DESCRIPTION OF REVENUE RECONCILIATION PROPOSAL

PART THREE: MISCELLANEOUS TAX PROVISIONS

Scheduled for Markup

by the

SENATE COMMITTEE ON FINANCE

on October 3, 1989

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

October 3, 1989

JCX-59-89

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of Part Three of a revenue reconciliation proposal (miscellaneous tax provisions) scheduled for consideration by the Senate Committee on Finance on October 3, 1989.

Part One (JCX-57-89) describes revenue-raising provisions of the revenue reconciliation proposal, and Part Two (JCX-58-89) describes expiring provisions, child care initiative and individual retirement accounts (IRAs).[2]

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

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1 This document may be cited as follows: Joint Committee on Taxation, Description of Revenue Reconciliation Proposal: Part Three (Miscellaneous Tax Provisions) (JCX-59-89), October 3, 1989.

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

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[Technical Corrections--See separate document, JCX-56-89]

2. Two-year extension of general fund transfers to Railroad Retirement Tier II Trust Fund of amounts from taxation of Tier II benefits

Present Law

The railroad retirement program consists of a Tier I benefit structure which is generally equivalent in benefits and financing to the social security program, and a separately financed Tier II benefit structure, which is similar to private-sector pension plans. The Tier II benefits are financed primarily by payroll taxes. Tier II benefits are generally includible in income for tax purposes in the same manner as benefits received under any employer-maintained qualified pension plan. The Railroad Retirement Solvency Act of 1983 provides for the transfer from the general fund to the Railroad Retirement Trust Fund of an amount equal to revenues received from the taxation of Tier II benefits. This transfer to the Railroad Retirement Trust Fund applies only to benefits that are received prior to October 1, 1989.

Explanation of Proposal

The transfer of proceeds from the taxation of railroad retirement Tier II benefits from the general fund of the Treasury to the Railroad Retirement Trust Fund would be extended for two additional years, to October 1, 1991.

Effective Date

The proposal would be effective for benefits received prior to October 1, 1991.

K. Other Provisions

1. Repeal of section 89 nondiscrimination rules

Present Law

Under present law, section 89 of the Code imposes nondiscrimination rules on employer-provided health benefits and group-term life insurance plans. In addition, section 89 requires that certain types of employee benefit plans meet minimum qualification requirements (e.g., that the plan be in writing and that plan participants be notified of plan provisions). Prior to the enactment of section 89 in the Tax Reform Act of 1986, prior law applied other nondiscrimination rules to group-term life insurance plans, cafeteria plans, and self-insured health plans.

Explanation of Proposal

The proposal would repeal present-law section 89, and generally reinstate the rules applicable before its enactment.

Effective Date

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

section 416(g)) for the plan year in which such election is made and the immediately preceding 2 plan years; and (3) the plan has more than 100 participants at all times during the plan year in which the election is made and the immediately preceding 2 plan years.

If the accrued liability ratio described above falls below 90 percent for any plan year for which the election is in effect, the alternative full funding limitation is phased out for the remainder of the period for which the election is in effect under rules to be prescribed by the Secretary. If a plan becomes a top-heavy plan or fails to meet the 100-participant requirement during any plan year in the period for which the election is in effect, the alternative full funding limitation ceases to apply. In addition, if the 90-percent requirement, top-heavy restriction, or 100-participant restriction is violated during the election period, the employer is precluded from making a subsequent election to use the alternative full funding limitation for 10 plan years following the election period.

Requirements with respect to election of alternative limitation

The election to use the modified full funding limitation would be subject to the following requirements:

(1) the election is to apply for a 5-plan year period beginning with the first plan year for which the election is effective;

(2) the election is to be made by application to the Secretary filed 60 days prior to the first day of the plan year immediately preceding the first plan year for which the election is effective;

(3) the election application is to include actuarial information (for each plan to be covered by the election) indicating the full funding limitation that will apply under each year of the period for which the election is in effect, and the full funding limitation that would apply in each of the years covered by the period in the absence of an election (in each case, based on reasonable estimates) as well as such other information as may be required by the Secretary; and

(4) the election is to be made for all defined benefit pension plans maintained by the controlled group of which the employer is a part.

An election may be made for successive 5-plan year periods upon application to the Secretary in accordance with the above criteria. If the employer does not choose to make a subsequent election after the expiration of any 5-plan year period, the employer may not make an election under the

3. Modification of full funding limitation

Present Law

Under present law, subject to certain limitations, an employer may make deductible contributions to a defined benefit pension plan up to the full funding limitation. The full funding limitation is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 150 percent of the plan's current liability, over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the actuarial value of the plan's assets (sec. 412(c)(7)). For plan years beginning before January 1, 1988, the 150 percent of current liability limitation does not apply.

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

Explanation of Proposal

In general

The proposal would allow certain employers to elect to apply the present-law full funding limitation without regard to the 150 percent of current liability limitation. The Secretary is required under the proposal to adjust the full funding limitation for all plans (other than those subject to such an election) in response to employer elections under the proposal so that the proposal has a negligible effect on Federal budget receipts.

Employers eligible to elect alternative full funding limitation

An employer may elect to use the alternative full funding limitation if (1) as of the first day of the plan year in which the election is made the accrued liability of participants accruing benefits under all defined pension benefit plans of the employer (and controlled group members) is at least 90 percent of the aggregate total accrued liability under all such plans; (2) no defined benefit pension plan maintained by the employer (or by any controlled group member) is a top-heavy plan (within the meaning of to other participants by a percentage between 140 and 150 percent as determined by the Secretary.

To the extent that net Federal budget receipts require additional adjustments to the full funding limitation, the full funding limitation is to be adjusted by multiplying the accrued liability of the plan (sec. 412(c)(7)(A)(i)(II)) for all participants in the plan by a percentage less than 100 percent, but in no event by reducing this liability below 140 percent of current liability.

Effective Date

The proposal would be effective on the date of enactment.

provision until 10 plan years after the expiration of such 5-plan year period.

An employer that makes an election may not be granted a minimum funding waiver for the period beginning after the election is made and ending at the expiration of the 5-plan year period. The Secretary may prescribe additional rules and requirements with respect to whether an employer is eligible to make an election.

In determining whether the accrued liability with respect to a participant may be aggregated with the accrued liability of other participants in order to meet the 90-percent requirement (i.e., whether the participant is accruing benefits under the plan), only active employees who have accrued benefits in the current year may be considered. Specifically, the Secretary is to issue guidance with respect to determining when a participant has accrued a benefit in the current year. Under such guidance, for example, for purposes of this provision, a participant in a plan where the employer has frozen accruals will not be considered to accrue benefits in the current year. In addition, a participant is not considered to accrue benefits solely because the participant's accrued benefit is increased by reason of a cost-of-living increase or similar feature in the plan.

It is intended that the Secretary limit the availability of this provision where one or more plans of the employer have been terminated or amended in a manner that significantly increases the likelihood that the employer will be eligible to make an election under this provision (e.g., where a plan has undergone a termination/re-establishment or a spin-off/termination within the preceding 10 plan years).

Required adjustment of full funding limitation

The proposal requires the Secretary to adjust the full funding limitation applicable to other defined benefit pension plans on an annual basis in response to the elections under this provision so that the provision has a negligible affect on net Federal budget receipts.

Any adjustment to the full funding limitation required to be made under the proposal is to be made with respect to all plans (other than those subject to the alternative limitation) and by reducing the full funding limitation with respect to participants who are not accruing benefits under the plan. This modification is made by substituting, with respect to these participants, a percentage between 140 percent and 150 percent for "150 percent" in the 150-percent full funding limitation. Thus, the full funding limit will be applied to the plan by multiplying the current liability attributable to active participants accruing benefits by 150 percent and by multiplying the current liability attributable

5. Tax-exempt status for cooperative service organizations for private foundations and community foundations

Present Law

Present-law section 501(c)(3) requires that an organization be organized and operated exclusively for an exempt purpose in order to qualify for tax-exempt status under that section.

Section 501(f) provides that an organization shall be treated as organized and operated exclusively for charitable purposes if it is comprised solely of members that are educational institutions and is organized and operated to hold, commingle, and collectively invest (including arranging for investment services by independent contractors) in stocks and securities, the moneys, contributed thereto by the members, and to collect income therefrom and turn over the entire amount thereof, less expenses, to such members.

Explanation of Proposal

The proposal would grant tax-exempt status to certain cooperative service organizations comprised solely of members which are tax-exempt private foundations or community foundations within the meaning of section 170(b)(1)(A)(vi). Such a cooperative service organization would be tax-exempt if: (1) it has at least 20 members; (2) no one member holds more than 10 percent (by value) of the interests in the organization; (3) no one member, by itself, controls the organization or controls any other member; (4) the members are permitted to dismiss the organization's investment adviser upon a vote of members holding a majority of interest in the organization; and (5) the organization is organized and operated solely to hold, commingle, and collectively invest (including arranging for investment services by independent contractors) in stocks and securities, the moneys contributed by the members, and to collect income therefrom and turn over the entire amount thereof, less expenses, to such members.

The cooperative service organization would be subject to the present-law excise tax provisions applicable to private foundations (e.g., sec 4941 rules governing self-dealing arrangements), other than sections 4940 and 4942. The proportionate share (whether or not distributed) of the net income of the cooperative service organization (including capital gains) of each member (other than certain exempt operating foundations) for any taxable year of the cooperative service organization would, for purposes of the excise tax imposed under present-law section 4940, be treated as net investment income of the member for the taxable year of such member in which the taxable year of the cooperative service organization ends.

4. Treatment of income from personal injury awards for minor children

Present Law

As a result of the Tax Reform Act of 1986, the unearned income of a child under 14 generally is taxed at the top marginal rate of his or her parents.

Explanation of Proposal

Income attributable to lump sum damages received on account of personal injuries or sickness would be taxed at the child's rate if such income accrues in a custodial account and is prohibited from being used to satisfy an obligation of support.

Effective Date

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

6. **Alternative recapture method for mutual savings banks changing from the reserve method to the specific charge-off method for bad debts**

Present Law

Under present law, a thrift institution (i.e., a building and loan association, mutual savings bank, or cooperative bank) is permitted a deduction for a reasonable addition to a reserve for bad debts if at least 60 percent of its assets are invested in qualified assets (including home mortgages). The reasonable addition to the reserve for bad debts for a thrift institution is an amount computed under the experience method or an amount equal to 8 percent of its otherwise taxable income. The amount of bad debt reserves are recaptured if the thrift institution is liquidated in a taxable transaction or makes dividend distributions in excess of post-1951 earnings (Code sec. 593(e)).

A commercial bank whose average adjusted bases of all assets does not exceed $500 million (i.e., a "small bank") also is allowed a deduction for a reasonable addition to a reserve for bad debts. The reasonable addition to the reserve is an amount computed under the experience method. A bank whose average adjusted bases of all assets exceeds $500 million (i.e., "big banks") is not permitted any deduction for an addition to a reserve for bad debts. In addition, big banks are required to recapture their existing bad debt reserves under one of two methods. Under the first method (called the "4-year recapture method"), the balance of the reserve generally is recaptured at the following rates: 10 percent in the first year, 20 percent in the second year, 30 percent in the third year, and 40 percent in the fourth year. Under the second method (called the "cut-off method"), specific bad debts on loans made before the change in method are charged to the reserve. Then, the balance of the reserve is recaptured as the reserve balance exceeds the amount of pre-change loans that remain outstanding.

Explanation of Proposal

Under the proposal, a mutual savings bank or a savings and loan association that changes from the reserve method of accounting for bad debts to the specific charge-off method would be allowed to elect to recapture only the so-called "experience portion" of their bad debt reserves under the "4-year recapture method" applicable to commercial banks. The experience portion of the bad debt reserve is based on the average of the institution's actual bad debts as a percentage of its loans outstanding. However, if the sum of the specific bad debts at the end of any year on loans held by the taxpayer before the accounting method change exceed the cumulative amount of reserves required to recaptured by the end of that year, the excess would not be deducted, but

Effective Date

The proposal would apply to taxable years beginning after December 31, 1989.

7. Denial of retroactive certifications for work incentive (WIN) tax credit

Present Law

Under prior law, the work incentive (WIN) credit provided a tax credit to employers for the employment of certain qualified individuals. Prior to the Economic Recovery Tax Act of 1981 (ERTA), the WIN credit did not specifically require certification of an employee as a qualified individual prior to the date of employment. In 1981, ERTA modified the WIN credit by merging it with the targeted jobs credit. ERTA also required that certification of an individual as a member of a targeted group must be obtained or requested before the date an individual begins work. This change was made generally effective on July 23, 1981, to avoid the potential for substantial revenue losses.

The law is unclear as to whether the requirement that the request for certification be made contemporaneously with employment applies only to the new targeted jobs credit or to the prior separate WIN credit. The Internal Revenue Service took the position that retroactive certifications under the prior-law WIN credit are not valid.[1] The Tax Court recently held that retroactive certifications are valid for purposes of claiming the prior-law WIN credit.[2]

Explanation of Proposal

The proposal clarifies that certifications for the WIN credit (sec. 50B(h)(1) of the Code as in effect for taxable years beginning before January 1, 1982) must be made on or before the day the individual begins work.

Effective Date

The proposal would be effective for WIN credits first claimed after March 11, 1987.

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1 General Council Memorandum 39604, 2/26/87.

2 Lucky Stores Inc. v. Commissioner, No. 35251-86, 92 T.C. No. 75, 5/3/89.

would be charged to the unrecaptured portion of the bad debt reserves (similar to the "cut-off method"). In addition, any remaining bad debt reserves would be recaptured when excessive dividends are paid by the savings bank or upon partial or complete liquidation of the savings bank (under the rules of Code sec. 593(e)).

Mutual savings banks that make an election under this provision would not be permitted to use the reserve method of accounting for bad debts in any subsequent year.

Effective Date

The proposal would be effective for taxable years ending after the date of enactment.

b. Inclusion in gross estate of gifts made within three years of death

Present Law

The first $10,000 of gifts of present interests to each donee during any one calendar year are excluded from Federal gift tax.

If an interest that is includible under sections 2036, 2037, 2038 or 2042 (or would have been includible had such interest been retained by the decedent on the date of his death) is transferred within three years of the decedent's death, the value of the gross estate includes the value of the property so transferred. This rate applies even if the transfer is of less than $10,000.

Explanation of Proposal

Gifts of less than $10,000 would not be included in the gross estate even if such gifts were made within three years of death and would have been included under sections 2036, 2037, 2038, or 2042 had the transferred interest been retained by the decedent at death. In addition, the statutory provision making the adjustment for gifts made within three years of death would be clarified without substantive change.

Effective Date

The proposal would be effective for decedents dying after the date of enactment.

8. Estate and gift tax provisions

a. Definition of qualified terminable interest property

Present Law

Since December 31, 1981, a marital deduction has been allowed for qualified terminable interest property (QTIP). In order to qualify as qualified terminable interest property, the surviving spouse must have a qualifying income interest for life, which in turn requires that the spouse be entitled to all of the income from the trust, payable annually or at more frequent intervals. Property qualifying under the QTIP rule generally is includible in the gross estate of the surviving spouse for Federal estate tax purposes.

Under proposed regulations, an income interest will not fail to constitute a qualifying income interest for life solely because income between the last distribution date and the date of the surviving spouse's death is not required to be distributed to the surviving spouse or the surviving spouse's estate. See Prop. Reg. secs. 20.2056(b)-7(c)(1), 25.2523(f)-1(b). Contrary to the regulations, the United States Tax Court has held that in order to satisfy the QTIP requirements, income accumulated by the trust between the last date of distribution and the date of the spouse's death must be paid to the spouse's estate or be subject to a power of appointment held by the spouse. See Estate of Howard v. Commissioner, 91 T.C. 329, 338 (1988).

Explanation of Proposal

An income interest would not fail to qualify as qualified income interest for life solely because income for the period after the last distribution date and on or before the date of the surviving spouse's death is not required to be distributed to the surviving spouse. The income for such period, however, would be includible in the gross estate of the surviving spouse for Federal estate tax purposes.

Effective Date

The proposal would apply to decedents dying, and gifts made, after October 3, 1989. The proposal would not require the inclusion in the surviving spouse's gross estate of property for which no marital deduction was claimed.

d. Estate tax inclusion related to valuation freezes

Present Law

If a person holds a substantial interest in an enterprise and in effect transfers property having a disproportionately large share of the potential appreciation in such person's interest in the income of, or rights in, the enterprise, then the transferred property is includible in such person's gross estate (sec. 2036(c)). The estate is entitled to recover from the person receiving the property a portion of the estate tax attributable to the inclusion (sec. 2207A).

The estate and gift tax is imposed on the value of property passing by gift or bequest. This value is the price at which the property would change hands between a willing buyer and willing seller. The statute of limitations for the gift tax is three years.

Explanation of Proposal

Code sections 2036(c) and 2207A would be repealed.

Effective Date

The repeal of section 2036(c) and 2207B would be retroactive from their date of enactment.

c. Waiver of right of recovery for certain marital deduction property

Present Law

For estate and gift tax purposes, a marital deduction is allowed for qualified terminable interest property (QTIP). Such property generally is includible in the gross estate of the surviving spouse for Federal estate tax purposes. The surviving spouse's estate is entitled to recover a portion of the Federal estate tax attributable to the inclusion in the surviving spouse's gross estate of the qualified terminable interest property (Code sec. 2207A), unless the spouse directs otherwise by will. Thus, a will requiring that all taxes be paid from probate property may have the effect of waiving the right to recovery.

Explanation of Provision

The right of recovery with respect to qualified terminable interest property would not apply unless the spouse otherwise directs in a provision of the will specifically referring to the statutory provision, i.e., a specific reference to section 2207A.

Effective Date

The provision would be effective for decedents dying after the date of enactment.

f. Marital deduction for property passing to noncitizen spouses

Present Law

In general

A deduction generally is allowed for Federal estate and gift tax purposes for the value of property passing to a spouse. Except in specified situations, no deduction is allowed if the interest passing to the spouse is terminable (i.e., the property cannot pass to another person on termination of the spouse's interest) (Code secs. 2056(b), 2523(b)).

Marital deduction for property passing to noncitizen spouse

The marital deduction generally is disallowed for the value of property passing to noncitizen spouse. Property passing at death to a noncitizen spouse may, however, qualify for the marital deduction so long as it satisfies the normal requirements for a marital deduction (sec. 2056(b)) and the property passes in a qualified domestic trust (QDT).

Definition of qualified domestic trust (QDT)

In order to be a QDT, a trust must meet four conditions. First, the trust instrument must require that all trustees be U.S. citizens or domestic corporations. Second, the surviving spouse must be entitled to all the income from the property in the trust, payable annually or at more frequent intervals. Third, the trust must meet the requirements of Treasury regulations prescribed to ensure collection of the estate tax imposed upon the trust. Finally, the executor must elect to treat the trust as a QDT.

Estate tax on QDT

An estate tax is imposed upon distributions from a QDT made prior to the surviving spouse's death and upon the value of property remaining in a QDT upon that spouse's death. The tax, however, is not imposed on distributions of income, as defined under local law. The tax is also imposed upon the trust property if a person other than a U.S. citizen or domestic corporation becomes a trustee of the trust or if the trust ceases to meet the requirements of Treasury regulations prescribed to ensure collection of the estate tax.

Explanation of Provisions

Marital deduction for bequests to noncitizen spouse

Spouse becomes citizen.--The marital deduction would be allowed for property passing to an alien spouse if the spouse

e. Exclusion from generation-skipping transfer tax for transfers to grandchildren

Present Law

The Tax Reform Act of 1986 imposed a generation-skipping transfer tax on direct transfers to grandchildren. However, a person may make direct skip transfers of up to $2 million to a grandchild prior to January 1, 1990, without incurring this tax (the "$2 million exclusion"). A transfer to a trust will qualify for the $2 million exclusion only if certain requirements are met, including annual distribution of trust income to (or for the benefit of) the grandchild after age 21 (the "distribution requirement").

Explanation of Proposal

The $2 million exclusion would be made permanent. The distribution requirement would be eliminated.

Effective Date

The proposal would be effective for transfers made after date of committee action.

The Secretary of the Treasury would be directed to prescribe regulations necessary or appropriate to carry out the purposes of the provisions, including regulations treating an annuity includible in decedent's gross estate as a QDT.

Effective Date

The provisions would be effective for decedents dying after November 10, 1988.

becomes a U.S. citizen before the date the estate tax return of the decedent spouse is filed, so long as the surviving spouse was a U.S. resident at the date of the decedent's death and at all times before becoming a U.S. citizen.

Trustees.--The rule that all the trustees of a QDT must be U.S. citizens or domestic corporations would be modified to require only that one trustee be a U.S. citizen or domestic corporation, so long as no distribution could be made from the trust without the approval of that trustee.

Income.--A trust could be treated as a QDT even if the surviving alien spouse did not have an income interest in the trust. However, in order to qualify for the marital deduction, the interest passing to the spouse would continue to be subject to requirements applicable to property passing to U.S. citizen spouses. To meet these requirements in particular situations, a spouse may need to have an income interest in the trust.

Reformation to meet QDT requirements.--A trust would meet the requirements for a QDT if it is reformed to meet those requirements before the filing of the return or in a suit initiated before that time.

Estate tax on qualified domestic trust (QDT)

Definition of "income".--The Secretary of the Treasury would be granted regulatory authority to modify the definition of "income" in order to insure that trust distributions do not deplete trust corpus.

No tax when surviving spouse becomes U.S. citizen.--The estate tax on a QDT would no longer be imposed if the surviving spouse subsequently becomes a U.S. citizen if either (1) the spouse was a U.S. resident at the date of the decedents death and at all times before becoming a U.S. citizen, or (2) the spouse elects to reduce his unified credit and amounts subject to lower transfer tax brackets by the amount of prior taxable distributions made from the trust.

Availability of estate tax benefits.--The charitable and marital deductions, capital gains treatment of redemptions of stock to pay estate tax, alternate valuation, special use valuation, and extension of time to pay estate tax would be allowed against the estate tax on QDTs if allowable to the estate of the surviving spouse.

Distribution for hardship.--The tax would not be imposed on distributions made to a spouse if such distribution is made in order to alleviate hardship.

Regulatory authority

10. Restoration of income averaging for farmers

Present Law

Prior to the enactment of the Tax Reform Act of 1986, certain individuals could elect to compute their income tax liability for the current year based on a formula that took into account their income for the current year and their average income of the prior three years. This election was repealed by the Tax Reform Act of 1986, effective for tax years beginning after December 31, 1986.

Explanation of Proposal

The proposal would restore the income averaging rules that were repealed by the Tax Reform Act of 1986 for certain qualified farmers. Qualified farmers would mean those individuals (1) who materially participate (within the meaning of sec. 469(h)) in the trade or business of farming (within the meaning of sec. 2032A(e)(4) and (5) of the Code), for each year of the averaging period; and (2) whose total annual gross receipts (including nonfarm gross receipts) for the preceding three taxable years does not exceed $5 million for each of such years.

Effective Date

The proposal would be effective for taxable years of individuals beginning December 31, 1989.

9. Adoption expense deduction

Present Law

The Tax Reform Act of 1986 (the "1986 Act") repealed the deduction for adoption expenses associated with special needs children, effective for taxable years beginning on or after January 1, 1987. Under prior law, a deduction of up to $1,500 of expenses associated with the adoption of special needs children was allowed. The 1986 Act provided for a new outlay program under the existing Adoption Assistance Program to reimburse expenses associated with the adoption process of these children. The group of children covered under the outlay program is somewhat broader than the group covered by the prior deduction. Aid to Families with Dependent Children (AFDC) and Title IV-E Foster Care assistance outlay program provides assistance for adoption expenses for these special needs children as well as special needs children in private and State-only programs.

One component of the Adoption Assistance Program requires States to reimburse certain costs incurred for special needs children. The Federal government shares 50 percent of these costs up to a maximum Federal share of $1,000 per child. Reimbursable expenses include those associated directly with the adoption process such as legal costs, social service review, and transportation costs.

Explanation of Proposal

The proposal would allow a taxpayer to exclude from adjusted gross income (AGI) up to $3,000 of expenses incurred in the course of the adoption of a child with special needs. This exclusion would be an "above-the-line" deduction. A child with special needs means any child who, as determined by a State, cannot or should not be returned to the home of the birth parents and cannot be placed with adoptive parents without providing adoption assistance.

Eligible adoption expenses would be limited to those: (1) directly associated with the adoption process and (2) that are of a type eligible for reimbursement under the Adoption Assistance Program. These include reasonable and necessary court costs, legal expenses, and other expenses directly related to the legal adoption of a child.

Effective Date

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

12. Definition of wholesale distributors of diesel fuel

Present Law

The excise tax on diesel and special fuels was imposed at the producer or importer level under the Omnibus Budget Reconciliation Act of 1987 (OBRA), beginning on April 1, 1988. As a result, retail distributors would not be able to purchase the fuels tax-free, and off-highway users of the fuels (e.g., business, farmers, State and local governments, and airlines) would purchase the fuels tax-paid and apply for refunds.

Congress amended the locus of tax imposition in the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), and restored the ability of off-highway fuels users to purchase fuels tax-free. The wholesale distributor was allowed to file for the refund, in effect stepping into the shoes of the retail purchasers eligible for tax-free purchases.

Under TAMRA, the definition of a wholesale distributor was revised to include distributors who sell taxable fuels in bulk quantities. Under regulations, the Internal Revenue Service provided that a person who sells 70 percent or more of its fuel to tax-exempt users also would qualify as a wholesale distributor who would be entitled to purchase and sell fuel tax free.

In the course of the legislative process in 1988, several distributors of diesel and special fuels, then classed as retail distributors, anticipated that Congress would revise how exempt diesel fuel users could purchase tax-free fuel and that the imposition of tax would be changed from OBRA 1987. Consequently, they did not collect the excise tax on sales to exempt or off-highway purchasers. Although those distributors now may qualify as wholesale distributors, they still could be made liable for excise taxes which were not collected between April 1, and December 31, 1988.

Explanation of Proposal

The proposal would allow a person who qualifies as a wholesale distributor under present tax regulations to be treated as having been a wholesale distributor during the period of April 1, through December 31, 1988.

Effective Date

The proposal would be effective as if included in the Omnibus Budget Reconciliation Act of 1987.

11. Treatment of certain payments received as a result of crop losses due to drought conditions

Present Law

A cash method taxpayer who receives insurance proceeds as a result of the destruction of, or damage to, crops may elect to include the proceeds in income for the taxable year following the year in which the destruction or damage occurs if, under the taxpayer's practice, income from such crops would have been included for a year following the year in which the destruction or damage occurred. For this purpose, payments received under the Agricultural Act of 1949, as amended, or Title II of the Disaster Assistance Act of 1988, as a result of the destruction of, or damage to, crops caused by drought, flood, or other natural disaster or the inability to plant crops because of such natural disaster are treated as insurance proceeds received as a result of the destruction of, or damage to, crops.

Explanation of Proposal

Payments received under the Disaster Assistance Act of 1989 (P.L. 101-82) would be treated in the same manner as payments received under the Agricultural Act of 1949 or Title II of the Disaster Assistance Act of 1988.

Effective Date

The proposal would apply to payments received before, on, or after the date of enactment.

14. Cost Recovery Provisions

a. Treatment of tuxedos held for rental

Present Law

Tuxedos held for rental are assigned a class life of 9 years, and, consequently, the applicable recovery period under the accelerated cost recovery system as modified by the Tax Reform Act of 1986 is 5 years.

Explanation of Proposal

Tuxedos held for rental would be assigned a class life of 2 years. Consequently, the cost of rental tuxedos would be recovered either over a 3-year period using the 200-percent declining balance method or, under the alternative depreciation system, over a 2-year period by using the straight-line method.

Effective Date

The proposal would apply to rental tuxedos placed in service after December 31, 1989.

13. Real estate investment trusts (REITs) holding a residual interest in a real estate mortgage investment conduit (REMIC)

Present Law

In order for an entity to qualify as a real estate investment trust ("REIT"), at least 95 percent of its gross income generally must be derived from certain passive sources, and from real estate assets (the "95-percent test"). Also, with certain exceptions, less than 30 percent of the gross income of a REIT must be derived from the sale or exchange of certain assets, including real property held for less than four years (the "30-percent test").

The Code provides rules governing the treatment of interest rate swap or cap agreements for REIT qualification purposes, i.e., agreements that protect the REIT from interest rate fluctuations on variable debt incurred to acquire or carry real estate assets. Such agreements are treated as securities under the 30-percent test and payments under them are treated as qualifying under the 95-percent test.

Explanation of Proposal

The present-law treatment of interest rate swap or cap agreements would be extended to similar arrangements, such as forward rate agreements and futures contracts. In addition, in determining whether an agreement hedges variable rate indebtedness, a REIT holding a residual interest in a real estate mortgage investment conduit (REMIC) would be treated as holding a proportionate share of the REMIC's assets and a proportionate share of the regular interests of the REMIC would be treated as direct indebtedness of the REIT.

Effective Date

The provision would be effective with respect to taxable years beginning after the date of enactment.

15. Employee Benefit Provisions

a. Repeal of limitation on ability of tax-exempt employers to maintain cash or deferred arrangements

Present Law

Under present law, if a tax qualified profit-sharing or stock bonus plan meets certain requirements, then an employee is not required to include in income any employer contributions to the plan merely because the employee could have elected to receive the amount contributed in cash (sec. 401(k)). Tax-exempt organizations are generally prohibited from establishing qualified cash or deferred arrangements, except for certain plans in existence on July 2, 1986.

Explanation of Proposal

The proposal would allow tax-exempt organizations to maintain cash or deferred arrangements for their employees. As under present law, the limitations on the amount that may be deferred by an individual participating in both a cash and deferred arrangement and a tax-sheltered annuity would apply.

Effective Date

The proposal would be effective with respect to plans established after December 31, 1989.

b. Treatment of certain capital expenditures incurred in order to assist the disabled

Present Law

A taxpayer may elect to deduct qualified architectural and transportation barrier removal expenses that are paid or incurred during any taxable year in lieu of capitalizing such expenses and recovering the expenses over the useful life of the property to which the expenses relate. The deduction allowed under this provision for any taxable year is limited to $35,000. For this purpose, a architectural and transportation barrier removal expense is any expenditure for the purpose of making any facility, or public transportation vehicle, owned or leased by the taxpayer for use in connection with a trade or business of the taxpayer more accessible to, and usable by, handicapped and elderly individuals. A qualified architectural and transportation barrier removal expense generally is any architectural and transportation barrier removal expense that satisfies standards contained in Treasury regulations.

Explanation of Proposal

The definition of qualified architectural and transportation barrier removal expense would be expanded to include capital expenditures incurred in connection with a trade or business to provide auxiliary aids and services (as defined in section 3(1) of the Americans with Disabilities Act of 1989) or reasonable accommodations (as defined in section 3(8) of the Americans with Disabilities Act of 1989) to individuals with disabilities. In addition, the annual limitation on the deduction allowed for qualified architectural and transportation barrier removal expenses would be reduced to $25,000.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1989.

c. Modify geographic local limitation on voluntary employees' beneficiary associations

Present Law

A voluntary employees' beneficiary association ("VEBA") that provides for the payment of life, sick, accident or other similar benefits to its members, their dependents or designated beneficiaries may qualify for exemption from income taxation if certain requirements are met (sec. 501(c)(9)). Among these requirements is that the members have an employment-related common bond determined by reference to objective standards.

Under Treasury regulations, employees of one or more employers engaged in the same line of business in the same geographic locale will be considered to have an employment-related bond. The Internal Revenue Service has taken the position that the geographic locale requirement may not be met by a VEBA established by a nationally-based trade association for its membership.

Explanation of Proposal

The proposal would clarify that the geographic locale requirement may be met by a VEBA that provides benefits to the employees of its members in a clearly defined geographic region that may include more than one state. Subject to such restrictions as may be imposed by the Secretary to ensure that the VEBA operates in a limited area, a VEBA will meet the geographic locale requirement if it provides benefits to the employees who are located in no more than three contiguous states. Thus, the proposal adopts the position of the Internal Revenue Service that an exempt VEBA may not provide benefits to employees over a wide geographic area.

Effective Date

The provision would be effective for years beginning on or after the date of committee action. No inference is intended with respect to the application of the geographic locale restriction under present law.

b. Modification of integration rules applicable to certain defined benefit pension plans

Present Law

Under present and prior law, benefits and contributions under a qualified plan may not discriminate in favor of highly compensated employees. Under prior law, a plan was not considered discriminatory merely because an employee's benefits under the plan were reduced in accordance with certain requirements to take into account the employee's social security benefits (sec. 401(l)).

The Tax Reform Act of 1986 (the 1986 Act) modified the integration rules to limit the permitted disparity between benefits for highly and nonhighly compensated employees. The 1986 Act rules are generally effective for plan years beginning after December 31, 1988. The 1986 Act contemplated that the Secretary would prescribe rules coordinating the benefits provided under the rules of prior law and the 1986 Act. In the case of a final pay defined benefit pension plan that is frozen as of January 1, 1989, and that was integrated in accordance with prior law, proposed Treasury regulations generally have the effect of precluding benefits from being calculated based on the final average pay of the participant when the participant retires (rather than the date the plan was frozen).

Explanation of Proposal

The proposal would clarify that, in coordinating the prior law and 1986 Act rules, the Secretary is to provide rules that permit a frozen defined benefit pension plan to calculate benefits based on final average pay in accordance with a benefit formula in existence on the effective date of the 1986 Act integration rules if appropriate conditions, as prescribed by the Secretary, are satisfied. It is intended that among the conditions to be imposed, the Secretary will include a requirement that the employer maintains a nonintegrated plan in years after 1989 that provides a minimum benefit level (i.e., 1 percent of compensation), and that the benefit formula in effect prior to 1988 would satisfy the 50 percent offset requirement in present law.

employment taxes, the individual is an employee of the organization who generally must be taken into The proposal would not alter the definition of a common-law employee, nor the rules that such employees are to be taken into account unless specifically excluded.

The proposal would clarify present law in that support staff of professionals would continue to be treated as leased employees (to the extent they are not already considered employees because they are common-law employees). In general, professionals would include those individuals defined as such under Treasury regulations relating to the minimum participation requirements (sec. 401(a)(26)) and the minimum coverage requirements (sec. 410). This clarification with respect to the support staff of professionals is not intended to create an inference with respect to the support staff of nonprofessionals.

Under the proposal, persons who perform services incidental to the sale of goods or equipment or incidental to the construction of a facility are generally not leased employees. This rule does not extend to the operation (including supervision over such operation) of the goods, equipment, or completed facility.

In addition, under the proposal, the nondiscrimination rules under section 129(d) as that section was amended by the Tax Reform Act of 1986 would continue to apply to dependent care assistance plans but are modified in the following respects. First, if a plan fails to meet the requirements of section 129(d), only highly compensated employees must include benefits under the program in gross income. Second, if a dependent care assistance program fails the 55-percent benefits test, then the highly compensated employee must include in gross income only that amount of benefit in excess of that level of benefit that would meet the benefits test. Finally, under the proposal, the 55-percent benefits test can be applied on a line of business basis (sec. 414(r)).

Effective Date

Under the proposal, the revised definition of leased employee would be effective for years beginning after December 31, 1983.

With respect to dependent care assistance programs, the proposal is effective for years beginning after December 31, 1988.

d. Modification of rules relating to employee leasing and dependent care assistance programs

Present Law

For purposes of specified pension requirements, a leased employee is treated as the employee of the person for whom the leased employee performs services (the "recipient"). A leased employee is generally defined as any person who is not an employee of the recipient if (1) such services are provided to the recipient under an agreement between the recipient and the organization providing the person's services (the "leasing organization"), (2) the person performs such services for the recipient (or for the recipient and related persons) on a substantially full-time basis for at least 1 year, and (3) such services are of a type historically performed, in the business field of the recipient, by employees.

In addition, under present law, an employee may exclude certain benefits received under an employer-provided dependent care assistance program provided certain requirements are satisfied (sec. 129).

Explanation of Proposal

Under the proposal, the present-law historically performed test is repealed and replaced with a new rule defining who must be considered a leased employee. This change is made because the proposed regulations under the leased employee rules (sec. 414(n)) are overly broad in defining who may be a leased employee. Under the proposal, the proposed regulations are no longer valid.

Under the proposal, an individual would not be considered a leased employee unless the individual is under the control of the recipient organization. The determination of whether an individual is controlled by the employer would be based on all the facts and circumstances. Among the factors that would be relevant in this determination are whether the recipient organization: (1) prescribes the individual's work methods; (2) supervises the individual; (3) sets the individual's working hours; and (4) sets the individual's level of compensation. Other factors that may be considered include those that are relevant for determining whether the employer is responsible for employment taxes on the compensation paid to the individual. The Secretary may designate other relevant factors. It would not be necessary that all these factors indicate that the individual is under the control of the employer in order to find that such individual is a leased employee. Nor would it be necessary that the recipient organization be responsible for employment taxes in order to find that the individual is a leased employee because, if the recipient organization is liable for

Effective Date

The proposal would be effective on the date of enactment.

16. Tax-Exempt Bonds

a. Tax-Exempt Debt of State Housing Agencies

Present Law

In general, interest on qualified private activity bonds is tax-exempt. Bonds, the proceeds of which are used directly or indirectly to make or finance loans to persons other than government units are private activity bonds. Categories of qualified private activity bond include: (1)an exempt facility bonds; (2) qualified mortgage bonds; (3) qualified small issue bonds; (4) qualified student loan bonds; (5) qualified redevelopment bonds; and (6) qualified 501(c)(3) bonds.

State and local bonds issued to purchase single family residences or residential rental real estate are generally (non-qualified) private activity bonds. State and local bonds issued to finance the disposition of single family residences owned by a State Housing Agency are not qualified private activity bonds unless all provisions of Code Section 143 relating to Qualified Mortgage Revenue Bonds are met. State and local bonds issued to finance the disposition of residential rental projects owned by a State Housing Agency to a private business user are not qualified private activity bonds.

Explanation of Proposal

The proposal would expand the definition of private activity bonds to include certain State Housing Agency Bonds. Qualified bond issues must spend at least 95 percent of the proceeds to: (1) acquire single family residences or residential rental projects from the Resolution Trust Corporation, the Federal Deposit Insurance Corporation, the Federal Housing Authority, the Veterans' Administration, or other agencies of the United States Government; (2) finance the disposition of single family residences owned by the above agencies to purchasers who meet the owner-occupancy requirements, the purchase price restrictions, and the family income restrictions of Code Section 143 (related to qualified mortgage bonds); or (3) finance the disposition of residential rental projects owned by the above agencies to private owners who would comply with the low-income targeting requirements of Code section 142(d). In all cases, all the dwellings must be located within the jurisdiction of the State Housing Agency purchasing the mortgage related assets.

The arbitrage restrictions of Code section 148 would apply to bonds issued pursuant to this exception. Moreover, the bonds described in this proposal would be subject to the annual state volume cap for qualified private activity bonds.

c. Conform treatment of 501(c)(3) bonds to governmental bonds

Present Law

Present law permits tax-exemption for interest on bonds to benefit section 501(c)(3) organizations (qualified 501(c)(3) bonds). Qualified 501(c)(3) bonds are defined as bonds which would not be private activity bonds if section 501(c)(3) organizations were treated as governmental units with respect to their exempt activities (sec. 145). Qualified 501(c)(3) bonds are classified as private activity bonds and such bonds are generally subject to several of the limitations on qualifying private activity bonds. In addition, no more than $150 million of qualified 501(c)(3) bonds (other than hospital bonds) may be outstanding with respect to any section 501(c)(3) organization at any time.

Explanation of Proposal

The proposal would repeal section 145 and generally treat bonds issued by 501(c)(3) organizations in the same manner in which present law treats bonds issued by governmental units. The proposal thereby would: (1) repeal the $150 million limitation on outstanding tax-exempt indebtedness of 501(c)(3) organizations; (2) repeal the two percent limitation on the financing of costs of issuance with bond proceeds; and (3) other changes.

Effective Dates

The proposal would generally be effective for bonds issued after December 31, 1989. The proposal would not apply to certain bonds issued after December 31, 1989, if such bonds are subject to any transition rule under subtitle B of title XIII of the Tax Reform Act of 1986.

b. Refinancings of certain bond issues

Present Law

A bond (including refunding bonds) is a private activity bond if an amount exceeding the lesser of five percent or $5 million of bond proceeds is to be used (directly or indirectly) to make or finance loans to any person other than a governmental unit.

Explanation of Proposal

The proposal would allow a current refunding on a tax-exempt basis to qualified issuers if the following restrictions are satisfied: (1) the amount of the refunding issue may not exceed the outstanding amount of the refunded bonds; and (2) the final maturity date of the refunding issue may not be extended later than July 1, 1995. A qualified issuer must have issued the bonds to be refunded to provide financial assistance to another issurer, which is a separate political subdivision, that has defaulted on its financial obligations and meet other restrictions.

Effective Date

The proposal would be effective on the date of enactment.

e. Sports stadium bonds

Present Law

The Tax Reform Act of 1986 restricted the availability of private activity tax-exempt bond financing. Specifically, the volume limitation applies to (1) exempt-facility bonds (other than bonds for airports, docks and wharves, and certain governmentally owned solid waste disposal facilities), (2) qualified mortgage bonds, (3) small-issue bonds, (4) qualified student loan bonds, and (5) qualified redevelopment bonds. Certain other private activity bonds for which tax-exemption specifically is provided in non-Code provisions also are subject to the new private activity bond volume limitations. While sports stadiums and convention facilities could be financed as qualified Industrial Development Bonds (IDBs) under prior law, they no longer fall within any category of exempt-facility bonds eligible for tax-exemption under present law.

Explanation of Proposal

The proposal would provide that sports stadiums are an exempt facility and can be financed using tax-exempt bonds subject to the State private activity bond limitation.

Effective Date

The proposal would be effective for bonds issued after December 31, 1989.

d. Mortgage credit certificates time limit suspension

Present Law

Generally, a qualified issuer may either issue Mortgage Revenue Bonds (MRBs) or exchange MRB authority for authority to issue Mortgage Credit Certificates (MCCs). After it has exchanged the authority the issuer can proceed with the actual issuance of the MCCs. The Tax Reform Act of 1986 imposed new restrictions, including tighter targeting, on MRBs and MCCs. The statutory language made these restrictions effective for MCCs issued after August 15, 1986. The Conference Committee Report, on the other hand, provided that these restrictions were effective with respect to bond authority exchanged for authority to issue MCCs after August 15, 1986. The "Bluebook" General Explanation noted that a technical correction would be necessary to correct the statutory language to conform to the legislative intent. This technical correction to apply the 1986 Act restrictions to exchanges of bond authority and not issuances of MCCs after August 15, 1986 was enacted in the Technical and Miscellaneous Revenue Act of 1988.

Code section 25(e)(3)(B) renders a MCC invalid unless the mortgagor incurs debt by the close of the second calendar year after the exchange the authority. The time limit under this section was not suspended by the 1986 Act.

Explanation of Proposal

The proposal would provide that the two-year time period allowed in Code section 25(e)(3)(B) commences running on the date of enactment of this technical for bond authority exchanged before August 15, 1986, but not issued as of that date.

Effective Date

The proposal would be effective on the date of enactment.

18. **Occupational tax on retail alcoholic beverage distributors**

Present Law

The occupational tax on retail establishments which sell alcoholic beverages is $250 per year. The occupational tax was increased from $54 per year in the Omnibus Budget Reconciliation Act of 1987, and became effective on January 1, 1988.

Explanation of Proposal

The proposal would reduce the occupational tax on certain retail establishments which sell alcoholic beverages from $250 to $150 per year. The reduction would apply to establishments with annual gross receipts from the sale of alcoholic beverages less than $250,000 and in which at least one-third of the alcoholic beverages sold are consumed on the premises of the establishment.

Effective Date

The proposal for a reduced occupational tax would be effective on and after January 1, 1990.

17. Treatment of immediate annuity contracts

Present Law

In order to curtail the marketing of serial contracts that are designed to avoid the distribution rules applicable to annuity contracts, the Technical and Miscellaneous Revenue Act of 1988 provided that all annuity contracts issued by the same insurer (or affiliates) to the same policyholder during any 12-month period are to be aggregated for purposes of determining the amount of any distribution that is includible in gross income under section 72(e) of the Internal Revenue Code. In addition, the Treasury Department was provided regulatory authority to prevent the avoidance of the distribution rules contained in section 72(e) through the serial purchase of contracts or otherwise.

Explanation of Proposal

The committee report to the bill would clarify that the present-law aggregation rules for determining the portion of any distribution from an annuity contract that is includible in gross income would not apply to an immediate annuity. In addition, the committee report would clarify that Congress did not intend to address the treatment of "combination" or "split" annuities in providing the Treasury Department with the authority to provide regulations that are necessary or appropriate to prevent avoidance of the distribution rules. The committee report would also provide that no inference is intended with respect to whether the Treasury Department may treat combination or split annuities as a single contract under its general authority to prescribe such rules and regulations as may be necessary to enforce the income tax laws.

Effective Date

The proposal would be effective as if included in the Technical and Miscellaneous Revenue Act of 1988.

20. Excise tax on reversions of qualified plan assets

Present Law

A nondeductible 15-percent excise tax is imposed on employer reversions from qualified plans (sec. 4980). The tax is designed to recapture the tax benefit received by the employer from the deferral of tax on pension fund earnings.

Explanation of Proposal

The proposal would increase the 15-percent excise tax to 20 percent.

Effective Date

The proposal would generally apply to reversions received after the date of committee action, other than reversions with respect to which a notice of intent to terminate was provided on or before such date.

19. Apply statute of limitations to uncollected occupational taxes for retail alcoholic beverage establishments

Present Law

The occupational tax on retail establishments which sell alcoholic beverages is $250 per year. The occupational tax was increased from $54 per year in the Omnibus Budget Reconciliation Act of 1987, and became effective on January 1, 1980.

Since the increase in the occupational tax and transfer of responsibility for administration of alcohol taxes to the Bureau of Alcohol, Tobacco and Firearms (BATF), enforcement activities have been intensified in a systematic manner. As a result, some taxpayers were located who had not paid occupational taxes for a number of years, some for a large number of years. Many taxpayers accused of tax delinquency claim to have not been aware of the existence of the occupational tax. Nevertheless, they have been assessed for back taxes plus interest and penalties on the back taxes.

Explanation of Proposal

The proposal would establish a statute of limitations from 1985 in order to limit the period for which back taxes, interest, and penalties may be assessed.

Effective Date

The proposal would be effective on the date of enactment.

22. Foreign Provisions

a. Consider certain leased assets for purposes of the passive foreign investment company asset test

Present Law

A foreign corporation is treated as a passive foreign investment company (PFIC) if it satisfies either an income test or an asset test. To satisfy the income test, at least 75 percent of the corporation's gross income for the taxable year must be passive income. The asset test is met if the average percentage of assets (based on either fair market value or adjusted basis) held by the corporation during the taxable year which produce, or are held for the production of, passive income is at least 50 percent.

Explanation of Proposal

The proposal would provide rules under which certain leasehold interests in certain assets would be treated in certain circumstances and to some extent as an asset held by a foreign corporation for purposes of applying the PFIC asset test to that corporation.

Effective Date

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

21. Include essential air services among Airport and Airway Trust Fund expenditure purposes

Present Law

Excise tax receipts appropriated to the Airport and Airway Trust Fund (AATF) may be spent only for statutory purposes specified in section 9502 of the Internal Revenue Code. Generally, these purposes are (1) airport improvement, which includes airport development and planning, noise abatement at airports, and enhancing airport capacity; (2) airway systems improvement, which includes air navigation and communications facilities and equipment, and instrument landing systems; (3) portions of administrative expenses which are attributable to activities under points (1) and (2); and (4) research, engineering and development, and demonstrations, which include projects relating to such activities as air traffic control, air navigation, aviation weather, aviation medicine, aircraft safety, environmental problems, and human factors.

Section 419 of the Federal Aviation Act of 1958, as amended, provides for subsidization of essential air services to an eligible point which is more than 45 highway miles from an airport hub and which has lost what is determined by the Secretary of Transportation to be essential air service. The Secretary is authorized to provide a reasonable amount of compensation to an air carrier which is selected to provide air services to an eligible point. Guidelines for determining compensation are to "include expense elements based upon representative costs of air carriers providing scheduled air transportation of persons, property, and mail, using aircraft of the type determined by the Secretary to be appropriate for providing such service."

Explanation of Proposal

The proposal would amend the expenditure purposes of the Airport and Airway Trust Fund to include the essential air services program which is authorized in section 419 of the Federal Aviation Act of 1959, as amended.

Effective Date

The proposal would apply to obligations incurred in fiscal years after September 30, 1989.

c. Treatment of certain scholarship or fellowship grants to nonresident aliens

Present Law

Generally under the Code, the United States imposes tax, at ordinary rates, on the taxable income of a nonresident alien individual that is effectively connected with the conduct of a trade or business in the United States. However, in computing taxable income, a nonresident alien cannot use the standard deduction and is in some cases entitled to only one personal exemption in cases where (because of rules for spouses and dependents) a U.S. resident or citizen would be entitled to multiple personal exemptions. Under the Code, a nonresident alien is generally subject to a 30 percent tax on gross amounts of fixed or determinable, annual or periodical income from U.S. sources that is not effectively connected with the conduct of a trade or business in the United States. The payor of income subject to this gross-basis tax is generally required to collect the tax by withholding at the full 30 percent rate.

U.S. source amounts that are received by a nonresident alien individual who is temporarily present in the United States under an F, J or M visa, and that are either (1) incident to a qualified scholarship to which section 117(a) applies (but are includible in gross income), or (2) a scholarship or fellowship for study, training, or research in the United States and received from a government, a 501(c)(3) organization, or certain types of international, binational, or multinational organizations, are treated as effectively connected with the conduct of a trade or business within the United States and eligible for withholding at a 14 percent rate.

Explanation of Proposal

In the case of a nonresident alien individual who is temporarily present in the United States under an F, J or M visa, the proposal would permit that individual the benefits of the standard deduction and the personal exemptions to which the individual would be entitled for the year if he or she (and his or her spouse, if any) were U.S. citizens, to the extent that deduction and those exemptions do not exceed the amounts which are granted to the individual during the taxable year by a federal, state, or local government agency, or a tax-exempt U.S. organization described in section 501(c)(3), as a scholarship or fellowship for study, training, teaching, research or career development in the United States, and which are included in the individual's gross income. Withholding would be reduced to account for the reduction in tax liability.

Effective Date

b. Modify definition of passive foreign investment company with regard to certain income of export trade corporations

Present Law

Certain income derived by an export trade corporation (ETC) from certain export activities is exempt from current taxation under subpart F (sec. 970). Under this exemption, the subpart F income of an ETC is reduced by certain amounts that constitute export trade income (as defined in section 971). No foreign corporation may qualify as an ETC unless it has so qualified generally since 1971 (sec. 971(a)(3)).

The income of any passive foreign investment company (PFIC) is generally subject to current U.S taxation (sec. 1291-1297). A PFIC is defined by section 1296 generally as any foreign corporation if either (1) 75 percent or more of its gross income for the taxable year is passive income, or (2) 50 percent or more, on average, of the assets held by such corporation during the taxable year produce passive income or are held for the production of passive income. For this purpose, passive income generally is defined by reference to section 954(c). Amounts that are passive income for this purpose may also constitute export trade income under section 971.

Explanation of Proposal

The proposal would exclude from the definition of passive income, solely for the purpose of determining whether a foreign corporation is a PFIC, any export trade income of an ETC to the extent that the subpart F income of such ETC is reduced under section 970 by such income.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1989, for which a foreign corporation is treated as an export trade corporation. An ETC that is a PFIC under present law but would not be a PFIC under the proposal would be treated as making distributions out of earnings that were accumulated in years during which the ETC was a PFIC, which distributions would be subject to the rules of section 1291, only after the distribution of all other accumulated earnings and profits.

23. Accounting Provisions

a. Treatment of safe-harbor leases of membership organizations

Present Law

Present law provides that, in the case of a membership organization (such a cooperative), losses from transactions with members cannot be used to offset income from transactions with nonmembers. The Internal Revenue Service has taken the position that the interest income derived from a safe-harbor sale-leaseback transaction is income not derived from transactions with members while the rental expense from such a sale-leaseback transaction must be allocated between income derived from members and nonmembers.

Explanation of Proposal

Under the proposal, the interest income and rental expense from the sale and leaseback of the property under a safe-harbor lease are to be first netted and the difference allocated between members and nonmembers in proportion to the business done with each group.

Effective Date

The proposal would be effective for all open taxable years.

The proposal would apply to taxable years beginning after December 31, 1989.

would be due if section 108 did apply; (5) the taxpayer's indebtedness both before and after the discharge is equal to 70 percent or more of the equity in all property held by the taxpayer; and (6) the taxpayer transfers only farm property to discharge the qualified farm indebtedness.

The $350,000 limit would be reduced by prior year exclusions of discharge of qualified farm indebtedness income under this provision.

With respect to farmers that do not satisfy the requirements described above but who otherwise realize income from the discharge of qualified farm indebtedness, the present-law rule that generally limits the exclusion of such income to the sum of the taxpayer's loss and credit carryovers and the taxpayer's basis in certain property, would not be changed by this provision.

Effective Date

The provision would apply to discharges of indebtedness occurring after December 31, 1986, in taxable years ending after such date.

b. Modify treatment of discharge of farm indebtedness for certain farmers

Present Law

Gross income generally includes income from the discharge of indebtedness (sec. 61(a)(12)). If an insolvent taxpayer realizes income from discharge of indebtedness, however, the income is excluded and certain tax attributes of the taxpayer (including items such as net operating loss carryovers and basis in property) generally are reduced by the excluded amount. The exclusion is limited to the amount by which the taxpayer is insolvent. If the taxpayer's discharge of indebtedness income (not in excess of the amount by which the taxpayer is insolvent) exceeds these tax attributes, the excess is forgiven, i.e., is not includible in income (sec. 108).

The Tax Reform Act of 1986 provided that, in the case of a solvent taxpayer who realizes income from the discharge by a "qualified person" of "qualified farm indebtedness," the discharge is treated in a manner similar to a discharge incurred by an insolvent taxpayer (sec. 108(g)). Qualified farm indebtedness is indebtedness incurred directly in connection with the operation of a farming business by a taxpayer who satisfies a specified gross receipts test. A qualified person is one regularly engaged in the business of lending money and meeting certain other requirements. The Technical and Miscellaneous Revenue Act of 1988 provided that the amount excluded under this provision generally may not exceed the sum of the taxpayer's loss and credit carryovers and the taxpayer's basis in property held for use in a trade or business or for the production of income. Thus, if there is any remaining discharge of indebtedness income after the taxpayer has reduced these tax attributes, income will be recognized.

Explanation of Proposal

Farmers meeting certain requirements could exclude income from discharge of qualified farm indebtedness, but not in excess of $350,000. This provision would apply to a taxpayer that meets all of the following requirements: (1) the taxpayer's adjusted gross income (with certain modifications) is less than the national median adjusted gross income; (2) more than 50 percent of the taxpayer's gross receipts for 6 of the 10 taxable years preceding the year of transfer is attributable to the farming business, the sale or lease of assets used in farming, or both; (3) the taxpayer materially participates in the farming business; (4) the amount of equity in all property held by the taxpayer after the discharge is less than the greater of (a) $25,000 or (b) 150 percent of the excess of the tax that would be due if section 108 of the Code did not apply, over the tax that

d. Modification of the percentage of completion method of accounting for long-term contracts and study of the treatment of long-term contracts

<u>Present Law</u>

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

Under the percentage of completion method, a taxpayer must include in gross income for any taxable year an amount that is based on the product of (1) the gross contract price and (2) the percentage of the contract completed as of the end of the taxable year. The percentage of the contract completed as of the end of a taxable year is determined by comparing costs incurred with respect to the contract as of the end of the year with the estimated total contract costs. In addition, under the percentage of completion method, costs allocable to the contract are taken into account for the taxable year in which incurred.

<u>Explanation of Proposal</u>

<u>Modification of the percentage of completion method of accounting for long-term contracts</u>

A taxpayer would be allowed to elect not to recognize income under a long-term contract or take into account any costs allocable to such long-term contract for any taxable year if as of the end of the taxable year less than 15 percent of the estimated total contract costs have been incurred. For the taxable year in which the 15-percent threshold is satisfied, all costs that have been incurred as of the end of the taxable year would be taken into account in determining the percentage of the contract that has been completed and in determining the amount of allowable deductions under the contract.

The election would also apply for purposes of the lookback method, in determining alternative minimum taxable income, and in determining adjusted current earnings under the alternative minimum tax. The election would be required to be made with respect to all long-term contracts of a taxpayer and would be treated as a method of accounting.

<u>Study of the treatment of long-term contracts</u>

The Treasury Department would be required to study the proper treatment of long-term contracts for Federal income

c. Contributions in aid of construction of alternative water supplies

Present Law

Contributions in aid of construction received by a public utility are treated as gross income of the utility and not as a contribution to the capital of the utility. Consequently, a utility is required to include in gross income the value of any property (including money) that it receives to provide, or to encourage it to provide, services to, or for the benefit of, any person transferring property to the utility. A utility is considered as having received property to encourage the provision of services if the receipt of the property is a prerequisite to the provision of services, if the receipt of the property results in the provision of services earlier than would have been the case had the property not been received, or if the receipt of the property otherwise causes the transferor to be favored in any manner.

Explanation of Proposal

A contribution of money or other property by a Federal, State or local government (or a political subdivision thereof) to a regulated public utility that provides water or sewage disposal services would be treated as a contribution to capital and not as an item of gross income if the contribution is in aid of construction of property that will be used predominantly in furnishing alternative water supplies for purposes of remedying environmental contamination or protecting the health of individuals threatened by environmental contamination. This treatment would apply only if the contribution (or any property acquired or constructed with the contribution) is not included in the utility's rate base for ratemaking purposes. In addition, no deduction or credit would be allowed with respect to any expenditure that constitutes a contribution to capital and the adjusted basis of any property acquired by such an expenditure would be zero.

Effective Date

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

e. **Modify material participation for certain timber activities of individuals under the passive loss rules**

Present Law

Present law, as amended by the 1986 Act, provides that deductions from passive trade or business activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), generally may not be deducted against other income. Suspended losses are carried forward and treated as deductions from passive activities in the next year. Suspended losses are allowed in full when the taxpayer disposes of his entire interest in the activity to an unrelated party in a transaction in which all realized gain or loss is recognized. The provision applies to individuals, estates, trusts, and personal service corporations. A special rule limits the use of passive activity losses and credits against portfolio income and tax attributable to portfolio income in the case of closely held corporations.

An activity generally is treated as passive if it is a rental activity, or if the taxpayer does not materially participate in it, i.e., the taxpayer is not involved in the operations of the activity on a basis which is regular, continuous, and substantial.

Under temporary and proposed Treasury regulations, a taxpayer may meet any of several tests for material participation, including a test based on all of the facts and circumstances. If an individual participates in an activity for 100 hours or less during the taxable year, the regulations provide that such individual shall not be treated as materially participating under the facts and circumstances test.

The regulations further provide that an individual's services performed in the management of an activity shall not be taken into account in determining whether such individual is treated as materially participating under the facts and circumstances test, unless, for such taxable year, (i) no person (other than such individual) who performs services in connection with the management of the activity receives compensation that is earned income in consideration for such services; and (ii) no individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by such individual.

Explanation of Proposal

Under the proposal, in the case of qualified timber property held by a natural person, material participation could be determined under the facts and circumstances test in tax purposes and report the results of the study to the House Ways and Means Committee and the Senate Finance Committee by February 28, 1990.

Effective Date

The proposal would apply to long-term contracts that are entered into after December 31, 1989.

f. Treatment of certain crops under the annual accrual method of accounting

Present Law

Present law provides an exception to the uniform cost capitalization rules for certain corporations and qualified partnerships that are permitted to use the annual accrual method of accounting with respect to the trade or business of farming sugar cane. Under the annual accrual method of accounting, revenues, costs, and expenses are determined under an accrual method of accounting and the preproductive period expenses incurred during any taxable year are charged to harvested crops or are deducted in determining taxable income for such years.

Explanation of Proposal

A corporation or qualified partnership that, for its last taxable year ending before January 1, 1987, was allowed to use, and actually used, the annual accrual method of accounting with respect to any crop would be allowed to continue to use such method of accounting with respect to such crop.

Effective Date

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

the regulations even though the person participates in the activity for 100 hours or less during the taxable year.

Qualified timber property for this purpose would mean a woodlot or other site located in the United States that will contain trees in significant commercial quantities and that is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products.

Effective Date

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

deferred tax for such obligations would equal the deferred tax reduced by the excess (if any) of the amount of income tax credits for such year over the amount of income tax for such year before reduction by credits. Alternatively, a C corporation would be allowed to elect to determine the net deferred tax by multiplying (1) the amount of gain under the obligations that has not been recognized as of the close of the taxable year, by (2) the maximum rate of tax in effect for such taxable year for C corporations.

Any interest determined under the proposal would be treated as a tax imposed for the taxable year following the year in which the interest was determined. The portion of the interest, however, that is allocable to installment obligations that have not been outstanding for a two-year period as of the close of the taxable year or that are in default as of the close of the taxable year would not result in an increase in tax for such taxable year. Instead, if such installment obligations are not in default at the close of any taxable year after the end of the two-year period, the amount of interest that was determined under the proposal but was not added to tax would be added to tax for the first taxable year following such year (together with additional interest compounded at the underpayment rate for each year that the original interest has not been added to tax).

The proposal would also clarify that the interest determined under the proposal is to be treated as tax for purposes of the estimated tax provisions applicable to corporations.

A C corporation that elects to pay interest under the proposal with respect to an installment sale of a timeshare or a residential lot would be allowed to use the installment method for purposes of the adjusted current earnings provision of the alternative minimum tax. In addition, for purposes of the adjusted current earnings provision of the alternative minimum tax, a taxpayer that is required to pay interest with respect to a nondealer disposition of property would be allowed to use the installment method for the portion of the gain with respect to which interest is required to be paid.

Effective Date

The proposal would apply to dispositions occurring in taxable years beginning after December 31, 1989.

g. Installment sales treatment of timeshares and residential lots sold by C corporations

Present Law

A taxpayer who disposes of a timeshare or a residential lot on the installment plan generally may report income derived from such a disposition on the installment method if the taxpayer elects to pay interest on the amount of deferred tax that is attributable to the use of the installment method. Under this election, interest is required to be paid for any taxable year that payments are received under the installment obligation (other than the taxable year in which the sale occurs). The interest is imposed for the period that begins on the date of the sale of the timeshare or the residential lot and ends on the date that each payment is received. The interest rate used for this purpose is the applicable Federal rate (compounded semiannually) in effect at the time of the sale for debt instruments with the same maturity as the installment obligation.

A taxpayer who elects to pay interest with respect to an installment sale of a timeshare or a residential lot may use the installment method in determining alternative minimum taxable income. However, for purposes of the adjusted current earnings provision of the alternative minimum tax, the installment method may not be used in determining income derived from an installment sale (including a nondealer installment sale of property) even though interest is required to be paid with respect to all or a portion of the deferred tax that is attributable to the use of the installment method. The adjusted current earnings provision of the alternative minimum tax applies to C corporations for taxable years beginning after December 31, 1989.

Explanation of Proposal

The proposal would modify the amount of interest that is payable by a C corporation that elects to use the installment method with respect to an installment sale of a timeshare or a residential lot. The interest would be determined for all outstanding installment obligations with respect to which an election was made by multiplying the total net deferred tax with respect to all such obligations by the underpayment rate in effect for the month with or within which the taxable year ends.

For any taxable year, the deferred tax for such obligations would equal (1) the amount of gain under the obligations that has not been recognized as of the close of the taxable year reduced by the excess (if any) of the total allowable deductions for such year over the total income for such year, multiplied by (2) the maximum rate of tax in effect for such taxable year for C corporations. The net

b. Proving tolerance limits for blending of gasohol

Present Law

Gasohol blenders which produce a blend containing 10 percent alcohol and 90 percent gasoline may receive a credit or refund of 6 cents per gallon of the 9 cents per gallon gasoline excise tax which is dedicated to the Highway Trust Fund.

Blenders have found in practise that it is difficult to achieve precisely the 10 percent alcohol content in a gasohol blend because of (1) mechanical imprecision in metering alcohol into a tankload of gasoline which can occur because the calibration of dispensing equipment may have become inexact during usage and (2) cut-off valves which do not respond instantaneously to mechanical or electronic signals to cease dispensing.

Explanation of Proposal

A range of tolerance of plus-or-minus one-tenth of one percent (+/- 0.1%) would be considered as meeting the requirements of a gasohol blend of 10 percent alcohol, so long as over a reasonable period of time the average ratio of alcohol to gasoline is 10.0 percent. The Secretary would be instructed to provide regulations governing the administration of this provision.

Effective Date

The proposal would be effective on January 1, 1990.

24. Energy/Excise Tax Provisions

a. Modifications to production credit for nonconventional fuels

Present Law

Nonconventional fuels are eligible for a production credit which is equal to $3 per barrel of BTU oil barrel equivalent. Those fuels which are eligible must be produced from a well drilled, or a facility placed in service, before January 1, 1991. Qualified fuels are eligible for the production credit through December 31, 2000.

Gas from a tight sands formation was eligible for the production credit as long as natural gas was subject to price controls, under sec. 107 of the Natural Gas Policy Act of 1978.

Explanation of Proposal

(1) Production of gas from a tight sands formation would be eligible for the production credit even though the price of natural gas no longer is subject to price control.

(2) The production credit for gas produced from a tight sands formation would be available for gas from wells drilled after December 31, 1989.

(3) The production credit for nonconventional fuels would be extended to apply to wells drilled or facilities placed in service before January 1, 1993, instead of before January 1, 1991.

Effective Date

The proposal would be effective on January 1, 1990.

25. Provide minimum tax credit for exclusionary items of corporations

Present Law

When a corporation pays the alternative minimum tax, the amount of the tax paid (to the extent attributable to timing differences with the regular tax), is allowed as a credit against the regular tax as a credit in future years. The credit (known as the minimum tax credit) cannot be used to reduce tax below the tentative minimum tax in subsequent years.

Explanation of Proposal

The proposal would provide that the entire amount of the corporate alternative minimum tax (rather than only the amount of tax attributable to timing differences) may be taken into account in computing the amount of the alternative minimum tax credit available in future years.

Effective Date

The proposal would allow the entire alternative minimum tax arising in taxable years beginning after December 31, 1989 to be allowable as a credit for subsequent years.

c. Allow crop dusters to apply for waivers from gasoline tax

Present Law

Crop dusters, who make aerial applications to farmers' crops, do not have to pay the excise tax on gasoline because the gasoline is not used on highways. In order to avoid payment of the gasoline tax, however, crop dusters must obtain a waiver from the farmer which provides that the farmer does not want the excise tax exemption and that the crop duster may claim it, even though the off-highway use took place on the farmer's land.

Crop dusters have found this procedure to be both burdensome and cumbersome, and have sought relief in favor of a process which allows them to claim an exemption for off-highway gasoline use directly without having to involve farmers in the process.

Explanation of Proposal

The proposal would allow crop dusters to purchase tax-free gasoline for off-highway farm use without having first to receive a waiver from a farmer.

Effective Date

The proposal would be effective on January 1, 1990.

would not be eligible for relief. Conforming changes would be made to the definition of short term capital gain property to reflect changes in the definition that have occurred since 1986.

Effective Date

The provision would be effective for distributions or sales occurring after December 31, 1988.

26. **Small business exemption from recognition of gain or loss on liquidating sales or distributions (exemption from repeal of the General Utilities doctrine)**

Present Law

Gain or loss is generally recognized by a corporation on a liquidating sale or distribution (including a deemed sale occurring when a corporation is acquired and an election is made to treat the transaction as an asset sale). This rule was added to the Code by the Tax Reform Act of 1986. Prior to the 1986 Act, gain was generally recognized in the case of nonliquidating sales or distributions but not in the case of liquidating sales (including sales involving the acquisition of the corporation). However, certain nonliquidating distributions to long-term individual shareholders were not taxed prior to the 1986 Act. The 1986 Act generally conformed the treatment of gain in liquidating sales and distributions to the treatment that resulted in the absense of a liquidation or an acquisition by requiring gain recognition in all cases.

The 1986 Act provided transition relief for certain small corporations. Corporations eligible for this relief were granted two additional years, until December 31, 1988, in which they could distribute assets, liquidate, or convert to subchapter S status without becoming subject to the 1986 Act provision except in the case of ordinary income assets or capital assets held less than six months, or in the case of certain conduit transactions with ineligible corporations.

Eligible corporations were those in existence on August 1, 1986, and whose value on the later of that date or the date of adoption of a plan of liquidation did not exceed $10 million, provided that on August 1, 1986 and at all times thereafter, more than 50 percent (by value) of the stock of such corporation was owned by a qualified group. This was a group of 10 of fewer individuals who at all times during the five year period ending on the date of adoption of the plan of liquidation (or during the life of the corporation, if shorter) owned more than 50 percent of the value of the corporate stock. Corporations whose value exceed $5 million were eligible only for partial relief and the relief was phased out entirely at a size of $10 million.

Explanation of Proposal

The 1986 Act relief from gain recognition for small corporations that expired at the end of 1988 would be reinstated. The relief would apply to corporations more than 50 percent of the stock of which is held by qualified shareholders each of whom has held his or her stock for at least 5 years. As under the 1986 Act transition rule, ordinary income property and short term capital gain property

Information reporting

Generally, every U.S. person is required to report certain information concerning any foreign corporation that such person controls and information relating to transactions between the corporation and certain specified persons. Failure to provide such information subjects the U.S. person to a monetary penalty plus a denial of foreign tax credits (sec. 6038). These information reporting requirements and this penalty do not specifically refer to all types of information needed to determine tax liabilities with respect to controlled foreign corporations.

Explanation of Proposal

Overview

The proposal would modify the information return penalties provided under present law in order to encourage persons to file correct information returns even though such returns are filed after the prescribed filing date. The proposal would establish a three-tier penalty structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure. This structure would give taxpayers an incentive to correct their errors as rapidly as possible. Taxpayers would be permitted correct a *de minimis* number of errors and avoid penalties entirely. Uniform reporting requirements would be made applicable to magnetic media. A study of service bureaus, which file information documents on behalf of other persons, would be required.

Failure to file correct information returns

Any person that fails to file a correct information return with the Internal Revenue Service on or before the prescribed filing date would be subject to a penalty that varies based on when, if at all, the correct information return is filed. If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty would be $15 per return, with a maximum penalty of $75,000 per calendar year. If a person files a correct information return after the date that is after 30 days after the prescribed filing date but on or before August 1, the amount of the penalty would be $30 per return, with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1 of any year, the amount of the penalty would be $50 per return, with a maximum penalty of $250,000 per calendar year.

The proposal would also provide a special rule for *de minimis* failures to include the required, correct information. This exception would apply to incorrect

27. Civil penalty reform

a. Information reporting penalties

Present Law

In general

Any person that fails to file an information return with the Internal Revenue Service on or before the prescribed filing date is subject to a $50 penalty for each failure, with a maximum penalty of $100,000 per calendar year. Information returns relating to interest and dividends are subject to this $50 penalty for each failure, but without any cap on the total amount of penalty that may be imposed. In addition, any person that fails to provide a copy of an information return (a "payee statement") to a taxpayer on or before the prescribed due date is subject to a penalty of $50 for each failure, with a maximum penalty of $100,000 per calendar year. If a person fails to include all of the information required to be shown on an information return or a payee statement or includes incorrect information, then a penalty of $5 may be imposed with respect to each such failure, with a maximum penalty of $20,000 per calendar year. Stricter penalty provisions apply in the case of interest and dividend returns and in the case of intentional failures to comply with the information return requirements.

A penalty may also be imposed for each failure to include a correct taxpayer identification number on a return or statement and for each failure to furnish a correct taxpayer identification number to another person. The amount of the penalty that may be imposed is either $5 or $50 for each failure, depending on the nature of the failure.

Foreign provisions

Income of foreign persons subject to withholding

Persons having control, receipt, custody, disposal, or payment of certain types of U.S. income of foreign persons are required to deduct and withhold U.S. tax from such income under chapter 3 of the Code's income tax provisions (secs. 1441-1464). Generally, any person required to serve as a withholding agent under chapter 3 must provide each income recipient an annual withholding statement (Form 1042S) and must file all required Forms 1042S with the IRS accompanied by a return (Form 1042) summarizing the information on the Forms 1042S (Reg. sec. 1.1461-2). As described above, the Code generally provides penalties for each failure to file a required information return with the IRS and each failure to provide a required payee statement. These penalties do not apply, however, to each failure with respect to Forms 1042S.

required to be shown on the statement, with no limitation on the maximum penalty per calendar year.

Failure to comply with other information reporting requirements

Any person that fails to comply with other specified information reporting requirements on or before the prescribed date would be subject to a penalty of $50 for each failure, with a maximum penalty of $100,000 per calendar year. The information reporting requirements specified for this purpose would include any requirement to include a correct taxpayer identification number on a return or statement and any requirement to furnish a correct taxpayer identification number to another person. The proposal would coordinate this penalty with the penalty for failure to file correct information returns and the penalty for failure to file correct payee statements by making this penalty inapplicable to failures penalized under those provisions.

Waiver, definitions, and special rules

The proposal would consolidate the waiver standards relating to information reporting into one provision. Thus, any of the information reporting penalties may be waived if it is shown that the failure to comply is due to reasonable cause and not to willful neglect. For this purpose, reasonable cause exists if significant mitigating factors are present, such as the fact that a person has an established history of complying with the information reporting requirements. If a payor correctly reports information that the payor received from a payee, the payor is not subject to penalty for errors that the payee made in reporting the information to the payor. The separate, higher waiver standard under present law for interest and dividends is repealed. Interest and dividend returns and statements are consequently subject to this general waiver standard.

Foreign provisions

Penalties for failure to file withholding statements

The proposal would integrate the penalty for failure to file Form 1042S and failure to provide Form 1042S to the payee into the general penalty structure. Thus, the proposal would treat each Form 1042S required to be filed with the IRS and provided to a payee as an information return and as a payee statement, respectively, as those terms are defined in section 6724. Accordingly, each failure to file any required Form 1042S will be subject to a separate penalty under

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[1] Five percent for several types of statements.

information returns that are corrected on or before August 1. Under the exception, if an information return is originally filed without all of the required information or with incorrect information and the return is corrected on or before August 1, then the original return would be treated as having been filed with all of the correct required information. The number of information returns that may qualify for this exception for any calendar year would be limited to the greater of (1) 10 returns or (2) one-half of one percent of the total number of information returns that are required to be filed by the person during the calendar year.

The use of 10 returns for this purpose effectively provides a special small-business rule in this penalty. According to IRS statistics, approximately 84 percent of payors who file information returns with the IRS file 10 or fewer forms. Thus, these payors will have until August 1 to correct without penalty errors of omission or commission on information returns that were originally timely-filed with the IRS. If the total number of returns corrected by the taxpayer exceeds the <u>de minimis</u> threshold, only the number exceeding the threshold is subject to penalty. This specific <u>de minimis</u> rule in no way restricts the ability of the IRS or the courts to grant a waiver based on reasonable cause (discussed below). The reasonable cause waiver is applied before the <u>de minimis</u> threshold is applied.

In addition, the proposal would provide special, lower maximum levels for this penalty for small businesses. Small businesses would be defined as firms having average annual gross receipts for the most recent 3 taxable years that do not exceed $5 million. The maximum penalties for small businesses would be: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or

The proposal would also incorporate into this general structure the penalty for failure to provide information reports to the IRS or statements to payees relating to pension payments.

<u>Failure to furnish correct payee statements</u>

Any person that fails to furnish a correct payee statement to a taxpayer on or before the prescribed due date would be subject to a penalty (as under present law) of $50 per statement, with a maximum penalty of $100,000 per calendar year. If the failure to furnish a correct payee statement to a taxpayer is due to intentional disregard of the requirement, the proposal generally provides a penalty of $100 per statement or, if greater, 10 percent[1] of the amount business of transmitting information returns or other documents to the IRS on behalf of other persons should be subject to registration or other regulation. A report on the study, together with any recommendations, is to be submitted to the tax-writing committees of the Congress not later than July 1, 1990.

Effective Dates

The information reporting provisions of the proposal would generally apply to information returns and payee statements the due date for which (determined without regard to extensions) is after December 31, 1989.

b. **Accuracy penalties**

Present Law

Negligence penalty

If any part of an underpayment of tax required to be shown on a return is due to negligence or disregard of rules or regulations, a penalty may be imposed equal to 5 percent of the total amount of the underpayment. An underpayment of tax that is attributable to a failure to include on an income tax return an amount shown on an information return is treated as subject to the negligence penalty absent clear and convincing evidence to the contrary.

Fraud penalty

If any part of an underpayment of tax required to be shown on a return is due to fraud, a penalty may be imposed equal to 75 percent of the portion of the underpayment that is attributable to fraud.

Substantial understatement penalty

If the correct income tax liability of a taxpayer for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to 25 percent of the underpayment of tax attributable to the understatement. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return. Special rules apply to tax shelters.

Valuation penalties

section 6721, and each failure to provide a payee any required Form 1042S will be subject to a separate penalty under section 6722.

Penalties for failure to report information with respect to certain foreign corporations

The proposal would clarify the reporting requirements and penalties imposed by section 6038 by expressly applying those provisions to failures to provide certain information with respect to related parties, such as controlled foreign corporations of which the person subject to the requirements is a U.S. shareholder.

Uniform requirements for returns on magnetic media

The proposal would provide that uniform magnetic media requirements apply to all information returns filed during any calendar year. The proposal would accomplish this by making statutory the requirement currently contained in IRS regulations that persons filing more than 250 information returns file those returns on magnetic media. The proposal would make this requirement applicable to all types of information returns. Thus, the proposal would repeal the provision of present law that requires persons filing more than 50 information returns relating to payments of interest, dividends, and patronage dividends to file all such returns on magnetic media. The proposal would provide that the penalty for failing to file information returns on magnetic media when required to do so applies only to the number required to be so filed that exceeds 250. The penalties for failure to file on a timely basis correct information returns would apply to the first 250 returns.

Study of procedures to prevent mismatching

The proposal would require the General Accounting Office, in consultation with the Treasury Department, to conduct a study on whether, if the name and taxpayer identification number of any person that is set forth on an information return do not correspond to the name and taxpayer identification number of such person contained on the records of the IRS, the IRS should be permitted to disclose to the person that has filed such information return such information as may be necessary to determine the correct name and taxpayer identification number. A report on the study, together with any recommendations, is to be submitted to the tax-writing committees of the Congress by June 1, 1990.

Study of service bureaus

The proposal would require the General Accounting Office, in consultation with the Treasury Department, to conduct a study of whether service bureaus engaged in the underpayment (both the portion attributable to negligence and the portion not attributable to negligence).

Negligence would include any careless, reckless, or intentional disregard of rules or regulations, as well as any failure to make a reasonable attempt to comply with the provisions of the Code. In addition, the proposal would repeal the present-law presumption under which an underpayment is treated as attributable to negligence if the underpayment is due to a failure to include on an income tax return an amount shown on an information return.

(2) Substantial understatement of income tax

The accuracy-related penalty that would apply to the portion of an underpayment that is attributable to a substantial understatement of income tax would be the same as the substantial understatement penalty provided under present law with three principal modifications. First, the rate would be lowered to 20 percent. Second, the proposal would expand the list of authorities upon which taxpayers may rely (currently contained in Treasury regulations) to include proposed regulations, private letter rulings, technical advice memoranda, actions on decisions, general counsel memoranda, information or press releases, notices, and any other similar documents published by the IRS in the Internal Revenue Bulletin. In addition, the list of authorities would include General Explanations of tax legislation prepared by the Joint Committee on Taxation (the "Blue Book"). Third, the proposal would require the IRS to publish not less frequently than annually a list of positions for which the IRS believes there is no substantial authority and which affect a significant number of taxpayers. The purpose of this list would be to assist taxpayers in determining whether a position should be disclosed in order to avoid the substantial understatement penalty. Thus, if a taxpayer takes a position that is enumerated on this list, the taxpayer could choose to disclose that position to avoid imposition of the substantial understatement component of the accuracy-related penalty. However, inclusion of a position on this list is not conclusive as to whether or not substantial authority exists with respect to that position. If, however, there is litigation as to whether there is substantial authority, and the court concludes that the IRS is correct in the belief that there is not substantial authority for the position, then this penalty would apply.

(3) Substantial valuation overstatement

The penalty that would apply to the portion of an underpayment that is attributable to a substantial valuation overstatement would generally be the same as the valuation overstatement penalty provided under present law with five principal modifications. First, the proposal would extend the penalty to all taxpayers. Second, a substantial valuation overstatement would exist if the value or adjusted basis of any property claimed on a return is 200 percent or more of the correct value or adjusted basis. Third, the penalty would apply only if the amount of the underpayment attributable to a valuation overstatement exceeds $5,000 ($10,000 in the case of most corporations). This would increase five-fold the threshold below which the penalty does not apply to individuals. Fourth, the amount of the penalty for a substantial valuation overstatement would be 20 percent of the amount of the underpayment if the value or adjusted basis claimed is 200 percent or more but less than 400 percent of the correct value or adjusted basis. Fifth, as explained below, the proposal would provide that the rate of this penalty is doubled if the value or adjusted basis claimed is 400 percent or more of the correct value or adjusted basis.

(4) Substantial overstatement of pension liabilities

The accuracy-related penalty would also apply to substantial overstatements of pension liabilities. This penalty would be derived from the present-law penalty in section 6659A. The proposal would, however, modify the present-law penalty by providing that the taxpayer is subject to this component of the accuracy-related penalty only if the actuarial determination of pension liabilities is 200 percent or more of the amount determined to be correct (under present law, the penalty applies to claims 150 percent or more in excess of the amount determined to be correct). As under present law, this penalty would apply only if the underpayment attributable to the valuation overstatement exceeds $1,000.

(5) Substantial estate or gift tax valuation understatement

The accuracy-related penalty also would apply to substantial estate or gift tax valuation understatements. This penalty would be derived from the present-law penalty in section 6660. The proposal would, however, modify the present-law penalty by providing that the taxpayer is subject to this penalty only if the value of any property claimed on an estate or gift tax return is 50 percent or less of the amount determined to be correct. (Under present law, the penalty applies to claims that are 66 2/3 percent or less of the amount determined to be correct.) In addition, the proposal would modify the present-law penalty by increasing five-fold the threshold below which the penalty does not apply, from $1,000 to $5,000.

(6) Gross valuation misstatements

The proposal would provide that the rate of the general

If an individual, personal service corporation, or closely held corporation underpays income tax for any taxable year by $1,000 or more as a result of a valuation overstatement, then a penalty may be imposed with respect to the amount of the underpayment that is attributable to the valuation overstatement. A valuation overstatement exists if the valuation or adjusted basis of any property claimed on a return is 150 percent or more of the correct value or adjusted basis. The amount of the penalty that may be imposed increases from 10 to 20 to 30 percent of the underpayment attributable to the valuation overstatement as the percentage by which the valuation claimed exceeds the correct valuation increases. Similar penalties may be imposed with respect to (1) an underpayment of income tax that is attributable to an overstatement of pension liabilities and (2) an underpayment of estate or gift tax that is attributable to a valuation understatement.

Explanation of Proposal

Overview

The proposal would consolidate into one part of the Internal Revenue Code all of the generally applicable penalties relating to the accuracy of tax returns. The penalties that would be consolidated are the negligence penalty, the substantial understatement penalty, and the valuation penalties. These consolidated penalties would also be coordinated with the fraud penalty. The proposal would repeal the present-law versions of these penalties. The proposal would reorganize the accuracy penalties into a new structure that operates to eliminate any stacking of the penalties. The proposal would be effective for returns the due date for which is after December 31, 1989.

Accuracy-related penalty

The accuracy-related penalty, which would be imposed at a rate of 20 percent, would apply to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation overstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement.

(1) Negligence

If an underpayment of tax is attributable to negligence, the negligence penalty would apply only to the portion of the underpayment that is attributable to negligence rather than, as under present law, to the entire underpayment of tax. This is a significant change from present law. Under present law, if any portion of an underpayment is attributable to negligence, the negligence penalty applies to the entire accu [illegible] is to be doubled (to 40 percent) in the case of g[illegible]n misstatements. There would be three types of g[illegible]n misstatements. The first would be the same [illegible]antial valuation overstatement component of the [illegible]ted penalty, except that the doubling would appl[illegible]uation overstatements claimed on a return that [illegible]ent or more of the amount determined to be the [illegible]t. The second would be the same as the subs[illegible]tatement of pension liabilities component of the [illegible]ated penalty, except that the doubling would appl[illegible]rstatements of pension liabilities that are 400 [illegible]re of the amount determined to be the corre[illegible] The third would be the same as the subst[illegible]e or gift tax valuation underst[illegible] compo[illegible] accuracy-related penalty, exce[illegible]he doubl[illegible]ply only to valuations claim[illegible] the estate or gi[illegible]n that are 25 pe[illegible] or less of the amount deter[illegible] the correct amou[illegible].

Frau[illegible]ena[illegible]

[illegible]e f[illegible]enalty, which would be imposed at a rate of 75 pe[illegible]ent [illegible] apply to the portion of any underpayment that [illegible] attr[illegible]ble to fraud.

[illegible]nder th[illegible], the accuracy-related penalty would not apply to [illegible]on of an underpayment on which the fraud penalty [illegible] imposed. (Under present law, the fraud penalty is coordinated in this manner with the negligence penalty, but not with the other components of the accuracy-related penalty.) However, the accuracy-related penal[illegible] may [illegible] applied to any portion of the underpayment that [illegible] not a[illegible]utable to fraud.

Defini[illegible]ions [illegible]ial rules

[illegible]e p[illegible] would provide special rules that apply to each [illegible] the [illegible]ies imposed under the new structure. First [illegible]he [illegible]l would provide standardized exception criter[illegible] f[illegible] these accuracy-related penalties. No penal[illegible] [illegible]mposed if it is shown that there was reas[illegible]e [illegible]or an underpayment and the taxpayer acted in g[illegible] [illegible]is standardized exception criterion is desig[illegible] the courts to review the assertion of penal[illegible]e same standards that apply in reviewing addit[illegible]t the Internal Revenue Service asserts is due.

[illegible]roposal would provide that an accur[illegible] fraud penalty is to be imposed only if a retur[illegible]led. This is intended to improve the coord[illegible]n the accuracy-related penalties and the fail[illegible]alties.

Third, the proposal would provide a standard definition of underpayment for all of the accuracy-related penalties.

Repeal of present-law penalties

The proposal would repeal the present-law penalties for negligence and fraud, substantial understatements of liability, valuation overstatements, and valuation understatements for purposes of estate or gift taxes. The proposal would also repeal the special negligence rules applicable to straddles and to amounts shown on information returns. Finally, the proposal would repeal the higher interest rate that applies to substantial underpayments that are attributable to tax-motivated transactions.

Effective Date

The accuracy provisions of the proposal would generally apply to returns the due date for which (determined without regard to extensions) is after December 31, 1989.

c. Preparer, promoter, and protester penalties

Present Law

Return preparer penalties

An income tax return preparer is subject to a penalty of $25 for each failure to (1) furnish a copy of a return or claim for refund to the taxpayer; (2) sign the return or claim for refund; or (3) furnish his or her identifying number.

Penalty for promoting abusive tax shelters

Any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, is subject to a penalty if in connection with such activity the person makes or furnishes a false or fraudulent statement or a gross valuation overstatement. The amount of the penalty equals the greater of $1,000 or 20 percent of the gross income derived or to be derived by the person from the activity. It is unclear under present law whether the term "activity" refers to each sale of an interest in a tax shelter or whether it refers to the overall activity of promoting an abusive tax shelter.

Penalty for aiding and abetting the understatement of tax liability

Any person who aids, assists in, procures, or advises with respect to the preparation or presentation of any portion of a return or other document under the tax laws which (1) the person knows will be used in connection with any material matter arising under the tax laws, and (2) the person knows will (if so used) result in an understatement of the tax liability of another person is subject to a penalty equal to $1,000 for each return or other document ($10,000 in the case of returns and documents relating to the tax of a corporation).

Frivolous income tax return penalty

Any individual who files a frivolous income tax return is subject to a penalty of $500.

Sanctions and costs awarded by courts

If it appears to the Tax Court that (1) proceedings before it have been instituted or maintained primarily for delay, (2) the taxpayer's position is frivolous, or (3) the taxpayer has unreasonably failed to pursue administrative remedies, the Court may award damages not to exceed $5,000 to the United States.

Authority to counterclaim for balance of penalty in partial refund suits

Taxpayers may pay a portion of the penalties for failure to collect and pay over tax, for understatement of a taxpayer's liability by an income tax return preparer, for promoting abusive tax shelters, and for aiding and abetting the understatement of tax liability. By doing so, they may obtain judicial review of the imposition of these penalties. Present law may prohibit the Federal Government from counterclaiming for the balance of the penalty in the same lawsuit.

Bonding requirement

Return preparers may post a bond, thereby preventing any proceeding by the Federal Government under section 7407 seeking to enjoin a return preparer from engaging in prohibited conduct.

Disclosure of certain information [illegible] return preparers

In general, return preparers are subject to penalty for disclosing tax return information that is furnished to the return preparer in connection with the preparation of tax returns. The IRS may by regulation provide exceptions to this general prohibition.

Explanation of Proposal

Return preparer penalties

The return preparer penalties that apply to each failure to (1) furnish a copy of a return or claim for refund to the taxpayer, (2) sign the return or claim for refund, (3) furnish his or her identifying number, and (4) file a correct information return, would be made uniform. The penalty would be $50 for each failure; the total penalties imposed for any single type of failure for any calendar year would be limited to $25,000.

Penalty for promoting abusive tax shelters

Under the proposal, the amount of the penalty imposed for promoting abusive tax shelters would equal $1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). In calculating the amount of the penalty, the organizing of an entity, plan or arrangement and the sale of each interest in an entity, plan, or arrangement would constitute separate activities. These modifications would be made because the courts have differed in their interpretations of the provisions of present law. The proposal would also provide a six-year statute of limitations for this penalty.

The proposal also would clarify that, under present law, "investment plan or arrangement" and "other plan or arrangement," as those terms are used in section 6700 of the Code, include obligations issued by or on behalf of State or local governments which are represented to be described in section 103(a) of the Code ("bonds").

Penalty for aiding and abetting the understatement of tax liability

The proposal would amend the penalty for aiding and abetting the understatement of tax liability by imposing the penalty in cases where the person aids, assists in, procures, or advises with respect to the preparation or presentation of any portion of a return or other document if (1) the person knows or has reason to believe that the return or other document will be used in connection with any material matter arising under the tax laws, and (2) the person knows that if the portion of the return or other document were so used, an understatement of the tax liability of another person would result. In addition, the proposal would provide that a penalty for promoting abusive tax shelters is not to be imposed on any person with respect to any document if an aiding and abetting penalty is imposed on such person with respect to the same document. The proposal would also provide a six-year statute of limitations for this penalty.

Frivolous income tax return penalty

The proposal would delete the special provision in present law permitting taxpayers who contest the imposition of this penalty to pay 15 percent of the penalty, which halts further collection proceedings until final judicial resolution of the dispute. Thus, taxpayers who wish to contest imposition of this penalty would be required to pay the full penalty before seeking judicial review of imposition of the penalty. Repealing this special 15-percent rule would place taxpayers who contest this penalty by way of a refund action in the same position as taxpayers who contest the assertion that they owe additional tax to the IRS.

Sanctions and costs awarded by courts

The proposal would authorize the Tax Court to impose a penalty not to exceed $25,000 if a taxpayer (1) institutes or maintains a proceeding primarily for delay, (2) takes a position that is frivolous, or (3) unreasonably fails to pursue available administrative remedies.

The proposal would also authorize the Tax Court to require any attorney or other person permitted to practice before the Court to pay excess costs, expenses, and attorney's fees that are incurred because the attorney or other person unreasonably and vexatiously multiplied any proceeding before the Court. If the attorney is appearing on behalf of the Commissioner of Internal Revenue, the United States would pay these costs in the same manner as an award of these costs by a district court.

Authority to counterclaim for balance of penalty in partial refund suits

The proposal would clarify that, where taxpayers utilize the provisions of present law (other than with respect to frivolous income tax returns) that permit partial (rather than full) payment of certain penalties to obtain judicial review of the imposition of these penalties, the United States may counterclaim as part of the same lawsuit for the remainder of the penalty. Present law may prohibit a counterclaim of this nature; thus, an additional lawsuit must be brought even if the taxpayer loses the case brought after partial payment of the tax.

Repeal of bonding requirement

The proposal would repeal the provision permitting return preparers to post a bond and thereby prevent any proceeding by the Federal Government under section 7407 seeking to enjoin a return preparer from engaging in prohibited conduct.

Disclosure of certain information by return preparers

The proposal would provide that the IRS regulations relating to the use of tax information by return preparers are to provide that a return preparer may disclose tax information to another return preparer solely for purposes of quality or peer reviews. This would enable a return preparer to obtain the benefits of having another return preparer review the first preparer's work.

Effective Dates

The modifications to the return preparer penalties would apply to documents prepared after December 31, 1989. The modifications to the penalty for promoting abusive tax shelters and the aiding and abetting penalty would apply to activities after December 31, 1989. The modification to the frivolous income tax return penalty would apply to returns filed after December 31, 1989. The modifications to the court-awarded sanctions would apply to proceedings pending on, or commenced after, December 31, 1989. The provision relating to counterclaims would be effective on the date of enactment. The provision repealing the bonding requirement for return preparers would be effective for actions or proceedings commenced after December 31, 1989. The provision relating to disclosures by return preparers would be effective on the date of enactment.

d. Delinquency penalties

Present Law

Failure to file

A taxpayer who fails to file a tax return on a timely basis is subject to a penalty equal to 5 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of 5 months or 25 percent. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.

Failure to make timely deposits of tax

If any person who is required to deposit taxes imposed by the Internal Revenue Code with a government depositary fails to deposit such taxes on or before the prescribed date, a penalty may be imposed equal to 10 percent of the amount of the underpayment, unless it is shown that such failure is due to reasonable cause and not willful neglect. The amount of the underpayment for this purpose is the excess of the amount of the tax required to be deposited over the amount of the tax, if any, deposited on or before the prescribed date.

Failure to withhold on income of foreign persons

As described above, persons having control, receipt, custody, disposal, or payment of certain types of U.S. income of foreign persons are required to deduct and withhold U.S. tax from such income under chapter 3 of the Code's income tax provisions (secs. 1441-1464). The amount withheld is credited against the U.S. tax liability of the foreign income recipient.

Where a tax on the U.S. income of a foreign recipient was required to be withheld but the withholding agent failed to do so, and instead the tax is paid by the income recipient, a penalty may be imposed on the recipient or the withholding agent for failure to pay the tax only if the failure was fraudulent and for the purpose of evading payment (sec. 1463). By contrast, where a U.S. employer fails to withhold income tax from an employee's wages but the employee pays the tax due, the employer remains liable for any penalties and additions to tax otherwise applicable (sec. 3402(d)).

Explanation of Proposal

Failure to file

The proposal would modify present law by providing that the fraud and negligence penalties are not to apply in the case of a negligent or fraudulent failure to file a return. Rather, in the case of a fraudulent failure to file a return, the failure to file penalty would be increased to 15 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of 5 months or 75 percent. This modification would improve the coordination of the failure to file penalty with the accuracy-related penalties.

Failure to make timely deposits of tax

The proposal would also modify the penalty for the failure to make timely deposits of tax in order to encourage depositors to correct their failures. The proposal would establish a four-tiered penalty structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure. A depositor would be subject to a penalty equal to 2 percent of the amount of the underpayment if the failure is corrected on or before the date that is 5 days after the prescribed due date. A depositor would be subject to a penalty equal to 5 percent of the amount of the underpayment if the failure is corrected after the date that is 5 days after the prescribed due date but on or before the date that is 15 days after the prescribed due date. A depositor would be subject to a penalty equal to 10 percent of the amount of the underpayment if the failure is corrected after the date that is 15 days after the due date but on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). Finally, a depositor would be subject to a penalty equal to 15 percent of the amount of the underpayment if the failure is not corrected on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). This would mean that, on average, a taxpayer will generally have approximately 40 days from the due date of the quarterly return that reconciles liability with amounts deposited to make up any shortfall in deposits before the rate of the penalty increases from 10 to 15 percent. This time period could be significantly shorter in cases of jeopardy. In cases of jeopardy, the 15-percent rate would apply if the taxes are not deposited on or before the date on which notice and demand for immediate payment is given under section 6861, section 6862, or the last sentence of section 6331(a). This penalty structure is designed to give the taxpayer an incentive to correct any underpayments before the IRS discovers the underpayment and demands payment. As under present law, no penalty is to be imposed if the failure to make a timely deposit is due to reasonable cause and not willful neglect.

Failure to withhold on income of foreign persons

The proposal would provide that in cases where a tax on the U.S. income of a foreign person was required to be withheld under chapter 3 but was not in fact withheld, and the person who would have been entitled to a credit for any withholding tax paid instead satisfies its own proper tax liability, the withholding agent would remain liable for any penalties and additions to tax otherwise applicable for failure to withhold. Thus, these withholding agents would be subject to the same general approach applicable to U.S. employers who withhold income taxes from employees' wages.

Effective Dates

The modification to the failure to file penalty would apply to returns the due date for which (determined without regard to extensions) is after December 31, 1989. The modification to the penalty for the failure to make timely deposits of tax would apply to deposits that are required to be made after December 31, 1989. The modification to the rules on liabilities of withholding agents would apply to failures to deduct and withhold taxes after December 31, 1989.

28. IRS notice to taxpayers of underreporting of amounts withheld

Present Law

Under procedures in effect for taxable years beginning before 1987, the Internal Revenue Service did not notify taxpayers or make adjustments on income tax returns when it was determined that the amount reported as withheld on an income tax return was less than the amount reported on an information return. On March 22, 1989, the Internal Revenue Service announced revisions in its procedures for the 1987 taxable year and thereafter. Under these revised procedures, discrepancies involving amounts reported as withheld on information returns will be adjusted in the same manner as discrepancies in amounts reported as withheld on Forms W-2 or W-2P. Such an adjustment may involve a correction of the return where information has been reported on the wrong part of the return. In other cases, the Internal Revenue Service's procedures require that the IRS contact the taxpayer to inform the taxpayer of the discrepancy.

Explanation of Proposal

If, in connection with one or more information return matching programs, the Internal Revenue Service determines that the amount of tax shown on information returns as withheld for any taxable year exceeds by $5 or more the amount of tax shown on the income tax return as withheld for that taxable year, then the Internal Revenue Service would be required to notify the taxpayer of such excess. (This would be identical to S. 811, introduced by Senator Bentsen.)

In addition, the proposal would provide that a taxpayer may file an amended return until April 15, 1990, for the taxable year ending December 31, 1985, if the amended return relates to an overpayment of tax attributable to the taxpayer's failure to take proper credit for amounts of tax withheld by a payor from any income included in the taxpayer's gross income for that taxable year. (This would be identical to S. 753, introduced by Senator Gore, Senator Pryor, and Senator Harkin.)

Effective Date

The proposal would apply to all information return matching that occurs after the date of enactment.

29. Increase in Joint Committee refund review threshold

Present Law

No refund or credit in excess of $200,000 of any income tax, estate or gift tax, or certain other specified taxes, may be made until 30 days after the date a report on the refund is given to the Joint Committee on Taxation (sec. 6405). A report is also required in the case of certain tentative refunds. Additionally, the Joint Committee staff conducts post-audit reviews of large deficiency cases and other select issues.

Explanation of Proposal

The threshold above which refunds must be submitted to the Joint Committee for review would be increased from $200,000 to $1,000,000. This increase would speed the issuance of refunds between $200,000 and $1,000,000 to the taxpayers involved. In addition, this increase would free up significant resources of both the Internal Revenue Service and the Joint Committee staff, without materially impairing the Joint Committee's ability to monitor problems in the administration of the tax laws.

In addition, the legislative history would state that the Joint Committee staff would be expected to continue to exercise its existing statutory authority to conduct a program of expanded post-audit reviews of large deficiency cases and other select issues. The legislative history would also indicate that the IRS would be expected to fully cooperate in this expanded program.

Effective Date

The proposal would be effective on the date of enactment, except that the higher threshold would not apply to a refund or credit with respect to which a report was made before the date of enactment.