DESCRIPTION OF SENATE FINANCE COMMITTEE CHAIRMAN'S MARK OF TAX TECHNICAL CORRECTIONS PROVISIONS

Scheduled for Markup

By the

SENATE COMMITTEE ON FINANCE

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Prepared by the Staff

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup of technical corrections provisions on March 31, 1998. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's mark for various technical corrections to previously enacted tax legislation, primarily the Taxpayer Relief Act of 1997 ("1997 Act"). As noted in the descriptions, these technical corrections generally are proposed to be effective as if included in the original provisions to which they relate. Proposed technical corrections that are clerical in nature generally are not described in this document.

Part I of the document is a description of technical corrections to the Taxpayer Relief Act of 1997, and Part II is a description of other technical correction provisions. Part III is a brief description of the differences between the proposed technical corrections in the Chairman's mark and those included in Title VI of H.R. 2676 ("Tax Technical Corrections Act of 1997") as passed by the House on November 5, 1997.[2]

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Senate Finance Committee Chairman's Mark of Tax Technical Corrections Provisions* (JCX-18-98), March 26, 1998.

[2] The "Tax Technical Corrections Act of 1997" was reported by the House Committee on Ways and Means in H.R. 2645 (H. Rept. 105-356, October 29, 1997), and the provisions were added to H.R. 2676 (Title VI) by a House amendment.

I. DESCRIPTION OF TECHNICAL CORRECTIONS TO THE TAXPAYER RELIEF ACT OF 1997

A. Amendments to Title I of the 1997 Act Relating to the Child Credit

1. Stacking rules for the child credit under the limitations based on tax liability (sec. 101 of the 1997 Act and sec. 24 of the Code)

Present Law

Present law provides a $500 ($400 for taxable year 1998) tax credit for each qualifying child under the age of 17. A qualifying child is defined as an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or a descendent of either), a stepson or stepdaughter of the taxpayer or an eligible foster child of the taxpayer. For taxpayers with modified adjusted gross income in excess of certain thresholds, the allowable child credit is phased out. The length of the phase-out range is affected by the number of the taxpayer's qualifying children.

Generally, the maximum amount of a taxpayer's child credit for each taxable year is limited to the excess of the taxpayer's regular tax liability over the taxpayer's tentative minimum tax liability (determined without regard to the alternative minimum foreign tax credit). In the case of a taxpayer with three or more qualifying children, the maximum amount of the taxpayer's child credit for each taxable year is limited to the greater of: (1) the amount computed under the rule described above, or (2) an amount equal to the excess of the sum of the taxpayer's regular income tax liability and the employee share of FICA taxes (and one-half of the taxpayer's SECA tax liability, if applicable) reduced by the earned income credit. In the case of a taxpayer with three or more qualifying children, the excess of the amount allowed in (2) over the amount computed in (1) is a refundable credit.

Nonrefundable credits may not be used to reduce tax liability below a taxpayer's tentative minimum tax. Certain credits not used as result of this rule may be carried over to other taxable years, while others may not. Special stacking rules apply in determining which nonrefundable credits are used in the current year. Generally, the stacking rules require that nonrefundable personal credits be considered first,[3] followed by other credits, (e.g., the business

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[3] It is understood that there is also a stacking rule under which the income tax liability limitation applies between the nonrefundable personal credits including the nonrefundable portion of the child credit. Generally, the nonrefundable portion of the child credit and the other nonrefundable personal credits which do not provide a carryforward are grouped together and stacked first followed by the nonrefundable personal credits which provide a carryforward for purposes of applying the income tax liability limitation. Therefore, if the sum of the taxpayer's nonrefundable credits exceeds the difference between the taxpayer's regular income tax liability and the taxpayer's alternative minimum tax liability (determined without regard to the alternative

credits). Refundable credits, which are not limited by the minimum tax, are not stacked until after the nonrefundable credits.

Description of Proposal

The proposal would clarify the application of the income tax liability limitation to the refundable portion of the child credit by treating the refundable portion of the child credit in the same way as the other refundable credits. Specifically, after all the other credits are applied according to the stacking rules of the income tax limitation then the refundable credits would be applied first to reduce the taxpayer's tax liability for the year and then to provide a credit in excess of income tax liability for the year.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

2. Treatment of a portion of the child credit as a supplemental child credit (sec. 101 of the 1997 Act and sec. 32(m) of the Code)

Present Law

A portion of the child credit may be treated as a supplemental child credit. The amount of the supplemental child credit, if any, equals the excess of (1) $500 times the number of qualifying children up to the excess of the taxpayer's income tax liability (net of applicable credits other than the earned income credit) over the taxpayer's tentative minimum tax (determined without regard to the alternative minimum foreign tax credit) over (2) the sum of the taxpayer's regular income tax liability (net of applicable credits other than the earned income credit) and the employee share of FICA taxes (and one-half of the taxpayer's SECA tax liability, if applicable) reduced by any earned income credit amount. The supplemental child credit is treated as provided under the earned income credit and the child credit amount is reduced by the amount of the supplemental child credit.

Description of Proposal

The proposal would clarify that the treatment of a portion of the child credit as a supplemental child credit under the earned income credit (sec. 32) and the offsetting reduction of the child credit (sec.24) does not effect any other credit available to the taxpayer. It would also clarify that the earned income credit rules (e.g., the phaseout of the earned credit) generally do

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minimum foreign tax credit) then the nonrefundable personal credits which do not provide a carryforward would be applied to reduce the income tax liability for that year first and any excess credits which allow a carryforward would be available to reduce the taxpayer's income tax liability in future years.

not apply to the supplemental child credit.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

B. Amendments to Title II of the 1997 Act Relating to Education Incentives

1. Clarifications to HOPE and Lifetime Learning tax credits (sec. 201 of the 1997 Act and secs. 25A and 6050S of the Code)

Present Law

Individual taxpayers are allowed to claim a nonrefundable HOPE credit against Federal income taxes up to $1,500 per student for qualified tuition and fees paid during the year on behalf of a student (i.e., the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer) who is enrolled in a post-secondary degree or certificate program at an eligible post-secondary institution on at least a half-time basis. The HOPE credit is available only for the first two years of a student's post-secondary education. The credit rate is 100 percent of the first $1,000 of qualified tuition and fees and 50 percent on the next $1,000 of qualified tuition and fees. The HOPE credit amount that a taxpayer may otherwise claim is phased out for taxpayers with modified adjusted gross income (AGI) between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). For taxable years beginning after 2001, the $1,500 maximum HOPE credit amount and the AGI phase-out range will be indexed for inflation. The HOPE credit is available for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date.

If a student is not eligible for the HOPE credit (or in lieu of claiming a HOPE credit with respect to a student), individual taxpayers are allowed to claim a nonrefundable Lifetime Learning credit against Federal income taxes equal to 20 percent of qualified tuition and fees paid during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or a dependent. In contrast to the HOPE credit, the student need not be enrolled on at least a half-time basis in order to be eligible for the Lifetime Learning credit, which is available for an unlimited number of years of post-secondary training. For expenses paid before January 1, 2003, up to $5,000 of qualified tuition and fees per taxpayer return will be eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return will be $1,000). For expenses paid after December 31, 2002, up to $10,000 of qualified tuition and fees per taxpayer return will be eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return will be $2,000). The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased out over the same modified AGI phase-out range as applies for purposes of the HOPE credit. The Lifetime Learning credit is available for expenses paid after June 30, 1998, for education furnished in academic periods beginning after such date.

Section 6050S provides that certain educational institutions and other taxpayers engaged in a trade or business must file information returns with the IRS and certain individual taxpayers, as required by regulations prescribed by the Secretary of the Treasury, containing information on individuals who made payments for qualified tuition and related expenses or to whom reimbursements or refunds were made of such expenses.

Description of Proposal

The proposal would clarify that, under section 6050S, information returns containing information with respect to qualified tuition and fees must be filed by a person that is not an eligible educational institution only if such person is engaged in a trade or business of making payments to any individual under an insurance arrangement as reimbursements or refunds (or similar payments) of qualified tuition and related expenses. As under present law, section 6050S also would require the filing of information returns by persons engaged in a trade or business if, in the course of such trade or business, the person receives from any individual interest aggregating $600 or more for any calendar year on one or more qualified education loans.

Effective Date

The proposal would be effective as if included in the 1997 Act--i.e., for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date.

2. Education IRAs (sec. 213 of the 1997 Act and sec. 530 of the Code)

Present Law

Section 530 provides that taxpayers may establish "education IRAs," meaning certain trusts or custodial accounts created exclusively for the purpose of paying qualified higher education expenses of a named beneficiary. Annual contributions to education IRAs may not exceed $500 per designated beneficiary, and may not be made after the designated beneficiary reaches age 18. Contributions to an education IRA may not be made by certain high-income taxpayers--i.e., the contribution limit is phased out for taxpayers with modified adjusted gross income between $95,000 and $110,000 ($150,000 and $160,000 for taxpayers filing joint returns). No contribution may be made to an education IRA during any year in which any contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary.

Until a distribution is made from an education IRA, earnings on contributions to the account generally are not subject to tax.[4] In addition, distributions from an education IRA are excludable from gross income to the extent that the distribution does not exceed qualified higher education expenses incurred by the beneficiary during the year the distribution is made (provided that a HOPE credit or Lifetime Learning credit is not claimed with respect to the beneficiary for the same taxable year). The earnings portion of an education IRA distribution not used to pay qualified higher education expenses is includible in the gross income of the distributee and

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[4] However, education IRAs are subject to the unrelated business income tax ("UBIT") imposed by section 511.

generally is subject to an additional 10-percent tax.[5] However, the additional 10-percent tax does not apply if a distribution is made of excess contributions above the $500 limit (and any earnings attributable to such excess contributions) if the distribution is made on or before the date that a return is required to be filed (including extensions of time) by the contributor for the year in which the excess contribution was made. In addition, section 530 allows tax-free rollovers of account balances from an education IRA benefiting one family member to an education IRA benefiting another family member. Section 530 is effective for taxable years beginning after December 31, 1997.

Description of Proposal

Consistent with the legislative history to the 1997 Act, the proposal would provide 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 (or, if earlier, within 30 days of the date that the beneficiary dies).

Under the proposal, the additional 10-percent tax provided for by section 530(d)(4) would not apply to a distribution from an education IRA, which (although used to pay for qualified higher education expenses) is includible in the beneficiary's gross income solely because the taxpayer elects to claim a HOPE or Lifetime Learning credit with respect to the beneficiary. The proposal further would provide that the additional 10-percent tax would not apply to the distribution of any contribution to an education IRA made during a taxable year if such distribution is made on or before the date that a return is required to be filed (including extensions of time) by the beneficiary for the taxable year during 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). In addition, the proposal would amend section 4973(e) to provide that the excise tax penalty applies under that section for each year that an excess contribution remains in an education IRA (and not merely the year that the excess contribution is made).

The proposal would clarify that, in order for taxpayers to establish an education IRA, the designated beneficiary must be a life-in-being. The proposal also would clarify 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.[6]

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[5] This 10-percent additional tax does not apply if a distribution from an education IRA is made on account of the death, disability, or scholarship received by the designated beneficiary.

[6] 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

The proposal also would provide that, if any qualified higher education expenses are taken into account in determining the amount of the exclusion under section 530 for a distribution from an education IRA, then no deduction (under section 162 or any other section), or exclusion (under section 135) or credit would be allowed under the Internal Revenue Code with respect to such qualified higher education expenses.

In addition, because the 1997 Act allows taxpayers to redeem U.S. Savings Bonds and be eligible for the exclusion under present-law section 135 (as if the proceeds were used to pay qualified higher education expenses) provided the proceeds from the redemption are contributed to an education IRA (or to a qualified State tuition program defined under section 529) on behalf of the taxpayer, the taxpayer's spouse, or a dependent, the proposal would conform the definition of "eligible educational institution" under section 135 to the broader definition of that term under present-law section 530 (and section 529). Thus, for purposes of section 135, as under present-law sections 529 and 530, the term "eligible educational institution" would be defined as an institution which (1) is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and (2) is eligible to participate in Department of Education student aid programs.

Effective Date

The provisions would be effective as if included in the 1997 Act--i.e., for taxable years beginning after December 31, 1997.

3. Treatment of cancellation of certain student loans (sec. 225 of the 1997 Act and sec. 108(f) of the Code)

Present Law

Under present law, an individual's gross income does not include forgiveness of loans

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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.

made by tax-exempt educational organizations if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance outstanding student loans and the student is not employed by the lender organization. The exclusion applies only if the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers. In addition, the student's work must fulfill a public service requirement.

Description of Proposal

The proposal would clarify that gross income does not include amounts from the forgiveness of loans made by educational organizations and certain tax-exempt organizations to refinance any existing student loan (and not just loans made by educational organizations). In addition, the proposal would clarify that refinancing loans made by educational organizations and certain tax-exempt organizations must be made pursuant to a program of the refinancing organization (e.g., school or private foundation) that requires the student to fulfill a public service work requirement.

Effective Date

The proposal would be effective as of August 5, 1997, the date of enactment of the 1997 Act.

4. Deduction for student loan interest (sec. 202 of the 1997 Act and sec. 221 of the Code)

Present Law

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, up to a maximum deduction of $2,500 per year. The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Months during which the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

Description of Proposal

The proposal would clarify that the student loan interest deduction may be claimed only by a taxpayer who is required to make the interest payments pursuant to the terms of the loan. Thus, nonmandatory payments of interest, whether by the borrower or another person, are not deductible.

Effective Date

The proposal would be effective for interest payments due and paid after December 31, 1997, on any qualified education loan.

5. Enhanced deduction for corporate contributions of computer technology and equipment (sec. 224 of the 1997 Act and sec. 170(e)(6) of the Code)

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization. However, in the case of a charitable contribution of inventory or other ordinary-income property, short-term capital gain property, or certain gifts to private foundations, the amount of the deduction is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, a taxpayer's deduction is limited to the adjusted basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.

The Taxpayer Relief Act of 1997 provided that certain contributions of computer and other equipment to eligible donees to be used for the benefit of elementary and secondary school children qualify for an augmented deduction. Under this special rule, the amount of the augmented deduction available to a corporation making a qualified contribution generally is equal to its basis in the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold. However, the augmented deduction cannot exceed twice the basis of the donated property. To qualify for the augmented deduction, the contribution must satisfy various requirements.

The legislative history of the provision states that the special tax treatment for contributions of computer and other equipment was to be effective for contributions made during a three-year period in taxable years beginning after December 31, 1997, and before January 1, 2001.[7] However, as a result of a drafting error, the statutory provision does not apply to contributions made during taxable years beginning after December 31, 1999.

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[7] H. Rept. 105-220, p. 374.

Description of Proposal

The proposal would correct the termination date of the provision to provide that the special rule applies to contributions made during taxable years beginning after December 31, 1997, and before December 31, 2000.

In addition, the proposal would clarify that the requirement set forth in section 170(e)(6)(B)(vi) that the donated property fit productively into an education plan applies to property donated to educational organizations as well as to certain tax-exempt charitable entities. Similarly, the requirement regarding permissible use and disposition of the property set forth in section 170(e)(6)(B)(vii) applies both to educational organizations and certain tax-exempt charitable entities.

Effective Date

The proposal would be effective as of August 5, 1997, the date of enactment of the 1997 Act.

6. Qualified State tuition programs (sec. 211 of the 1997 Act and sec. 529 of the Code)

Present Law

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" means expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible post-secondary educational institution, 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. 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.

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. 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.

Description of Proposal

The proposal would clarify 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.

In addition, the proposal would modify section 529(e)(2) to clarify that--for purposes of tax-free rollovers and changes of designated beneficiaries--a "member of the family" includes the spouse of the original beneficiary.

Effective Date

The proposal would be effective for distributions made after December 31, 1997.

7. Qualified zone academy bonds (sec. 226 of the 1997 Act and sec. 1397E of the Code)

Present Law

Certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold "qualified zone academy bonds" are entitled to a nonrefundable tax credit in an amount equal to a credit rate (set monthly by the Treasury Department[8]) multiplied by the face amount of the bond (sec. 1397E). The credit rate applies to all such bonds issued in each month. A taxpayer holding a qualified zone academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a

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[8] The Treasury Department will set the credit rate each month at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer.

credit. The credit is includible in gross income (as if it were an interest payment on the bond), and may be claimed against regular income tax and AMT liability.

"Qualified zone academy bonds" are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy"--meaning certain public schools located in empowerment zones or enterprise communities or with a certain percentage of students from low-income families--and (2) private entities have promised to make contributions to the qualified zone academy with a value equal to at least 10 percent of the bond proceeds.

A total of $400 million of "qualified zone academy bonds" may be issued in each of 1998 and 1999. The $400 million aggregate bond cap will be allocated each year to the States according to their respective populations of individuals below the poverty line.[9] Each State, in turn, will allocate the credit to qualified zone academies within such State. A State may carry over any unused allocation into subsequent years.

Description of Proposal

The proposal would modify section 6655(g)(1)(B) to provide that the credit for certain holders of qualified zone academy bonds may be claimed for estimated tax purposes. Similarly, the proposal would clarify under section 6401(b)(1) the manner in which the credit is taken into account when determining whether a taxpayer has made an overpayment of tax.

Effective Date

The proposal would be effective for obligations issued after December 31, 1997.

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[9] See Rev. Proc. 98-9, which sets forth the maximum face amount of qualified zone academy bonds that may be issued for each State during 1998; IRS Proposed Rules (REG-119449-97), which provides guidance to holders and issuers of qualified zone academy bonds.

C. Amendments to Title III of the 1997 Act Relating to Savings Incentives

1. Conversions of IRAs into Roth IRAs (sec. 302 of the 1997 Act and secs. 408A and 72(t) of the Code)

Present Law

A taxpayer with adjusted gross income of less than $100,000 may convert a present-law deductible or nondeductible IRA into a Roth IRA at any time. The amount converted is includible in income in the year of the conversion, except that if the conversion occurs in 1998, the amount converted is includible in income ratably over the 4-year period beginning with the year in which the conversion occurs.[10] Amounts includible in income as a result of the conversion are not taken into account in determining whether the $100,000 threshold is exceeded. The 10-percent tax on early withdrawals does not apply to conversions of IRAs into Roth IRAs.

In general, distributions of earnings from a Roth IRA are excludable from income if the individual has had a Roth IRA for at least 5 years and certain other requirements are satisfied. The 5-year holding period with respect to conversion Roth IRAs begins from the year of the conversion. (Distributions that are excludable from income are referred to as qualified distributions.)

Present law does not contain a specific rule addressing what happens if an individual dies during the 4-year spread period for 1998 conversions.

Description of Proposal

Distributions of converted amounts

Distributions before the end of the 4-year spread

The proposal would modify the rules relating to conversions of IRAs into Roth IRAs in order to prevent taxpayers from receiving premature distributions from a Roth conversion IRA while retaining the benefits of 4-year income averaging. In the case of conversions to which the 4-year income inclusion rule applies, income inclusion would be accelerated with respect to any amounts withdrawn before the final year of inclusion. Under this rule, a taxpayer that withdraws converted amounts prior to the last year of the 4-year spread would be required to include in

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[10] If the conversion is accomplished by means of a withdrawal and a rollover into a Roth IRA, the 4-year rule applies if the withdrawal is made during 1998 and the rollover occurs within 60 days of the withdrawal. In such a case, the 4-year period begins with the year in which the withdrawal was made. For purposes of this discussion, such conversions are treated as occurring in 1998.

income the amount otherwise includible under the 4-year rule, plus the lesser of (1) the taxable amount of the withdrawal, or (2) the remaining taxable amount of the conversion (i.e., the taxable amount of the conversion not included in income under the 4-year rule in the current or a prior taxable year). In subsequent years (assuming no such further withdrawals), the amount includible in income under the 4-year will be the lesser of (1) the amount otherwise required under the 4-year rule (determined without regard to the withdrawal) or (2) the remaining taxable amount of the conversion.

Under the proposal, application of the 4-year spread would be elective. The election would be made in the time and manner prescribed by the Secretary. An election with respect to the 4-year spread could not be changed after the due date for the return for the first year of the income inclusion (including extensions).

The following example illustrates the application of these proposed rules.

Example: Taxpayer A has a nondeductible IRA with a value of $100 (and no other IRAs). The $100 consists of $75 of contributions and $25 of earnings. A converts the IRA into a Roth IRA in 1998 and elects the 4-year spread. As a result of the conversion, $25 is includible in income ratably over 4 years ($6.25 per year). The 10-percent early withdrawal tax does not apply to the conversion. At the beginning of 1999, the value of the account is $110, and A makes a withdrawal of $10. Under the proposal, the withdrawal would be treated as attributable entirely to amounts that were includible in income due to the conversion. In the year of withdrawal, $16.25 would be includible in income (the $6.25 includible in the year of withdrawal under the 4-year rule, plus $10 ($10 is less than the remaining taxable amount of $12.50 ($25-$12.50)). In the next year, $2.50 would be includible in income under the 4-year rule. No amount would be includible in income in year 4 due to the conversion.

Application of early withdrawal tax to converted amounts

The proposal would modify the rules relating to conversions to prevent taxpayers from receiving premature distributions (i.e., within 5 years) while retaining the benefit of the nonpayment of the early withdrawal tax. Under the proposal, if converted amounts are withdrawn within the 5-year period beginning with the year of the conversion, then, to the extent attributable to amounts that were includible in income due to the conversion, the amount withdrawn would be subject to the 10-percent early withdrawal tax.[11]

Applying this rule to the example above, the $10 withdrawal would be subject to the 10-percent early withdrawal tax (unless as exception applies).

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[11] The otherwise available exceptions to the early withdrawal tax, e.g., for distributions after age 59-1/2, would apply.

Application of 5-year holding period

The proposal would also eliminate the special rule under which a separate 5-year holding period begins for purposes of determining whether a distribution of amounts attributable to a conversion is a qualified distribution; thus, the 5-year holding rule for Roth IRAs would begin with the year for which a contribution is first made to a Roth IRA. A subsequent conversion would not start the running of a new 5-year period.

Ordering rules

Ordering rules would apply to determine what amounts are withdrawn in the event a Roth IRA contains both conversion amounts (possibly from different years) and other contributions. Under these rules, regular Roth IRA contributions would be deemed to be withdrawn first, then converted amounts (starting with the amounts first converted). Withdrawals of converted amounts would be treated as coming first from converted amounts that were includible in income. As under present law, earnings would be treated as withdrawn after contributions. For purposes of these rules, all Roth IRAs would be considered a single Roth IRA.

Corrections

In order to assist individuals who erroneously convert IRAs into Roth IRAs or otherwise wish to change the nature of an IRA contribution, contributions to an IRA (and earnings thereon) may be transferred from any IRA to another IRA by the due date for the taxpayer's return for the year of the contribution (including extensions). Any such transferred contributions will be treated as if contributed to the transferee IRA (and not to the transferor IRA).

Effect of death on 4-year spread

Under the proposal, in general, any amounts remaining to be included in income as a result of a 1998 conversion would be includible in income on the final return of the taxpayer. If the surviving spouse is the beneficiary of the Roth IRA, the spouse could continue the deferral by including the remaining amounts in his or her income over the remainder of the 4-year period.

Calculation of AGI limit for conversions

The proposal would clarify that, for purposes of applying the $100,000 AGI limit on IRA conversions into Roth IRAs, the conversion amount (to the extent otherwise includible in AGI) is subtracted from AGI as determined under the rules relating to IRAs (sec. 219). Thus, for example, the AGI-based phase out of the exemption from the disallowance for passive activity losses form rental real estate activities (sec. 469(i)(3)) would be applied taking into account the amount of the conversion that is includible in AGI, and then the amount of the conversion would be subtracted from AGI in determining whether a taxpayer is eligible to convert and IRA into a Roth IRA.

Effective Date

The provision would be effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.

2. Penalty-free distributions for education expenses and purchase of first homes (secs. 203 and 303 of the 1997 Act and sec. 402 of the Code)

Present Law

The 10-percent early withdrawal tax does not apply to distributions from an IRA if the distribution is for first-time homebuyer expenses, subject to a $10,000 life-time cap, or for higher education expenses. These exceptions do not apply to distributions from employer-sponsored retirement plans. A distribution from an employer-sponsored retirement plan that is an "eligible rollover distribution" may be rolled over to an IRA. The term "eligible rollover distribution" means any distribution to an employee of all or a portion or the balance to the credit of the employee in a qualified trust. Distributions from cash or deferred arrangements made on account of hardship are eligible rollover distributions. An eligible rollover distribution which is not transferred directly to another retirement plan or an IRA is subject to 20-percent withholding on the distribution.

Description of Proposal

Under present law, participants in employer-sponsored retirement plans can avoid the early withdrawal tax applicable to such plans by rolling over hardship distributions to an IRA and withdrawing the funds from the IRA. The proposal would modify the rules relating to the ability to roll over hardship distributions from employer-sponsored retirement plans in order to prevent such avoidance of the 10-percent early withdrawal tax. The proposal would provide that distributions from cash or deferred arrangements and similar arrangements made on account of hardship of the employee are not eligible rollover distributions. Such distributions would not be subject to the 20-percent withholding applicable to eligible rollover distributions.

Effective Date

The proposal would be effective for distributions after December 31, 1998.

3. Limits based on modified adjusted gross income (sec. 302(a) of the 1997 Act and sec. 72(t) of the Code)

Present Law

The $2,000 Roth IRA maximum contribution limit is phased out for individual taxpayers with adjusted gross income ("AGI") between $95,000 and $110,000 and for married taxpayers filing a joint return with AGI between $150,000 and $160,000. The maximum deductible IRA contribution is phased out between $0 and $10,000 of AGI in the case of married couples filing a separate return.

Description of Proposal

The proposal would clarify the phase-out range for the Roth IRA maximum contribution limit for a married individual filing a separate return and conform it to the range for deductible IRA contributions. Under the proposal, the phase-out range for married individuals filing a separate return would be $0 to $10,000 of AGI.

Effective Date

The proposal would be effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.

4. Contribution limit to Roth IRAs (sec. 302 of the 1997 Act and sec. 408A(c) of the Code)

Present Law

An individual who is an active participant in an employer-sponsored plan may deduct annual IRA contributions up to the lesser of $2,000 or 100 percent of compensation if the individual's adjusted gross income ("AGI") does not exceed certain limits. For 1998, the limit is phased-out over the following ranges of AGI: $30,000 to $40,000 in the case of a single taxpayer and $50,000 to $60,000 in the case of married taxpayers. An individual who is not an active participant in an employer-sponsored retirement plan (and whose spouse is not an active participant) may deduct IRA contributions up to the limits described above without limitation based on income. An individual who is not an active participant in an employer-sponsored retirement plan (and whose spouse is such an active participant) may deduct IRA contributions up to the limits described above if the AGI of the such individuals filing a joint return does not exceed certain limits. The limit is phased for out for such individuals with AGI between $150,000 and $160,000.

An individual may make nondeductible contributions up to the lesser of $2,000 or 100 percent of compensation to a Roth IRA if the individual's AGI does not exceed certain limits. An individual may make nondeductible contributions to an IRA to the extent the individual does not or cannot make deductible contributions to an IRA or contributions to a Roth IRA. Contributions to all an individual's IRAs for a taxable year may not exceed $2,000.

Description of Proposal

The proposal would clarify the intent of the Act that an individual may contribute up to $2,000 a year to all the individual's IRAs. Thus, for example, suppose an individual is not eligible to make deductible IRA contributions because of the phase-out limits, and is eligible to make a $1,000 Roth IRA contribution. The individual could contribute $1,000 to the Roth IRA and $1,000 to a nondeductible IRA.

Effective Date

The proposal would be effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.

5. Contribution limitations for active participants in an IRA (sec. 301(b) of the 1997 Act and sec. 219(g) of the Code)

Present Law

Under present law, if a married individual (filing a jqint return) is an active participant in an employer-sponsored retirement plan, the $2,000 IRA deduction limit is phased out over the following levels of adjusted gross income ("AGI"):

Taxable years beginning in:	Phase-out Range
1997	$40,000 to $50,000
1998	$50,000 to $60,000
1999	$51,000 to $61,000
2000	$52,000 to $62,000
2001	$53,000 to $63,000
2002	$54,000 to $64,000
2003	$60,000 to $70,000
2004	$65,000 to $75,000
2005	$70,000 to $80,000
2006	$75,000 to $85,000
2007	$80,000 to $100,000

An individual is not considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is an active participant. The $2,000 maximum deductible IRA contribution for an individual who is not an active participant, but whose spouse is, is phased out for taxpayers with AGI between $150,000 and $160,000.

Description of Proposal

The proposal would clarify the intent of the Act relating to the AGI phase-out ranges for married individuals who are active participants in employer-sponsored plans and the AGI phase-out range for spouses of such active participants as described above.

Effective Date

The proposal would be effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.

D. Amendments to Title III of the 1997 Act Relating to Capital Gains

1. Individual capital gain rate reductions (sec. 311 of the 1997 Act and sec. 1(h) of the Code)

Present Law

The 1997 Act provided lower capital gains rates for individuals. Generally, the 1997 Act reduced the maximum capital gains rate from 28 percent to 20 percent and provided a 10-percent rate for capital gains otherwise taxed at a 15-percent rate. The 1997 Act generally retained a 28-percent maximum rate for gain from collectibles, gain included in income from the sale of certain small business stock, net gain properly taken into account before May 7, 1997, and net gain properly taken into account after July 28, 1997, from property held more than one year but not more than 18 months. In addition, a maximum rate of 25 percent is provided for the long-term capital gain attributable to real estate depreciation. Lower rates are also provided in the future for certain property held more than five years.

Under the provisions of the 1997 Act, net short-term capital losses and long-term capital loss carryovers offset gain taxed at a 20-percent rate before offsetting gain taxed at the 25- or 28-percent rates.

Description of Proposal

The proposal would make the following technical corrections to the individual capital gain rate reduction provisions of the 1997 Act:

Collectibles gains and losses, certain small business stock gain included in income, capital gains and losses properly taken into account after July 28, 1997, from the disposition of property held more than one year but not more than 18 months, and long-term capital gains and losses properly taken into account before May 7, 1997, would be placed in one basket ("28-percent rate gain") taxed a maximum rate of 28 percent. All the gains and losses in this basket would be netted for purposes of determining the amount taxed at a maximum 28-percent rate.

Any net short-term capital loss for the taxable year and any long-term capital loss carryover to the taxable year would be placed in the 28-percent rate gain basket. This would allow these capital losses to offset gain taxed at the 28-percent rate before offsetting gain taxed at lower rates. Any net loss in the 28-percent rate gain basket next would offset gain taxed at the 25-percent rate.

Several conforming amendments would be made to coordinate the multiple holding periods with other provisions of the Code. Inherited property and certain patents would be deemed to have a holding period of more than 18 months, thus, allowing the lower 10- and 20-percent rates to apply. The proposal would clarify that long-term capital gain or loss on a section 1256 contract would be treated as gain or loss from property held more than 18 months. Also, the short sale holding period rules of section 1233 and the holding period rules of section 1092(f) would be amended to conform those rules with the new 12-18 month holding period. Amounts treated as ordinary income by reason of section 1231(c) would be allocated among categories of gain in accordance with IRS forms or regulations.

Finally, the proposal would reorder some of the provisions and make other minor technical changes, including a provision to reduce the minimum tax preference on small business stock to 28 percent, beginning in 2006.

Effective Date

The proposal would be effective for taxable years ending after May 6, 1997.

2. Rollover of gain from sale of qualified stock (sec. 313 of the 1997 Act and sec. 1045 of the Code)

Present Law

The 1997 Act provided that gain from the sale of qualified small business stock held by an individual for more than 6 months can be "rolled over" tax-free to other qualified small business stock.

Description of Proposal

Under the proposal, a partnership or an S corporation can roll over gain from qualified small business stock held more than 6 months if (and only if) all the interests in the partnership or S corporation are held by individuals, estates, or trusts (other than trusts with corporations as beneficiaries) at all times during the taxable year.

Effective Date

The proposal would be effective on August 5, 1997, the date of enactment of the 1997 Act.

3. Exclusion of gain on the sale of a principal residence owned and used less than two years (sec. 312(a) of the 1997 Act and sec. 121 of the Code)

Present Law

Under present law, a taxpayer generally is able to exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned the residence and used it as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or unforeseen circumstances is able to exclude a fraction of the taxpayer's realized gain equal to the fraction of the two years that the requirements are met.

Description of Proposal

The proposal would clarify that an otherwise qualifying taxpayer who fails to satisfy the two-year ownership and use requirements is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return), not the fraction of the realized gain which is equal to the fraction of the two years that the ownership and use requirements are met. For example, an unmarried taxpayer who owns and uses a principal residence for one year then sells at realized gain of $500,000 may exclude $125,000 of gain (one-half of $250,000) not $250,000 of gain (one-half of the realized gain). Similarly, an unmarried taxpayer who owns and uses a principal residence for one year then sells at a realized gain of $50,000 may exclude the entire $50,000 of gain since it is less than one half of $250,000. The exclusion is not limited to $25,000 (one-half of the $50,000 realized gain).

In addition, the proposal would provide that if a married couple filing a joint return does not qualify for the $500,000 exclusion, the amount of the exclusion claimed by the couple will be the sum of each spouse's exclusion determined on a separate basis.

Effective Date

The proposal would be effective as if included in section 312 of the 1997 Act.

4. Effective date of the exclusion of gain on the sale of a principal residence (sec. 312(d)(2) of the 1997 Act and sec. 121 of the Code)

Present law

The exclusion for gain on sale of a principal residence under the 1997 Act generally applies to sales or exchanges occurring after May 6, 1997. A taxpayer may elect, however, to apply prior law to a sale or exchange (1) made before the date of enactment of the Act, (2) made after the date of enactment pursuant to a binding contract in effect on such date, or (3) where a replacement residence was acquired on or before the date of enactment (or pursuant to a binding contract in effect on the date of enactment) and the prior-law rollover provision would apply.

Description of Proposal

The proposal would clarify that a taxpayer may elect to apply prior law with respect to a sale or exchange on the date of enactment of section 312 of the 1997 Act.

Effective Date

The proposal would be effective as if included in section 312 of the 1997 Act.

E. Amendments to Title IV of the 1997 Act Relating to Alternative Minimum Tax

1. Election to use AMT depreciation for regular tax purposes (sec. 402 of the Act and sec. 168 of the Code)

Present Law

For regular tax purposes, depreciation deductions for certain shorter-lived tangible property may be determined using the 200-percent declining balance method over 3-, 5-, 7-, or 10-year recovery periods (depending on the type of property). For alternative minimum tax ("AMT") purposes, depreciation on such property placed in service after 1986 and before 1999 is computed by using the 150-percent declining balance method over the longer class lives prescribed by the alternative depreciation system of section 168(g). A taxpayer may elect to use the methods and lives applicable to AMT depreciation for regular tax purposes.

The 1997 Act conformed the recovery periods (but not the methods) used for purposes of the AMT depreciation to the recovery periods used for purposes of the regular tax, for property placed in service after 1998. The 1997 Act did not make a conforming change to the election to use the pre-1998 AMT recovery methods and recovery periods for regular tax purposes.

Description of Proposal

For property placed in service after 1998, a taxpayer would be allowed to elect, for regular tax purposes, to compute depreciation on tangible personal property otherwise qualified for the 200-percent declining balance method by using the 150-percent declining balance method over the recovery periods applicable to the regular tax (rather than the longer class lives of the alternative depreciation system of sec. 168(g)).

Effective Date

The proposal would be effective for property placed in service after December 31, 1998.

2. Clarification of the small business exemption (sec. 401 of the Act and sec. 55 of the Code)

The corporate alternative minimum tax is repealed for small corporations for taxable years beginning after December 31, 1997. A small corporation is one that had average gross receipts of $5 million or less for a prior three-year period. A corporation that meets the $5 million gross receipts test will continue to be treated as a small corporation exempt from the alternative minimum tax so long as its average gross receipts do not exceed $7.5 million.

Description of Proposal

The proposal would clarify the application of the $5 million and $7.5 million gross receipts tests that a corporation must meet to be a small corporation exempt from the AMT. For example, in order for an existing corporation to qualify as a small corporation for its first taxable year beginning after December 31, 1997, (1) the corporation's average gross receipts for the three-taxable year period beginning after December 31, 1993 must be $5 million or less and (2) the corporation's average gross receipts for the three-taxable year period beginning after December 31, 1994 must be $7.5 million or less.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

F. Amendments to Title V of the 1997 Act Relating to Estate and Gift Taxes

1. Clarification of phaseout range for 5-percent surtax to phase out the benefits of the unified credit and graduated rates (sec. 501 of the 1997 Act and sec. 2001(c)(2) of the Code)

Present Law

Prior to the 1997 Act, a 5-percent surtax was imposed upon cumulative taxable transfers between $10 million and $21,040,000 to phase out the benefits of the graduated rates and the unified credit. The 1997 Act increased the unified credit beginning in 1998, from an effective exemption of $600,000 to an effective exemption of $1,000,000 in 2006. A conforming amendment was made to the 5-percent surtax provision in section 2001(c)(2) that was intended to reflect the increased unified credit. However, the conforming amendment was drafted in a manner that had the effect of phasing out the benefits of the graduated rates but not the unified credit.

Description of Proposal

The proposal would clarify section 2001(c)(2) to properly phase out the benefits of both the graduated rates and the unified credit.

Effective Date

The proposal would be effective for decedents dying, and gifts made, after December 31, 1997.

2. Clarification of effective date for indexing of generation-skipping exemption (secs. 501(d) and (f) of the 1997 Act and sec. 2631(c) of the Code)

Present Law

The 1997 Act provided for the indexation of the $1 million exemption from generation-skipping transfers effective for decedents dying after December 31, 1998.

Description of Proposal

The proposal would clarify that the indexing of the exemption from generation-skipping transfers would be effective with respect to all generation-skipping transfers (i.e., direct skips, taxable terminations, and taxable distributions) made after 1998.

With respect to existing trusts, transferors would be permitted to make a late allocation of any additional GST exemption amount attributable to indexing adjustments in accordance with the present-law rules applicable to late allocations as set forth in sections 2632 and 2642, and the regulations promulgated thereunder. For example, assume an individual transferred $2 million to a trust in 1995, and allocated his entire $1 million GST exemption to the trust at that time (resulting in an inclusion ratio of .50). Assume further that in 2001, the GST exemption has increased to $1,100,000 as the result of indexing, and that the value of the trust assets is now $3 million. If the individual is still alive in 2001, he would be permitted to make a late allocation of $100,000 of GST exemption to the trust, resulting in a new inclusion ratio of 1-(($1,500,000+100,000)/$3,000,000), or .467.

Effective Date

The proposal would be effective for generation-skipping transfers made after December 31, 1998.

3. Coordination between unified credit and family-owned business exclusion (sec. 502 of the 1997 Act and sec. 2033A(a) of the Code)

Present Law

The 1997 Act effectively increased the amount of lifetime gifts and transfers at death that are exempt from unified estate and gift tax from $600,000 to $1,000,000 over the period 1997 to 2006, through increases in an individual's unified credit. In addition, the 1997 Act provided a limited exclusion for certain family-owned business interests. The exclusion for family-owned business interests may be taken only to the extent that the exclusion for family-owned business interests, plus the amount effectively exempted by the unified credit, does not exceed $1.3 million. As a result, for years after 1998, the maximum amount of exclusion for family-owned business interests is reduced by increases in the dollar amount of transfers effectively exempted through the unified credit.

Because the structure of the 1997 Act increases the unified credit over time (until 2006) while decreasing over the same period the benefit of the closely-held business exclusion, the estate tax on estates with family-owned businesses increases over time until 2006. This increase in estate tax results from the fact that increases in the unified credit provide a benefit at the decedent's lowest estate tax brackets, while the exclusion for family-owned businesses provides a benefit at the decedent's highest estate tax brackets.

Description of Proposal

Under the proposal, if an executor elects to utilize the qualified family-owned business exclusion, the estate tax liability would be calculated as if the estate were allowed a maximum qualified family-owned business exclusion of $675,000 and an applicable exclusion amount under section 2010 (i.e., the amount exempted by the unified credit) of $625,000, regardless of the year in which the decedent dies. If the estate includes less than $675,000 of qualified family-owned business interests, the applicable exclusion amount would be increased on a dollar-for-dollar basis, but only up to the applicable exclusion amount generally available for the year of death.

For example, assume the decedent dies in 2005, when the applicable exclusion amount under section 2010 is $800,000. If the estate includes qualified family-owned business interests valued at $675,000 or more, the estate tax liability would be calculated as if the estate were allowed a qualified family-owned business exclusion of $675,000, and the applicable exclusion amount under section 2010 would be limited to $625,000. If the estate includes qualified family-owned business interests of $500,000 or less, all of the qualified family-owned business interests could be excluded from the estate, and the applicable exclusion amount under section 2010 would be $800,000. If the estate includes qualified family-owned business interests valued between $500,000 and $675,000, all of the qualified family-owned business interests could be excluded from the estate, and the applicable exclusion amount under section 2010 would be calculated as the excess of $1.3 million over the amount of qualified family-owned business interests. (For example, if the qualified family-owned business interests were valued at $600,000, the applicable exclusion amount under section 2010 would be $700,000.)

If a recapture event occurs with respect to any qualified family-owned business interest, the total amount of estate taxes potentially subject to recapture would be calculated as the difference between the actual amount of estate tax liability for the estate, and the amount of estate taxes that would have been owed had the qualified family-owned business election not been made.

Effective Date

The proposal would be effective for decedents dying after December 31, 1997.

4. Clarification of businesses eligible for family-owned business exclusion (sec. 502 of the 1997 Act and sec. 2033A(b)(3) of the Code)

Present Law

In order to be eligible to exclude from the gross estate a portion of the value of a family-owned business, the sum of (1) the adjusted value of family-owned business interests includible in the decedent's estate, and (2) the amount of gifts of family-owned business interests to family members of the decedent that are not included in the decedent's gross estate, must exceed 50 percent of the decedent's adjusted gross estate.

Description of Proposal

The proposal would clarify the formula for determining the amount of gifts of family-owned business interests made to members of the decedent's family that are not otherwise includible in the decedent's gross estate.

Effective Date

The proposal would be effective with respect to decedents dying after December 31, 1997.

5. Clarification that interests eligible for family-owned business exclusion must be passed to a qualified heir (sec. 502 of the Act and sec. 2033A(a)(1) of the Code)

Present Law

The 1997 Act provided a new exclusion for qualified family-owned business interests. One of the requirements for the exclusion is that such interests must pass to a "qualified heir," which includes members of the decedent's family and any individual who has been actively employed by the trade or business for at least 10 years prior to the date of the decedent's death.

Description of Proposal

The proposal would clarify section 2033A(a)(1) to provide that qualified family-owned business interests must be passed to a qualified heir in order to qualify for the exclusion.

Effective Date

The proposal would be effective with respect to estates of decedents dying after December 31, 1997.

6. Clarification of "trade or business" requirement for family-owned business exclusion (sec. 502 of the Act and sec. 2033A(e) of the Code)

Present Law

A qualified family-owned business interest is defined as any interest in a trade or business that meets certain requirements--e.g., the decedent and members of his family must own certain percentages of the trade or business, the decedent or members of his family must have materially participated in the trade or business for five of the eight years preceding the decedent's death, and the qualified heir or members of his family must materially participate in the trade or business for at least five years of any eight-year period within 10 years following the decedent's death.

Description of Proposal

The proposal would clarify that an individual's interest in property used in a trade or business may qualify for the qualified family-owned business exclusion as long as such property is used in a trade or business by the individual or a member of the individual's family. Thus, for example, if a brother and sister inherit farmland upon their father's death, and the sister cashleases her portion to her brother, who is engaged in the trade or business of farming, the "trade or business" requirement is satisfied with respect to both the brother and the sister.

Effective Date

The proposal would be effective with respect to estates of decedents dying after December 31, 1997.

7. Conversion of qualified family-owned business exclusion into a deduction (sec. 502 of the Act and sec. 2033A of the Code)

Present Law

The qualified family-owned business provision in the 1997 Act provides an exclusion from estate taxes for certain qualified family-owned business interests. It is unclear whether the provision provides an exclusion of value or an exclusion of property from the estate, and thus it is unclear how the new provision interacts with other provisions in the Internal Revenue Code (e.g., secs. 1014, 2032A, 2056, 2612, and 6166).

Description of Proposal

The proposal would convert the qualified family-owned business exclusion into a deduction. The requirements of the provision would otherwise remain unchanged. The qualified family-owned business deduction would not be available for generation-skipping tax purposes.

Effective Date

The proposal would be effective with respect to estates of decedents dying after December 31, 1997.

8. Other modifications to the qualified family-owned business provision (sec. 502 of the 1997 Act and sec. 2033A of the Code)

Present Law

The qualified family-owned business provision incorporates by cross-reference several other provisions of the Code, including a number of provisions in section 2032A and the personal holding company rules of section 543(a).

Description of Proposal

The proposal would modify section 2033A(g) (relating to the security requirements for noncitizen qualified heirs) by deleting the cross-reference to section 2033A(i)(3)(M), which does not appear to be appropriate. The proposal also would make rules similar to those set forth in section 2032A(h) and (i) (relating to conversions and exchanges of property under sections 1031 and 1033) applicable for purposes of section 2033A. Finally, the proposal would clarify that, in identifying assets that produce (or are held for the production of) income of a type described in section 543(a), section 543(a) would be applied without regard to section 543(a)(2)(B) (the dividend requirement for corporate entities).

Effective Date

The proposal would be effective with respect to estates of decedents dying after December 31, 1997.

9. Clarification of interest on installment payment of estate tax on holding companies (sec. 503 of the 1997 Act and secs. 6166(b)(7)(A) and 6166(b)(8)(A) of the Code)

Present Law

If certain conditions are met, a decedent's estate may elect to pay the estate tax attributable to certain closely-held businesses over a 14-year period. The 1997 Act provided for a 2-percent interest rate on the estate tax on first $1 million in value of interests in qualified closely-held businesses, and a rate equal to 45 percent of the regular deficiency rate on the amount in excess of the portion eligible for the 2-percent rate, but also provided that none of interest on the deferred payment of estate taxes would be deductible for income or estate tax purposes. Interests in holding companies and non-readily-tradeable business interests are not eligible for the 2-percent rate.

Description of Proposal

The proposal would clarify that deferred payments of estate tax on holding companies and non-readily-tradable business interests do not qualify for the 2-percent interest rate, but instead are subject to a rate of 45 percent of the regular deficiency rate. Such interest payments are not deductible for income or estate tax purposes.

Effective Date

The proposal generally would be effective for decedents dying after December 31, 1997.

10. Clarification on declaratory judgment jurisdiction of U.S. Tax Court regarding installment payment of estate tax (sec. 505 of the 1997 Act and sec. 7479(a) of the Code)

Present Law

If certain conditions are met, a decedent's estate may elect to pay estate tax attributable to certain closely-held business over a 14-year period. The 1997 Act provided that the U.S. Tax Court would have jurisdiction to determine whether the estate of a decedent qualifies for the 14-year installment payment of estate tax.

Description of Proposal

The proposal would clarify that the jurisdiction of the U.S. Tax Court to determine whether an estate qualifies for installment payment of estate tax on closely-held businesses extends to determining which businesses in an estate are eligible for the deferral.

Effective Date

The proposal would be effective for decedents dying after the date of enactment of the 1997 Act.

11. Clarification of rules governing revaluation of gifts (sec. 506 of the 1997 Act and sec. 2504(c) of the Code)

Present Law

The valuation of a gift becomes final for gift tax purposes after the statute of limitations on any gift tax assessed or paid has expired. The 1997 Act extended that rule to apply for estate tax purposes, provided for a lengthened statute of limitations for gift tax purposes if certain information is not disclosed with the gift tax return, and provided jurisdiction to the U.S. Tax Court to determine the value of any gift.

Description of Proposal

The proposal would clarify that in determining the amount of taxable gifts made in preceding calendar periods, the value of prior gifts is the value of such gifts as finally determined, even if no gift tax was assessed or paid on that gift. For this purpose, final determinations would include, e.g., the value reported on the gift tax return (if not challenged by the IRS prior to the expiration of the statute of limitations), the value determined by the IRS (if not challenged through the declaratory judgment procedure by the taxpayer), the value determined by the courts, or the value agreed to by the IRS and the taxpayer in a settlement agreement.

Effective Date

The proposal would be effective with respect to gifts made after the date of enactment of the 1997 Act.

12. Clarification with respect to post-mortem conservation easements (sec. 506 of the 1997 Act and sec. 2031(c) of the Code)

Present Law

A deduction is allowed for estate tax purposes for a contribution of a qualified real property interest to a charity (or other qualified organization) exclusively for conservation purposes (sec. 2055(f)). The 1997 Act also provided an election to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement that meets certain requirements. The 1997 Act provided that the executor of the decedent's estate, or the trustee of a trust holding the land, could grant a qualifying easement after the decedent's death, as long as the easement is granted prior to the date of the election (generally, within nine months after the date of the decedent's death).

Description of Proposal

The proposal would clarify that, in the case of a qualified conservation contribution made after the date of the decedent's death, an estate tax deduction would be allowed under section 2055(f). However, no income tax deduction would be allowed to the estate or the qualified heirs with respect to such post-mortem conservation easements.

Effective Date

The proposal would be effective with respect to estates of decedents dying after December 31, 1997.

G. Amendments to Title VII of the 1997 Act Relating to Incentives for the District of Columbia (sec. 701 of the 1997 Act and secs. 1400, 1400B and 1400C of the Code)

Present Law

Designation of D.C. Enterprise Zone

Certain economically depressed census tracts within the District of Columbia are designated as the "D.C. Enterprise Zone," within which businesses and individual residents are eligible for special tax incentives. The census tracts that compose the D.C. Enterprise Zone for purposes of the wage credit, expensing, and tax-exempt financing incentives include all census tracts that presently are part of the D.C. enterprise community and census tracts within the District of Columbia where the poverty rate is not less than 20 percent. The D.C. Enterprise Zone designation generally will remain in effect for five years for the period from January 1, 1998, through December 31, 2002.

Empowerment zone wage credit, expensing, and tax-exempt financing

The following tax incentives generally are available in the D.C. Enterprise Zone: (1) a 20-percent wage credit for the first $15,000 of wages paid to D.C. residents who work in the D.C. Enterprise Zone; (2) an additional $20,000 of expensing under Code section 179 for qualified zone property placed in service by a "qualified D.C. Zone business"; and (3) special tax-exempt financing for certain zone facilities.

Qualified D.C. Zone business

For purposes of the increased expensing under section 179, as well as for purposes of the zero percent capital gains rate (described below), a corporation or partnership is a qualified D.C. Zone business if: (1) the sole trade or business of the corporation or partnership is the active conduct of a "qualified business" (defined below) within the D.C. Zone; (2) at least 50 percent (80 percent for purposes of the zero percent capital gains rate) of the total gross income of such entity is derived from the active conduct of a qualified business within the D.C. Zone; (3) a substantial portion of the use of the entity's tangible property (whether owned or leased) is within the D.C. Zone; (4) a substantial portion of the entity's intangible property is used in the active conduct of such business; (5) a substantial portion of the services performed for such entity by its employees are performed within the D.C. Zone; and (6) less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business. Similar rules apply to a qualified business carried on by an individual as a proprietorship.

In general, a "qualified business" means any trade or business. However, a "qualified business" does not include any trade or business that consists predominantly of the development or holding of intangibles for sale or license. In addition, a qualified business does not include any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, liquor store, or certain large farms (so-called "excluded businesses"). The rental of residential real estate is not a qualified business. The rental of commercial real estate is a qualified business only if at least 50 percent of the gross rental income from the real property is from qualified D.C. Zone businesses. The rental of tangible personal property to others also is not a qualified business unless at least 50 percent of the rental of such property is by qualified D.C. Zone businesses or by residents of the D.C. Zone.

For purposes of the tax-exempt financing provisions, the term "D.C. Zone business" generally is defined as for purposes of the increased expensing under section 179. However, a qualified D.C. Zone business for purposes of the tax-exempt financing provisions includes a business located in the D.C. Zone that would qualify as a D.C. Zone business if it were separately incorporated. In addition, under a special rule applicable only for purposes of the tax-exempt financing rules, a business is not required to satisfy the requirements applicable to a D.C. Zone business until the end of a startup period if, at the beginning of the startup period, there is a reasonable expectation that the business will be a qualified D.C. Zone business at the end of the startup period and the business makes bona fide efforts to be such a business. With respect to each property financed by a bond issue, the startup period ends at the beginning of the first taxable year beginning more than two years after the later of (1) the date of the bond issue financing such property, or (2) the date the property was placed in service (but in no event more than three years after the date of bond issuance). In addition, if a business satisfies certain requirements applicable to a qualified D.C. Zone business for a three-year testing period following the end of the start-up period and thereafter continues to satisfy certain business requirements, then it will be treated as a qualified D.C. Zone business for all years after the testing period irrespective of whether it satisfies all of the requirements of a qualified D.C. Zone business.

__Zero-percent capital gains rate__

A zero-percent capital gains rate applies to capital gains from the sale of certain qualified D.C. Zone assets held for more than five years. For purposes of the zero-percent capital gains rate, the D.C. Enterprise Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than 10 percent. Only capital gain that is attributable to the 10-year period beginning December 31, 1997, and ending December 31, 2007, is eligible for the zero-percent rate.

In general, qualified "D.C. Zone assets" mean stock or partnership interests held in, or tangible property held by, a D.C. Zone business. Such assets must generally be acquired after December 31, 1997, and before January 1, 2003. However, under a special rule, qualified D.C. Zone assets include property that was a qualified D.C. Zone asset in the hands of a prior owner, provided that at the time of acquisition, and during substantially all of the subsequent purchaser's holding period, either (1) substantially all of the use of the property is in a qualified D.C. Zone business, or (2) the property is an ownership interest in a qualified D.C. Zone business.

First-time homebuyer tax credit

First-time homebuyers of a principal residence in the District are eligible for a tax credit of up to $5,000 of the amount of the purchase price, except that the credit phases out for individual taxpayers with adjusted gross income ("AGI") between $70,000 and $90,000 ($110,000-$130,000 for joint filers). The credit is available with respect to property purchased after the date of enactment and before January 1, 2001. Any excess credit may be carried forward indefinitely to succeeding taxable years.

Description of Proposals

Eligible census tracts

The proposal would clarify that the determination of whether a census tract in the District of Columbia satisfies the applicable poverty criteria for inclusion in the D.C. Enterprise Zone for purposes of the wage credit, expensing, and special tax-exempt financing incentives (poverty rate of not less than 20 percent) or for purposes of the zero-percent capital gains rate (poverty rate of not less than 10 percent), would be based on 1990 decennial census data. Thus, data from the 2000 decennial census would not result in the expansion or other reconfiguration of the D.C. Enterprise Zone.

Qualified D.C. Zone business

The proposal would modify section 1400B(c) to clarify that a proprietorship can constitute a D.C. Zone business for purposes of the zero-percent capital gains rate.

The proposal also would clarify that qualified D.C. Zone businesses that take advantage of the special tax-exempt financing incentives do not become subject to a 35-percent zone resident requirement after the close of the testing period.

Zero-percent capital gains rate

The proposal would clarify that there is no requirement that D.C. Zone business property be acquired by a subsequent purchaser prior to January 1, 2003, to be eligible for the special rule applicable to subsequent purchasers.

In addition, the proposal would clarify that the termination of the D.C. Enterprise Zone designation at the end of 2002 will not, by itself, result in property failing to be treated as a qualified D.C. Zone asset for purposes of the zero-percent capital gains rate, provided that the property would otherwise continue to qualify were the D.C. Zone designation in effect.

First-time homebuyer credit

The proposal would clarify that, for purposes of the first-time homebuyer credit, a "first-time homebuyer" means any individual if such individual (and, if married, such individual's spouse) did not have a present ownership interest in a principal residence in the District of Columbia during the one-year period ending on the date of the purchase of the principal residence to which the credit applies.

The proposal also would clarify that the phaseout of the credit for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000-$130,000 for joint filers) applies only in the year the credit is generated, and does not apply in subsequent years to which the credit may be carried over.

In addition, the proposal would clarify that the term "purchase price" means the adjusted basis of the principal residence on the date the residence is purchased. Newly constructed residences would be treated as purchased by the taxpayer on the date the taxpayer first occupies such residence.

The proposal would clarify that the first-time homebuyer credit is a nonrefundable personal credit and would provide that the first-time homebuyer credit is claimed after the credits described in Code sections 25 (credit for interest on certain home mortgages) and 23 (adoption credit).

Finally, the proposal would clarify that the first-time homebuyer credit would be available only for property purchased after August 4, 1997, and before January 1, 2001. Thus, the credit would be available to first-time home purchasers who acquire title to a qualifying principal residence on or after August 5, 1997, and on or before December 31, 2000, irrespective of the date the purchase contract was entered into.

Effective Date

The proposal would be effective as of August 5, 1997, the date of enactment of the 1997 Act.

H. Amendments to Title IX of the 1997 Act Relating to Miscellaneous Provisions

1. Clarification of effect of certain transfers to Highway Trust Fund (sec. 901 of the 1997 Act, and sec. 9503 of the Code)[12]

Present Law

The 1997 Act provided for the transfer of an additional 4.3 cents per gallon of the highway motor fuels tax revenues from the General Fund to the Highway Trust Fund, and provided that revenues transferred to the Trust Fund under this provision could not be used in a manner resulting in changes in direct spending. The 1997 Act further changed the dates by which certain taxes would be required to be deposited with the Treasury in fiscal year 1998.

Description of Proposal

The proposal would clarify that the tax deposit delays included in the provisions affecting transfers to the Highway Trust Fund, like the revenue transfers themselves, do not affect direct spending from the Trust Fund.

Effective Date

The proposal would be effective as if included in the 1997 Act.

2. Clarification of Mass Transit Account portions of highway motor fuels taxes (sec. 907 of the 1997 Act, and sec. 9503 of the Code)[13]

Present Law

The 1997 Act provided for the transfer to the Highway Trust Fund of revenues attributable to a General Fund fuels tax rate of 4.3 cents per gallon. That Act further enacted reduced rates, based on energy content, for propane, liquefied natural tax, compressed natural gas, and methanol produced from natural gas. When deposited in the Highway Trust Fund, revenues from the taxes on each of these products are divided between the Trust Fund's Highway Account and the Mass Transit Account.

Description of Proposal

The proposal would clarify that the Mass Transit Account portion of the highway motor fuels taxes generally is 2.86 cents per gallon and that taxes on the four fuels eligible for reduced

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[12] S. 1173, as passed by the Senate, would repeal this provision.

[13] S. 1173, as passed by the Senate includes an identical technical correction.

rates are divided between the Highway Account and the Mass Transit Account in the same proportion as is the tax on gasoline.

Effective Date

The proposal would be effective as if included in the 1997 Act.

3. Clarification of qualification for reduced rate of tax on certain hard ciders (section 908 of the 1997 Act and section 5041 of the Code)

Present Law

Distilled spirits are taxed at a rate of $13.50 per proof gallon; beer is taxed at a rate of $18 per barrel (approximately 58 cents per gallon); and still wines of 14 percent alcohol or less are taxed at a rate of 1.07 per wine gallon. The Code defines still wines as wines containing not more than 0.392 gram of carbon dioxide per hundred milliliters of wine. Higher rates of tax are applied to wines with greater alcohol content, to sparkling wines (e.g., champagne), and to artificially carbonated wines.

Certain small wineries may claim a credit against the excise tax on wine of 90 cents per wine gallon on the first 100,000 gallons of still wine produced annually (i.e., net tax rate of 17 cents per wine gallon on wines with an alcohol content of 14 percent or less). No credit is allowed on sparkling wines. Certain small breweries pay a reduced tax of $7.00 per barrel (approximately 22.6 cents per gallon) on the first 50,000 barrels of beer produced annually.

Hard cider is a wine fermented solely from apples or apple concentrate and water, containing no other fruit product and containing at least one-half of one percent and less than seven percent alcohol by volume. The 1997 Act provided a lower excise tax rate of 22.6 cents per gallon on hard cider. Qualifying small producers that produce 250,000 gallons or less of hard cider and other wines in a calendar year may claim a credit of 5.6 cents per wine gallon on the first 100,000 gallons of hard cider produced. This credit produces an effective tax rate of 17 cents per gallon, the same effective rate as that applied to small producers of still wines having an alcohol content of 14 percent or less. This credit is phased out for production in excess of 100,000 gallons but less than 250,000 gallons annually.

Description of the Proposal

The proposal would clarify that the 22.6-cents-per-gallon tax rate applies only to apple cider that otherwise would be a still wine.

Effective Date

The proposal would be effective as if included in the 1997 Act.

4. Combined employment tax reporting demonstration project (sec. 976 of the 1997 Act and sec. 6103 of the Code)

Present Law

Traditionally, Federal tax forms are filed with the Federal Government and State tax forms are filed with individual states. This necessitates duplication of items common to both returns. Some States have recently been working with the IRS to implement combined State and Federal reporting of certain types of items on one form as a way of reducing the burdens on taxpayers. The State of Montana and the IRS have cooperatively developed a system to combine State and Federal employment tax reporting on one form. The one form would contain exclusively Federal data, exclusively State data, and information common to both: the taxpayer's name, address, TIN, and signature.

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service ("IRS") to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Implementation of the combined Montana-Federal employment tax reporting project had been hindered because the IRS interprets section 6103 to apply that provision's restrictions on disclosure to information common to both the State and Federal portions of the combined form, although these restrictions would not apply to the State with respect to the State's use of State-requested information if that information were supplied separately to both the State and the IRS.

The 1997 Act permits implementation of a demonstration project to assess the feasibility and desirability of expanding combined reporting in the future. There are several limitations on the demonstration project. First, it is limited to the State of Montana and the IRS. Second, it is limited to employment tax reporting. Third, it is limited to disclosure of the name, address, TIN, and signature of the taxpayer, which is information common to both the Montana and Federal portions of the combined form. Fourth, it is limited to a period of five years.

Description of Proposal

The proposal would permit Montana to use this information as if it had collected it separately by eliminating Federal penalties for disclosure of this information. The proposal would also correct a cross-reference to the provision.

Effective Date

The proposal would be effective on the date of enactment of the 1997 Act (August 5, 1997), and will expire on the date five years after the date of enactment of the 1997 Act.

5. Election for 1987 partnerships to continue exception from treatment of publicly traded partnerships as corporations (sec. 964 of the 1997 Act and sec. 7704 of the Code)

Present Law

In general

In the case of an electing 1987 partnership that elects to be subject to a 3.5-percent tax on gross income from the active conduct of a trade or business, the general rule treating a publicly traded partnership as a corporation does not apply. The 3.5-percent tax was intended to approximate the corporate tax the partnership would pay if it were treated as a corporation for Federal tax purposes.

Tax on partnership

The 3.5-percent tax is imposed on the electing 1987 partnership under the provision (sec. 7704(g)(3)). The provision does not specifically make inapplicable, however, the general rule that a partnership as such is not subject to income tax, but rather, the partners are liable for the tax in their separate or individual capacities (sec. 701).

Estimated tax payments

The provision does not specifically make applicable the requirements for payment of estimated tax that apply generally to payments of corporate tax.

Description of Proposal

Tax on partnership

The proposal would clarify that the general rule of section 701(a) that a partnership as such is not subject to income tax, but rather, the partners are liable for the tax in their separate or individual capacities does not apply to the payment of the 3.5-percent tax by the partnership. Thus, the proposal would clarify that the partnership pays the tax.

Estimated tax payments

The proposal would make applicable to the 3.5-percent tax payable by an electing 1987 partnership the requirements for payment of estimated tax that apply generally to payments of corporate tax.

Effective Date

Tax on partnership

The proposal would be effective as if enacted with the 1997 Act.

Estimated tax payments

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

6. Depreciation limitations for electric vehicles (sec. 971 of the Act and sec. 280F of the Code)

Present Law

Annual depreciation deductions with respect to passenger automobiles are limited to specified dollar amounts, indexed for inflation. Any cost not recovered during the 6-year recovery period of such vehicles may be recovered during the years succeeding the recovery period, subject to similar limitations. The recovery-period limitations are trebled for vehicles that are propelled primarily by electricity.

Description of Proposal

The depreciation limitations applicable to post-recovery periods would be trebled for vehicles that are propelled primarily by electricity.

Effective Date

The proposal would be effective for property placed in service after August 5, 1997 and before January 1, 2005.

7. Modification of operation of elective carryback of existing net operating losses of the National Railroad Passenger Corporation ("Amtrak") (sec. 977 of the 1997 Act)

Present Law

The 1997 Act provides elective procedures that allow Amtrak to consider the tax attributes of its predecessors (i.e., those railroads that were relieved of their responsibility to provide intercity rail passenger service as a result of the Rail Passenger Service Act of 1970) in the use of Amtrak's net operating losses. The benefit allowable under these procedures is limited to the least of: (1) 35 percent of Amtrak's existing qualified carryovers, (2) the net tax liability for the carryback period, or (3) $2,323,000,000. One half of the amount so calculated will be treated as a payment of the tax imposed by chapter 1 of the Internal Revenue Code of

1986 for Amtrak's taxable year ending December 31, 1997, and a similar amount for Amtrak's taxable year ending December 31, 1998.

The availability of the elective procedures is conditioned on Amtrak (1) agreeing to make payments of one percent of the amount it receives to each of the non-Amtrak States to offset certain transportation related expenditures and (2) using the balance for certain qualified expenses. Non-Amtrak States are those States that are not receiving Amtrak service at any time during the period beginning on the date of enactment and ending on the date of payment.

Description of Proposal

The proposal would provide that a State would not lose its status as a non-Amtrak State with respect to any payment by reason of acquiring Amtrak service with any payment from Amtrak under the 1997 Act provision.

Effective Date

The proposal would be effective as if included in section 977 of the 1997 Act.

I. Amendments to Title X of the 1997Act Relating to Revenue-Raising Provisions

1. Exception from constructive sales rules for certain debt positions (sec. 1001(a) of the 1997 Act and sec. 1259(b)(2) of the Code)

Present Law

A taxpayer is required to recognize gain (but not loss) upon entering into a constructive sale of an "appreciated financial position," which generally includes an appreciated position with respect to any stock, debt instrument or partnership interest. An exception is provided for positions with respect to debt instruments that have an unconditionally payable principal amount, that are not convertible into the stock of the issuer or a related person, and the interest on which is either fixed, payable at certain variable rates or based on certain interest payments on a pool of mortgages.

Description of Proposal

The proposal would clarify that, to qualify for the exception for positions with respect to debt instruments, the position would have to either itself meet the requirements as to unconditional principal amount, non-convertibility and interest terms or, alternatively, be a hedge of a position meeting these requirements. A hedge for this purpose would include any position that reduces the taxpayer's risk of interest rate or price changes or currency fluctuations with respect to another position.

Effective Date

The proposal would generally be effective for constructive sales entered into after June 8, 1997.

2. Definition of forward contract under constructive sales rules (sec. 1001(a) of the 1997 Act and sec. 1259(d)(1) of the Code)

Present Law

A constructive sale of an appreciated financial position generally results when the taxpayer enters into a forward contact to deliver the same or substantially identical property. A forward contract for this purpose is defined as a contract that provides for delivery of a substantially fixed amount of property at a substantially fixed price.

Description of Proposal

The proposal would clarify that the definition of a forward contract includes a contract that provides for cash settlement with respect to a substantially fixed amount of property at a substantially fixed price.

Effective Date

The proposal would generally be effective for constructive sales entered into after June 8, 1997.

3. Treatment of mark-to-market gains of electing traders (sec. 1001(b) of the 1997 Act and sec. 475(f)(1)(D) of the Code)

Present Law

Securities and commodities traders may elect application of the mark-to-market accounting rules. Gain or loss recognized by an electing taxpayer under these rules is treated as ordinary gain or loss.

Under the Self-Employment Contributions Act ("SECA"), a tax is imposed on an individual's net earnings from self-employment ("NESE"). Gain or loss from the sale or exchange of a capital asset is excluded from NESE.

A publicly-traded partnership generally is treated as a corporation for Federal tax purposes. An exception to this rule applies if 90 percent or more of the partnership's gross income consists of passive-type income, which includes gain from the sale or disposition of a capital asset.

Description of Proposal

The proposal would clarify that gain or loss of a securities or commodities trader that is treated as ordinary solely by reason of election of mark-to-market treatment would not be treated as other than gain or loss from a capital asset for purposes of determining NESE for SECA tax purposes, determining whether the passive-type income exception to the publicly-traded partnership rules is met or for purposes of any other Code provision specified by the Treasury Department in regulations.

Effective Date

The proposal would apply to taxable years of electing securities and commodities traders ending after the date of enactment of the 1997 Act.

4. Special effective date for constructive sale rules (sec. 1001(d) of the 1997 Act and sec. 1259 of the Code)

Present Law

The constructive sales rules contain a special effective date provision for decedents dying after June 8, 1997, if (1) a constructive sale of an appreciated financial position occurred before such date, (2) the transaction remains open for not less than two years, (3) the transaction remains open at any time during the three years prior to the decedent's death, and (4) the transaction is not closed within the 30-day period beginning on the date of enactment of the 1997 Act. If the requirements of the special effective date provision are met, both the appreciated financial position and the transaction resulting in the constructive sale are generally treated as property constituting rights to receive income in respect of a decedent under section 691. However, gain with respect to a position in a constructive sale transaction that accrues after the transaction is closed is not included in income in respect of a decedent.

Description of Proposal

The proposal would clarify the special effective date rule to provide that the rule does not apply if the constructive sale transaction is closed at any time prior to the end of the 30th day after the date of enactment of the 1997 Act.

Effective Date

The proposal would be effective for decedents dying after June 8, 1997.

5. Gain recognition for certain extraordinary dividends (sec. 1011 of the Act and sec. 1059 of the Code)

Present Law

A corporate shareholder generally can deduct at least 70 percent of a dividend received from another corporation. This dividends received deduction is 80 percent if the corporate shareholder owns at least 20 percent of the distributing corporation and generally 100 percent if the shareholder owns at least 80 percent of the distributing corporation.

Section 1059 of the Code requires a corporate shareholder that receives an "extraordinary dividend" to reduce the basis of the stock with respect to which the dividend was received by the nontaxed portion of the dividend. Whether a dividend is "extraordinary" is determined, among other things, by reference to the size of the dividend in relation to the adjusted basis of the shareholder's stock. In addition, a dividend resulting from a non pro rata redemption or a partial liquidation is an extraordinary dividend. Gain is recognized if the reduction in basis of stock exceeds the basis in the stock with respect to which an extraordinary dividend is received.

The consolidated return regulations provide similar basis adjustment rules with respect to dividends paid within a consolidated group of corporations. These rules provide that a dividend paid from one member of a group to its parent reduces the parent's basis in the stock of the payor and if such reduction exceeds the parent's basis, an "excess loss account" is created or increased. Except as provided in regulations, the extraordinary dividend provisions do not apply to result in a double reduction in basis in the case of distributions between members of an affiliated group filing consolidated returns or in the double inclusion of earnings and profits.

Description of Proposal

The proposal would provide coordination between the basis adjustment rules of section 1059 and the consolidated return regulations. These rules generally would provide that, except as provided in regulations, section 1059 will not cause current gain recognition to the extent that the consolidated return regulations require the creation or increase of an excess loss account.

Effective Date

The proposal generally would be effective for distributions after May 3, 1995.

6. Treatment of certain corporate distributions (sec. 1012 of the 1997 Act and secs. 355(e)(3)(A)(iv) and 358(c) of the Code)

Present Law

The 1997 Act (sec. 1012(a)) requires a distributing corporation ("distributing") to recognize corporate level gain on the distribution of stock of a controlled corporation ("controlled") under section 355 of the Code if, pursuant to a plan or series of related transactions, one or more persons acquire a 50-percent or greater interest (defined as 50 percent or more of the voting power or value of the stock) of either the distributing or controlled corporation (Code sec. 355(e)). Certain transactions are excepted from the definition of acquisition for this purpose, including, under section 355(e)(3)(A)(iv), the acquisition by a person of stock in a corporation if shareholders owning directly or indirectly stock possessing more than 50 percent of the voting power and more than 50 percent of the value of the stock in distributing or any controlled corporation before such acquisition own directly or indirectly stock possessing such vote and value in such distributing or controlled corporation after such acquisition.[14]

In the case of a 50-percent or more acquisition of either the distributing corporation or the controlled corporation, the amount of gain recognized is the amount that the distributing

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[14] This exception (as certain other exceptions) does not apply if the stock held before the acquisition was acquired pursuant to a plan (or series of related transactions) to acquire a 50-percent or greater interest in the distributing or a controlled corporation.

corporation would have recognized had the stock of the controlled corporation been sold for fair market value on the date of the distribution. The Statement of Managers states that no adjustment to the basis of the stock or assets of either corporation is allowed by reason of the recognition of the gain.[15]

The 1997 Act (sec. 1012(b)(1)) also provides that, except as provided in regulations, section 355 shall not apply to the distribution of stock from one member of an affiliated group of corporations (as defined in section 1504(a)) to another member of such group (an intragroup spin-off) if such distribution is part of a such a plan or series of related transactions pursuant to which one or more persons acquire stock representing a 50-percent or greater interest in a distributing or controlled corporation, determined after the application of the rules of section 355(e).

In addition, the 1997 Act (sec. 1012(c)) provides that in the case of any distribution of stock of one member of an affiliated group of corporations to another member under section 355, the Treasury Department has regulatory authority under section 358(c) to provide adjustments to the basis of any stock in a corporation which is a member of such group, to reflect appropriately the proper treatment of such distribution.

The 1997 Act also modified certain rules for determining control immediately after a distribution in the case of certain divisive transactions in which a controlled corporation is distributed and the transaction meets the requirements of section 355. In such cases, under section 351 and modified section 368(a)(2)(H) with respect to reorganizations under section 368(a)(1)(D), those shareholders receiving stock in the distributed corporation are treated as in control of the distributed corporation immediately after the distribution if they hold stock representing a greater than 50 percent interest in the vote and value of stock of the distributed corporation.

The effective date (Act section 1012(d)(1)) states that the forgoing provisions of the 1997 Act apply to distributions after April 16, 1997, pursuant to a plan (or series of related transactions) which involves an acquisition occurring after such date (unless certain transition provisions apply).

Description of Proposal

Acquisition of a 50-percent or greater interest

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[15] The 1997 Act does not limit the otherwise applicable Treasury regulatory authority under section 336(e) of the Code. Nor does it limit the otherwise applicable provisions of section 1367 with respect to the effect on shareholder stock basis of gain recognized by an S corporation under this provision.

The proposal would clarify that the acquisitions described in Code section 355(e)(3)(A) are disregarded in determining whether there has been an acquisition of a 50-percent or greater interest in a corporation. However, other transactions that are part of a plan or series of related transactions could result in an acquisition of a 50-percent or greater interest.

In the case of acquisitions under section 355(e)(3)(A)(iv), the proposal clarifies that the acquisition of stock in the distributing corporation or any controlled corporation is disregarded to the extent that the percentage of stock owned directly or indirectly in such corporation by each person owning stock in such corporation immediately before the acquisition does not decrease.

Example: Shareholder A owns 10 percent of the vote and value of the stock of corporation D (which owns all of corporation C). There are nine other equal shareholders of D. A also owns 100 percent of the vote and value of the stock of unrelated corporation P. D distributes C to all the shareholders of D. Thereafter, pursuant to a plan or series of related transactions, D (worth 100x) merges with corporation P (worth 900x). After the merger, each of the former shareholders of corporation D owns stock of the merged entity reflecting the vote and value attributable to that shareholder's respective 10 percent former stock ownership of D. Each of the former shareholders of D owns 1 percent of the stock of the merged corporation, except that shareholder A (who owned 100 percent of corporation P and 10 percent of corporation D before the merger) now owns 91 percent of the stock of the merged corporation. In determining whether a 50-percent or greater interest in D has been acquired, the interest of each of the continuing shareholders is disregarded only to the extent there has been no decrease in such shareholder's direct or indirect ownership. Thus, the 10 percent interest of A, and the 1 percent interest of each of the nine other former shareholder of D, is not counted. The remaining 81 percent ownership of the merged corporation, representing a decrease of nine percent in the interests of each of the nine former shareholders other than A, is counted in determining the extent of an acquisition. Therefore, a 50-percent or greater interest in D has been acquired.

Treasury regulatory authority

The proposal would also clarify that the regulatory authority of the Treasury Department under section 358(c) applies to distributions after April 16, 1997, without regard to whether a distribution involves a plan (or series of related transactions) which involves an acquisition. As stated in the Conference Report to the Act, with respect to the Treasury Department regulatory authority under section 358(c) as applied to intragroup spin-off transactions that are not part of a plan or series of related transactions that involve an acquisition of a 50-percent of greater interest under new section 355(f), it is expected that any Treasury regulations will be applied prospectively, except in cases to prevent abuse.

Section 351(c) and section 368(a)(2)(H) "control immediately after" requirement

The proposal would clarify that in the case of certain divisive transactions in which a corporation contributes assets to a controlled corporation and then distributes the stock of the controlled corporation in a transaction that meets the requirements of section 355 (or so much of section 356 as relates to section 355), the "control immediately after" requirement of section 351(c) and section 368(a)(2)(H) shall be deemed satisfied.

Effective Date

The proposal generally would be effective for distributions after April 16, 1997.

7. Certain preferred stock treated as "boot"--statute of limitations (sec. 1014 of the 1997 Act and sec. 354(a) of the Code)

Present law

Under the 1997 Act, certain preferred stock received in otherwise tax-free transactions is treated as "other property." Exchanges of stock in certain recapitalizations of family-owned corporations are excepted from this rule. A family-owned corporation is defined as any corporation if at least 50 percent of the total voting power and value of the stock of such corporation is owned by the same family for five years preceding the recapitalization. In addition, a recapitalization does not qualify for the exception if the same family does not own 50 percent of the total voting power and value of the stock throughout the three-year period following the recapitalization.

Description of Proposal

The proposal would provide that the statutory period for the assessment of any deficiency attributable to a corporation failing to be a family-owned corporation shall not expire before the expiration of three years after the date the Secretary of the Treasury is notified by the corporation (in such manner as the Secretary may prescribe) of such failure, and such deficiency may be assessed before the expiration of such three-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

Effective Date

The proposal would apply to transactions after June 8, 1997.

8. Certain preferred stock treated as "boot"--treatment of transferor (sec. 1014 of the 1997 Act and sec. 351(g) of the Code)

Present Law

The 1997 Act amended section 351 of the Code to provide that in the case of a person who transfers property to a controlled corporation and receives nonqualified preferred stock, section 351(b) will apply to such person. Section 351(b) provides that if section 351(a) of the Code would apply to an exchange but for the fact that there is received, in addition to stock permitted to be received under section 351(a), other property or money, then gain but no loss to such recipient shall be recognized. The Statement of Managers to the 1997 Act states that if nonqualified preferred stock is received, gain but not loss shall be recognized.

Description of Proposal

The proposal would clarify that section 351(b) applies to a transferor who transfers property in a section 351 exchange and receives nonqualified preferred stock in addition to stock that is not treated as "other property" under that section. Thus, if a transferor received only nonqualified preferred stock but the transaction in the aggregate otherwise qualified as a section 351 exchange, such a transferor would recognize loss and the basis of the nonqualified preferred stock and of the property in the hands of the transferee corporation would reflect the transaction in the same manner as if that particular transferor had received solely "other property" of any other type. As under the 1997 Act, the nonqualified preferred stock continues to be treated as stock received by a transferor for purposes of qualification of a transaction under section 351(a), unless and until regulations may provide otherwise.

Effective Date

The proposal would apply to transactions after June 8, 1997.

9. Application of section 304 to certain international transactions (sec. 1013 of the 1997 Act and sec. 304 of the Code)

Present Law

Under section 304, if one corporation purchases stock of a related corporation, the transaction generally is recharacterized as a redemption. Under section 304(a), as amended by the 1997 Act, to the extent that a section 304 transaction is treated as a distribution under section 301, the transferor and the acquiring corporation are treated as if (1) the transferor had transferred the stock involved in the transaction to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation had then redeemed the stock it is treated as having issued. In the case of a section 304 transaction, both the amount which is a dividend and the source of such dividend is determined as if the property were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits (sec. 304(b)(2)). Section 304(b)(5), as added by the 1997 Act, provides special rules that apply if the acquiring corporation in a section 304 transaction is a foreign corporation. Under section 304(b)(5), the earnings and profits of the acquiring corporation that are taken into account are limited to the portion of such earnings and profits that (1) is attributable to stock of such acquiring corporation held by a corporation or individual who is the transferor (or a person related thereto) and who is a U.S. shareholder (within the meaning of section 951(b)) of such corporation and (2) was accumulated during periods in which such stock was owned by such person while such acquiring corporation was a controlled foreign corporation. For purposes of this rule, except as otherwise provided by the Secretary of the Treasury, the rules of section

1248(d) (relating to certain exclusions from earnings and profits) apply. The Secretary is to prescribe regulations as appropriate, including regulations determining the earnings and profits that are attributable to particular stock of the acquiring corporation.

For foreign tax credit purposes, under section 902, a U.S. corporation that receives a dividend from a foreign corporation in which it owns at least 10 percent of the voting stock is treated as if it had paid the foreign income taxes paid by the foreign corporation which are attributable to such dividend. The Internal Revenue Service issued rulings providing that a domestic corporation that is a transferor in a section 304 transaction may compute foreign taxes deemed paid under section 902 on the dividends from both a foreign acquiring corporation and a foreign issuing corporation. Rev. Rul. 92-86, 1992-2 C.B. 199; Rev. Rul. 91-5, 1991-1 C.B. 114. Both rulings involve section 304 transactions in which both the domestic transferor and the foreign acquiring corporation are wholly owned by a domestic parent corporation.

Description of Proposal

The proposal would eliminate the cross-reference to section 1248(d) for purposes of determining the earnings and profits to be taken into account under section 304(b)(5). Instead, under the proposal, the direction to the Secretary to issue regulations would specifically include regulations to prevent the multiple inclusion of an item of income and to provide appropriate basis adjustments. The 1997 Act amendments to section 304, including the modifications under the proposal, are not intended to change the foreign tax credit results reached in Rev. Rul. 92-86 and 91-5.

Effective Date

The proposal generally would be effective for distributions or acquisitions after June 8, 1997.

10. Establish IRS continuous levy and improve debt collection (secs. 1024, 1025, and 1026 of the 1997 Act and secs. 6331 and 6334 of the Code)

Present Law

If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand by the IRS, the IRS may then collect the tax by levy upon all property and rights to property belonging to the person, unless there is an explicit statutory restriction on doing so. A levy is the seizure of the person's property or rights to property. A levy on salary and wages is continuous from the date it is first made until the date it is fully paid or becomes unenforceable.

The 1997 Act provides that a continuous levy is also applicable to non-means tested recurring Federal payments and specified wage replacement payments.

Explanation of Provision

The proposal would clarify that the IRS must approve the use of a continuous levy before it may take effect.

Effective Date

The proposal would be effective for levies issued after the date of enactment of the 1997 Act (August 5, 1997).

11. Clarification regarding aviation gasoline excise tax (sec. 1031 of the 1997 Act, and sec. 6421(f) of the Code)

Present Law

Before enactment of the 1997 Act, aviation gasoline was subject to a 19.3-cents-per-gallon tax rate, with 15 cents per gallon being deposited in the Airport and Airway Trust Fund and 4.3 cents per gallon being retained in the General Fund. The 1997 Act extended the 15-cents-per-gallon rate for 10 years, through September 30, 2007, and expanded deposits to the Trust Fund to include revenues from the 4.3-cents-per-gallon rate. The tax does not apply to fuel used in flight segments outside the United States or to flight segments from the United States to foreign countries.

Description of Proposal

The proposal would clarify the application of the gasoline tax refund provisions to aviation gasoline used in flight segments outside the United States and to flight segments from the United States to foreign countries.

Effective Date

The proposal would be effective as if included in the 1997 Act.

12. Clarification of requirement that registered fuel terminals offer dyed fuel (sec. 1032 of the 1997 Act and sec. 4101 of the Code)[16]

Present Law

The 1997 Act provides that fuel terminals are eligible to register to handle non-tax-paid diesel fuel and kerosene only if the terminal operator offers both undyed (taxable) and dyed (nontaxable) fuel.

Description of Proposal

The proposal would clarify that the Code requires terminals eligible to handle non-tax-paid diesel to offer dyed diesel fuel and terminals eligible to handle non-tax-paid kerosene (including diesel fuel #1 and kerosene-type aviation fuel) to offer dyed kerosene. The proposal does not require that a terminal offer for sale kerosene as a condition of receiving diesel fuel on a non-tax-paid basis. Similarly, the proposal does not require terminals that sell only kerosene to offer diesel fuel as a condition of receiving non-tax-paid kerosene.

Effective Date

The proposal would be effective as if included in the 1997 Act.

13. Clarification of treatment of prepaid telephone cards (sec. 1034 of the 1997 Act and sec. 4251 of the Code)

Present Law

A 3-percent excise tax is imposed on amounts paid for local and toll (long-distance) telephone service and teletypewriter exchange service. The tax is collected by the provider of the service from the consumer. In the case of so-called "prepaid telephone cards" the tax is treated as paid when the card is transferred by any telecommunications carrier to any person who is not a telecommunications carrier.

A "prepaid telephone card" is defined as any card or other similar arrangement which permits its holder to obtain communications services and pay for such services in advance.

Description of the Proposal

The proposal would clarify that payment to a communications service provider from a third party such as a joint venture credit card company is treated as payment made by the holder

[16] S. 1173, as passed by the Senate, would delay the effective date of this requirement for two years, until July 1, 2000.

of the credit card to obtain communication services and the tax is treated as paid in a manner similar to that applied to prepaid telephone cards.

Effective Date

The proposal would be effective as if included in the Taxpayer Relief Act of 1997.

14. Modify UBIT rules applicable to second-tier subsidiaries (sec. 1041 of the 1997 Act and sec. 512(b)(13) of the Code)

Present Law

In general, interest, rents, royalties and annuities are excluded from the unrelated business income ("UBI") of tax-exempt organizations. However, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as UBI if such income is received from a taxable or tax-exempt subsidiary that is controlled by the parent tax-exempt organization.

Under the provision, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity. In this regard, section 512(b)(13)(B)(i)(I) cross references a non-existent Code section.

The provision generally applies to taxable years beginning after the date of enactment. However, the provision does not apply to payments made during the first two taxable years beginning on or after the date of enactment if such payments are made pursuant to a binding written contract in effect as of June 8, 1997, and at all times thereafter before such payment.

Description of Proposal

The proposal would clarify that rent, royalty, annuity, and interest income that would otherwise be excluded from UBI is included in UBI under section 512(b)(13) if such income is derived from a taxable or tax-exempt subsidiary that is controlled by the parent tax-exempt organization. The proposal further would clarify that the provision does not apply to any payment made during the first two taxable years beginning on or after the date of enactment if such payment is made pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

Effective Date

The proposal would be effective as of August 5, 1997, the date of enactment of the 1997 Act.

15. Clarification of provision expanding the limitations on deductibility of premiums and interest with respect to life insurance, endowment and annuity contracts (sec. 1084 of the 1997 Act and sec. 264 of the Code)

Present Law

Master contracts

The 1997 Act provided limitations on the deductibility of interest and premiums with respect to life insurance, endowment and annuity contracts. Under the pro rata interest disallowance provision added by the Act, an exception is provided for any policy or contract owned by an entity engaged in a trade or business, covering an individual who is an employee, officer or director of the trade or business at the time first covered. The exception applies to any policy or contract owned by an entity engaged in a trade or business, which covers one individual who (at the time first insured under the policy or contract) is (1) a 20-percent owner of the entity, or (2) an individual (who is not a 20-percent owner) who is an officer, director or employee of the trade or business.[17] The provision is silent as to the treatment of coverage of such an individual under a master contract.

Reporting

The provision does not apply to any policy or contract held by a natural person; however, if a trade or business is directly or indirectly the beneficiary under any policy or contract, the policy or contract is treated as held by the trade or business and not by a natural person. In addition, the provision includes a reporting requirement. Specifically, the provision provides that the Treasury Secretary shall require such reporting from policyholders and issuers as is necessary to carry out the rule applicable when the trade or business is directly or indirectly the beneficiary under any policy or contract held by a natural person. Any report required under this reporting requirement is treated as a statement referred to in Code section 6724(d)(1) (relating to information returns). The provision does not specifically refer to Code section 6724(d)(2) (relating to payee statements).

Description of Proposals

Master contracts

The proposal would clarify that if coverage for each insured individual under a master contract is treated as a separate contract for purposes of sections 817(h), 7702, and 7702A of the

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[17] The exception also applies in the case of a joint-life policy or contract under which the sole insureds are a 20-percent owner and the spouse of the 20-percent owner. A joint-life contract under which the sole insureds are a 20-percent owner and his or her spouse is the only type of policy or contract with more than one insured that comes within the exception.

Code, then coverage for each such insured individual is treated as a separate contract, for purposes of the exception to the pro rata interest disallowance rule for a policy or contract covering an individual who is a 20-percent owner, employee, officer or director of the trade or business at the time first covered. A master contract would not include any contract if the contract (or any insurance coverage provided under the contract) is a group life insurance contract within the meaning of Code section 848(e)(2). No inference would be intended that coverage provided under a master contract, for each such insured individual, is not treated as a separate contract for each such individual for other purposes under present law.

Reporting

The proposal would clarify that the required reporting to the Treasury Secretary is an information return (within meaning of sec. 6724(d)(1)), and any reporting required to be made to any other person is a payee statement (within the meaning of sec. 6724(d)(2)). Thus, the $50-per-report penalty imposed under sections 6722 and 6723 of the Code for failure to file or provide such an information return or payee statement would apply. It would be clarified that the Treasury Secretary may require reporting by the issuer or policyholder of any relevant information either by regulations or by any other appropriate guidance (including but not limited to publication of a form).

Effective Date

The proposals would be effective as if included in the 1997 Act.

16. Clarification of allocation of basis of properties distributed to a partner by a partnership (sec. 1061 of the 1997 Act and sec. 732(c) of the Code)

Present Law

Present law, as amended by the 1997 Act, provides rules for allocating basis to property in the hands of a partner that receives a distribution from a partnership. Under these rules, basis is first allocated to unrealized receivables and inventory items in an amount equal to the partnership's adjusted basis in each property. If the basis to be allocated is less than the sum of the adjusted bases of the properties in the hands of the partnership, then, to the extent a decrease is required to make the total adjusted bases of the properties equal the basis to be allocated, the decrease is allocated (as described below) for adjustments that are decreases. To the extent of any basis not allocated to inventory and unrealized receivables under the above rules, basis is allocated to other distributed properties, first to the extent of each distributed property's adjusted basis to the partnership. Any remaining basis adjustment, if an increase, is allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), and then in proportion to their respective fair market values. If the remaining basis adjustment is a decrease, it is allocated among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (to the extent of each property's depreciation), and then in proportion to their respective adjusted bases (taking into account the adjustments already made).

For purposes of these rules, "unrealized receivables" has the meaning set forth in section 751(c) (as provided in sec. 732(c)(1)(A)(i)). Section 751(c) provides that the term "unrealized receivables" includes certain accrued but unreported income. In addition, the last two sentences of section 751(c) provide that for purposes of certain specified partnership provisions (sections 731, 741 and 751), the term "unrealized receivables" includes certain property the sale of which will give rise to ordinary income (for example, depreciation recapture under sections 1245 or 1250), but only to the extent of the amount that would be treated as ordinary income on a sale of that property at fair market value.

Description of Proposal

The proposal would clarify that for purposes of the allocation rules of section 732(c), "unrealized receivables" has the meaning in section 751(c) including the last two sentences of section 751(c), relating to items of property that give rise to ordinary income. Thus, in applying the allocation rules of section 732(c) to property listed in the last two sentences of section 751(c), such as property giving rise to potential depreciation recapture, the amount of unrealized appreciation in any such property would not include any amount that would be treated as ordinary income if the property were sold at fair market value, because such amount would be treated as a separate asset for purposes of the basis allocation rules.[18]

For example, assume that a partnership has 3 partners, A, C and D. The partnership has 6 assets. Three are capital assets each with adjusted basis equal to fair market value of $20,000. The other three are depreciable equipment each with adjusted basis of $5,000 and fair market value of $30,000. Each of the pieces of equipment would have $25,000 of depreciation recapture if sold by the partnership for its $30,000 value. A has a basis in its partnership interest of $60,000. Assume that one of the capital assets and one of the pieces of equipment is distributed to A in liquidation of its interest. A would be treated as receiving three assets: (1) depreciation recapture (an unrealized receivable) with a basis to the partnership of zero and a value of $25,000; (2) a piece of equipment with a basis to the partnership of $5,000 and a value of $5,000 (its $30,000 value reduced by the $25,000 of depreciation recapture); and (3) a capital asset with a basis to the partnership of $20,000 and a value of $20,000.

Under the provision, as clarified by the technical correction, A's $60,000 basis in its partnership interest would be allocated as follows. First, basis would be allocated to the depreciation recapture, an unrealized receivable, in an amount equal to the partnership's adjusted basis in it, or zero (sec. 732(c)(1)(A)(i)). Then basis would be allocated to the extent of each of

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[18] Treasury regulations under section 751(b) provide for a similar bifurcation of assets among potential ordinary income amounts and other amounts in applying the definition of "unrealized receivables" for purposes of that section. Treas. Reg. 1.751-1(c)(4).

the other distributed properties' adjusted basis to the partnership, or $5,000 to the equipment (not including the depreciation recapture), and $20,000 to the capital asset. A's remaining $35,000 of basis would be allocated next among properties, if any, with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), but neither of the distributed properties to which basis may be allocated has unrealized appreciation. Basis is then allocated then in proportion to the properties' respective fair market values ($5,000 for the equipment and $20,000 for the capital asset). Thus, of the remaining $35,000, $7,000 is allocated to the equipment, so that its total basis in the partner's hands is $12,000; and $28,000 is allocated to the capital asset, so that its total basis in the partner's hands is $48,000.

Effective Date

The proposal would be effective as if enacted with the 1997 Act.

17. Clarification to the definition of modified adjusted gross income for purposes of the earned income credit phaseout (sec. 1085(d) of the 1997 Act and sec. 32(c) of the Code)

Present Law

The earned income credit ("EIC") is phased out above certain income levels. For individuals with earned income (or modified adjusted gross income ("modified AGI"), if greater) in excess of the beginning of the phaseout range, the maximum credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or modified AGI, if greater) in excess of the beginning of the phaseout range. For individuals with earned income (or modified AGI, if greater) in excess of the end of the phaseout range, no credit is allowed. The definition of modified AGI used for the phase out of the earned income credit is the sum of: (1) AGI with certain losses disregarded, and (2) certain nontaxable amounts not generally included in AGI. The losses disregarded are: (1) net capital losses (if greater than zero); (2) net losses from trusts and estates; (3) net losses from nonbusiness rents and royalties; (4) 75 percent of the net losses from business, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses.[19] The nontaxable amounts included in modified AGI which are generally not included in AGI are: (1) tax-exempt interest; and (2) nontaxable distributions from pensions, annuities, and individual retirement arrangements (but only if not rolled over into similar vehicles during the applicable rollover period).

[19] The 1997 Act increased the amount of net losses from businesses, computed separately with respect to sole proprietorships (other than farming), sole proprietorships in farming, and other businesses disregarded from 50 percent to 75 percent.

Description of Proposal

The proposal would clarify that the two nontaxable amounts that are added to adjusted gross income to compute modified AGI for purposes of the EIC phaseout are additions to adjusted gross income and not disregarded losses.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

J. Amendments to Title XI of the 1997 Act Relating to Foreign Provisions

1. Application of attribution rules under PFIC provisions (sec. 1121 of the 1997 Act and sec. 1298 of the Code)

Present Law

Special attribution rules apply to the extent that the effect is to treat stock of a passive foreign investment company ("PFIC") as owned by a U.S. person. In general, if 50 percent or more in value of the stock of a corporation is owned (directly or indirectly) by or for any person, such person is considered as owning a proportionate part of the stock owned directly or indirectly by or for such corporation, determined based on the person's proportionate interest in the value of such corporation's stock. However, this 50-percent limitation does not apply in the case of a corporation that is a PFIC. Accordingly, a person that is a shareholder of a PFIC is considered as owning a proportionate part of the stock owned directly or indirectly by or for such PFIC, without regard to whether such shareholder owns at least 50 percent of the PFIC's stock by value.

A corporation is not treated as a PFIC with respect to a shareholder during the qualified portion of the shareholder's holding period for the stock of such corporation. The qualified portion of the shareholder's holding period generally is the portion of such period which is after the effective date of the 1997 Act and during which the shareholder is a United States shareholder (as defined in sec. 951(b)) and the corporation is a controlled foreign corporation.

If a corporation is not treated as a PFIC with respect to a shareholder for the qualified portion of such shareholder's holding period, it is unclear whether the attribution rules that apply with respect to stock owned by or for such corporation apply without regard to the requirement that the shareholder own 50 percent or more of the corporation's stock.

Description of Proposal

The proposal would clarify that the attribution rules apply without regard to the provision that treats a corporation as a non-PFIC with respect to a shareholder for the qualified portion of the shareholder's holding period. Accordingly, stock owned directly or indirectly by or for a corporation that is not treated as a PFIC for the qualified portion of the shareholder's holding period nevertheless will be attributed to such shareholder, regardless of the shareholder's ownership percentage of such corporation.

Effective Date

The proposal would be effective for taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

2. Treatment of PFIC option holders (sec. 1121 of the 1997 Act and secs. 1297 and 1298 of the Code)

Present Law

Under the provisions of subpart F, a controlled foreign corporation (a "CFC") is defined generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only) (sec. 957). Stock ownership includes not only stock owned directly, but also stock owned indirectly through a foreign entity or constructively (sec. 958). Pursuant to the constructive ownership rules, a person that has an option to acquire stock generally is treated as owning such stock (secs. 958(b) and 318(a)(4)).

The U.S. 10-percent shareholders of a CFC are subject to current U.S. tax on their pro rata shares of certain income of the CFC and their pro rata shares of the CFC's earnings invested in certain U.S. property (sec. 951). For purposes of determining the U.S. shareholder's includible pro rata share of the CFC's income and earnings, only stock held directly or indirectly through a foreign entity (and not stock held constructively) is taken into account (secs. 951(b) and 958(a)).

A foreign corporation is a passive foreign investment company (a "PFIC") if it satisfies a passive income test or a passive assets test for the taxable year (sec. 1297). A U.S. shareholder of a PFIC generally is subject to U.S. tax, plus an interest charge, on distributions from a PFIC and gain realized upon a disposition of PFIC stock (sec. 1291). Alternatively, the U.S. shareholder may elect either to be subject to current U.S. tax on the shareholder's share of the PFIC's earnings or, in the case of PFIC stock that is marketable, to mark to market the PFIC stock (secs. 1293 and 1296). For purposes of the PFIC provisions, constructive ownership rules apply (sec. 1298(a)). Under these rules, an option to acquire stock is treated as stock for purposes of applying the interest charge regime to a disposition of such option, and the holding period for stock acquired pursuant to the exercise of an option includes the holding period for such option (sec. 1298(a)(4) and prop. Treas. reg. sec. 1.1291-1(d) and (h)(3)).

A corporation that is a CFC is also a PFIC if it meets the passive income test or the passive assets test. Under section 1297(e), as added by the 1997 Act, a corporation is not treated as a PFIC with respect to a shareholder during the period after December 31, 1997 in which the corporation is a CFC and the shareholder is a U.S. shareholder (within the meaning of section 951(b)) thereof. Under this rule eliminating the overlap between the PFIC and CFC provisions, a shareholder that is subject to the subpart F rules with respect to a corporation is not also subject to the PFIC rules with respect to such corporation.

Description of Proposal

Under the proposal, the elimination of the overlap between the PFIC and the CFC provisions would not apply to a U.S. person with respect to PFIC stock that such person is treated as owning by reason of an option to acquire such stock. Accordingly, for example, the PFIC rules would continue to apply to a U.S. person that holds only an option on stock of a corporation that is a CFC because such person does not own stock of such corporation directly or indirectly through a foreign entity and therefore is not subject to the current inclusion rules of subpart F with respect to such corporation.

Effective Date

The proposal would be effective for taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

3. Application of PFIC mark-to-market rules to RICs (sec. 1122 of the 1997 Act and sec. 1296 of the Code)

Present Law

Under section 1296, as added by the 1997 Act, a shareholder of a passive foreign investment company (a "PFIC") may make a mark-to-market election with respect to the stock of the PFIC, provided that such stock is marketable. Under this election, the shareholder includes in income each year an amount equal to the excess, if any, of the fair market value of the PFIC stock as of the close of the taxable year over the shareholder's adjusted basis in such stock. The shareholder is allowed a deduction for the excess, if any, of the shareholder's adjusted basis in the PFIC stock over its fair market value as of the close of the taxable year, but only to the extent of any net mark-to-market gains with respect to such stock included by the shareholder under section 1296 for prior years.

The mark-to-market election of section 1296 is effective for taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons. Prior to the enactment of section 1296, a proposed Treasury regulation provided for a mark-to-market election with respect to PFIC stock held by certain regulated investment companies ("RICs") (prop. Treas. reg. sec. 1.1291-8).

Section 1296(j) provides rules applicable in the case of a shareholder that makes a mark-to-market election under section 1296 later than the beginning of the shareholder's holding period for the PFIC stock. Special rules apply in the case of a RIC that makes such a mark-to-market election under section 1296 with respect to PFIC stock that the RIC had previously marked to market under the proposed Treasury regulation.

Description of Proposal

Under the proposal, for purposes of determining allowable deductions for any excess of the shareholder's adjusted basis in PFIC stock over the fair market value of the stock as of the close of the taxable year, deductions would be allowed to the extent not only of prior mark-to-market inclusions under section 1296 but also of prior mark-to-market inclusions under the proposed Treasury regulation applicable to a RIC that holds stock in a PFIC.

Effective Date

The proposal would be effective for taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

4. Interaction between the PFIC provisions and other mark-to-market rules (sec. 1122 of the 1997 Act and secs. 1291 and 1296 of the Code)

Present Law

A U.S. shareholder of a passive foreign investment company (a "PFIC") generally is subject to U.S. tax, plus an interest charge, on distributions from a PFIC and gain realized upon a disposition of PFIC stock (sec. 1291). As an alternative to this interest charge regime, the U.S. shareholder may elect to be subject to current U.S. tax on the shareholder's share of the PFIC's earnings (sec. 1293). Section 1296, as added by the 1997 Act, provides another alternative available in the case of a PFIC the stock of which is marketable; under section 1296, a U.S. shareholder of a PFIC may make a mark-to-market election with respect to the stock of the PFIC.

The interest charge regime generally does not apply to distributions from, and dispositions of stock of, a PFIC for which the U.S. shareholder has made either a mark-to-market election under section 1296 or an election to include the PFIC's earnings in income currently (sec. 1291(d)(1)). However, special coordination rules provide for limited application of the interest charge regime in the case of a U.S. shareholder that makes a mark-to-market election under section 1296 later than the beginning of the shareholder's holding period for the PFIC stock (sec. 1296(j)).

Under section 475(a), a dealer in securities is required to mark to market certain securities held by the dealer. Under section 475(f), as added by the 1997 Act, a trader in securities may elect to mark to market securities held in connection with the person's trade or business as a trader in securities. Other provisions similarly allow stock to be marked to market (e.g., sec. 1092(b)(1) and temp. Treas. reg. Sec. 1.1092-4T).

Description of Proposal

Under the proposal, the interest charge regime generally would not apply to distributions from, and dispositions of stock of, a PFIC where the U.S. shareholder has marked to market such stock under section 475 or any other provision (in the same manner that such regime does not apply where the shareholder has marked to market such stock under section 1296). In addition, under the proposal, coordination rules like those provided in section 1296(j) would apply in the case of a U.S. shareholder that marks to market PFIC stock under section 475 or any other provision later than the beginning of the shareholder's holding period for the PFIC stock.

Effective Date

The proposal would be effective for taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons. No inference would be intended regarding the treatment of PFIC stock that was marked to market prior to the effective date.

5. Application of foreign tax credit holding period rule to RICs (sec. 1053 of the 1997 Act and secs. 853 and 901 of the Code)

Present Law

Section 901(k), as added by the 1997 Act, generally imposes a holding period requirement for claiming foreign tax credits with respect to dividends. Under section 901(k), foreign tax credits with respect to a dividend from a foreign corporation or a regulated investment company (a "RIC") are disallowed if the shareholder has not held the stock for more than 15 days in the case of common stock or more than 45 days in the case of preferred stock. This disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is not held for the required period and to indirect foreign tax credits for taxes paid by a lower-tier foreign corporation or a RIC where any of the stock in the required chain of ownership is not held for the required period. Foreign taxes for which credits are disallowed under section 901(k) may be deducted.

Under section 853, a RIC may elect to flow through to its shareholders the foreign tax credits for foreign taxes paid by the RIC. Under this election, the RIC is not entitled to a deduction or credit for foreign taxes paid; the shareholders of an electing RIC are treated as having paid their proportionate shares of the foreign taxes paid by the RIC. Accordingly, foreign tax credits are claimed at the shareholder level and not at the RIC level.

Description of Proposal

Under the proposal, the flow-through election of section 853 would not apply to any foreign taxes paid by the RIC for which a credit is disallowed under section 901(k) because the RIC did not satisfy the applicable holding period. Accordingly, such taxes would be deductible at the RIC level. The election of section 853 would apply only to foreign taxes with respect to which the RIC has satisfied any applicable holding period requirement.

Effective Date

The proposal would be effective for dividends paid or accrued more than 30 days after the date of enactment of the 1997 Act.

K. Amendments to Title XII of the 1997 Act Relating to Simplification Provisions

1. Travel expenses of Federal employees participating in a Federal criminal investigation (sec. 1204 of the 1997 Act and sec. 162 of the Code)

Present Law

Unreimbursed ordinary and necessary travel expenses paid or incurred by an individual in connection with temporary employment away from home (e.g., transportation costs and the cost of meals and lodging) are generally deductible, subject to the two-percent floor on miscellaneous itemized deductions. Travel expenses paid or incurred in connection with indefinite employment away from home, however, are not deductible. A taxpayer's employment away from home in a single location is indefinite rather than temporary if it lasts for one year or more; thus, no deduction is permitted for travel expenses paid or incurred in connection with such employment (sec. 162(a)). If a taxpayer's employment away from home in a single location lasts for less than one year, whether such employment is temporary or indefinite is determined on the basis of the facts and circumstances.

The 1997 Act provided that the one-year limitation with respect to deductibility of expenses while temporarily away from home does not include any period during which a Federal employee is certified by the Attorney General (or the Attorney General's designee) as traveling on behalf of the Federal Government in a temporary duty status to investigate or provide support services to the investigation of a Federal crime. Thus, expenses for these individuals during these periods are fully deductible, regardless of the length of the period for which certification is given (provided that the other requirements for deductibility are satisfied).

Description of Proposal

The proposal would clarify that prosecuting a Federal crime or providing support services to the prosecution of a Federal crime is considered part of investigating a Federal crime.

Effective Date

The proposal would be effective for amounts paid or incurred with respect to taxable years ending after the date of enactment of the 1997 Act.

2. Effective date for provisions relating to electing large partnerships, partnership returns required on magnetic media, and treatment of partnership items of individual retirement arrangements (sec. 1226 of the 1997 Act)

Present Law

Rules for simplified flowthrough and simplified audit procedures for electing large partnerships, as well as a March 15 due date for furnishing information to partners of an electing large partnership, were added to present law by the 1997 Act. The 1997 Act also added a rule providing that partnership returns are required on magnetic media, and modified the treatment of partnership items of individual retirement arrangements. The 1997 Act statement of managers provided that these provisions apply to partnership taxable years beginning after December 31, 1997. The statute provided that the rules for simplified flowthrough for electing large partnerships apply to partnership taxable years beginning after December 31, 1997 (Act sec. 1221(c)), although the statute also provided that all the provisions apply to partnership taxable years ending on or after December 31, 1997 (Act sec. 1226).

Description of Proposal

The proposal would provide that these provisions apply to partnership taxable years beginning after December 31, 1997.

Effective Date

The proposal would be effective as if enacted in the 1997 Act.

3. Modification of distribution rules for REITs (sec. 1256 of the 1997 Act and sec. 857 of the Code)

Present Law

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate investments and meets certain other requirements. A REIT receives conduit treatment (i.e., one level of tax) for income distributed to its shareholders. A REIT generally must distribute 95 percent of its earnings (sec. 857(a)(1)). An entity loses its status as a REIT if it retains non-REIT earnings and profits (sec. 857(a)(2)). A REIT simplification provision in the 1997 Act provides that any distribution from a REIT will be deemed to first come from the earliest earnings and profits of the entity. As a result, in the case of a REIT with accumulated REIT earnings and profits that inherits subsequently earned non-REIT earnings and profits (e.g., by way of merger with a C corporation), that the entity must distribute both the accumulated REIT earnings and profits as well as the inherited non-REIT earnings and profits under the 1997 Act provision in order to retain its REIT status.

Description of Proposal

The proposal would amend the simplification provision to provide that any distribution from a REIT will be deemed to first come from non-REIT earnings and profits. The proposal would not change the requirement that a REIT must distribute 95 percent of its REIT earnings.

Effective Date

The proposal would be effective for taxable years beginning after August 5, 1997.

L. Amendments to Title XIII of the 1997 Act Relating to Estate, Gift and Trust Simplification

1. Clarification of treatment of revocable trusts for purposes of the generation-skipping transfer tax (sec. 1305 of the Act and secs. 2652 and 2654 of the Code)

Present Law

The 1997 Act provided an irrevocable election to treat a qualified revocable trust as part of the decedent's estate for Federal income tax purposes. For this purpose, a qualified revocable trust is any trust (or portion thereof) which was treated as owned by the decedent with respect to whom the election is being made, by reason of a power in the grantor (i.e., trusts that are treated as owned by the decedent solely by reason of a power in a nonadverse party would not qualify). A conforming change was also made to section 2652(b) for generation-skipping tax purposes.

Description of Proposal

The proposal would clarify that the election to treat a qualified revocable trust as part of the decedent's estate would apply for generation-skipping tax purposes only with respect to the application of section 2654(b)(describing when a single trust may be treated as two or more trusts). The election would have no other effect for generation-skipping tax purposes.

Effective Date

The proposal would apply to decedents dying after the date of enactment of the 1997 Act.

2. Provision of regulatory authority for simplified reporting of funeral trusts terminated during the taxable year (sec. 1309 of the Act and sec. 685(f) of the Code)

Present Law

The 1997 Act provided an election which allows the trustee of a qualified pre-need funeral trust to elect special tax treatment for such a trust, to the extent the trust would otherwise be treated as a grantor trust. As part of this provision, the Secretary of the Treasury was granted regulatory authority to prescribe rules for simplified reporting of all trusts having a single trustee.

Description of Proposal

The proposal would extend the Secretary's regulatory authority to include rules providing for the inclusion of trusts terminated during the year (e.g., in the event of the death of the beneficiary) in the simplified reporting.

Effective Date

The proposal would apply to decedents dying after the date of enactment of the 1997 Act.

M. Amendment to Title XV of the 1997 Act Relating to Pensions and Employee Benefits

1. Treatment of certain disability payments to public safety employees (sec. 1529 of the Act and sec. 104 of the Code)

Present Law

Under present law, certain payments made on behalf of full-time employees of any police or fire department organized and operated by a State (or any political subdivision, agency, or instrumentality thereof) are excludable from income. This treatment applies to payments made on account of heart disease or hypertension of the employee and that were received in 1989, 1990, or 1991 pursuant to a State law as amended on May 19, 1992, which irrebuttably presumed that heart disease and hypertension are work-related illnesses (but only for employees separating from service before July 1, 1992). Claims for refund or credit for overpayments resulting from the provision may be filed up to 1 year after August 5, 1997, without regard to the otherwise applicable statute of limitations.

Description of Proposal

In order to address problems taxpayers are encountering with the IRS in seeking refunds under the present-law provision, the proposal would clarify the scope of the provision.

The proposal would provide that payments made on account of heart disease or hypertension of the employee and that were received in 1989, 1990, or 1991 pursuant to a State law as described under present law, or received under any other statute, ordinance, labor agreement, or similar provision as a disability pension payment or in the nature of a disability pension payment attributable to employment as a police officer or as a fireman would be excludable from income.

Effective Date

The proposal would be effective as if included in the Taxpayer Relief Act.

N. Amendments to Title XVI of the 1997 Act Relating to Technical Corrections

1. Application of requirements for SIMPLE IRAs in the case of mergers and acquisitions (sec. 1601 of the 1997 Act and sec. 408(p)(2) of the Code)

Present Law

If an employer maintains a qualified plan and a SIMPLE IRA in the same year due to an acquisition, disposition or similar transaction the SIMPLE IRA is treated as a qualified salary reduction arrangement for the year of the transaction and the following calendar year provided rules similar to the special coverage rules of section 410(b)(6)(C) apply. There is a similar provision with respect to an employer who, because of an acquisition, disposition or similar transaction, fails to be an eligible employer because such employer employs more than 100 employees. In this situation, the employer is treated as an eligible employer for two years following the transaction provided rules similar to the coverage rules of section 410(b)(6)(C)(i) apply.

Description of Proposal

The proposal would conform the treatment applicable to SIMPLE IRAs upon acquisition, disposition or similar transaction for purposes of (1) the 100 employee limit, (2) the exclusive plan requirement, and (3) the coverage rules for participation. In the event of such a transaction, the employer will be treated as an eligible employer and the arrangement will be treated as a qualified salary reduction arrangement for the year of the transaction and the two following years, provided rules similar to the rules of section 410(b)(6)(C)(i)(II) are satisfied and the arrangement would satisfy the requirements to be a qualified salary reduction arrangement after the transaction if the trade or business that maintained the arrangement prior to the transaction had remained a separate employer.

Effective Date

The proposal would be effective as if included in the Small Business Job Protection Act of 1996.

2. Treatment of Indian tribal governments under section 403(b) (sec. 1601 of the 1997 Act and sec. 403(b) of the Code)

Present Law

Any 403(b) annuity contract purchased in a plan year beginning before January 1, 1995, by an Indian tribal government is treated as purchased by an entity permitted to maintain a tax-sheltered annuity plan. Such contracts may be rolled over into a section 401(k) plan maintained by the Indian tribal government in accordance with the rollover rules of section 403(b)(8). An employee participating in a 403(b) annuity contract of the Indian tribal government may roll over amounts from such contract to a section 401(k) plan maintained by the Indian tribal government whether or not the annuity contract is terminated.

Description of Proposal

The proposal would clarify that an employee participating in a 403(b)(7) custodial account of the Indian tribal government may roll over amounts from such account to a section 401(k) plan maintained by the Indian tribal government.

Effective Date

The proposal would be effective as if included in the Small Business Job Protection Act of 1996.

II. TECHNICAL CORRECTIONS TO OTHER TAX LEGISLATION

A. Treatment of Adoption Tax Credit Carryovers (sec. 1807(a) of the Small Business Job Protection Act of 1996 and sec. 23 of the Code)

Present Law

Under present law taxpayers are allowed a maximum nonrefundable credit against income tax liability of $5,000 per child for qualified adoption expenses paid or incurred by the taxpayer. In the case of a special needs adoption, the maximum credit amount is $6,000 ($5,000 in the case of a foreign special needs adoption). To the extent the otherwise allowable credit exceeds the tax liability limitation of section 26 (reduced by other personal credits) the excess is carried forward as an adoption credit into the next taxable year, up to a maximum of five taxable years.

The credit is phased out ratably for taxpayers with modified adjusted gross income (AGI) above $75,000, and is fully phased out at $115,000 of modified AGI. For these purposes modified AGI is computed by increasing the taxpayer's AGI by the amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands, and residents of Puerto Rico, respectively).

Description of Proposal

The proposal would clarify that the AGI phaseout only applies in the year that the credit is generated and is not reapplied to further reduce any carry-forward amounts.

Effective Date

The proposal would be effective as if included in the Small Business Job Protection Act of 1996.

B. Disclosure Requirements for Apostolic Organizations (sec. 1313 of the Taxpayer Bill of Rights 2 and sec. 6104 of the Code)

Present Law

Section 501(d) provides tax-exempt status to certain religious or apostolic associations or corporations, if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members, but only if the members thereof include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the taxable income of the association or corporation for such year.[20] Any amount so included in the gross income of a member is treated as a dividend received. The effect of section 501(d) is to exempt the religious and apostolic associations or corporations which conduct communal activities (such as farming) from the Federal corporate-level income tax and the undistributed-profits tax, provided that members claim their shares of the corporation's income on their own individual returns.

Section 6033 generally requires tax-exempt organizations to file annual information returns, and such information returns are available for public inspection under sections 6104(b) and 6104(e), except that public disclosure is not required of the identity of contributors to an organization. Section 501(d) entities must include with their annual information return (Form 1065) a Schedule K-1 that identifies the members of the association or corporation and their ratable portions of net income and expenses.

Description of Proposal

The proposal would amend sections 6104(b) and 6104(e) to provide that public disclosure is not required of a Schedule K-1 filed by a religious or apostolic organization described in section 501(d).

Effective Date

The proposal would be effective on the date of enactment.

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[20] Under section 501(d), the requirement of a "common treasury" or "community treasury" is satisfied when all of the income generated from property owned by the organization is placed into a common fund that is maintained by such organization and is used for the maintenance and support of its members, with all members having equal, undivided interests in this common fund, but no right to claim title to any part thereof. See Twin Oaks Community, Inc. v. Commissioner, 87 T.C. 1233, at 1254 (1986). See also Rev. Rul. 78-100, 1978-1 C.B. 162 (sec. 501(d) entity must be supported by internally operated business activities rather than merely being supported by wages of members who are engaged in outside employment).

C. Allow Deduction for Unused Employer Social Security Credit (sec. 13443 of the Omnibus Budget Reconciliation Act of 1993 and sec. 196 of the Code)

Present Law

The general business credit ("GBC") consists of various individual tax credits (including the employer social security credit of Code section 45B) allowed with respect to certain qualified expenditures and activities. In general, the various individual tax credits contain provisions that prohibit "double benefits," either by denying deductions in the case of expenditure-related credits or by requiring income inclusions in the case of activity-related credits. Unused credits may be carried back one year and carried forward 20 years. Section 196 allows a deduction to the extent that certain portions of the GBC expire unused after the end of the carry forward period. Section 196 does not allow a deduction to the extent that the portion of the GBC that expires unused after the end of the carry forward period relates to the employer social security credit.

Description of Proposal

The proposal would allow a deduction to the extent that the portion of the GBC relating to the employer social security credit expires unused after the end of the carry forward period.

Effective Date

The proposal would be effective as if included in the Omnibus Budget Reconciliation Act of 1993.

D. Earned Income Credit Qualification Rules (sec. 11111(a) of the Omnibus Budget Reconciliation Act of 1990 as amended by sec. 742 of the Uruguay Round Agreements Act and sec. 451(a) of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 and sec. 32 of the Code)

Present Law

In general

In order to claim the earned income credit ("EIC"), an individual must be an eligible individual. To be an eligible individual, an individual must include a taxpayer identification number ("TIN") for the taxpayer and the taxpayer's spouse and must either have a qualifying child or meet other requirements. In order to claim the EIC without a qualifying child, an individual must not be a dependent and must be over age 24 and under age 65.

Qualifying child

A qualifying child must meet a relationship test, an age test, an identification test, and a residence test. Under the relationship and age tests, an individual is eligible for the EIC with respect to another person only if that other person: (1) is a son, daughter, or adopted child (or a descendent of a son, daughter, or adopted child); a stepson or stepdaughter; or a foster child of the taxpayer (a foster child is defined as a person whom the individual cares for as the individual's child; it is not necessary to have a placement through a foster care agency); and (2) is under the age of 19 at the close of the taxable year (or is under the age of 24 at the end of the taxable year and was a full-time student during the taxable year), or is permanently and totally disabled. Also, if the qualifying child is married at the close of the year, the individual may claim the EIC for that child only if the individual may also claim that child as a dependent.

To satisfy the identification test, an individual must include on their tax return the name, age, and "TIN" of each qualifying child.

The residence test requires that a qualifying child must have the same principal place of abode as the taxpayer for more than one-half of the taxable year (for the entire taxable year in the case of a foster child), and that this principal place of abode must be located in the United States. For purposes of determining whether a qualifying child meets the residence test, the principal place of abode shall be treated as in the United States for any period during which a member of the Armed Forces is stationed outside the United States while serving on extended active duty.

Description of Proposal

The proposal would clarify that the identification requirement is a requirement for claiming the EIC, rather than an element of the definitions of "eligible individual" and "qualifying child."

Effective Date

The proposal would be effective as if included in the originally enacted related legislation.

III. DIFFERENCES BETWEEN PROPOSED TECHNICAL CORRECTIONS CONTAINED IN THE CHAIRMAN'S MARK AND THE PROVISIONS OF TITLE VI OF H.R. 2676

Title VI of H.R. 2676, as passed by the House on November 5, 1997,[21] contains technical corrections to the 1997 Act and other legislation. Except for one instance noted below, the Chairman's mark generally contains the provisions of Title VI of H.R. 2676. Some of these provisions would be modified by the Chairman's mark. In addition, the Chairman's mark contains additional proposed technical corrections. The differences between the proposed technical corrections in the Chairman's mark and the provisions contained in Title VI of H.R. 2676 are briefly described below.

1. Education Incentives of the 1997 Act

Education IRAs.--The Chairman's mark adds provisions to: (1) provide that the excise tax of section 4973 would apply to each year that an excess contribution remains in an education IRA and (2) clarify that a beneficiary of an education IRA must be a life-in-being. In addition, the Chairman's mark includes tax technical corrections that were included in S. 1133, as reported by the Senate Finance Committee on February 19, 1998.[22]

Student loan interest.--The Chairman's mark adds a provision to clarify that only the borrower may deduct student loan interest.

Enhanced deduction for corporate donations of computers.--The Chairman's mark adds a provision to clarify the entities and organizations to which computers may be donated for purposes of the enhanced deduction.

Qualified State tuition programs.--The Chairman's mark adds a provision that would include the original beneficiary's spouse within the definition of "member of the family."

Qualified zone academy bonds.--The Chairman's mark adds a provision that would clarify the application of the credit to the estimated tax and overpayment rules.

2. Savings Incentives of the 1997 Act

The Chairman's mark would modify the technical corrections relating to individual retirement arrangements ("IRAs") in H.R. 2676 as passed by the House bill as follows.

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[21] The "Tax Technical Corrections Act of 1997" was added as an amendment to H.R. 2676 (Title VI) on the House floor. The provisions were previously reported by the House Committee on Ways and Means in H.R. 2645 (H. Rept. 105-356, October 29, 1997).

[22] See, S. Rept. 105-164.

Conversion of IRAs into Roth IRAs.--In the case of conversions of IRAs into Roth IRAs, the taxpayer would be able to elect whether to have the amount converted includible in income in the year of the conversion (or the year of withdrawal if the conversion is accomplished through a roll over) or ratably over 4 years. If an individual elects application of the 4-year spread and withdraws amounts before the entire amount of the conversion has been included in income, the amount withdrawn would be includible in income (in addition to any amount required to be included under the 4-year spread). In no case would the amount includible under this proposal exceed the amount converted. This proposal would replace the additional 10-percent tax under H.R. 2676 for 1998 conversions. Under the proposal, a new 5-year holding period for determining whether distributions from a Roth IRA are qualified distributions would not apply to converted amounts. The proposal would eliminate the rules in H.R. 2676 regarding separate accounts. The proposal would also clarify calculation of adjusted gross income for purposes of applying the $100,000 adjusted gross income limit on individuals eligible to convert IRAs to Roth IRAs.

Penalty-free distributions for education expenses and purchase of first homes.--The Chairman's mark would modify the provision in H.R. 2676 as passed by the House intended to prevent avoidance of the 10-percent early withdrawal tax in the case of hardship distributions under qualified plans and similar arrangements by providing that hardship distributions from qualified cash or deferred arrangements and similar plan are not eligible rollover distributions (and not subject to 20 percent withholding). The Chairman's mark would also modify the effective date of the House bill provision.

3. Capital Gains Provisions of the 1997 Act

The Chairman's mark would modify two provisions of H.R. 2676 to (1) clarify the provision relating to the holding period of positions in certain short sales and straddles, and (2) provide that new section 1045 (relating to rollovers of small business stock) applies to stock held by certain partnerships with trusts as partners. The Chairman's mark adds a provision to clarify the amount of exclusion applicable to the sale of a principal residence by a married couple filing a joint return who do not qualify for the full $500,000 exclusion.

4. Alternative Minimum Tax Provisions of the 1997 Act

The Chairman's mark adds provisions that would (1) conform the regular-tax election to use AMT depreciation to the changes made to AMT depreciation by the 1997 Act and (2) clarify the eligibility of the small corporation exemption.

5. Estate and Gift Tax Provisions of the 1997 Act

The Chairman's mark would modify the provisions of H.R. 2676 that: (1) clarify the effective date for the generation-skipping exemption; (2) coordinate the unified credit and the qualified family-owned business exclusion; and (3) clarify the rules governing revaluation of gifts. The Chairman's mark also adds provisions that would: (1) clarify the phaseout range for the 5-percent surtax to phase out the benefits of the unified credit and graduated rates; (2) clarify that interests eligible for the family-owned business exclusion must be passed to a qualified heir; (3) clarify the "trade or business" requirement for the family-owned business exclusion; (4) convert the family-owned business exclusion into a deduction; (5) make other technical changes to items cross-referenced in the family-owned business provision; and (6) clarify the treatment of post-mortem conservation contributions.

6. D.C. Zone Incentives of the 1997 Act

The Chairman's mark would modify provisions of H.R. 2676 to further clarify the definitions of businesses and property eligible for special incentives available with respect to the D.C. zone. In addition, the Chairman's mark would add a provision that provides that the phase-out rules applicable to the D.C. first-time homebuyers credit is not applicable to credit carryovers.

7. Miscellaneous Provisions of the 1997 Act

The Chairman's mark adds provisions that would: (1) clarify the qualification of the reduced rate of tax on hard ciders; (2) clarify the treatment of the tax paid by electing publicly treated partnerships; (3) modify the depreciation limitation of electric vehicles; and (4) modify the definition of "non-Amtrak State" for purposes of the Amtrak net operating loss provision.

8. Revenue-Increase Provisions of the 1997 Act

The Chairman's mark adds provisions that would: (1) provide coordination between the basis adjustment rules relating to extraordinary dividends and similar rules applicable to consolidated returns; (2) clarify the interaction of section 355 and rules relating to certain divisive transactions involving asset contributions to a subsidiary; (3) clarify the application of section 304 to certain international transactions; (4) clarify the treatment of prepaid telephone cards for telephone excise tax purposes; (5) modify the unrelated business income tax rules applicable to second-tier subsidiaries; and (6) clarify the allocation of basis of properties distributed by a partnership.

9. Foreign Provisions of the 1997 Act

The Chairman's mark adds provisions that would: (1) clarify the treatment of PFIC option holders; (2) clarify the application of PFIC mark-to-market rules to RICs; (3) clarify the interaction between the PFIC and other mark-to-market regimes; and (4) modify the interaction between section 901(k) and the foreign tax credit flow-through rules for RICs.

10. Simplification Provisions of the 1997 Act

The Chairman's mark adds a provision that would provide that distributions from a REIT are deemed to first come from any non-REIT earnings.

11. Estate, Gift, and Trust Simplification Provisions of the 1997 Act

The Chairman's mark adds provisions that would (1) clarify the treatment of revocable trusts for purposes of the generation-skipping transfer tax, and (2) provide regulatory authority for simplified reporting of funeral trusts terminated during the taxable year.

12. Pension and Employee Benefits Provisions of the 1997 Act

The Chairman's mark adds a clarification to the scope of the provision relating to the treatment of disability payments made to public safety employees.

13. Technical Corrections Relating to Other Legislation

<u>Adoption credit</u>.--The Chairman's mark would add a provision that would provide that the phase-out rules applicable to the adoption credit is not applicable to credit carryovers.

<u>Disclosure requirements of apostolic organizations</u>.--The Chairman's mark would add a provision that would provide that section 501(d) apostolic organizations are not required to disclose Schedules K-1.

<u>Earned income credit qualification</u>.--The Chairman's mark would add provisions that would clarify the application of the taxpayer identification number rules for purposes of determining eligibility for the earned income credit.

<u>Stapled REIT grandfather rule</u>.--The Chairman's mark does not include the provision of H.R. 2676 relating to the grandfather rule applicable to stapled REITs.