TECHNICAL EXPLANATION OF THE
"ECONOMIC SECURITY AND WORKER ASSISTANCE ACT OF 2001"

Prepared by
the Staff of the
JOINT COMMITTEE ON TAXATION

December 19, 2001
JCX-91-01

CONTENTS

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the "Economic Security and Worker Assistance Act of 2001."

---

[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the "Economic Security and Worker Assistance Act of 2001"* (JCX-91-01), December 19, 2001.

I. SUPPLEMENTAL STIMULUS PAYMENTS (sec. 101 of the bill and sec. 6428 of the Code)

Present Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 provided for a rate reduction credit for 2001. The credit is computed in the following manner. Taxpayers are entitled to a credit in tax year 2001 of 5 percent (the difference between the 15-percent rate and the 10-percent rate) of the amount of income that would have been eligible for the new 10-percent rate. Taxpayers may not receive this credit in excess of their income tax liability (determined after nonrefundable credits).

Most eligible taxpayers have received this credit in the form of a check issued by the Department of the Treasury. The amount of the check was computed in the same manner as the credit, except that it was done on the basis of tax returns filed for 2000 (instead of 2001).

On their tax returns for 2001, taxpayers will reconcile the amount of the credit with the check they receive in the following manner. They will complete a worksheet calculating the amount of the credit based on their 2001 tax return. They will then subtract from the credit the amount of the check they received. For many taxpayers, these two amounts will be the same. If, however, the result is a positive number (because, for example, the taxpayer paid no tax in 2000 but is paying tax in 2001), the taxpayer may claim that amount as a credit against 2001 tax liability. If, however, the result is negative (because, for example, the taxpayer paid tax in 2000 but owes no tax for 2001), the taxpayer is not required to repay that amount to the Treasury. Otherwise, the checks have no effect on tax returns filed in 2001; the amount is not includible in gross income and it does not otherwise reduce the amount of withholding. In no event may the Department of the Treasury issue checks after December 31, 2001. This is designed to prevent errors by taxpayers who might claim the full amount of the credit on their 2001 tax returns and file those returns early in 2002, at the same time the Treasury check might be mailed to them. Payment of the credit (or the check) is treated, for all purposes of the Code,[2] as a payment of tax. As such, the credit or the check is subject to the refund offset provisions, such as those applicable to past-due child support under section 6402 of the Code.

In general, taxpayers eligible for the credit (and the check) are individuals other than estates or trusts, nonresident aliens, or dependents. The determination of this status for the relevant year is made on the basis of the information filed on the tax return.

Explanation of Provision

The bill provides for new supplemental stimulus payments. Individuals who filed income tax returns for 2000[3] before October 16, 2001 (regardless of whether they had any income tax

---

[2] A special rule provides that no interest will be paid with respect to the checks.

[3] Taxpayers who did not file an income tax return for 2000 but who do file an income tax return for 2001 will continue to be eligible for the rate reduction credit previously enacted, the

liability, any payroll tax liability, or showed any amount as wages) are eligible for this payment. The amount of the payment is calculated in the following manner: taxpayers are eligible for the maximum payment amount for their filing status ($300 single or married filing separately, $500 head of household, $600 joint filers) minus the amount (if any) of any previous rebate check issued. Thus, for example, if a single person received $100 earlier this year as her rate reduction credit, she will receive an additional $200 as a supplemental stimulus payment. Those taxpayers who earlier received the full amount for their filing status will receive no supplemental stimulus payment.

Dependents and nonresident aliens generally are ineligible for these supplemental stimulus payments (as they were for the previous rebates). It is expected that the IRS will send notices to affected taxpayers explaining the computation of their supplemental stimulus payment amounts and how the taxpayer should properly complete the rebate reconciliation schedule contained in the tax return forms package.

Effective Date

The provision is effective on the date of enactment. In order to prevent difficulties that could arise in the simultaneous administration of the rebate and supplemental stimulus payment provisions, the issuance of checks under the previous rebate provision is required to cease on the earlier of the date of enactment of the supplemental stimulus payment provision or December 31, 2001.

---

amount of which is dependent upon the amount of income subject to the 10-percent rate. They are not, however, eligible for this stimulus payment.

II. INDIVIDUAL PROVISIONS

A. Accelerate the 25-Percent Rate Bracket to 2002 (sec. 102 of the bill and sec. 1 of the Code)

Present Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") reduced the prior-law 28-percent individual regular income tax rate to 25 percent. This rate reduction is phased-in over six years. The rate is 27 percent for taxable years beginning in calendar years 2001-2003,[4] 26 percent for taxable years beginning in calendar years 2004-2005, and 25 percent for taxable years beginning in calendar years 2006 and thereafter.

Explanation of Provision

The bill provides that the 25-percent rate is effective for taxable years beginning after December 31, 2001.

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

---

[4] A blended rate of 27.5 percent applies in 2001 because of the July 1, 2001 effective date of EGTRRA.

B. Alternative Minimum Tax Exemption for Individuals (sec. 102(b) of the bill and sec. 55 of the Code)

Present Law

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $45,000 ($49,000 in taxable years beginning before 2005) in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 ($35,750 in taxable years beginning before 2005) in the case of other unmarried individuals; (3) $22,500 ($24,500 in taxable years beginning before 2005) in the case of married individuals filing a separate return; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Explanation of Provision

For 2002 and 2003, the $49,000 exemption amount is increased by $3,200; the $35,750 exemption amount is increased by $1,600; and the $24,500 exemption amount is increased by $1,600.

For 2004, the $49,000 exemption amount is increased by $1,700; the $35,750 exemption amount is increased by $850; and the $24,500 exemption amount is increased by $850.

Effective Date

The provision is effective for taxable years beginning after December 31, 2001 and before January 1, 2005.

III. BUSINESS PROVISIONS

A. Special Depreciation Allowance for Certain Property (sec. 201 of the bill and sec. 168 of the Code)

Present Law

Depreciation deductions

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Section 280F limits the annual depreciation deductions with respect to passenger automobiles to specified dollar amounts, indexed for inflation.

Section 167(f)(1) provides that capitalized computer software costs, other than computer software to which section 197 applies, are recovered ratably over 36 months.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment generally may elect to deduct up to $24,000 (for taxable years beginning in 2001 or 2002) of the cost of qualifying property placed in service for the taxable year (sec. 179). This amount is increased to $25,000 for taxable years beginning in 2003 and thereafter. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

Explanation of Provision

The provision allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.[5] The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year

---

[5] The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under section 162 or subject to capitalization under section 263 or section 263A.

depreciation deduction. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements. First, the property must be property to which the general rules of MACRS[6] apply with (1) an applicable recovery period of 20 years or less (except for qualified leasehold improvement property[7]), (2) water utility property (as defined in section 168(e)(5)), or (3) computer software other than computer software covered by section 197. Second, the original use[8] of the property must commence with the taxpayer on or after September 11, 2001.[9] Third, the taxpayer must purchase the property within the applicable time period. Finally, the property must be placed in service before January 1, 2005. An extension of the place in service date of one year (i.e., January 1, 2006) is provided for certain property with a recovery period of ten years or longer and certain transportation property.[10] Transportation

---

[6] A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.

[7] Qualified leasehold improvement property (which includes qualified New York Liberty Zone leasehold improvement property) means property defined in section 168(e)(6). Section 168(e)(6) is added by section 205 of the bill.

[8] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. It is intended that, when evaluating whether property qualifies as "original use," the factors used to determine whether property qualified as "new section 38 property" for purposes of the investment tax credit would apply. See Treasury Regulation 1.48-2. Thus, it is intended that additional capital expenditures incurred to recondition or rebuild acquired property (or owned property) would satisfy the "original use" requirement. However, the cost of reconditioned or rebuilt property acquired by the taxpayer would not satisfy the "original use" requirement. For example, if on February 1, 2002, a taxpayer buys from X for $20,000 a machine that has been previously used by X. Prior to September 11, 2004, the taxpayer makes an expenditure on the property of $5,000 of the type that must be capitalized. Regardless of whether the $5,000 is added to the basis of such property or is capitalized as a separate asset, such amount would be treated as satisfying the "original use" requirement and would be qualified property (assuming all other conditions are met). No part of the $20,000 purchase price would qualify for the additional first year depreciation.

[9] A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

[10] In order for property to qualify for the extended placed in service date, the property is required to have a production period exceeding two years or an estimated production period exceeding one year and a cost exceeding $1 million.

property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is (1) after September 10, 2001 and before September 11, 2004, and no binding written contract for the acquisition is in effect before September 11, 2001 or (2) pursuant to a binding written contract which was entered into after September 10, 2001, and before September 11, 2004. With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after September 10, 2001, and before September 11, 2004. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before September 11, 2004 ("progress expenditures") shall be eligible for the additional first year depreciation.[11]

The limitation on the amount of depreciation deductions allowed with respect to certain passenger automobiles (sec. 280F of the Code) is increased in the first year by $4,600 for automobiles that qualify (and do not elect out of the increased first year deduction). The $4,600 increase is not indexed for inflation.

The following examples illustrate the operation of the provision.

EXAMPLE 1. -- Assume that on March 1, 2002, a calendar year taxpayer acquires and places in service qualified property that costs $1 million. Under the provision, the taxpayer is allowed an additional first-year depreciation deduction of $300,000. The remaining $700,000 of adjusted basis is recovered in 2002 and subsequent years pursuant to the depreciation rules of present law.

EXAMPLE 2. -- Assume that on March 1, 2002, a calendar year taxpayer acquires and places in service qualified property that costs $50,000. In addition, assume that the property qualifies for the expensing election under section 179. Under the provision, the taxpayer is first allowed a $35,000 deduction under section 179.[12] The taxpayer then is allowed an additional first-year depreciation deduction of $4,500 based on $15,000 ($50,000 original cost less the section 179 deduction of $35,000) of adjusted basis. Finally, the remaining adjusted basis of $10,500 ($15,000 adjusted basis less $4,500 additional first-year depreciation) is to be recovered in 2002 and subsequent years pursuant to the depreciation rules of present law.

---

[11] For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to sec. 46(d)(3) as in effect prior to the Tax Reform Act of 1986 shall apply.

[12] A subsequent provision in the bill increases the amount deductible in 2002 under section 179 to $35,000.

Effective Date

The provision applies to property placed in service after September 10, 2001.

B. Temporary Increase in Section 179 Expensing (sec. 202 of the bill and sec. 179 of the Code)

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $24,000 (for taxable years beginning in 2001 or 2002) of the cost of qualifying property placed in service for the taxable year (sec. 179). This amount is increased to $25,000 of the cost of qualified property placed in service for taxable years beginning in 2003 and thereafter. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $24,000 ($25,000 for taxable years beginning in 2003 and thereafter) amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

Explanation of Provision

The provision provides that the maximum dollar amount that may be deducted under section 179 is increased to $35,000 for property placed in service in taxable years beginning after December 31, 2001, and before January 1, 2004.[13] The provision increases the present law $200,000 limit to $325,000. Thus, under the provision the $35,000 amount is reduced by the amount by which the cost of qualifying property placed in service exceeds $325,000. As under present law, no general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. For taxable years beginning after December 31, 2003, present law applies (i.e., up to a $25,000 deduction that is reduced by the amount of qualifying property placed in service by the taxpayer that exceeds $200,000).

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

[13] As a result of the increased deduction, the maximum dollar amount that may be deducted by an enterprise zone business, a renewal community business, or a business located in the New York Liberty Zone (see section 401 of the bill) is increased to $70,000 for taxable years beginning after December 31, 2001, and before January 1, 2004. See sec. 1397A, sec. 1400J, and sec 1400L.

C. Modify Alternative Minimum Tax
(sec. 203 of the bill and secs. 56 and 59 of the Code)

<u>Present Law</u>

Present law imposes an alternative minimum tax ("AMT") on an individual or a corporation to the extent the taxpayer's tentative minimum tax exceeds its regular tax liability. The individual tentative minimum tax is computed at rates of 26 and 28 percent on alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount; the corporate tentative minimum tax is computed at a rate of 20 percent on AMTI in excess of a phased-out $40,000 exemption amount. Corporations with average gross receipts of less than $7.5million are generally exempt from the AMT.

AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. In the case of a corporation, in addition to the regular set of adjustments and preferences, there is a second set of adjustments known as the "adjusted current earnings" adjustment.

One of the adjustments in computing AMTI is an adjustment for depreciation. In the case of property place in service after 1998, the 150-percent declining balance method is used rather than the 200-percent declining balance method, using the same recovery periods that are used for regular tax purposes. Other adjustments apply to property place in service before 1999.

A taxpayer's net operating loss deduction may not exceed 90 percent of AMTI determined without regard to the deduction. Foreign tax credits cannot reduce a taxpayer's tentative minimum tax by more than 90 percent of the amount of tentative minimum tax that would be computed without regard to the foreign tax credit and the net operating loss deduction.

<u>Explanation of Provision</u>

The provision repeals the minimum tax depreciation adjustments.

The provision repeals the 90-percent limitations on the use of the net operating loss deduction and foreign tax credits.

<u>Effective Date</u>

The provision applies to taxable years beginning after December 31, 2001. The depreciation change applies to property placed in service in those years.

D. Five-Year Carryback of Net Operating Losses (sec. 204 of the bill and secs. 172 and 56 of the Code)

Present Law

A net operating loss ("NOL") is, generally, the amount by which a taxpayer's allowable deductions exceed the taxpayer's gross income. A carryback of an NOL generally results in the refund of Federal income tax for the carryback year. A carryforward of an NOL reduces Federal income tax for the carryforward year.

In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years. Different rules apply with respect to NOLs arising in certain circumstances. For example, a three-year carryback applies with respect to NOLs (1) arising from casualty or theft losses of individuals, or (2) attributable to Presidentially declared disasters for taxpayers engaged in a farming business or a small business. A five-year carryback period applies to NOLs from a farming loss (regardless of whether the loss was incurred in a Presidentially declared disaster area). Special rules also apply to real estate investment trusts (no carryback), specified liability losses (10-year carryback), and excess interest losses (no carryback to any year preceding a corporate equity reduction transaction).

The alternative minimum tax rules provide that a taxpayer's NOL deduction cannot reduce the taxpayer's alternative minimum taxable income ("AMTI") by more than 90 percent of the AMTI.

Explanation of Provision

The provision temporarily extends the general NOL carryback period to five years (from two years) for NOLs arising in taxable years ending in 2001 and 2002.[14] In addition, the five-year carryback period applies to NOLs from these years that qualify under present law for a three-year carryback period (i.e., NOLs arising from casualty or theft losses of individuals or attributable to certain Presidentially declared disaster areas).

---

[14] The provision does not affect the terms and conditions that the Internal Revenue Service may impose on a taxpayer seeking approval for a change in its annual accounting period. *See e.g.*, Rev. Proc. 2000-11, 2000-1 C.B. 309, sec. 5.06 ("If the corporation (or consolidated group) has a NOL (or consolidated NOL) in the short period required to effect the change, the NOL may not be carried back but must be carried over in accordance with the provisions of sec. 172 beginning with the first taxable year after the short period. However, the short period NOL (or consolidated NOL) is carried back or carried over in accordance with sec. 172 if it is either: (a) $50,000 or less, or (b) results from a short period of 9 months or longer and is less than the NOL (or the consolidated NOL) for a full 12-month period beginning with the first day of the short period.")

The provision also allows an NOL deduction attributable to these taxable years to offset 100 percent of a taxpayer's AMTI in a carryback year.[15]

A taxpayer can elect to forgo the five-year carryback period. The election to forgo the five-year carryback period is made in the manner prescribed by the Secretary of the Treasury and must be made by the due date of the return (including extensions) for the year of the loss. The election is irrevocable. If a taxpayer elects to forgo the five-year carryback period, then the losses are subject to the rules that otherwise would apply under section 172 absent the provision.

Effective Date

The provision is effective for net operating losses generated in taxable years ending after December 31, 2000.

---

[15] Section 172(b)(2) should be appropriately applied in computing AMTI to take proper account of the order that the NOL carryovers and carrybacks are used as a result of this provision. *See* section 56(d)(1)(B)(ii). A separate provision (section 203) repeals the 90 percent NOL limitation under the AMT rules for taxable years beginning after December 31, 2001.

E. Treatment of Leasehold Improvements (sec. 205 of the bill and sec. 168 of the Code)

Present Law

Depreciation of leasehold improvements

Depreciation allowances for property used in a trade or business generally are determined under the modified Accelerated Cost Recovery System ("MACRS") of section 168. Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)).[16] This rule applies regardless whether the lessor or lessee places the leasehold improvements in service.[17] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168(b)(3), (c)(1), (d)(2), and (i)(6)).[18]

Treatment of dispositions of leasehold improvements

A lessor of leased property that disposes of a leasehold improvement which was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrevocably disposed of or abandoned by the lessor at the termination of the lease.[19] This rule conforms the treatment of

---

[16] The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System ("ACRS") to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The Tax Reform Act of 1986 also denied the use of component depreciation under MACRS.

[17] Former Code sections 168(f)(6) and 178 provided that in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. These provisions were repealed by the Tax Reform Act of 1986.

[18] If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods and accelerated methods applicable to such property. The determination of whether certain improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a "structural component" of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, for example, *Metro National Corp.*, 52 TCM 1440 (1987); *King Radio Corp.*, 486 F.2d 1091 (10th Cir., 1973); *Mallinckrodt, Inc.*, 778 F.2d 402 (8th Cir., 1985) (with respect various leasehold improvements).

[19] The conference report describing this provision mistakenly states that the provision applies to improvements that are irrevocably disposed of or abandoned by the *lessee* (rather than the *lessor*) at the termination of the lease.

lessors and lessees with respect to leasehold improvements disposed of at the end of a term of lease. For purposes of applying this rule, it is expected that a lessor must be able to separately account for the adjusted basis of the leasehold improvement that is irrevocably disposed of or abandoned. This rule does not apply to the extent section 280B applies to the demolition of a structure, a portion of which may include leasehold improvements.[20]

Explanation of Provision

The provision provides that 15-year property for purposes of the depreciation rules of section 168 includes qualified leasehold improvement property. The straight line method is required to be used with respect to qualified leasehold improvement property.

Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee) of that portion of the building, or by the lessor of that portion of the building. That portion of the building is to be occupied exclusively by the lessee (or any sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service.

Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

A 15-year period is specified as the class life of qualified leasehold improvement property for purposes of the alternative depreciation system. Therefore, the general rule that the class life for nonresidential real and residential rental property is 40 years does not apply to qualified leasehold improvement property.

For purposes of the provision, a commitment to enter into a lease is treated as a lease, and the parties to the commitment are treated as lessor and lessee. A lease between related persons is not considered a lease for this purpose.

Under the provision, an improvement made by the person who was the lessor of the improvement when it was placed in service generally is treated as qualified leasehold improvement property only so long as the improvement is held by that person. Exceptions are provided under this rule in the case of certain changes in form of business. Under these exceptions, property does not cease to be qualified leasehold improvement property under the provision by reason of (1) death, (2) a transaction to which section 381 (relating to carryovers in certain corporate acquisitions) applies, or (3) a mere change in the form of conducting the trade or business so long as the property is retained in the business as qualified leasehold improvement property and the taxpayer retains a substantial interest in the business. In the case of property that ceases to be treated as leasehold improvement property because the taxpayer fails to retain a

---

[20] Under present law, section 280B denies a deduction for any loss sustained on the demolition of any structure.

substantial interest in a trade or business in connection with such a mere change in form, the remaining adjusted basis of the property is depreciated over 39 years.

Qualified leasehold improvement property is not eligible for the 30 percent expensing provided under a separate provision of the bill.

Effective Date

The provision is effective for qualified leasehold improvement property placed in service on or after September 11, 2001.

IV. EXTENSIONS OF CERTAIN EXPIRING PROVISIONS

A. Extend Alternative Minimum Tax Relief for Individuals (sec. 301 of the bill and sec. 26 of the Code)

Present Law

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit[21], the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the IRA credit, and the D.C. homebuyer's credit). For taxable years beginning after 2001, these credits (other than the adoption credit, child credit and IRA credit) are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, child credit, and IRA credit are allowed to the full extent of the individual's regular tax and alternative minimum tax.

For taxable years beginning in 2001, all the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $45,000 ($49,000 in taxable years beginning before 2005) in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 ($35,750 in taxable years beginning before 2005) in the case of other unmarried individuals; (3) $22,500 ($24,500 in taxable years beginning before 2005) in the case of married individuals filing a separate return; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Explanation of Provision

The provision allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the personal nonrefundable credits in 2002 and 2003.

---

[21] A portion of the child credit may be refundable.

Effective Date

The provision is effective for taxable years beginning in 2002 and 2003.

B. Extend Credit for Purchase of Electric Vehicles (sec. 302 of the bill and secs. 30 and 280F of the Code)

Present Law

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000 (sec. 30). A qualified electric vehicle is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current, the original use of which commences with the taxpayer, and that is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2002. The credit phases down in the years 2002 through 2004, and is unavailable for purchases after December 31, 2004.[22]

Explanation of Provision

The bill defers the phase down of the credit for two years. Taxpayers may claim the full amount of the credit for qualified purchases made in 2002 and 2003. Under the bill, the phase down of the credit value commences in 2004 and the credit is unavailable for purchases after December 31, 2006. A conforming modification is made to section 280F.

Effective Date

The provision is effective on the date of enactment.

---

[22] The amount the taxpayer may claim as a depreciation deduction for any passenger automobile is limited (sec. 280F). In the case of a passenger vehicle designed to be propelled primarily by electricity and built by an original equipment manufacturer, the otherwise applicable limitation amounts are tripled. These exceptions from sec. 280F apply to vehicles placed in service prior to January 1, 2005.

C. Extend Section 45 Credit for Production of Electricity from Wind, Closed Loop Biomass, and Poultry Litter (sec. 303 of the bill and sec. 45 of the Code)

Present Law

An income tax credit is allowed for the production of electricity from either qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste facilities (sec. 45).

The credit applies to electricity produced by a wind energy facility placed in service after December 31, 1993, and before January 1, 2002, to electricity produced by a closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2002, and to a poultry waste facility placed in service after December 31, 1999, and before January 1, 2002. The credit is allowable for production during the 10-year period after a facility is originally placed in service. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party. In the case of a poultry waste facility, the taxpayer may claim the credit as a lessee/operator of a facility owned by a governmental unit.

Closed-loop biomass is plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not include waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). The credit also is not available to taxpayers who use standing timber to produce electricity. Poultry waste means poultry manure and litter, including wood shavings, straw, rice hulls, and other bedding material for the disposition of manure.

The credit for electricity produced from wind, closed-loop biomass, or poultry waste is a component of the general business credit (sec. 38(b)(8)). The credit, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000, or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39). To coordinate the carryback with the period of application for this credit, the credit for electricity produced from closed-loop biomass facilities may not be carried back to a tax year ending before 1993 and the credit for electricity produced from wind energy may not be carried back to a tax year ending before 1994 (sec. 39).

Explanation of Provision

The bill extends the placed in service date for qualified facilities by two years to include those facilities placed in service prior to January 1, 2004.

Effective Date

The provision is effective on the date of enactment.

D. Extend the Work Opportunity Tax Credit (sec. 304 of the bill and sec. 51 of the Code)

Present Law

In general

The work opportunity tax credit ("WOTC") is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit equals 40 percent (25 percent for employment of less than 400 hours) of qualified wages. Generally, qualified wages are wages attributable to service rendered by member of a targeted group during the one-year period beginning with the day the individual began work for the employer.

The maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages).

For purposes of the credit, wages are generally defined as under the Federal Unemployment Tax Act, without regard to the dollar cap.

Targeted groups eligible for the credit

The eight targeted groups are: (1) families eligible to receive benefits under the Temporary Assistance for Needy Families ("TANF") Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income ("SSI") benefits.

The employer's deduction for wages is reduced by the amount of the credit.

Expiration date

The credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2002.

Explanation of Provision

The bill extends the work opportunity tax credit for two years (through December 31, 2003).

Effective Date

The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2002, and before January 1, 2004.

E. Extend the Welfare-To-Work Tax Credit (sec. 305 of the bill and sec. 51A of the Code)

Present Law

In general

The welfare-to-work tax credit is available on an elective basis for employers for the first $20,000 of eligible wages paid to qualified long-term family assistance recipients during the first two years of employment. The credit is 35 percent of the first $10,000 of eligible wages in the first year of employment and 50 percent of the first $10,000 of eligible wages in the second year of employment. The maximum credit is $8,500 per qualified employee.

Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family that is no longer eligible for family assistance because of either Federal or State time limits, if they are hired within two years after the Federal or State time limits made the family ineligible for family assistance. Family assistance means benefits under the Temporary Assistance to Needy Families ("TANF") program.

For purposes of the credit, wages are generally defined under the Federal Unemployment Tax Act, without regard to the dollar amount. In addition, wages include the following: (1) educational assistance excludable under a section 127 program; (2) the value of excludable health plan coverage but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129.

The employer's deduction for wages is reduced by the amount of the credit.

Expiration date

The welfare to work credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2002.

Explanation of Provision

The bill extends the welfare to work credit for two years (through December 31, 2003).

Effective Date

The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2002, and before January 1, 2004.

F. Extend Deduction for Qualified Clean-Fuel Vehicle Property and Qualified Clean-Fuel Vehicle Refueling Property (sec. 306 of the bill and secs. 179A and 280F of the Code)

Present Law

Certain costs of qualified clean-fuel vehicle property and clean-fuel vehicle refueling property may be expensed and deducted when such property is placed in service (sec. 179A).[23] Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which is methanol, ethanol, any other alcohol or ether). The maximum amount of the deduction is $50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with seating capacities of at least 20 adults; $5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and $2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction.

Clean-fuel vehicle refueling property comprises property for the storage or dispensing of a clean-burning fuel, if the storage or dispensing is the point at which the fuel is delivered into the fuel tank of a motor vehicle. Clean-fuel vehicle refueling property also includes property for the recharging of electric vehicles, but only if the property is located at a point where the electric vehicle is recharged. Up to $100,000 of such property at each location owned by the taxpayer may be expensed with respect to that location.

The deduction for clean-fuel vehicle property phases down in the years 2002 through 2004, and is unavailable for purchases after December 31, 2004. The deduction for clean-fuel vehicle refueling property is unavailable for property placed in service after December 31, 2004.

Explanation of Provision

The bill defers the phase down of the deduction for clean-fuel vehicle property by two years. Taxpayers may claim the full amount of the deduction for qualified vehicles placed in service in 2002 and 2003. Under the bill, the phase down of the deduction for clean-fuel vehicles commences in 2004 and the deduction is unavailable for purchases after December 31, 2006. A conforming modification is made to section 280F.

---

[23] The amount the taxpayer may claim as a depreciation deduction for any passenger automobile is limited (sec. 280F). In the case of a qualified clean-burning fuel vehicle, the limitation of sec. 280F applies only to that portion of the vehicle's cost not represented by the installed qualified clean-burning fuel property. The taxpayer may claim an amount otherwise allowable as a depreciation deduction on the installed qualified clean-burning fuel property, without regard to the limitation. These exceptions from sec. 280F apply to vehicles placed in service prior to January 1, 2005.

The provision extends the placed in service date for clean-fuel vehicle refueling property by two years. The deduction for clean-fuel vehicle refueling property is available for property placed in service prior to January 1, 2007.

Effective Date

The provision is effective on the date of enactment.

G. Taxable Income Limit on Percentage Depletion for Marginal Production (sec. 307 of the bill and sec. 613A of the Code)

Present Law

In general

Depletion, like depreciation, is a form of capital cost recovery. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset -- in the case of depletion for oil or gas interests, the mineral reserve itself -- is being expended in order to produce income. Certain costs incurred prior to drilling an oil or gas property are recovered through the depletion deduction. These include costs of acquiring the lease or other interest in the property and geological and geophysical costs (in advance of actual drilling). Depletion is available to any person having an economic interest in a producing property.

Two methods of depletion are allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method (secs. 611-613). Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

Under the percentage depletion method, generally, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year (sec. 613A(c)). The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation") (sec. 613(a)). The Taxpayer Relief Act of 1997 suspended the 100-percent-of-net-income limitation for production from marginal wells for taxable years beginning after December 31, 1997, and before January 1, 2000. The limitation subsequently was extended to include taxable years beginning before January 1, 2002. Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions) (sec. 613A(d)(1)).[24] Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.

A taxpayer is required to determine the depletion deduction for each oil or gas property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost depletion method. If the cost depletion deduction is larger, the taxpayer must utilize that method for the taxable year in question (sec. 613(a)).

[24] Amounts disallowed as a result of this rule may be carried forward and deducted in subsequent taxable years, subject to the 65-percent taxable income limitation for those years.

Limitation of oil and gas percentage depletion to independent producers and royalty owners

Generally, only independent producers and royalty owners (as contrasted to integrated oil companies) are allowed to claim percentage depletion. Percentage depletion for eligible taxpayers is allowed only with respect to up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas (sec. 613A(c)). For producers of both oil and natural gas, this limitation applies on a combined basis.

In addition to the independent producer and royalty owner exception, certain sales of natural gas under a fixed contract in effect on February 1, 1975, and certain natural gas from geopressured brine, are eligible for percentage depletion, at rates of 22 percent and 10 percent, respectively. These exceptions apply without regard to the 1,000-barrel-per-day limitation and regardless of whether the producer is an independent producer or an integrated oil company.

Explanation of Provision

The provision extends the period when the 100-percent net-income limit is suspended to include taxable years beginning in 2002 and 2003.

Effective Date

The provision is effective on the date of enactment.

H. Extension of Authority to Issue Qualified Zone Academy Bonds (sec. 308 of the bill and sec. 1397E of the Code)

Present Law

Tax-exempt bonds

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Activities that can be financed with these tax-exempt bonds include the financing of public schools (sec. 103).

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue “qualified zone academy bonds” ("QZABs") (sec. 1397E). A total of $400 million of qualified zone academy bonds may be issued annually in calendar years 1998 through 2001. The $400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

Financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includable in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond.

“Qualified zone academy bonds” are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy” and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a “qualified zone academy” if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zones enterprise community designated under the Code, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

Explanation of Provision

The provision authorizes issuance of up to $400 million of qualified zone academy bonds annually in calendar years 2002 and 2003.

Effective Date

The provision is effective on the date of enactment.

I. Extension of Increased Coverover Payments to Puerto Rico and the Virgin Islands (sec. 309 of the bill and sec. 7652 of the Code)

Present Law

A $13.50 per proof gallon[25] excise tax is imposed on distilled spirits produced in, or imported or brought into, the United States. The excise tax does not apply to distilled spirits that are exported from the United States or to distilled spirits that are consumed in U.S. possessions (e.g., Puerto Rico and the Virgin Islands).

The Code provides for coverover (payment) of $13.25 per proof gallon of the excise tax imposed on rum imported (or brought) into the United States (without regard to the country of origin) to Puerto Rico and the Virgin Islands during the period July 1, 1999 through December 31, 2001. Effective on January 1, 2002, the coverover rate is scheduled to return to its permanent level of $10.50 per proof gallon.

Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.

Explanation of Provision

The provision extends the $13.25-per-proof-gallon coverover rate for two additional years, through December 31, 2003.

Effective Date

The provision is effective on the date of enactment.

[25] A proof gallon is a liquid gallon consisting of 50 percent alcohol.

J. Tax on Failure to Comply with Mental Health Parity Requirements (sec. 310 of the bill and sec. 9812(f) of the Code)

Prior Law

The Mental Health Parity Act of 1996 amended ERISA and the Public Health Service Act to provide that group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not imposed on substantially all medical and surgical benefits. The provisions of the Mental Health Parity Act are effective with respect to plan years beginning on or after January 1, 1998, but do not apply to benefits for services furnished on or after September 30, 2001.

The Taxpayer Relief Act of 1997 added to the Internal Revenue Code the requirements imposed under the Mental Health Parity Act, and imposed an excise tax on group health plans that fail to meet the requirements. The excise tax is equal to $100 per day during the period of noncompliance and is imposed on the employer sponsoring the plan if the plan fails to meet the requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10 percent of the employer's group health plan expenses for the prior year or $500,000. No tax is imposed if the Secretary determines that the employer did not know, and exercising reasonable diligence would not have known, that the failure existed.

The excise tax is applicable with respect to plan years beginning on or after January 1, 1998, and expired with respect to benefits for services provided on or after September 30, 2001.

Explanation of Provision

The excise tax on failures to comply with mental health parity requirements is extended to apply to benefits for services provided during 2002 and 2003.

Effective Date

The provision is effective with respect to plan years beginning after December 31, 2000.

K. Suspension of Reduction of Deductions for Mutual Life Insurance Companies (sec. 311 of the bill and sec. 809 of the Code)

Prior and Present Law

In general, a corporation may not deduct amounts distributed to shareholders with respect to the corporation's stock. The Deficit Reduction Act of 1984 added a provision to the rules governing insurance companies that was intended to remedy the failure of prior law to distinguish between amounts returned by mutual life insurance companies to policyholders as customers, and amounts distributed to them as owners of the mutual company.

Under the provision, section 809, a mutual life insurance company is required to reduce its deduction for policyholder dividends by the company's differential earnings amount. If the company's differential earnings amount exceeds the amount of its deductible policyholder dividends, the company is required to reduce its deduction for changes in its reserves by the excess of its differential earnings amount over the amount of its deductible policyholder dividends. The differential earnings amount is the product of the differential earnings rate and the average equity base of a mutual life insurance company.

The differential earnings rate is based on the difference between the average earnings rate of the 50 largest stock life insurance companies and the earnings rate of all mutual life insurance companies. The mutual earnings rate applied under the provision is the rate for the second calendar year preceding the calendar year in which the taxable year begins. Under present law, the differential earnings rate cannot be a negative number.

A company's equity base equals the sum of: (1) its surplus and capital increased by 50 percent of the amount of any provision for policyholder dividends payable in the following taxable year; (2) the amount of its nonadmitted financial assets; (3) the excess of its statutory reserves over its tax reserves; and (4) the amount of any mandatory security valuation reserves, deficiency reserves, and voluntary reserves. A company's average equity base is the average of the company's equity base at the end of the taxable year and its equity base at the end of the preceding taxable year.

A recomputation or "true-up" in the succeeding year is required if the differential earnings amount for the taxable year either exceeds, or is less than, the recomputed differential earnings amount. The recomputed differential earnings amount is calculated taking into account the average mutual earnings rate for the calendar year (rather than the second preceding calendar year, as above). The amount of the true-up for any taxable year is added to, or deducted from, the mutual company's income for the succeeding taxable year.

Explanation of Provision

The provision provides a zero rate for both the differential earnings rate and recomputed differential earnings rate ("true-up") for a life insurance company's taxable years beginning in 2001, 2002, or 2003, under the rules requiring reduction in certain deductions of mutual life insurance companies (sec. 809).

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

L. Extension of Archer Medical Savings Accounts ("MSAs") (sec. 312 of the bill and sec. 220 of the Code)

Present Law

In general

Within limits, contributions to a an Archer medical savings account ("MSA") are deductible in determining adjusted gross income if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an Archer MSA are not currently taxable. Distributions from an Archer MSA for medical expenses are not taxable. Distributions not used for medical expenses are taxable. In addition, distributions not used for medical expenses are subject to an additional 15-percent tax unless the distribution is made after age 65, death, or disability.

Eligible individuals

Archer MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high deductible health plan.[26] An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year. An individual is not eligible for an Archer MSA if they are covered under any other health plan in addition to the high deductible plan.

Tax treatment of and limits on contributions

Individual contributions to an Archer MSA are deductible (within limits) in determining adjusted gross income (i.e., "above the line"). In addition, employer contributions are excludable from gross income and wages for employment tax purposes (within the same limits), except that this exclusion does not apply to contributions made through a cafeteria plan. In the case of an employee, contributions can be made to an Archer MSA either by the individual or by the individual's employer.

The maximum annual contribution that can be made to an Archer MSA for a year is 65 percent of the deductible under the high deductible plan in the case of individual coverage and 75 percent of the deductible in the case of family coverage.

Definition of high deductible plan

A high deductible plan is a health plan with an annual deductible of at least $1,600 and no more than $2,400 in the case of individual coverage and at least $3,200 and no more than $4,800 in the case of family coverage. In addition, the maximum out-of-pocket expenses with

[26] Self-employed individuals include more than 2-percent shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to section 1372.

respect to allowed costs (including the deductible) must be no more than $3,200 in the case of individual coverage and no more than $5,850 in the case of family coverage.[27] A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage (as described above). In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

Taxation of distributions

Distributions from an Archer MSA for the medical expenses of the individual and his or her spouse or dependents generally are excludable from income.[28] However, in any year for which a contribution is made to an Archer MSA, withdrawals from an Archer MSA maintained by that individual generally are excludable from income only if the individual for whom the expenses were incurred was covered under a high deductible plan for the month in which the expenses were incurred.[29] For this purpose, medical expenses are defined as under the itemized deduction for medical expenses, except that medical expenses do not include expenses for insurance other than long-term care insurance, premiums for health care continuation coverage, and premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law.

Distributions that are not used for medical expenses are includible in income. Such distributions are also subject to an additional 15-percent tax unless made after age 65, death, or disability.

Cap on taxpayers utilizing Archer MSAs

The number of taxpayers benefiting annually from an Archer MSA contribution is limited to a threshold level (generally 750,000 taxpayers). If it is determined in a year that the threshold level has been exceeded (called a "cut-off" year) then, in general, for succeeding years during the pilot period 1997-2002, only those individuals who (1) made an Archer MSA contribution or had an employer Archer MSA contribution for the year or a preceding year (i.e., are active Archer MSA participants) or (2) are employed by a participating employer, those individuals are eligible for an Archer MSA contribution. In determining whether the threshold for any year has been exceeded, Archer MSAs of individuals who were not covered under a health insurance plan for the six month period ending on the date on which coverage under a high deductible plan

---

[27] These dollar amounts are for 2001. These amounts are indexed for inflation in $50 increments.

[28] This exclusion does not apply to expenses that are reimbursed by insurance or otherwise.

[29] The exclusion still applies to expenses for continuation coverage or coverage while the individual is receiving unemployment compensation, even for an individual who is not an eligible individual.

commences would not be taken into account.[30] However, if the threshold level is exceeded in a year, previously uninsured individuals are subject to the same restriction on contributions in succeeding years as other individuals. That is, they would not be eligible for an Archer MSA contribution for a year following a cut-off year unless they are an active Archer MSA participant (i.e., had an Archer MSA contribution for the year or a preceding year) or are employed by a participating employer.

The number of Archer MSAs established has not exceeded the threshold level.

<u>End of Archer MSA pilot program</u>

After 2002, no new contributions may be made to Archer MSAs except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer. An employer is a participating employer if (1) the employer made any Archer MSA contributions for any year to an Archer MSA on behalf of employees or (2) at least 20 percent of the employees covered under a high deductible plan made Archer MSA contributions of at least $100 in the year 2001.

Self-employed individuals who made contributions to an Archer MSA during the period 1997-2002 also may continue to make contributions after 2002.

Explanation of Provision

The provision extends the Archer MSA program for another year, through December 31, 2003.

Effective Date

The provision is effective on the date of enactment.

---

[30] Permitted coverage, as described above, does not constitute coverage under a health insurance plan for this purpose.

M. Extension of Tax Incentives for Investment on Indian Reservations (sec. 313 of the bill and secs. 45A and 168(j) of the Code)

Present Law

Present law provides the following tax incentives in order to encourage investment on Indian reservations.

Indian employment credit

A general business credit is available for an employer of qualified employees that work on an Indian reservation.[31] The credit is equal to 20 percent of the excess of qualified wages and health insurance costs paid to qualified employees in the current year over the amount paid in 1993, up to a maximum of $20,000. Wages for which the work opportunity credit is available are not qualified wages and are not eligible for the credit.

Employees generally are qualified employees if they (or their spouse) are enrolled in an Indian tribe and live on or near the Indian reservation where they work, perform services that are all or substantially all within an Indian reservation, and do not receive wages greater than $30,000 (adjusted for inflation after 1994) for the taxable year. The credit is not available for employees involved in certain gaming activities or who work in a building that houses certain gaming activities.

The Indian employment credit is not available after December 31, 2003.

Accelerated depreciation of property on Indian reservations

A special depreciation recovery period is available to qualified Indian reservation property.[32] In general, qualified Indian reservation property is property used predominantly in the active conduct of a trade or business within an Indian reservation, which is not used outside the reservation on a regular basis and was not acquired from a related person. Property used to conduct or house certain gaming activities is not qualified Indian reservation property.

The applicable recovery period for qualified Indian reservation property is as follows:

In the case of:	The applicable recovery period is:
3 year property	2 years
5 year property	3 years
7 year property	4 years
10 year property	6 years
15 year property	9 years

[31] Section 45A.

[32] Section 168(j).

20 year property	12 years
Nonresidential real property	22 years

Accelerated depreciation of property on Indian reservations is not available for property placed in service after December 31, 2003.

Explanation of Provision

The provision extends for one year (i.e., through December 31, 2004) the Indian employment credit and the accelerated depreciation rules for property on Indian reservations.

Effective Date

The provision is effective on the date of enactment.

N. Extension and Modification of Exceptions under Subpart F for Active Financing Income (sec. 314 of the bill and secs. 953 and 954 of the Code)

Present Law

Under the subpart F rules, 10-percent U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, foreign personal holding company income and insurance income. In addition, 10-percent U.S. shareholders of a CFC are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income (Prop. Treas. Reg. sec. 1.953-1(a)).

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").[33]

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a

---

[33] Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998. Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999. The Tax Relief Extension Act of 1999 (P.L. No. 106-170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002.

qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of insurance, in addition to a temporary exception from foreign personal holding company income for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, certain temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met.

In the case of a life insurance or annuity contract, reserves for such contracts are determined as follows for purposes of these provisions. The reserves equal the greater of: (1) the net surrender value of the contract (as defined in sec. 807(e)(1)(A)), including in the case of pension plan contracts; or (2) the amount determined by applying the tax reserve method that would apply if the qualifying life insurance company were subject to tax under Subchapter L of the Code, with the following modifications. First, there is substituted for the applicable Federal interest rate an interest rate determined for the functional currency of the qualifying insurance company's home country, calculated (except as provided by the Treasury Secretary in order to address insufficient data and similar problems) in the same manner as the mid-term applicable Federal interest rate (within the meaning of sec. 1274(d)). Second, there is substituted for the prevailing State assumed rate the highest assumed interest rate permitted to be used for purposes of determining statement reserves in the foreign country for the contract. Third, in lieu of U.S. mortality and morbidity tables, mortality and morbidity tables are applied that reasonably reflect the current mortality and morbidity risks in the foreign country. Fourth, the Treasury Secretary may provide that the interest rate and mortality and morbidity tables of a qualifying insurance company may be used for one or more of its branches when appropriate. In no event may the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe, equalization, or deficiency reserve or any similar reserve.

Present law also provides a temporary exception from foreign personal holding company income for income from investment of assets equal to 10 percent of reserves (determined for purposes of the provision) for contracts regulated in the country in which sold as life insurance or annuity contracts. This exception does not apply to investment income with respect to excess surplus.

Explanation of Provision

The provision extends for five years the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

The provision generally retains present law with respect to the determination of an insurance company's reserve for a life insurance or annuity contract under these exceptions. The provision does, however, permit a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve for such contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes. In seeking a ruling, the taxpayer is required to provide the IRS with necessary and appropriate information as to the method, interest rate, mortality and morbidity assumptions and other assumptions under the foreign reserve rules so that a comparison can be made to the reserve amount determined by applying the tax reserve method that would apply if the qualifying insurance company were subject to tax under Subchapter L of the Code (with the modifications provided under present law for purposes of these exceptions). The IRS also may issue published guidance indicating its approval. Present law continues to apply with respect to reserves for any life insurance or annuity contract for which the IRS has not approved the use of the foreign statement reserve. An IRS ruling request under this provision is subject to the present-law provisions relating to IRS user fees.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2001, and before January 1, 2007, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

O. Repeal of Dyed-Fuel Requirement for Registered Diesel or Kerosene Terminals (sec. 315 of the bill and sec. 4101 of the Code)

Present Law

Excise taxes are imposed on highway motor fuels, including gasoline, diesel fuel, and kerosene, to finance the Highway Trust Fund programs. Subject to limited exceptions, these taxes are imposed on all such fuels when they are removed from registered pipeline or barge terminal facilities, with any tax-exemptions being accomplished by means of refunds to consumers of the fuel.[34] One such exception allows removal of diesel fuel or kerosene without payment of tax if the fuel is destined for a nontaxable use (e.g., use as heating oil) and is indelibly dyed.

Terminal facilities are not permitted to receive and store non-tax-paid motor fuels unless they are registered with the Internal Revenue Service. Under present law, a prerequisite to registration is that if the terminal offers for sale diesel fuel, it must offer both dyed and undyed diesel fuel. Similarly, if the terminal offers for sale kerosene, it must offer both dyed and undyed kerosene. This "dyed-fuel mandate" was enacted in 1997, to be effective on July 1, 1998. Subsequently, the effective date was delayed until July 1, 2000, and later until January 1, 2002.

Explanation of Provision

The diesel fuel and kerosene dyeing mandate is repealed.

Effective Date

The provision is effective on the date of enactment.

[34] Tax is imposed before that point if the motor fuel is transferred (other than in bulk) from a refinery or if the fuel is sold to an unregistered party while still held in the refinery or bulk distribution system (e.g., in a pipeline or terminal facility).

V. TEMPORARY ASSISTANCE TO NEEDY FAMILIES PROVISIONS
(secs. 321 - 322 of the bill)

A. Reauthorization of TANF Supplemental Grants for Population Increases For Fiscal Year 2002

Present Law

The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (P.L. 104-193) established a separate grant authority for certain states with high population growth and/or low federal expenditures per poor person under the preceding welfare program Aid to Families with Dependent Children (AFDC). A total of $800 million was appropriated for fiscal years 1998 through 2001 to states that qualified under a formula that considered state population growth and historical federal AFDC expenditures relative to the number of poor persons in the state. Grant amounts per state were determined by a formula, and grew each year a state met the qualifying criteria. Authorization and appropriations for the Supplemental Grant program expired on September 30, 2001.

A total of 17 states received Supplemental Grants in 2001, totaling $319 million. The states were: Alabama, Alaska, Arizona, Arkansas, Colorado, Florida, Georgia, Idaho, Louisiana, Mississippi, Montana, Nevada, New Mexico, North Carolina, Tennessee, Texas, and Utah.

Explanation of Provision

The Temporary Assistance for Needy Families (TANF) Supplemental Grant program is reauthorized and appropriations are provided for one year (fiscal year 2002) with individual state grant amounts frozen at the exact amount received by the state in fiscal year 2001.

Effective Date

The provision is effective upon enactment.

B. 1-Year Extension of Contingency Fund Under the TANF Program

Present Law

P.L. 104-193 established a contingency fund, a capped matching grant program for states that experience high and increasing unemployment rates or increased food stamp caseloads. A total of $1.960 billion was appropriated to the contingency fund for fiscal years 1997 through 2001. To qualify for contingency funds, a state had to meet one of two criteria of "need": an unemployment rate of at least 6.5 percent during the most recent 3-month period and at least 10 percent higher than the rate in the corresponding 3-month period in either of the previous 2 years; or a food stamp caseload at least 10 percent higher in the most recent 3-month period than in the corresponding 3-month period in fiscal year 1994 or 1995. (The fiscal year 1994 and 1995 food stamp participation numbers were adjusted by subtracting those made ineligible for food stamp benefits by the 1996 welfare reform law.) A state also had to meet a special maintenance of effort requirement – 100 percent of the fiscal year 1994 level of state spending for AFDC and related emergency assistance and job training programs – and match any contingency funds it receives with state funds.

Explanation of Provision

The TANF contingency fund is reauthorized for one year.

Effective Date

The provision is effective upon enactment.

VI. TAX BENEFITS FOR AREA OF NEW YORK CITY DAMAGED IN TERRORIST ATTACKS ON SEPTEMBER 11, 2001

A. Special Depreciation Allowance for Certain Property (sec. 401(a) of the bill and new sec. 1400L of the Code)

Present Law

Depreciation deductions

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized. In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $24,000 (for taxable years beginning in 2001 or 2002) of the cost of qualifying property placed in service for the taxable year (sec. 179). For taxable years beginning in 2003 and thereafter, the amount deductible under section 179 is increased to $25,000.

Section 167(f)(1) provides that capitalized computer software costs, other than computer software to which section 197 applies, are recovered ratably over 36 months.

Explanation of Provision

The provision allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified New York Liberty Zone ("Liberty Zone") property. The additional depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.[35] The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

---

[35] The additional depreciation deduction is subject to the general rules regarding whether an item is deductible under section 162 or subject to capitalization under section 263 or section 263A.

Property qualifies for the additional first-year depreciation deduction if the property is (1) property to which MACRS applies except qualified leasehold improvement property[36] and any railroad grading or tunnel bore, or (2) computer software other than computer software covered by section 197 and, substantially all of the use of such property is in the Liberty Zone. In order to be qualified Liberty Zone property, the original use[37] of the property in the Liberty Zone must commence with the taxpayer on or after September 11, 2001.[38] A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.[39] In addition, property is precluded from the additional first year depreciation provided under this provision to the extent such property is eligible for additional first year depreciation under section 168(k) (i.e., property is eligible for only one 30% additional first year depreciation).[40]

In addition, property qualifies only if acquired by purchase[41] by the taxpayer (1) after September 10, 2001 and placed in service on or before December 31, 2006, and no binding written contract for the acquisition is in effect before September 11, 2001. For nonresidential real property and residential rental property the property must be placed in service on or before December 31, 2009 in lieu of December 31, 2006. Finally, property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins

---

[36] Qualified leasehold improvement property (which includes qualified New York Liberty Zone leasehold improvement property) is defined in another provision of the bill. Leasehold improvements that do not satisfy the requirements to be treated as "qualified leasehold improvement property" are eligible for the 30 percent additional first-year depreciation deduction.

[37] Thus, used property may constitute qualified property so long as it has not previously been used within the Liberty Zone. In addition, it is intended that additional capital expenditures incurred to recondition or rebuild property the original use of which in the Liberty Zone began with the taxpayer would satisfy the "original use" requirement. See Treasury Regulation 1.48-2 Example 5.

[38] A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

[39] A subsequent part of the provision provides that property, to the extent financed by a qualified New York rebuilding bond, is exempted from the general requirement that such property be recovered under the alternative depreciation system of MACRS. As such, qualified Liberty Zone property financed with such tax-exempt bonds would not be precluded from qualifying for additional first year depreciation due to such tax-exempt financing.

[40] See section 201 of the bill.

[41] For purposes of this provision, purchase is defined under section 179(d).

the manufacture, construction, or production of the property after September 10, 2001, and the property is placed in service on or before December 31, 2006[42] (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

The Liberty Zone means the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York.

The following examples illustrate the operation of the provision.

EXAMPLE 1. -- Assume that on March 1, 2002, a calendar year taxpayer acquires and places in service qualified property in the Liberty Zone that costs $1 million. Under the provision, the taxpayer is allowed an additional first-year depreciation deduction of $300,000. The remaining $700,000 of adjusted basis is recovered in 2002 and subsequent years pursuant to the depreciation rules of present law.

EXAMPLE 2. -- Assume that on March 1, 2002, a calendar year taxpayer acquires and places in service qualified property in the Liberty Zone that costs $100,000. In addition, assume that the property qualifies for the expensing election under section 179. Under the provision, the taxpayer is first allowed a $70,000 deduction under section 179.[43] The taxpayer then is allowed an additional first-year depreciation deduction of 9,000 based on $30,000 ($100,000 original cost less the section 179 deduction of $70,000) of adjusted basis. Finally, the remaining adjusted basis of $21,000 ($30,000 adjusted basis less $9,000 additional first-year depreciation) is to be recovered in 2002 and subsequent years pursuant to the depreciation rules of present law.

---

[42] December 31, 2009 with respect to nonresidential real property and residential rental property.

[43] A previous provision of the bill increases the amount allowable as a deduction unders section 179 to $35,000. In addition, a subsequent provision provides that property in the Liberty Zone is eligible for an additional $35,000 of expensing under section 179.

B. Treatment of Qualified Leasehold Improvement Property (sec. 401(b) of the bill and new sec. 1400L of the Code)

Present Law

Depreciation of leasehold improvements

Depreciation allowances for property used in a trade or business generally are determined under the modified Accelerated Cost Recovery System ("MACRS") of section 168. Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)).[44] This rule applies regardless whether the lessor or lessee places the leasehold improvements in service.[45] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168(b)(3), (c)(1), (d)(2), and (i)(6)).[46]

Treatment of dispositions of leasehold improvements

A lessor of leased property that disposes of a leasehold improvement which was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrevocably disposed of or abandoned by the lessor at the termination of the lease.[47] This rule conforms the treatment of

---

[44] The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System ("ACRS") to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The Tax Reform Act of 1986 also denied the use of component depreciation under MACRS.

[45] Former Code sections 168(f)(6) and 178 provided that in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. These provisions were repealed by the Tax Reform Act of 1986.

[46] If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods and accelerated methods applicable to such property. The determination of whether certain improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a "structural component" of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, for example, *Metro National Corp.*, 52 TCM 1440 (1987); *King Radio Corp.*, 486 F.2d 1091 (10th Cir., 1973); *Mallinckrodt, Inc.*, 778 F.2d 402 (8th Cir., 1985) (with respect various leasehold improvements).

[47] The conference report describing this provision mistakenly states that the provision applies to improvements that are irrevocably disposed of or abandoned by the *lessee* (rather than the *lessor*) at the termination of the lease.

lessors and lessees with respect to leasehold improvements disposed of at the end of a term of lease. For purposes of applying this rule, it is expected that a lessor must be able to separately account for the adjusted basis of the leasehold improvement that is irrevocably disposed of or abandoned. This rule does not apply to the extent section 280B applies to the demolition of a structure, a portion of which may include leasehold improvements.[48]

Explanation of Provision

The provision provides that 5-year property for purposes of the depreciation rules of section 168 includes qualified New York Liberty Zone leasehold improvement property ("qualified NYLZ leasehold improvement property"). The term qualified NYLZ leasehold improvement property means property defined in section 168(e)(6)[49] that is placed in service after September 10, 2001 and before January 1, 2007 (and not subject to a binding contract on September 10, 2001) in the New York Liberty Zone. The straight-line method is required to be used with respect to qualified NYLZ leasehold improvement property. A 9-year period is specified as the class life of qualified NYLZ leasehold improvement property for purposes of the alternative depreciation system.

---

[48] Under present law, section 280B denies a deduction for any loss sustained on the demolition of any structure.

[49] Section 168(e)(6) regarding qualified leasehold improvement property is added by section 205 of the bill.

C. Increase in Expensing Treatment for Business Property Used in the New York Liberty Zone (sec. 401(c) of the bill and new sec. 1400L of the Code)

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $24,000 (for taxable years beginning in 2001 or 2002) of the cost of qualifying property placed in service for the taxable year (sec. 179). This amount is increased to $25,000 of the cost of qualified property placed in service for taxable years beginning in 2003 and thereafter. The $24,000 ($25,000 for taxable years beginning in 2003 and thereafter) amount is phased-out (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000.

Additional section 179 incentives are provided with respect to a qualified zone property used by a business in an empowerment zone (sec. 1397A). Such a business may elect to deduct an additional $20,000 (i.e., a total of $44,000) of the cost of qualified zone property placed in service in year 2001. The $20,000 amount is increased to $35,000 for taxable years beginning in 2002 and thereafter. In addition, the phase-out range is applied by taking into account only 50 percent of the cost of qualified zone property that is section 179 property.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

Explanation of Provision

The provision increases the amount a taxpayer can deduct under section 179 for qualifying property used in the New York Liberty Zone.[50] Specifically, the provision increases the maximum dollar amount that may be deducted under section 179 by the lesser of (1) $35,000 or (2) the cost of qualifying property placed in service during the taxable year. This amount is in addition to the amount otherwise deductible under section 179.[51]

Qualifying property means section 179 property[52] purchased and placed in service by the taxpayer after September 10, 2001 and before January 1, 2007, where (1) substantially all of its use is in the New York Liberty Zone in the active conduct of a trade or business by the taxpayer

---

[50] The "New York Liberty Zone" means the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York.

[51] Another provision in this bill increases the section 179 amount (and the beginning of the phase-out threshold).

[52] As defined in section 179(d)(1).

in the zone, and (2) the original use of which in the New York Liberty Zone commences with the taxpayer after September 10, 2001.

As under present law with respect to empowerment zones, the phase-out range for the section 179 deduction attributable to New York Liberty Zone property is applied by taking into account only 50 percent of the cost of New York Liberty Zone property that is section 179 property. Also, no general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

D. Authorize Issuance of Tax-Exempt Private Activity Bonds for Rebuilding the Portion of New York City Damaged in the September 11, 2001, Terrorist Attack (sec. 401(d) of the bill and new sec. 1400L of the Code)

Present Law

Rules governing issuance of tax-exempt bonds

In general

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103). Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called "private activity bonds."[53] The term "private person" includes the Federal Government and all other individuals and entities other than States or local governments.

Private activities eligible for financing with tax-exempt private activity bonds

Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code ("qualified 501(c)(3) bonds") may be financed with tax-exempt bonds.

States or local governments may issue tax-exempt "exempt-facility bonds" to finance property for certain private businesses. Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, and hazardous waste disposal facilities); privately owned and/or operated low-income rental housing;[54] and certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses.

Tax-exempt private activity bonds also may be issued to finance limited non-business purposes: certain student loans and mortgage loans for owner-occupied housing ("qualified

---

[53] Interest on private activity bonds (other than qualified 501(c)(3) bonds) is a preference item in calculating the alternative minimum tax.

[54] Residential rental projects must satisfy low-income tenant occupancy requirements for a minimum period of 15 years.

mortgage bonds" and "qualified veterans' mortgage bonds"). Purchasers of houses financed with qualified mortgage bonds must be first-time homebuyers satisfying prescribed income limits, the purchase prices of the houses is limited, the amount by which interest rates charged to homebuyers may exceed the interest paid by issuers is restricted, and a recapture provision applies to target the benefit to purchasers having longer-term need for the subsidy provided by the bonds. Qualified veterans' mortgage bonds are not subject to these limitations, but these bonds may only be issued by five States and may only be used to finance mortgage loans to veterans who served on active duty before January 1, 1977.

With the exception of qualified 501(c)(3) bonds, private activity bonds may not be issued to finance working capital requirements of private businesses.

In most cases, the aggregate volume of tax-exempt private activity bonds that may be issued in a State is restricted by annual volume limits. These annual volume limits are equal to $62.50 per resident of the State, or $187.5 million if greater. The volume limits are scheduled to increase to the greater of $75 per resident of the State or $225 million in calendar year 2002. After 2002, the volume limits will be indexed annually for inflation.

Arbitrage restrictions on tax-exempt bonds

The Federal income tax does not apply to the income of States and local governments that is derived from the exercise of an essential governmental function. To prevent these tax-exempt entities from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods" before funds are needed for the purpose of the borrowing) or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, profits that are earned during these periods or on such investments must be rebated to the Federal Government. Governmental bonds are subject to less restrictive arbitrage rules that most private activity bonds.

Miscellaneous additional restrictions on tax-exempt bonds

Several additional restrictions apply to the issuance of tax-exempt bonds. First, private activity bonds (other than qualified 501(c)(3) bonds) may not be advance refunded. Governmental bonds and qualified 501(c)(3) bonds may be advance refunded one time. An advance refunding occurs when the refunded bonds are not retired within 90 days of issuance of the refunding bonds.

Issuance of private activity bonds is subject to restrictions on use of proceeds for the acquisition of land and existing property, use of proceeds to finance certain specified facilities, (e.g., airplanes, skyboxes, other luxury boxes, health club facilities, gambling facilities, and liquor stores) and use of proceeds to pay costs of issuance (e.g., bond counsel and underwriter fees). Additionally, the term of the bonds generally may not exceed 120 percent of the economic life of the property being financed and certain public approval requirements (similar to requirements that typically apply under State law to issuance of governmental debt) apply under

Federal law to issuance of private activity bonds. Present law precludes substantial users of property financed with private activity bonds from owning the bonds to prevent their deducting tax-exempt interest paid to themselves. Finally, owners of most private-activity-bond-financed property are subject to special "change-in-use" penalties if the use of the bond-financed property changes to a use that is not eligible for tax-exempt financing while the bonds are outstanding.

Explanation of Provision

In general

The provision authorizes issuance during calendar years 2002, 2003, and 2004 of an aggregate amount of $15 billion of tax-exempt private activity bonds to finance the construction and rehabilitation of nonresidential real property[55] and residential rental real property[56] in a newly designated "Liberty Zone" (the"Zone") of New York City.[57] Property eligible for financing with these bonds includes buildings and their structural components, fixed tenant improvements,[58] and public utility property (e.g., gas, water, electric and telecommunication lines). All business addresses located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan are considered to be located within the New York Recovery Zone. Issuance of bonds authorized under the provision is limited to projects approved by the Governor of New York.

If the Governor of New York determines that it is not feasible to use all of the authorized bond proceeds for property located in the Zone, up to $7 billion of bond proceeds may be used for the construction and rehabilitation of commercial real property (including fixed tenant improvements) located outside the Zone and within New York City.[59] Bond-financed property located outside the Zone must meet the additional requirements that the project have at least

---

[55] No more than $1.5 billion of the authorized bond amount may be used to finance property used for retail sales of tangible property (e.g., department stores, restaurants, etc.) and functionally related and subordinate property. The term nonresidential real property includes structural components of such property if the taxpayer treats such components as part of the real property structure for all Federal income tax purposes (e.g., cost recovery).

[56] No more than $3 billion of the authorized bond amount may be used to finance residential rental property.

[57] Current refundings of outstanding bonds issued under the provision do not count against the $15 billion volume limit to the extent that the principal amount of the refunding bonds does not exceed the outstanding principal amount of the bonds being refunded. The bonds cannot be advance refunded.

[58] Fixtures and equipment that could be removed from the designated zone for use elsewhere are not eligible for financing with these bonds.

[59] Public utility property and residential property located outside the Zone cannot be financed with the bonds.

100,000 square feet of usable office or other commercial space in a single building or multiple adjacent buildings.

Subject to the following exceptions and modifications, issuance of these tax-exempt bonds is subject to the general rules applicable to issuance of exempt-facility private activity bonds:

(1) Issuance of the bonds is not subject to the aggregate annual State private activity bond volume limits (sec. 146);

(2) The restriction on use of private activity bond proceeds to finance land acquisition is determined by reference to the $15 billion amount of bonds authorized under the provision rather than by reference to individual bond issues (sec. 147(c));

(3) The restriction on acquisition of existing property is applied using a minimum requirement of 50 percent of the cost of acquiring the building being devoted to rehabilitation (sec. 147(d));

(4) The special arbitrage expenditure rules for certain construction bond proceeds apply to available construction proceeds of the bonds (sec. 148(f)(4)(C));

(5) The tenant targeting rules applicable to exempt-facility bonds for residential rental property (and the corresponding change in use penalties for violation of those rules) do not apply to such property financed with the bonds (secs. 142(d) and 150(b)(2));

(6) Repayments of bond-financed loans may not be used to make additional loans, but rather must be used to retire outstanding bonds (with the first such retirement occurring 10 years after issuance of the bonds);[60]

(7) Interest on the bonds is not a preference item for purposes of the alternative minimum tax preference for private activity bond interest (sec. 57(a)(5)); and

(8) Property financed with these bonds will not be treated as financed with tax-exempt bonds under the Code provisions governing cost recovery deductions (and the bonus depreciation included in the bill).

Effective Date

The provision is effective for bonds issued after December 31, 2001 and before January 1, 2005.

[60] It is intended that redemptions will occur at least semi-annually beginning at the end of 10 years after the bonds are issued; however, amounts of less than $250,000 are not to be required to be used to redeem bonds at such intervals.

E. Extension of Replacement Period for Certain Property Involuntarily Converted in the New York Liberty Zone (sec. 401(e) of the bill and new sec. 1400L of the Code)

Present Law

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period (the "replacement period") property similar or related in service or use (sec. 1033). If the taxpayer does not replace the converted property with property similar or related in service or use, then gain generally is recognized. If the taxpayer elects to apply the rules of section 1033, gain on the converted property is recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property. In general, the replacement period begins with the date of the disposition of the converted property and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized.[61] The replacement period is extended to three years if the converted property is real property held for the productive use in a trade or business or for investment.[62]

Special rules apply for property converted in a Presidentially declared disaster.[63] With respect to a principal residence that is converted in a Presidentially declared disaster, no gain is recognized by reason of the receipt of insurance proceeds for unscheduled personal property that was part of the contents of such residence. In addition, the replacement period for the replacement of such a principal residence is extended to four years after the close of the first taxable year in which any part of the gain upon conversion is realized. With respect to investment or business property that is converted in a Presidentially declared disaster, any tangible property acquired and held for productive use in a business is treated as similar or related in service or use to the converted property.

Explanation of Provision

The provision extends the replacement period to five years for a taxpayer to purchase property to replace property that was involuntarily converted within the New York Liberty Zone[64] as a result of the terrorist attacks that occurred on September 11, 2001. However, the five-year period is available only if substantially all of the use of the replacement property is in New York City. In all other cases, the present-law replacement period rules continue to apply.

---

[61] Section 1033(a)(2)(B).

[62] Section 1033(g)(4).

[63] Section 1033(h). For this purpose, a "Presidentially declared disaster" means any disaster which, with respect to the area in which the property is located, resulted in a subsequent determination by the President that such area warrants assistance by the Federal Government under the Disaster Relief and Emergency Assistance Act.

[64] The "New York Liberty Zone" has the same definition throughout this bill. *See e.g.*, note 14, *supra*.

Effective Date

The provision is effective for involuntary conversions in the New York Liberty Zone occurring on or after September 11, 2001, as a consequence of the terrorist attacks on such date.

VII. RELIEF PROVISIONS FOR VICTIMS OF TERRORIST ATTACKS, PRESIDENTIALLY DECLARED DISASTERS, AND CERTAIN OTHER DISASTERS

A. Background

Historically, the Congress has provided Federal tax relief for members of the U.S. Armed Forces who serve in combat zones. In addition, the Congress has taken action on several occasions to provide Federal tax relief for service members and other individuals whose lives have been affected by particular instances of hostile action involving the United States. In 1970, the Congress enacted legislation that provided tax relief to individuals who had been removed from a U.S. vessel and died while being illegally detained by the Democratic People's Republic of Korea during 1968.[65] Specifically, the legislation treated these individuals as having served in a combat zone for purposes of tax provisions that apply only to individuals serving in designated combat zones. Thus, service personnel who were crewmembers of the U.S.S. *Pueblo* (which was illegally detained in 1968 by North Korea), and who died during the detention, were eligible for the income tax exclusion (and other special tax rules) available for service personnel who die in combat zones.

In 1980, the Congress enacted legislation concerning the American hostages who were held captive in Iran between November 4, 1979, and December 31, 1981, and who died as a result of injury or disease or physical or mental disability that was incurred or aggravated while in captive status.[66] The legislation provided that no Federal income tax would be imposed with respect to the year in which the individual died or any prior year ending on or after the first day the individual was in captive status. This legislation applied to military and civilian personnel of the United States, as well as to certain other U.S. taxpayers taken captive outside Iran on or before December 31, 1981. Moreover, if there had been any unpaid income tax liability of such an individual from years prior to captivity, the liability was forgiven. This total income tax exemption for American hostages who died as a result of captive status was available only if death occurred within two years after the individual ceased to be in captive status.

In 1984, the Congress enacted legislation after hostile action occurred in Lebanon and Grenada involving U.S. military and civilian personnel.[67] This legislation provided special Federal income tax rules for certain individuals who die while in active service as a member of the Armed Forces of the United States or while in the civilian employment of the United States. Under the legislation, if death occurs as a result of wounds or injuries incurred outside the United States in a terrorist or military action, then no Federal income tax applies with respect to income of the individual for the year of death or for any earlier year in the period beginning with the last year ending before the year in which the wounds or injuries were incurred (sec. 692(c)). The legislation only applies to injuries or wounds that are incurred in a terrorist or military action. Thus, for example, the legislation would not have applied with respect to a U.S. serviceperson

[65] Pub. L. No. 91-235.

[66] Pub. L. No. 96-449.

[67] Pub. L. Nos. 98-259 and 98-369.

stationed in Lebanon who died as a result of an accidental fall because, if not caused by hostile forces, such an injury was not incurred in a terrorist or military action. In order to apply the special tax rules provided by the legislation to other hostile actions that occurred before the date of enactment (such as the attempt to rescue the American hostages in Iran), the legislation was made effective with respect to all taxable years of individuals dying as a result of wounds or injuries incurred after December 31, 1979.

The 1984 legislation applies to the year preceding the year in which the wounds or injuries were incurred because the Congress determined that forgiveness of income tax only for the period from the year of the injuries or wounds to the year of death would have inequitable results in certain circumstances. Under such a limitation, a soldier who is killed in a terrorist attack on a U.S. base in a foreign country on January 31 would be exempt from income tax only on one month's income, while a soldier who is killed in an attack on December 31 would be exempt from income tax on an entire year's income. Accordingly, the Congress concluded that it is more equitable to extend the tax forgiveness under the provision to income for the year preceding the year of injury.

In 1990, the Congress enacted legislation providing limited income tax benefits to victims of the terrorist attack that resulted in the downing of Pan American Airways Flight 103 over Lockerbie, Scotland on December 21, 1988.[68] The legislation provided that, in the case of any individual whose death was a direct result of the terrorist attack involving Flight 103, the income tax provisions of subtitle A of the Internal Revenue Code did not apply with respect to: (1) the taxable year that included December 21, 1988; and (2) the prior taxable year. However, the income tax benefit in each taxable year was limited to an amount equal to 28 percent of the annual rate of basic pay at Level V of the U.S. Executive Schedule as of December 21, 1988. This limitation was intended to limit the amount of tax relief to that which was provided to personnel of the United States who were on Flight 103, thus providing equal relief to all of the victims who were on Flight 103. In addition, the legislation required the President to submit recommendations to Congress concerning whether future legislation should be enacted to authorize the United States to provide monetary and tax relief as compensation to U.S. citizens who are victims of terrorism. The legislation also authorized the President to establish a board to develop criteria for compensation and to recommend changes to existing laws to establish a single comprehensive approach to victim compensation for terrorist acts.

In 1991, the Congress enacted legislation extending the benefits of the suspension of time provisions under section 7508 to any individual (and the spouse of such an individual) who performed certain services that preceded the designation of a combat zone with regard to Operation Desert Shield.[69] The individuals eligible for such benefits included individuals who provided services in the Armed Forces of the United States (or in support of the Armed Services) if such services were performed in the area designated by the President as the "Persian Gulf Desert Shield Area" and such services were performed during the period beginning August 2, 1990, and ending on the date on which any portion of the area was designated by the President as

[68] Pub. L. No. 101-604.

[69] Pub. L. No. 102-2.

a combat zone. After January 17, 1991 (the date on which the Persian Gulf Desert Shield Area became designated as a combat zone by the President), individuals performing such services became eligible for the benefits of the present-law tax provisions applicable to service in a designated combat zone. An Executive Order terminating the designation of the Persian Gulf Desert Shield Area as a combat zone has not been issued.

In 1996, the Congress enacted legislation concerning certain individuals serving in portions of former Yugoslavia (i.e., Bosnia and Herzegovina, Croatia, and Macedonia) as part of Operation Joint Endeavor and Operation Able Sentry.[70] This legislation provided that such service is treated in the same manner as if it were performed in a designated combat zone for purposes of the tax provisions applicable to service in a designated combat zone. The legislation also made the suspension of time provisions of section 7508 applicable to certain other individuals participating in Operation Joint Endeavor. In addition, the legislation increased the maximum officer combat pay exclusion from $500 per month to the highest rate of pay applicable to enlisted personnel plus the amount of hostile fire/imminent danger pay received by the officer.

In 1997, the Congress enacted legislation authorizing procedural tax benefits with regard to Presidentially declared disasters in general.[71] The legislation provided that the Secretary of the Treasury may prescribe regulations under which a period of up to 90 days may be disregarded for performing various acts under the Internal Revenue Code, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, for any taxpayer determined by the Secretary to be affected by a Presidentially declared disaster (sec. 7508A). In 2001, the Congress amended section 7508A to extend from 90 to 120 the authorized period of days that may be disregarded by the Secretary.

[70] Pub. L. No. 104-117.

[71] Pub. L. No. 105-34.

B. Relief Provisions for Victims of Specific Terrorist Attacks

1. Income taxes of victims of terrorist attacks (sec. 501 of the bill and sec. 692 of the Code)

Present Law

An individual in active service as a member of the Armed Forces who dies while serving in a combat zone (or as a result of wounds, disease, or injury received while serving in a combat zone) is not subject to income tax or self-employment tax for the year of death (as well as for any prior taxable year ending on or after the first day the individual served in the combat zone) (sec. 692(a)(1)). Special computational rules apply in the case of joint returns. Military and civilian employees of the United States are entitled to a similar exemption if they die as a result of wounds or injury which was incurred outside the United States in terrorist or military action (sec. 692(c)).

The exemption applies not only to the tax liability of the individual attributable to income received before the date of death and reported on the decedent's final return. The exemption applies also to the liability of another person to the extent the liability is attributable to an amount received after the individual's death which would have been includable in the individual's income for the taxable year in which the date of death falls (determined as if the individual had survived).[72] For example, the individual's final wage payment, or interest or dividends payable in the year of death with respect to the individual's assets, are exempt from income tax when paid to another person or the individual's estate after the date of death but before the end of the taxable year of the decedent (determined without regard to the death).

This exemption is available for the year of death and for prior taxable years beginning with the taxable year prior to the taxable year in which the wounds or injury were incurred. Thus, for example, if someone is injured and dies in the year the injury occurred, the exemption applies for the year of death and the prior taxable year. Similarly, if someone is injured and dies two years later, this exemption is available for the taxable year of death as well as the three prior taxable years (i.e., the year preceding the injury, the year of the injury, and the two years following the year of the injury).

Explanation of Provision

Application of relief to victims of September 11, 2001, April 19, 1995, and anthrax attacks

The bill extends relief similar to the present-law treatment of military or civilian employees of the United States who die as a result of terrorist or military activity outside the United States to individuals who die as a result of wounds or injury which were incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, and individuals who die as a result of illness incurred due to an attack involving anthrax that occurs on or after September 11, 2001, and before January 1, 2002. Under the bill, such individuals generally are exempt from income tax for the year of death and for prior taxable years beginning

[72] Treas. Reg. sec. 1.692-1(a)(2)(ii).

with the taxable year prior to the taxable year in which the wounds or injury occurred.[73] The exemption applies to these individuals whether killed in an attack (e.g., in the case of the September 11, 2001, attack in one of the four airplanes or on the ground) or in rescue or recovery operations.

The provision provides a minimum tax relief benefit of $10,000 to each eligible individual regardless of the income tax liability of the individual for the eligible tax years. If an eligible individual's income tax for years eligible for the exclusion under the provision is less than $10,000, the individual is treated as having made a tax payment for such individual's last taxable year in an amount equal to the excess of $10,000 over the amount of tax not imposed under the provision.

Subject to rules prescribed by the Secretary, the exemption from tax does not apply to the tax attributable to (1) deferred compensation which would have been payable after death if the individual had died other than as a specified terrorist victim, or (2) amounts payable in the taxable year which would not have been payable in such taxable year but for an action taken after September 11, 2001. Thus, for example, the exemption does not apply to amounts payable from a qualified plan or individual retirement arrangement to the beneficiary or estate of the individual. Similarly, amounts payable only as death or survivor's benefits pursuant to deferred compensation preexisting arrangements that would have been paid if the death had occurred for another reason are not covered by the exemption. In addition, if the individual's employer makes adjustments to a plan or arrangement to accelerate the vesting of restricted property or the payment of nonqualified deferred compensation after the date of the particular attack, the exemption does not apply to income received as a result of that action.[74] Also, if the individual's beneficiary cashed in savings bonds of the decedent, the exemption does not apply. On the other hand, the exemption does apply, for example, to a final paycheck of the individual or dividends on stock held by the individual when paid to another person or the individual's estate after the date of death but before the end of the taxable year of the decedent (determined without regard to the death). The exemption also applies to payments of an individual's accrued vacation and accrued sick leave.

The provision does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

---

[73] The bill does not provide relief from self-employment tax liability.

[74] Such amounts may, however, be excludable from gross income under the death benefit exclusion provided in section 502 of the bill.

Simplified refund procedures

It is intended that the Secretary will establish procedures to simplify refunds of these amounts, including expanding the directions in Revenue Procedure 85-35 to include specific instructions for Form 1041.

Effective Date

The provision is effective for taxable years ending before, on, or after September 11, 2001.

A special rule extends the period of limitations to permit the filing of a claim for refund resulting from this provision until one year after the date of enactment, if that period would otherwise have expired before that date.

2. Exclusion of certain death benefits (sec. 502 of the bill and sec. 101 of the Code)

Present Law

In general, gross income includes income from whatever source derived (sec. 61), including payments made as a result of the death of an individual. Certain exceptions to this general rule of inclusion may apply to such payments in certain cases.

For example, gross income generally does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injury (including death) or sickness (sec. 104(a)(2)). Further, gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract if such amounts are paid by reason of the death of the insured (sec. 101(a)).

In addition, gifts are not includable in gross income (sec. 102). However, with very limited exceptions, payments made by an employer to, or for the benefit of, an employee are not excluded from gross income as gifts (sec. 102(c)). In business contexts in which section 102(c) does not apply, payments are excludable as gifts only if objective inquiry demonstrates that the payments were made out of "detached and disinterested generosity" and not in return for past or future services or from motives of anticipated benefit.[75]

Explanation of Provision

The bill generally provides an exclusion from gross income for amounts received if such amounts are paid by an employer (whether in a single sum or otherwise[76]) by reason of the death of an employee who dies as a result of wounds or injury which were incurred as a result of the

---

[75] *Comm'r v. Duberstein,* 363 U.S. 278 (1960).

[76] Thus, for example, payments made over a period of years could qualify for the exclusion.

terrorist attacks that occurred on September 11, 2001, or April 19, 1995, or as a result of illness incurred due to an attack involving anthrax that occurs on or after September 11, 2001, and before January 1, 2002. Subject to rules prescribed by the Secretary, the exclusion does not apply to amounts that would have been payable if the individual had died for a reason other than the attack. For example, the provision does not apply to payments by an employer under a nonqualified deferred compensation plan[77] to the extent that the amounts would have been payable if the death had occurred for another reason. The exclusion does apply, however, to death benefits provided under a qualified plan that satisfy the incidental benefit rule.

For purposes of the exclusion, self-employed individuals are treated as employees. Thus, for example, payments by a partnership to the surviving spouse of a partner who died as a result of the September 11, 2001, attacks may be excludable under the provision.

The provision does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

No change to present law is intended as to the deductibility of death benefits paid by the employer or otherwise merely because the payments are excludable by the recipient. Thus, it is intended that payments excludable from income under the provision are deductible to the same extent they would be if they were includable in income.

The bill is not intended to narrow the scope of any applicable exclusion under present law. Accordingly, payments that are not specifically excludable under the bill remain excludable to the same extent provided under present law.

In connection with the September 11, 2001, terrorist attacks, insurance companies may pay death benefits under a life insurance contract even if the contract terms provide for an exclusion for death occurring as a result of an act of terrorism or act of war. It is understood that such a death benefit payment would fall within the present-law exclusion (under sec. 101(a)) for payments made under the contract if it otherwise meets the requirements of the present-law exclusion.

Effective Date

The provision is effective for taxable years ending before, on, or after September 11, 2001.

A special rule extends the period of limitations to permit the filing of a claim for refund resulting from this provision until one year after the date of enactment, if that period would otherwise have expired before that date.

---

[77] The provision does not apply to amounts received under a qualified plan because such payments are not made by the employer.

3. Estate tax reduction (sec. 503 of the bill and sec. 2201 of the Code)

Present Law

Present law provides a reduction in Federal estate tax for taxable estates of U.S. citizens or residents who are active members of the U.S. Armed Forces and who are killed in action while serving in a combat zone (sec. 2201). This provision also applies to active service members who die as a result of wounds, disease, or injury suffered while serving in a combat zone by reason of a hazard to which the service member was subjected as an incident of such service.

In general, the effect of section 2201 is to replace the Federal estate tax that would otherwise be imposed with a Federal estate tax equal to 125 percent of the maximum State death tax credit determined under section 2011(b). Credits against the tax, including the unified credit of section 2010 and the State death tax credit of section 2011, then apply to reduce (or eliminate) the amount of the estate tax payable.

The reduction in Federal estate taxes under section 2201 is equal in amount to the "additional estate tax" with respect to the estates of decedents dying before January 1, 2005. The additional estate tax is the difference between the Federal estate tax imposed by section 2001 and 125 percent of the maximum State death tax credit determined under section 2011(b). With respect to the estates of decedents dying after December 31, 2004, section 2201 provides that the additional estate tax is the difference between the Federal estate tax imposed by section 2001 and 125 percent of the maximum state death tax credit determined under section 2011(b) as in effect prior to its repeal by the Economic Growth and Tax Relief Reconciliation Act of 2001.

Explanation of Provision

The bill generally treats individuals who die from wounds or injury incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, or as a result of illness incurred due to an attack involving anthrax that occurs on or after September 11, 2001, and before January 1, 2002, in the same manner as if they were active members of the U.S. Armed Forces killed in action while serving in a combat zone or dying as a result of wounds or injury suffered while serving in a combat zone for purposes of section 2201. Consequently, the estates of these individuals are eligible for the reduction in Federal estate tax provided by section 2201. The provision does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

The bill also changes the general operation of section 2201, as it applies to both the estates of service members who qualify for special estate tax treatment under present law and to the estates of individuals who qualify for the special treatment under the bill. Under the bill, the Federal estate tax is determined in the same manner for all estates that are eligible for Federal estate tax reduction under section 2201. In addition, the executor of an estate that is eligible for special estate tax treatment under section 2201 may elect not to have section 2201 apply to the estate. Thus, in the event that an estate may receive more favorable treatment without the application of section 2201 in the year of death than it would under section 2201, the executor may elect not to apply the provisions of section 2201, and the estate tax owed (if any) would be determined pursuant to the generally applicable rules.

Under the bill, section 2201 no longer reduces Federal estate tax by the amount of the additional estate tax. Instead, the bill provides that the Federal estate tax liability of eligible estates is determined under section 2001, using a rate schedule that is equal to 125 percent of the present-law maximum State death tax credit amount. This rate schedule is used to compute the tax under section 2001(b) (i.e., both the tentative tax under section 2001(b)(1) and the hypothetical gift tax under section 2001(b)(2) is computed using this rate schedule). As a result of this provision, the estate tax is unified with the gift tax for purposes of section 2201 so that a single graduated (but reduced) rate schedule applies to transfers made by the individual at death, based upon the cumulative taxable transfers made both during lifetime and at death.

In addition, while the bill provides an alternative reduced rate table for purposes of determining the tax under section 2001(b), the amount of the unified credit nevertheless is determined as if section 2201 did not apply, based upon the unified credit as in effect on the date of death. For example, in the case of victims of the September 11, 2001, terrorist attack, the applicable unified credit amount under section 2010(c) would be determined by reference to the actual section 2001(c) rate table.

As a conforming amendment, the bill repeals section 2011(d) because it no longer will have any application to taxpayers.

Effective Date

The provision applies to estates of decedents dying on or after September 11, 2001, or, in the case of victims of the Oklahoma City terrorist attack, estates of decedents dying on or after April 19, 1995.

A special rule extends the period of limitations to permit the filing of a claim for refund resulting from this provision until one year after the date of enactment, if that period would otherwise have expired before that date.

4. Payments by charitable organizations treated as exempt payments (sec. 504 of the bill and secs. 501 and 4941 of the Code)

Present Law

In general, organizations described in section 501(c)(3) of the Code are exempt from taxation. Contributions to such organizations generally are tax deductible (sec. 170). Section 501(c)(3) organizations must be organized and operated exclusively for exempt purposes and no part of the net earnings of such organizations may inure to the benefit of any private shareholder or individual. An organization is not organized or operated exclusively for one or more exempt purposes unless the organization serves a public rather than a private interest. Thus, an organization described in section 501(c)(3) generally must serve a charitable class of persons that is indefinite or of sufficient size.

Tax-exempt private foundations are a type of organization described in section 501(c)(3) and are subject to special rules. Private foundations are subject to excise taxes on acts of self-dealing between the private foundation and a disqualified person with respect to the foundation (sec. 4941). For example, it is self-dealing if the income or assets of a private foundation are transferred to, or used by or for the benefit of a disqualified person, such as a substantial contributor to the foundation or a person in control of the foundation, and the benefit is not incidental or tenuous.

Explanation of Provision

In light of the extraordinary distress caused by the attacks on the United States of September 11, 2001, and the subsequent attacks involving anthrax, the bill provides that organizations described in section 501(c)(3) that make payments by reason of the death, injury, wounding, or illness of an individual incurred as a result of the September 11, 2001, attacks, or as a result of an attack involving anthrax occurring on or after September 11, 2001, and before January 1, 2002, are not required to make a specific assessment of need for the payments to be related to the purpose or function constituting the basis for the organization's exemption. This rule applies provided that the organization makes the payments in good faith using a reasonable and objective formula which is consistently applied. As under present law, such payments must be for public and not private benefit and therefore must serve a charitable class. For example, under this standard, a charitable organization that assists families of firefighters killed in the line of duty could make a pro-rata distribution to the families of firefighters killed in the attacks, even though the specific financial needs of each family are not directly considered. Similarly, if the amount of a distribution is based on the number of dependents of a charitable class of persons killed in the attacks and this standard is applied consistently among distributions, the specific needs of each recipient do not have to be taken into account. However, it would not be appropriate for a charity to make pro-rata payments based on the recipients' living expenses before September 11 if the result generally is to provide significantly greater assistance to persons in a better position to provide for themselves than to persons with fewer financial resources. Although such a distribution might be based on objective criteria, it would not, under the statutory standard, be a reasonable formula for distributing assistance in an equitable manner. Similarly, although specific assessments of need are not required, the bill does not change the other substantive standards for exemption under section 501(c)(3), including the prohibition on private inurement and the need for a charitable class. It is impossible to list or anticipate the kinds of payments that meet the statutory test, but, in general, charities that make distributions in good faith using a reasonable and objective formula will be treated as acting consistently with exempt purposes. A charity that makes payments subject to this provision should indicate clearly on the charity's information return, for example by notation at the top of the relevant page of the return, that the charity relied on this provision in making distributions. The bill also provides that if a private foundation makes payments under the conditions described above, the payment is not treated as made to a disqualified person for purposes of section 4941.

For charities making payments in connection with the September 11 attacks or attacks involving anthrax, but not in reliance on this provision, present law rules apply. It is expected that, because of the severity of distress arising out of the September 11 and anthrax attacks and the extensive variety of needs that the thousands of victims and their family members may have, a wide array of expenses will be consistent with operation for exclusively charitable purposes.

For instance, payments to permit a surviving spouse with young children to remain at home with the children rather than being forced to enter the workplace seem to be appropriate to maintain the psychological well-being of the entire family. Similarly, assistance with elementary and secondary school tuition to permit a child to remain in the same educational environment seems to be appropriate, as does assistance needed for higher education. Assistance with rent or mortgage payments for the family's principal residence or car loans also seems to be appropriate to forestall losses of a home or transportation that would cause additional trauma to families already suffering. Other types of assistance that the scope of the tragedy makes it difficult to anticipate may also serve a charitable purpose.

Effective Date

The provision applies to payments made on or after September 11, 2001.

5. Exclusion for certain cancellations of indebtedness (sec. 505 of the bill)

Present Law

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain farm indebtedness, and certain real property business indebtedness (secs. 61(a)(12) and 108). In cases involving discharges of indebtedness that are excluded from gross income (except for discharges of real property business indebtedness), taxpayers generally exclude discharge of indebtedness from income but reduce tax attributes by the amount of the discharge of indebtedness. The amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange).

Present law generally requires "applicable entities" to file information returns with the Internal Revenue Service regarding any discharge of indebtedness in the amount of $600 or more (sec. 6050P). This requirement applies without regard to whether the debtor is subject to tax on the discharged indebtedness.[78] The term "applicable entities" includes: (1) any financial institution (as described in section 581 (relating to banks) or section 591(a) (relating to savings institutions)); (2) any credit union; (3) any corporation that is a direct or indirect subsidiary of an entity described in (1) or (2) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a Federal or State agency regulating such entities; (4) the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, the National Credit Union Administration, certain other Federal executive agencies, and any successor or subunit of any of them; (5) an executive, judicial, or legislative agency (as defined in 31 U.S.C. sec. 3701(a)(4)); and (6) any other organization a significant trade or business of which is the lending

[78] Treas. Reg. sec. 1.6050P-1(a)(3).

of money. Failures to file correct information returns with the Internal Revenue Service or to furnish statements to taxpayers with respect to these discharges of indebtedness are subject to the same general penalty that is imposed with respect to failures to provide other types of information returns. Accordingly, the penalty for failure to furnish statements to taxpayers generally is $50 per failure, subject to a maximum of $100,000 for any calendar year. These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

Explanation of Provision

The bill provides that gross income does not include any amount realized from the discharge (in whole or in part) of indebtedness if the indebtedness is discharged by reason of the death of an individual incurred as a result of the September 11, 2001, attacks, or as a result of a terrorist attack involving anthrax occurring on or after September 11, 2001, and before January 1, 2002. In all cases, the provision applies only if the indebtedness is discharged because the individual died as a result of one the attacks. Therefore, except in circumstances that indicate the taxpayer was financially dependent upon an individual who died in one of the attacks, it is intended that the provision generally applies only if the taxpayer was, or became, an obligor or co-obligor with respect to indebtedness of an individual who died as a result of one of the attacks (e.g., the surviving spouse or estate of the individual).

The bill also provides that the information return filing requirements that otherwise apply to discharges of indebtedness do not apply with respect to any discharge of indebtedness that is excluded from gross income under this provision.

Effective Date

This provision applies to discharges made on or after September 11, 2001, and before January 1, 2002.

C. Other Relief Provisions

1. Exclusion of disaster relief payments (sec. 511 of the bill and new sec. 139 of the Code)

Present Law

Taxation of disaster relief payments

Gross income includes all income from whatever source derived unless a specific exception applies (sec. 61). There is no specific statutory exclusion from income for disaster payments. However, various types of disaster payments made to individuals have been excluded from gross income under a general welfare exception.[79] The exception has been held to exclude from income payments made under legislatively provided social benefit programs for the promotion of the general welfare. The general welfare exception generally applies if the payments (1) are made from a governmental general welfare fund, (2) are for the promotion of the general welfare (on the basis of need and not to all residents), and (3) are made without respect to services rendered by the recipient. The exclusion generally applies to payments for food, medical, housing, personal property, transportation, and funeral expenses.

The general welfare exception generally does not apply to payments in the nature of income replacement, such as payments to individuals for lost wages or unemployment compensation or payments in the nature of income replacement to businesses.[80] Income replacement payments are includable in gross income, unless another exception applies.

Disaster relief payments may be excludable under other provisions. For example, payments made by charitable relief organizations may be excluded from the gross income of the recipients as gifts. Payments made in a business context generally are not treated as gifts. Factual issues may arise as to whether a payment in the context of a business relationship is a gift or taxable compensation for services. In general, payments made by an employer to, or for the benefit of, an employee are not excluded from gross income as gifts (sec. 102(c)).

Under present law, gross income generally does not include payments received as damages (other than punitive damages) on account of personal physical injury (including death) or sickness (sec. 104(a)(2)). Such payments are excluded from gross income regardless of whether received by suit or agreement and whether received as a lump sum or as periodic payments.

Section 406 of the Air Transportation Safety and System Stabilization Act provides for the payment of compensation for eligible individuals who suffered physical harm or death as a result of the terrorist-related aircraft crashes of September 11, 2001. There is no statutory provision specifically addressing the taxation of such compensation; however, such

---

[79] Rev. Rul. 98-19, 1998-1 C.B. 840; Rev. Rul. 76-144, 1976-1 C.B. 17.

[80] IRS Publication 547 (Casualties, Disasters, and Thefts), page 5 (revised December 2000); Rev. Rul. 91-55, 1991-2 C.B. 321; Rev. Rul. 73-408, 1973-2 C.B. 15.

compensation may be excludable from income under generally applicable Code provisions (e.g., section 104).

<u>Rules relating to charitable organizations</u>

In general, organizations described in section 501(c)(3) of the Code are exempt from taxation. Contributions to such organizations generally are tax deductible (sec. 170). Section 501(c)(3) organizations must be organized and operated exclusively for exempt purposes and no part of the net earnings of such organizations may inure to the benefit of any private shareholder or individual. An organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, an organization described in section 501(c)(3) generally must serve a charitable class of persons that is indefinite or of sufficient size.

Tax-exempt private foundations are a type of organization described in section 501(c)(3) and are subject to special rules. Private foundations are subject to excise taxes on acts of self-dealing between the private foundation and a disqualified person with respect to the foundation (sec. 4941). For example, it is self-dealing if the income or assets of a private foundation are transferred to, or used by or for the benefit of a disqualified person, such as a substantial contributor to the foundation or a person in control of the foundation, and the benefit is not incidental or tenuous. Private foundations also are subject to excise taxes on taxable expenditures (sec. 4945). For example, it is a taxable expenditure if a private foundation pays an amount that does not further certain charitable purposes, or makes a grant to an individual for educational or other similar purposes without following certain procedures.

<u>Explanation of Provision</u>

<u>Taxation of disaster relief payments</u>

The bill clarifies that any amount received as payment under section 406 of the Air Transportation Safety and System Stabilization Act is excludable from gross income. In addition, the bill provides a specific exclusion from income for qualified disaster relief payments. No inference is intended as to the taxability of such payments under present law. In addition, the provision is not intended to preclude the exclusion of other types of payments under the general welfare exception or other Code provisions.

Qualified disaster relief payments include payments, from any source, to, or for the benefit of, an individual to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster. Personal, family, and living expenses are intended to have the same meaning as when used in section 262. Personal expenses include personal property expenses.

Qualified disaster relief payments also include payments, from any source, to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence, or for the repair or replacement of its contents, to the extent that the need for the repair, rehabilitation, or replacement is attributable to a qualified disaster. For purposes of determining the tax basis of a rehabilitated residence, it is intended that qualified disaster relief payments be treated in the same manner as amounts received on an involuntary conversion of a principal residence under section 121(d)(5) and sections 1033(b) and (h). A residence is not precluded from being a personal residence solely because the taxpayer does not own the residence; a rented residence can qualify as a personal residence.

Qualified disaster relief payments also include payments by a person engaged in the furnishing or sale of transportation as a common carrier on account of death or personal physical injuries incurred as a result of a qualified disaster. Thus, for example, payments made by commercial airlines to families of passengers killed as a result of a qualified disaster would be excluded from gross income.[81]

Qualified disaster relief payments also include amounts paid by a Federal, State or local government in connection with a qualified disaster in order to promote the general welfare. As under the present law general welfare exception, the exclusion does not apply to payments in the nature of income replacement, such as payments to individuals of lost wages, unemployment compensation, or payments in the nature of business income replacement.

Qualified disaster relief payments do not include payments for any expenses compensated for by insurance or otherwise. No change from present law is intended as to the deductibility of qualified disaster relief payments, made by an employer or otherwise, merely because the payments are excludable by the recipients. Thus, it is intended that payments excludable from income under the provision are deductible to the same extent they would be if they were includable in income. In addition, in light of the extraordinary circumstances surrounding a qualified disaster, it is anticipated that individuals will not be required to account for actual expenses in order to qualify for the exclusion, provided that the amount of the payments can be reasonably expected to be commensurate with the expenses incurred.

Particular payments may come within more than one category of qualified disaster relief payments; the categories are not intended to be mutually exclusive. Qualified disaster relief payments also are excludable for purposes of self-employment taxes and employment taxes. Thus, no withholding applies to qualified disaster relief payments.

Under the bill, a qualified disaster includes a disaster which results from a terroristic or military action (as defined in section 692(c)(2), as amended by the bill), a Presidentially declared disaster, a disaster which results from an accident involving a common carrier or from any other event which would be determined by the Secretary to be of a catastrophic nature, or, for purposes of payments made by a Federal, State or local government, a disaster designated by Federal, State or local authorities to warrant assistance.

The exclusion from income under section 139 does not apply to any individual identified by the Attorney General to have been a participant or conspirator in the terrorist-related aircraft crashes of September 11, 2001, or any other terrorist attack, or to a representative of such individual.

---

[81] The exclusion from income applies irrespective of section 104(a)(2). As previously discussed, no inference is intended that payments excludable under section 139 would not be otherwise excludable under another Code provision.

Rules applicable to charitable organizations making disaster relief payments

Recognizing that employers and employees may also contribute to section 501(c)(3) organizations that make disaster relief payments, clarification of the type of disaster relief grants such organizations may make consistent with exempt purposes to assist individuals in distress as a result of the September 11 attacks, and more generally, may be helpful. Because the bill provides a special rule for certain payments made by reason of death, injury, wounding, or illness of an individual as a result of the September 11 attacks, and certain attacks involving anthrax, the following discussion relates to disaster relief generally.

Generally speaking, a charitable organization must serve a public rather than a private interest. Providing assistance to relieve distress for individuals suffering the effects of a disaster generally serves a public rather than a private interest if the assistance benefits the community as a whole, or if the recipients otherwise lack the resources to meet their physical, mental and emotional needs. Such assistance could include cash grants to provide for food, clothing, housing, medical care, funeral costs, transportation, education and other needs. All such grants must be need-based, taking into account the family's financial resources and their physical, mental and emotional well-being.

Charitable organizations generally are in the best position to determine the type and amount of, and appropriate beneficiaries for, disaster relief. Accordingly, it is expected that the Secretary will presume that a charity providing cash assistance in good faith to victims (and their family members) of a qualified disaster is acting consistent with the requirements of section 501(c)(3) if the class of beneficiaries is sufficiently large or indefinite and the charity can demonstrate that it is applying consistent, objective criteria for assessing need.

In addition to the rules described above that are applicable to all charities, special rules apply with respect to disaster relief provided by private foundations controlled by an employer. In such cases, clarification of the appropriate treatment of the foundation and the payments may be helpful. In general, a private foundation that is established and controlled by an employer violates the requirements of section 501(c)(3) if it provides benefits to a class of beneficiaries composed exclusively of the employer's employees, and such benefits are a form of compensation. The IRS recently held in a private letter ruling,[82] and in similar rulings, that a private foundation that is established, funded and controlled by a particular employer for the purpose of providing disaster relief for employees of a particular employer does not qualify as a charitable organization under section 501(c)(3), because the foundation is not operated solely for charitable purposes and is providing a benefit on behalf of the employer in violation of the prohibition on private inurement. Although private letter rulings do not constitute precedent for other taxpayers, considerable uncertainty exists regarding IRS' position relating to employer-controlled private foundations making disaster relief payments to employee-beneficiaries.

If payments in connection with a qualified disaster are made by a private foundation to employees (and their family members) of an employer that controls the foundation, the presumption that the charity acts consistently with the requirements of section 501(c)(3) applies

[82] Priv. Ltr. Rul. 199914040.

if the class of beneficiaries is large or indefinite and if recipients are selected based on an objective determination of need by an independent committee of the private foundation, a majority of the members of which are persons other than persons who are in a position to exercise substantial influence over the affairs of the controlling employer (determined under principles similar to those in effect under section 4958). The presumption does not apply to grants made to, or for the benefit of, a disqualified person or member of the selection committee. However, the absence of an independent selection committee does not necessarily mean that a foundation violates the requirements of section 501(c)(3). Other procedures and standards may be adequate substitutes to ensure that any benefit to the employer is incidental and tenuous. Similarly, providing need-based payments to employees and their survivors in response to a disaster other than a qualified disaster may well further charitable purposes consistent with the requirements of section 501(c)(3).

It is intended that an employer-controlled private foundation is not providing an inappropriate benefit and is not disqualified from exemption under section 501(c)(3) if it makes a payment to an employee or a family member of an employee (who is employed by an employer who controls the foundation) that relieves distress caused by a qualified disaster as defined under section 139, provided that it awards grants based on an objective determination of need using either an independent selection committee or adequate substitute procedures, as described above. It is further intended that section 102(c) of the Code, which provides that a transfer from an employer to, or for the benefit of, an employee generally is not excludable from income as a gift, does not apply to such payments. It is further expected that the Service will reconsider the ruling position it has taken to ensure that private foundations established and controlled by employers will have appropriate guidance, consistent with the principles outlined above, on the circumstances under which they may provide disaster assistance in connection with a qualified disaster specifically to the employers' employees.

It is intended that the making by a private foundation of disaster relief payments that qualify for the presumption stated above (1) will not be treated as an act of self-dealing under section 4941 merely because the recipient is an employee (or family member of an employee) of a disqualified person with respect to the foundation, (2) will be treated as in furtherance of section 170(c)(2)(B) purposes, and (3) will be considered to meet the requirements of section 4945(g) to the extent that they apply. Moreover, contributions to a section 501(c)(3) organization administering relief in a manner outlined above (including those made by employers and any of their employees) are deductible under the generally applicable rules of section 170. Finally, it is confirmed that need-based payments made by an employer-controlled foundation to an individual for exclusively charitable purposes generally are excludable from the recipients' income as gifts.[83] Thus, such payments made by a foundation to relieve distress caused by a qualified disaster are excludable from the recipients' income regardless of whether they fall within the scope of section 139, or any other such provision of the Code providing for an exclusion. The IRS is directed to issue prompt guidance to taxpayers relating to the requirements applicable to private foundations making disaster assistance payments. The principles discussed above should apply to foundations and public charities providing relief in response to both the September 11, 2001, disaster and future qualified disasters.

---

[83] *See, e.g.*, Rev. Rul. 99-44, 1999-2 C.B. 549.

Effective Date

The provision applies to taxable years ending on or after September 11, 2001.

2. Authority to postpone certain deadlines and required actions (sec. 512 of the bill, sec. 7508A of the Code, and new sec. 518 and sec. 4002 of the Employee Retirement Income Security Act of 1974)

Present Law

In general

In general, the Secretary of the Treasury may prescribe regulations under which a period of up to 120 days may be disregarded for performing various acts under the Internal Revenue Code, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, for any taxpayer determined by the Secretary to be affected by a Presidentially declared disaster (sec. 7508A).

The suspension of time may apply to the following acts:

(1) Filing any return of income, estate, or gift tax (except employment and withholding taxes);

(2) Payment of any income, estate, or gift tax (except employment and withholding taxes);

(3) Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court;

(4) Allowance of a credit or refund of any tax;

(5) Filing a claim for credit or refund of any tax;

(6) Bringing suit upon any such claim for credit or refund;

(7) Assessment of any tax;

(8) Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;

(9) Collection of the amount of any liability in respect of any tax;

(10) Bringing suit by the United States in respect of any liability in respect of any tax; and

(11) Any other act required or permitted under the internal revenue laws specified in regulations prescribed by the Secretary of the Treasury.[84]

Individuals may, if they choose, perform any of these acts during the period of suspension.

On September 13, 2001, the IRS issued Notice 2001-61 providing relief to taxpayers affected by the September 11, 2001, terrorist attack. Prior to issuance of this notice, the President had declared certain affected areas to be disaster areas. In addition, on September 14, 2001, the IRS issued Notice 2001-63 providing additional tax relief to taxpayers who found it difficult to meet their tax filing and payment obligations.

Employee benefit plans

Questions have arisen about the scope of section 7508A in relation to employee benefit plans. Some acts related to employee benefit plans are not clearly covered by the suspension. For example, a plan sponsor or plan administrator may be required to provide a notice to plan participants or to make a plan contribution, or a plan participant may be required to make a benefit election or take a distribution under the plan. In addition, some acts related to employee benefit plans may be required or provided for under the Employee Retirement Income Security Act ("ERISA") or under the terms of the plan, rather than under the Internal Revenue Code. For example, on September 14, 2001, the Department of Labor issued News Release No. 01-36, announcing that the Pension and Welfare Benefits Administration, the Internal Revenue Service, and the Pension Benefit Guaranty Corporation were extending the deadline for filing Form 5500 and Form 5500-EZ.

Explanation of Provision

In general

The bill redrafts section 7508A to expand its scope and to clarify its application. Specifically, the bill permits the Secretary to suspend the period of time under this provision for up to one year (increased from up to 120 days). The bill also clarifies that interest on underpayments may be waived or abated pursuant to section 7508A with respect to either a declared disaster or a terroristic or military action. The bill clarifies that the Secretary of the Treasury has the authority to postpone actions pursuant to section 7508A in response to a terroristic or military action, regardless of whether a disaster area has been declared by the President in connection with the action. The bill facilitates the prompt issuance of guidance by the Secretary of the Treasury with respect to section 7508A by removing the requirement that regulations be published listing the scope of additional actions that may be postponed pursuant to section 7508(a)(1)(K); accordingly, the Secretary may provide authoritative guidance via a notice or other mechanism of the Secretary's choice that may be issued more rapidly. It is intended that the Secretary construe this authority as broadly as is necessary and appropriate to

[84] Treas. Reg. sec. 301.7508A-1(c)(1)(vii) states, with respect to this clause, that it encompasses "any other act specified in a revenue ruling, revenue procedure, notice, announcement, news release, or other guidance published in the Internal Revenue Bulletin."

respond to specific disasters or terroristic or military actions. The authority to postpone “any ... act” is sufficiently broad to encompass, for example, specific deadlines enumerated in the Code, such as those in section 1031 (relating to the exchange of property held for productive use or investment). Similarly, it is intended that the Secretary utilize this authority to address issues that arise from the discovery of tax information subsequent to the filing of a tax return that would affect the tax liability reported on that return.

Employee benefit plans

The bill expands and clarifies the scope of the deadlines and required actions that may be postponed pursuant to section 7508A. The bill provides that the Secretary of the Treasury may prescribe a period of up to one year which may be disregarded in determining the date by which any action by a pension or other employee benefit plan, or by a plan sponsor, administrator, participant, beneficiary or other person would be required or permitted to be completed. The bill provides similar authority to the Secretary of Labor and the Pension Benefit Guaranty Corporation with respect to actions within their respective jurisdictions.

The bill is not limited to actions under the Internal Revenue Code. Accordingly, actions under ERISA or under the terms of the plan come within the scope of this provision. Acts performed within the extended period are considered timely under the Internal Revenue Code, ERISA, and the plan. In addition, a plan is not treated as operating in a manner inconsistent with its terms or in violation of its terms merely because acts provided for under the plan are performed during the extended period.

Examples of acts covered by the provision include (1) the filing of a form with the IRS, Department of Labor or the Pension Benefit Guaranty Corporation, (2) an employer’s contribution to the plan of required quarterly amounts for the current year or the prior year minimum funding amounts, (3) the filing of an application for a waiver of the minimum funding standard, (4) the payment of premiums to the Pension Benefit Guarantee Corporation, (5) a participant’s election of a form of benefits under a plan, (6) the plan administrator’s distribution of benefits in accordance with a participant’s election, (7) notice to an employee of eligibility for continuation coverage under a group health plan, and (8) an employee’s election of continuation coverage.

Effective Date

The provision applies to disasters and terroristic or military actions occurring on or after September 11, 2001, with respect to any action of the Secretary of the Treasury, the Secretary of Labor, or the Pension Benefit Guaranty Corporation on or after the date of the enactment.

3. Application of certain provisions to terroristic or military actions (sec. 513 of the bill and secs. 104 and 692 of the Code)

<u>Present Law</u>

<u>Taxation of disability income of U.S. employees related to terrorist activity outside the United States</u>

Gross income does not include amounts received by an individual as disability income attributable to injuries incurred as a direct result of a terrorist attack (as determined by the Secretary of State) which occurred while the individual was performing official duties as an employee of the United States outside the United States (sec. 104(a)(5)).

<u>Income tax relief for military and civilian U.S. employees who die as a result of terrorist activity outside the United States</u>

Military and civilian employees of the United States who die as a result of wounds or injury incurred outside the United States in a terroristic or military action are not subject to income tax for the year of death and for prior taxable years beginning with the taxable year prior to the taxable year in which the wounds or injury were incurred. Accordingly, if such an individual is injured and dies in the same taxable year, this exemption from income tax is available for the taxable year of death as well as the prior taxable year.

<u>Explanation of Provision</u>

<u>Taxation of disability income related to terrorist activity</u>

The bill expands the present-law exclusion from gross income for disability income of U.S. civilian employees attributable to a terrorist attack outside the United States to apply to disability income received by any individual attributable to a terroristic or military action.

<u>Income tax relief for individuals who die as a result of terrorist activity</u>

The bill extends the income tax relief provided under present law to U.S. military and civilian personnel who die as a result of terroristic activity or military action outside the United States to such personnel regardless of where the terroristic activity or military action occurred.

<u>Effective Date</u>

The provision is effective for taxable years ending on or after September 11, 2001.

4. Clarification that the special deposit rules provided under the Air Transportation Safety and Stabilization Act do not apply to employment taxes (sec. 514 of the bill and sec. 301 of the Air Transportation Safety and Stabilization Act)

Present Law

Section 301 of the Air Transportation Safety and System Stabilization Act[85] provides a special rule for the deposit of certain taxes. If a deposit of these taxes was required to be made after September 10, 2001, and before November 15, 2001, they are treated as timely made if deposited by November 15, 2001. The Secretary of the Treasury is given the authority to extend this deadline further, but no later than January 15, 2002. For eligible air carriers, the special deposit rules are applicable to the excise taxes imposed on air travel. The special deposit rules were also applied inadvertently to the deposit of the following employment taxes: both the employer and employee portions of FICA, railroad retirement taxes, and income taxes withheld by employers from employees.

Explanation of Provision

The applicability of these special deposit rules to employment taxes is repealed. The applicability of these special deposit rules to excise taxes is unaffected. It is intended that no penalties be imposed with respect to taxes that were not deposited timely in reliance on the provisions of the Air Transportation Safety and System Stabilization Act prior to the enactment of this provision.

Effective Date

The provision is effective as if included in section 301 of the Air Transportation Safety and System Stabilization Act.

5. Treatment of purchase of structured settlements (sec. 515 of the bill and new sec. 5891 of the Code)

Present Law

Present law provides tax-favored treatment for structured settlement arrangements for the payment of damages on account of personal injury or sickness.

Under present law, an exclusion from gross income is provided for amounts received for agreeing to a qualified assignment to the extent that the amount received does not exceed the aggregate cost of any qualified funding asset (sec. 130). A qualified assignment means any assignment of a liability to make periodic payments as damages (whether by suit or agreement) on account of a personal injury or sickness (in a case involving physical injury or physical sickness), provided the liability is assumed from a person who is a party to the suit or agreement, and the terms of the assignment satisfy certain requirements. Generally, these requirements are that (1) the periodic payments are fixed as to amount and time; (2) the payments cannot be

---

[85] Pub. L. No. 107-42.

accelerated, deferred, increased, or decreased by the recipient; (3) the assignee's obligation is no greater than that of the assignor; and (4) the payments are excludable by the recipient under section 104(a)(1) or (2) as workmen's compensation for personal injuries or sickness, or as damages on account of personal physical injuries or physical sickness.

A qualified funding asset means an annuity contract issued by an insurance company licensed in the U.S., or any obligation of the United States, provided the annuity contract or obligation meets statutory requirements. An annuity that is a qualified funding asset is not subject to the rule requiring current inclusion of the income on the contract which generally applies to annuity contract holders that are not natural persons (e.g., corporations) (sec. 72(u)(3)(C)). In addition, when the payments on the annuity are received by the structured settlement company and included in income, the company generally may deduct the corresponding payments to the injured person, who, in turn, excludes the payments from his or her income (sec. 104). Thus, neither the amount received for agreeing to the qualified assignment of the liability to pay damages, nor the income on the annuity that funds the liability to pay damages, generally is subject to tax.

The exclusion for recipients of the periodic payments received under a structured settlement arrangement as damages for personal physical injuries or physical sickness can be contrasted with the treatment of investment earnings that are not paid as damages. If a recipient of damages chooses to receive a lump sum payment (excludable from income under sec. 104), and then to invest it himself, generally the earnings on the investment are includable in income. For example, if the recipient uses the lump sum to purchase an annuity contract providing for periodic payments, then a portion of each payment under the annuity contract is includable in income, and the balance is excludable under present-law rules based on the ratio of the individual's investment in the contract to the expected return on the contract (sec. 72(b)).

Present law provides that the payments to the injured person under the qualified assignment cannot be accelerated, deferred, increased, or decreased by the recipient (sec. 130). Consistent with these requirements, it is understood that contracts under structured settlement arrangements generally contain anti-assignment clauses. It is understood, however, that injured persons may nonetheless be willing to accept discounted lump sum payments from certain "factoring" companies in exchange for their payment streams. The tax effect on the parties of these transactions may not be completely clear under present law.

Explanation of Provision

The bill generally imposes an excise tax on any person who acquires certain payment rights under a structured settlement arrangement from a structured settlement recipient for consideration. The amount of the excise tax is 40 percent of the excess of (1) the undiscounted amount of the payments being acquired, over (2) the total amount actually paid to acquire them.

The 40-percent excise tax does not apply, however, if the transfer is approved in advance in a final order, judgment or decree that: (1) finds that the transfer does not contravene any Federal or State statute or the order of any court or responsible administrative authority; (2) finds that the transfer is in the best interest of the payee, taking into account the welfare and support of the payee's dependents; and (3) is issued under an applicable State statute by a court or is issued by the responsible administrative authority. Rules are provided for determining the applicable State statute.

The provision also provides that the acquisition transaction does not affect the application of certain present-law rules, if those rules were satisfied at the time the structured settlement was entered into. The rules are section 130 (relating to an exclusion from gross income for personal injury liability assignments), section 72 (relating to annuities), sections 104(a)(1) and (2) (relating to an exclusion for amounts received under workers' compensation acts and for damages on account of personal physical injuries or physical sickness), and section 461(h) (relating to the time of economic performance in determining the taxable year of a deduction).

Effective Date

The provision generally is effective for acquisition transactions entered into on or after 30 days following enactment. A transition rule applies during the period from that date to July 1, 2002. Under the transition rule, if no applicable State law (relating to the best interest of the payee) applies to a transfer during that period, then the exception from the 40 percent excise tax is available without the otherwise required court (or administrative) order, provided certain disclosure requirements are met. Under the transition rule, the person acquiring the structured settlement payments is required to disclose in advance to the payee: (1) the amounts and due dates of the payments to be transferred; (2) the aggregate amount to be transferred; (3) the consideration to be received by the payee; (4) the discounted present value of the transferred payments; and (5) the expenses to be paid by the payee or deducted from the payee's proceeds.

The provision providing that the acquisition transaction does not affect the application of certain present-law rules is effective for transactions entered into before, on or after the 30th day following enactment.

6. Personal exemption deduction for certain disability trusts (sec. 516 of the bill and sec. 642 of the Code)

Present Law

Present law provides a $300 personal exemption for trusts that are required by their governing instruments to currently distribute all of their income. For other trusts, present law provides a $100 personal exemption. These deductions are in lieu of the personal exemption that generally is provided under section 151 for individuals (sec. 642(b)).

Under present law, a grantor who transfers property to a trust while retaining certain powers or interests over the trust is treated as the owner of the trust for income tax purposes under the so-called "grantor trust rules" (secs. 671-677). Similarly, a third party who is not adverse to the grantor is treated as the owner of the trust under these rules to the extent that the third party is granted certain powers over the trust. If a grantor or third party is treated as the owner of a trust (a "grantor trust"), the income and deductions of the trust are included directly in the taxable income of the grantor or third party. Because the personal exemption under section 642(b) applies to income that is taxable to a trust (rather than a grantor or third party), the personal exemption under section 642(b) does not apply to grantor trusts.

Explanation of Provision

The bill provides that certain disability trusts may claim a personal exemption in an amount that is based upon the personal exemption provided for individuals under section 151(d), rather than the $300 or $100 personal exemption provided under present law. The provision applies to taxable disability trusts described in 42 U.S.C. sec. 1396p(c)(2)(B)(iv) (relating to the treatment, for purposes of determining eligibility for medical assistance under the Social Security Act, of assets transferred to a trust established solely for the benefit of a disabled individual under 65 years of age).

The provision only applies to disability trusts the beneficiaries of which have been determined by the Commissioner of Social Security to be disabled (other than holders of a remainder or reversionary interest in the trust), within the meaning of 42 U.S.C. sec. 1382c(a)(3) (relating to the definition of a "disabled individual" for purposes of determining eligibility for Supplemental Security Income).

The provision applies if all of the beneficiaries of the trust at the end of the taxable year are determined under 42 U.S.C. sec. 1382c(a)(3) to be disabled for some portion of such year. Thus, a disability trust may claim the personal exemption under the provision even if one or more of the beneficiaries becomes no longer disabled during the taxable year. However, the trust may claim the personal exemption for the following taxable year only if such individual or individuals are no longer beneficiaries of the trust at the end of the following taxable year (i.e., all remaining beneficiaries of the trust at the end of the following taxable year are disabled or were disabled during some portion of such year). In the case of a disability trust with a single beneficiary, the trust may claim the personal exemption under the provision for the taxable year during which the beneficiary becomes no longer disabled, but not for subsequent taxable years.

The personal exemption provided for disability trusts under the provision is equal in amount to the section 151(d) personal exemption for unmarried individuals with no dependents and is subject to a phaseout, which is determined by reference to the phaseout of the personal exemption for such individuals under sec. 151(d)(3)(C)(iii). For purposes of computing the phaseout of the personal exemption under the provision, the adjusted gross income of the trust is determined by reference to section 67(e) (relating to the determination of adjusted gross income of estates and trusts for purposes of computing the 2-percent floor on miscellaneous itemized deductions).

The provision does not affect the determination of whether a disability trust is treated as a grantor trust under the present-law grantor trust rules, and does not change the inapplicability of the personal exemption under section 642(b) to grantor trusts. Thus, the provision does not apply to disability trusts that are treated as grantor trusts.

Effective Date

The provision applies to taxable years of disability trusts ending on or after September 11, 2001.

7. Disclosure of tax information in terrorism and national security investigations (sec. 517 of the bill and sec. 6103 of the Code)

Present Law

In general

Returns and return information are confidential (sec. 6103). A "return" is any tax return, information return, declaration of estimated tax, or claim for refund filed under the Code on behalf of or with respect to any person. The term return also includes any amendment or supplement, including supporting schedules, attachments, or lists, which are supplemental to or are part of a filed return. Return information is defined broadly. It includes the following information:

- a taxpayer's identity, the nature, source or amount of income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments;
- whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing;
- any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense;
- any part of any written determination or any background file document relating to such written determination which is not open to public inspection under section 6110;
- any advance pricing agreement entered into by a taxpayer and the Secretary and any background information related to the agreement or any application for an advance pricing agreement; and
- any agreement under section 7121 (relating to closing agreements), and any similar agreement, and any background information related to such agreement or request for such agreement (sec. 6103(b)(2)).

The term "return information" does not include data in a form that cannot be associated with or otherwise identify, directly or indirectly, a particular taxpayer. "Taxpayer return information" means return information which is filed with, or furnished to, the Internal Revenue Service by or on behalf of the taxpayer to whom such return information relates.

Section 6103 provides that returns and return information may not be disclosed by the IRS, other Federal employees, State employees, and certain others having access to the information except as provided in the Internal Revenue Code. Section 6103 contains a number of exceptions to this general rule of nondisclosure that authorize disclosure in specifically identified circumstances (including nontax criminal investigations) when certain conditions are satisfied.

Recordkeeping and safeguard requirements also are imposed. These requirements establish a system of records to keep track of disclosure requests and disclosures and to ensure that the information is securely stored and that access to the information is restricted to authorized persons. These conditions and safeguards are intended to ensure that an individual's right to privacy is not unduly compromised and the information is not misused or improperly disclosed. The IRS also must submit reports to the Joint Committee on Taxation and to the public regarding requests for and disclosures made of returns and return information 90 days after the close of the calendar year (sec. 6103(p)(3)). Criminal and civil sanctions apply to the unauthorized disclosure or inspection of returns and return information (secs. 7213, 7213A, and 7431).

<u>Disclosure of returns and return information for use in nontax criminal investigations - by *ex parte* court order</u>

A Federal agency enforcing a nontax criminal law must obtain an *ex parte* court order to receive a return or taxpayer return information (i.e., that information submitted by or on behalf of a taxpayer to the IRS) (sec. 6103(i)(1)).[86] Only the Attorney General, Deputy Attorney General, Assistant Attorney Generals, United States Attorneys, Independent Counsels, or an attorney in charge of an organized crime strike force may authorize an application for the order.

For a judge or magistrate to grant such an order, the application must demonstrate that:

- there is reasonable cause to believe, based upon information believed to be reliable, that a specific criminal act has been committed;
- there is reasonable cause to believe that the return or return information is or may be relevant to a matter relating to the commission of such act;
- the return or return information is sought exclusively for use in a Federal criminal investigation or proceeding concerning such act; and
- the information sought reasonably cannot be obtained, under the circumstances, from another source.

Pursuant to the *ex parte* order, the information may be disclosed to officers and employees of the Federal agency who are personally and directly engaged in (1) the preparation for any judicial or administrative proceeding pertaining to the enforcement of a specifically designated Federal criminal statute (not involving tax administration) to which the United States or such agency is a party, (2) any investigation which may result in such a proceeding, or (3) any Federal grand jury proceeding pertaining to enforcement of such a criminal statute to which the United States or such agency is or may be a party.

A Federal agency may obtain, by *ex parte* court order, the return and return information of a fugitive from justice for purposes of locating such individual (sec. 6103(i)(5)). The application for an *ex parte* order must establish that (1) a Federal felony arrest warrant has been issued and the taxpayer is a fugitive from justice, (2) the return or return information is sought

[86] Return information other than that submitted by the taxpayer may be obtained by *ex parte* court order under this provision as well.

exclusively for locating the fugitive taxpayer, and (3) reasonable cause exists to believe the information may be relevant in determining the location of the fugitive. Only the Attorney General, Deputy Attorney General, Assistant Attorney Generals, United States Attorneys, Independent Counsels, or an attorney in charge of an organized crime strike force may authorize an application for this order. Once a court grants the application for an *ex parte* order, the return or return information may be disclosed to any Federal agency exclusively for purposes of locating the fugitive individual.

Agency request procedure for disclosure of return information other than taxpayer return information to the IRS for use in criminal investigations

For nontax criminal investigations, Federal agencies can obtain return information, other than taxpayer return information, without a court order. For nontax criminal purposes, the head of a Federal agency and other persons specifically identified by section 6103 may make a written request for return information that was not provided to the IRS by the taxpayer or his representative (sec. 6103(i)(2)). The written request must contain:

- the taxpayer's name, and address;
- the taxable period for which the information is sought;
- the statutory authority under which the criminal investigation or judicial, administrative or grand jury proceeding is being conducted; and
- the reasons why such disclosure is or may be relevant to the investigation or proceeding. Unlike the requirements for an *ex parte* order, the requesting agency does not have to demonstrate that the information sought is not reasonably available elsewhere.

Disclosure of return information to apprise appropriate officials of criminal activities or emergency circumstances

Criminal activities

Section 6103 permits the IRS to disclose return information (other than taxpayer return information) that may be evidence of a crime (sec. 6103(i)(3)(A)). The IRS may make the disclosure in writing to the head of a Federal agency charged with enforcing the laws to which the crime relates. Return information also may be disclosed to apprise Federal law enforcement of the imminent flight of any individual from Federal prosecution. The IRS may not disclose returns under this provision.

Emergency circumstances

In cases of imminent danger of death or physical injury to an individual, the IRS may disclose return information to Federal and State law enforcement agencies (sec. 6103(i)(3)(B)). The statute does not grant authority, however, to disclose return information to local law enforcement, such as city, county, or town police. The statute does not permit the IRS to disclose return information concerning terrorist activities if there is no imminent danger of death or physical injury to an individual.

Tax convention information

With limited exceptions, the Code prohibits the disclosure of tax convention information (sec. 6105). A tax convention is any: (1) income tax or gift and estate tax convention, or (2) other convention or bilateral agreement (including multilateral conventions and agreements and any agreement with a possession of the United States) providing for the avoidance of double taxation, the prevention of fiscal evasion, nondiscrimination with respect to taxes, the exchange of tax relevant information with the United States, or mutual assistance in tax matters. Tax convention information is any: (1) agreement entered into with the competent authority of one or more foreign governments pursuant to a tax convention; (2) application for relief under a tax convention; (3) background information related to such agreement or application; (4) document implementing such agreement; and (5) other information exchanged pursuant to a tax convention which is treated as confidential or secret under the tax convention.

The general rule that tax convention information cannot be disclosed does not apply to the disclosure of tax convention information to persons or authorities (including courts and administrative bodies) that are entitled to disclosure under the tax convention and any generally applicable procedural rules regarding applications for relief under a tax convention. It also does not apply to the disclosure of tax convention information not relating to a particular taxpayer if the IRS determines, after consultation with the parties to the tax convention, that such disclosure would not impair tax administration.

Explanation of Provision

In general

The bill expands the availability of returns and return information for purposes of investigating terrorist incidents, threats, or activities, and for analyzing intelligence concerning terrorist incidents, threats, or activities. In general, under the bill, returns and taxpayer return information must be obtained pursuant to an *ex parte* court order. Return information, other than taxpayer return information, generally is available upon a written request meeting specific requirements. Present-law safeguards, recordkeeping, reporting requirements, and civil and criminal penalties for unauthorized disclosures apply to disclosures made pursuant to the bill. The bill also permits the disclosure of tax convention information for the same purposes and in the same manner that return information is made available under the bill. No disclosures may be made under the bill after December 31, 2003.

Disclosure of returns and return information including taxpayer return information - by *ex parte* court order

Ex parte court orders sought by Federal law enforcement and Federal intelligence agencies.--The bill permits, pursuant to an *ex parte* court order, the disclosure of returns and return information (including taxpayer return information) to certain officers and employees of a Federal law enforcement agency or Federal intelligence agency. These officers and employees are required to be personally and directly engaged in any investigation of, response to, or analysis of intelligence and counterintelligence information concerning any terrorist incident, threat, or activity. These officers and employees are permitted to use this information solely for their use in the investigation, response, or analysis, and in any judicial, administrative, or grand jury proceeding, pertaining to any such terrorist incident, threat, or activity.

The Attorney General, Deputy Attorney General, Associate Attorney General, an Assistant Attorney General, or a United States attorney, may authorize the application for the *ex parte* court order to be submitted to a Federal district court judge or magistrate. The Federal district court judge or magistrate would grant the order if based on the facts submitted he or she determines that:

- there is reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity; and
- the return or return information is sought exclusively for the use in a Federal investigation, analysis, or proceeding concerning any terrorist incident, threat, or activity.

Special rule for *ex parte* court ordered disclosure initiated by the IRS.--If the Secretary of Treasury possesses returns or return information that may be related to a terrorist incident, threat, or activity, the Secretary of the Treasury (or his delegate), may on his own initiative, authorize an application for an *ex parte* court order to permit disclosure to Federal law enforcement. In order to grant the order, the Federal district court judge or magistrate must determine that there is reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity. Under the bill, the information may be disclosed only to the extent necessary to apprise the appropriate Federal law enforcement agency responsible for investigating or responding to a terrorist incident, threat, or activity and for officers and employees of that agency to investigate or respond to such terrorist incident, threat, or activity. Further, use of the information is limited to use in a Federal investigation, analysis, or proceeding concerning a terrorist incident, threat, or activity. Because the Department of Justice represents the Secretary of the Treasury in Federal district court, the Secretary is permitted to disclose returns and return information to the Department of Justice as necessary and solely for the purpose of obtaining the special IRS *ex parte* court order.

Disclosure of return information other than taxpayer return information

Disclosure by the IRS without a request.--The bill permits the IRS to disclose return information, other than taxpayer return information, related to a terrorist incident, threat, or activity to the extent necessary to apprise the head of the appropriate Federal law enforcement agency responsible for investigating or responding to such terrorist incident, threat, or activity. As under present law Code section 6103(i)(3)(A), the IRS on its own initiative and without a written request may make this disclosure. The head of the Federal law enforcement agency may disclose information to officers and employees of such agency to the extent necessary to investigate or respond to such terrorist incident, threat, or activity. A taxpayer's identity is not treated as return information supplied by the taxpayer or his or her representative.

Disclosure upon written request of a Federal law enforcement agency.--The bill permits the IRS to disclose return information, other than taxpayer return information, to officers and employees of Federal law enforcement upon a written request satisfying certain requirements. The request must: (1) be made by the head of the Federal law enforcement agency (or his delegate) involved in the response to or investigation of terrorist incidents, threats, or activities, and (2) set forth the specific reason or reasons why such disclosure may be relevant to a terrorist incident, threat, or activity. The information is to be disclosed to officers and employees of the Federal law enforcement agency who would be personally and directly involved in the response to or investigation of terrorist incidents, threats, or activities. The information is to be used by such officers and employees solely for such response or investigation.

The bill permits the redisclosure by a Federal law enforcement agency to officers and employees of State and local law enforcement personally and directly engaged in the response to or investigation of the terrorist incident, threat, or activity. The State or local law enforcement agency must be part of an investigative or response team with the Federal law enforcement agency for these disclosures to be made.

Disclosure upon request from the Departments of Justice or Treasury for intelligence analysis of terrorist activity.--Upon written request satisfying certain requirements discussed below, the IRS is to disclose return information (other than taxpayer return information[87]) to officers and employees of the Department of Justice, Department of Treasury, and other Federal intelligence agencies, who are personally and directly engaged in the collection or analysis of intelligence and counterintelligence or investigation concerning terrorist incidents, threats, or activities. Use of the information is limited to use by such officers and employees in such investigation, collection, or analysis.

The written request is to set forth the specific reasons why the information to be disclosed is relevant to a terrorist incident, threat, or activity. The request is to be made by an individual who is (1) an officer or employee of the Department of Justice or the Department of Treasury, (2) appointed by the President with the advice and consent of the Senate, and (3) responsible for the collection, and analysis of intelligence and counterintelligence information concerning terrorist incidents, threats, or activities. The Director of the United States Secret Service also is an authorized requester under the bill.

Tax convention information

The bill permits the disclosure of tax convention information on the same terms as return information may be disclosed under the bill, except that in the case of tax convention information provided by a foreign government, no disclosure may be made under this paragraph without the written consent of the foreign government.

[87] A taxpayer's identity is not treated as having been supplied by the taxpayer or his representative.

Definitions

The term "terrorist incident, threat, or activity" is statutorily defined to mean an incident, threat, or activity involving an act of domestic terrorism or international terrorism, as both of those terms were defined in the recently enacted USA PATRIOT Act.[88]

Effective Date

The provision is effective for disclosures made on or after the date of enactment.

[88] 18 U.S.C. sec. 2331.

VIII. MISCELLANEOUS AND TECHNICAL PROVISIONS

A. Allowance of Electronic Forms 1099 (sec. 601 of the bill)

Present Law

Many provisions in the Code require entities to file information returns with the IRS and to provide copies to taxpayers. For example, employers are required to provide information with respect to wages paid to employees, and entities (such as banks and credit unions) that pay interest to individuals are also required to provide information with respect to those payments. In general, the copies of the information returns that are provided to taxpayers are provided on paper via the U.S. mail.

Temporary regulations allow Form W-2 to be furnished electronically on a voluntary basis. Under Temp. Treas. Reg. §31.6051-1T(j), a recipient must have affirmatively consented to receive the statement electronically and must not have withdrawn that consent before the statement is furnished. A similar rule cannot be implemented administratively with respect to some information returns, because the Code requires that the copies furnished to individuals must be furnished either in person or in a statement sent by first-class mail in a specified format.[89]

IRS Form 5498 is used to report contributions to an Archer MSA, an Individual Retirement Account, or a Coverdell education savings accounts. In addition, distributions from these accounts are reported on IRS Form 1099. Under present law, the Secretary has the authority to issue rules under which Forms 5498 and 1099 related to these accounts may be provided electronically.

Explanation of Provision

The provision removes the statutory impediment to providing copies of specified information returns to taxpayers electronically. Accordingly, these copies may be furnished electronically to a recipient who has consented to this; the copies may be furnished in a manner similar to the one permitted with respect to Form W-2 or in another manner provided by the Secretary.

Effective Date

The provision is effective on date of enactment.

---

[89] See 6042(c), 6044(e),and 6049(c)(2).

B. Discharge of Indebtedness of an S Corporation (sec. 602 of the bill and sec. 108 of the Code)

Present Law

In general, an S corporation is not subject to the corporate income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. Each shareholder takes into account separately his or her pro rata share of these items on their individual income tax returns. To prevent double taxation of these items, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder may deduct losses only to the extent of a shareholder's basis in his or her stock in the S corporation plus the shareholder's adjusted basis in any indebtedness of the corporation to the shareholder. Any loss that is disallowed by reason of lack of basis is "suspended" at the corporate level and is carried forward and allowed in any subsequent year in which the shareholder has adequate basis in the stock or debt.

In general, gross income includes income from the discharge of indebtedness. However, income from the discharge of indebtedness of a taxpayer in a bankruptcy case or when the taxpayer is insolvent (to the extent of the insolvency) is excluded from income.[90] The taxpayer is required to reduce tax attributes, such as net operating losses, certain carryovers, and basis in assets, to the extent of the excluded income.

In the case of an S corporation, the eligibility for the exclusion and the attribute reduction are applied at the corporate level. For this purpose, a shareholder's suspended loss is treated as a tax attribute that is reduced. Thus, if the S corporation is in bankruptcy or is insolvent, any income from the discharge of indebtedness by a creditor of the S corporation is excluded from the corporation's income, and the S corporation reduces its tax attributes (including any suspended losses).

To illustrate these rules, assume that a sole shareholder of an S corporation has zero basis in its stock of the corporation. The S corporation borrows $100 from a third party and loses the entire $100. Because the shareholder has no basis in its stock, the $100 loss is "suspended" at the corporate level. If the $100 debt is forgiven when the corporation is in bankruptcy or is insolvent, the $100 income from the discharge of indebtedness is excluded from income, and the $100 "suspended" loss should be eliminated in order to achieve a tax result that is consistent with the economics of the transactions in that the shareholder has no economic gain or loss from these transactions.

Notwithstanding the economics of the overall transaction, the United States Supreme Court ruled in the case of *Gitlitz v. Commissioner*[91] that, under present law, income from the discharge of indebtedness of an S corporation that is excluded from income is treated as an item of income which increases the basis of a shareholder's stock in the S corporation and allows the

---

[90] Special rules also apply to certain real estate debt and farm debt.

[91] 531 U.S. 206 (2001).

suspended corporate loss to pass thru to a shareholder. Thus, under the decision, an S corporation shareholder is allowed to deduct a loss for tax purposes that it did not economically incur.

Explanation of Provision

The provision provides that income from the discharge of indebtedness of an S corporation that is excluded from the S corporation's income is not taken into account as an item of income by any shareholder and thus does not increase the basis of any shareholder's stock in the corporation.

Effective Date

The provision generally applies to discharges of indebtedness after October 11, 2001. The provision does not apply to any discharge of indebtedness before March 1, 2002, pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001.

C. Limitation on Use of Non-Accrual Experience Method of Accounting (sec. 603 of the bill and sec. 448 of the Code)

Present Law

An accrual method taxpayer generally must recognize income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. An accrual method taxpayer may deduct the amount of any receivable that was previously included in income that becomes worthless during the year.

Accrual method taxpayers are not required to include in income amounts to be received for the performance of services which, on the basis of experience, will not be collected (the "non-accrual experience method"). The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

Generally, a cash method taxpayer is not required to include an amount in income until received. A taxpayer generally may not use the cash method if purchase, production, or sale of merchandise is an income producing factor. Such taxpayers generally are required to keep inventories and use an accrual method of accounting. In addition, corporations (and partnerships with corporate partners) generally may not use the cash method of accounting if their average annual gross receipts years exceed $5 million. An exception to this $5 million rule is provided for qualified personal service corporations. A qualified personal service corporation is a corporation (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates or heirs. Qualified personal service corporations are allowed to use the cash method without regard to whether their average annual gross receipts exceed $5 million.

Explanation of Provision

Under the provision, the non-accrual experience method of accounting is available only for amounts to be received for the performance of qualified services and for services provided by certain small businesses. Amounts to be received for all other services are subject to the general rule regarding inclusion in income. Qualified services are services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. As under present law, the availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

Under a special rule, the non-accrual experience method of accounting continues to be available for the performance of non-qualified services if the average annual gross receipts (as defined in sec. 448(c)) of the taxpayer (or any predecessor) does not exceed $5 million. The rules of paragraph (2) and (3) of section 448(c) (i.e., the rules regarding the aggregation of related taxpayers, taxpayers not in existence for the entire three year period, short taxable years, definition of gross receipts, and treatment of predecessors) apply for purposes of determining the average annual gross receipts test.

The provision requires that the Secretary of the Treasury prescribe regulations to permit a taxpayer to use alternative computations or formulas if such alternative computations or formulas accurately reflect, based on experience, the amount of its year-end receivables that will not be collected. It is anticipated that the Secretary of the Treasury will consider providing safe harbors in such regulations that may be relied upon by taxpayers. In addition, the provision also provides that the Secretary of the Treasury permit taxpayers to adopt, or request consent of the Secretary of the Treasury to change to, an alternative computation or formula that clearly reflects the taxpayer's experience. The provision requires the Secretary of Treasury to approve a request provided that the alternative computation or formula clearly reflects the taxpayer's experience.

Effective Date

The provision is effective for taxable years ending after date of enactment. Any change in the taxpayer's method of accounting required as a result of the limitation on the use of the non-accrual experience method is treated as a voluntary change initiated by the taxpayer with the consent of the Secretary of the Treasury. Any resultant section 481(a) adjustment is to be taken into account over a period not to exceed the lesser of the number of years the taxpayer has used the non-accrual experience method of accounting or four years under principles consistent with those in Rev. Proc. 99-49.[92]

[92] 1999-2 C.B. 725

D. Expansion of the Exclusion from Income for Qualified Foster Care Payments (sec. 604 of the bill and sec. 131 of the Code)

Present Law

If certain requirements are satisfied, an exclusion from gross income is provided for qualified foster care payments paid to a foster care provider by either (1) a State or local government; or (2) a tax-exempt placement agency. Qualified foster care payments are amounts paid for caring for a qualified foster care individual in the foster care provider's home and difficulty of care payments.[93] A qualified foster care individual is an individual living in a foster care family home in which the individual was placed by: (1) an agency of the State or local government (regardless of the individual's age at the time of placement); or (2) a tax-exempt placement agency licensed by the State or local government (if such individual was under the age of 19 at the time of placement).

Explanation of Provision

The bill makes two modifications to the present-law exclusion for qualified foster care payments. First, the bill expands the definition of qualified foster care payments to include payments by any placement agency that is licensed or certified by a State or local government, or an entity designated by a State or local government to make payments to providers of foster care. Second, the bill expands the definition of a qualified foster care individual by including foster care individuals placed by a qualified foster care placement agency (regardless of the individual's age at the time of placement).

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

---

[93] A difficulty of care payment is a payment designated by the person making such payment as compensation for providing the additional care of a qualified foster care individual in the home of the foster care provider which is required by reason of a physical, mental, or emotional handicap of such individual and with respect to which the State has determined that there is a need for additional compensation.

E. Interest Rate Used in Determining Additional Required Contributions to Defined Benefit Plans and PBGC Variable Rate Premiums (sec. 605 of the bill, sec. 412 of the Code, and secs. 302 and 4006 of ERISA)

Present Law

In general

ERISA and the Code impose both minimum and maximum[94] funding requirements with respect to defined benefit pension plans. The minimum funding requirements are designed to provide at least a certain level of benefit security by requiring the employer to make certain minimum contributions to the plan. The amount of contributions required for a plan year is generally the amount needed to fund benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit.

Additional contributions for underfunded plans

Additional contributions are required under a special funding rule if a single-employer defined benefit pension plan is underfunded.[95] Under the special rule, a plan is considered underfunded for a plan year if the value of the plan assets is less than 90 percent of the plan's current liability.[96] The value of plan assets as a percentage of current liability is the plan's "funded current liability percentage."

If a plan is underfunded, the amount of additional required contributions is based on certain elements, including whether the plan has an unfunded liability related to benefits accrued before 1988 or 1995 or to changes in the mortality table used to determine contributions, and whether the plan provides for unpredictable contingent event benefits (that is, benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce). However, the amount of additional contributions cannot exceed the amount needed to increase the plan's funded current liability percentage to 100 percent.

---

[94] The maximum funding requirement for a defined benefit plan is referred to as the full funding limitation. Additional contributions are not required if a plan has reached the full funding limitation.

[95] Plans with no more than 100 participants on any day in the preceding plan year are not subject to the special funding rule. Plans with more than 100 but not more than 150 participants are generally subject to lower contribution requirements under the special funding rule.

[96] Under an alternative test, a plan is not considered underfunded if (1) the value of the plan assets is at least 80 percent of current liability and (2) the value of the plan assets was at least 90 percent of current liability for each of the two immediately preceding years or each of the second and third immediately preceding years.

Required interest rate

In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan. The interest rate used to determine a plan's current liability must be within a permissible range of the weighted average of the interest rates on 30-year Treasury securities for the four-year period ending on the last day before the plan year begins.[97] The permissible range is from 90 percent to 105 percent. As a result of debt reduction, the Department of the Treasury does not currently issue 30-year Treasury securities.

Timing of plan contributions

In general, plan contributions required to satisfy the funding rules must be made within 8-1/2 months after the end of the plan year. If the contribution is made by such due date, the contribution is treated as if it were made on the last day of the plan year.

In the case of a plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year. The amount of each required installment is 25 percent of the lesser of (1) 90 percent of the amount required to be contributed for the current plan year or (2) 100 percent of the amount required to be contributed for the preceding plan year.[98]

PBGC premiums

Because benefits under a defined benefit pension plan may be funded over a period of years, plan assets may not be sufficient to provide the benefits owed under the plan to employees and their beneficiaries if the plan terminates before all benefits are paid. In order to protect employees and their beneficiaries, the Pension Benefit Guaranty Corporation ("PBGC") generally insures the benefits owed under defined benefit pension plans. Employers pay premiums to the PBGC for this insurance coverage.

In the case of an underfunded plan, additional PBGC premiums are required based on the amount of unfunded vested benefits. These premiums are referred to as "variable rate premiums." In determining the amount of unfunded vested benefits, the interest rate used is 85 percent of the interest rate on 30-year Treasury securities for the month preceding the month in which the plan year begins.

---

[97] The interest rate used under the plan must be consistent with the assumptions which reflect the purchase rates which would be used by insurance companies to satisfy the liabilities under the plan (section 412(b)(5)(B)(iii)(II)).

[98] No additional quarterly contributions are due once the plan's funded current liability percentage for the plan year reaches 100 percent.

Explanation of Provision

Additional contributions

The provision expands the permissible range of the statutory interest rate used in calculating a plan's current liability for purposes of applying the additional contribution requirements for plan years beginning after December 31, 2001, and before January 1, 2004. Under the provision, the permissible range is from 90 percent to 120 percent for these years. Use of a higher interest rate under the expanded range will affect the plan's current liability, which may in turn affect the need to make additional contributions and the amount of any additional contributions.

Because the quarterly contributions requirements are based on current liability for the preceding plan year, the provision also provides special rules for applying these requirements for plans years beginning in 2002 (when the expanded range first applies) and 2004 (when the expanded range no longer applies). In each of those years ("present year"), current liability for the preceding year is redetermined, using the permissible range applicable to the present year. This redetermined current liability will be used for purposes of the plan's funded current liability percentage for the preceding year, which may affect the need to make quarterly contributions and for purposes of determining the amount of any quarterly contributions in the present year, which is based in part on the preceding year.

PBGC variable rate premiums

Under the provision, the interest rate used in determining the amount of unfunded vested benefits for variable rate premium purposes is increased to 100 percent of the interest rate on 30-year Treasury securities for the month preceding the month in which the plan year begins.

Effective Date

The provision is effective with respect to plan contributions and PBGC variable rate premiums for plan years beginning after December 31, 2001, and before January 1, 2004.

F. Deduction for Classroom Materials
(sec. 606 of the bill and sec. 62 of the Code)

Present Law

In general, ordinary and necessary business expenses are deductible (sec. 162). However, unreimbursed employee business expenses are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income.

An individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of $137,300 (for 2002).[99] In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Explanation of Provision

The bill provides an above-the-line deduction for up to $250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under 162 as a trade or business expense.

An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, or principal in a school for at least 900 hours during a school year. A school means any school which provides elementary education or secondary education, as determined under State law.

Effective Date

The provision is effective for taxable years beginning after December 31, 2001, and before January 1, 2004.

[99] The effect of this overall limitation is phased down beginning in 2006, and is repealed for 2010.

IX. TAX TECHNICAL CORRECTIONS
(secs. 611-618 of the bill)

Except as otherwise provided, the technical corrections contained in the bill generally are effective as if included in the originally enacted related legislation.

Amendments to the Economic Growth and Tax Relief Reconciliation Act of 2001

Section 6428 credit interaction with refundable child tax credit.--The provision treats the section 6428 credit (rate reduction) like a nonrefundable personal credit, thus allowing it prior to determining the refundable child credit.

Child tax credit.--The provision clarifies that for taxable years beginning in 2001, the portion of the child credit that is refundable is determined by referring in Code section 24(d)(1)(B) to "the aggregate amount of credits allowed by this subpart." This would retain prior law that was inadvertently changed by the Act.

Interaction of adoption credit limits.--Under prior law, the maximum adoption tax credit was $5,000 ($6,000 in the case of special needs adoptions). Under prior and present law, the credit generally is allowed in the year following the year the expenses are paid or incurred, except for the year that the adoption becomes final and later years. The Act increased the credit amount to $10,000 for taxable years beginning after 2001, but did not include a provision describing the dollar limit for amounts paid or incurred in 2001 for adoptions that do not become final in 2001. The provision clarifies that expenses paid or incurred in 2001 but allowed as a credit in 2002 are subject to the $5,000 (or $6,000) dollar cap in effect immediately prior to the enactment of the Act.

Dollar amount of credit for special needs adoptions.-- The provision provides that for special needs adoptions that become final after 2002, the $10,000 limit set forth in the Act relating to special needs adoptions is determined net of the aggregate credit allowed for that year and prior years.

Employer-provided adoption assistance exclusion with respect to special needs adoptions.-- The provision clarifies that the maximum exclusion in the case of a special needs adoption is $10,000 (before any AGI phaseout) for all taxable years cumulatively. As under prior law, a taxpayer may apply the dollar limits separately to each qualifying adoption. Also, the provision deems the employee to have qualified adoption expenses of $10,000 (less any such amounts actually paid or incurred with respect to that adoption) in the year a special needs adoption becomes final.

Credit for employer expenses for child care assistance.--The provision clarifies that recapture tax with respect to this credit is treated like recapture taxes with respect to other credits under chapter 1 of the Code. Thus, it would not be treated as a tax for purposes of determining the amounts of other credits or determining the amount of alternative minimum tax.

Elimination of marriage penalty in standard deduction.--The provision provides rules that were inadvertently omitted providing for separate returns and rounding rules for the standard deduction for the transition period years.

Education IRAs; non-application of 10-percent additional tax with respect to amounts for which HOPE credit is claimed.--Under the law prior to the Act, taxpayers could not claim the HOPE (or Lifetime learning) credit in the same year that they claimed an exclusion from income from an education IRA. Taxpayers were permitted to waive the exclusion in order to claim the HOPE (or Lifetime learning) credit. For taxpayers electing the waiver, earnings from amounts withdrawn from education IRAs and attributable to education expenses for which a HOPE (or Lifetime learning) credit was claimed were includable in income, but the additional ten percent tax was not applied. Under the Act, taxpayers are permitted to claim the education IRA exclusion and claim a HOPE (or Lifetime learning) credit in the same year, provided they do not claim both with respect to the same educational expenses. The election to waive the education IRA exclusion was thus unnecessary, and was dropped. However, a reference to the election was retained (sec. 530(d)(4)(b)(iv)). The reference to the election was intended to preserve the rule relating to the non-application of the 10-percent additional tax for education IRA earnings that are includable in income solely because the HOPE (or Lifetime learning) credit is claimed for those expenses. The provision clarifies the present-law rules to reflect this result.

The provision prevents the 10-percent additional tax from applying to a distribution from an education IRA (or qualified tuition program) that is used to pay qualified higher education expenses, but the taxpayer elects to claim a HOPE or Lifetime Learning credit in lieu of the exclusion under section 530 or 529. Thus, the income distributed from the education IRA (or qualified tuition program) would be subject to income tax, but not to the 10-percent additional tax.

Transfers in trust.--The provision clarifies that the effect of section 511(e) of the Act (effective for gifts made after 2009) is to treat certain transfers in trust as transfers of property by gift. The result of the clarification is that the gift tax annual exclusion and the marital and charitable deductions may apply to such transfers.

Recovery of taxes claimed as credit (State death tax credit).--The provision eliminates as deadwood a reference to the State death tax credit.

Pension-Related Amendments to the Economic Growth and Tax Relief Reconciliation Act of 2001

Individual Retirement Arrangements ("IRAs").-- Under the Act, a qualified employer plan may provide for voluntary employee contributions to a separate account that is deemed to be an IRA. The provision clarifies that, for purposes of deemed IRAs, the term "qualified employer plan" includes the following types of plans maintained by a governmental employer: a qualified retirement plan under section 401(a), a qualified annuity plan under section 403(a), a tax-sheltered annuity plan under section 403(b), and an eligible deferred compensation plan under section 457(b). The provision also clarifies that the Employee Retirement Income Security

Act ("ERISA") is intended to apply to a deemed IRA in a manner similar to a simplified employee pension ("SEP").

<u>Increase in benefit and contribution limits</u>.--Under the Act, the benefit and contribution limits that apply to qualified retirement plans are increased. These increases are generally effective for years beginning after December 31, 2001, but the increase in the limit on benefits under a defined benefit plan is effective for years ending after December 31, 2001. In the case of some plans that incorporate the benefit limits by reference and that use a plan year other than the calendar year, the increased benefit limits became effective under the plan automatically, causing unintended benefit increases. The provision permits an employer to amend such a plan by June 30, 2002, to reduce benefits to the level that applied before enactment of the Act without violating the anticutback rules that generally apply to plan amendments.

In connection with the increases in the benefit and contribution limits under the Act, a new base period applies in indexing the 2002 dollar amounts for future cost-of-living adjustments. The same indexing method applies to the dollar amounts used to determine eligibility to participate in a SEP and to determine the proper period for distributions from an employee stock ownership plan ("ESOP"). The provision changes these dollar amounts to the 2002 indexed amounts so that future indexing will operate properly.

<u>Modification of top-heavy rules</u>.--Under the Act, in determining whether a plan is top-heavy, distributions made because of separation from service, death, or disability are taken into account for one year after distribution. Other distributions are taken into account for five years. The Act also permits distributions from a section 401(k) plan, a tax-sheltered annuity plan, or an eligible deferred compensation plan to be made when the participant has a severance from employment (rather than separation from service). The provision clarifies that distributions made after severance from employment (rather than separation from service) are taken into account for only one year in determining top-heavy status.

<u>Elective deferrals not taken into account for deduction limits</u>.--The provision clarifies that elective deferrals to a SEP are not subject to the deduction limits and are not taken into account in applying the limits to other SEP contributions. The provision also clarifies that the combined deduction limit of 25 percent of compensation for qualified defined benefit and defined contribution plans does not apply if the only amounts contributed to the defined contribution plan are elective deferrals.

<u>Deduction limits</u>.--Under present law, contributions to a SEP are included in an employee's income to the extent they exceed the lesser of 15 percent of compensation or $40,000 (for 2002), subject to a reduction in some cases. Under prior law, the annual limitation on the amount of deductible contributions to a SEP was 15 percent of compensation. Under the Act, the annual limitation on the amount of deductible contributions that can be made to a SEP is increased from 15 percent of compensation to 25 percent of compensation. The provision makes a conforming change to the rule that limits the amount of SEP contributions that may be made for a particular employee. Under the provision, contributions are included in an employee's income to the extent they exceed the lesser of 25 percent of compensation or $40,000 (for 2002), subject to a reduction in some cases.

Under present law, the Secretary of the Treasury has the authority to require an employer who makes contributions to a SEP to provide simplified reports with respect to such contributions. Consistent with present law and the provision, such reports could appropriately include information as to compliance with the requirements that apply to SEPs, including the contribution limits.

Nonrefundable credit for certain individuals for elective deferrals and IRA contributions.--The provision clarifies that the amount of contributions taken into account in determining the credit for elective deferrals and IRA contributions is reduced by the amount of a distribution from a qualified retirement plan, an eligible deferred compensation plan, or a traditional IRA that is includible in income or that consists of after-tax contributions. The provision retains the rule that distributions that are rolled over to another retirement plan do not affect the credit.

Small business tax credit for new retirement plan expenses.--The provision clarifies that the small business tax credit for new retirement plan expenses applies in the case of a plan first effective after December 31, 2001, even if adopted on or before that date.

Additional salary reduction catch-up contributions.--Under the Act, an individual aged 50 or over may make additional elective deferrals ("catch-up contributions") to certain retirement plans, up to a specified limit. A plan may not permit catch-up deferrals in excess of this limit. The provision clarifies that, for this purpose, the limit applies to all qualified retirement plans, tax-sheltered annuity plans, SEPs and SIMPLE plans maintained by the same employer on an aggregated basis, as if all plans were a single plan. The limit applies also to all eligible deferred compensation plans of a government employer on an aggregated basis.

Under the Act, catch-up contributions up to the specified limit are excluded from an individual's income. The provision also clarifies that the total amount that an individual may exclude from income as catch-up contributions for a year cannot exceed the catch-up contribution limit for that year (and for that type of plan), without regard to whether the individual made catch-up contributions under plans maintained by the more than one employer.

The provision clarifies that an individual who will attain age 50 by the end of the taxable year is an eligible participant as of the beginning of the taxable year rather than only at the attainment of age 50. The provision also clarifies that a participant in an eligible deferred compensation plan of a government employer may make catch-up contributions in an amount equal to the greater of the amount permitted under the new catch-up rule and the amount permitted under the special catch-up rule for eligible deferred compensation plans.

The provision revises the lists of requirements that do not apply to catch-up contributions to reflect other statutory amendments made by the Act and to reflect the fact that catch-up contributions can be made only to a qualified defined contribution plan, not to a qualified defined benefit plan. The provision also clarifies that the special nondiscrimination rule for mergers and acquisitions applies for purposes of the nondiscrimination requirement applicable to catch-up contributions.

Equitable treatment for contributions of employees to defined contribution plans.-- Under prior law, the limits on contributions to a tax-sheltered annuity plan applied at the time contributions became vested. Under the Act, tax-sheltered annuity plans are generally subject to the same contribution limits as qualified defined contribution plans, but certain special rules were retained.

The provision clarifies that the limits apply to contributions to a tax-sheltered annuity plan in the year the contributions are made without regard to when the contributions become vested. The provision also clarifies that contributions may be made for an employee for up to five years after retirement, based on includible compensation for the last year of service before retirement. The provision also restores special rules for ministers and lay employees of churches and for foreign missionaries that were inadvertently eliminated.

Under the Act, amounts deferred under an eligible deferred compensation plan are generally subject to the same contribution limits as qualified defined contribution plans. The provision conforms the definition of compensation used in applying the limits to an eligible deferred compensation plan to the definition used for defined contribution plans.

Rollovers of retirement plan and IRA distributions.--Under prior law and under the Act, a qualified retirement plan must provide for the rollover of certain distributions directly to a qualified defined contribution plan, a qualified annuity plan, a tax-sheltered annuity plan, a governmental eligible deferred compensation plan, or a traditional IRA, if the participant elects a direct rollover. The provision clarifies that a qualified retirement plan must provide for the direct rollover of after-tax contributions only to a qualified defined contribution plan or a traditional IRA. The provision also clarifies that, if a distribution includes both pretax and after-tax amounts, the portion of the distribution that is rolled over is treated as consisting first of pretax amounts.

Employers may disregard rollovers for purposes of cash-out amounts.-- Under prior and present law, if a participant in a qualified retirement plan ceases to be employed with the employer maintaining the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed $5,000. Under the Act, a plan may provide that the present value of the benefit is determined without regard to the portion of the benefit that is attributable to rollover contributions (and any earnings allocable thereto) for purposes of determining whether the participant must consent to the cash-out of the benefit. The provision clarifies that rollover amounts may be disregarded also in determining whether a spouse must consent to the cash-out of the benefit.

Notice of significant reduction in plan benefit accruals.-- Under the Act, notice must be provided to participants if a defined benefit plan is amended to provide for a significant reduction in the future rate of benefit accrual, including any elimination or reduction of an early retirement benefit or retirement-type subsidy. The provision clarifies that the notice requirement applies to a defined benefit plan only if the plan is qualified. The provision further clarifies that, in the case of an amendment that eliminates an early retirement benefit or retirement-type subsidy, notice is required only if the early retirement benefit or retirement-type subsidy is significant. The provision also eliminates inconsistencies in the statutory language.

Modification of timing of plan valuations.--Under the Act, a plan valuation may be made as of any date in the immediately preceding plan year if, as of such date, plan assets are not less than 100 percent of the plan's current liability. Under the Act, a change in funding method to use a valuation date in the prior year generally may not be made unless, as of such date, plan assets are not less than 125 percent of the plan's current liability. The provision conforms the statutory language to Congressional intent as reflected in the Statement of Managers.

ESOP dividends may be reinvested without loss of dividend deduction.--Under prior and present law, a deduction is permitted for a dividend paid with respect to employer stock held in an ESOP if the dividend is (1) paid in cash directly to participants or (2) paid to the plan and subsequently distributed to the participants in cash no later than 90 days after the close of the plan year in which the dividend is paid to the plan. The deduction is allowable for the taxable year of the corporation in which the dividend is paid or distributed to the participants.

Under the Act, in addition to the deductions permitted under present law, a deduction is permitted for a dividend paid with respect to employer stock that, at the election of the participants, is payable in cash directly to participants or paid to the plan and subsequently distributed to the participants in cash no later than 90 days after the close of the plan year in which the dividend is paid to the plan, or paid to the plan and reinvested in qualifying employer securities. Under the provision, the deduction for dividends that are reinvested in qualifying employer securities at the election of participants is allowable for the taxable year in which the later of the reinvestment or the election occurs. The provision also clarifies that a dividend that is reinvested in qualifying employer securities at the participant's election must be nonforfeitable.

Amendments to the Community Renewal Tax Relief Act of 2000

Phaseout of $25,000 amount for certain rental real estate under passive loss rules.--Present law provides for a phaseout of the $25,000 amount allowed in the case of certain deductions and certain credits with respect to rental real estate activities, for taxpayers with adjusted gross income exceeding $100,000. The phaseout rule does not apply, or applies separately, in the case of the rehabilitation credit, the low-income housing credit, and the commercial revitalization deduction. The provision clarifies the operation of the ordering rules to reflect the exceptions and separate phaseout rules for these items.

Treatment of missing children.--Present law provides that in the case of a dependent child of the taxpayer that is kidnapped, the taxpayer may continue to treat the child as a dependent for purposes of the dependency exemption, child credit, surviving spouse filing status, and head of household filing status. A similar rule applies under the earned income credit. The provision clarifies that, if a taxpayer met the household maintenance requirement of the surviving spouse filing status or the head of household filing status, respectively, with respect to his or her dependent child immediately before the kidnapping, then the taxpayer would be deemed to continue to meet that requirement for purposes of the filing status rule of section 2 of the Code until the child would have reached age 18 or is determined to be dead.

Basis of property in an exchange by a corporation involving assumption of liabilities.--The provision clarifies that the basis reduction rule of section 358(h) of the Code gives rise to a basis reduction in the amount of any liability that is assumed by another party as part of the exchange in which the property (whose basis exceeds its fair market value) is received, so long as the other requirements under section 358(h) apply.

<u>Tax treatment of securities futures contracts</u>.--The provision clarifies that the termination (by offset or otherwise) of a securities futures contract is treated in a manner similar to a sale or exchange of a securities futures contract for purposes of determining the character of any gain or loss from the termination of the contract. Under the provision, any gain or loss from the termination of a securities futures contract (other than a dealer securities futures contract) is treated as gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has (or would have) in the hands of the taxpayer.

In addition, the provision clarifies that a securities futures contract to sell generally is treated in a manner similar to a short sale of the property to which the contract relates. Under the provision, the wash sale rules that are applicable to the closing of a short sale (sec. 1091(e)) also apply in a similar manner to the closing of a securities futures contract to sell. Thus, the wash sale rules apply to any loss realized on the closing of a securities futures contract to sell if, within a period beginning 30 days before the date of such closing and ending 30 days after such date: (1) stock that is substantially identical to the stock to which the contract relates is sold; or (2) another securities futures contract to sell involving such substantially identical stock is entered into. The provision also clarifies that a securities futures contract to sell is treated in a manner similar to a short sale for purposes of the special holding period rules in section 1233. Thus, subsections (b) and (d) of section 1233 generally apply to the acquisition and closing of a securities futures contract.

<u>Amendment to the Tax Relief Extension Act of 1999</u>

<u>Taxable REIT subsidiaries - 100 percent tax on improperly allocated amounts</u>.--The provision clarifies that redetermined rents, to which the excise tax applies, are the excess of the amount treated by the REIT as rents from real property under Code section 856(d) over the amount that would be so treated after reduction under Code section 482 to clearly reflect income as a result of services furnished or rendered by a taxable REIT subsidiary of the REIT to a tenant of the REIT. Similarly, redetermined deductions are the excess of the amount treated by the taxable REIT subsidiary as other deductions over the amount that would be so treated after reduction under Code section 482.

<u>Amendments to the Taxpayer Relief Act of 1997</u>

<u>Election to recognize gain on assets held on January 1, 2001; treatment of gain on sale of principal residence</u>.--The provision clarifies that the gain to which the mark-to-market election applies is included in gross income. Thus, the exclusion of gain on the sale of a principal residence under Code section 121 would not apply with respect to an asset for which the election to mark to market is made. The provision is consistent with the holding of Rev. Rul. 2001-57.

<u>Election to recognize gain on assets held on January 1, 2001; treatment of disposition of interest in passive activity</u>.--The provision clarifies that the election to mark to market an interest in a passive activity does not result in the deduction of suspended losses by reason of section 469(g)(1)(A). Any gain taken into account by reason of an election with respect to any interest in a passive activity is taken into account in determining the passive activity loss for the taxable year (as defined in section 469(d)(1)). Section 469(g)(1)(A) may apply to a subsequent disposition of the interest in the activity by the taxpayer.

Amendment to the Balanced Budget Act of 1997

Medicare+Choice MSA.--The provision conforms the treatment of the additional tax on Medicare+Choice MSAs distributions not used for qualified medical expenses if a minimum balance is not maintained to the treatment of the additional tax on Archer MSA distributions not used for qualified medical expenses, for purposes of determining whether certain taxes are included within regular tax liability under Code section 26(b).

Amendment to other Acts

Advance payments of earned income credit.--The provision corrects a reference in section 32(g)(2) to refer to credits allowable under this part (i.e., all tax credits) rather than under this subpart (i.e., the refundable credits). The provision is effective as if included in section 474 of the Tax Reform Act of 1984.

Clarification of permissible extension of limitations period for installment agreements.--Uncertainty existed as to whether the permissible extension of the period of limitations in the context of installment agreements is governed by reference to an agreement of the parties pursuant to section 6502 or by reference to the period of time during which the installment agreement is in effect pursuant to sections 6331(k)(3) and (i)(5). A 2000 technical correction clarified that the permissible extension of the period of limitations in the context of installment agreements is governed by the pertinent provisions of section 6502. The provision further clarifies that the elimination of the application of the section 6331(i)(5) rules applies only to section 6331(k)(2)(C). The provision modifies section 313(b)(3) of H.R. 5662, the Community Renewal Tax Relief Act of 2000 (Pub. Law No. 106-554). This is the further technical correction referred to in footnote 185a, Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 106th Congress* (JCS-2-01), April 19, 2001, page 162. The provision is effective on the date of enactment.

Determination of whether a life insurance contract is a modified endowment contract.--The provision clarifies that, for purposes of determining whether a life insurance contract is a modified endowment contract, if there is a material change to the contract, appropriate adjustments are made in determining whether the contract meets the 7-pay test to take into account the cash surrender value under the contract. No reference is needed to the cash surrender under the "old contract" (as was provided under section 318(a)(2) of H.R. 5662, the Community Renewal Tax Relief Act of 2000 (Pub. Law No. 106-554)) because prior and present law provide a definition of cash surrender value for this purpose (by cross reference to section 7702(f)(2)(A)). It is reiterated that Code section 7702A(c)(3)(ii) is not intended to permit a policyholder to engage in a series of "material changes" to circumvent the premium limitations in section 7702A. Thus, if there is a material change to a life insurance contract, it is intended that the fair market value of the contract be used as the cash surrender value under the provision, if the amount of the putative cash surrender value of the contract is artificially depressed. For example, if there is a material change because of an increase in the face amount of the contract, any artificial or temporary reduction in the cash surrender value of the contract is not to be taken into account, but rather, it is intended that the fair market value of the contract be used as cash surrender value, so that the substance rather than the form of the transaction is reflected. Further, as stated in the 1988 Act legislative history to section 7702A,[100] in applying the 7-pay test to any premiums paid under a contract that has been materially changed, the 7-pay premium for each of the first 7 contract years after the change is to be reduced by the product of (1) the cash surrender value of the contract as of the date that the material change takes effect (determined without regard to any increase in the cash surrender value that is attributable to the amount of the premium payment that is not necessary), and (2) a fraction the numerator of which equals the 7-pay premium for the future benefits under the contract, and the denominator of which equals the net single premium for such benefits computed using the same assumptions used in determining the 7-pay premium. The provision is effective as if section 318(a) of the Community Renewal Tax Relief Act of 2000 (114. Stat. 2763A-645) had not been enacted.

Treatment of settlements under partnership audit rules.--The provision clarifies that the partnership audit procedures that apply to settlement agreements entered into by the Secretary also apply to settlement agreements entered into by the Attorney General. Under present law, when the Secretary enters into a settlement agreement with a partner with respect to partnership items, those items convert to nonpartnership items, and the other partners in the partnership have a right to request consistent settlement terms. The conversion of the settling partner's partnership items to nonpartnership items is the mechanism by which the settling partner is removed from the ongoing partnership proceeding. If these rules did not apply to settlement agreements entered into by the Attorney General (or his delegate), it is possible that a settling partner would inadvertently be bound by the outcome of the partnership proceeding rather than the settlement agreement entered into with the Attorney General (or his delegate) (sec. 6224(c)(2)). Similar changes are made to related provisions with respect to settlement agreements. The provision is effective for settlement agreements entered into after the date of enactment.

Disclosure by the Social Security Administration to Federal child support enforcement agencies.--Section 6103(l)(8) permits the Social Security Administration (SSA) to disclose certain tax information in its possession to State child support enforcement agencies. The Office of Child Support Enforcement (OCSE), a Federal agency, oversees child support enforcement at the Federal level and acts as a coordinator for most programs involved with child support enforcement. OCSE acts as a conduit for the disclosure of tax information from the Internal Revenue Service to the various State and local child support enforcement agencies. The change to section 6103(l)(8) permits SSA to make disclosures directly to OCSE, which in turn would make the disclosures to the State and local child support enforcement agencies. The provision is effective on the date of enactment.

---

[100] Conference Report to accompany H.R. 4333, the "Technical and Miscellaneous Revenue Act of 1988" (H. Rep. No. 100-1104), Oct. 21, 1988, vol. II, p. 105.

Clerical amendments

The bill makes a number of clerical and typographical amendments to the Code.

Additional Corrections

Adoption credit and employer-provided adoption assistance exclusion rounding rules.--The provision provides uniform rounding rules (to the nearest multiple of $10) for the inflation-adjusted dollar limits and income limitations in the adoption credit and the employer-provided adoption assistance exclusion. The provision is effective as if included in the provision of the Economic Growth and Tax Reform Reconciliation Act of 2001 to which it relates.

Dependent care credit.--The provision conforms the dollar limit on deemed earned income of a taxpayer's spouse who is either (1) a full-time student, or (2) physically or mentally incapable of caring for himself, to the dollar limit on employment-related expenses applicable in determining the maximum credit amount. The 2001 Act increased the dollar limit on employer-related expenses to $3,000 for one qualifying individual or $6,000 for two or more qualifying individuals annually but did not conform the dollar limit on deemed earned income of a spouse. The provision is effective as if included in the provision of the Economic Growth and Tax Reform Reconciliation Act of 2001 to which it relates.

X. UNEMPLOYMENT ASSISTANCE PROVISIONS
(secs. 701-709 of the bill)

A. Unemployment Assistance

Present Law

States set unemployment benefit rules within a broad federal framework. The maximum length of benefits is 26 weeks in all but two states. The average duration on unemployment was 14 weeks in 2001. During fiscal year 2001, 28 percent of recipients used all of their eligibility or "exhausted eligibility."

Under the regular Federal-State Extended Benefits Program, up to an additional 13 weeks of benefits are available in states suffering severe economic distress. These benefits become available when a state's "insured" unemployment rate is 5 percent and 120 percent of the average over the last two years or, at state option, if the "insured" rate is 6 percent. States also may adopt another trigger, a total unemployment rate of 6.5 percent and 110 percent of the average over the past two years. The benefits are 50 percent federally-funded. (Regular unemployment benefits are funded by state taxes levied on employers.)

Explanation of Provision

The bill provides for up to 13 weeks of temporary extended unemployment benefits for eligible displaced workers. These benefits would be available following enactment in any state entering into an agreement with the Secretary of Labor to provide such extended benefits. Benefits would be available to workers who filed an initial claim for unemployment benefits on or after March 15, 2001 (that is, approximately when the current recession began) and who remain unable to find work after having exhausted their regular unemployment benefits.

The provision follows current law regarding certain eligibility rules for receipt of extended benefits, for example providing that individuals qualify for the lesser of 13 weeks of extended benefits or 50 percent of the length of time they qualified for regular unemployment benefits under the laws of their state; to ensure that workers with a strong attachment to the workforce qualify, individuals must have worked 20 weeks of full-time insured employment or earned the equivalent in insured wages to be eligible for these extended benefits.

The benefits would be 100 percent federally funded and would be available through December 31, 2002 or until a state terminates its agreement, if sooner.

Effective Date

The temporary extended unemployment provision would be effective upon enactment.

B. Special Reed Act Transfer in Fiscal Year 2002

Present Law

When three federal accounts in the Unemployment Trust Fund (UTF) reach their statutory limits at the end of a federal fiscal year, any excess funds are transferred to the individual state accounts in the UTF. These transfers are called "Reed Act" distributions. States can use this funding for payment of cash benefits and administrating their unemployment compensation and employment services programs. The Balanced Budget Act of 1997 limited Reed Act transfers to states to $100 million after each of fiscal years 1999, 2000, and 2001 and limited these funds' use to paying administrative expenses of unemployment compensation laws.

If the Secretary finds that a state is not eligible to receive Reed Act transfers at the beginning of a fiscal year, the amount available for transfer to the state instead is transferred to the federal unemployment account. If the state becomes eligible during the following one year period, the amount which was available for transfer will be transferred from the federal unemployment account to the state's account. If the state does not become eligible within one year, the amount remains in the federal unemployment account for other uses. If any state has borrowed from the federal unemployment account, any amount that would be transferred is retained and credited against any balance due to the state.

Explanation of Provision

The $100 million limit on distributions from excess federal funds available at the end of fiscal year 2001 is repealed. The provision also repeals the limitation on the use of funds applied to the $100 million special distribution under the Balanced Budget Act of 1997. This limitation applied only to special distributions at the end of fiscal years 1999, 2000, and 2001, and with the repeal of the underlying special distribution provision is no longer relevant.

The Secretary of the Treasury will transfer excess federal UTF balances as of the close of fiscal year 2001 into the account of each state in the UTF. Each state's share of distributions from the $100 million already provided at the beginning of fiscal year 2002 will be subtracted from the distribution to each state under this provision. (Thus of the $9.3 billion in excess federal funds as of the end of fiscal year 2001, only $9.2 billion will be provided under the bill, reflecting the fact that $0.1 billion already has been forwarded to state accounts under the 1997 Balanced Budget Act provision.)

At the option of the state, amounts transferred to state accounts may be used for the payment of cash benefits to individuals with respect to unemployment, including regular unemployment compensation or additions to regular benefits. States also may use these funds to support payment of benefits to individuals not otherwise eligible for regular unemployment compensation benefits under the laws of the state, such as individuals seeking only part-time work or those eligible only under an alternative base period.

Other than for cash benefits, states may use amounts transferred to their accounts in the administration of their public employment laws and public employment offices, including for the provision of employment services needed to help individuals return to work.

Effective Date

Transfers under this provision shall be made by December 31, 2001 or, if the date of enactment is after December 31, 2001, within 10 days following enactment.

XI. DISPLACED WORKER HEALTH INSURANCE CREDIT
(secs. 801 and 802 of the bill and new sec. 6429 of the Code)

Present Law

Under present law, the tax treatment of health insurance expenses depends on the individual's circumstances. In general, employer contributions to an accident or health plan are excludable from an employee's gross income (sec. 106).

Self-employed individuals are entitled to deduct a portion of the amount paid for health insurance expenses for the individual and his or her spouse and dependents. The percentage of deductible expenses is 60 percent in 2001, 70 percent in 2002, and 100 percent in 2003 and thereafter.

Individuals other than self-employed individuals who purchase their own health insurance and itemize deductions may deduct their expenses to the extent that their total medical expenses exceed 7.5 percent of adjusted gross income.

Present law does not provide a tax credit for the purchase of health insurance.

The health care continuation rules (commonly referred to as "COBRA" rules, after the Consolidated Omnibus Budget Reconciliation Act of 1985 in which they were enacted) require that most employer-sponsored group health plans must offer certain covered employees and their dependents ("qualified beneficiaries") the option of purchasing continued health coverage in the event of loss of coverage resulting from certain qualifying events. These qualifying events include: termination or reduction in hours of employment, death, divorce or legal separation, enrollment in Medicare, the bankruptcy of the employer, or the end of a child's dependency under a parent's health plan. In general, the maximum period of COBRA coverage is 18 months. An employer is permitted to charge qualified beneficiaries 102 percent of the applicable premium for COBRA coverage.

Under present law, individuals without access to COBRA are able to purchase individual policies on a guarantee issue basis without exclusion of coverage for pre-existing conditions, if they had 18 months of creditable coverage under an employer sponsored group health plan, governmental plan, or a church plan. Those with access to COBRA are required to exhaust their 18 months of COBRA prior to accessing the same individual market protections.

Explanation of Provision

The bill provides a refundable tax credit for 2002 and 2003 for a portion of expenses for qualified health insurance of an unemployed taxpayer and his or her spouse and dependents. Qualified health insurance is any insurance that constitutes medical care (as defined in sec. 213), except insurance substantially all of which is coverage of certain excepted benefits.[101] Thus, for

---

[101] Excepted benefits are: (1) coverage only for accident or disability income or any combination thereof; (2) coverage issued as a supplement to liability insurance; (3) liability insurance, including general liability insurance and automobile liability insurance; (4) worker's compensation or similar insurance; (5) automobile medical payment insurance; (6) credit-only

example, the credit is available with respect to COBRA continuation coverage, individual policies, and group policies, provided the requirements for the credit are otherwise satisfied. The credit is available only with respect to amounts paid by the taxpayer. The credit is equal to 60 percent of the taxpayer's expenses for qualified health insurance coverage in 2002 and 2003. No more than 12 months of coverage are eligible for the credit.

Eligibility for the credit is determined on a monthly basis. In general, a taxpayer is eligible for the credit for a month if, as of the first day of the month, the taxpayer (1) is unemployed, (2) is covered by qualified health insurance, and (3) the taxpayer does not have other specified coverage. In addition, the period of unemployment must have begun after March 15, 2001, and before January 1, 2004. In the case of a joint return, the eligibility requirements are met if at least one spouse satisfies the requirements.

An individual is considered unemployed during any period if, during such period, the individual (1) is receiving unemployment compensation or (2) is certified by a State agency (or any other entity designated by the Secretary of the Treasury) as otherwise being entitled to receive unemployment compensation but for the termination of the period during which such compensation was payable or an exhaustion of such individual's rights to such compensation. An individual is eligible for the credit for one additional month after the individual is reemployed (provided other requirements for the credit are satisfied e.g., the individual does not have other specified coverage).

An otherwise eligible taxpayer is not eligible for the credit for a month if, as of the first day of the month the individual has other specified covered. Specified coverage is (1) coverage under any qualified health insurance if at least 50 percent of the cost of the coverage is paid by an employer[102] (or former employer) of the individual or his or her spouse or (2) coverage under certain governmental health programs.[103] Amounts taken into account in determining the credit may not be taken into account in determining the amount allowable under the itemized deduction

---

insurance; (7) coverage for on-site medical clinics; (8) other insurance coverage similar to the coverages in (1)-(7) specified in regulations under which benefits for medical care are secondary or incidental to other insurance benefits; (9) limited scope dental or vision benefits; (10) benefits for long-term care, nursing home care, home health care, community-based care, or any combination thereof; and (11) other benefits similar to those in (9) and (10) as specified in regulations; (12) coverage only for a specified disease or illness; (13) hospital indemnity or other fixed indemnity insurance; and (14) Medicare supplemental insurance.

[102] An amount is considered paid by the employer if it is excludable from income. Thus, for example, amounts paid for health coverage on a salary reduction basis under an employer plan are considered paid by the employer.

[103] Specifically, an individual is not eligible for the credit if, as of the first day of the month, the individual is (1) entitled to benefits under Medicare Part A, enrolled in Medicare Part B, or enrolled in Medicaid or SCHIP (2) enrolled in a health benefits plan under the Federal Employees Health Benefit Plan, or (3) entitled to receive benefits under chapter 55 of title 10 of the United States Code (relating to military personnel).

for medical expenses or the deduction for health insurance expenses of self-employed individuals. Amounts distributed from a medical savings account are not eligible for the credit.

The credit may be claimed on the taxpayer's return for 2002 and 2003. In addition, the bill provides for payment of the credit on an advance basis (i.e., prior to the filing of the taxpayer's return) pursuant to a program to be established by the Secretary of the Treasury. Such program is to provide for making payments on behalf of eligible individuals to providers of health insurance. In order to receive the credit on an advance basis, a qualified health insurance credit eligibility certificate must be in effect for the taxpayer. A qualified health insurance credit eligibility certificate is a statement certified by a State agency (or by any other entity designated by the Secretary) which certifies that the individual was unemployed as of the first day of any month and provides such information as the Secretary may require.

The bill would provide that any person who receives payments during a calendar year for qualified health insurance and claims a reimbursement for an advance credit amount is to file an information return with respect to each individual from whom such payments were received and amounts advanced. The return is to be in such form as the Secretary may prescribe and is to contain the name, address, and taxpayer identification number of the individual, the aggregate of the advance credit amounts provides, the number of months for which advance credit amounts are provided, and such other information as the Secretary may prescribe. The bill requires that similar information be provided to the individual no later than January 31 of the year for which the information return is made.

If the taxpayer receives any advance credit amount, the amount advanced is reconciled on the tax return under rules similar to those applied under the advance payment mechanism for the earned income credit.

The bill allows guarantee issue and pre-existing condition protections without the requirement to exhaust COBRA coverage. Individuals ineligible for COBRA coverage must have 12 months of employer creditable coverage to access these protections.

Effective Date

The credit is effective for taxable years beginning after December 31, 2001.

XII. EMPLOYMENT AND TRAINING ASSISTANCE AND TEMPORARY HEALTH CARE COVERAGE ASSISTANCE (NATIONAL EMERGENCY GRANTS) (sec. 901 of the bill)

Present Law

The Workforce Investment Act authorizes Dislocated Worker Employer and Training formula grants to states and National Emergency Grants (NEGs) for a variety of employment and training services to unemployed workers who are able to show an attachment to the labor market. The NEGs are administered by the Secretary of Labor, and a state must apply to the Department for access to NEG funds. The grants are used to assist workers dislocated as a result of plant closures and mass layoffs, and may be accessed in times of declared disasters. Currently, the grants may be used to support job training and reemployment services and to make certain income support payments to individuals enrolled in training. The grants also may be used to help pay for supportive services, such as childcare and transportation, to help individuals complete training and transition back to work.

Explanation of Provision

In order to assist local regions and communities suffering due to mass layoffs and plant closings including those caused by the September 11th tragedy, the National Emergency Grant (NEG) provisions will temporarily expand the NEG program within the Workforce Investment Act (WIA) by providing $4 billion to assist dislocated workers during this recovery period. This emergency expansion will be maintained for obligation in Fiscal Years 2002, 2003 and 2004.

Under the program, states and outlying areas are eligible for a special NEG if the governor of a state or outlying area certifies that a major economic dislocation, such as a plant closure, mass layoff, or multiple layoff, including dislocations caused by the terrorist attacks on September 11th, contributed importantly to the dislocations. States may provide employment and training assistance that includes supportive services, as well as temporary health care coverage assistance to dislocated workers. Not less than 30 percent of the cost of assistance requested in a grant shall go towards temporary health care coverage assistance. Each state or outlying area that requests a grant and meets the grant requirements shall be awarded at least one grant. Each state or outlying area shall be awarded a grant or grants of not less than $5,000,000. An individual who is a dislocated worker in a state or outlying area in which the Governor has made the appropriate certification with regard to the dislocation shall be eligible to receive assistance.

Dislocated workers who are receiving employment and training assistance and are not already eligible for health care assistance under Medicaid or SCHIP are qualified to receive temporary health care coverage assistance consisting of health care coverage premium assistance for coverage for themselves, their spouses, their dependents or any combination thereof. Allowable uses include but are not limited to temporary health care coverage assistance for COBRA premiums or state COBRA equivalents, premium assistance to purchase coverage in the individual market, and coverage through the Medicaid or SCHIP infrastructure.

Employment and training assistance provided by the states could be used to provide additional weeks of income support for individuals who have used up their unemployment compensation or are ineligible for unemployment compensation but are able to demonstrate a sufficient attachment to employment -- as long as those individuals are enrolled in training. In addition, the funds could be used in order to offer a full array of job search and training services, including customized training, placement assistance, relocation expenses and additional supportive services.

Effective Date

The funds would be effective upon date of enactment of the legislation and would be available for fiscal years 2002, 2003, and 2004. No expenditures would be allowable after June 30, 2004.

XIII. TEMPORARY STATE HEALTH CARE ASSISTANCE
(sec. 1001 of the bill)

Explanation of Provision

In order to provide immediate relief to states, this provision allocates $4.6 billion directly to states to expend on health care services. This section will remain in effect for one year. States will not be permitted to use these resources to match other federal expenditures or in any other manner that results in an increase of federal spending in excess of the amounts provided under this section.

XIV. NO IMPACT ON SOCIAL SECURITY TRUST FUNDS
(sec. 1101 of the bill)

Present Law

Present law provides for the transfer of Social Security taxes and certain self-employment taxes to the Social Security trust fund. In addition, the income tax collected with respect to a portion of Social Security benefits included in gross income is transferred to the Social Security trust fund.

Explanation of Provision

The bill provides that the Secretary is to annually estimate the impact of the bill on the income and balances of the Social Security trust fund. If the Secretary determines that the bill has a negative impact on the income and balances of the fund, then the Secretary is to transfer from the general revenues of the Federal government an amount sufficient so as to ensure that the income and balances of the Social Security trust funds are not reduced as a result of the bill. Such transfers are to be made not less frequently than quarterly.

The bill provides that the provisions of the bill are not to be construed as an amendment of title II of the Social Security Act.

Effective Date

The provision is effective on the date of enactment.

XV. EMERGENCY DESIGNATION
(sec. 1102 of the bill)

Present Law

Under the Balanced Budget and Emergency Deficit Control Act of 1985, as amended, any legislation that reduces revenues or increases outlays is subject to a pay-as-you-go ("PAYGO") requirement. The PAYGO system tracks legislation that may increase budget deficits using a "scorecard" estimated by the Office of Management and Budget. Under PAYGO requirements, in order to avoid sequestration, any revenue loss or increase in outlays would need to be offset by revenue increases or reductions in direct spending.

If a provision of direct spending or receipts legislation is enacted that the President designates as an emergency requirement and that the Congress so designates in statute, the amounts of new budget authority, outlays, and receipts in all fiscal years resulting from that provision are not taken into account in determining the PAYGO scorecard.

Explanation of Provision

The provision designates any revenue loss, new budget authority, and new outlays under the bill in excess of those allowed under the FY 2002 budget resolution as emergency requirements pursuant to section 252(e) of the Balanced Budget and Emergency Deficit Control Act of 1985.

Effective Date

The provision is effective on the date of enactment.