) in the case of a sale or exchange is disregarded. Property leased by a corporation is not taken into account in testing for PFC status under the asset test either if the lessor is a related person (as that term is defined under the foreign base company rules) with respect to the lessee, or if a principal purpose of leasing the property was to avoid the PFC provisions.

The bill also modifies the present law rules that provide an exception from the definition of a PFIC in the case of a company changing businesses. Under the bill, if a foreign corporation holds 25 percent or more of the stock of a second corporation that qualifies for the change-of-business exception (current sec. 1297(b)(3)), then in applying the look-though rules (current sec. 1296(c)), the first corporation may treat otherwise passive assets or income of the second corporation as active.[35]

The bill generally retains those provisions of current law the application of which depends upon whether a foreign corporation was a PFIC for years after 1986 (e.g., current sec. 1291(d)), but modifies these provisions to test whether the foreign corporation was a PFC for years after 1986. As a transitional definition, the bill provides that a foreign corporation that was treated as a PFIC for any taxable year beginning before the introduction of the bill is treated as having been a PFC for each such year.

The bill provides a new election that will allow certain passive foreign corporations to be treated as domestic corporations. A foreign corporation is eligible to make this election if (1) it would qualify for treatment as a regulated investment company (RIC) under the relevant provisions of the Code if it actually were a domestic corporation, (2) it meets such requirements as the Secretary may prescribe to ensure the collection of taxes imposed by the Internal Revenue Code on the passive foreign corporation, and (3) the electing passive foreign corporation waives all benefits which are granted by the United States under any treaty (including treaties other than tax treaties) and to which the corporation is otherwise entitled by reason of being a resident of another country. The rules governing such an election generally will be similar to those applicable to the election by a foreign insurance company to be treated as a domestic corporation under section 953(d). The rules governing the election under the PFC rules, however, will not include rules similar to the special rules applicable under section 953(d) for pre-effective-date earnings and profits (sec. 953(d)(4)(B)).

The bill provides a special rule regarding the application of the PFC rules to tax-exempt organizations that own stock in passive foreign corporations. The PFC rules, under the bill, apply to any stock held by a tax-exempt organization (under section 501) in a passive foreign corporation only to the extent that a dividend on that stock would be taken into account in determining the organization's unrelated business taxable income. To that extent, the PFC rules apply with respect to amounts taken into account in comput-

[35] The bill retains the present law rules that provide an exception from the definition of a PFIC in the case of a start-up company (current sec. 1297(b)(2)). Under the bill, it is intended that the start-up company exception be applied, where necessary to carry out the purposes of the PFC rules, by treating as one corporation all related foreign corporations that transferred assets to the start-up company.

ing unrelated business taxable income in the same manner as if the organization were fully taxable. Even if a dividend on the PFC stock would not be taken into account in determining the organization's unrelated business taxable income, however, it is intended that any U.S. corporation regardless of its tax-exempt status will be treated as a U.S. person for purposes of determining whether or not a PFC is U.S. controlled.

Tax treatment under full elimination of deferral

The benefits of deferral are eliminated with respect to the income of a PFC under three alternative methods: current inclusion, mark-to-market, or interest charge on excess distributions.

Current inclusion method

Mandatory current inclusion.—If a passive foreign corporation is U.S. controlled, the bill will subject every U.S. person owning (directly or indirectly) stock in the PFC to income inclusions under a modified version of the controlled foreign corporation rules. If a PFC is not U.S. controlled, every U.S. person owning (directly or indirectly) 25 percent or more of the vote or value of the stock of the PFC will be subject to the same rules. Under the bill, the entire gross income of the passive foreign corporation (subject to applicable deductions) is treated as foreign base company income, and thus is included (net of appropriate deductions) on a pro rata basis in the income of each U.S. person directly or indirectly owning stock in the PFC, under a modified application of the rules of sections 951 and 961.[36] Actual distributions of earnings by such a PFC are treated similarly to distributions of previously taxed income under sections 959 and 961. These rules supersede all application of the present-law rules applicable to foreign personal holding companies, under which earnings are deemed distributed and then contributed to the capital of the foreign personal holding company.

In applying the subpart F inclusion rules to PFC inclusions, the bill applies the subpart F high-tax exception (under sec. 954(b)(4)) only to those shareholders in the PFC who are treated as "U.S. shareholders" of a controlled foreign corporation under the general rules of subpart F (i.e., those who own, whether directly, indirectly, or constructively, at least 10 percent of the voting power of the controlled foreign corporation). This limitation on the application of the controlled foreign corporation rules preserves present law to the extent that no high-tax exception is available to PFICs that are not also controlled foreign corporations. However, because the bill repeals the foreign personal holding company provisions of the Code, the effect of this high-tax exception is to increase the possibility for deferral in the case of a company that under present law meets the definitions of both a controlled foreign corporation and a foreign personal holding company.

Also in general conformity with present law, the bill permits the character of the PFC's income as either ordinary income or capital

[36] The treatment of PFC income as foreign base company income for purposes of subpart F is not intended to affect the application of look-through treatment of that income for purposes of the foreign tax credit limitation.

gain to be passed through to those shareholders of the PFC who are not treated as "U.S. shareholders" of a controlled foreign corporation under the general rules of subpart F (i.e., those who do not own, whether directly, indirectly, or constructively, at least 10 percent of the voting power of the controlled foreign corporation).

In addition, the bill modifies the application of subpart F to PFCs by including foreign base company income of a PFC in the income of U.S. persons without regard to otherwise applicable reductions pursuant to the export trade corporation rules (secs. 970 and 971). This modification to the application of the controlled foreign corporation rules preserves present law in that the PFIC provisions apply in full force to export trade corporations. A passive foreign corporation is treated under the bill as U.S. controlled for this purpose either if it would be treated as a controlled foreign corporation under the rules of subpart F, or if, at any time during the taxable year, more than 50 percent of the vote or value of the corporation's stock was owned directly or indirectly by five or fewer U.S. persons (including but not limited to individuals, and including all U.S. citizens regardless of their residence). Indirect stock ownership under the bill generally refers to stock ownership through foreign entities within the meaning of section 958(a)(2). In addition, for the purpose of determining whether a foreign corporation is U.S. controlled by virtue of the ownership of more than 50 percent of its stock by five or fewer U.S. persons, the constructive ownership principles of the present-law foreign personal holding company rules generally apply. In the case of pass-through entities such as partnerships, S corporations, estates, and trusts, the constructive ownership principles of the present-law foreign personal holding company rules apply except as provided in regulations. It is contemplated that regulations may modify the constructive ownership rules, for example, in the case of a trust in which the beneficial interests may be contingent, subject to determination or adjustment within the discretion of the trustee, or otherwise variable or indeterminate.

Elective current inclusion.—A U.S. person not subject to the above mandatory current inclusion rules—that is, a U.S. person owning less than 25 percent of the stock in a PFC that is not U.S. controlled—may elect application of those rules. As under current law, the PFC is characterized as a "qualified electing fund" with respect to such a U.S. person. In the application of the elective current-inclusion rules, the passive foreign corporation is treated as a controlled foreign corporation with respect to the taxpayer, and the taxpayer is treated as a U.S. shareholder of the corporation. For foreign tax credit purposes, amounts included in the taxpayer's gross income under this modified application of the controlled foreign corporation rules are treated as dividends received from a foreign corporation which is not a controlled foreign corporation. Thus, an amount would be treated as a dividend from a noncontrolled section 902 corporation, or as passive income, depending on the shareholder's percentage ownership and status as an individual or a corporation.

The application and operation of the shareholder-level election for treatment as a qualified electing fund generally are the same as under the present-law PFIC rules. It is intended that, in the case of

PFC stock owned through a foreign partnership, a partner-level election for treatment as a qualified electing fund will be permitted (except in the case of a foreign partnership that is subject to the simplified reporting rules available to certain large partnerships under subtitle C of the bill's simplification provisions).

Mark-to-market method

Less-than-25-percent shareholders of passive foreign corporations that are not U.S.-controlled, and who do not elect current inclusion ("nonelecting shareholders"), are subject under the bill to one of two methods for taxing the economic equivalent of the PFC's current income: the mark-to-market method or the interest-charge method. The mark-to-market method does not apply to the stock of a U.S. person in any PFC that is U.S. controlled (as discussed above), to the stock of a person choosing qualified electing fund treatment, or to stock of a U.S. person who is a 25-percent shareholder (as defined above).

Under the bill, nonelecting shareholders of a PFC with marketable stock are required to mark their PFC shares to market annually. Under the mark-to-market method, the U.S. person is required to include in gross income each taxable year an amount equal to the excess (if any) of the fair market value of the PFC stock as of the close of the taxable year over the adjusted basis of the stock. In the event the adjusted basis of the stock exceeds its fair market value, the U.S. person is allowed a deduction for the taxable year equal to the lesser of the amount of the excess or the "unreversed inclusions" with respect to the stock. The bill defines the term "unreversed inclusions" to mean, with respect to any stock in a passive foreign corporation, the excess (if any) of the total amount of mark-to-market gains with respect to the stock included by the taxpayer for prior taxable years, over the amount of mark-to-market losses with respect to such stock that were allowed as deductions for prior taxable years.

The adjusted basis of stock in a passive foreign corporation is increased by the amount of mark-to-market gain included in gross income, and is decreased by the amount of mark-to-market losses allowed as deductions with respect to such stock. In the case of stock owned indirectly by the U.S. person, such as through a foreign partnership, foreign estate or foreign trust (as discussed below), the basis adjustments for mark-to-market gains and losses apply to the basis of the PFC stock in the hands of the intermediary owner, but only for purposes of the subsequent application of the PFC rules to the tax treatment of the indirect U.S. owner. In addition, similar basis adjustments are made to the adjusted basis of the property actually held by the U.S. person by reason of which the U.S. person is treated as owning PFC stock.

All amounts of mark-to-market gain on PFC stock, as well as gain on the actual sale or distribution of PFC stock, are treated as ordinary income. Similarly, ordinary loss treatment applies to the deductible portion of any mark-to-market loss on PFC stock, as well as to any loss realized on the actual sale or other disposition of PFC stock to the extent that the amount of such loss does not exceed the unreversed inclusions with respect to that stock. These

loss deductions are treated as deductions allowable in computing adjusted gross income.

The source of any amount of mark-to-market gain on PFC stock is determined in the same manner as if the amount of income were actual gain from the sale of stock in the passive foreign corporation. Similarly, the source of any amount allowed as a deduction for mark-to-market loss on PFIC stock is determined in the same manner as if that amount were an actual loss incurred on the sale of stock in the passive foreign corporation.

Definition of "marketable stock."—The mark-to-market method under the bill only applies to passive foreign corporations the stock of which is "marketable." PFC stock is treated as marketable if it is regularly traded on a qualified exchange, whether inside or outside the United States. An exchange qualifies for this treatment if it is a national securities exchange which is registered with the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934, or if the Secretary is satisfied that the requirements for trading on that exchange ensure that the market price on that exchange represents a legitimate and sound fair market value for the stock. It is intended that the Secretary may adopt a definition of the term "regularly traded" that differs from definitions provided for other purposes under the Code. Further, it is intended that the Secretary not be bound by definitions applied for purposes of enforcing other laws, including Federal securities laws. Similarly, in identifying qualified foreign exchanges for these purposes, it is intended that the Secretary not be required to include exchanges that satisfy standards established under Federal securities laws and regulations. PFC stock is also treated as marketable, to the extent provided in Treasury regulations, if the PFC continuously offers for sale or has outstanding any stock (of which it is the issuer) that is redeemable at its net asset value in a manner comparable to a U.S. regulated investment company (RIC). In addition, the bill treats as marketable any stock in a passive foreign corporation that is owned by a RIC that continuously offers for sale or has outstanding any stock (of which it is the issuer) that is redeemable at its net asset value. It is believed that the RIC's determination of PFC stock value for this non-tax purpose would ensure a sufficiently accurate determination of the fair market value of PFC stock owned by the RIC. The bill also treats as marketable any stock in a passive foreign corporation that is held by any other RIC, except to the extent provided in regulations. It is believed that even for RICs that do not make a market in their own stock, but that do regularly report their net asset values in compliance with the securities laws, inaccurate valuations may bring exposure to legal liabilities, and this exposure may ensure the reliability of the values such RICs assign to the stock they hold in PFCs. However, it is intended that Treasury regulations will disallow mark-to-market treatment for nonmarketable stock held by any RIC that is not required to perform such a net asset valuation at the close of each taxable year, that does not publish such a valuation, or that otherwise does not provide what the Secretary regards as sufficient indicia of the reliability of its valuations under the relevant circumstances.

Coordination with RIC rules.—The bill coordinates the application of the mark-to-market method with the tax rules generally applicable to RICs. The bill treats mark-to-market gain on PFC stock as a dividend for purposes of both the 90-percent investment income test of section 851(b)(2) and the 30-percent short-short limitation of section 851(b)(3). In addition, the bill permits RICs to determine their mark-to-market gain using a fiscal year ending on October 31 of each year, solely for purposes of determining their ordinary income for purposes of the excise tax on the undistributed income of regulated investment companies (sec. 4982). Reductions in value of the PFC stock between October 31 and the end of the RIC's normal taxable year are treated, to the extent provided in regulations, as occurring in the following taxable year for purposes of computing the RIC's investment company taxable income (sec. 852(b)) and the RIC's earnings and profits (sec. 852(c)).[37]

Marketable stock not directly owned by a U.S. person.—In the case of a controlled foreign corporation (including a passive foreign corporation that is treated under the bill as a controlled foreign corporation) that owns or is treated as owning stock in a passive foreign corporation, the mark-to-market method generally is applied as if the controlled foreign corporation were a U.S. person. For purposes of the application of subpart F to the controlled foreign corporation, mark-to-market gains are treated as if they were foreign personal holding company income of the character of dividends, interest, royalties, rents or annuities, and allowable deductions for mark-to-market losses are treated as deductions allocable to that category of foreign personal holding company income. The source of such income or loss, however, is determined by reference to the actual (foreign) residence of the controlled foreign corporation.

For purposes of the mark-to-market method, any stock in a passive foreign corporation that is owned, directly or indirectly, by or for a foreign partnership or foreign trust or foreign estate is treated as if it were owned proportionately by its partners or beneficiaries, except as provided in regulations.[38] Stock in a passive foreign corporation that is thus treated as owned by a person is treated as actually owned by that person for the purpose of applying the constructive ownership rule at another level. In the case of a U.S. person who is treated as owning stock in a passive foreign corporation by application of this constructive ownership rule, any disposition by the U.S. person or by any other person that results in the U.S. person being treated as no longer owning the stock in the passive foreign corporation, as well as any disposition by the person actually owning the stock of the passive foreign corporation, is treated under the bill as adisposition by the U.S. person of stock in the passive foreign corporation.

Transition to mark-to-market.—The bill provides certain transition rules for PFC stock that becomes subject to the mark-to-market method—that is, generally, marketable PFC stock with re-

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[37] Similar rules apply under present law for currency gains of RICs (secs. 4982(e)(5), 852(b)(8), and 852(c)(2)).

[38] For this purpose, it is intended that proportionate ownership will take into account any special or discretionary allocations of the distributions or gains with respect to stock in the passive foreign corporation.

spect to which current inclusion rules do not apply. One method applies in general, another applies to PFC stock held by regulated investment companies, and a third method applies to PFC stock held by individuals who become subject to U.S. tax jurisdiction as the result of a change in residence or citizenship.

(1) The general rule applies in the case of marketable stock in a PFC that is held by the shareholder on the effective date of the bill, where the PFC was also a PFIC under present law but was not a qualified electing fund with respect to the shareholder for all post-1986 years in the taxpayer's holding period during which the PFC was either a PFIC or a PFC (under the law then applicable). Under this general rule, tax is imposed under the bill's mark-to-market rule on the amount of mark-to-market gain representing the stock's appreciation (if any) in the first post-effective date year. In addition, if the stock has not depreciated in the first post-effective date year, tax may be imposed on the full amount of mark-to-market gain representing the stock's appreciation prior to the effective date, as if the stock had been sold at the end of the last pre-effective-date year and taxed subject to present law's interest-charge method.

If on the other hand the stock has not appreciated during the first post-effective date year, tax is imposed only on the amount of the net mark-to-market gain representing the stock's appreciation between the beginning of the taxpayer's holding period and the last day of the first post-effective date year. In either case, the difference between the fair market value of the PFC stock at the close of the first taxable year under the bill and the shareholder's adjusted basis in the PFC stock, less the amount of that difference (if any) that represents appreciation during that first taxable year, is treated pursuant to the interest-charge method as having accrued ratably over the shareholder's holding period (ending prior to that first taxable year) in the stock of the PFC.

Both the amount of pre-effective-date appreciation included in gross income (in this case, generally the portion of appreciation treated as having accrued before 1987), and the amount excluded from gross income (but subject to the "deferred tax amount" under the interest-charge method) are treated as an unreversed inclusion for purposes of the application of the mark-to-market method in future years.

In addition, the bill provides an election to defer the payment of tax (similar to the election for qualified electing funds to defer the payment of tax under present law's section 1294) imposed as a result of the recognition of the pre-effective-date gain. Under the bill, this election is treated as terminated to the extent a future mark-to-market loss deduction is allocable to the unreversed inclusion for pre-effective-date appreciation. This election is also terminated to the extent of any distribution received by the shareholder that would be an excess distribution under the interest-charge rules if those rules applied to the stock. In either case, the bill contemplates that regulations will provide rules for determining the appropriate proportion of the deferred tax for which the extension will terminate. As under present law, any direct or indirect loan by the PFC to the shareholder is treated as a distribution for purposes of determining the extent to which the extension remains in effect.

Also, the extension generally is terminated upon disposition of the PFC stock. To the extent provided in regulations, however, a disposition of PFC stock in a nonrecognition transaction does not terminate the extension; rather, the person acquiring the PFC stock succeeds to the transferor's treatment of the PFC stock under the mark-to-market rules.

(2) Regulated investment companies are subject to a special transition rule for the PFC stock they hold on the bill's effective date. Instead of applying the interest-charge method to the amount of pre-effective-date appreciation, RICs include the full amount of pre-effective-date appreciation under the mark-to-market method, and pay a separate nondeductible interest charge. No election to defer the payment of tax is available.

(3) In the case of a shareholder of a PFC with marketable stock who becomes subject to the tax jurisdiction of the United States as a result of a change in residence or citizenship, no U.S. tax applies under the mark-to-market method or under the interest-charge method to the appreciation of the stock's value prior to the time that the shareholder becomes subject to the tax jurisdiction of the United States. The bill implements this rule by treating the greater of (i) the fair market value of the PFC stock at the time that the shareholder enters U.S. tax jurisdiction, or (ii) the shareholder's basis in the PFC stock, as the shareholder's basis in the PFC stock solely for purposes of the mark-to-market method.

Interest-charge method

Nonelecting shareholders[39] of a PFC with stock that is not marketable are subject to the interest-charge method, based on the PFIC interest-charge method that is currently provided in Code section 1291, with certain modifications.

First, although allowable foreign tax credits may reduce a U.S. person's net U.S. tax liability on an excess distribution, the interest charge computed on that excess distribution is computed, under the bill, without regard to reductions in net U.S. tax liability on account of direct foreign tax credits.

The PFIC provisions of present law, to the extent provided in regulations, impose recognition of gain in the case of a transfer of interest-charge PFIC stock in a transaction that would otherwise qualify for the nonrecognition provisions of the Code. The bill imposes that result as a general rule, except as otherwise provided in Treasury regulations. As noted above, under proposed Treasury regulations nonrecognition provisions may apply to the gain, but only to the extent that the transferee will be subject to the interest-charge method on a subsequent distribution by the PFC or disposition of the PFC stock.

In addition, the bill requires that proper adjustment be made to the basis of property, held by the U.S. person, through which the U.S. person is treated as owning stock in the passive foreign corporation.

The PFIC provisions of present law apply rules for the attribution of ownership of PFIC stock to U.S. persons, including a rule

[39] All citizens (and residents) of the United States are included, irrespective of residence in a U.S. commonwealth or possession.

that attributes PFIC stock owned by a corporation to any person who owns, directly or indirectly, 50 percent or more of the value of the stock of the corporation. Under the bill, the 50-percent threshold applies not only to stock owned directly or indirectly, but also to stock treated as owned by application of the family attribution rules of the personal holding company provisions (sec. 544 (c)(2)).

The PFIC provisions of present law provide special rules for the application of the interest-charge method in the case of PFIC stock held by an U.S. person through an intermediary entity. These rules describe the dispositions that are treated as dispositions of PFIC stock by the U.S. person, and include rules to eliminate the possibility of double taxation (sec. 1297(b)(5)). The bill clarifies that, under regulations, these rules apply to any transaction that results in the U.S. person being treated as no longer owning the PFC stock, as well as any disposition of the PFC stock by the entity actually owning the PFC stock. These rules apply regardless of whether the transaction involves a disposition of the PFC stock, and regardless of whether the parties to the transaction include the U.S. person, the entity actually owning the PFC stock, or some other entity. For example, these rules apply to the issuance of additional stock by an intermediary corporation to an unrelated party in a case where, by increasing the total outstanding stock of the intermediary corporation, the transaction causes the U.S. person to fall below the ownership threshold for indirect ownership of the PFC stock. The bill also clarifies that an income inclusion under the interest-charge method takes precedence over an income inclusion under subpart F resulting from the same disposition. The second clarification ensures that the interest charge is imposed without regard to the structure of the transaction.

Under the bill, the interest-charge method applies to any stock in a passive foreign corporation unless either the stock is marketable (and therefore the mark-to-market method applies) as of the time of the distribution or disposition involved, or the stock in the passive foreign corporation was subject to the current inclusion method (under the bill or under prior law) for each taxable year beginning after December 31, 1986 which includes any portion of the taxpayer's holding period in the PFC stock during which the PFC was either a PFIC or a PFC (under the law then applicable). In the event that PFC stock, not subject to the current inclusion method, becomes marketable during the taxpayer's holding period, the interest-charge method applies to any distributions and dispositions during the year in which the stock becomes marketable, as well as to the mark-to-market gain (if any) as of the close of that year. In the event that PFC stock was initially marketable, and later becomes unmarketable and subject to the interest-charge method, the taxpayer's holding period in the PFC stock for purposes of the interest-charge method is treated as beginning on the first day of the first taxable year beginning after the last taxable year for which the mark-to-market method applies to the taxpayer's stock in the PFC.

Under the bill, as under the present-law PFIC rules, stock in a foreign corporation generally is treated as PFC stock if, at any time during the taxpayer's holding period of that stock, the foreign corporation (or any predecessor) is a passive foreign corporation

subject to the interest-charge method (current sec. 1297(b)(1)). (This rule is sometimes referred to as the "once-a-PFIC-always-a-PFIC" rule.) Under present law this rule generally does not affect a taxpayer holding stock in a foreign corporation if at all times during the holding period of the taxpayer with respect to the stock when the foreign corporation (or any predecessor) is a PFIC, qualified electing fund treatment applies with respect to the taxpayer. Under the bill, the similar once-a-PFC-always-a-PFC rule does not apply if during the taxpayer's entire holding period with respect to the stock when the foreign corporation (or any predecessor) is a PFC, either (a) mark-to-market treatment applies, (b) mandatory current inclusion of income applies (either because the corporation is U.S. controlled or because the taxpayer is a 25-percent shareholder), or (c) elective current inclusion of income applies.[40] Thus, for example, a shareholder of a controlled foreign corporation is subject to current inclusion with respect to all the corporation's income in any year for which the corporation is a PFC, but is subject to current inclusion only to the extent provided under subpart F in any year for which the controlled foreign corporation is not a PFC.

The bill also provides for full basis adjustment for partnerships and S corporations that own stock in a passive foreign corporation subject to the interest-charge method. Although tax is imposed on a distribution or disposition under the interest-charge method without including the distribution or disposition in gross income, thus precluding the natural basis adjustments for amounts included in gross income, the bill grants regulatory authority for appropriate basis adjustments to partnerships and S corporations based on the amount of income subject to tax under the interest-charge method and thereby excluded from gross income.

The bill includes a broad grant of regulatory authority, as does the present-law PFIC statute. In addition, the bill specifies that necessary or appropriate regulations under the PFC rules may include regulations providing that gross income should be determined without regard to the operation of the interest-charge method for such purposes as may be specified in the regulations. Such regulations may relieve pressure on many aspects of the Code that result from the operation of the interest-charge method other than through gross income. In addition, the bill specifies that necessary or appropriate PFC regulations may include regulations dealing with changes in residence status or citizenship by shareholders in passive foreign corporations (e.g., a resident alien becoming a nonresident, or a nonresident U.S. citizen renouncing U.S. citizenship). It is intended that no inference be drawn from this explicit regulatory authority as to the Secretary's authority to issue similar regulations under the authority of the PFIC provisions of present law.

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[40] In the case of a PFC that was a PFIC prior to the effective date of the bill, even if the PFC is subject to either mark-to-market treatment or mandatory current inclusion, the once-a-PFC-always-a-PFC rule applies unless the PFIC was subject to elective current inclusion for the entire portion of the taxpayer's holding period prior to the effective date of the bill. In the case of a PFC that was not a PFIC prior to the effective date of the bill, the application of the once-a-PFC-always-a-PFC rule is determined without regard to the portion of the taxpayer's holding period prior to the effective date of the bill.

Modification or repeal of other antideferral regimes

While the bill includes in the passive foreign corporation rules most of the provisions that it preserves from the present-law PFIC, foreign personal holding company, and foreign investment company regimes, the bill modifies subpart F in one respect to reflect a present-law provision of the foreign personal holding company rules (sec. 553(a)(5)). The bill treats as foreign personal holding company income for subpart F purposes an amount received under a personal service contract if a person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract. The bill similarly treats as foreign personal holding company income for subpart F purposes any amount received from the sale or distribution or disposition of such a contract. This rule applies only if at some time during the taxable year 25 percent or more of the value of the corporation's stock is owned (directly, indirectly, or constructively) by or for the individual who may be designated to perform the services.[41] Income from such personal service contracts is not, however, treated as passive for foreign tax credit purposes.

The bill repeals the foreign personal holding company provisions, the PFIC provisions (except as modified and preserved as the passive foreign corporation provisions), and the foreign investment company provisions. The bill also excludes all foreign corporations from the application of the accumulated earnings tax and the personal holding company tax. It is understood that the purposes of all the anti-deferral regimes are adequately served by the passive foreign corporation provisions as set forth in the bill, in conjunction with the controlled foreign corporation provisions as modified by the bill.

In addition, the bill denies installment sales treatment for any installment obligation arising out of a sale of stock in a passive foreign corporation that is subject to the interest-charge regime.

As a conforming amendment to the special rules applicable to RICs holding PFC stock, the bill confirms that the income of a RIC from either a controlled foreign corporation or a PFC, which income is derived from the active conduct of the business of investing in stocks or securities, is a type of income that counts toward meeting the 90-percent investment income test of section 851(b)(2).

In addition, as a conforming amendment to the elimination of the present-law PFIC rules, distributions from a PFC of amounts that previously were included in a shareholder's income under the elective current-inclusion rules of present law are treated, under the bill, as previously taxed income under the subpart F rules (sec. 959).

Effective Date

The provision generally is effective for taxable years of U.S. persons beginning after December 31, 1993, and taxable years of for-

[41] This rule was included in the definition of foreign personal holding company income for purposes of subpart F prior to the amendments included in the 1986 Act.

eign corporations ending with or within such taxable years of U.S. persons.

The denial of installment sales treatment is effective for sales or dispositions after December 31, 1993.

The bill does not affect the determination of the basis of any stock that was acquired from a decedent in a taxable year beginning before January 1, 1994.

2. Treatment of controlled foreign corporations (secs. 411-415 of the bill and secs. 902, 951, 952, 956, 959, 960, 961, 964, and 1248 of the Code)

Present Law

Treatment of controlled foreign corporation earnings

In general

A U.S. shareholder generally treats dividends from a controlled foreign corporation as ordinary income from foreign sources that carries both direct and indirect foreign tax credits. Under look-through rules, the income and credits are subject to those foreign tax credit limitations which are consistent with the character of the income of the foreign corporation.

Several Code provisions result in similar tax treatment of a U.S. shareholder if it either disposes of the controlled foreign corporation stock, or the controlled foreign corporation realizes certain types of income (including income with respect to lower-tier controlled foreign corporations). First, under section 1248, gain resulting from the disposition by a U.S. person of stock in a foreign corporation that was a controlled foreign corporation with respect to which the U.S. person was a U.S. shareholder in the previous five years is treated as a dividend to the extent of allocable earnings.

Second, a controlled foreign corporation has subpart F income when it realizes gain on disposition of stock and, ordinarily, when it receives a dividend. Under sections 951 and 960, such subpart F income may result in taxation to the U.S. shareholder similar (but not identical) to that on a dividend from the controlled foreign corporation. In addition to provisions for characterizing income and credits in these situations, the Code also provides certain rules that adjust basis, or otherwise result in modifying the tax consequences of subsequent income, to account for these and other subpart F income inclusions.

Third, when in exchange for property any corporation (including a controlled foreign corporation) acquires stock in another corporation (including a controlled foreign corporation) controlled by the same persons that control the acquiring corporation, earnings of the acquiring corporation (and possibly the acquired corporation) may be treated under section 304 as having been distributed as a dividend to the seller.

For foreign tax credit separate limitation purposes, a controlled foreign corporation is not treated as a noncontrolled section 902 corporation with respect to any distribution out of its earnings and profits for periods during which it was a controlled foreign corporation and except as provided in regulations, the recipient of the dis-

tribution was a U.S. shareholder in such corporation.[42] The consequence of not being treated as a section 902 corporation is application of the so-called "look-through" rule. That is, dividends paid by such controlled foreign corporation to its U.S. shareholder are characterized for separate limitation purposes by reference to the character of the underlying earnings of the controlled foreign corporation.

Lower-tier controlled foreign corporations

For purposes of applying the separate foreign tax credit limitations, receipt of a dividend from a lower-tier controlled foreign corporation by an upper-tier controlled foreign corporation may result in a subpart F income inclusion for the U.S. shareholder that is treated as income in the same limitation category as the income of the lower-tier controlled foreign corporation. The income inclusion of the U.S. shareholder may carry deemed-paid credits for foreign taxes paid by the lower-tier controlled foreign corporation, and the basis of the U.S. shareholder in the stock of the first-tier controlled foreign corporation is increased by the amount of the inclusion. If, on the other hand, the upper-tier controlled foreign corporation sells stock of a lower-tier controlled foreign corporation, then the gain generally is also included in the income of the U.S. shareholder as subpart F income and the U.S. shareholder's basis in the stock of the first-tier controlled foreign corporation is increased to account for the inclusion, but the inclusion is not treated for foreign tax credit limitation purposes by reference to the nature of the income of the lower-tier controlled foreign corporation. Instead it generally is treated as passive income.

If subpart F income of a lower-tier controlled foreign corporation is included in the gross income of a U.S. shareholder, no provision of present law allows adjustment of the basis of the upper-tier controlled foreign corporation's stock in the lower-tier controlled foreign corporation.

Subpart F inclusions in year of disposition

The subpart F income earned by a foreign corporation during its taxable year is taxed to the persons who are U.S. shareholders of the corporation on the last day, in that year, on which the corporation is a controlled foreign corporation. In the case of a U.S. shareholder who acquired stock in a controlled foreign corporation during the year, such inclusions are reduced by all or a portion of the amount of dividends paid in that year by the foreign corporation to any person other than the acquirer with respect to that stock. The reduction is the lesser of the amount of dividends with respect to such stock received by other persons during the year or the amount determined by multiplying the subpart F income for

[42] Under proposed regulations, if a controlled foreign corporation distributes a dividend to an upper-tier controlled foreign corporation or to a United States shareholder that owns directly or indirectly more then 90 percent of the total combined voting power of the controlled foreign corporation at the time of the distribution, and the dividend is attributable to earnings and profits accumulated during a period in which the distributing corporation was a controlled foreign corporation but the 90 percent or more United States shareholder was not a United States shareholder of the corporation, the dividend generally would be treated as a dividend from a noncontrolled section 902 corporation. (Prop. Treas. Reg. sec. 1.904-4(g)(3)(ii)).

the year by the proportion of the year during which the acquiring shareholder did not own the stock.

Distributions of previously taxed income

If in a year after the year of a subpart F income inclusion, a U.S. shareholder in the controlled foreign corporation receives a distribution from the corporation, the distribution may be deemed to come first out of the corporation's previously taxed income and, therefore, may be excluded from the U.S. shareholder's income. However, a distribution by a foreign corporation to a domestic corporation of earnings and profits previously taxed under subpart F is treated as an actual dividend, solely for purposes of determining the indirect foreign tax credit available to the domestic corporation (sec. 960(a)(3)).

In addition, the domestic corporation is permitted to increase its foreign tax credit limitation in the year of the distribution of previously taxed earnings and profits in an amount equal to the excess of the amount by which its foreign tax credit limitation for the year of the subpart F inclusion was increased as a result of that inclusion, over the amount of foreign taxes which were allowable as a credit in that year and which would not have been so allowable but for the subpart F inclusion (sec. 960(b)). The increase in the foreign tax credit limitation may not, however, exceed the amount of the foreign taxes taken into account under this provision with respect to the distribution of previously taxed earnings and profits. In order for this rule to apply, the domestic corporation either must have elected to credit foreign taxes in the year of the subpart F inclusion or must not have paid or accrued any foreign taxes in such year, and it must elect the foreign tax credit in the year of the distribution of previously taxed earnings and profits.

Treatment of United States source income earned by a controlled foreign corporation

As a general rule, subpart F income does not include income earned from sources within the United States if the income is effectively connected with the conduct of a U.S. trade or business by the controlled foreign corporation. This general rule does not apply, however, if the income is exempt from, or subject to a reduced rate of, U.S. tax pursuant to a provision of a U.S. treaty.

Indirect foreign tax credits

A U.S. corporation owning at least 10 percent of the voting stock of a foreign corporation is treated as if it had paid a share of the foreign income taxes paid by the foreign corporation in the year in which the foreign corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder (sec. 902(a)). A U.S. corporation may also be deemed to have paid taxes paid by a second- or third-tier foreign corporation. That is, where a first-tier foreign corporation pays a dividend to a 10-percent-or-more U.S. corporate shareholder, then for purposes of deeming the U.S. corporation to have paid foreign tax, the first-tier foreign corporation may be deemed to have paid a share of the foreign taxes paid by a second-tier foreign corporation of which the first-tier foreign corporation owns at least 10 percent of the voting stock, and from

which the first-tier foreign corporation received dividends. The same principle applies to dividends from a second-tier or third-tier foreign corporation. No taxes paid by a second- or third-tier foreign corporation are deemed paid by the first- or second-tier foreign corporation, respectively, unless the product of the percentage ownership of voting stock at each level from the U.S. corporation down equals at least 5 percent (sec. 902(b)). Under present law, foreign taxes paid below the third tier of foreign corporations are not eligible for the indirect foreign tax credit.

An indirect foreign tax credit generally is also available to a U.S. corporate shareholder meeting the requisite ownership threshold with respect to inclusions of subpart F income from controlled foreign corporations (sec. 960(a)).[43] Moreover, an indirect foreign tax credit may also be available to U.S. corporate shareholders with respect to inclusions of income from passive foreign investment companies.

Investments in U.S. property by controlled foreign corporations

As described above (Title IV, Item 1), investments by controlled foreign corporations in U.S. property (e.g., certain debt obligations of U.S. persons) are sometimes treated similarly to repatriations (sec. 951(a)(1)(B)). A controlled foreign corporation is not treated as having repatriated foreign earnings if it invests in an obligation of an unrelated U.S. corporation, as defined specially for this purpose (sec. 956(b)(2)(F)).

Reasons for Simplification

It is believed that complexities have been caused by uncertainties and gaps in the statutory schemes for taxing gains on dispositions of stock in controlled foreign corporations as dividend income or subpart F income. These uncertainties and gaps may prompt taxpayers to refrain from behavior that would otherwise be the result of rational business decisions, for fear of excessive tax—for example, double corporate-level taxation of income. In many cases, concerns about excessive taxation can be allayed, but only at the cost of avoiding the simpler and more rational economic behavior in favor of tax-motivated planning.

It is understood that, as a general matter, other aspects of the tax system may have interfered with rational economic decision making by prompting taxpayers to engage in tax-motivated planning in order to eliminate taxation in cases where income is in fact earned. Some such characteristics of the tax system have in the past been altered by Congress in order to reduce excessive interference by the tax system in labor, investment, and consumption decisions of taxpayers.[44] It is believed that in the context of tax simplification, it generally is appropriate to reduce complexities caused by aspects of the rules governing controlled foreign corporations that provide for nonuniform tax results from dividends, on the one

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[43] Unlike the indirect foreign tax credit for actual dividend distributions, the indirect credit for subpart F inclusions can be available to individual shareholders in certain circumstances if an election is made (sec. 962).

[44] See, e.g., Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess. *General Explanation of the Tax Reform Act of 1986*, at 6 et seq. (1987) ("General Reasons For The Act").

hand, and stock disposition proceeds to the extent earnings and profits underlie those proceeds, on the other.

In light of the bill's provisions extending section 1248 treatment to dispositions of stock in lower-tier companies, it is believed appropriate to repeal the limitation on look-through treatment (for foreign tax credit separate limitation purposes) of dividends from controlled foreign corporations to U.S. shareholders out of earnings from periods in which the payor was a controlled foreign corporation but the dividend recipient was not a U.S. shareholder of the controlled foreign corporation. By extending section 1248 treatment to dispositions of stock in lower-tier companies, it is believed that earnings and profits (and related foreign tax credits) of lower-tier controlled foreign corporations cannot readily be transferred from the control of one U.S taxpayer to another. Moreover, it is believed that repeal of this limitation on look-through treatment will avoid significant complexity that would otherwise be engendered by practical application of the limitation. It is understood that the present-law provisions which permit an indirect foreign tax credit and an increased foreign tax credit limitation to be claimed in the event of a distribution of previously taxed earnings by a controlled foreign corporation are particularly difficult to administer. This difficulty arises because taxpayers are required to compute and keep track of excess foreign tax credit limitation accounts with respect to subpart F income inclusions on a foreign corporation by foreign corporation basis, as well as on a year by year basis. Additional complexities arise as taxpayers are required, as a result of distributions, to trace earnings and profits up chains of foreign corporations. It is believed that affording regulatory authority to modify and simplify these rules may result in alleviating some of the system-wide recordkeeping and computations involved, without undermining the operation of the provision.

It is also understood that certain arbitrary limitations placed on the operation of the indirect foreign tax credit may have resulted in taxpayers undergoing burdensome and sometimes costly corporate restructurings. In other cases, there is concern that these limitations may have contributed to decisions by U.S companies against acquiring foreign subsidiaries. It is deemed appropriate to ease certain of these restrictions in cases where the administration of the foreign tax credit rules by taxpayers and the IRS will not be significantly impaired.

Explanation of Provisions

In general

The bill makes a number of modifications in the treatment of income derived from the disposition of stock in a controlled foreign corporation. The bill provides deemed dividend treatment for gains on dispositions of lower-tier controlled foreign corporations. Where the lower-tier controlled foreign corporation previously earned subpart F income, the bill permits the amount of gain taxed to the U.S. shareholder to be adjusted for previous income inclusions. Where proceeds from the sale of stock to a controlled foreign corporation that previously has earned subpart F income would be treated as a dividend under the principles of section 304, the bill ex-

pressly permits exclusion of the deemed section 304 dividend from taxation to the extent of the previously taxed earnings and profits of the controlled foreign corporation from which the property was deemed to be distributed. (Appropriate basis adjustments also are permitted to be made.) Where a controlled foreign corporation (whether or not it is a lower-tier controlled foreign corporation) earns subpart F income in a year in which a U.S. shareholder sells its stock, in a transaction that does not result in the foreign corporation ceasing to be a controlled foreign corporation, the bill contains statutory language providing for a proportional reduction in the taxation of the subpart F income in that year to the acquiring U.S. shareholder.

The bill contains four additional provisions related to controlled foreign corporations. First, the bill repeals the limitation on look-through treatment (for foreign tax credit separate limitation purposes) of dividends from controlled foreign corporations to U.S. shareholders out of earnings from periods in which the payor was a controlled foreign corporation, but the dividend recipient was not a U.S. shareholder of the controlled foreign corporation. Second, the bill provides regulatory authority to develop a simplified mechanism for computing indirect foreign tax credits and increases in foreign tax credit limitations resulting upon certain distributions by controlled foreign corporations of previously taxed earnings and profits. Third, the bill clarifies the effect of a treaty exemption or reduction of the branch profits tax on the determination of subpart F income. Fourth, the bill extends application of the indirect foreign tax credit to fourth-, fifth-, and sixth-tier controlled foreign corporations where the necessary ownership thresholds (as extended under the bill to these tiers) are satisfied.

Lower-tier controlled foreign corporations

Characterization of gain on stock disposition

The bill provides that if a controlled foreign corporation is treated as having gain from the sale or exchange of stock in a foreign corporation, the gain is treated as a dividend to the same extent that it would have been so treated under section 1248 if the controlled foreign corporation were a U.S. person. This provision, however, does not affect the determination of whether the corporation whose stock is sold or exchanged is a controlled foreign corporation.

Thus, for example, if a U.S. corporation owns 100 percent of the stock a foreign corporation, which owns 100 percent of the stock of a second foreign corporation, then under the bill, any gain of the first corporation upon a sale or exchange of stock of the second corporation is treated as a dividend for purposes of subpart F income inclusions to the U.S. shareholder, to the extent of earnings and profits of the second corporation attributable to periods in which the first foreign corporation owned the stock of the second foreign corporation while the latter was a controlled foreign corporation with respect to the U.S. shareholder.

As another example, assume that the U.S. corporation has always owned 40 percent of the voting stock and 60 percent of the value of all of the stock of a foreign corporation, which has always

owned 40 percent of the voting stock and 60 percent of the value of all of the stock of a second foreign corporation. All the other stock of the foreign corporations has always been owned by foreign individuals unrelated to the U.S. corporation. In this case, the second foreign corporation has never been a controlled foreign corporation. Therefore, none of the gain of the first corporation upon a sale of stock of the second corporation is treated as a dividend.

Gain on disposition of stock in a related corporation created or organized under the laws of, and having substantial part of assets in a trade or business in, the same foreign country as the gain recipient, even if recharacterized as a dividend under the bill, is not therefore excluded from foreign personal holding company income under the same-country exception that applies to actual dividends.

The bill provides that for purposes of this provision, a controlled foreign corporation is treated as having sold or exchanged stock if, under any provision of subtitle A of the Code, the controlled foreign corporation is treated as having gain from the sale or exchange of such stock. Thus, for example, if a controlled foreign corporation distributes to its shareholder stock in a foreign corporation, and the distribution results in gain being recognized by the controlled foreign corporation under section 311(b) as if the stock were sold to the shareholder for fair market value, the bill makes clear that for purposes of this provision, the controlled foreign corporation is treated as having sold or exchanged the stock.

The bill also repeals a provision added to the Code by the Technical and Miscellaneous Revenue Act of 1988 [45] (the "1988 Act") which, except as provided by regulations, requires a recipient of a distribution from a controlled foreign corporation to have been a United States shareholder of that controlled foreign corporation for the period during which the earnings and profits which gave rise to the distribution were generated in order to avoid treating the distribution as one coming from a noncontrolled section 902 corporation. Thus, under the bill, a controlled foreign corporation is not treated as a noncontrolled section 902 corporation with respect to any distribution out of its earnings and profits for periods during which it was a controlled foreign corporation, whether or not the recipient of the distribution was a U.S. shareholder of the corporation when the earnings and profits giving rise to the distribution were generated.

Adjustments to basis of stock

The bill also provides that when a lower-tier controlled foreign corporation earns subpart F income, and stock in that corporation is later disposed of by an upper-tier controlled foreign corporation, the resulting income inclusion of the U.S. shareholders are, under regulations, adjusted to account for previous inclusions, in a manner similar to the adjustments currently provided to the basis of stock in a first-tier controlled foreign corporation. Thus, just as the basis of a U.S. shareholder in a first-tier controlled foreign corporation rises when subpart F income is earned and falls when previously taxed income is distributed, so as to avoid double taxation

[45] P.L. 100-647, sec. 1012(a)(10).

of the income on a later disposition, it is intended that by regulation the subpart F income from gain on the disposition of a lower-tier controlled foreign corporation generally would be reduced by income inclusions of earnings that were not subsequently distributed by the lower-tier controlled foreign corporation. It is intended that the Secretary will have sufficient flexibility in promulgating regulations under this provision to permit adjustments only in those cases where, by virtue of the historical ownership structure of the corporations involved, the Secretary is satisfied that the inclusions for which adjustments can be made can be clearly identified.

For example, assume that a U.S person is the owner of all of the stock of a first-tier controlled foreign corporation which, in turn, is the sole shareholder of a second-tier controlled foreign corporation. In year 1, the second-tier controlled foreign corporation earns $100 of subpart F income which is included in the U.S. person's gross income for that year. In year 2, the first-tier controlled foreign corporation disposes of the second-tier controlled foreign corporation's stock and recognizes $300 of income with respect to the disposition. All of that income would constitute subpart F foreign personal holding company income. Under the bill, the Secretary is granted regulatory authority to reduce the U.S. person's year 2 subpart F inclusion by $100—the amount of year 1 subpart F income of the second-tier controlled foreign corporation that was included, in that year, in the U.S. person's gross income. Such an adjustment would, in effect, allow for a step-up in the basis of the stock of the second-tier controlled foreign corporation to the extent of its subpart F income previously included in the U.S. person's gross income.

As another example, assume the same facts as in the preceding paragraph except that in year 2, the first-tier controlled foreign corporation distributes the stock of the second-tier controlled foreign corporation to the U.S. person. Assume that as a result of the distribution, the first-tier controlled foreign corporation recognizes taxable income of $300 under section 311(b). This income represents subpart F income, $100 of which is due to no adjustment having been made to the basis of the second-tier controlled foreign corporation's stock for its year 1 subpart F income. The bill contemplates that in such a situation, the $300 of subpart F income would be reduced under regulations to $200 to account for the year 1 subpart F income inclusion.

Subpart F inclusions in year of disposition

If a U.S. shareholder acquires the stock of a controlled foreign corporation from another U.S. shareholder during a taxable year of the controlled foreign corporation in which it earns subpart F income, the bill reduces the acquirer's subpart F inclusion for that year by a portion of the amount of the dividend deemed (under sec. 1248) to be received by the transferor. The portion by which the inclusion is reduced (as is currently the case if a dividend was paid to the previous owner of the stock) would not exceed the lesser of the amount of dividends with respect to such stock deemed received (under sec. 1248) by other persons during the year or the amount determined by multiplying the subpart F income for the year by

the proportion of the year during which the acquiring shareholder did not own the stock.

Avoiding double inclusions in other cases

The bill clarifies the appropriate scope of regulatory authority with respect to the treatment of cross-chain section 304 dividends out of the earnings of controlled foreign corporations that were previously included in the income of a U.S. shareholder under subpart F. The bill contemplates that in such a case, the Secretary in his discretion may by regulation treat such dividends as distributions of previously taxed income, with appropriate basis adjustments. It is also anticipated that other occasions may arise where the exercise of similar regulatory authority may be appropriate to avoid double income inclusions, or an inclusion or exclusion of income without a corresponding basis adjustment. Therefore, the bill states that, in addition to cases involving section 304, the Secretary may by regulation modify the application of subpart F in any other case where there would otherwise be a multiple inclusion of any item of income (or an inclusion or exclusion without an appropriate basis adjustment) by reason of the structure of a U.S. shareholder's holdings in controlled foreign corporations or by reason of other circumstances. The bill is not intended to create any inference as to the application of present law in these cases.

Foreign tax credit in year of receipt of previously taxed income

With respect to the present-law provisions which permit a foreign tax credit to be claimed in the case of a distribution of previously taxed income, the bill provides authority for Treasury regulations to establish a simplified method for computing the increase in foreign tax credit limitation that results from the application of these provisions. It is understood that the Secretary has regulatory flexibility in the determination of the amount of creditable foreign taxes on or with respect to the accumulated earnings and profits of a foreign corporation from which a distribution of previously taxed income is made, which were not deemed paid by the domestic corporation in a prior taxable year.

The bill makes clear that the regulations may require taxpayers to use any simplified methods so established, rather than making the use of such methods elective by taxpayers. The bill does not mandate, however, that regulations provide such simplified methods, or in the case that such methods are provided, that they be made uniformly applicable to all taxpayers.

For example, in certain situations the Treasury Secretary might deem it appropriate not to require taxpayers to trace specific items of previously taxed income of specific controlled foreign corporations and to associate those items with specific amounts of excess foreign tax credit limitation. Rather, regulations might allow for some sort of simplified approach for accounting for excess limitation amounts (allocated to the various foreign tax credit separate limitation categories from which they originally arose) and for utilization of portions of these amounts upon distributions of previously taxed income from the same categories.

Treatment of United States income earned by a controlled foreign corporation

The bill provides that an exemption or reduction by treaty of the branch profits tax that would be imposed under section 884 on a controlled foreign corporation does not affect the general statutory exemption from subpart F income that is granted for U.S. source effectively connected income. For example, assume a controlled foreign corporation earns income of a type that generally would be subpart F income, and that income is earned from sources within the United States in connection with business operations therein. Further assume that repatriation of that income is exempted from the U.S. branch profits tax under a provision of an applicable U.S. income tax treaty. The bill provides that, notwithstanding the treaty's effect on the branch tax, the income is not treated as subpart F income as long as it is not exempt from U.S. taxation (or subject to a reduced rate of tax) under any other treaty provision.

Indirect foreign tax credit

The bill extends the application of the indirect foreign tax credit (secs. 902 and 960) to certain taxes paid or accrued by certain fourth-, fifth-, and sixth-tier foreign corporations. In general, three requirements must be satisfied by a foreign company at any of these tiers to qualify for the credit. First, the company must be a controlled foreign corporation. Second, the domestic corporation referred to in section 902(a) must be a U.S. shareholder (as defined in section 951(b)) with respect to the foreign company. Third, the product of the percentage ownership of voting stock at each level from the U.S. corporation down must equal at least 5 percent. The bill limits the application of the indirect foreign tax credit below the third tier to taxes paid or incurred in taxable years during which the payor is a controlled foreign corporation. No inference is intended as to the availability of indirect foreign tax credits, under present law, for taxes paid by foreign corporations in the first three tiers, for periods prior to the time when the present-law ownership requirements were met as to those corporations. All foreign taxes paid below the sixth tier of foreign corporations remain ineligible for the indirect foreign tax credit.

Investments in U.S. property by controlled foreign corporations

It is understood that a controlled foreign corporation is not treated as having repatriated foreign earnings if it invests in an obligation of an unrelated U.S. corporation. A similar rule, however, is not applicable to an investment in an obligation of an unrelated U.S. person other than a corporation. The bill provides that the Treasury Department study the tax treatment of investments by controlled foreign corporations in obligations of U.S. persons other than corporations, and provide the Committee on Ways and Means with a report of such study by December 31, 1993. The study is to include the Treasury's views as to whether those rules should be amended insofar as they relate to the treatment of investments by controlled foreign corporations in the obligations of U.S. persons other than corporations, along with a discussion of the merits and consequences of any such amendment.

Effective Dates

Lower-tier controlled foreign corporations

The provision treating gains on dispositions of stock in lower-tier controlled foreign corporations as dividends under section 1248 principles applies to gains recognized on transactions occurring after date of enactment of the bill. The provision that expands look-through treatment, for foreign tax credit limitation purposes, of dividends from controlled foreign corporations, is effective for distributions after the date of enactment.

The provision providing for regulatory adjustments to U.S. shareholder inclusions, with respect to gains of controlled foreign corporations from dispositions of stock in lower-tier controlled foreign corporations that previously had subpart F income, is effective for determining inclusions for taxable years of U.S. shareholders beginning after December 31, 1993. Thus, the bill permits regulatory adjustments to an inclusion occurring after the effective date to account for previous subpart F income inclusions occurring both prior to and subsequent to the effective date of the provision.

Subpart F inclusions in year of disposition

The provision permitting dispositions of stock to be taken into consideration in determining a U.S. shareholder's subpart F inclusion for a taxable year is effective with respect to dispositions occurring after the date of enactment.

Distributions of previously taxed income

The provision allowing the Secretary to make regulatory adjustments to avoid double inclusions in cases such as those to which section 304 applies takes effect on the date of enactment.

Foreign tax credit in year of receipt of previously taxed income

The provision granting regulatory authority to establish simplified methods for determining the amount of increase in foreign tax credit limitation resulting from a distribution of previously taxed income is effective on the date of enactment.

Treatment of United States source income earned by a controlled foreign corporation

The provision concerning the effect of treaty exemptions from or reductions of the branch profits tax on the determination of subpart F income is effective for taxable years beginning after December 31, 1986.

Indirect foreign tax credit

The provision which extends application of the indirect foreign tax credit to certain controlled foreign corporations below the third tier is effective for foreign taxes paid or incurred by controlled foreign corporations for taxable years of such corporations beginning after the date of enactment.

In the case of any chain of foreign corporations the taxes of which would be eligible for the indirect foreign tax credit, under present law or under the bill, but for the denial of indirect credits below the third or sixth tier, as the case may be, no liquidation,

reorganization, or similar transaction in a taxable year beginning after the date of enactment shall have the effect of permitting taxes to be taken into account under the indirect foreign tax credit provisions of the Code which could not have been taken into account under those provisions but for such transaction. As one example, no such transaction shall have the effect of permitting credits for taxes which, but for such transaction, would have been noncreditable (given the effective date provisions of the bill) because they are taxes of a fourth-, fifth-, or sixth-tier corporation for a year beginning before the date that the bill is enacted. No inference is intended regarding the creditability or noncreditability of such taxes under present law.

3. Translation of foreign taxes into U.S. dollar amounts (sec. 421 of the bill and secs. 905(c) and 986(a) of the Code)

Present Law

Translation of foreign taxes

Foreign income taxes paid in foreign currencies are required to be translated into U.S. dollar amounts using the exchange rate as of the time such taxes are paid to the foreign country or U.S. possession (sec. 986(a)(1)). This rule applies equally to foreign taxes paid directly by U.S. taxpayers, which are creditable only in the year paid or accrued (or during a carryover period), and to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation, and hence creditable, in the year that the U.S. corporation receives a dividend or income inclusion.

Redetermination of foreign taxes

For taxpayers who utilize the accrual basis of accounting for determining creditable foreign taxes, accrued and unpaid foreign tax liabilities denominated in foreign currencies are translated into U.S. dollar amounts at the exchange rate as of the last day of the taxable year of accrual.[46] In certain cases where a difference exists between the dollar value of accrued foreign taxes and the dollar value of those taxes when paid, a redetermination (or adjustment) of foreign taxes is required.[47] Generally, such an adjustment may be attributable to one of three causes. One such cause would be a refund of foreign taxes. Second, a foreign tax redetermination may be required because the amount of foreign currency units actually paid differs from the amount of foreign currency units accrued. These first two cases generally give rise to a so-called "section 905(c) regular adjustment." Third, a redetermination may arise due to fluctuations in the value of the foreign currency relative to the dollar between the date of accrual and the date of payment giving rise to a so-called "section 905(c) translation adjustment."

As a general matter, a redetermination of foreign tax paid or accrued directly by a U.S. person requires notification of the Internal Revenue Service and a redetermination of U.S tax liability for the taxable year for which the foreign tax was claimed as a credit. Ex-

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[46] Temp. Treas. Reg. sec. 1.905-3T(b)(1).
[47] Temp. Treas. Reg. sec. 1.905-3T(c).

ceptions to this rule apply for de minimis amounts of foreign tax redeterminations.[48] In the case of redeterminations of foreign taxes that qualify for the deemed-paid foreign tax credit under sections 902 and 960, taxpayers generally are required to make appropriate adjustments to the pools of earnings and profits and foreign taxes.[49]

Reasons for Simplification

If each foreign income tax payment is required to be translated at a separate daily exchange rate for the day of the payment, the number of currency exchange rates that are relevant to foreign tax credit calculations varies directly with the frequency of foreign income tax payments. Where U.S. corporations are deemed to pay a portion of the "pool" of foreign taxes paid by foreign corporations, the correct amount of tax in the pool is the product of each tax payment times the relevant translation rate. The longer the period between the time the income is earned and the time it is repatriated to the U.S. corporation (or otherwise included in the U.S. corporation's income), the greater the period over which the amounts of tax payments and translation rates are relevant to the determination of net U.S. tax liability.

It is believed that the recordkeeping, verification, and examination burdens—both on the IRS and on taxpayers—associated with the advantages of deferral and the foreign tax credit (including the indirect credit) are not insignificant. For example, if events that happened in one year affected only the return filed for that year, and each tax return was affected only by events that happened in the year for which that return was filed, then presumably tax-related records would need to be maintained only between the time the taxable year began and the year that the assessment period for that year expired. On the other hand, for example, if income earned in years 1 through 5 is taxed in year 6, then the amount of documentation relevant to the year-6 return potentially is increased five-fold, and the period over which that information must be maintained is at least five years longer.

U.S. persons who pay foreign income taxes directly and choose the benefits of the foreign tax credit have always been required to maintain detailed foreign tax payment documentation, including exchange rate data for the dates on which they paid foreign income taxes, and U.S. corporations that operate through foreign corporations have been required to maintain documentation regarding the earnings and foreign tax payments of the foreign corporations.[50] Some have argued, however, that relief is warranted for taxpayers that would otherwise bear the combined currency translation responsibilities applicable to direct foreign taxpayers with the extended recordkeeping responsibilities applicable to taxpayers that receive the benefits of deferral.

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[48] Temp. Treas. Reg. sec. 1.905-3T(d)(1).

[49] Temp. Treas. Reg. sec. 1.905-3T(d)(2); Notice 90-26, 1990-1 C.B. 336.

[50] Also, note that in *Commissioner* v. *American Metal Co.*, 221 F.2d 134,141 (2d. Cir.), *cert. denied,* 350 U.S. 879 (1955), where a foreign corporation kept its books in U.S. dollars, foreign taxes were translated as of their payment date.

It is believed that an appropriate response to this combination of burdens is to permit regulatory modification of the "time of payment" concept in such a way that preserves the uniformity of treatment of branches and foreign subsidiaries of U.S. taxpayers, but permits recourse to reasonably accurate average translation rates for the period in which the tax payments are made. Simplification may be provided in this way by reducing, sometimes substantially, the number of translation calculations that are required to be made. There may be situations in which the use of an average exchange rate over a specified time period, to be applied to all tax payments made in that currency during that period, would provide results not substantially different than those that would be derived under present law. This could result, for example, where the value of a foreign currency as it relates to the U.S. dollar does not fluctuate significantly over the specified period.

In addition, it is believed that in certain cases, taxpayers who are on the accrual basis of accounting for purposes of determining creditable foreign taxes should be permitted to translate those taxes into U.S. dollar amounts in the year to which those taxes relate, and should not be required to make adjustments or redeterminations to those translated amounts, if actual tax payments are made—within a reasonably short period of time—after the close of such year. Moreover, it is believed that it is appropriate to mandate the use of an average exchange rate for the taxable year with respect to which such foreign taxes relate for purposes of translating those taxes. On the other hand, it is believed that a foreign tax not paid within a reasonably short period after the close of the year to which the taxes relate should not be treated as a foreign tax for such year; in such a case permitting the foreign tax credit for that year is less a mechanism for preventing double taxation, and more one resulting in the avoidance of all tax. By drawing a bright line between those foreign tax payment delays that do and do not require a redetermination, it is believed that a reasonable degree of certainty and clarity will be added to the law in this area. It is anticipated that in most cases, the combination of translating accrued taxes in this manner and exempting certain translation differences from redetermination should significantly alleviate present-law complexities, but should not provide results that are materially different from those that would appropriately be reached under present law.

One of the fundamental premises behind the amendments enacted in 1986 with respect to the translation of foreign taxes was that foreign taxes paid by foreign corporations should be translated in the same manner as foreign taxes paid by foreign branches of U.S. persons. In keeping with that premise, it is believed that any provision to allow the use of average exchange rates for this purpose or to allow for translation in years to which accrued taxes relate should be made equally applicable to foreign branches and subsidiaries.

Explanation of Provision

In general

The bill sets forth two sets of operating rules for the translation of foreign taxes. The first set establishes new rules for the translation of certain accrued foreign taxes. The other set modifies the rules of present law for translating all other foreign taxes.

Translation of foreign taxes

Translation of certain accrued foreign taxes

With respect to taxpayers who take foreign income taxes into account when accrued for purposes of determining the foreign tax credit, the bill generally permits foreign taxes to be translated at the average exchange rate for the taxable year to which such taxes relate. If tax in excess of the accrued amount is actually paid, such excess amount would be translated using the exchange rate in effect as of the time of payment.

This set of rules does not apply (1) to taxpayers that are not on the accrual basis for determining creditable foreign taxes, (2) with respect to taxes of an accrual-basis taxpayer that are actually paid in a taxable year prior to the year to which they relate, or (3) to the extent provided in regulations, to tax payments denominated in a currency determined to be an inflationary currency in accordance with such regulations. It is intended that the Secretary will have discretion to define "inflationary" for this purpose so as to take into account the particular need under this provision to avoid distortions in the computation of the foreign tax credit. In addition, as discussed in detail below, this set of rules does not apply to, and thus a redetermination of foreign tax is required for, any foreign income tax paid after the date two years after the close of the taxable year to which such taxes relate.

For example, assume that in year 1 a taxpayer accrues 1,000 units of foreign tax that relate to year 1. Further assume that as of the end of year 1 the tax is unpaid and the currency involved is not treated as inflationary by the Secretary for translation purposes. In this case, the bill provides that the taxpayer would translate 1,000 units of accrued foreign tax into U.S. dollars at the average exchange rate for year 1.[51] If the 1,000 units of tax were paid by the taxpayer in either year 2 or year 3, no redetermination of foreign tax would be required. If, any portion of the tax so accrued remained unpaid as of the end of year 3, however, the taxpayer would be required to redetermine its foreign tax accrued in year 1 to account for the accrued but unpaid tax.

As another example, assume a taxpayer accrues 1,000 units of foreign tax in year 2, but pays the tax in year 1. Also assume that the tax relates to year 2. In this case, the taxpayer would translate the tax using the exchange rate as of the time the tax is paid (i.e., using the applicable year 1 exchange rate) since the tax is paid in a year prior to the year to which it relates.

As an illustration of what is meant by the taxable year to which taxes relate, assume that a foreign corporation is charged by a for-

[51] The same result would occur if the 1,000 units of tax were both accrued and paid in year 1.

eign government with an income tax of 100 units for 1993. Assume that the currency involved is not treated as inflationary by the Secretary for translation purposes under the provision. Due to a contest between the foreign government and the corporation that ends in 1994, the 100 units of tax are not paid until 1994. Assume that under the U.S. rules governing accrual, the foreign tax accrues for 1993 but does not do so until 1994.[52] Under the bill, the taxes will be translated at the rate in effect for 1993, because the taxes relate to 1993, even though they did not accrue until 1994. If instead the contest was over, and the taxes were accrued and paid, in 1998, the translation rate used would be that of 1998, rather than 1993 because 1998 is more than 2 years after the end of 1993. Now assume that the contest was over in 1998, but the taxes were deposited in 1994 and not accrued until 1998. These taxes are paid before the beginning of the year in which the taxes were accrued (1998), but after the year to which the taxes relate (1993). Thus, under the bill, the taxes may be translated at the rate for the year (1993) to which the taxes relate. If the taxes are instead paid in 1996, under the provision they will be translated at the relevant rate for 1996 because 1996 is more than 2 years after the end of 1993.

As an additional illustration of what is meant under the bill as the taxable year to which taxes relate, assume that a foreign corporation accrues a foreign income tax of 100 units of noninflationary currency for 1993. Further assume that the actual amount of foreign tax liability of the foreign corporation for 1993 is 110 units, all of which is paid in 1994. Under the bill, the 110 units of foreign tax are translated at the rate in effect for 1993 because the taxes relate to 1993, even though the total tax liability for that year was not actually accrued by the taxpayer in 1993.

Finally, assume that under foreign law, a foreign income tax liability accrues in 1998 under a long-term contract method of accounting, but advance deposits of that liability accruing in 1998 are made in each of the years 1993 through 1997. Under the bill, it is intended that if the payments in 1993 through 1997 are treated as relating to 1998, these payments are nevertheless to be translated at the relevant rates for 1993 through 1997. Although the bill provides a rule for translation of the taxes in this case, no change is intended as to the application of present law accounting rules for determining the year for which the taxes are eligible for credit or deduction for U.S. income tax purposes.

Translation of all other foreign taxes

Foreign taxes not eligible for application of the preceding rules generally are translated into U.S. dollars using the exchange rates as of the time such taxes are paid. The bill grants the Secretary of the Treasury authority to issue regulations that would allow foreign tax payments made by a foreign corporation or by a foreign branch of a U.S. person to be translated into U.S. dollar amounts using an average U.S. dollar exchange rate for a specified period. It is anticipated that the applicable average exchange rate would be

[52] See, e.g., Rev. Rul. 84-125, 1984-2 C.B. 125.

the rate as published by a qualified source of exchange rate information for the period during which the tax payments were made.

Redetermination of foreign taxes

As revised by the bill, section 905(c) requires foreign tax redeterminations to occur in three cases: (1) if accrued taxes when paid (in foreign currency) differ from the amounts claimed (in foreign currency) as credits by the taxpayer, (2) if accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate, and (3) if any tax paid is refunded in whole or in part. Thus, for example, the bill provides that if at the close of the second taxable year after the close of the accrual year any tax so accrued has not yet been paid, a foreign tax redetermination under section 905(c) is required for the amount of such unpaid tax. That is, the accrual of any tax that is unpaid as of that date would be retroactively denied. In cases where a redetermination is required, as under present law, the bill specifies that the taxpayer must notify the Secretary, who shall redetermine the amount of the tax for the year or years affected.

The bill provides that in the case of accrued taxes not paid within the date two years after the close of the taxable year to which such taxes relate, whether or not such taxes were previously accrued, any such taxes if subsequently paid are taken into account for the taxable year in which paid, and no redetermination with respect to the original year of accrual is required on account of such payment. In such a case, those taxes would be translated into U.S. dollar amounts using the exchange rates in effect for the period during which such taxes are paid. Nothing in the bill is intended to change present law as to the length of time after the year to which the redetermination relates within which redeterminations may be made or required.[53]

Effective Date

The provision is effective for taxes paid (in the case of taxpayers using the cash basis for determining the foreign tax credit) or accrued (in the case of taxpayers using the accrual basis for determining the foreign tax credit) in taxable years beginning after December 31, 1992.

With respect to taxes of an accrual-basis taxpayer that relate to a taxable year beginning before January 1, 1993, the return for which (if one were due) would not yet be due on date of enactment of the bill (taking into account extensions of time to file), it is contemplated that the Secretary would, in appropriate circumstances, provide taxpayers with a reasonable average-rate method for translating such taxes that are not paid until after the effective date of the bill.

The bill's changes to the foreign tax redetermination rules apply to taxes which relate to taxable years beginning after December 31, 1992. Thus, for example, the redetermination rules under the bill do not apply to a foreign tax that relates to a taxable year begin-

[53] See sec. 6501(c)(5). See also, e.g., *Pacific Metals Corp.* v. *Commissioner,* 1 T.C. 1028 (1943); *Texas Co. (Caribbean) Ltd.* v. *Commissioner,* 12 T.C. 925 (1949).

ning in or before 1992, even though the tax does not properly accrue until a taxable year beginning after December 31, 1992.

4. Foreign tax credit limitation under the alternative minimum tax (sec. 422 of the bill and sec. 59(a) of the Code)

Present Law

Computing foreign tax credit limitations requires the allocation and apportionment of deductions between items of foreign source and U.S. source income. Foreign tax credit limitations must be computed both for regular tax purposes and for purposes of the alternative minimum tax (AMT). Consequently, after allocating and apportioning deductions for regular tax foreign tax credit limitation purposes, additional allocations and apportionments generally must be performed in order to compute the AMT foreign tax credit limitation.

Reasons for Simplification

The process of allocating and apportioning deductions for purposes of calculating the regular and AMT foreign tax credit limitations can be complex. Taxpayers that have allocated and apportioned deductions for regular tax foreign tax credit purposes generally must reallocate and reapportion the same deductions for AMT foreign tax credit purposes, based on assets and income that reflect AMT adjustments (including depreciation). However, the differences between regular taxable income and alternative minimum taxable income are often relevant primarily to U.S. source income. As a result of the combined effects of these differences, it is believed that foreign source alternative minimum taxable income generally will not differ significantly from foreign source regular taxable income. By permitting taxpayers to use foreign source regular taxable income in computing their AMT foreign tax credit limitation, the bill eliminates the need to reallocate and reapportion every deduction.

Explanation of Provision

The bill permits taxpayers to elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source regular taxable income to entire alternative minimum taxable income, rather than the ratio of foreign source alternative minimum taxable income to entire alternative minimum taxable income. Foreign source regular taxable income may be used, however, only to the extent it does not exceed entire alternative minimum taxable income. In the event that foreign source regular taxable income does exceed entire alternative minimum taxable income, and the taxpayer has income in more than one foreign tax credit limitation category, it is intended that the foreign source taxable income in each such category generally shall be reduced by a pro rata portion of that excess.

The election under the bill is available only in the first taxable year beginning after December 31, 1993, for which the taxpayer claims an AMT foreign tax credit. A taxpayer will be treated, for this purpose, as claiming an AMT foreign tax credit for any tax-

able year for which the taxpayer chooses to have the benefits of the foreign tax credit, and in which the taxpayer is subject to the alternative minimum tax or would be subject to the alternative minimum tax but for the availability of the AMT foreign tax credit. The election applies to all subsequent taxable years, and may be revoked only with the permission of the Secretary of the Treasury.

Effective Date

The provision applies to taxable years beginning after December 31, 1993.

5. Outbound and inbound transfers (secs. 423 and 424 of the bill and secs. 367, 1057, and 1491–1494 of the Code)

Present Law

Outbound transfers

Corporate nonrecognition provisions

Certain types of exchanges relating to the organization, reorganization, and liquidation of a corporation can be made without recognition of gain to the corporation involved or to its shareholders. In 1932 Congress enacted an exception to the nonrecognition rules, which became section 367 of the 1954 Code, for the case where such an exchange involves a foreign corporation. The legislative history indicates that the exception was enacted in order to prevent tax avoidance that might have otherwise occurred upon the transfer of appreciated property outside U.S. tax jurisdiction.[54] Under that provision, in determining the extent to which gain (but not loss) was recognized in these exchanges, a foreign corporation was not considered a corporation unless it was established to the satisfaction of the IRS that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

The Code now provides that if a U.S. person transfers property to a foreign corporation in connection with certain corporate organizations, reorganizations, or liquidations, the foreign corporation will not, for purposes of determining the extent to which gain is recognized on such transfer, be considered to be a corporation (sec. 367(a)(1)). Various exceptions to the operation of this rule are provided, including a broad grant of authority to provide exceptions by regulation. The statutory language has changed substantially since 1932, but it has retained in large part its primary operative result—that of treating a foreign corporation as not a corporation. Since corporate status is essential to qualify for the tax-free organization, reorganization, and liquidation provisions, failure to satisfy the requirements of section 367 could result in the recognition of gain to the participant corporations and shareholders.

[54] H.R. Rep. No. 708, 72d Cong., 1st Sess. 20 (1932).

Excise tax on transfers to a foreign entity

At the same time that Congress enacted the original predecessor of current section 367, Congress also enacted an excise tax on outbound transfers that might not constitute income tax recognition events even after imposition of the anti-avoidance income tax rule adopted for corporate transactions. As in the case of the corporate nonrecognition override provision, the purpose of the excise tax was to check transfers of property in which there was a large appreciation in value to foreign entities for the purpose of avoidance of taxes on capital gains.[55] Therefore, as in the case of the corporate provision, the excise tax generally has been imposed only in certain cases where it has been believed necessary or appropriate to preserve U.S. tax on appreciated assets.

Under present law, the excise tax generally applies on transfers of property by a U.S. person to a foreign corporation—as paid-in surplus or as a contribution to capital—or to a foreign estate, trust, or partnership.[56] The tax is 35 percent of the amount of gain inherent in the property transferred, but not recognized for income tax purposes at the time of the transfer (sec. 1491). For income tax purposes, the basis of the property whose appreciation and transfer triggers the tax is not increased to account for imposition of the tax.

The excise tax does not apply in certain cases where the transferee is exempt from U.S. tax under Code sections 501-505 (sec. 1492(1)). In addition, the excise tax does not apply in some cases where income tax rules governing outbound transfers apply, either by their terms or by the election of the taxpayer. Thus, the excise tax does not apply to a transfer described in section 367, or to a transfer not described in section 367 but with respect to which the taxpayer elects (before the transfer) the application of principles similar to the principles of section 367 (sec. 1492(2)).

In addition, a taxpayer may elect (under regulations prescribed by the Secretary) to treat a transfer described in section 1491 as a sale or exchange of the property transferred and to recognize as gain (but not loss) in the year of the transfer the excess of the fair market value of the property transferred over the adjusted basis (for determining gain) of the property in the hands of the transferor (sec. 1057; Treas. Reg. sec. 7.0). To the extent that gain is recognized pursuant to the election in the year of the transfer, the transfer is not subject to the excise tax, and the basis of the property in the hands of the transferee will be increased by the amount of gain received (sec. 1492(3)). The legislative history of the elective income recognition provision indicates that the making of an election which has as one of its principle purposes the avoidance of Federal income taxes is not permitted.[57]

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[55] *Id.* at 52.

[56] The Internal Revenue Service has in the past wavered on the question whether this tax applies to a transfer to a foreign trust with respect to which the transferor is treated as the owner under the grantor trust rules. Compare Rev. Rul. 69-450, 1969-2 C.B. 168 (holding that such a transfer is subject to tax under section 1491); with Rev. Rul. 87-61, 1987-2 C.B. 219 (revoking Rev. Rul. 69-450, and holding that such a transfer is *not* subject to tax under section 1491).

[57] Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1976,* at 226 (1976).

The excise tax is due at the time of the transfer (sec. 1494(a)). Under regulations, the excise tax may be abated, remitted, or refunded if the taxpayer, after the transfer, elects the application of principles similar to the principles of section 367 (sec. 1494(b)).

Inbound corporate transfers

Although the legislative history of the 1932 Act indicated a concern with outbound transfers, the statutory standard for determining that a transaction did not have as one of its principal purposes tax avoidance evolved through administrative interpretation into a requirement that, in the case of transfers into the United States by a foreign corporation, tax-free treatment generally would be permitted only if the U.S. tax on accumulated earnings and profits was paid. For example, in 1968, the IRS issued guidelines (Rev. Proc. 68-23, 1968-1 C.B. 821) as to when favorable rulings "ordinarily" would be issued. As a condition of obtaining a favorable ruling with respect to certain transactions, the section 367 guidelines required the taxpayer to agree to include certain items in income (the amount to be included was called the section 367 toll charge). For example, if the transaction involved the liquidation of a foreign corporation into a domestic parent corporation, a favorable ruling was issued if the domestic parent agreed to include in its income as a dividend for the taxable year in the which the liquidation occurred the portion of the accumulated earnings and profits of the foreign corporation which were properly attributable to the domestic corporation's stock interest in the foreign corporation (Rev. Proc. 68-23, sec. 3.01(1); see also sec. 3.03(1)(b)).

Absence of a toll charge on accumulated earnings of a foreign corporation upon liquidation or asset reorganization into a U.S. corporation clearly would permit avoidance of tax. For example, if a U.S. corporation owns 100 percent of the stock of a U.S. subsidiary, no tax is imposed either on a dividend from the subsidiary to the parent (sec. 243) or the liquidation of the subsidiary into the parent (secs. 332 and 337). In each case, the earnings of the subsidiary already have been subject to U.S. tax jurisdiction, and the liquidation provisions allow nonrecognition of gain inherent in appreciated property of the subsidiary. On the other hand, if a U.S. corporation owns 100 percent of the stock of a foreign subsidiary, earnings of the subsidiary generally are not subject to current U.S. tax. Instead, tax generally is imposed on a dividend from the subsidiary to the parent, net of creditable foreign taxes. If a liquidation of the subsidiary could be accomplished tax-free under the Code, U.S. tax on its earnings would be avoided; more generally, the parent would be able to succeed to the basis and other tax attributes of the foreign corporation without having subjected to U.S. tax jurisdiction the earnings that gave rise to those tax attributes.

Outbound transfers since the Tax Reform Act of 1976

For purposes of the transactions described above, section 367 (and its predecessors) remained largely unchanged between 1932 and 1976. In 1976, however, a number of problems caused Congress to revise section 367. One result of the 1976 revision was to separate the provision into 2 sets of rules: one set dealing with outbound transfers, where the statutory aim is to prevent the removal

of appreciated assets or inventory from U.S. tax jurisdiction prior to their sale (sec. 367(a)), and the other set dealing with both transfers into the United States and those which are exclusively foreign (sec. 367(b)).

Section 367(b) now provides, in part, that in the case of certain exchanges in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation will be considered to be a corporation except to the extent provided in regulations which are necessary or appropriate to prevent the avoidance of Federal income taxes.

Although it is clear that absence of a toll charge on accumulated earnings of a foreign corporation upon liquidation or reorganization into a U.S. corporation leads to avoidance of tax, and Congress in 1976 noted without disapproval the adoption of IRS positions that would prevent the avoidance of tax in these cases,[58] neither section 367(b) as revised in 1976, nor its predecessors, were drafted in such a way that directly causes tax to be imposed on foreign earnings.

For example, assume that a U.S. corporation owns 100 percent of the stock of a liquidating foreign corporation, and, pursuant to regulations under section 367(b), the foreign corporation is not treated as a corporation for purposes of section 332. In that case, the U.S. corporation would be required under the Code to recognize the difference between the basis and the value of its stock in the foreign corporation. That gain, however, may be more or less than the accumulated earnings of the foreign corporation attributable to the period when the U.S. corporation owned the stock of the foreign corporation.

Perhaps as a result, neither the present temporary regulations nor the recently proposed regulations under section 367(b) mandate a tax based on the accumulated earnings of a foreign corporation that liquidates or reorganizes into a U.S. corporation. The temporary regulations allow the taxpayer to elect treatment of the foreign corporation as a corporation if the tax on earnings is paid. If the taxpayer chooses not to make the election, the foreign corporation is not treated as a corporation under the relevant nonrecognition provision (e.g., sec. 332, 354), but is treated as a corporation for other purposes, such as for purposes of the basis rules (secs. 334, 358, 362), and carryover provisions (sec. 381) (Temp. Treas. Reg. secs. 7.367(b)-5(b) and 7.367(b)-7(c)(2)). The proposed regulations generally require that the foreign corporation be treated as a corporation, and permit the taxpayer to elect either to pay the tax on earnings, or to pay tax on the gain; but if the latter option is chosen, adjustments must be made to either net operating loss carryovers, capital loss carryovers, or asset bases (Proposed Treas. Reg. sec. 1.367(b)-3(b)(2)).

[58] E.g., Staff of the Joint Comm. on Taxation, 94th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1976*, at 264 (1976).

Reasons for Simplification

Outbound transfers

The excise tax was intended to prevent U.S. taxpayers from transferring appreciated property to foreign entities in attempts to avoid the payment of a capital gains tax. During the 60 years since its enactment, the excise tax potentially due on a transfer has only roughly approximated the income tax consequences that would have flowed from gain recognition. In some cases the excise tax has been much harsher than that income tax.[59] Nevertheless, it is and has been the case that any taxpayer could properly avoid the excise tax by subjecting itself to the income tax. It is understood that in some cases taxpayers are subject to the excise tax only because of inadvertent failure to elect to be subject to income tax. It is understood that in order to defeat the tax avoidance possibilities of outbound transfers, in appropriate cases taxpayers need be subject to income tax on transfers of appreciated property to foreign entities, but not an excise tax.

Some have argued that partnership and trust provisions added to the Code since 1932 generally obviate any need for either the excise tax or any new alternative provision. However, implementation of many of those provisions requires regulations that may or may not exist, and may or may not adequately prevent the tax avoidance that prompted enactment of the excise tax. It is believed that other statutes, while representing an improvement over pre-1932 law from the standpoint of preventing abuses, do not in all cases represent an adequate backstop where there is a failure to elect gain recognition or application of section 367 principles.

Inbound transfers

It is believed that the uncertainty surrounding the IRS authority to impose conditions on the treatment of a foreign corporation as a corporation, in cases other than outbound transfers, is not suited to prevent the avoidance of tax through the use of foreign corporations in the most straightforward fashion.

For example, assume that a U.S. corporation establishes a 100 percent-owned foreign corporation with capital of $100 cash. Assume that the foreign corporation spends $50 on operating assets and $50 on investment assets, and that the operating assets generate $100 of earnings and profits. Assume that the value and tax basis of operating assets maintained by the company remains at $50, while the value of the investment assets declines to $25, so that the stock in the foreign corporation is worth $175. Upon liquidation of the foreign corporation, assume that the taxpayer could avail itself of a gain limitation. Potentially, the taxpayer might achieve a double deduction of the $25 loss on the investment; once by sheltering $25 of earnings from taxation on repatriation, and again when the loss on the investment asset is realized upon disposition of that asset.[60]

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[59] When the excise tax was enacted, the income tax on capital gains of individuals was 12.5 percent; the excise tax was 25 percent (Revenue Act of 1932, secs. 101 and 901).

[60] Cf. Tech. Advice Memo. 9003005 (Sept. 28, 1989).

It is understood that the ambiguity of the statute in this case may foster complexity. For example, in the absence of regulations, the statute authorizes treatment of the foreign corporation as a corporation, and non-taxation of any earnings of the foreign corporation. To prevent this clear avoidance of tax, the IRS is authorized to provide for a different treatment of the foreign corporation by regulations. On one hand, it could be argued that the most the IRS can do in this case is to treat the transaction as if section 332 did not exist (resulting in gain recognition to the parent of $75). On the other hand, it could be argued that the Secretary is authorized to mandate the treatment of the foreign corporation as a corporation, subject to whatever regulations are necessary or appropriate to prevent the avoidance of tax on the repatriated earnings. One result of the ambiguity is a recently proposed regulation under which $75 of the earnings are taxed upon the liquidation, with the remaining $25 of earnings subject to future tax through a mandatory reduction of certain tax attributes, such as bases in the operating assets. It is believed that requiring full taxation of the repatriated earnings is reasonable as a matter of the historic function of section 367 to prevent tax avoidance in inbound cases, and that such tax-avoidance can be prevented more directly and simply by explicitly authorizing the IRS to dispense with the gain limitation in appropriate cases.

Explanation of Provisions

Outbound transfers

The bill repeals the excise tax on outbound transfers. In its place, the bill requires the full recognition of gain on a transfer of property by a U.S. person to a foreign corporation as paid-in surplus, or as a contribution to capital, or to a foreign estate, trust, or partnership.[61] The Secretary may, however, in lieu of applying this full recognition rule, provide regulations under which principles similar to the principles of section 367 shall apply to any such transfer. Moreover, the Secretary may provide rules under which recognition of gain will not be triggered by section 1491 in cases where the Secretary is satisfied that application of other Code rules (such as those relating to partnerships or trusts) will prevent the avoidance of tax consistent with the purposes of the bill. Full recognition of gain can also be avoided in the case of a transfer described in section 367. It is anticipated that prior to the promulgation of regulations, the Secretary generally will continue to permit taxpayers to elect the application of principles similar to the principles of section 367, provided the election is made by the time for filing the income tax return for the taxable year of the transfer.

Inbound transfers

The bill provides that in the case of certain corporate organizations, reorganizations, and liquidations described in section 332,

[61] By converting the excise tax to a recognition rule for income tax purposes, it is not intended to affect the outcome of the question, should the Internal Revenue Service choose to revisit it, of whether tax may be incurred upon a transfer of appreciated property to a foreign trust with respect to which the transferor is treated as the owner under the grantor trust rules.

351, 354, 355, 356, or 361 in which the status of a foreign corporation as a corporation is a condition for nonrecognition by a party to the transaction, income shall be recognized to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes. This provision is limited in its application, under the bill, so as not to apply to a transaction in which the foreign corporation is not treated as a corporation under section 367(a)(1). Thus, the bill permits the IRS to provide by regulations for recognition of income, without regard to the amount of gain that would be recognized in the absence of the relevant nonrecognition provision listed above. As under current law, such regulations will be subject to normal court review as to whether they are necessary or appropriate for the prevention of avoidance of Federal income taxes.

In addition, the bill clarifies that rules for income recognition under section 367(b) may also be applied in a case involving a transfer literally described in section 367(a)(1), where necessary or appropriate to prevent the avoidance of Federal income taxes.[62]

Effective Date

The provision that amends the outbound rules and repeals the excise tax applies to transfers after date of enactment. The provision that amends section 367(b) applies to transfers after December 31, 1993.

[62] See Temp. Treas. Reg. sec. 7.367(b)-4(b); Proposed Treas. Reg. sec. 1.367(a)-3(a).

TITLE V. TREATMENT OF INTANGIBLES

1. Amortization of goodwill and certain other intangibles (sec. 501 of the bill and new sec. 197 of the Code)

Present Law

In determining taxable income for Federal income tax purposes, a taxpayer is allowed depreciation or amortization deductions for the cost or other basis of intangible property that is used in a trade or business or held for the production of income if the property has a limited useful life that may be determined with reasonable accuracy. No depreciation or amortization deductions are allowed with respect to goodwill or going concern value.

Reasons for Simplification

The Federal income tax treatment of the costs of acquiring intangible assets is a source of considerable controversy between taxpayers and the Internal Revenue Service. Disputes arise concerning (1) whether an amortizable intangible asset exists; (2) in the case of an acquisition of a trade or business, the portion of the purchase price that is allocable to an amortizable intangible asset; and (3) the proper method and period for recovering the cost of an amortizable intangible asset.

It is believed that much of the controversy that arises under present law with respect to acquired intangible assets could be eliminated by specifying a single method and period for recovering the cost of most acquired intangible assets and by treating acquired goodwill and going concern value as amortizable intangible assets. It is also believed that there is no need at this time to change the Federal income tax treatment of self-created intangible assets, such as goodwill that is created through advertising and other similar expenditures.

Accordingly, the bill requires the cost of most acquired intangible assets, including goodwill and going concern value, to be amortized ratably over a 14-year period. It is recognized that the useful lives of certain acquired intangible assets to which the bill applies may be shorter than 14 years, while the useful lives of other acquired intangible assets to which the bill applies may be longer than 14 years. The 14-year amortization period was selected so that the bill would be approximately revenue neutral over the next five fiscal years.

Explanation of Provision

In general

The bill allows an amortization deduction with respect to the capitalized costs of certain intangible property (defined as a "sec-

tion 197 intangible") that is acquired by a taxpayer and that is held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income. The amount of the deduction is determined by amortizing the adjusted basis (for purposes of determining gain) of the intangible ratably over a 14-year period that begins with the month that the intangible is acquired.[63] No other depreciation or amortization deduction is allowed with respect to a section 197 intangible that is acquired by a taxpayer.

In general, the bill applies to a section 197 intangible acquired by a taxpayer regardless of whether it is acquired as part of a trade or business. In addition, the bill generally applies to a section 197 intangible that is treated as acquired under section 338 of the Code. The bill generally does not apply to a section 197 intangible that is created by the taxpayer if the intangible is not created in connection with a transaction (or series of related transactions) that involves the acquisition of a trade or business or a substantial portion thereof.

Except in the case of amounts paid or incurred under certain covenants not to compete (or under certain other arrangements that have substantially the same effect as covenants not to compete) and certain amounts paid or incurred on account of the transfer of a franchise, trademark, or trade name, the bill generally does not apply to any amount that is otherwise currently deductible (i.e., not capitalized) under present law.

No inference is intended as to whether a depreciation or amortization deduction is allowed under present law with respect to any intangible property that is either included in, or excluded from, the definition of a section 197 intangible. In addition, no inference is intended as to whether an asset is to be considered tangible or intangible property for any other purpose of the Internal Revenue Code.

Definition of section 197 intangible

In general

The term "section 197 intangible" is defined as any property that is included in any one or more of the following categories: (1) goodwill and going concern value; (2) certain specified types of intangible property that generally relate to workforce, information base, know-how, customers, suppliers, or other similar items; (3) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof; (4) any covenant not to compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof); and (5) any franchise, trademark, or trade name.

Certain types of property, however, are specifically excluded from the definition of the term "section 197 intangible." The term "section 197 intangible" does not include: (1) any interest in a cor-

[63]. In the case of a short taxable year, the amortization deduction is to be based on the number of months in such taxable year.

poration, partnership, trust, or estate; (2) any interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial contract; (3) any interest in land; (4) certain computer software; (5) certain interests in films, sound recordings, video tapes, books, or other similar property; (6) certain rights to receive tangible property or services; (7) certain interests in patents or copyrights; (8) any interest under an existing lease of tangible property; (9) any interest under an existing indebtedness (except for the deposit base and similar items of a financial institution); (10) a franchise to engage in any professional sport, and any item acquired in connection with such a franchise; and (11) certain transaction costs.

In addition, the Treasury Department is authorized to issue regulations that exclude certain rights of fixed duration or amount from the definition of a section 197 intangible.

Goodwill and going concern value

For purposes of the bill, goodwill is the value of a trade or business that is attributable to the expectancy of continued customer patronage, whether due to the name of a trade or business, the reputation of a trade or business, or any other factor.

In addition, for purposes of the bill, going concern value is the additional element of value of a trade or business that attaches to property by reason of its existence as an integral part of a going concern. Going concern value includes the value that is attributable to the ability of a trade or business to continue to function and generate income without interruption notwithstanding a change in ownership. Going concern value also includes the value that is attributable to the use or availability of an acquired trade or business (for example, the net earnings that otherwise would not be received during any period were the acquired trade or business not available or operational).

Workforce, information base, know-how, customer-based intangibles, supplier-based intangibles and other similar items

Workforce.—The term "section 197 intangible" includes workforce in place (which is sometimes referred to as agency force or assembled workforce), the composition of a workforce (for example, the experience, education, or training of a workforce), the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of a highly-skilled workforce is to be amortized over the 14-year period specified in the bill. As a further example, the cost of acquiring an existing employment contract (or contracts) or a relationship with employees or consultants (including but not limited to any "key employee" contract or relationship) as part of the acquisition of a trade or business is to be amortized over the 14-year period specified in the bill.

Information base.—The term "section 197 intangible" includes business books and records, operating systems, and any other information base including lists or other information with respect to

current or prospective customers (regardless of the method of recording such information). Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the intangible value of technical manuals, training manuals or programs, data files, and accounting or inventory control systems is to be amortized over the 14-year period specified in the bill. As a further example, the cost of acquiring customer lists, subscription lists, insurance expirations,[64] patient or client files, or lists of newspaper, magazine, radio or television advertisers is to be amortized over the 14-year period specified in the bill.

Know-how.—The term "section 197 intangible" includes any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item. For this purpose, the term "section 197 intangible" is to include package designs, computer software, and any interest in a film, sound recording, video tape, book, or other similar property, except as specifically provided otherwise in the bill.[65]

Customer-based intangibles.—The term "section 197 intangible" includes any customer-based intangible, which is defined as the composition of market, market share, and any other value resulting from the future provision of goods or services pursuant to relationships with customers (contractual or otherwise) in the ordinary course of business. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of customer base, circulation base, undeveloped market or market growth, insurance in force, mortgage servicing contracts, investment management contracts, or other relationships with customers that involve the future provision of goods or services, is to be amortized over the 14-year period specified in the bill. On the other hand, the portion (if any) of the purchase price of an acquired trade or business that is attributable to accounts receivable or other similar rights to income for those goods or services that have been provided to customers prior to the acquisition of a trade or business is not to be taken into account under the bill.[66]

In addition, the bill specifically provides that the term "customer-based intangible" includes the deposit base and any similar asset of a financial institution. Thus, for example, the portion (if any) of the purchase price of an acquired financial institution that is attributable to the checking accounts, savings accounts, escrow accounts and other similar items of the financial institution is to be amortized over the 14-year period specified in the bill.

Supplier-based intangibles.—The term "section 197 intangible" includes any supplier-based intangible, which is defined as the value resulting from the future acquisition of goods or services pursuant to relationships (contractual or otherwise) in the ordinary

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[64] Insurance expirations are records that are maintained by insurance agents with respect to insurance customers. These records generally include information relating to the type of insurance, the amount of insurance, and the expiration date of the insurance.

[65] See below for a description of the exceptions for certain patents, certain computer software, and certain interests in films, sound recordings, video tapes, books, or other similar property.

[66] As under present law, the portion of the purchase price of an acquired trade or business that is attributable to accounts receivable is to be allocated among such receivables and is to be taken into account as payment is received under each receivable or at the time that a receivable becomes worthless.

course of business with suppliers of goods or services to be used or sold by the taxpayer. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of a favorable relationship with persons that provide distribution services (for example, favorable shelf or display space at a retail outlet), the existence of a favorable credit rating, or the existence of favorable supply contracts, is to be amortized over the 14-year period specified in the bill.[67]

Other similar items.—The term "section 197 intangible" also includes any other intangible property that is similar to workforce, information base, know-how, customer-based intangibles, or supplier-based intangibles.

Licenses, permits, and other rights granted by governmental units

The term "section 197 intangible" also includes any license, permit, or other right granted by a governmental unit or any agency or instrumentality thereof (even if the right is granted for an indefinite period or the right is reasonably expected to be renewed for an indefinite period).[68] Thus, for example, the capitalized cost of acquiring from any person a liquor license, a taxi-cab medallion (or license), an airport landing or takeoff right (which is sometimes referred to as a slot), a regulated airline route, or a television or radio broadcasting license is to be amortized over the 14-year period specified in the bill. For purposes of the bill, the issuance or renewal of a license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof is to be considered an acquisition of such license, permit, or other right.

Covenants not to compete and other similar arrangements

The term "section 197 intangible" also includes any covenant not to compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete; hereafter "other similar arrangement") entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof). For this purpose, an interest in a trade or business includes not only the assets of a trade or business, but also stock in a corporation that is engaged in a trade or business or an interest in a partnership that is engaged in a trade or business.

Any amount that is paid or incurred under a covenant not to compete (or other similar arrangement) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof) is chargeable to capital account and is to be amortized ratably over the 14-year period specified in the bill. In addition, any amount that is paid or incurred under a covenant not to compete (or other similar arrangement) after the taxable year in which the covenant (or other similar ar-

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[67] See below, however, for a description of the exception for certain rights to receive tangible property or services from another person.

[68] A right granted by a governmental unit or an agency or instrumentality thereof that constitutes an interest in land or an interest under a lease of tangible property is excluded from the definition of a section 197 intangible. See below for a description of the exceptions for interests in land and for interests under leases of tangible property.

rangement) was entered into is to be amortized ratably over the remaining months in the 14-year amortization period that applies to the covenant (or other similar arrangement) as of the beginning of the month that the amount is paid or incurred.

For purposes of this provision, an arrangement that requires the former owner of an interest in a trade or business to continue to perform services (or to provide property or the use of property) that benefit the trade or business is considered to have substantially the same effect as a covenant not to compete to the extent that the amount paid to the former owner under the arrangement exceeds the amount that represents reasonable compensation for the services actually rendered (or for the property or use of property actually provided) by the former owner. As under present law, to the extent that the amount paid or incurred under a covenant not to compete (or other similar arrangement) represents additional consideration for the acquisition of stock in a corporation, such amount is not to be taken into account under this provision but, instead, is to be included as part of the acquirer's basis in the stock.

Franchises, trademarks, and trade names

The term "section 197 intangible" also includes any franchise, trademark, or trade name. For this purpose, the term "franchise" is defined, as under present law, to include any agreement that provides one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area.[69] In addition, as provided under present law, the renewal of a franchise, trademark, or trade name is to be treated as an acquisition of such franchise, trademark, or the name.[70]

The bill continues the present-law treatment of certain contingent amounts that are paid or incurred on account of the transfer of a franchise, trademark, or trade name. Under these rules, a deduction is allowed for amounts that are contingent on the productivity, use, or disposition of a franchise, trademark, or trade name only if (1) the contingent amounts are paid as part of a series of payments that are payable at least annually throughout the term of the transfer agreement, and (2) the payments are substantially equal in amount or payable under a fixed formula.[71] Any other amount, whether fixed or contingent, that is paid or incurred on account of the transfer of a franchise, trademark, or trade name is chargeable to capital account and is to be amortized ratably over the 14-year period specified in the bill.

Exceptions to the definition of a section 197 intangible

In general.—The bill contains several exceptions to the definition of the term "section 197 intangible." Several of the exceptions contained in the bill apply only if the intangible property is not ac-

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[69] Section 1253(b)(1) of the Code.

[70] Only the costs incurred in connection with the renewal, however, are to be amortized over the 14-year period that begins with the month that the franchise, trademark, or trade name is renewed. Any costs incurred in connection with the issuance (or an earlier renewal) of a franchise, trademark, or trade name are to continue to be taken into account over the remaining portion of the amortization period that began at the time of such issuance (or earlier renewal).

[71] Section 1253(d)(1) of the Code.

quired in a transaction (or series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business. It is anticipated that the Treasury Department will exercise its regulatory authority to require any intangible property that would otherwise be excluded from the definition of the term "section 197 intangible" to be taken into account under the bill under circumstances where the acquisition of the intangible property is, in and of itself, the acquisition of an asset which constitutes a trade or business or a substantial portion of a trade or business.

The determination of whether acquired assets constitute a substantial portion of a trade or business is to be based on all of the facts and circumstances, including the nature and the amount of the assets acquired as well as the nature and amount of the assets retained by the transferor. It is not intended, however, that the value of the assets acquired relative to the value of the assets retained by the transferor is determinative of whether the acquired assets constitute a substantial portion of a trade or business.

For purposes of the bill, a group of assets is to constitute a trade or business if the use of such assets would constitute a trade or business for purposes of section 1060 of the Code (i.e., if the assets are of such a character that goodwill or going concern value could under any circumstances attach to the assets). In addition, the acquisition of a franchise, trademark or trade name is to constitute the acquisition of a trade or business or a substantial portion of a trade or business.

In determining whether a taxpayer has acquired an intangible asset in a transaction (or series of related transactions) that involves the acquisition of assets that constitute a trade or business or a substantial portion of a trade or business, only those assets acquired in a transaction (or a series of related transactions) by a taxpayer (and persons related to the taxpayer) from the same person (and any related person) are to be taken into account. In addition, any employee relationships that continue (or covenants not to compete that are entered into) as part of the transfer of assets are to be taken into account in determining whether the transferred assets constitute a trade or business or a substantial portion of a trade or business.

Interests in a corporation, partnership, trust, or estate.—The term "section 197 intangible" does not include any interest in a corporation, partnership, trust, or estate. Thus, for example, the bill does not apply to the cost of acquiring stock, partnership interests, or interests in a trust or estate, whether or not such interests are regularly traded on an established market.[72]

Interests under certain financial contracts.—The term "section 197 intangible" does not include any interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial contract, whether or not such interest is regularly traded on an established market. Any interest under a mortgage servicing contract, credit

[72] A temporal interest in property, outright or in trust, may not be used to convert a section 197 intangible into property that is amortizable more rapidly than ratably over the 14-year period specified in the bill.

card servicing contract or other contract to service indebtedness issued by another person, and any interest under an assumption reinsurance contract[73] is not excluded from the definition of the term "section 197 intangible" by reason of the exception for interests under certain financial contracts.

Interests in land.—The term "section 197 intangible" does not include any interest in land. Thus, the cost of acquiring an interest in land is to be taken into account under present law rather than under the bill. For this purpose, an interest in land includes a fee interest, life estate, remainder, easement, mineral rights, timber rights, grazing rights, riparian rights, air rights, zoning variances, and any other similar rights with respect to land. An interest in land is not to include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television services.

The costs of acquiring licenses, permits, and other rights relating to improvements to land, such as building construction or use permits, are to be taken into account in the same manner as the underlying improvement in accordance with present law.

Certain computer software.—The term "section 197 intangible" does not include computer software (whether acquired as part of a trade or business or otherwise) that (1) is readily available for purchase by the general public; (2) is subject to a non-exclusive license; and (3) has not been substantially modified. In addition, the term "section 197 intangible" does not include computer software which is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

For purposes of the bill, the term "computer software" is defined as any program (i.e., any sequence of machine-readable code) that is designed to cause a computer to perform a desired function. The term "computer software" includes any incidental and ancillary rights with respect to computer software that (1) are necessary to effect the legal acquisition of the title to, and the ownership of, the computer software, and (2) are used only in connection with the computer software. The term "computer software" does not include any data base or similar item (other than a data base or item that is in the public domain and that is incidental to the software[74]) regardless of the form in which it is maintained or stored.

If a depreciation deduction is allowed with respect to any computer software that is not a section 197 intangible, the amount of the deduction is to be determined by amortizing the adjusted basis of the computer software ratably over a 36-month period that begins with the month that the computer software is placed in service. For this purpose, the cost of any computer software that is taken into account as part of the cost of computer hardware or other tangible property under present law is to continue to be taken into account in such manner under the bill. In addition, the cost of any computer software that is currently deductible (i.e., not capitalized) under present law is to continue to be taken into account in such manner under the bill.

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[73] See below for a description of the "Treatment of assumption reinsurance contracts."

[74] For example, a data base would not include a dictionary feature used to spell-check a word processing program.

Certain interests in films, sound recordings, video tapes, books, or other similar property.—The term "section 197 intangible" does not include any interest (including an interest as a licensee) in a film, sound recording, video tape, book, or other similar property (including the right to broadcast or transmit a live event) if the interest is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

Certain rights to receive tangible property or services.—The term "section 197 intangible" does not include any right to receive tangible property or services under a contract (or any right to receive tangible property or services granted by a governmental unit or an agency or instrumentality thereof) if the right is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

If a depreciation deduction is allowed with respect to a right to receive tangible property or services that is not a section 197 intangible, the amount of the deduction is to be determined in accordance with regulations to be promulgated by the Treasury Department. It is anticipated that the regulations may provide that in the case of an amortizable right to receive tangible property or services in substantially equal amounts over a fixed period that is not renewable, the cost of acquiring the right will be taken into account ratably over such fixed period. It is also anticipated that the regulations may provide that in the case of a right to receive a fixed amount of tangible property or services over an unspecified period, the cost of acquiring such right will be taken into account under a method that allows a deduction based on the amount of tangible property or services received during a taxable year compared to the total amount of tangible property or services to be received.

For example, assume that a taxpayer acquires from another person a favorable contract right of such person to receive a specified amount of raw materials each month for the next three years (which is the remaining life of the contract) and that the right to receive such raw materials is not acquired as part of the acquisition of assets that constitute a trade or business or a substantial portion thereof (i.e., such contract right is not a section 197 intangible). It is anticipated that the taxpayer may be required to amortize the cost of acquiring the contract right ratably over the three-year remaining life of the contract. Alternatively, if the favorable contract right is to receive a specified amount of raw materials during an unspecified period, it is anticipated that the taxpayer may be required to amortize the cost of acquiring the contract right by multiplying such cost by a fraction, the numerator of which is the amount of raw materials received under the contract during any taxable year and the denominator of which is the total amount of raw materials to be received under the contract.

It is also anticipated that the regulations may require a taxpayer under appropriate circumstances to amortize the cost of acquiring a renewable right to receive tangible property or services over a period that includes all renewal options exercisable by the taxpayer at less than fair market value.

Certain interests in patents or copyrights.—The term "section 197 intangible" does not include any interest in a patent or copyright which is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

If a depreciation deduction is allowed with respect to an interest in a patent or copyright and the interest is not a section 197 intangible, then the amount of the deduction is to be determined in accordance with regulations to be promulgated by the Treasury Department. It is expected that the regulations may provide that if the purchase price of a patent is payable on an annual basis as a fixed percentage of the revenue derived from the use of the patent, then the amount of the depreciation deduction allowed for any taxable year with respect to the patent equals the amount of the royalty paid or incurred during such year.[75]

Interests under leases of tangible property.—The term "section 197 intangible" does not include any interest as a lessor or lessee under an existing lease of tangible property (whether real or personal).[76] The cost of acquiring an interest as a lessor under a lease of tangible property where the interest as lessor is acquired in connection with the acquisition of the tangible property is to be taken into account as part of the cost of the tangible property. For example, if a taxpayer acquires a shopping center that is leased to tenants operating retail stores, the portion (if any) of the purchase price of the shopping center that is attributable to the favorable attributes of the leases is to be taken into account as a part of the basis of the shopping center and is to be taken into account in determining the depreciation deduction allowed with respect to the shopping center.

The cost of acquiring an interest as a lessee under an existing lease of tangible property is to be taken into account under present law (see section 178 of the Code and Treas. Reg. sec. 1.162-11(a)) rather than under the provisions of the bill.[77] In the case of any interest as a lessee under a lease of tangible property that is acquired with any other intangible property (either in the same transaction or series of related transactions), however, the portion of the total purchase price that is allocable to the interest as a lessee is not to exceed the excess of (1) the present value of the fair market value rent for the use of the tangible property for the term of the lease,[78] over (2) the present value of the rent reasonably expected to be paid for the use of the tangible property for the term of the lease.

Interests under indebtedness.—The term "section 197 intangible" does not include any interest (whether as a creditor or debtor)

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[75] See *Associated Patentees, Inc.*, 4 T.C. 979 (1945); and Rev. Rul. 67-136, 1967-1 C.B. 58.

[76] The bill provides that a sublease is to be treated in the same manner as a lease of the underlying property. Thus, the term "section 197 intangible" does not include any interest as a sublessor or sublessee of tangible property.

[77] The lease of a gate at an airport for the purpose of loading and unloading passengers and cargo is a lease of tangible property for this purpose. It is anticipated that such treatment will serve as guidance to the Internal Revenue Service and taxpayers in resolving existing disputes.

[78] In no event is the present value of the fair market value rent for the use of the tangible property for the term of the lease to exceed the fair market value of the tangible property as of the date of acquisition. The present value of such rent is presumed to be less than the value of the tangible property if the duration of the lease is less than the economic useful life of the property.

under any indebtedness that was in existence on the date that the interest was acquired.[79] Thus, for example, the value of assuming an existing indebtedness with a below-market interest rate is to be taken into account under present law rather than under the bill. In addition, the premium paid for acquiring the right to receive an above-market rate of interest under a debt instrument may be taken into account under section 171 of the Code, which generally allows the amount of the premium to be amortized on a yield-to-maturity basis over the remaining term of the debt instrument. This exception for interests under existing indebtedness does not apply to the deposit base and other similar items of a financial institution.

Professional sports franchises.—The term "section 197 intangible" does not include a franchise to engage in professional baseball, basketball, football, or other professional sport, and any item acquired in connection with such a franchise. Consequently, the cost of acquiring a professional sports franchise and related assets (including any goodwill, going concern value, or other section 197 intangibles) is to be allocated among the assets acquired as provided under present law (see, for example, section 1056 of the Code) and is to be taken into account under the provisions of present law.

Certain transaction costs.—The term section 197 intangible does not include the amount of any fees for professional services, and any transaction costs, incurred by parties to a transaction with respect to which any portion of the gain or loss is not recognized under part III of subchapter C. This provision addresses a concern that some taxpayers might attempt to contend that the 14-year amortization provided by the provision applies to any such amounts that may be required to be capitalized under present law but that do not relate to any asset with a readily identifiable useful life.[80] The exception is provided solely to clarify that section 197 is not to be construed to provide 14-year amortization for any such amounts. No inference is intended that such amounts would (but for this provision) be properly characterized as amounts eligible for such 14-year amortization, nor is any inference intended that any amounts not specified in this provision should be so characterized. In addition, no inference is intended regarding the proper treatment of professional fees or transaction costs in other circumstances under present law.

Regulatory authority regarding rights of fixed term or duration.—The bill authorizes the Treasury Department to issue regulations that exclude a right received under a contract, or granted by a governmental unit or an agency or instrumentality thereof, from the definition of a section 197 intangible if (1) the right is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business (or a substantial portion thereof) and (2) the right either (A) has a fixed duration of less than 14 years or (B) is fixed as to amount [81] and

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[79] For purposes of this exception, the term "interest under any existing indebtedness" is to include mortgage servicing rights to the extent that the rights are stripped coupons under section 1286 of the Code. See Rev. Rul. 91-46, 1991-2 C.B. 358.

[80] See, e.g., *INDOPCO, Inc.* v. Commissioner, 112 S. Ct. 1039 (1992).

[81] For example, an emission allowance granted a public utility under Title IV of the Clean Air Act Amendments of 1990 is a right that is limited in amount within the meaning of this provision, because each allowance grants a right to a fixed amount of emissions.

the cost is properly recoverable (without regard to this provision) under a method similar to the unit of production method.

Generally, it is anticipated that the mere fact that a taxpayer will have the opportunity to renew a contract or other right on the same terms as are available to others, in a competitive auction or similar process that is designed to reflect fair market value and in which the taxpayer is not contractually advantaged, will not be taken into account in determining the duration of such right or whether it is for a fixed amount. However, the fact that competitive bidding occurs at the time of renewal and that there are or may be modifications in price (or in terms or requirements relating to the right that increase the cost to the bidder) shall not be within the scope of the preceding sentence unless the bidding also actually produces a fair market value price comparable to the price that would obtain if the rights were purchased immediately after renewal from a person (other than the person granting the renewal) in an arm's length transaction. Furthermore, it is expected that, as under present law, the Treasury Department will take into account all the facts and circumstances, including any facts indicating an actual practice of renewals or expectancy of renewals.

For example, assume Company A enters into a license with Company B to use certain know-how developed by B. In addition, assume that the license is for five years, that the license cannot be renewed by A except on terms that are fully available to A's competitors and that the price paid by A will reflect the arm's length price that a third party would pay A for the license immediately after renewal. Finally, assume that the license does not constitute a substantial portion of a trade or business and is not entered into as part of a transaction (or series of related transactions) that constitute the acquisition of a trade or business or substantial portion thereof. It is anticipated that in these circumstances the regulations will provide that the license is not a section 197 intangible because it is of fixed duration.

The regulations may also prescribe rules governing the extent to which renewal options and similar items will be taken into account for the purpose of determining whether rights are fixed in duration or amount. It is also anticipated that such regulations may prescribe the appropriate method of amortizing the capitalized costs of rights which are excluded by such regulations from the definition of a section 197 intangible.

Exception for certain self-created intangibles

The bill generally does not apply to any section 197 intangible that is created by the taxpayer if the section 197 intangible is not created in connection with a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion thereof.

For purposes of this exception, a section 197 intangible that is owned by a taxpayer is to be considered created by the taxpayer if the intangible is produced for the taxpayer by another person under a contract with the taxpayer that is entered into prior to the production of the intangible. For example, a technological process or other know-how that is developed specifically for a taxpayer under an arrangement with another person pursuant to which the

taxpayer retains all rights to the process or know-how is to be considered created by the taxpayer.

The exception for "self-created" intangibles does not apply to the entering into (or renewal of) a contract for the use of a section 197 intangible. Thus, for example, the exception does not apply to the capitalized costs incurred by a licensee in connection with the entering into (or renewal of) a contract for the use of know-how or other section 197 intangible. These capitalized costs are to be amortized over the 14-year period specified in the bill.

In addition, the exception for "self-created" intangibles does not apply to: (1) any license, permit, or other right that is granted by a governmental unit or an agency or instrumentality thereof; (2) any covenant not to compete (or other similar arrangement) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof); and (3) any franchise, trademark, or trade name. Thus, for example, the capitalized costs incurred in connection with the development or registration of a trademark or trade name are to be amortized over the 14-year period specified in the bill.

Special rules

Determination of adjusted basis

The adjusted basis of a section 197 intangible that is acquired from another person generally is to be determined under the principles of present law that apply to tangible property that is acquired from another person. Thus, for example, if a portion of the cost of acquiring an amortizable section 197 intangible is contingent, the adjusted basis of the section 197 intangible is to be increased as of the beginning of the month that the contingent amount is paid or incurred. This additional amount is to be amortized ratably over the remaining months in the 14-year amortization period that applies to the intangible as of the beginning of the month that the contingent amount is paid or incurred.

Treatment of certain dispositions of amortizable section 197 intangibles

Special rules apply if a taxpayer disposes of a section 197 intangible that was acquired in a transaction or series of related transactions and, after the disposition,[82] the taxpayer retains other section 197 intangibles that were acquired in such transaction or series or related transactions.[83] First, no loss is to be recognized by reason of such a disposition. Second, the adjusted bases of the retained section 197 intangibles that were acquired in connection with such

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[82] For this purpose, the abandonment of a section 197 intangible or any other event that renders a section 197 intangible worthless is to be considered a disposition of a section 197 intangible.

[83] These special rules do not apply to a section 197 intangible that is separately acquired (i.e., a section 197 intangible that is acquired other than in a transaction or a series of related transactions that involve the acquisition of other section 197 intangibles). Consequently, a loss may be recognized upon the disposition of a separately acquired section 197 intangible. In no event, however, is the termination or worthlessness of a portion of a section 197 intangible to be considered the disposition of a separately acquired section 197 intangible. For example, the termination of one or more customers from an acquired customer list or the worthlessness of some information from an acquired data base is not to be considered the disposition of a separately acquired section 197 intangible.

transaction or series of related transactions are to be increased by the amount of any loss that is not recognized. The adjusted basis of any such retained section 197 intangible is increased by the product of (1) the amount of the loss that is not recognized solely by reason of this provision, and (2) a fraction, the numerator of which is the adjusted basis of the intangible as of the date of the disposition and the denominator of which is the total adjusted bases of all such retained section 197 intangibles as of the date of the disposition.

For purposes of these rules, all persons treated as a single taxpayer under section 41(f)(1) of the Code are treated as a single taxpayer. Thus, for example, a loss is not to be recognized by a corporation upon the disposition of a section 197 intangible if after the disposition a member of the same controlled group as the corporation retains other section 197 intangibles that were acquired in the same transaction (or a series of related transactions) as the section 197 intangible that was disposed of. It is anticipated that the Treasury Department will provide rules for taking into account the amount of any loss that is not recognized due to this rule (for example, by allowing the corporation that disposed of the section 197 intangible to amortize the loss over the remaining portion of the 14-year amortization period).

Treatment of certain nonrecognition transactions

If any section 197 intangible is acquired in a transaction to which section 332, 351, 361, 721, 731, 1031, or 1033 of the Code applies (or any transaction between members of the same affiliated group during any taxable year for which a consolidated return is filed),[84] the transferee is to be treated as the transferor for purposes of applying this provision with respect to the amount of the adjusted basis of the transferee that does not exceed the adjusted basis of the transferor.

For example, assume that an individual owns an amortizable section 197 intangible that has been amortized under section 197 for 4 full years and has a remaining unamortized basis of $300,000. In addition, assume that the individual exchanges the asset and $100,000 for a like-kind amortizable section 197 intangible in a transaction to which section 1031 applies. Under the bill, $300,000 of the basis of the acquired amortizable section 197 intangible is to be amortized over the 10 years remaining in the original 14-year amortization period for the transferred asset and the other $100,000 of basis is to be amortized over the 14-year period specified in the bill.[85]

Treatment of certain partnership transactions

Generally, consistent with the rules described above for certain nonrecognition transactions, a transaction in which a taxpayer ac-

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[84] The termination of a partnership under section 708(b)(1)(B) of the Code is a transaction to which this rule applies. In such a case, the bill applies only to the extent that the adjusted basis of the section 197 intangibles before the termination exceeds the adjusted basis of the section 197 intangibles after the termination. (See the example below in the discussion of "Treatment of Certain Partnership Transactions.")

[85] No inference is intended whether any asset treated as a section 197 intangible under the bill is eligible for like kind exchange treatment.

quires an interest in an intangible held through a partnership (either before or after the transaction) will be treated as an acquisition to which the bill applies only if, and to the extent that, the acquiring taxpayer obtains, as a result of the transaction, an increased basis for such intangible.[86]

For example, assume that A, B and C each contribute $700 for equal shares in partnership P, which on January 1, 1994, acquires as its sole asset an amortizable section 197 intangible for $2,100. Assume that on January 1, 1998, (1) the sole asset of P is the intangible acquired in 1994, (2) the intangible has an unamortized basis of $1,500 and A, B, and C each have a basis of $500 in their partnership interests, and (3) D (who is not related to A, B, or C) acquires A's interest in P for $800. Under the bill, if there is no section 754 election in effect for 1998, there will be no change in the basis or amortization of the intangible and D will merely step into the shoes of A with respect to the intangible. D's share of the basis in the intangible will be $500, which will be amortized over the 10 years remaining in the amortization period for the intangible.

On the other hand, if a section 754 election is in effect for 1998, then D will be treated as having an $800 basis for its share of P's intangible. Under section 197, D's share of income and loss will be determined as if P owns two intangible assets. D will be treated as having a basis of $500 in one asset, which will continue to be amortized over the 10 remaining years of the original 14-year life. With respect to the other asset, D will be treated as having a basis of $300 (the amount of step-up obtained by D under section 743 as a result of the section 754 election) which will be amortized over a 14-year period starting with January of 1998. B and C will each continue to share equally in a $1,000 basis in the intangible and amortize that amount over the remaining 10-year life.

As an additional example, assume the same facts as described above, except that D acquires both A's and B's interests in P for $1,600. Under section 708, the transaction is treated as if P is liquidated immediately after the transfer, with C and D each receiving their pro rata share of P's assets which they then immediately contribute to a new partnership. The distributions in liquidation are governed by section 731. Under the bill, C's interest in the intangible will be treated as having a $500 basis, with a remaining amortization period of 10 years. D will be treated as having an interest in two assets: one with a basis of $1,000 and a remaining amortization period of 10 years, and the other with a basis of $600 and a new amortization period of 14 years.

As discussed more fully below, the bill also changes the treatment of payments made in liquidation of the interest of a deceased or retired partner in exchange for goodwill. Except in the case of payments made on the retirement or death of a general partner of a partnership for which capital is not a material income-producing factor, such payments will not be treated as a distribution of partnership income. Under the bill, however, if the partnership makes an election under section 754, section 734 will generally provide the partnership the benefit of a stepped-up basis for the retiring or de-

[86] This discussion is subject to the application of the anti-churning rules which are discussed below.

ceased partner's share of partnership goodwill and an amortization deduction for the increase in basis under section 197.

For example, using the facts from the preceding examples, assume that on January 1, 1998, A retires from the partnership in exchange for a payment from the partnership of $800, all of which is in exchange for A's interest in the intangible asset owned by P. Under the bill, if there is a section 754 election in effect for 1998, P will be treated as having two amortizable section 197 intangibles: one with a basis of $1,500 and a remaining life of 10 years, and the other with a basis of $300 and a new life of 14 years.

Treatment of assumption reinsurance transactions

The bill applies to any insurance contract that is acquired from another person through an assumption reinsurance transaction (but not through an indemnity reinsurance transaction).[87] The amount taken into account as the adjusted basis of such a section 197 intangible, however, is to equal the excess of (1) the amount paid or incurred by the acquirer/reinsurer under the assumption reinsurance transaction,[88] over (2) the amount of the specified policy acquisition expenses (as determined under section 848 of the Code) that is attributable to premiums received under the assumption reinsurance transaction. The amount of the specified policy acquisition expenses of an insurance company that is attributable to premiums received under an assumption reinsurance transaction is to be amortized over the period specified in section 848 of the Code.

Treatment of amortizable section 197 intangible as depreciable property

For purposes of chapter 1 of the Internal Revenue Code, an amortizable section 197 intangible is to be treated as property of a character which is subject to the allowance for depreciation provided in section 167. Thus, for example, an amortizable section 197 intangible is not a capital asset for purposes of section 1221 of the Code, but an amortizable section 197 intangible held for more than one year generally qualifies as property used in a trade or business for purposes of section 1231 of the Code. As further examples, an amortizable section 197 intangible is to constitute section 1245 property, and section 1239 of the Code is to apply to any gain recognized upon the sale or exchange of an amortizable section 197 intangible, directly or indirectly, between related persons.

Treatment of certain amounts that are properly taken into account in determining the cost of property that is not a section 197 intangible

The bill does not apply to any amount that is properly taken into account under present law in determining the cost of property that

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[87] An assumption reinsurance transaction is an arrangement whereby one insurance company (the reinsurer) becomes solely liable to policyholders on contracts transferred by another insurance company (the ceding company). In addition, for purposes of the bill, an assumption reinsurance transaction is to include any acquisition of an insurance contract that is treated as occurring by reason of an election under section 338 of the Code.

[88] The amount paid or incurred by the acquirer/reinsurer under an assumption reinsurance transaction is to be determined under the principles of present law. (See Treas. Reg. sec. 1.817-4(d)(2).)

is not a section 197 intangible. Thus, for example, no portion of the cost of acquiring real property that is held for the production of rental income (for example, an office building, apartment building or shopping center) is to be taken into account under the bill (i.e., no goodwill, going concern value or any other section 197 intangible is to arise in connection with the acquisition of such real property). Instead, the entire cost of acquiring such real property is to be included in the basis of the real property and is to be recovered under the principles of present law applicable to such property.

Modification of purchase price allocation and reporting rules for certain asset acquisitions

Sections 338(b)(5) and 1060 of the Code authorize the Treasury Department to promulgate regulations that provide for the allocation of purchase price among assets in the case of certain asset acquisitions. Under regulations that have been promulgated pursuant to this authority, the purchase price of an acquired trade or business must be allocated among the assets of the trade or business using the "residual method."

Under the residual method specified in the Treasury regulations, all assets of an acquired trade or business are divided into the following four classes: (1) Class I assets, which generally include cash and cash equivalents; (2) Class II assets, which generally include certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency; (3) Class III assets, which generally include all assets other than those included in Class I, II, or IV (generally all furniture, fixtures, land, buildings, equipment, other tangible property, accounts receivable, covenants not to compete, and other amortizable intangible assets); and (4) Class IV assets, which include intangible assets in the nature of goodwill or going concern value. The purchase price of an acquired trade or business (as first reduced by the amount of the assets included in Class I) is allocated to the assets included in Class II and Class III based on the value of the assets included in each class. To the extent that the purchase price (as reduced by the amount of the assets in Class I) exceeds the value of the assets included in Class II and Class III, the excess is allocable to assets included in Class IV.

It is expected that the present Treasury regulations which provide for the allocation of purchase price in the case of certain asset acquisitions will be amended to reflect the fact that the bill allows an amortization deduction with respect to intangible assets in the nature of goodwill and going concern value. It is anticipated that the residual method specified in the regulations will be modified to treat all amortizable section 197 intangibles as Class IV assets and that this modification will apply to any acquisition of property to which the bill applies.

Section 1060 also authorizes the Treasury Department to require the transferor and transferee in certain asset acquisitions to furnish information to the Treasury Department concerning the amount of any purchase price that is allocable to goodwill or going concern value. The bill provides that the information furnished to the Treasury Department with respect to certain asset acquisitions is to specify the amount of purchase price that is allocable to amor-

tizable section 197 intangibles rather than the amount of purchase price that is allocable to goodwill or going concern value. In addition, it is anticipated that the Treasury Department will exercise its existing regulatory authority to require taxpayers to furnish such additional information as may be necessary or appropriate to carry out the provisions of the bill, including the amount of purchase price that is allocable to intangible assets that are not amortizable section 197 intangibles.[89]

General regulatory authority

The Treasury Department is authorized to prescribe such regulations as may be appropriate to carry out the purposes of the bill including such regulations as may be appropriate to prevent avoidance of the purposes of the bill through related persons or otherwise. It is anticipated that the Treasury Department will exercise its regulatory authority where appropriate to clarify the types of intangible property that constitute section 197 intangibles.

Study

The Treasury Department is directed to conduct a continuing study of the implementation and effects of the bill, including effects on merger and acquisition activities (including hostile takeovers and leveraged buyouts). It is expected that the study will address effects of the legislation on the pricing of acquisitions and on the reported values of different types of intangibles (including goodwill). The Treasury Department is to report the initial results of such study as expeditiously as possible and no later than December 31, 1994. The Treasury Department is to provide additional reports annually thereafter.

Report regarding backlog of pending cases

The purpose of the provision is to simplify the law regarding the amortization of intangibles. The severe backlog of cases in audit and litigation is a matter of great concern, and any principles established in such cases will no longer have precedential value due to the provision. Therefore, the Internal Revenue Service is urged in the strongest possible terms to expedite the settlement of cases under present law. In considering settlements and establishing procedures for handling existing controversies in an expedient and balanced manner, the Internal Revenue Service is strongly encouraged to take into account the principles of the bill so as to produce consistent results for similarly situated taxpayers. However, no inference is intended that any deduction should be allowed in these cases for assets that are not amortizable under present law.

The Treasury Department is required to report annually to the House Ways and Means Committee and the Senate Finance Committee, regarding the volume of pending disputes in audit and litigation involving the amortization of intangibles and the progress made in resolving such disputes. It is expected that the report will also address the effects of the provision on the volume and nature

[89] There is no intention to codify any aspect of the existing regulations under section 1060 or other provisions. Furthermore, it is expected that the Treasury Department will review the operation of the regulations under sections 1060 and 338 in light of new section 197.

of disputes regarding the amortization of intangibles. The first such report shall be made no later than December 31, 1994.

Effective Date

In general

The provision generally applies to property acquired after the date of enactment of the bill. As more fully described below, however, a taxpayer may elect to apply the bill to all property acquired after July 25, 1991. In addition, a taxpayer that does not make this election may elect to apply present law (rather than the provisions of the bill) to property that is acquired after the date of enactment of the bill pursuant to a binding written contract in effect on the date of enactment of the bill and at all times thereafter until the property is acquired. Finally, special "anti-churning" rules may apply to prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under present law into amortizable property to which the bill applies.

Election to apply bill to property acquired after July 25, 1991

A taxpayer may elect to apply the bill to all property acquired by the taxpayer after July 25, 1991. If a taxpayer makes this election, the bill also applies to all property acquired after July 25, 1991, by any taxpayer that is under common control with the electing taxpayer (within the meaning of subparagraphs (A) and (B) of section 41(f)(1)) of the Code) at any time during the period that began on November 22, 1991, and that ends on the date that the election is made.[90]

The election is to be made at such time and in such manner as may be specified by the Treasury Department,[91] and the election may be revoked only with the consent of the Treasury Department.

Elective binding contract exception

A taxpayer may also elect to apply present law (rather than the provisions of the bill) to property that is acquired after the date of enactment of the bill if the property is acquired pursuant to a binding written contract that was in effect on the date of enactment of the bill and at all times thereafter until the property is acquired. This election may not be made by any taxpayer that is subject to the election described above that applies the provisions of the bill to property acquired before the date of enactment of the bill.

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[90] However, with certain exceptions, an amortization deduction is not to be allowed under the bill for goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill if: (1) the section 197 intangible is acquired after July 25, 1991; and (2) either (a) the taxpayer or a related person held or used the intangible on July 25, 1991; (b) the taxpayer acquired the intangible from a person that held such intangible on July 25, 1991, and, as part of the transaction, the user of the intangible does not change; or (c) the taxpayer grants the right to use the intangible to a person (or a person related to such person) that held or used the intangible on July 25, 1991. See below for a more detailed description of these "anti-churning" rules.

[91] It is anticipated that the Treasury Department will require the election to be made on the timely filed Federal income tax return of the taxpayer for the taxable year that includes the date of enactment of the bill.

The election is to be made at such time and in such manner as may be specified by the Treasury Department,[92] and the election may be revoked only with the consent of the Treasury Department.

Anti-churning rules

Special rules are provided by the bill to prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under present law into amortizable property to which the bill applies.

Under these "anti-churning" rules, goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill[93] may not be amortized as an amortizable section 197 intangible if: (1) the section 197 intangible is acquired by a taxpayer after the date of enactment of the bill; and (2) either (a) the taxpayer or a related person held or used the intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill; (b) the taxpayer acquired the intangible from a person that held such intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill and, as part of the transaction, the user of the intangible does not change; or (c) the taxpayer grants the right to use the intangible to a person (or a person related to such person) that held or used the intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill. The anti-churning rules, however, do not apply to the acquisition of any intangible by a taxpayer if the basis of the intangible in the hands of the taxpayer is determined under section 1014(a) (relating to property acquired from a decedent).

For purposes of the anti-churning rules, a person is related to another person if: (1) the person bears a relationship to that person which would be specified in section 267(b)(1) or 707(b)(1) of the Code if those sections were amended by substituting 20 percent for 50 percent; or (2) the persons are engaged in trades or businesses under common control (within the meaning of subparagraphs (A) and (B) of section 41(f)(1) of the Code). A person is treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the intangible involved.

In addition, in determining whether the anti-churning rules apply with respect to any increase in the basis of partnership property under section 732, 734, or 743 of the Code, the determinations are to be made at the partner level and each partner is to be treated as having owned or used the partner's proportionate share of the partnership property. Thus, for example, the anti-churning rules do not apply to any increase in the basis of partnership property that occurs upon the acquisition of an interest in a partner-

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[92] It is anticipated that the Treasury Department will require the election to be made on the timely filed Federal income tax return of the taxpayer for the taxable year that includes the date of enactment of the bill.

[93] Amounts that are properly deductible pursuant to section 1253 under present law are to be treated for purposes of the anti-churning provision as amounts for which depreciation or amortization is allowable under present law.

ship that has made a section 754 election if the person acquiring the partnership interest is not related to the person selling the partnership interest.[94]

As a further example, it is anticipated that in the case of a transaction to which section 338 of the Code applies, the corporation that is treated as selling its assets will not to be considered related to the corporation that is treated as purchasing the assets if at least 80 percent of the stock of the corporation that is treated as selling its assets is acquired by purchase after July 25, 1991.

These "anti-churning" rules are not to apply to any section 197 intangible that is acquired from a person with less than a 50-percent relationship to the acquirer to the extent that: (1) the seller recognizes gain on the transaction with respect to such intangible; and (2) the seller agrees, notwithstanding any other provision of the Code, to pay a tax on such gain which, when added to any other Federal income tax imposed on such gain, equals the product of such gain and the highest rate of tax imposed by section 1 or 11 of the Code, whichever is applicable. The seller is treated as satisfying the second requirement if the excess of (1) the total tax liability for the year of the transaction over (2) what its tax liability for such year would have been had the sale of the intangible (but not the remainder of the transaction) been excluded from the computation equals or exceeds the product of the gain on that asset times the relevant maximum rate.

The bill also contains a general anti-abuse rule that applies to any section 197 intangible that is acquired by a taxpayer from another person. Under this rule, a section 197 intangible may not be amortized under the provisions of the bill if the taxpayer acquired the intangible in a transaction one of the principal purposes of which is to (1) avoid the requirement that the intangible be acquired after the date of enactment of the bill or (2) avoid any of the anti-churning rules described above that are applicable to goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill.

Finally, the special rules described above that apply in the case of a transactions described in section 332, 351, 361, 721, 731, 1031, or 1033 of the Code also apply for purposes of the effective date. Consequently, if the transferor of any section 197 property is not allowed an amortization deduction with respect to such property under this provision, then the transferee is not allowed an amortization deduction under this provision to the extent of the adjusted basis of the transferee that does not exceed the adjusted basis of the transferor. In addition, this provision is to apply to any subsequent transfers of any such property in a transaction described in section 332, 351, 361, 721, 731, 1031, or 1033.

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[94] In addition to these rules, it is anticipated that rules similar to the anti-churning rules under section 168 of the Code will apply in determining whether persons are related. (See Prop. Treas. Reg. 1.168-4 (February 16, 1984).) For example, it is anticipated that a corporation, partnership, or trust that owned or used property at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill and that is no longer in existence will be considered to be in existence for purposes of determining whether the taxpayer that acquired the property is related to such corporation, partnership, or trust.

2. Modify special treatment of certain liquidation payments (sec. 502 of the bill and sec. 736 of the Code)

Present Law

Payments for purchase of goodwill and accounts receivable

A current deduction generally is not allowed for a capital expenditure (i.e., an expenditure that yields benefits beyond the current taxable year). The cost of goodwill acquired in connection with the assets of a going concern normally is a capital expenditure, as is the cost of acquiring accounts receivable. The cost of acquiring goodwill is recovered only when the goodwill is disposed of, while the cost of acquiring accounts receivable is taken into account only when the receivable is disposed of or becomes worthless.

Payments made in liquidation of partnership interest

The tax treatment of a payment made in liquidation of the interest of a retiring or deceased partner depends upon whether the payment is made in exchange for the partner's interest in partnership property. A liquidating payment made in exchange for such property is treated as a distribution by the partnership (sec. 736(b)). Such distribution generally results in gain to the retiring partner only to the extent that the cash distributed exceeds such partner's adjusted basis in the partnership interest.

A liquidating payment not made in exchange for the partner's interest in partnership property receives either of two possible treatments. If the amount of the payment is determined without reference to partnership income, it is treated as a guaranteed payment and is generally deductible (sec. 736(a)(2)). If the amount of payment is determined by reference to partnership income, the payment is treated as a distributive share of partnership income, thereby reducing the distributive shares of other partners (which is equivalent to a deduction) (sec. 736(a)(2)).

A special rule treats amounts paid for goodwill of the partnership (except to the extent provided in the partnership agreement) and unrealized receivables as not made in exchange for an interest in partnership property (sec. 736(b)(2)(B)). Thus, such amounts may be deductible. Unrealized receivables include unbilled amounts, accounts receivable, depreciation recapture, market discount, and certain other items (sec. 751(c)).

Sale or exchange of a partnership interest

The sale or exchange of a partnership interest results in capital gain or loss to the transferor partner, except to the extent that ordinary income or loss is recognized with respect to the partner's share of the partnership's unrealized receivables and substantially appreciated inventory items (sec. 741). It is often unclear whether a payment by a partnership to a retiring partner is made in sale or exchange of, or in liquidation of, a partnership interest.

Reasons for Simplification

In general

By treating a payment for unstated goodwill and unrealized receivables as a guaranteed payment or distributive share, present law in effect permits a deduction for an amount that would otherwise constitute a capital expenditure. This treatment does not measure partnership income properly. It also threatens to erode the rule requiring capitalization of such payments generally. Under present law, a prospective buyer of a business may structure the transaction so as to currently deduct such an amount by first entering into a partnership with the seller and then liquidating the seller's partnership interest.

Section 736 was intended to simplify the taxation of payments in liquidation. Instead, it has created confusion as to whether a particular payment is a payment in liquidation or is made pursuant to a sale of the partnership interest to the continuing partners. The proposal reduces this confusion by eliminating a primary difference between sales and liquidations.

The special treatment of goodwill was apparently predicated on the assumption that the adverse positions of the taxpayers will result in a stated price equal to the true value of the goodwill. That assumption is false. If the value of the preferential rate (if any) and the income deflection are not equal, the stated goodwill and total retirement payments will likely be set so as to maximize the combined tax savings for both retiring and continuing partners.

It is recognized, however, that general partners in service partnerships do not ordinarily value goodwill in liquidating partners. Accordingly, such partners may continue to receive the special rule of present law.

Unrealized receivables

When originally enacted, the term "unrealized receivables" was limited to unbilled amounts and accounts receivable. The tax deferral resulting from immediate deduction of amounts paid for these items is relatively short because payment is usually received in the near future. Such deferral is considerably longer, however, with respect to the deduction of other items now included in the expanded definition of unrealized receivables, such as depreciation recapture on business assets, which are slow to give rise to ordinary income.

Explanation of Provision

In general

The bill generally repeals the special treatment of liquidation payments made for goodwill and unrealized receivables. Thus, such payments would be treated as made in exchange for the partner's interest in partnership property, and not as a distributive share or guaranteed payment that could give rise to a deduction or its equivalent. The bill does not change present law with respect to payments made to a general partner in a partnership in which capital is not a material income-producing factor. The determination of whether capital is a material income-producing factor would be

made under principles of present and prior law.[95] For purposes of this provision, capital is not a material income-producing factor where substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual. The practice of his or her profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individual conducts his or her practice so long as such capital investment is merely incidental to such professional practice. In addition, the bill does not affect the deductibility of compensation paid to a retiring partner for past services.

Unrealized receivables

The bill also repeals the special treatment of payments made for unrealized receivables (other than unbilled amounts and accounts receivable) for all partners. Such amounts would be treated as made in exchange for the partner's interest in partnership property. Thus, for example, a payment for depreciation recapture would be treated as made in exchange for an interest in partnership property, and not as a distributive share or guaranteed payment that could give rise to a deduction or its equivalent.

Effective Date

The provision generally applies to partners retiring or dying on or after January 5, 1993. The provision does not apply to any partner who retires on or after January 5, 1993, if a written contract to purchase the partner's interest in the partnership was binding on January 4, 1993 and at all times thereafter until such purchase. For this purpose, a written contract is to be considered binding only if the contract specifies the amount to be paid for the partnership interest and the timing of any such payments.

[95] E.g., sections 401(c)(2) and 911(d) of the Code and old section 1348(b)(1)(A) of the Code.

TITLE VI. OTHER INCOME TAX PROVISIONS

A. Subchapter S Corporation Provisions

1. Authority to validate certain invalid elections (sec. 601 of the bill and sec. 1362 of the Code)

Present Law

Under present law, if the Internal Revenue Service determines that a corporation's Subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and shareholders agree to be treated as if the election had been in effect for that period. Present law does not grant the Internal Revenue Service the ability to waive the effect of an inadvertent invalid Subchapter S election.

In addition, under present law, a small business corporation must elect to be an S corporation no later than the 15th day of the third month of the taxable year for which the election is effective. The Internal Revenue Service may not validate a late election.

Reasons for Simplification

The provision promotes simplification by giving the Secretary the flexibility to validate an invalid S election where the failure to properly elect S status was inadvertent or untimely.

Explanation of Provision

Under the bill, the authority of the Internal Revenue Service to waive the effect of an inadvertent termination is extended to allow the Service to waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (including elections regarding qualified subchapter S trusts), or both. It is intended that the Internal Revenue Service be reasonable in granting waivers of inadvertent invalid elections so that a corporation whose election was inadvertently invalid would be treated as an S corporation as if the election had been effective.[96]

The bill also allows the Internal Revenue Service to treat a late Subchapter S election as timely where the Service determines that there was reasonable cause for the failure to make the election timely. It is intended that the Internal Revenue Service adopt a

[96] Thus, for example, the Internal Revenue Service would have authority to waive the effect of an invalid election in a situation such as that set forth in PLR 8807070 (Nov. 25, 1987) where the election was not valid because the election was filed before the issuance of a certificate of incorporation by the State.

standard similar to the standard currently set forth in Treasury regulation sec. 1.9100-1 in applying this provision.

Effective Date

The provision applies to taxable years beginning after December 31, 1982.[97]

2. Treatment of distributions by S corporations during loss year (sec. 602 of the bill and secs. 1366 and 1368 of the Code)

Present Law

Under present law, the amount of loss an S corporation shareholder may take into account for a taxable year cannot exceed the sum of the shareholder's adjusted basis in his or her stock of the corporation and the adjusted basis in any indebtedness of the corporation to the shareholder. Any excess loss is carried forward.

Any distribution to a shareholder by an S corporation generally is tax-free to the shareholder to the extent of the shareholder's adjusted basis of his or her stock. The shareholder's adjusted basis is reduced by the tax-free amount of the distribution. Any distribution in excess of the shareholder's adjusted basis is treated as gain from the sale or exchange of the stock.

Under present law, income (whether or not taxable) and expenses (whether or not deductible) serve, respectively, to increase and decrease an S corporation shareholder's basis in the stock of the corporation. These rules appear to require that the adjustments to basis for items of both income and loss for any taxable year apply before the adjustment for distributions applies.[98]

These rules limiting losses and allowing tax-free distributions up to the amount of the shareholder's adjusted basis are similar in certain respects to the rules governing the treatment of losses and cash distributions by partnerships. Under the partnership rules (unlike the S corporation rules), for any taxable year, a partner's basis is first increased by items of income, then decreased by distributions, and finally is decreased by losses for that year.[99]

In addition, if the S corporation has accumulated earnings and profits,[100] any distribution in excess of the amount in an "accumulated adjustments account" will be treated as a dividend (to the extent of the accumulated earnings and profits). A dividend distribution does not reduce the adjusted basis of the shareholder's stock. The "accumulated adjustments account" generally is the amount of the accumulated undistributed post-1982 gross income less deductions.

Reasons for Simplification

The provision promotes simplification by conforming the S corporation rules regarding distributions to the partnership rules and by

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[97] This is the effective date of the present-law provision regarding inadvertent terminations.

[98] See section 1366(d)(1)(A); H. Rep. 97-826, p. 17; S. Rep. 97-640, p. 18; Prop. Treas. Reg. sec. 1.1367-1(e).

[99] Treas. Reg. sec. 1.704-1(d)(2); Rev. Rul. 66-94, 1966-1 C.B. 166.

[100] An S corporation may have earnings and profits from years prior to its subchapter S election or from pre-1983 subchapter S years.

eliminating uncertainty regarding the treatment of distributions made during the year.

Explanation of Provision

The bill provides that the adjustments for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for the year. Thus, distributions during a year reduce the adjusted basis for purposes of determining the allowable loss for the year, but the loss for a year does not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year.

The bill also provides that in determining the amount in the accumulated adjustment account for purposes of determining the tax treatment of distributions made during a taxable year by an S corporation having accumulated earnings and profits, net negative adjustments (i.e., the excess of losses and deductions over income) for that taxable year are disregarded.

The following examples illustrate the application of these provisions:

Example 1.—X is the sole shareholder of corporation A, a calendar year S corporation with no accumulated earnings and profits. X's adjusted basis in the stock of A on January 1, 1995, is $1,000 and X holds no debt of A. During 1995, A makes a distribution to X of $600, recognizes a capital gain of $200 and sustains an operating loss of $900. Under the bill, X's adjusted basis in the A stock is increased to $1,200 ($1,000 plus $200 capital gain recognized) pursuant to section 1368(d) to determine the effect of the distribution. X's adjusted basis is then reduced by the amount of the distribution to $600 ($1,200 less $600) to determine the application of the loss limitation of section 1366(d)(1). X is allowed to take into account $600 of A's operating loss, which reduces X's adjusted basis to zero. The remaining $300 loss is carried forward pursuant to section 1366(d)(2).

Example 2.—The facts are the same as in Example 1, except that on January 1, 1995, A has accumulated earnings and profits of $500 and an accumulated adjustments account of $200. Under the bill, because there is a net negative adjustment for the year, no adjustment is made to the accumulated adjustments account before determining the effect of the distribution under section 1368(c).

As to A, $200 of the $600 distribution is a distribution of A's accumulated adjustments account, reducing the accumulated adjustments account to zero. The remaining $400 of the distribution is a distribution of accumulated earnings and profits ("E&P") and reduces A's E&P to $100. A's accumulated adjustments account is then increased by $200 to reflect the recognized capital gain and reduced by $900 to reflect the operating loss, leaving a negative balance in the accumulated adjustment account on January 1, 1996, of $700 (zero plus $200 less $900).

As to X, $200 of the distribution is applied against X's adjusted basis of $1,200 ($1,000 plus $200 capital gain recognized), reducing X's adjusted basis to $1,000. The remaining $400 of the distribution is taxable as a dividend and does not reduce X's adjusted basis. Because X's adjusted basis is $1,000, the loss limitation does not apply

to X, who may deduct the entire $900 operating loss. X's adjusted basis is then decreased to reflect the $900 operating loss. Accordingly, X's adjusted basis on January 1, 1996, is $100 ($1,000 plus $200 less $200 less $900).

Effective Date

These provisions apply to distributions made in taxable years beginning after December 31, 1992.

3. Treatment of S corporations as shareholders in C corporations (sec. 603(a) of the bill and sec. 1371 of the Code)

Present Law

Present law contains several provisions relating to the treatment of S corporations as corporations generally for purposes of the Internal Revenue Code.

First, under present law, the taxable income of an S corporation is computed in the same manner as in the case of an individual (sec. 1363(b)). Under this rule, the provisions of the Code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction, do not apply to S corporations.

Second, except as otherwise provided by the Internal Revenue Code and except to the extent inconsistent with subchapter S, subchapter C (i.e., the rules relating to corporate distributions and adjustments) applies to an S corporation and its shareholders (sec. 1371(a)(1)). Under this second rule, provisions such as the corporate reorganization provisions apply to S corporations. Thus, a C corporation may merge into an S corporation tax-free.

Finally, an S corporation in its capacity as a shareholder of another corporation is treated as an individual for purposes of subchapter C (sec. 1371(a)(2)). The Internal Revenue Service has taken the position that this rule prevents the tax-free liquidation of a C corporation into an S corporation because a C corporation cannot liquidate tax-free when owned by an individual shareholder.[101] Thus, a C corporation may elect S corporation status tax-free or may merge into an S corporation tax-free, but may not liquidate into an S corporation tax-free.[102] Also, the Service's reasoning would prevent an S corporation from making an election under section 338 where a C corporation was acquired by an S corporation.

Reasons for Simplification

The provision promotes simplification by treating similar transactions in a similar manner for tax purposes.

Explanation of Provision

The bill repeals the rule that treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus,

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[101] See PLR 8818049, (Feb. 10, 1988). However, see PLR 9245004, (July 28, 1992) for a contrary ruling.

[102] A tax is imposed with respect to LIFO inventory held by a C corporation becoming an S corporation.

the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules, including the provisions of sections 332 and 337 allowing the tax-free liquidation of a corporation into its parent corporation. Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax under section 1374 upon a subsequent disposition. An S corporation will also be eligible to make a section 338 election (assuming all the requirements are otherwise met), resulting in immediate recognition of all the acquired C corporation's gains and losses (and the resulting imposition of a tax).

The repeal of this rule does not change the general rule governing the computation of income of an S corporation. For example, it does not allow an S corporation, or its shareholders, to claim a dividends received deduction with respect to dividends received by the S corporation, or to treat any item of income or deduction in a manner inconsistent with the treatment accorded to individual taxpayers.

No inference is intended regarding the present-law treatment of these transactions.

Effective Date

The provision takes effect on date of enactment.

4. S corporations permitted to hold subsidiaries (sec. 603(b) of the bill and sec. 1361 of the Code)

Present Law

Under present law, an S corporation may not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). The legislative history indicates that this rule was adopted to prevent the filing of consolidated returns by a group which includes an S corporation.[103]

Reasons for Simplification

The provision promotes simplification by eliminating a barrier to using the S corporation form of entity and providing more appropriate treatment of corporations with subsidiaries, i.e., the prohibition of filing a consolidated return if S corporate status is elected rather than disqualification of the S election.

Explanation of Provision

The bill repeals the rule that an S corporation may not be a member of an affiliated group of corporations. Thus, an S corporation will be allowed to own up to 100 percent of the stock of a C corporation. However, an S corporation cannot be included in a group filing a consolidated return.

Under the bill, if an S corporation holds 100 percent of the stock of a C corporation that, in turn, holds 100 percent of the stock of another C corporation, the two C corporations may elect to file a

[103] See S. Rpt. No. 1983 (85th Cong., 2d Sess., 1958), p. 88.

consolidated return (if otherwise eligible), but the S corporation may not join in the election.

Effective Date

The provision takes effect on date of enactment.

5. Elimination of pre-1983 earnings and profits of S corporations (sec. 603(c) of the bill)

Present Law

Under present law, the accumulated earnings and profits of a corporation are not increased for any year in which an election to be treated as an S corporation is in effect. However, under the subchapter S rules in effect before revision in 1982, a corporation electing subchapter S for a taxable year increased its accumulated earnings and profits if its earnings and profits for the year exceeded both its taxable income for the year and its distributions out of that year's earnings and profits. As a result of this rule, a shareholder may later be required to include in his income the accumulated earnings and profits when it is distributed by the corporation. The 1982 revision to subchapter S repealed this rule for earnings attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.

Reasons for Simplification

The provision promotes simplification by eliminating the need to keep records of certain generally small amounts of earnings arising before 1983.

Explanation of Provision

The bill provides that if a corporation is an S corporation for its first taxable year beginning after December 31, 1992, the accumulated earnings and profits of the corporation as of the beginning of that year are reduced by the accumulated earnings and profits (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S. Thus, such a corporation's accumulated earnings and profits will be solely attributable to taxable years for which an S election was not in effect. This rule is generally consistent with the change adopted in 1982 limiting the S shareholder's taxable income attributable to S corporation earnings to his share of the taxable income of the S corporation.

Effective Date

The provision applies to taxable years beginning after December 31, 1992.

6. Treatment of items of income in respect of a decedent held by an S corporation (sec. 603(d) of the bill and sec. 1367 of the Code)

Present Law

Income in respect of a decedent (IRD) generally consists of items of gross income that accrued during the decedent's lifetime but were not yet includible in the decedent's income before his death under his method of accounting. IRD is includible in the income of the person acquiring the right to receive such item. A deduction for the estate tax attributable to an item of IRD is allowed to the person who includes the item in gross income (sec. 691(c)). The cost or basis of property acquired from a decedent is its fair market value at the date of death (or alternate valuation date if that date is elected for estate tax purposes). This basis often is referred to as a "stepped-up basis". Property that constitutes a right to receive IRD does not receive a stepped-up basis.

The basis of a partnership interest or corporate stock acquired from a decedent generally is stepped-up at death. Under Treasury regulations, the basis of a partnership interest acquired from a decedent is reduced to the extent that its value is attributable to items constituting IRD.[104] Although S corporation income is included in the income of the shareholders in a manner similar to the inclusion of partnership income in the income of the partners, no comparable regulation provides for a reduction in the basis of stock of an S corporation acquired from a decedent where the S corporation holds items of IRD on the date of death of a shareholder. Thus, under present law, the treatment of an item of IRD held by an S corporation is unclear.

Reasons for Simplification

The provision promotes simplification by eliminating the uncertainty of present law, and by treating items of IRD held by a taxpayer directly, through a partnership, or through an S corporation in a similar manner.

Explanation of Provision

The bill provides that a person acquiring stock in an S corporation from a decedent will treat as IRD his pro rata share of any item of income of the corporation which would have been IRD if that item had been acquired directly from the decedent. Where a item is treated as IRD, a deduction for the estate tax attributable to the item generally will be allowed under the provisions of section 691(c). The stepped-up basis in the stock will be reduced by the extent to which the value of the stock is attributable to items consisting of IRD. This basis rule is comparable to the present-law partnership rule.

No inference is intended regarding the present-law treatment of IRD in the case of S corporations.

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[104] Treas. Reg. sec. 1.742-1.

Effective Date

The provision applies with respect to decedents dying after date of enactment of the bill.

B. Accounting Provisions

1. Modifications to the look-back method for long-term contracts (sec. 611 of the bill and sec. 460 of the Code)

Present Law

Taxpayers engaged in the production of property under a long-term contract generally must compute income from the contract under the percentage of completion method. Under the percentage of completion method, a taxpayer must include in gross income for any taxable year an amount that is based on the product of (1) the gross contract price and (2) the percentage of the contract completed as of the end of the year. The percentage of the contract completed as of the end of the year is determined by comparing costs incurred with respect to the contract as of the end of the year with the estimated total contract costs.

Because the percentage of completion method relies upon estimated, rather than actual, contract price and costs to determine gross income for any taxable year, a "look-back method" is applied in the year a contract is completed in order to compensate the taxpayer (or the Internal Revenue Service) for the acceleration (or deferral) of taxes paid over the contract term. The first step of the look-back method is to reapply the percentage of completion method using actual contract price and costs rather than estimated contract price and costs. The second step generally requires the taxpayer to recompute its tax liability for each year of the contract using gross income as reallocated under the look-back method. If there is any difference between the recomputed tax liability and the tax liability as previously determined for a year, such difference is treated as a hypothetical underpayment or overpayment of tax to which the taxpayer applies a rate of interest equal to the overpayment rate, compounded daily.[105] The taxpayer receives (or pays) interest if the net amount of interest applicable to hypothetical overpayments exceeds (or is less than) the amount of interest applicable to hypothetical underpayments.

The look-back method must be reapplied for any item of income or cost that is properly taken into account after the completion of the contract.

The look-back method does not apply to any contract that is completed within two taxable years of the contract commencement date and if the gross contract price does not exceed the lesser of (1) $1 million or (2) one percent of the average gross receipts of the taxpayer for the preceding three taxable years. In addition, a simplified look-back method is available to certain pass-through entities and, pursuant to Treasury regulations, to certain other taxpayers. Under the simplified look-back method, the hypothetical un-

[105] The overpayment rate equals the applicable Federal short-term rate plus two percentage points. This rate is adjusted quarterly by the IRS. Thus, in applying the look-back method for a contract year, a taxpayer may be required to use five different interest rates.

derpayment or overpayment of tax for a contract year generally is determined by applying the highest rate of tax applicable to such taxpayer to the change in gross income as recomputed under the look-back method.

Reasons for Simplification

Present law may require multiple applications of the look-back method with respect to a single contract or may otherwise subject contracts to the look-back method even though the amounts necessitating the look-back computations are de minimis relative to the aggregate contract income. In addition, the use of multiple interest rates complicates the mechanics of the look-back method.

Explanation of Provision

Election not to apply the look-back method for de minimis amounts

The bill provides that a taxpayer may elect not to apply the look-back method with respect to a long-term contract if for each prior contract year, the cumulative taxable income (or loss) under the contract as determined using estimated contract price and costs is within 10 percent of the cumulative taxable income (or loss) as determined using actual contract price and costs.

Thus, under the election, upon completion of a long-term contract, a taxpayer would be required to apply the first step of the look-back method (the reallocation of gross income using actual, rather than estimated, contract price and costs), but would not be required to apply the additional steps of the look-back method if the application of the first step resulted in de minimis changes to the amount of income previously taken into account for each prior contract year.

The election applies to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Example 1.—A taxpayer enters into a three-year contract and upon completion of the contract, determines that annual net income under the contract using actual contract price and costs is $100,000, $150,000, and $250,000, respectively, for Years 1, 2, and 3 under the percentage of completion method. An electing taxpayer need not apply the look-back method to the contract if it had reported cumulative net taxable income under the contract using estimated contract price and costs of between $90,000 and $110,000 as of the end of Year 1; and between $225,000 and $275,000 as of the end of Year 2.

Election not to reapply the look-back method

The bill provides that a taxpayer may elect not to reapply the look-back method with respect to a contract if, as of the close of any taxable year after the year the contract is completed, the cumulative taxable income (or loss) under the contract is within 10 percent of the cumulative look-back income (or loss) as of the close of the most recent year in which the look-back method was applied

(or would have applied but for the other de minimis exception described above). In applying this rule, amounts that are taken into account after completion of the contract are not discounted.

Thus, an electing taxpayer need not apply or reapply the look-back method if amounts that are taken into account after the completion of the contract are de minimis.

The election applies to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Example 2.—A taxpayer enters into a three-year contract and reports taxable income of $12,250, $15,000 and $12,750, respectively, for Years 1 through 3 with respect to the contract. Upon completion of the contract, cumulative look-back income with respect to the contract is $40,000, and 10 percent of such amount is $4,000. After the completion of the contract, the taxpayer incurs additional costs of $2,500 in each of the next three succeeding years (Years 4, 5, and 6) with respect to the contract. Under the bill, an electing taxpayer does not reapply the look-back method for Year 4 because the cumulative amount of contract taxable income ($37,500) is within 10 percent of contract look-back income as of the completion of the contract ($40,000). However, the look-back method must be applied for Year 5 because the cumulative amount of contract taxable income ($35,000) is not within 10 percent of contract look-back income as of the completion of the contract ($40,000). Finally, the taxpayer does not reapply the look-back method for Year 6 because the cumulative amount of contract taxable income ($32,500) is within 10 percent of contract look-back income as of the last application of the look-back method ($35,000).

Interest rates used for purposes of the look-back method

The bill provides that for purposes of the look-back method, only one rate of interest is to apply for each accrual period. An accrual period with respect to a taxable year begins on the day after the return due date (determined without regard to extensions) for the taxable year and ends on such return due date for the following taxable year. The applicable rate of interest is the overpayment rate in effect for the calendar quarter in which the accrual period begins.

Effective Date

The provisions apply to contracts completed in taxable years ending after the date of enactment.

2. Simplified method for applying uniform cost capitalization rules (sec. 612 of the bill and sec. 263A of the Code)

Present Law

In general, the uniform cost capitalization rules require taxpayers that are engaged in the production of real or tangible personal property or in the purchase and holding of property for resale to capitalize or include in inventory the direct costs of the property

and the indirect costs that are allocable to the property. In determining whether indirect costs are allocable to production or resale activities, taxpayers are allowed to use various methods so long as the method employed reasonably allocates indirect costs to production and resale activities.

Reasons for Simplification

The uniform cost capitalization rules require taxpayers to determine for each taxable year the costs of each administrative, service, or support function or department that are allocable to production or resale activities. If a taxpayer does not elect any of the simplified methods provided in Treasury regulations, this allocation may be unduly burdensome and costly.

Explanation of Provision

The bill authorizes (but does not require) the Treasury Department to issue regulations that allow taxpayers in appropriate circumstances to determine the costs of any administrative, service, or support function or department that are allocable to production or resale activities by multiplying the total amount of costs of any such function or department by a fraction, the numerator of which is the amount of costs of the function or department that was allocable to production or resale activities for a base period and the denominator of which is the total amount of costs of the function or department for the base period. It is anticipated that the regulations will provide that the base period is to begin no earlier than 4 taxable years prior to the taxable year with respect to which this simplified method applies.

Effective Date

The provision applies to taxable years beginning after the date of enactment of the bill. Thus, the regulations may permit the use of the simplified method for taxable years beginning after this date. The simplified method, however, may not be used for any taxable year that begins prior to the date that the Treasury Department publishes regulations that authorize the use of the simplified method and set forth the requirements that must be satisfied in order for the method to be used.

C. Provisions Relating to Regulated Investment Companies

1. Repeal the short-short test for regulated investment companies (sec. 621 of the bill and sec. 851(b)(3) of the Code)

Present Law

A regulated investment company ("RIC") is treated, in essence, as a conduit for Federal income tax purposes. If a corporation qualifies as a RIC, it is allowed a deduction for dividends paid (or deemed paid) to its shareholders (sec. 852(b)). Thus, no corporate level tax is payable on earnings of a RIC distributed (or deemed distributed) to its shareholders.

In order for a corporation to qualify as a RIC, a corporation must elect such status and must satisfy certain tests (sec. 851(b)). In par-

ticular, a corporation must derive less than 30 percent of its gross income from the sale or disposition of certain investments (including stock, securities, options, futures, and forward contracts) held less than 3 months (the "short-short test") (sec. 851(b)(3)).

Reasons for Simplification

The short-short test restricts the investment flexibility of RICs. The test can, for example, limit a RIC's ability to "hedge" its investment (e.g., to use options to protect against adverse market moves).

The test also burdens a RIC with significant recordkeeping, compliance, and administration costs. The RIC must keep track of the holding periods of assets and the relative percentages of short-term and long-term gain that it realizes throughout the year.

Explanation of Provision

The bill repeals the short-short test.

Effective Date

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

2. Require brokers and mutual funds to report basis to customers (sec. 622 of the bill and secs. 1012 and 6045 of the Code)

Present Law

Information returns

Brokers [106] are required to report to the Internal Revenue Service the gross proceeds from sales and exchanges by customers (sec. 6045(a)). Brokers also must give each customer a written statement containing that information by January 31 of the year following the calendar year the transaction occurred (sec. 6045(b)).[107]

Gain or loss from the sale of mutual fund shares

A taxpayer who sells or exchanges mutual fund shares is required to report the gain or loss along with any other capital gains or losses. A taxable sale or exchange includes a direct redemption or sale, a check written on a fund, or exchanges from one fund into another fund.

The amount of gain or loss is the difference between the amount the taxpayer realized from the sale or exchange and the taxpayer's adjusted basis in the shares (sec. 1001). In general, the amount a taxpayer realizes from a sale or exchange of shares is the money and value of any property received for the shares minus expenses (such as sales commissions, sales charges, or exit fees). A taxpayer's

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[106] Under section 6045, "broker" is defined to include dealers, barter exchanges, and any other person who, for a consideration, regularly acts as a middleman with respect to property or services. Under the regulations, the term is defined to include mutual funds that deal directly with customers (i.e., mutual funds that stand ready to redeem their shares). The term "broker" has this meaning for purposes of this section.

[107] Brokers are required to use Form 1099-B, Statement for Recipients of Proceeds From Broker and Barter Exchange Transactions (or an IRS-authorized substitute) for these reporting purposes.

adjusted basis generally is his original cost (including any sales charges or "load") or other basis adjusted for such things as wash sales and return of capital distributions.

A taxpayer who sells any of his shares may choose one of three methods to determine the adjusted basis of the shares that were sold (Treas. Reg. secs. 1.1012-1(c) and (e)):

(1) the first-in, first-out (FIFO) method which requires the taxpayer to assume that the first shares sold were the first ones purchased by the taxpayer;

(2) the specific identification method which permits the taxpayer to identify exactly which shares were sold—but the method is available only if, at the time of sale, the taxpayer specified to the broker the particular shares to be sold and the broker confirms such specification in a written document within a reasonable time after the sale; or

(3) the average cost method which permits the taxpayer to calculate his gain or loss based on the average price he paid for his shares. The average cost method may be determined either by the single category method (which uses the average cost of all of the taxpayer's shares and determines the holding period for the shares that are sold on a first-in first-out basis) or the double category method (which separates the taxpayer's shares into long-term and short-term holdings and provides a separate average cost for each category). A taxpayer may elect the average cost method by attaching a statement to his return. Once the taxpayer elects the average cost method, the taxpayer must use that method for all of his accounts in that fund.

The wash sale rule provides that a loss sustained upon a sale or other disposition of stock or securities is not allowed if, within a period beginning 30 days before the date of the sale or disposition and ending 30 days after that date, the taxpayer has acquired, or has entered into a contract or option to acquire, substantially identical stock or securities (sec. 1091). The load basis deferral rule provides that, under certain circumstances, a load charge on a mutual fund will not be taken into account as part of the purchaser's basis for purposes of computing profit or loss on a sale of the mutual fund shares (sec. 852(f)). The rule applies only if the mutual fund shares are sold before the 91st day following their purchase and where the purchaser subsequently purchases mutual fund shares pursuant to a reinvestment right he received when he bought the original shares. The basis disallowance of the load charge applies to the extent the charge does not exceed the reduction in the load charge for the new purchase.

Reasons for Simplification

Many mutual fund investors engage in a large number of transactions in mutual fund shares. For example, some taxpayers purchase mutual fund shares periodically through participation in dividend reinvestment or payroll deduction plans. Other taxpayers, such as retired individuals, frequently sell shares to pay current expenses. Because of the many purchases or sales in different amounts, at different times, and at different prices, taxpayers frequently have difficulty in calculating gain or loss upon the sale of

mutual fund shares. In many cases, these calculations require taxpayers to retain accurate records for many years.

Explanation of Provision

Information returns

In general.—The bill requires brokers that are currently required to report gross proceeds on sales or exchanges of mutual fund shares to report basis and holding-period information on the same information return. Those brokers that are not currently required to report gross proceeds, such as money market mutual funds, are not required by the bill to report basis information.

Required basis information.—For each sale or exchange, a broker is required to report the basis of the shares that have been sold and the portion of the gross proceeds for the shares that have been held for more than 1 year. Basis is determined using the single-category average cost basis method (and not the double-category). The bill also provides the Secretary of the Treasury authority to determine the manner in which basis and holding period are to be reported. Such authority includes the authority to require brokers to take into account commissions, wash sales, return of capital distributions, and other events that might affect a basis calculation. Such authority also includes the authority to permit brokers to report the basis information for each sale or exchange in an aggregate form.

Multiple accounts.—The bill requires the basis calculation to be done on an account-by-account basis. If an individual holds shares in two separate accounts with a mutual fund, then a separate basis calculation must be done for each account. In addition, if a customer holds shares in two mutual funds through a securities broker (rather than directly through the mutual funds themselves), the shares for each mutual fund (i.e., for each position) must be considered separate accounts for purposes of these rules.

Due date of returns.—Under the bill, information returns are required to be sent to shareholders by January 31, which is, under present law, the same date by which the information returns for gross proceeds must be provided to taxpayers. The bill contemplates that amended basis information returns may be necessary in certain cases.

Treasury is authorized to promulgate regulations to require a transfer of information between brokers (including RICs) where the transfer is necessary to comply with the reporting requirements of this section. For example, if a broker holds shares in a mutual fund as a nominee for another person and the shares are transferred to another broker, the old broker would be required to furnish the new broker the information necessary for the new broker to meet the information-reporting requirements.

The Internal Revenue Service is expected to consult with representatives of the industries affected by the basis reporting provision to develop the regulations necessary to implement the provision.

Gain or loss from the sale of mutual fund shares

The bill generally requires a taxpayer to calculate basis and adjustments to basis as under present law. However, unless a taxpayer elects otherwise, a taxpayer must determine basis for mutual fund shares by using the single-category average basis of all of the shares of the account from which a sale or exchange was made (which generally is the amount required to be reported by the broker).

Under the bill, a taxpayer can elect a method other than the single-category average basis (i.e., FIFO or specific identification) if he made such an election on his return for the first taxable year in which a sale from the account occurs (and he satisfied present law requirements). In addition, under the bill, a taxpayer can elect different methods for different accounts in the same fund.

Coordination with wash sale and load basis deferral rules

The bill modifies the wash sale rules for certain sales of shares from an account covered by the new provision. Losses that are sustained from a sale of shares in December will not be disallowed by reason of a purchase after January 15 of additional shares through a dividend reinvestment program that the shareholder had elected at the time the account was opened or, if later, at least 6 months before the date of the sale.

The bill also modifies the load basis deferral rule when the rule is triggered by a purchase after January 15 of the calendar year following the original sale. Under these circumstances, the load charge described in the rule is permitted to be taken into account in determining the amount of gain or loss on the original sale, and the load charge is included as short-term capital gain for the taxable year of the purchase.

Effective Date

The provision is effective for mutual fund shares held in accounts opened on or after January 1, 1995. For example, if prior to the effective date a taxpayer holds shares in mutual fund B in an account maintained by a securities broker and holds shares in mutual fund F directly from the fund, additions to either of those positions after January 1, 1995, would not trigger the basis reporting requirement. If, however, after January 1, 1995, the taxpayer purchased shares in mutual fund F through the securities broker, or through a new account opened with mutual fund F, a new position would have been opened and basis reporting would be required on that new position.

The provision is not applicable, however, to shares in an account that includes shares not acquired by purchase. Thus, the provision does not apply to shares in an account opened after January 1, 1995, that includes shares that had been acquired by gift. The basis in such shares is determined as under present law.

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3. Permit common trust funds to convert to regulated investment companies without taxation (sec. 623 of the bill and 584 of the Code)

Present Law

A common trust fund is a fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, guardian, or custodian of certain accounts and in conformity with rules and regulations of the Board of Governors of the Federal Reserve System or the Comptroller of the Currency pertaining to the collective investment of trust funds by national banks (sec. 584(a)).

The common trust fund of a bank is not subject to tax and is not treated as a corporation (sec. 584(b)). Each participant in a common trust fund includes his proportional share of common trust fund income, whether or not the income is distributed or distributable (sec. 584(c)).

No gain or loss is realized by the fund upon admission or withdrawal of a participant. Participants generally treat their admission to the fund as the purchase of an interest. Withdrawals from the fund generally are treated as the sale of an interest by the participant (sec. 584(e)).

A RIC also is treated as a conduit for Federal income tax purposes. Present law is unclear as to the tax consequences when a common trust fund transfers its assets, or converts its status, to a RIC.

Reasons for Simplification

Banks are inhibited from converting common trust funds into RICs by the possibility of the merger being taxable and by State laws that treat the triggering of an income tax on trust fund participants as a breach of the banks' fiduciary obligations. It is believed that common trust funds should be permitted to transfer their assets on a tax-free basis to a RIC, subject to certain limitations.

Explanation of Provision

In general, the bill permits a common trust fund to transfer substantially all of its assets to a RIC without gain or loss being recognized by the fund or its participants. The fund must transfer its assets to the RIC solely in exchange for shares of the RIC, and the fund must then distribute the RIC shares to the fund's participants in exchange for the participant's interests in the fund.

In determining whether a transfer is solely in exchange for shares of the RIC, the assumption of liabilities by the RIC is to be ignored. A special rule, however, requires gain to be recognized to the extent the assumed liabilities exceed the aggregate adjusted bases (in the hands of the common trust fund) of the assets transferred to the RIC.

The basis of any asset that is received by the RIC will be the basis of the asset in the hands of the fund prior to transfer (in-

creased by the amount of gain recognized by reason of the rule regarding the assumption of liabilities). In addition, the basis of any RIC shares that are received by a fund participant will be the participant's basis in the interests exchanged (increased by the amount of gain recognized by reason of the rule regarding the assumption of liabilities).

The tax-free transfer is not available to a common trust fund with assets that are not diversified under the requirements of section 368(a)(2)(F)(ii), except that the diversification test is modified so that Government securities are not to be included as securities of an issuer and are to be included in determining total assets for purposes of the 25 and 50 percent tests.

No inference is intended as to the tax consequences under present law when a common trust fund transfers its assets, or converts its status, to a RIC.

Effective Date

The provision is effective for transfers after the date of enactment.

D. Tax-Exempt Bond Provisions

Overview

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

Unlike the interest on governmental bonds, described above, interest on private activity bonds generally is taxable. A private activity bond is a bond issued by a State or local governmental unit acting as a conduit to provide financing for private parties in a manner violating either (1) a private business use and payment test or (2) a private loan restriction. However, interest on private activity bonds is not taxable if (1) the financed activity is specified in the Code and (2) at least 95 percent of the net proceeds of the bond issue is used to finance the specified activity.

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

1. Simplification of arbitrage rebate requirement for governmental bonds (sec. 631 of the bill and sec. 148 of Code)

Present Law

Subject to limited exceptions, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. No rebate is required if the gross proceeds of an issue are spent for the governmental purpose of the borrowing within six months after issuance.

This six-month exception is deemed to be satisfied by issuers of governmental bonds (other than tax and revenue anticipation notes) and qualified 501(c)(3) bonds if (1) all proceeds other than an amount not exceeding the lesser of five percent or $100,000 are so spent within six months and (2) the remaining proceeds are spent within one year after the bonds are issued.

Reasons for Simplification

The principal Federal policy concern underlying the arbitrage rebate requirement is to discourage the earlier and larger than necessary issuance of tax-exempt bonds to take advantage of the opportunity to profit by investing funds borrowed at low-cost tax-exempt rates in higher yielding taxable investments. If at least 95 percent of the proceeds of an issue is spent within six months, and the remainder is spent within one year, opportunities for such arbitrage profit are significantly limited.

Explanation of Provision

The $100,000 limit on proceeds that may remain unspent after six months for certain governmental and qualified 501(c)(3) bonds otherwise exempt from the rebate requirement is deleted. Thus, if at least 95 percent of the proceeds of these bonds is spent within six months after their issuance, and the remainder is spent within one year, the six-month exception is deemed to be satisfied.

Effective Date

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

2. Simplification of compliance with 24-month arbitrage rebate exception for construction bonds (sec. 632 of the bill and sec. 148 of the Code)

Present Law

In general, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. An exception is provided for certain construction bond issues if the bonds are governmental bonds, qualified 501(c)(3) bonds, or exempt-facility private activity bonds for governmentally owned property.

This exception is satisfied only if the available construction proceeds of the issue are spent at minimum specified rates during the 24-month period after the bonds are issued. The exception does not apply to bond proceeds invested after the 24-month expenditure period as part of a reasonably required reserve or replacement fund, a bona fide debt service fund, or to certain other investments (e.g., sinking funds). Issuers of these construction bonds also may elect to comply with a penalty regime in lieu of rebating arbitrage profits if they fail to satisfy the exception's spending requirements.

Reasons for Simplification

Bond proceeds invested in a bona fide debt service fund generally must be spent at least annually for current debt service. The short-term nature of investments in such funds results in only limited potential for generating arbitrage profits. If the spending requirements of the 24-month rebate exception are satisfied, the administrative complexity of calculating rebate on these proceeds outweighs the other Federal policy concerns addressed by the rebate requirement.

Explanation of Provision

The bill exempts earnings on bond proceeds invested in bona fide debt service funds from the arbitrage rebate requirement and the penalty requirement of the 24-month exception if the spending requirements of that exception are otherwise satisfied.

Effective Date

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

3. Simultaneous issuance of certain discrete issues not aggregated (sec. 633 of the bill and sec. 148 of the Code)

Present Law

In certain cases, the Treasury Department treats multiple issues of tax-exempt bonds paid from substantially the same source of funds as a single issue in applying the Code's tax-exempt bond restrictions when the bonds are issued within a relatively short period of time (31 days).

Reasons for Simplification

Requiring issuers that simultaneously issue discrete issues of tax and revenue anticipation notes ("TRANs") and other governmental bonds to separate issuance of these bonds by 31 days adds administrative complexity and increases costs of issuance.

Explanation of Provision

The bill provides that discrete issues of governmental bonds issued simultaneously will not be treated as a single issue in cases where one of the issues is a TRAN reasonably expected to satisfy the arbitrage rebate safe harbor of section 148(f)(4)(B)(iii).

Effective Date

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

No inference is intended by this effective date as to the proper treatment of any bonds issued before the date of the provision's enactment.

4. Repeal of unrelated and disproportionate use limit (sec. 634 of the bill and sec. 141(b) of the Code)

Present Law

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

Reasons for Simplification

Whether a private business use is "related" to a governmental activity also being financed with a bond issue may be a complex facts and circumstances determination. In light of the general ten-percent limit on private business use, the private loan restriction, and the State volume limit allocation requirement for larger governmental bond issues, the complexity associated with this determination may be eliminated without sacrificing the Federal policy of strictly limiting use of governmental bond proceeds to finance private activities not specifically approved by the Congress.

Explanation of Provision

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

Effective Date

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

5. Simplification of arbitrage rebate requirement for smaller issuers of governmental bonds (sec. 635 of the bill and sec. 148 of Code)

Present Law

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

Reasons for Simplification

The Federal policy addressed by the arbitrage rebate requirement is the elimination of earlier and larger issuance of tax-exempt bonds than necessary to obtain a financial advantage by investing funds borrowed at lower tax-exempt rates in higher yielding taxable investments. The exception from the arbitrage rebate

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

Explanation of Provision

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

Effective Date

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

6. Repeal of 150-percent of debt service limit (sec. 636 of the bill and sec. 148 of the Code)

Present Law

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

Except for temporary periods and amounts held pending use to pay current debt service, present law also limits the amount of the proceeds of private activity bonds (other than qualified 501(c)(3) bonds) that may be invested at materially higher yields at any time during a bond year to 150 percent of the debt service for that bond year. This restriction affects primarily investments in reasonably required reserve or replacement funds. Present law further restricts the amount of proceeds from the sale of bonds that may be invested in these reserve funds to ten percent of such proceeds. The second set of arbitrage restrictions requires generally that all arbitrage profits earned on investments unrelated to the governmental purpose of the borrowing be rebated to the Federal Government. Arbitrage profits include all earnings (in excess of bond yield) derived from the investment of bond proceeds (and subsequent earnings on any such earnings).

Reasons for Simplification

The 150-percent of debt service limit was enacted before enactment of the arbitrage rebate requirement and the ten-percent limit on the size of reasonably required reserve or replacement funds. It was intended to eliminate arbitrage-motivated activities available

from investment of such reserve funds. Provided that comprehensive yield restriction and rebate requirements and the present-law overall size limit on reserve funds are maintained, the 150-percent of debt service yield restriction limit may be viewed as duplicative.

Explanation of Provision

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

Effective Date

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

7. Repeal of expired provisions (sec. 637 of the bill and sec. 148 of the Code)

Present Law

Present law includes two special exceptions to the arbitrage rebate and pooled financing temporary period rules for certain qualified student loan bonds. These exceptions applied only to bonds issued before January 1, 1989.

Explanation of Provision

These special exceptions are deleted as "deadwood."

Effective Date

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

8. Clarification of definition of "investment-type property" (sec. 638 of the bill and sec. 148 (b)(2) of the Code)

Present Law

Interest on State and local government bonds is not tax-exempt if the bonds are arbitrage bonds. A bond generally is an arbitrage bond if the proceeds are invested in materially higher yielding "investment-type property," other than during prescribed temporary periods or as a part of a reasonably required reserve or replacement fund. Additionally, all profits earned on investment of bond proceeds other than for the governmental purpose of the borrowing generally must be rebated to the Federal Government.

If issuers of tax-exempt bonds prepay amounts for activities being financed with the bonds, arbitrage profits may be indirectly earned and retained by the issuers. Therefore, present law provides that property or services acquired pursuant to most transactions involving prepayments is investment-type property, and is subject to either yield restriction or arbitrage rebate requirements.

Explanation of Provision

The bill deletes and reinserts the term "investment-type property" in the Code arbitrage restrictions. This provision is intended to clarify Congress' original intent as to the meaning of that term. Absent restrictions, issuers might use bond proceeds to prepay

items in such a manner that the tax-exempt bond arbitrage restrictions would be avoided and the issuers would retain the economic benefit of arbitrage profits. The expansion of property subject to the Code arbitrage restrictions to include all "investment-type property" was intended to preclude such arrangements.

As was stated in the legislative history accompanying the Tax Reform Act of 1986 (the "1986 Act"), however, in certain circumstances, advance payments for property or services may be made because of non-arbitrage-motivated business customs. For example, a governmental unit may decide to purchase property (e.g., a government office building or equipment) with an accompanying bond-financed up-front payment rather than lease the property without such an initial debt issuance. It was not intended that the fact that an issuer purchases, rather than leases, property should necessarily be construed as giving rise to investment-type property.

Similarly, certain services (e.g., bond insurance for the entire term of the bonds) may be available only in exchange for a lump-sum payment made in advance, or the credit standing of an issuer may be such that vendors will not supply property or services before receiving payment. As was indicated in the legislative history of the 1986 Act, the term investment-type property is not intended to include property or services acquired in exchange for debt-financed lump-sum payments, whether or not discounted, that are dictated by independent, non-arbitrage-motivated business customs governing availability of the property or services to all similarly-situated persons (whether or not State or local governmental units).

Further, the provision is intended to clarify the application of this 1986 Act restriction to certain governmental and section 501(c)(3) organization procurement activities.[108] When States and local governments and section 501(c)(3) organizations purchase property or services for use in carrying out their governmental or exempt activities, they may be offered discounts on the same terms as fully taxable purchasers for prompt or early payment or for volume purchases. Availability of these discounts presents an opportunity for economic arbitrage, and by taking advantage of the discounts, States and local governments and section 501(c)(3) organizations could be viewed as acquiring investment-type property. It is intended, however, that acquisition at a discounted price of property or services to be used in carrying out a governmental or section 501(c)(3) organization exempt activity should not be treated as the acquisition of investment-type property if—

(1) the trade discount is available on the same terms to all purchasers of the property or services (governmental, section 501(c)(3) and fully taxable nongovernmental entities); [109] and

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[108] The clarification relating to trade discounts is intended only to address the treatment of the discounts described. It is not intended to change or otherwise give rise to any inference as to the proper meaning of the term "investment property" in other circumstances.

[109] Any trade discount which is structured differently for purchasers eligible to use taxable and tax-exempt debt or which is set at a level such that beneficiaries of tax-exempt bonds are more likely to take advantage of the discount than fully taxable purchasers (e.g., in a manner related to the tax-exempt borrowing costs of the purchaser) is not intended to qualify as a trade discount that is available on the same terms to all purchasers of the property or services.

Continued

(2) the scheduled or actual timing of any early payment or the volume of any purchase by a governmental unit or section 501(c)(3) organization is not substantially different from the comparable timing of payments or volume of purchases by similarly situated fully taxable nongovernmental entities purchasing the same property or services.

Effective Date

The provision is effective as if included in Title XIII of the Tax Reform Act of 1986.

E. Insurance Provisions

1. Treatment of certain insurance contracts on retired lives (sec. 641 of the bill and sec. 817(d) of the Code)

Present Law

Life insurance companies are allowed a deduction for any net increase in reserves and are required to include in income any net decrease in reserves. The reserve of a life insurance company for any contract is the greater of the net surrender value of the contract or the reserve determined under Federally prescribed rules. In no event, however, may the amount of the reserve for tax purposes for any contract at any time exceed the amount of the reserve for annual statement purposes.

Special rules are provided in the case of a variable contract. Under these rules, the reserve for a variable contract is adjusted by (1) subtracting any amount that has been added to the reserve by reason of appreciation in the value of assets underlying such contract, and (2) adding any amount that has been subtracted from the reserve by reason of depreciation in the value of assets underlying such contract. In addition, the basis of each asset underlying a variable contract is adjusted for appreciation or depreciation to the extent the reserve is adjusted.

A variable contract generally is defined as any annuity or life insurance contract (1) that provides for the allocation of all or part of the amounts received under the contract to an account that is segregated from the general asset accounts of the company, and (2) under which, in the case of an annuity contract, the amounts paid in, or the amounts paid out, reflect the investment return and the market value of the segregated asset account, or, in the case of a life insurance contract, the amount of the death benefit (or the period of coverage) is adjusted on the basis of the investment return and the market value of the segregated asset account. A pension plan contract that is not a life, accident, or health, proper-

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It is recognized, however, that the implicit discount rate in any purchase arrangement is related to borrowing costs, and that therefore, beneficiaries of tax-exempt bonds may benefit economically more from any uniform discount rate than comparable taxable borrowers. This fact alone is not to be construed as violating the uniformity requirement, provided the discount rate is uniform for governmental, section 501(c)(3) organizations, and fully taxable nongovernmental purchasers and is set at a sufficient level to be taken advantage of generally by purchasers using taxable financing as well as by governmental and section 501(c)(3) organizations benefiting from tax-exempt bonds.

ty, casualty, or liability insurance contract is treated as an annuity contract for purposes of this definition.

Reasons for Simplification

It is believed that certain contracts which provide insurance on retired lives should be treated as variable contracts in order to simplify the treatment of such contracts and to provide a more accurate measure of the income of life insurance companies with respect to such contracts.

Explanation of Provision

The bill provides that a variable contract is to include a contract that provides for the funding of group term life or group accident and health insurance on retired lives if: (1) the contract provides for the allocation of all or part of the amounts received under the contract to an account that is segregated from the general asset account of the company; and (2) the amounts paid in, or the amounts paid out, under the contract reflect the investment return and the market value of the segregated asset account underlying the contract.

Thus, the reserve for such a contract is to be adjusted by (1) subtracting any amount that has been added to the reserve by reason of appreciation in the value of assets underlying such contract, and (2) adding any amount that has been subtracted from the reserve by reason of depreciation in the value of assets underlying such contract. In addition, the basis of each asset underlying the contract is to be adjusted for appreciation or depreciation to the extent that the reserve is adjusted.

Effective Date

The provision applies to taxable years beginning after December 31, 1992.

2. Treatment of modified guaranteed contracts (sec. 642 of the bill and new sec. 817A of the Code)

Present Law

Life insurance companies are allowed a deduction for any net increase in reserves and are required to include in income any net decrease in reserves. The reserve of a life insurance company for any contract is the greater of the net surrender value of the contract or the reserve determined under Federally prescribed rules. The net surrender value of a contract is the cash surrender value reduced by any surrender penalty, except that any market value adjustment required on surrender is not taken into account. In no event, however, may the amount of the reserve for tax purposes for any contract at any time exceed the amount of the reserve for annual statement purposes.

In general, assets held for investment are treated as capital assets. Any gain or loss from the sale or exchange of a capital asset is treated as a capital gain or loss and is taken into account for the taxable year in which the asset is sold or exchanged.

Reasons for Simplification

Life insurance companies have recently begun issuing annuity contracts, life insurance contracts, and pension plan contracts that provide for a guaranteed interest rate for a specified period of time and a market value adjustment in the event that the owner of the contract surrenders the contract for cash prior to the end of the guaranteed interest period. These contracts are commonly referred to as modified guaranteed contracts.

If the premium or other consideration received under a modified guaranteed contract is allocated to an account that is segregated from the general asset accounts of the life insurance company, then the reserve for the contract and the assets in the segregated account generally are required to be taken into account at market value for annual statement purposes. For Federal income tax purposes, the reserve for a modified guaranteed contract may reflect the market value adjustment, while the market fluctuations in the assets underlying the contract are not taken into account unless the assets are disposed of.

It is considered appropriate to conform the Federal income tax treatment of modified guaranteed contracts with the annual statement treatment of such contracts in order to simplify the accounting for such contracts and to provide a more accurate measure of the income of life insurance companies with respect to such contracts. Nevertheless, mark-to-market treatment is not considered appropriate for the general account assets of a life insurance company.

Explanation of Provision

The bill generally applies a mark-to-market regime to assets held as part of a segregated account under a modified guaranteed contract issued by a life insurance company. Gain or loss with respect to such assets held as of the close of any taxable year is taken into account for that year (even though the assets have not been sold or exchanged),[110] and is treated as ordinary. If gain or loss is taken into account by reason of the mark-to-market requirement, then the amount of gain or loss subsequently realized as a result of sale, exchange, or other disposition of the asset, or as a result of the application of the mark-to-market requirement is to be appropriately adjusted to reflect such gain or loss. In addition, the reserve for a modified guaranteed contract is determined by taking into account the market value adjustment required on surrender of the contract.

A modified guaranteed contract is defined as any life insurance contract, annuity contract or pension plan contract[111] that is not a variable contract (within the meaning of Code section 817), and that satisfies the following requirements. All or a part of the amounts received under the contract must be allocated to an account which, pursuant to State law or regulation, is segregated

[110] The wash sale rules of section 1091 of the Code are not to apply to any loss that is required to be taken into account solely by reason of the mark-to-market requirement.

[111] The provision applies only to a pension plan contract that is not a life, accident or health, property, casualty, or liability contract.

from the general asset accounts of the company and is valued from time to time by reference to market values. The reserves for the contract must be valued at market for annual statement purposes. Further, a modified guaranteed contract includes only a contract that provides either for a net surrender value or for a policyholder's fund (within the meaning of section 807(e)(1)).

The Treasury Department is authorized to issue regulations that provide for the application of the mark-to-market requirement at times other than the close of a taxable year or the last business day of a taxable year. The Treasury Department is also authorized to issue such regulations as may be necessary or appropriate to carry out the purposes of the provision and to provide for the treatment of modified guaranteed contracts under sections 72, 7702, and 7702A. In addition, the Treasury Department is authorized to determine the interest rates applicable under sections 807(c)(3), 807(d)(2)(B) and 812 with respect to modified guaranteed contracts annually, calculating such rates as appropriate for modified guaranteed contracts. For example, it may be appropriate to take into account the yield on the assets underlying the contract in determining such rates. The Treasury Department is also authorized, to the extent appropriate for such a contract, to modify or waive section 811(d).

The Treasury Department is also authorized to provide rules limiting the ordinary treatment provided under the provision to gain or loss on those assets properly taken into account in calculating the reserve for Federal tax purposes (and necessary to support such reserves) for modified guaranteed contracts, and to provide rules for limiting such treatment with respect to other assets (such as assets representing surplus of the company). Particular concern has been expressed about characterization of gain or loss as ordinary under the provision in transactions that would otherwise either (1) have to meet the requirements of the hedging exception to the straddle rules to receive this treatment, or (2) be treated as capital transactions under present law. It is intended that the mark-to-market treatment apply to all assets held as part of a segregated account established under the provision, even though ordinary treatment may not apply (pursuant to Treasury regulatory authority) to assets held as part of the segregated account that are not necessary to support the reserve for modified guaranteed contracts.

The bill authorizes the Treasury Department to prescribe regulations that provide for the treatment of assets transferred to or from a segregated account. This regulatory authority is provided because of concern that taxpayers may exercise selective ordinary loss (or income or gain) recognition by virtue of the ordinary treatment under the provision. One example of selective ordinary loss recognition could arise if assets are always marked to market when transferred out of the segregated account. For example, if at the beginning of the taxable year an asset in the segregated account is worth $1,000, but declines to $900 in July, the taxpayer might choose to recognize $100 of ordinary loss while continuing to own the asset, simply by transferring it out of the segregated account in July and replacing $1,000 of cash (for example) in the segregated account.

It is intended that the regulations relating to asset transfers will forestall opportunities for selective recognition of ordinary items. Prior to the issuance of these regulations, the following rules shall apply.

If an asset is transferred to a segregated account, gain or loss attributable to the period during which the asset was not in the segregated account is taken into account when the asset is actually sold, and retains the character (as ordinary or capital) properly attributable to that period. Appropriate adjustments are made to the basis of the asset to reflect gain or loss attributable to that period.

If an asset is transferred out of a segregated account, the transfer is deemed to occur on the last business day of the taxable year and gain or loss with respect to the transferred asset is taken into account as of that day. Loss with respect to such transferred asset is treated as ordinary to the extent of the lesser of (1) the loss (if any) that would have been recognized if the asset had been sold for its fair market value on the last business day of the taxable year (or the date the asset was actually sold by the taxpayer, if earlier) or (2) the loss (if any) that would have been recognized if the asset had been sold for its fair market value on the date of the transfer. A similar rule applies for gains. Proper adjustment is made in the amount of any gain or loss subsequently realized to reflect gain or loss under the provision.

For example, assume that a capital asset in the segregated account that is worth $1,000 at the beginning of the year is transferred out of the segregated account in July at a value of $900, is retained by the company and is worth $950 on the last business day of the taxable year. A $50 ordinary loss is taken into account with respect to the asset for the taxable year (the difference between $1,000 and $950). The asset is not marked to market in any subsequent year under the provision, provided that it is not transferred back to the segregated account.

As an additional example, assume that a capital asset in the segregated account that is worth $1,000 at the beginning of the year is transferred out of the segregated accounted in July at a value of $900, is retained by the company and continues to decline in value to $850 on the last business day of the taxable year. A $100 ordinary loss ($1,000 less $900) and a $50 capital loss ($900 less $850) is taken into account with respect to the asset for the taxable year.

Effective Date

The provision applies to taxable years beginning after December 31, 1992. A taxpayer that is required to (1) change its calculation of reserves to take into account market value adjustments and (2) mark to market its segregated assets in order to comply with the requirements of the provision is treated as having initiated changes in method of accounting and as having received the consent of the Treasury Department to make such changes.

The section 481(a) adjustments required by reason of the changes in method of accounting are to be combined and taken into account as a single net adjustment for the taxpayer's first taxable year beginning after December 31, 1992.

F. Other Provisions

1. Close partnership taxable year with respect to deceased partner, etc. (sec. 651 of the bill and sec. 706(c) of the Code)

Present Law

The partnership taxable year closes with respect to a partner whose entire interest is sold, exchanged, or liquidated. Such year, however, generally does not close upon the death of a partner. Thus, a decedent's entire share of items of income, gain, loss, deduction and credit for the partnership year in which death occurs is taxed to the estate or successor in interest rather than to the decedent on his or her final income tax return. See *Estate of Hesse* v. *Commissioner*, 74 T.C. 1307, 1311 (1980).

Reasons for Simplification

The rule leaving open the partnership taxable year with respect to a deceased partner was adopted in 1954 to prevent the bunching of income that could occur with respect to a partnership reporting on a fiscal year other than the calendar year. Without this rule, as many as 23 months of income might have been reported on the partner's final return. Legislative changes occurring since 1954 have required most partnerships to adopt a calendar year, reducing the possibility of bunching. Consequently, income and deductions are better matched if the partnership taxable year closes upon a partner's death and partnership items are reported on the decedent's last return.

Present law closes the partnership taxable year with respect to a deceased partner only if the partner's entire interest is sold or exchanged pursuant to an agreement existing at the time of death. By closing the taxable year automatically upon death, the provision reduces the need for such agreements.

Explanation of Provision

The bill provides that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation or otherwise.

The provision is not intended to change present law with respect to the effect upon the partnership taxable year of a transfer of a partnership interest by a debtor to the debtor's estate (under Chapters 7 or 11 of Title 11, relating to bankruptcy).

Effective Date

The provision applies to partnership taxable years beginning after December 31, 1993.

2. Treatment of built-in losses for purposes of the corporate alternative minimum tax (sec. 652 of the bill and sec. 56(g) of the Code)

Present Law

For purposes of the regular corporate tax, if at the time of an ownership change, a corporation has a net operating loss or a net unrealized built-in loss, the use of such losses in post-change periods is limited. A corporation has a net unrealized built-in loss if the aggregate adjusted bases of the assets of the corporation exceed the fair market value of the assets immediately before the change of ownership (sec. 382).

For purposes of the adjusted current earnings (ACE) component of the corporate alternative minimum tax (AMT), if a corporation with a net unrealized built-in loss undergoes an ownership change in a taxable year beginning after 1989, the adjusted basis of each asset of such corporation generally is adjusted to each asset's fair market value (sec. 56(g)(4)(G)). This rule essentially eliminates, rather than limits, the use of built-in losses for ACE purposes. The net operating loss of a corporation, on the other hand, is not eliminated for AMT purposes after a change of ownership.

Reasons for Simplification

Present law complicates the treatment of built-in losses of a corporation after a change of ownership by providing different rules for regular and alternative minimum tax and by providing rules different than those applicable to net operating losses. The present-law alternative minimum tax rules applicable to built-in losses requires a significant amount of additional recordkeeping.

Explanation of Provision

The bill repeals the ACE rule relating to the treatment of built-in losses after a change of ownership. Thus, for ACE purposes, the treatment of built-in losses would be similar to the treatment of net operating loss carryovers (in the same way that the treatment of built-in losses is similar to the treatment of net operating losses for regular tax purposes).

Effective Date

The provision is effective for changes of ownership occurring after the date of enactment.

3. Depreciation under the corporate alternative minimum tax (sec. 653 of the bill and secs. 56 and 168 of the Code)

Present Law

Under present law, a corporation is subject to an alternative minimum tax (AMT) which is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax liability. Alternative minimum taxable income (AMTI) is the corporation's taxable income increased by the corporation's tax preferences and adjusted by determining the tax treatment of

certain items in a manner which negates the deferral of income resulting from the regular tax treatment of those items.

One of the adjustments which is made to taxable income to arrive at AMTI relates to depreciation. Depreciation on personal property to which the modified ACRS system adopted in 1986 applies is calculated using the 150-percent declining balance method (switching to straight line in the year necessary to maximize the deduction) over the life described in Code section 168(g) (generally the ADR life of the property).

For taxable years beginning after 1989, AMTI is increased by an amount equal to 75 percent of the amount by which adjusted current earnings (ACE) exceed AMTI (as determined before this adjustment). In general, ACE means AMTI with additional adjustments that generally follow the rules presently applicable to corporations in computing their earnings and profits. For purposes of ACE, depreciation is computed using the straight-line method over the class life of the property. Thus, a corporation generally must make two depreciation calculations for purposes of the AMT—once using the 150 percent declining balance method and again using the straight-line method. Taxpayers may elect to use either depreciation method for regular tax purposes. If a taxpayer uses the straight-line method for regular tax purposes, it must also use the straight-line method for AMT purposes.

Reasons for Simplification

The use of two separate depreciation systems complicates the calculation of, and the recordkeeping for, the corporate alternative minimum tax.

Explanation of Provision

The bill applies a 120-percent declining balance method (switching to straight-line at a point maximizing depreciation deductions) for personal property (other than transition property to which the ACRS system in effect before the Tax Reform Act of 1986 applies) for determining the AMTI of a corporation. No further depreciation adjustment for this property would be required for ACE. Thus, corporations would be required to keep only one set of depreciation records for purposes of the AMT.

Corporate taxpayers may elect to use the 120-percent declining balance method of depreciation for regular tax purposes. As under present law, if a corporation uses the straight-line method for regular tax purposes, it must also use the straight-line method for AMT purposes.

Effective Date

The provision is effective for property placed in service in taxable years beginning after December 31, 1992.

4. Determinations of gas produced from qualifying sources under the nonconventional fuels production credit (sec. 654 of the bill and sec. 29 of the Code)

Present Law

Nonconventional fuels are eligible for a production credit ("the section 29 credit") equal to $3 per barrel or Btu oil barrel equivalent [112] (the credit amount generally is adjusted for inflation, except for gas produced from a tight formation). Fuels qualifying for the credit must be produced domestically from a well drilled, or a facility treated as placed in service, before January 1, 1993. The production credit generally is available for qualifying fuels sold before January 1, 2003.

Qualifying fuels include (1) oil produced from shale and tar sands, (2) gas produced from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass (i.e., any organic material other than oil, natural gas, or coal (or any product thereof)), and (3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite), including such fuels when used as feedstocks. The amount of the credit is determined without regard to any production attributable to a property from which gas from Devonian shale, coal seams, geopressured brine, or a tight formation was produced in marketable quantities before 1980.

As a general rule, the determination of whether any gas is produced from geopressured brine, Devonian shale, coal seams, or a tight formation is made in accordance with section 503 of the Natural Gas Policy Act of 1978 (the "NGPA").[113] The term "gas from a tight formation" means only gas from a tight formation which either, as of April 20, 1977, was committed or dedicated to interstate commerce (as defined in section 2(18) of the NGPA, as in effect on the date of enactment of the Omnibus Budget Reconciliation Act of 1990, or is produced from a well drilled after November 5, 1990.

Under section 503 of the NGPA,[114] if any State or Federal agency [115] makes any final determination that a well produces certain "high-cost natural gas," [116] that determination is applicable unless it is reversed by the Federal Energy Regulatory Commission (FERC) under special procedures established by the NGPA.[117]

Under the regulatory authority granted to it by the NGPA, FERC has furnished the following definitions of certain types of

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[112] The term barrel-of-oil equivalent generally means that amount of the qualifying fuel which has a Btu (British thermal unit) content of 5.8 million.

[113] P.L. 95-621, Nov. 9, 1978.

[114] 15 U.S.C. sec. 3413 (1988).

[115] Under the NGPA, a State or Federal agency having regulatory jurisdiction with respect to the production of natural gas is authorized to make determinations for qualification under certain categories of natural gas. Such an agency, however, may waive its authority to make such determinations by entering into an agreement with FERC allowing FERC to be the determination-making body. (15 U.S.C. sec. 3413(c) (1988).)

[116] Under the NGPA, high-cost natural gas includes gas produced from geopressured brine, coal seams, or Devonian shale. In addition, the NGPA grants FERC the authority to treat other types of natural gas as high-cost natural gas if the gas is produced under such other conditions that FERC determines to present extraordinary risks or costs. Under this authority, FERC treats gas produced from a tight formation as high-cost natural gas. (15 U.S.C. sec. 3317(c) (1988).)

[117] 15 U.S.C. sec. 3413(a)(1) (1988).

high-cost natural gas. Natural gas produced from geopressured brine is natural gas which is dissolved before initial production of the natural gas in subsurface brine aquifers with at least 10,000 parts of dissolved solids per million parts of water and with an initial reservoir geopressure gradient in excess of 0.465 pounds per square inch for each vertical foot of depth.[118]

Occluded natural gas produced from coal seams means naturally occurring natural gas from entrapment from the fractures, pores and bedding planes of coal seams.[119]

Natural gas produced from Devonian shale means natural gas produced from fractures, micropores and bedding planes of shales deposited during the paleozoic Devonian Period. Shales deposited during such period are defined as either (1) the gross Devonian age stratigraphic interval encountered by a well bore, at least 95 percent of which has a gamma ray index of 0.7 or greater; or (2) generally, one continuous interval within the gross Devonian age stratigraphic interval, encountered by a well bore, as long as at least 95 percent of the selected Devonian shale interval has a gamma ray index of 0.7 or greater.[120] When measuring the Devonian age stratigraphic interval, the gamma ray index at any point is calculated by dividing the gamma ray log value at that point by the gamma log value at the shale base line established over the entire Devonian age interval penetrated by the well bore.

In general, guidelines for making a determination that a formation is a tight formation are as follows: (1) The estimated average in situ gas permeability, throughout the pay section, is expected to be 0.1 millidarcy or less; (2) the stabilized production rate, against atmospheric pressure, of wells completed for production in the formation, without stimulation, is not expected to exceed the production rate set forth by FERC in regulations; [121] and (3) no well drilled into the recommended tight formation is expected to produce, without stimulation, more than 5 barrels of crude oil per day.[122] The FERC regulations establishing a definition of tight formation also set forth determination and review requirements similar to those provided by the NGPA for high-cost natural gas.

Any Federal or State agency that makes a determination that a formation is a tight formation or that a well produces high-cost natural gas is required to provide timely notice in writing of such determination to FERC.[123] The notice must include such substantiation and be in such a manner as FERC may, by ruling, require.

The NGPA provides that FERC will reverse any final State or Federal agency determination that a formation is a tight formation or that a well produces high-cost natural gas if (1) FERC finds that such determination is not supported by substantial evidence in the record upon which such determination was made; and (2) the preliminary finding and required notice thereof is made within 45 days after the date on which FERC received notice of the determination by the State or Federal agency and the final finding is made

[118] 18 C.F.R. sec. 272.103(c).
[119] 18 C.F.R. sec. 272.103(d).
[120] 18 C.F.R. sec. 272.103(e).
[121] See table in 18 C.F.R. sec. 271.703(c)(1)(B).
[122] 18 C.F.R. sec. 271.703(c).
[123] 15 U.S.C. sec. 3413(a)(2) (1988).

within 120 days after the date of the preliminary finding.[124] If (1) FERC finds that a State or Federal agency determination is not consistent with information contained in FERC's public records, and which is not part of the record upon which the State or Federal agency's determination was made, and (2) the preliminary finding by FERC and required notice thereof is made within 45 days after the date on which FERC received notice of the determination and the final finding is made within 120 days after the date of the preliminary finding, FERC may remand the matter to the State or Federal agency for consideration of such information.[125] If the agency, after consideration of the information transmitted to it by FERC, affirms its previous determination, such determination, as so affirmed, is subject to additional review by FERC. Such findings and remands by FERC may be subject to judicial review.[126]

In general, any final determination by a State or Federal agency (or by FERC) that a formation is a tight formation or that a well produces high-cost natural gas which is no longer subject to FERC or judicial review is thereafter binding with respect to such natural gas.[127]

In 1989, the Natural Gas Wellhead Decontrol Act [128] was enacted. That Act repealed Title I of the NGPA, effective on January 1, 1993. It also repealed FERC's determination review responsibility under section 503 of the NGPA. The legislative history to the Natural Gas Wellhead Decontrol Act stated that the Senate Committee on Energy and Natural Resources did not intend, by repealing sections of the NGPA referenced in section 29 of the Internal Revenue Code, to reflect an adverse judgment as to the merits of the tax credits for any categories of natural gas production that might be affected by such action.[129] In view of this indication that Congress did not intend the 1989 legislation to limit the availability of the section 29 credit, FERC initially announced that it would continue to process well determinations until January 1, 1993, in order to allow producers to obtain tax credits that are dependent upon such determinations even if the gas has been otherwise decontrolled.[130] FERC has subsequently announced that it will continue to process well determinations received by June 30, 1993 if they are filed with jurisdictional agencies by December 31, 1992.[131]

Reasons for Simplification

It is understood that the Internal Revenue Code requires certain formations and wells to be determined as qualifying for the section 29 credit under relevant provisions of the Natural Gas Policy Act of 1978. It is further understood that based on the repeal of that statute, effective January 1, 1993, and based on published statements by FERC, it may be that certain wells, the production from which should qualify for the credit, will not be subject to FERC de-

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[124] 15 U.S.C. sec. 3413(b)(1) (1988).
[125] 15 U.S.C. sec. 3413(b)(2) (1988).
[126] 15 U.S.C. sec. 3413(b)(4) (1988).
[127] 15 U.S.C. sec. 3413(d) (1988).
[128] P.L. 101-60, July 26, 1989.
[129] S. Rep. No. 101-39, 101st Cong., 1st Sess. 9 (1989).
[130] F.E.R.C. Order No. 523, 55 Fed. Reg. 17425, April 25, 1990.
[131] F.E.R.C. Order No. 539, 57 Fed. Reg. 13009, April 15, 1992.

termination. In order to ensure that qualifying gas production from such wells in fact will receive the credit, it is believed necessary to continue the well and formation determination process for periods after FERC discontinues its role in this process.

Because the sole purpose for well and formation determinations following the repeal of Title I of the NGPA will be for section 29 tax credit qualification, it is believed appropriate to mandate that the Treasury Department be the determination-making body for periods after FERC ceases making such determinations. Moreover, it is believed appropriate to require Treasury to make determinations using guidelines substantially consistent with those presently employed by FERC.

Explanation of Provision

With respect to determinations required under the Internal Revenue Code of whether gas is produced from geopressured brine, Devonian shale, coal seams, or from a tight formation, in the event that such a determination is not made by FERC in accordance with section 503 of the Natural Gas Policy Act of 1978 due to the expiration of that statute, the bill requires the Secretary of Treasury to make such determinations. For this purpose, the bill mandates that any such determination by the Treasury Department be based on the guidelines for making determinations set forth in the NGPA (and in regulations thereunder) prior to its repeal. In addition, the bill clarifies that for purposes of the section 29 credit, the definitions of gas produced from geopressured brine, Devonian shale, coal seams, or from a tight formation are as established by the Federal Energy Regulatory Commission under the NGPA prior to repeal of provisions of that statute relating to such definitions.

Effective Date

The provision is effective on January 1, 1993.

TITLE VII. ESTATE AND GIFT TAX PROVISIONS

1. Waiver of right of recovery for certain marital deduction property (sec. 701 of the bill and secs. 2207A and 2207B of the Code)

Present Law

For estate and gift tax purposes, a marital deduction is allowed for qualified terminable interest property (QTIP). Such property generally is included in the surviving spouse's gross estate. The surviving spouse's estate is entitled to recover the portion of the estate tax attributable to such inclusion from the person receiving the property, unless the spouse directs otherwise by will (sec. 2207A). For this purpose, a will provision specifying that all taxes shall be paid by the estate is presently sufficient to waive the right of recovery.

The gross estate includes the value of previously transferred property in which the decedent retains enjoyment or the right to income (sec. 2036). The estate is entitled to recover from the person receiving the property a portion of the estate tax attributable to the inclusion (sec. 2207B). This right may be waived only by a provision in the will (or revocable trust) specifically referring to section 2207B.

Reasons for Simplification

It is understood that persons utilizing standard testamentary language often inadvertently waive the right of recovery with respect to QTIP. Similarly, persons waiving a right to contribution are unlikely to refer to the code section granting the right. Accordingly, allowing the right of recovery (or right of contribution) to be waived only by specific reference should simplify the drafting of wills by better conforming with the testator's likely intent.

Explanation of Provision

The bill provides that the right of recovery with respect to QTIP is waived to the extent that language in the decedent's will or revocable trust specifically so indicates. Thus, a general provision specifying that all taxes be paid by the estate is no longer sufficient to waive the right of recovery. The bill also provides that the right of contribution for property over which the decedent retained enjoyment or the right to income is waived by a specific indication, but specific reference to section 2207B would no longer be required.

Effective Date

The provision applies to decedents dying after the date of enactment.

2. Inclusion in gross estate of certain gifts made within three years of death (sec. 702 of the bill and secs. 2035 and 2038 of the Code)

Present Law

The first $10,000 of gifts of present interests to each donee during any one calendar year are excluded from Federal gift tax.

The value of the gross estate includes the value of any previously transferred property if the decedent retained the power to revoke the transfer (sec. 2038). The gross estate also includes the value of any property with respect to which such power is relinquished during the three years before death (sec. 2035). This rule has been interpreted to include in the gross estate certain transfers made from a revocable trust within three years of death.[132] Such inclusion subjects gifts that would otherwise qualify under the annual $10,000 exclusion to estate tax.

Reasons for Simplification

The inclusion of certain property transferred during the three years before death is directed at transfers that would otherwise reduce the amount subject to estate tax by more than the amount subject to gift tax, disregarding appreciation between the times of gift and death. Because all amounts transferred from a revocable trust are subject to the gift tax, it is believed that inclusion of such amounts is unnecessary where the transferor has retained no power over the property transferred out of the trust. It is understood that repeal of such inclusion eliminates a principal tax disadvantage of funded revocable trusts, which are generally used for nontax purposes.

Explanation of Provision

The bill provides that a transfer from a trust over which the grantor held the power to revoke would be treated as if made directly by the grantor. Thus, an annual exclusion gift from such trust is not included in the gross estate. It is intended that no inference be drawn from the provision with respect to the treatment of transfers from revocable trusts under present law.

The bill also revises section 2035 to improve its clarity.

Effective Date

The provision applies to decedents dying after the date of enactment.

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[132] See, e.g., *Jalkut Estate v. Commissioner*. 96 T.C. 675 (1991) (transfers from revocable trust to permissible beneficiaries of the trust includible in the grantor's gross estate); LTR 9117003 (same).

3. Definition of qualified terminable interest property (sec. 703 of the bill and secs. 2044, 2056(b)(7), and 2523(f) of the Code)

Present Law

A marital deduction is allowed for qualified terminable interest property (QTIP). Property is QTIP only if the surviving spouse has a qualifying income interest for life (e.g., the spouse is entitled to all of the income from the property, payable at least annually). QTIP generally is includible in the surviving spouse's gross estate.

The United States Tax Court has held that, in order to satisfy the QTIP requirements, the income accumulating between the last distribution date and the date of the surviving spouse's death (the "accumulated income") must be paid to the spouse's estate or be subject to a power of appointment held by the spouse. See *Estate of Howard* v. *Commissioner,* 91 T.C. 329, 338 (1988), rev'd, 910 F.2d 633 (9th Cir. 1990). In contrast, proposed Treasury regulations presently provide that an income interest may constitute a qualifying income interest for life even if the accumulated income is not required to be distributed to the surviving spouse or the surviving spouse's estate. See Prop. Reg. secs. 20.2056(b)-7(c)(1), 25.2523(f)-1(b).

Reasons for Simplification

It is believed that an income interest may constitute a qualifying income interest for life even if the accumulated income is not required to be distributed to the surviving spouse or the surviving spouse's estate. The provision will alleviate the uncertainty caused by the Tax Court opinion in Estate of Howard as to when a trust qualifies for the marital deduction. This uncertainty makes planning difficult and necessitates closing agreements designed to prevent the whipsaw that would occur if a deduction is allowed for property that is not subsequently included in the spouse's estate.

Explanation of Provision

Under the bill, an income interest does not fail to be a qualified income interest for life solely because the accumulated income is not required to be distributed to the surviving spouse. Such income is includible in the surviving spouse's gross estate.

It is intended that no inference be drawn from the provision with respect to the definition of a qualified income interest for life under present law.

Effective Date

The provision applies to decedents dying, and gifts made, after the date of enactment. However, the bill does not include in the surviving spouse's gross estate property transferred before the date of enactment for which no marital deduction was claimed.

4. Requirements for qualified domestic trust (sec. 704 of the bill and sec. 2056A of the Code)

Present Law

A deduction generally is allowed for Federal estate tax purposes for the value of property passing to a spouse. The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") denied the marital deduction for property passing to an alien spouse outside a qualified domestic trust (QDT). An estate tax is generally imposed on corpus distributions from a QDT.

TAMRA defined a QDT as a trust that, among other things, required all trustees be U.S. citizens or domestic corporations. This provision was modified in the Omnibus Budget Reconciliation Acts of 1989 and 1990 to require that at least one trustee be a U.S. citizen or domestic corporation and that no corpus distribution be made unless such trustee has the right to withhold any estate tax imposed on the distribution (the "withholding requirement").

Reasons for Simplification

Wills drafted under the TAMRA rules must be revised to conform with the withholding requirement, even though both the TAMRA rule and its successor ensure that a U.S. trustee is personally liable for the estate tax on a QDT. Reinstatement of the TAMRA rule for wills drafted in reliance upon it reduces the number of will revisions necessary to comply with statutory changes, thereby simplifying estate planning.

Explanation of Provision

A trust created before the enactment of the Omnibus Budget Reconciliation Act of 1990 is treated as satisfying the withholding requirement if its governing instrument requires that all trustees be U.S. citizens or domestic corporations.

Effective Date

The provision applies as if included in the Omnibus Budget Reconciliation Act of 1990.

5. Election of special use valuation of farm property for estate tax purposes (sec. 705 of the bill and sec. 2032A of the Code)

Present Law

For estate tax purposes, an executor may elect to value certain real property used in farming or other closely held business operations at its current use value rather than its highest and best use (sec. 2032A). A written agreement signed by each person with an interest in the property must be filed with the election.

Treasury regulations require that a notice of election and certain information be filed with the Federal estate tax return (Treas. Reg. sec. 20.2032A-8). The administrative policy of the Treasury Department is to disallow current use valuation elections unless the required information is supplied.

Under procedures prescribed by the Secretary of the Treasury, an executor who makes the election and substantially complies with the regulations but fails to provide all required information or the signatures of all persons with an interest in the property may supply the missing information within a reasonable period of time (not exceeding 90 days) after notification by the Secretary.

Reasons for Simplification

It is understood that executors commonly fail to include with the filed estate tax return a recapture agreement signed by all persons with an interest in the property or all information required by Treasury regulations. It is believed that allowing such signatures or information to be supplied later is consistent with the legislative intent of section 2032A and eases return filing.

Explanation of Provision

The bill extends the procedures allowing subsequent submission of information to any executor who makes the election and submits the recapture agreement, without regard to compliance with the regulations. Thus, the bill allows the current use valuation election if the executor supplies the required information within a reasonable period of time (not exceeding 90 days) after notification by the IRS. During that time period, the bill also allows addition of signatures to a previously filed agreement.

Effective Date

The provision applies to decedents dying after the date of enactment.

TITLE VIII. EXCISE TAX SIMPLIFICATION

A. Fuel Tax Provisions

1. Consolidate provisions imposing diesel and aviation fuel excise taxes (sec. 801 of the bill and secs. 4041 and 4091 of the Code)

Present Law

Code section 4091 imposes a tax on the sale of diesel and aviation fuel by a "producer." The term producer generally includes refiners, compounders, blenders, and wholesalers who are registered with the Internal Revenue Service. The term also includes persons to whom diesel or aviation fuel has been sold tax-free.

As a backup, section 4041 imposes a tax on certain sales or uses of diesel and aviation fuel if a taxable sale of such fuel has not occurred under section 4091.

Reasons for Simplification

Consolidating the diesel and aviation tax rules into one section of the Code will make the rules easier to find and understand.

Explanation of Provision

The bill combines the diesel and aviation fuel tax provisions currently divided between Code sections 4041 and 4091 into a revised section 4091. The use of diesel and aviation fuel in a taxable use by producers will be taxed under section 4091, and the definition of producer is clarified to include purchasers in tax-reduced sales.

The bill also simplifies the Code by eliminating two unnecessary provisions: sections 4041(b)(1)(B) and (j) of the Code. These provisions are redundant.

Effective Date

The provision is effective for sales or uses on or after January 1, 1994.

2. Permit refund of tax to taxpayer for diesel and aviation fuel resold to certain exempt purchasers (sec. 802(a) of the bill and sec. 6416(b) of the Code)

Present Law

As a general matter, purchasers who use tax-paid fuels for an exempt use are entitled to a refund or credit. Purchasers of tax-paid fuels generally are not permitted a refund or credit if they resell the fuels to another person who subsequently uses them in an exempt use.

However, persons who buy and then resell (1) fuel subject to the special motor fuel or gasoline taxes and (2) certain other articles are permitted a refund or credit (in place of the ultimate users claiming the credit or refund) if they resell the fuel or article for use in the following exempt uses: (a) export, (b) supplies for aircraft or vessels, (c) use by a State or local government, or (d) use by a nonprofit educational organization for its exclusive use.

Reasons for Simplification

Diesel and aviation fuel sales are not subject to the special refund or credit procedures. The general rules require users of such fuels for exempt purposes to bear the burden of filing for the refund or credit themselves and, therefore, make such purchases more difficult compared to purchases of gasoline and special motor fuels.

Explanation of Provision

The bill allows a refund or credit to sellers of diesel and aviation fuel who purchase the fuels tax-paid and re-sell the fuels without payment of tax for any of the exempt uses described above.

Effective Date

The provision is effective for sales on or after January 1, 1994.

3. Consolidate refund provisions for fuel excise taxes (sec. 802(b) of the bill and secs. 6420, 6421, and 6427 of the Code)

Present Law

As a general matter, purchasers who use fuels for an exempt use are entitled to a refund if the fuels have been purchased tax-paid. The refund provisions for the fuels excise taxes are found in several sections of the Code.

In general, a purchaser entitled to a refund may file a quarterly refund claim for any of the first three quarters of the purchaser's tax year, if the claim exceeds a threshold dollar amount (with the lowest threshold being $750). The threshold amounts differ for different fuels and different exempt uses. A purchaser cannot file a quarterly claim for refund for its fourth quarter, but must file the claim as a credit on that year's income tax return.

There is an expedited procedure for gasohol blenders claiming a refund of part of the excise tax included in the price of the gasoline used for blending into gasohol.

Finally, only an income tax credit, and not a refund, may be claimed for excise taxes on gasoline and special motor fuel used on a farm for farming purposes.

Reasons for Simplification

Consolidating the credit and refund provisions for fuel excise taxes into one section in the Code will make these provisions easier to find and understand. Standardizing the refund procedures will reduce confusion and allow taxpayers to obtain refunds more quickly.

Explanation of Provision

The bill consolidates the user credit and refund provisions for the fuels excise taxes into one section of the Code. The bill also combines the three refund procedures for fuels taxes into a uniform refund procedure. The new uniform refund procedure permits an exempt user to aggregate its refund claims for all fuels taxes and file for a refund in any calendar quarter in which the amount of the aggregate claim exceeds $750. The uniform refund procedure also permits such a user to file for a refund for its fourth quarter rather than apply for a credit.

The special expedited procedure for gasohol blenders is unchanged.

Effective Date

The provision is effective for sales on or after January 1, 1994.

4. Repeal waiver requirement for fuel tax refunds for cropdusters and other fertilizer applicators (sec. 802(c) of the bill and sec. 6420 of the Code)

Present Law

In general, farmers who use gasoline and aviation fuel on a farm are entitled to a refund of the tax that has been paid on that fuel. Cropdusters and other fertilizer applicators that use gasoline and aviation fuel on a farm are entitled to a refund of the tax paid on that fuel in lieu of the farmer, but only if the owner or operator of the farm waives its right to a refund for such fuel.

Reasons for Simplification

Eliminating the waiver will reduce the paperwork burden of a taxpayer seeking a refund.

Explanation of Provision

The bill eliminates the waiver requirement for fuels tax refunds for cropdusters and other fertilizer applicators.

Effective Date

The provision is effective for fuels purchased on or after January 1, 1994.

5. Authorize exceptions from information reporting for certain sales of diesel and aviation fuel (sec. 803 of the bill and sec. 4093(c)(4) of the Code)

Present Law

Certain producers and importers and purchasers are required to file information returns for reduced-tax sales of diesel and aviation fuel.

Reasons for Simplification

Allowing the Internal Revenue Service to exempt certain classes of taxpayers from the mandatory information return requirement will simplify its administration of the registration requirements and eliminate unnecessary paperwork for taxpayers.

Explanation of Provision

The bill permits the IRS by regulation to provide exceptions to the mandatory information return requirement for certain sales of diesel and aviation fuel.

Effective Date

The provision applies to sales on or after January 1, 1994.

B. Provisions Relating to Distilled Spirits, Wines, and Beer (secs. 811-821 of the bill, secs. 5008(c), 5044, 5053, 5055, 5115, 5175(c), 5207 and new 5222(b), sec. 5418(b) of the Code)

Present Law

Return of imported bottled distilled spirits

Present law provides that when tax-paid distilled spirits which have been withdrawn from bonded premises of a distilled spirits plant are returned for destruction or redistilling, the excise taxes are refunded (sec. 5008(c)). This provision does not apply to imported bottled distilled spirits, since they are withdrawn from customs custody and not from bonded premises.

Bond for exported distilled spirits

Bond generally must be furnished to the Department of the Treasury when distilled spirits are removed from bonded premises for exportation without payment of tax. These bonds are canceled or credited when evidence is submitted to the Department of the Treasury that the distilled spirits have been exported (sec. 5175(c)).

Distilled spirits plant records

Distilled spirits plant proprietors are required to maintain records of their production, storage, denaturation, and other processing activities on the premises where the operations covered by the records are carried on (sec. 5207(c)).

Transfers from breweries to distilled spirits plants

Under present law, beer may be transferred without payment of tax from a brewery to a distilled spirits plant to be used in the production of distilled spirits, but only if the brewery is contiguous to the distilled spirits plant (sec. 5222(b)).

Posting of sign by wholesale liquor dealers

Wholesale liquor dealers (i.e., dealers, other than wholesale dealers in beer alone, who sell distilled spirits, wines, or beer to other persons who re-sell such products) are required to post a sign conspicuously on the outside of their place of business indicating that they are wholesale liquor dealers (sec. 5115).

Refund of tax for wine returned to bond

Under present law, when unmerchantable wine is returned to bonded production premises, tax that has been paid is returned or credited to the proprietor of the bonded wine cellar to which the wine is delivered (sec. 5044). In contrast, when beer is returned to a brewery, tax that has been paid is returned or credited, regardless of whether the beer is unmerchantable (sec. 5056(a)).

Use of ameliorating material in certain wines

The Code contains rules governing the extent to which ameliorating material (e.g., sugar) may be added to wines made from high acid fruits and the product still be labelled as a standard, natural wine. In general, ameliorating material may not exceed 35 percent of the volume of juice and ameliorating material combined (sec. 5383(b)(1)). However, wines made exclusively from loganberries, currants, or gooseberries are permitted a volume of ameliorating material of up to 60 percent (sec. 5384(b)(2)(D)).

Domestically produced beer for use by foreign embassies, etc.

Under present law, domestically produced distilled spirits and wine may be removed from bond, without payment of tax, for transfer to any customs bonded warehouse for storage pending removal for the official or family use of representatives of foreign governments or public international organizations (secs. 5066 and 5362(e)). (A similar rule also applies to imported distilled spirits, wine, and beer.) No such provision exists under present law for domestically produced beer.

Withdrawal of beer for destruction

Present law does not specifically permit beer to be removed from a brewery for destruction without payment of tax.

Records of exportation of beer

Present law provides that a brewer is allowed a refund of tax paid on exported beer upon submission to Department of the Treasury of certain records indicating that the beer has been exported (sec. 5055).

Transfer to brewery of beer imported in bulk

Imported beer brought into the United States in bulk containers may not be transferred from customs custody to brewery premises without payment of tax. Under certain circumstances, distilled spirits imported into the United States in bulk containers may be transferred from customs custody to bonded premises of a distilled spirits plant without payment of tax (sec. 5232).

Reasons for Simplification

In addition to imposing taxes, the Internal Revenue Code regulates many aspects of the alcoholic beverage industry. These regulations date in many cases from the Prohibition Era or earlier. In 1980, the method of collecting excise taxes on alcoholic beverages was changed from a system under which Treasury Department inspectors regularly were present at production facilities to a bonded

premises system, which more closely tracks the systems used in connection with other Federal excise taxes. Many of the record-keeping requirements and other regulatory measures imposed in connection with these taxes have not been modified to conform to these collection system changes. In addition, modification of statutory provisions is warranted in view of advances in technology used in the alcoholic beverage industry and environmental protection concerns.

Explanation of Provisions

Return of imported bottled distilled spirits

The procedures for refunds of tax collected on imported bottled distilled spirits returned to bonded premises are conformed to the rules for domestically produced and imported bulk distilled spirits. Thus, refunds are available for all distilled spirits on their return to a bonded distilled spirits plant.

Bond for exported distilled spirits

For purposes of canceling or crediting bonds furnished when distilled spirits are removed from bonded premises for exportation, the Department of the Treasury is authorized to permit records of exportation to be maintained by the exporter, rather than requiring submission of proof of exportation to Treasury in all cases.

Distilled spirits plant records

Distilled spirits plant proprietors are permitted to maintain records of their activities at locations other than the premises where the operations covered by the records are carried on (e.g., corporate headquarters), provided that the records are available for inspection by the Treasury Department during business hours.

Transfers from breweries to distilled spirits plants

The bill allows beer to be transferred without payment of tax from a brewery to a distilled spirits plant to be used in the production of distilled spirits, regardless of whether the brewery is contiguous to the distilled spirits plant. In the case of beer previously removed from a brewery, the bill also provides that a transfer to a distilled spirits plant may occur without the beer being first retransferred to the brewery.

Posting of sign by wholesale liquor dealers

The requirement that wholesale liquor dealers post a sign outside their place of business indicating that they are wholesale liquor dealers is repealed.

Refund of tax for wine returned to bond

The bill deletes the requirement that wine returned to bonded premises be "unmerchantable" in order for tax to be refunded to the proprietor of the bonded wine cellar to which the wine is delivered.

Use of ameliorating material in certain wines

The wine labelling restrictions are modified to allow any wine made exclusively from a fruit or berry with a natural fixed acid of 20 parts per thousand or more (before any correction of such fruit or berry) to contain a volume of ameliorating material not in excess of 60 percent.

Domestically produced beer for use by foreign embassies, etc.

The bill extends to domestically produced beer the present-law rule applicable to domestically produced distilled spirits and wine (and imported distilled spirits, wine, and beer) which permits these products to be withdrawn from the place of production without payment of tax for the official or family use of representatives of foreign governments or public international organizations.

Withdrawal of beer for destruction

The bill allows beer to be removed from a brewery without payment of tax for purposes of destruction, subject to Treasury Department regulations.

Records of exportation of beer

The bill repeals the requirement that proof of exportation be submitted to the Treasury Department in all cases as a condition of receiving a refund of tax. This proof will continue to be required to be maintained at the exporter's place of business.

Transfer to brewery of beer imported in bulk

The bill extends the present-law rule applicable to distilled spirits imported into the United States in bulk containers to beer imported into the United States in bulk containers, so that imported beer may, subject to Treasury regulations, be withdrawn from customs custody for transfer to a brewery without payment of tax.

Effective Date

These provisions of the bill generally are effective beginning 180 days after date of the bill's enactment. The provision deleting the requirement that wholesale liquor dealers post a sign outside their place of business is effective on the date of the bill's enactment.

C. Other Excise Tax Provisions

1. Authority for IRS to grant exemptions from registration requirements (sec. 831 of the bill and sec. 4222 of the Code)

Present Law

Under section 4222, certain sales of articles subject to Federal excise taxes may not be made without payment of tax unless the manufacturer, the first purchaser, and the second purchaser (if any) are all registered under regulations prescribed by the Secretary.

Reasons for Simplification

Allowing the Internal Revenue Service to exempt certain classes of taxpayers from the registration requirements will simplify the IRS's administration of the registration provisions. Also, the provision will reduce unnecessary paperwork for affected taxpayers.

Explanation of Provision

The bill allows the IRS to provide exemption from generally applicable excise tax registration requirements for certain classes of taxpayers.

Effective Date

The provision applies to sales occurring after the 180 days after the date of enactment.

2. Repeal temporary reduction in tax on piggyback trailers (sec. 832(a) of the bill and sec. 4051(d) of the Code)

Present Law

Piggyback trailers and semitrailers sold within the 1-year period beginning on July 18, 1984 were permitted a temporary reduction in the retail excise tax on trailers.

Explanation of Provision

The bill repeals the temporary reduction in tax on piggyback trailers as "deadwood."

Effective Date

The provision is effective on the date of enactment.

3. Expiration of excise tax on deep seabed minerals (sec. 832(b) of the bill and secs. 4495-4498 of the Code)

Present Law

The Deep Seabed Mineral Resources Act (P.L. 96-283) imposed an excise tax on certain hard minerals mined on the deep seabed. The tax revenues were intended to fund obligations of the United States under a contemplated Law of the Sea Convention.

The tax was scheduled to terminate on the earlier of the date on which a U.N. international deep seabed treaty took effect with respect to the United States, or June 28, 1990 (10 years after the date of enactment of the tax). Because the United States did not sign the treaty, the excise tax provisions expired on June 28, 1990.

Explanation of Provision

The bill deletes the deep seabed hard minerals excise tax provisions as "deadwood."

Effective Date

The provision is effective on the date of enactment.

TITLE IX. ADMINISTRATIVE PROVISIONS

A. General Provisions

1. Simplify employment tax reporting for household employees (sec. 901 of the bill and secs. 3102, 3121, 3306 and 6654 of the Code)

Present Law

An employer who pays a household employee wages of $50 or more in a calendar quarter for household work must withhold social security taxes (including medicare taxes) from wages paid to the employee during the quarter. The employer must also pay an amount of tax that matches the tax withheld from the employee's wages. The employer must file an Employer's Quarterly Tax Return (Form 942) each quarter and a Wage and Tax Statement (Form W-2) at the end of the year.

In addition, an employer must pay Federal unemployment taxes if he or she paid cash wages to household employees totalling $1,000 or more in a calendar quarter in the current or preceding year. The employer must file an Employer's Annual Federal Unemployment Tax Return (Form 940 or Form 940-EZ) at the end of the year.

Reasons for Simplification

Employer return requirements are confusing and burdensome for many individuals, who may be employers only because they employ a domestic employee on an intermittent basis. Streamlining the return requirements would reduce the filing burden for individuals employing domestic employees.

Explanation of Provision

The bill changes the threshold for withholding and paying social security taxes with respect to domestic service employment from $50 a quarter to $300 a year. The bill requires an individual who employs only household employees (regardless of the amount of the remuneration) to report any social security or Federal unemployment tax obligation for wages paid to such employees on his or her income tax return for the year. The bill includes a household employer's social security and unemployment taxes in the estimated tax provisions. The bill also authorizes the Secretary to enter into agreements with States to collect State unemployment taxes in the same manner.

The bill provides that the Secretary may prescribe such regulations as may be necessary or appropriate to carry out the purposes of this provision. These regulations may treat domestic service employment taxes as taxes imposed by chapter 1 of subtitle A for pur-

poses of coordinating the assessment and collection of domestic service employment taxes with the assessment and collection of domestic employers' income taxes.

Effective Date

The provision is effective for remuneration paid in calendar years beginning after December 31, 1993.

2. Clarify that reproductions from digital images are reproductions for recordkeeping purposes (sec. 902 of the bill and sec. 6103(p) of the Code)

Present Law

Reproductions of a return, document, and certain other matters have the same legal status as the original for purposes of judicial and administrative proceedings. It is unclear whether reproductions made from digital images are also accorded the same legal status as originals.

Reasons for Simplification

Reducing the IRS' need to maintain hard-copy originals of documents would simplify the administration of the tax laws. As part of its systems modernization plan, the IRS intends to store returns, documents, and other materials in digital image format. This plan will permit the IRS to respond much more quickly to taxpayers' inquiries about the status of their accounts. It will facilitate implementation of this plan to clarify that reproductions made from such images would be accorded the same legal status as other reproductions.

Explanation of Provision

The bill provides that the term reproduction includes a reproduction from a digital image. The bill also requires the Comptroller General to conduct a study of available digital image technology for the purpose of determining the extent to which reproductions of documents stored using that technology accurately reflect the data on the original document and the appropriate period for retaining the original document.

Effective Date

The provision is effective on the date of enactment.

3. Repeal of authority to disclose whether a prospective juror has been audited (sec. 903 of the bill and sec. 6103(h)(5) of the Code)

Present Law

In connection with a civil or criminal tax proceeding to which the United States is a party, the Secretary must disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an

audit or other tax investigation by the Internal Revenue Service (sec. 6103(h)(5)).

Reasons for Simplification

This disclosure requirement, as it has been interpreted by several recent court decisions, has created significant difficulties in the civil and criminal tax litigation process. First, the litigation process can be substantially slowed. It can take the Secretary a considerable period of time to compile the information necessary for a response (some courts have required searches going back as far as 25 years). Second, providing early release of the list of potential jurors to defendants (which several recent court decisions have required to permit defendants to obtain disclosure of the information from the Secretary) can provide an opportunity for harassment and intimidation of potential jurors in organized crime, drug, and some tax protester cases. Third, significant judicial resources have been expended in interpreting this procedural requirement that might better be spent resolving substantive disputes. Fourth, differing judicial interpretations of the nature of this provision have caused confusion. In some instances, defendants convicted of criminal tax offenses have obtained reversals of those convictions because of failures to comply fully with this provision.

Explanation of Provision

The bill repeals the requirement that the Secretary disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service.

Effective Date

The provision is effective for judicial proceedings pending on, or commenced after, the date of enactment.

4. Repeal TEFRA audit rules for S corporations (sec. 904 of the bill and secs. 6037, 6241, 6242, 6243, 6244, and 6245 of the Code)

Present Law

An S corporation generally is not subject to income tax on its taxable income. Instead, it files an information return and the shareholders report their pro rata share of the S corporation's income and deductions on their own tax returns.

The Subchapter S Revision Act of 1982 generally made the TEFRA partnership audit and litigation rules applicable to S corporations. These rules require the determination of all "Subchapter S items" at the corporate, rather than the shareholder, level. These rules also require a shareholder to report all Subchapter S items consistently with the corporation's information return or to notify the IRS of any inconsistency. Temporary regulations contain an exception from these rules for "small S corporations," i.e., those with

five or fewer shareholders, each of whom is a natural person or an estate.

Reasons for Simplification

An S corporation generally is limited to 35 investors. In addition, the vast majority of both existing and newly formed S corporations are expected to qualify for the small S corporation exception from the unified audit and litigation provisions. Consequently, a unified audit procedure is an unnecessary requirement for S corporations.

Explanation of Provision

The bill repeals the unified audit procedures for S corporations. The bill retains, however, the requirement that shareholders report items in a manner consistent with the corporation's return.

Effective Date

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

5. Clarify statute of limitations for items from pass-through entities (sec. 905 of the bill and sec. 6501(a) of the Code)

Present Law

Passthrough entities (such as S corporations, partnerships, and certain trusts) generally are not subject to income tax on their taxable income. Instead, these entities file information returns and the entities' shareholders (or beneficial owners) report their pro rata share of the gross income and are liable for any taxes due.

Some believe that present law may be unclear as to whether the statute of limitations for adjustments that arise from distributions from passthrough entities should be applied at the entity or individual level (i.e., whether the 3-year statute of limitations for assessments runs from the time that the entity files its information return or from the time that a shareholder timely files his or her income tax return). (Compare *Fehlhaber v. Comm.*, 94 TC 863 (1990) with *Kelly v. Comm.*, 877 F.2d 7567 (9th Cir. 1989)).

Reasons for Simplification

Uncertainty regarding the correct statute of limitations hinders the resolution of factual and legal issues and creates needless litigation over collateral matters.

Explanation of Provision

The bill clarifies that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit. The provision is not intended to create any inference as to the proper interpretation of present law.

Effective Date

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

6. Interest rate on large corporate underpayments (sec. 906 of the bill and sec. 6621(c) of the Code)

Present Law

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

Reasons for Simplification

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

Explanation of Provision

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

Effective Date

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

7. Simplify estimated tax payment rules for small corporations (sec. 907 of the bill and sec. 6655 of the Code)

Present Law

A corporation is subject to an addition to tax for any underpayment of estimated tax. For taxable years beginning after June 30, 1992 and before 1997, a corporation does not have an underpayment of estimated tax if it makes four timely estimated tax payments that total at least 97 percent of its tax liability for the cur-

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

Reasons for Simplification

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

Explanation of Provision

The bill provides that a small corporation (i.e., a corporation that is not a "large corporation" under present law) with no tax liability in the preceding taxable year may avoid the addition to tax if it makes four timely estimated tax payments each equal to at least 25 percent of its tax liability for the second preceding taxable year.[133] This rule will apply so long as (1) neither the preceding taxable year nor the second preceding taxable year was a short tax year, and (2) the corporation filed tax returns for both years. If the corporation satisfies these two requirements and did not have a tax liability for either of the two preceding taxable years, the corporation will not be required to make estimated tax payments for the current taxable year.

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

Effective Date

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

B. Tax Court Provisions

1. Clarify jurisdiction of Tax Court with respect to overpayment determinations (sec. 911 of the bill and sec. 6512(b) of the Code)

Present Law

The Tax Court may order the refund of an overpayment determined by the Court, plus interest, if the IRS fails to refund such overpayment and interest within 120 days after the Court's deci-

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

sion becomes final. Whether such an order is appealable is uncertain.

In addition, it is unclear whether the Tax Court has jurisdiction over the validity or merits of certain credits or offsets (e.g., providing for collection of student loans, child support, etc.) made by the IRS that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Reasons for Simplification

Clarification of the jurisdiction of the Tax Court and the appealability of orders of the Tax Court would provide for greater certainty for taxpayers and the Government in conducting cases before the Tax Court. Clarification will also reduce litigation.

Explanation of Provision

The bill clarifies that an order to refund an overpayment is appealable in the same manner as a decision of the Tax Court. The bill also clarifies that the Tax Court does not have jurisdiction over the validity or merits of the credits or offsets that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Effective Date

The provision is effective on the date of enactment.

2. Clarify procedures for administrative cost awards (sec. 912 of the bill and sec. 7430 of the Code)

Present Law

Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding.

No time limit is specified for the taxpayer to apply to the IRS for an award of administrative costs. In addition, no time limit is specified for a taxpayer to appeal to the Tax Court an IRS decision denying an award of administrative costs. Finally, the procedural rules for adjudicating a denial of administrative costs are unclear.

Reasons for Simplification

The proper procedures for applying for a cost award are uncertain in some instances. Clarifying these procedures will decrease litigation over these procedural issues and will provide for expedited settlement of these claims.

Explanation of Provision

The bill provides that a taxpayer who seeks an award of administrative costs must apply for such costs within 90 days of the date on which the taxpayer was determined to be a prevailing party. The bill also provides that a taxpayer who seeks to appeal an IRS

denial of an administrative cost award must petition the Tax Court within 90 days after the date that the IRS mails the denial notice.

The bill clarifies that dispositions by the Tax Court of petitions relating only to administrative costs are to be reviewed in the same manner as other decisions of the Tax Court.

Effective Date

The provision is effective on the date of enactment.

3. Clarify Tax Court jurisdiction over interest determinations (sec. 913 of the bill and sec. 7481(c) of the Code)

Present Law

A taxpayer may seek a redetermination of interest after certain decisions of the Tax Court have become final by filing a petition with the Tax Court.

Reasons for Simplification

It would be beneficial to taxpayers if a proceeding for a redetermination of interest supplemented the original deficiency action brought by the taxpayer to redetermine the deficiency determination of the IRS. A motion, rather than a petition, is a more appropriate pleading for relief in these cases.

Explanation of Provision

The bill provides that a taxpayer must file a "motion" (rather than a "petition") to seek a redetermination of interest in the Tax Court.

Effective Date

The provision is effective on the date of enactment.

4. Clarify net worth requirements for awards of administrative or litigation costs (sec. 914 of the bill and sec. 7430 of the Code)

Present Law

Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding. A person who substantially prevails must meet certain net worth requirements to be eligible for an award of administrative or litigation costs. In general, only an individual whose net worth does not exceed $2,000,000 is eligible for an award, and only a corporation or partnership whose net worth does not exceed $7,000,000 is eligible for an award. (The net worth determination with respect to a partnership or S corporation applies to all actions that are in substance partnership actions or S corporation actions, including unified entity-level proceedings under sections 6226 or 6228, that are nominally brought in the name of a partner or a shareholder.)

Reasons for Simplification

Although the net worth requirements are explicit for individuals, corporations, and partnerships, it is not clear which net worth requirement is to apply to other potential litigants. It is also unclear how the individual net worth rules are to apply to individuals filing a joint tax return. Clarifying these rules will provide certainty for potential claimants and will decrease needless litigation over procedural issues.

Explanation of Provision

The bill provides that the net worth limitations currently applicable to individuals also apply to estates and trusts. The bill also provides that individuals who file a joint tax return shall be treated as one individual for purposes of computing the net worth limitations. Consequently, the net worths of both spouses are aggregated for purposes of this computation. An exception to this rule is provided in the case of a spouse otherwise qualifying for innocent spouse relief.

Effective Date

The provision applies to proceedings commenced after the date of enactment.

C. Permit IRS to Enter Into Cooperative Agreements With State Tax Authorities (sec. 921 of the bill and new sec. 7524 of the Code)

Present Law

The IRS is generally not authorized to provide services to non-Federal agencies even if the cost is reimbursed (62 Comp. Gen. 323,335 (1983)).

Reasons for Simplification

Most taxpayers reside in States with an income tax and, therefore, must file both Federal and State income tax returns each year. Each return is separately prepared, with the State return often requiring information taken directly from the Federal return. Permitting the IRS to enter into agreements that are designed to promote efficiency through joint tax administration programs with States would reduce the burden on taxpayers because much of the same information could be used by both Governments.

For example, the burden on taxpayers could be significantly reduced through joint electronic filing of tax returns, whereby a taxpayer electronically transmits both Federal and State returns to one location. Joint Federal and State electronic filing could simplify and shorten return preparation time for taxpayers. Also, State governments could benefit from reduced processing costs, while the IRS could benefit from the potential increase in taxpayers who would elect to file electronically because they would be able to fulfill both their Federal and State obligations simultaneously.

Explanation of Provision

The bill provides that the Secretary is authorized to enter into cooperative agreements with State tax authorities to enhance joint tax administration. These agreements may include (1) joint filing of Federal and State income tax returns, (2) single processing of these returns, and (3) joint collection of taxes (other than Federal income taxes).

The bill provides that these agreements may require reimbursement for services provided by either party to the agreement. Any funds appropriated for tax administration may be used to carry out the responsibilities of the IRS under these agreements, and any reimbursement received under an agreement shall be credited to the amount appropriated.

No agreement may be entered into that does not provide for the protection of confidentiality of taxpayer information that is required by section 6103.

Effective Date

The provision is effective on the date of enactment.

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