DESCRIPTION OF CHAIRMAN'S MARK OF AN AMENDMENT TO S. 1133 ("PARENT AND STUDENT SAVINGS ACCOUNT PLUS ACT")

Scheduled for Markup

By the

SENATE COMMITTEE ON FINANCE

on February 10, 1998

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

February 6, 1998

JCX-5-98

CONTENTS

INTRODUCTION

The Senate Committee on Finance has scheduled a markup on February 10, 1998, on a proposed Chairman's amendment ("Chairman's mark") to S. 1133 ("Parent and Student Savings Account Plus Act").

S. 1133, which was introduced by Senator Coverdell on July 31, 1997, and was referred to the Senate Committee on Finance, would expand and modify the education IRAs enacted in the Taxpayer Relief Act of 1997 by increasing the annual contribution limit and by including as qualified expenses certain elementary and secondary education expenses.

The Chairman's mark would be an amendment to S. 1133 in the nature of a substitute. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's mark. Part I is a description of the provisions relating to education savings and employer-provided educational assistance, and Part II is a description of the revenue offsets relating to the treatment of the employer deductions for vacation pay and the foreign tax credit carryover rules.

---

[1] This document may be cited as follows: Joint Committee on Taxation, Description of Chairman's Mark of an Amendment to S. 1133 ("Parent and Student Savings Account Plus Act") (JCX-5-98), February 6, 1998.

I. EDUCATION SAVINGS AND EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

Present Law

Education IRAs

In general.--Section 530 provides tax-exempt status to "education IRAs," meaning certain trusts (or custodial accounts) which are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a named beneficiary.[2] Contributions to education IRAs may be made only in cash. Annual contributions to education IRAs may not exceed $500 per designated beneficiary (except in cases involving certain tax-free rollovers, as described below), and may not be made after the designated beneficiary reaches age 18.[3] Moreover, section 4973 imposes a penalty excise tax if a contribution is made by any person to an education IRA established on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified State tuition program (defined under sec. 529) on behalf of the same beneficiary. These provisions were enacted as part of the Taxpayer Relief Act of 1997 ("1997 Act").

Phase-out of contribution limit.--The $500 annual contribution limit for education IRAs is phased out ratably for contributors with modified AGI between $95,000 and $110,000 ($150,000 and $160,000 for joint returns). Individuals with modified AGI above the phase-out range are not allowed to make contributions to an education IRA established on behalf of any other individual.

Treatment of distributions.--Amounts distributed from education IRAs are excludable from gross income to the extent that the amounts distributed do not exceed qualified higher education expenses of the designated beneficiary incurred during the year the distribution is made (provided that a HOPE credit or Lifetime Learning credit is not claimed under sec. 25A

---

[2] Education IRAs generally are not subject to Federal income tax, but are subject to the unrelated business income tax ("UBIT") imposed by section 511.

[3] An excise tax penalty may be imposed under present-law section 4973 to the extent that excess contributions above the $500 annual limit are made to an education IRA. However, Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997, clarifies that neither the excise tax penalty under section 4973 nor the additional 10-percent tax under section 530(d)(4) (described infra) may be imposed in cases where contributions (and any earnings thereon) are distributed from the education IRA before the date that a return is required to be filed (including extensions of time) by the beneficiary for the year in which the contribution was made (or, if the beneficiary is not required to file such a return, April 15th of the year following the taxable year during which the contribution was made).

with respect to the beneficiary for the same taxable year).[4] If a HOPE credit or Lifetime Learning credit is claimed with respect to a student for a taxable year, then a distribution from an education IRA may (at the option of the taxpayer) be made during that taxable year on behalf of that student, but an exclusion is not available under the Act for the earnings portion of such distribution.[5]

Distributions from an education IRA generally are deemed to consist of distributions of principal (which, under all circumstances, are excludable from gross income) and earnings (which may be excludable from gross income) by applying the ratio that the aggregate amount of contributions to the account for the beneficiary bears to the total balance of the account.[6] If the qualified higher education expenses of the student for the year are at least equal to the total amount of the distribution (i.e., principal and earnings combined) from an education IRA, then the earnings in their entirety will be excludable from gross income. If, on the other hand, the qualified higher education expenses of the student for the year are less than the total amount of the distribution (i.e., principal and earnings combined) from an education IRA, then the qualified higher education expenses will be deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. Thus, in such a case, only a portion of the earnings will be excludable under section 530 (i.e., a portion of the earnings based on the ratio that the qualified higher education expenses bear to the total amount of the distribution) and the

---

[4] The exclusion will not be a preference item for alternative minimum tax (AMT) purposes.

[5] If a HOPE credit or Lifetime Learning credit was claimed with respect to a student for an earlier taxable year, the exclusion provided for by section 530 may be claimed with respect to the same student for a subsequent taxable year with respect to a distribution from an education IRA made in that subsequent taxable in order to cover qualified higher education expenses incurred during that year. Conversely, if an exclusion is claimed for a distribution from an education IRA with respect to a particular student, then a HOPE credit or Lifetime Learning credit will be available in a subsequent taxable year with respect to that same student (provided that no exclusion is claimed in such other taxable years for distributions from an education IRA on behalf of that student and provided that the requirements of the HOPE credit or Lifetime Learning credit are satisfied in the subsequent taxable year).

[6] Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997, clarifies that, under rules contained in present-law section 72, distributions from education IRAs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account, and also makes certain conforming changes to section 72. In particular, the Tax Technical Corrections Act of 1997 provides that, under section 72(e)(8)(B), the determination of the ratio that the aggregate amount of contributions to an education IRA bears to the account balance is to be made at the time of the distribution or at such other time as the Secretary of the Treasury may prescribe.

remaining portion of the earnings will be includible in the distributee's gross income.[7] To the extent that a distribution exceeds qualified higher education expenses of the designated beneficiary, an additional 10-percent tax is imposed on the earnings portion of such excess distribution under section 530(d)(4), unless such distribution is made on account of the death or disability of, or scholarship received by, the designated beneficiary.[8]

Section 530(d) allows tax-free (and penalty-free) transfers or rollovers of account balances from one education IRA benefiting one beneficiary to another education IRA benefiting another beneficiary (as well as redesignations of the named beneficiary), provided that the new beneficiary is a member of the family of the old beneficiary.[9]

The legislative history to the 1997 Act indicates that any balance remaining in an education IRA will be deemed to be distributed within 30 days after the date that the named

---

[7] For example, if an education IRA has a total balance of $10,000, of which $4,000 represents principal (i.e., contributions) and $6,000 represents earnings, and if a distribution of $2,000 is made from such an account, then $800 of that distribution will be treated as a return of principal (which under no event is includible in the gross income of the distributee) and $1,200 of the distribution will be treated as accumulated earnings. In such a case, if qualified higher education expenses of the beneficiary during the year of the distribution are at least equal to the $2,000 total amount of the distribution (i.e., principal plus earnings), then the entire earnings portion of the distribution will be excludible under section 530, provided that a Hope credit or Lifetime Learning credit is not claimed for that same taxable year on behalf of the beneficiary. If, however, the qualified higher education expenses of the beneficiary for the taxable year are less than the total amount of the distribution, then only a portion of the earnings will be excludable from gross income under section 530. Thus, in the example discussed above, if the beneficiary incurs only $1,500 of qualified higher education expenses in the year that a $2,000 distribution is made, then only $900 of the earnings will be excludable from gross income under section 530 (i.e., an exclusion will be provided for the pro-rata portion of the earnings, based on the ratio that the $1,500 of qualified higher education expenses bears to the $2,000 distribution) and the remaining $300 of the earnings portion of the distribution will be includible in the distributee's gross income.

[8] A technical correction is needed to section 530(d)(4) to clarify that the 10-percent additional tax should not be imposed in cases where a distribution (although used to pay for qualified higher education expenses) is includible in gross income because the taxpayer elects the HOPE or Lifetime Learning credit on behalf of the student for the same taxable year.

[9] For this purpose, a "member of the family" means persons described in paragraphs (1) through (8) of section 152(a)--e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws, etc.--and any spouse of such persons.

beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies).[10]

Qualified higher education expenses.--The term "qualified higher education expenses" includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis. Moreover, the term "qualified higher education expenses include room and board expenses (meaning the minimum room and board allowance applicable to the student as determined by the institution in calculating costs of attendance for Federal financial aid programs under sec. 472 of the Higher Education Act of 1965) for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, section 530(b)(2)(B) specifically provides that qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified State tuition program, as defined in section 529, for the benefit of the beneficiary of the education IRA.

Qualified higher education expenses generally include only out-of-pocket expenses. Such qualified higher education expenses do not include expenses covered by educational assistance for the benefit of the beneficiary that is excludable from gross income. Thus, total qualified higher education expenses are reduced by scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under section 127. In addition, qualified higher education expenses do not include expenses paid with amounts that are excludible under section 135. No reduction of qualified higher education expenses is required, however, for a gift, bequest, devise, or inheritance within the meaning of section 102(a). Qualified higher education expenses do not include any education expense for which a deduction is claimed under section 162 or any other section of the Code.

Eligible educational institution.--Eligible educational institutions are defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

---

[10] A technical correction providing that any balance remaining in an education IRA will be deemed distributed within 30 days after the date that the designated beneficiary reaches age 30 is included in Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

Qualified State tuition programs

Section 529 provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. The term "qualified higher education expenses" has the same meaning as does the term for purposes of education IRAs (as described above) and, thus, includes expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution[11], as well as room and board expenses (meaning the minimum room and board allowance applicable to the student as determined by the institution in calculating costs of attendance for Federal financial aid programs under sec. 472 of the Higher Education Act of 1965) for any period during which the student is at least a half-time student.

Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor or another distributee (e.g., when a parent receives a refund) will be included in the contributor's/distributee's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary.[12]

A qualified State tuition program is required to provide that purchases or contributions only be made in cash.[13] Contributors and beneficiaries are not allowed to directly or indirectly

---

[11] "Eligible educational institutions" are defined the same for purposes of education IRAs (described above) and qualified State tuition programs.

[12] Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997, clarifies that, under rules contained in present-law section 72, distributions from qualified State tuition programs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account, and also makes certain conforming changes to section 72. In particular, the Tax Technical Corrections Act of 1997 provides that, under section 72(e)(8)(B), the determination of the ratio that the aggregate amount of contributions to a qualified State tuition program on behalf of a beneficiary bears to the total balance (or value) of the account for the beneficiary is to be made at the time of the distribution or at such other time as the Secretary of the Treasury may prescribe.

[13] Sections 529(c)(2), (c)(4), and (c)(5), and section 530(d)(3) provide special estate and gift tax rules for contributions made to, and distributions made from, qualified State tuition

direct any investments made on their behalf by the program. The program is required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified State tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a State or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships. A transfer of credits (or other amounts) from one account benefiting one designated beneficiary to another account benefiting a different beneficiary will be considered a distribution (as will a change in the designated beneficiary of an interest in a qualified State tuition program), unless the beneficiaries are members of the same family.[14] Earnings on an account may be refunded to a contributor or beneficiary, but the State or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, or (3) made on account of a scholarship received by the designated beneficiary to the extent the amount refunded does not exceed the amount of the scholarship used for higher education expenses.

No amount is includible in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any contribution to or earnings on such a program until a distribution is made from the program, at which time the earnings portion of the distribution (whether made in cash or in-kind) will be includible in the gross income of the distributee. However, to the extent that a distribution from a qualified State tuition program is used to pay for qualified tuition and related expenses (as defined in sec. 25A(f))(1)), the distributee (or another taxpayer claiming the distributee as a dependent) will be able to claim the HOPE credit or Lifetime Learning credit under section 25A with respect to such tuition and related expenses (assuming that the other requirements for claiming the HOPE credit or Lifetime Learning credit are satisfied and the modified AGI phaseout for those credits does not apply).

<u>Employer-provided educational assistance</u>

Under present-law section 127, an employee's gross income and wages do not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts are paid or incurred pursuant to an educational assistance program that meets certain requirements. This exclusion is limited to $5,250 of educational assistance with respect to an individual during a calendar year. The exclusion does not apply with respect to graduate level courses. The exclusion is scheduled to expire with respect to courses beginning after May

---

programs and education IRAs.

[14] For this purpose, the term "member of the family" means persons described in paragraphs (1) through (8) of section 152(a)--e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws, etc--and any spouse of such persons.

31, 2000.

In the absence of the exclusion provided for by section 127, educational assistance is excludable from income only if the education is related to the employee's current job, meaning that the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (but not if the education relates to certain minimum educational requirements or enables a taxpayer to begin working in a new trade or business).

Description of Chairman's Mark

Education IRAs

Annual contribution limit.--For the period 1999 through 2002, the proposal would increase to $2,000 the annual contribution limit that currently applies to education IRAs under section 530(b)(1)(A)(iii). Thus, under the proposal, aggregate contributions that could be made by all contributors to one (or more) education IRAs established on behalf of any particular beneficiary would be limited to $2,000 for each year during the period 1999 through 2002. For 2003 and later years, the annual contribution limit for education IRAs will be $500.

Qualified expenses.--With respect to contributions made during the period 1999 through 2002 (and earnings attributable to such contributions), the proposal would expand the definition of qualified education expenses that may be paid with tax-free distributions from an education IRA. Specifically, the definition of qualified education expenses would be expanded to include "qualified elementary and secondary education expenses" meaning (1) tuition, fees, tutoring, books, supplies, equipment (including computers and related software and services), and special needs services in connection with the enrollment or attendance of the designated beneficiary of the trust at a public, private, or religious school providing elementary or secondary education (through grade 12), and (2) transportation and supplementary expenses (such as the cost of uniforms) required or provided by such a school for the enrollment or attendance of the designated beneficiary. "Qualified elementary and secondary education expenses" also include homeschooling education expenses if the requirements of any applicable State or local law are met with respect to such homeschooling. For contributions made in 2003 or later years (and for earnings attributable to such contributions), the definition of qualified education expenses will be limited to post-secondary education expenses.

With respect to post-secondary education, qualified education expenses would include (1) tuition, fees, tutoring, books, supplies, equipment and special needs services in connection with the enrollment or attendance of the designated beneficiary at an eligible post-secondary educational institution, and (2) room and board expenses (meaning the minimum room and board allowance applicable to the student as determined by the institution calculating costs of attendance for Federal financial aid programs) for any period during which the student is at least a half-time student.

Special needs beneficiaries.--The proposal also would provide that, although contributions to an education IRA generally may not be made after the designated beneficiary reaches age 18, contributions may continue to be made to an education IRA in the case of a special needs beneficiary (as defined by Treasury Department regulations). In addition, under the proposal, in the case of a special needs beneficiary, a deemed distribution of any balance in an education IRA will not be required when the beneficiary reaches age 30.

Contributions by persons other than individuals.--The proposal would clarify that corporations and other entities (e.g., tax-exempt entities) are permitted to make contributions to education IRAs, regardless of the income of the corporation or entity during the year of the contribution. As under present law, the eligibility of high-income individuals to make contributions to education IRAs is phased out ratably for individuals with modified AGI between $95,000 and $110,000 ($150,000 and $160,000 for joint returns).

Technical corrections.--The proposal would provide for several technical corrections to section 530 (as enacted as part of the Taxpayer Relief Act of 1997), including: (1) adding a provision that any balance remaining in an education IRA would be deemed to be distributed within 30 days after the date that the named beneficiary reaches age 30; (2) clarifying that, under rules contained in present-law section 72, distributions from education IRAs are treated as representing a pro-rata share of the principal and accumulated earnings in the account; and (3) clarifying that, under section 530(d)(4), the 10-percent additional tax should not be imposed in cases where a distribution (although used to pay for qualified higher education expenses) is includible in gross income because the taxpayer elects the HOPE or Lifetime Learning credit on behalf of the student for the same taxable year.

Qualified State tuition programs

Under the proposal, an exclusion from gross income would be provided for distributions from qualified State tuition programs (as defined in sec. 529) to the extent that the distribution is used to pay for (1) tuition, fees, tutoring, books, supplies, equipment (including computers and related software and services), and special needs services in connection with the enrollment or attendance of a designated beneficiary at an eligible post-secondary educational institution (i.e., colleges, universities, and certain vocational schools), and (2) room and board expenses (meaning the minimum room and board allowance applicable to the student as determined by the institution calculating costs of attendance for Federal financial aid programs) for any period during which the student is at least a half-time student. As under present law, there would be no specific dollar limitation imposed under the Internal Revenue Code on contributions made to qualified State tuition programs, although section 529(b)(7) would continue to require that the programs themselves provide adequate safeguards to prevent contributions on behalf of a beneficiary in excess of those necessary to provide for qualified higher education expenses of the beneficiary.

As with the present-law exclusion from gross income for distributions from education IRAs, the tax-free treatment for a distribution from a qualified State tuition program would be allowed only if, for the taxable year during which the distribution is made, a HOPE or Lifetime Learning credit (under sec. 25A) is not claimed on behalf of the student. As under present law, if a student is claimed as a dependent by his or her parent, then the parent (if eligible) must decide whether to elect to claim a HOPE or Lifetime Learning credit with respect to that student for that taxable year; and, if the parent elects to claim a HOPE or Lifetime Learning credit, then the earnings portion of a distribution made to a student from a qualified State tuition program would be includible in the gross income of the student.

Employer-provided educational assistance

The proposal would expand the exclusion provided by section 127 for employer-provided educational benefits so that the exclusion is available for graduate-level courses. The exclusion provided for by section 127 would be scheduled to expire such that the exclusion would not be available for courses beginning after December 31, 2002.

Effective date

The proposals modifying education IRAs under section 530 generally would be effective for taxable years beginning after December 31, 1998. However, the proposed increase in the annual contribution limit for education IRAs would apply during the period January 1, 1999, through December 31, 2002, and the proposed expansion of qualified education expenses to include qualified elementary and secondary education expenses would apply for contributions (and earnings thereon) made during the period January 1, 1999, through December 31, 2002. The expansion of qualified State tuition programs would be effective for distributions made in taxable years beginning after December 31, 1998. The expansion of section 127 to graduate-level courses would be effective for expenses paid with respect to courses beginning during the period January 1, 1998, through December 31, 2002. The exclusion provided under section 127 for undergraduate courses would be extended for courses beginning on or before December 31, 2002.

II. REVENUE OFFSETS

1. Employer deductions for vacation pay

Present Law

For deduction purposes, any method or arrangement that has the effect of a plan deferring the receipt of compensation or other benefits for employees is treated as a deferred compensation plan (sec. 404(b)). In general, contributions under a deferred compensation plan (other than certain pension, profit-sharing and similar plans) are deductible in the taxable year in which an amount attributable to the contribution is includible in income. However, vacation pay which is treated as deferred compensation is deductible for the taxable year of the employer in which the vacation pay is paid to the employee (sec. 404(a)(5)).

Temporary Treasury regulations provide that a plan, method, or arrangement defers the receipt of compensation or benefits to the extent it is one under which an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. A plan, method or arrangement is presumed to defer the receipt of compensation for more than a brief period of time after the end of an employer's taxable year to the extent that compensation is received after the 15th day of the 3rd calendar month after the end of the employer's taxable year in which the related services are rendered (the "2-1/2 month" period). A plan, method or arrangement is not considered to defer the receipt of compensation or benefits for more than a brief period of time after the end of the employer's taxable year to the extent that compensation or benefits are received by the employee on or before the end of the applicable 2-1/2 month period. (Temp. Treas. Reg. Sec. 1.404(b)-1T A-2.)

The Tax Court recently addressed the issue of when vacation pay and severance pay are considered deferred compensation in Schmidt Baking Co., Inc., 107 T.C. 271 (1996). In Schmidt Baking, the taxpayer was an accrual basis taxpayer with a fiscal year that ended December 28, 1991. The taxpayer funded its accrued vacation and severance pay liabilities for 1991 by purchasing an irrevocable letter of credit on March 13, 1992. The parties stipulated that the letter of credit represented a transfer of substantially vested interest in property to employees for purposes of section 83, and that the fair market value of such interest was includible in the employees' gross incomes for 1992 as a result of the transfer.[15] The Tax Court held that the purchase of the letter of credit, and the resulting income inclusion, constituted payment of the vacation and severance pay within the 2-1/2 month period. Thus, the vacation and severance pay were treated as received by the employees within the 2-1/2-month period and were not treated as deferred compensation. The vacation pay and severance pay were deductible by the taxpayer for its 1991 fiscal year pursuant to its normal accrual method of accounting.

---

[15] While the rules of section 83 may govern the income inclusion, section 404 governs the deduction if the amount involved is deferred compensation.

Description of Chairman's Mark

The proposal specifically overrules the result in Schmidt Baking and provides that, except with respect to severance pay,[16] the Internal Revenue Code will be applied without regard to the result reached in that case. Thus, under the proposal, the fact that an item is includible in income is not taken into account in determining whether or not payment has been made. For example, with respect to the determination of wether an item of compensation is deferred compensation, the fact that the item is includible in the income of employees within the applicable 2-1/2 month period is not taken into account in determining whether there has been payment or receipt by the employees. Rather, the item must have been actually paid or received within the 2-1/2 period in order for the compensation not to be treated as deferred compensation.

While Schmidt Baking involved only vacation and severance pay, there is concern that this type of arrangement could be used to circumvent other provisions of the Code where payment is required in order for a deduction to occur. Thus, the proposal is intended to apply to vacation pay and other forms of compensation, except for severance pay. The proposal is not limited to the determination of whether compensation is deferred compensation.

It is intended that similar arrangements, in addition to the letter of credit approach used in Schmidt Baking, will not constitute payment, even if there is an income inclusion. Thus, for example, payment does not include the furnishing of a note or letter or other evidence of indebtedness of the taxpayer, whether or not the evidence is guaranteed by any other instrument or by any third party. As a further example, payment does not include a promise of the taxpayer to provide service or property in the future (whether or not the promise is evidenced by a contract or other written agreement). In addition, payment does not include an amount transferred as a loan, refundable deposit, or contingent payment.

The proposal does not affect the determination of whether an item is includible in income. Thus, for example, using the mechanism in Schmidt Baking for vacation or severance pay still results in income inclusion to the employees, but the employer is not entitled to a deduction for the vacation until actually paid to and received by the employees.

Similarly, the proposal does not affect situations in which payment is not required in order for a deduction to occur. Thus, the proposal does not change the general rule that deferred compensation (other than deferred compensation provided through certain types of plans), other than vacation pay, is deductible in the taxable year in which it is includible in the gross income of employees participating in the plan.

---

[16] A provision that overrules *Schmidt Baking* with respect to severance pay is included in H.R. 2644, the "United States - Caribbean Trade Partnership Act," as reported by the Committee on Ways and Means on October 9, 1997.

The proposal is effective for taxable years ending after the date of enactment. Any change in method of accounting required by the provision is treated as initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment required by section 481 as a result of the change is taken into account in the year of the change.

2. Modify foreign tax credit carryover rules

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. Separate foreign tax credit limitations are applied to specific categories of income.

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and forward five years. The amount carried over may be used as a credit in a carryover year to the extent the taxpayer otherwise has excess foreign tax credit limitation for such year. The separate foreign tax credit limitations apply for purposes of the carryover rules.

Description of Chairman's Mark

The proposal would reduce the carryback period for excess foreign tax credits from two years to one year. The proposal also would extend the excess foreign tax credit carryforward period from five years to seven years.