DESCRIPTION OF CHAIRMAN'S MARK OF PROPOSALS RELATING TO EDUCATION INCENTIVES

Scheduled for Markup

By the

SENATE COMMITTEE ON FINANCE

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Prepared by the Staff

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JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on May 19, 1999, on various education tax incentives.

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the education tax incentives (Part I) and revenue offsets (Part II) contained in the Chairman's Mark.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Chairman's Mark of Proposals Relating to Education Incentives* (JCX-20-99) May 17, 1999.

I. EDUCATION TAX INCENTIVES

A. Modifications to Education Individual Retirement Accounts

Present Law

In general

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

Phase-out of contribution limit

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

Treatment of distributions

Amounts distributed from an education IRA are excludable from gross income to the extent that the amounts distributed do not exceed qualified higher education expenses of the designated beneficiary incurred during the year the distribution is made (provided that a HOPE credit or Lifetime Learning credit is not claimed with respect to the beneficiary for the same taxable year). Distributions from an education IRA are generally deemed to consist of distributions of principal (which, under all circumstances, are excludable from gross income) and earnings (which may be excludable from gross income) by applying the ratio that the aggregate

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

[3] An excise tax may be imposed under present law to the extent that excess contributions above the $500 annual limit are made to an education IRA.

amount of contributions to the account for the beneficiary bears to the total balance of the account. If the qualified higher education expenses of the student for the year are at least equal to the total amount of the distribution (i.e., principal and earnings combined) from an education IRA, then the earnings in their entirety are excludable from gross income. If, on the other hand, the qualified higher education expenses of the student for the year are less than the total amount of the distribution (i.e., principal and earnings combined) from an education IRA, then the qualified higher education expenses are deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. Thus, in such a case, only a portion of the earnings are excludable (i.e., a portion of the earnings based on the ratio that the qualified higher education expenses bear to the total amount of the distribution) and the remaining portion of the earnings is includible in the distributee's gross income. To the extent that a distribution exceeds qualified higher education expenses of the designated beneficiary, an additional 10-percent tax is imposed on the earnings portion of such excess distribution, unless such distribution is made on account of the death or disability of, or scholarship received by, the designated beneficiary.

Present law allows tax-free transfers or rollovers of account balances from one education IRA benefitting one beneficiary to another education IRA benefitting another beneficiary (as well as redesignations of the named beneficiary), provided that the new beneficiary is a member of the family of the old beneficiary. For this purpose, a "member of the family" means persons described in paragraphs (1) through (8) of section 152(a) -- e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws -- and any spouse of such persons or of the original beneficiary.

Any balance remaining in an education IRA will 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).

Qualified higher education expenses

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

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

Eligible educational institution

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

Description of Proposal

Annual contribution limit

For the period 2000 through 2003, the proposal would increase to $2,000 the annual education IRA contribution limit. Thus, under the proposal, aggregate contributions that could be made by all contributors to one (or more) education IRAs established on behalf of any particular beneficiary would be limited to $2,000 for each year during the period 2000 through 2003. For 2004 and later years, the annual contribution limit for education IRAs would be $500.

Qualified expenses

With respect to contributions made during the period 2000 through 2003 (and earnings attributable to such contributions), the proposal would expand the definition of qualified education expenses that may be paid with tax-free distributions from an education IRA. Specifically, the definition of qualified education expenses would be expanded to include "qualified elementary and secondary education expenses" meaning (1) tuition, fees, academic tutoring, special needs services, books, supplies, and equipment (including computers and related software and services) incurred in connection with the enrollment or attendance of the designated beneficiary as an elementary or secondary student at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12), and (2) room and board, uniforms, transportation, and supplementary items and services (including extended-day programs) required or provided by such a school in connection with such enrollment or attendance of the designated beneficiary. "Qualified elementary and secondary education expenses" also would include certain homeschooling education expenses if the requirements of any applicable State or local law are met with respect to such homeschooling. For contributions made in 2004 or later years (and for earnings attributable to such contributions), the definition of qualified education expenses would be limited to post-secondary education expenses.

Special needs beneficiaries

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

Contributions by persons other than individuals

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

Contributions permitted until April 15

Under the proposal, individual contributors to education IRAs would be deemed to have made a contribution on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (not including extensions), generally April 15 in the case of individual taxpayers.

Coordination with HOPE and Lifetime Learning credits

The proposal would allow a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and receive an exclusion from gross income for amounts distributed (both the principal and the earnings portions) from an education IRA on behalf of the same student as long as the distribution is not used for the same expenses for which a credit was claimed.

Coordination with qualified tuition plans

The proposal would repeal the excise tax on contributions made by any person to an education IRA on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary (sec. 4973(e)(1)(B)).

Effective Date

The proposals modifying education IRAs would generally be effective for taxable years beginning after December 31, 1999. The provision that increases the annual contribution limit for education IRAs to $2,000 per year applies during the period January 1, 2000, through December 31, 2003, and the provision that expands the definition of qualified education expenses to include qualified elementary and secondary expenses applies to contributions (and earnings thereon) made during the period January 1, 2000, through December 31, 2003.

B. Private Pre-Paid Tuition Programs; Exclusion from Gross Income of Education Distributions from Qualified Tuition Programs

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" has the same meaning as does the term for purposes of education IRAs (as described above) and, thus, includes expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution[4], 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.

No amount is 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) are 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) are included in the contributor's/distributee's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary.[5]

A qualified State tuition program is required to provide that purchases or contributions only be made in cash.[6] Contributors and beneficiaries are not allowed to directly or indirectly direct the investment of contributions to the program (or earnings thereon). The program is

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

[5] 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.

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

required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified State tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a State or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships. A transfer of credits (or other amounts) from one account benefitting one designated beneficiary to another account benefitting a different beneficiary is considered a distribution (as is 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 -- and any spouse of such persons or of the original 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.

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

Description of Proposal

Eligible educational institutions

The proposal would expand the definition of "qualified tuition program" to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under section 529 (other than the present-law State sponsorship rule). In the case of a qualified tuition program maintained by one or more private educational institutions, persons would be able to purchase tuition credits or certificates on behalf of a designated beneficiary as set forth in section 529(b)(1)(A)(i), but would not be able to make contributions to an account as described in section 529(b)(1)(A)(ii) (so-called "savings account plans").

Exclusion from gross income

Under the proposal, an exclusion from gross income would be provided for distributions made in taxable years beginning after December 31, 1999, from qualified State tuition programs to the extent that the distribution is used to pay for qualified higher education expenses. This exclusion from gross income would be extended to distributions from qualified tuition programs established and maintained by an entity other than a State or agency or instrumentality thereof, for distributions made in taxable years after December 31, 2003. If a HOPE credit or Lifetime Learning credit is claimed with respect to a student for a taxable year, then a distribution from any qualified tuition program may (at the option of the taxpayer) be made on behalf of that student during that taxable year, but an exclusion from gross income would not be available for the earnings portion of such distribution.

Rollovers for benefit of same beneficiary

The proposal would modify section 529(c)(3) to clarify that a transfer of credits (or other amounts) from one account benefitting a designated beneficiary to another account benefitting the same beneficiary will not be considered a distribution for a maximum of three such transfers.

Member of family

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 first cousins of the original beneficiary.

Effective Date

The proposal that would provide for the establishment of qualified tuition programs maintained by one or more private educational institutions would be effective for taxable years beginning after December 31, 1999. The proposal that would allow an exclusion from gross income for certain distributions from qualified State tuition programs under section 529 (and the modification to the definition of qualified higher education expenses under that section) is effective for distributions made in taxable years beginning after December 31, 1999. In the case of a qualified tuition program established and maintained by an entity other than a State or agency or instrumentality thereof, the proposal would be effective for distributions made in taxable years after December 31, 2003.

C. Exclusion for Employer-Provided Educational Assistance

Present Law

Educational expenses paid by an employer for its employees are generally deductible to the employer.

Employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under a section 127 educational assistance plan or if the expenses qualify as a working condition fringe benefit under section 132. Section 127 provides an exclusion of $5,250 annually for employer-provided educational assistance. The exclusion does not apply to graduate courses. The exclusion for employer-provided educational assistance expires with respect to courses beginning on or after June 1, 2000.

In order for the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The educational assistance program must not discriminate in favor of highly compensated employees. In addition, not more than 5 percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance plan can be provided for the class of individuals consisting of more than 5-percent owners of the employer (and their spouses and dependents).

Educational expenses that do not qualify for the section 127 exclusion may be excludable from income as a working condition fringe benefit.[7] In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business.[8]

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[7] These rules also apply in the event that section 127 expires and is not reinstated.

[8] In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's AGI. The 2-percent floor limitation is disregarded in determining whether an item is excludable as a working condition fringe benefit.

Description of Proposal

The proposal would extend the present-law exclusion for employer-provided educational assistance to undergraduate courses beginning before January 1, 2004. The proposal would also extend the exclusion to graduate education, effective for courses beginning after January 1, 2000, and before January 1, 2004.

Effective Date

The proposal to extend the exclusion for undergraduate courses would be effective for courses beginning before January 1, 2004. The exclusion with respect to graduate-level courses would be effective for courses beginning after January 1, 2000, and before June 1, 2004.

D. Eliminate 60-Month Limit on Student Loan Interest Deduction

Present Law

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit (sec. 221). 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. Required payments of interest generally do not include nonmandatory payments, such as interest payments made during a period of loan forbearance. Months during which interest payments are not required because 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 solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending on at least a half-time basis (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.

The maximum allowable deduction per taxpayer return is $1,500 in 1999, $2,000 in 2000, and $2,500 in 2001 and thereafter.[9] The deduction is phased out ratably for individual taxpayers with modified adjusted gross income of $40,000-$55,000 and $60,000-$75,000 for joint returns. The income ranges will be indexed for inflation after 2002.

Description of Proposal

The proposal would eliminate the limit on the number of months during which interest paid on a qualified education loan is deductible.

Effective Date

The proposal would be effective for interest paid on qualified education loans after December 31, 1999.

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[9] The maximum allowable deduction for 1998 was $1,000.

E. Eliminate Tax on Awards Under National Health Corps Scholarship Program and F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program

Present Law

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations.

Section 117(c) specifically provides that the exclusion for qualified scholarships and qualified tuition reductions does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction.

Section 134 provides that any "qualified military benefit," which includes any allowance, is excluded from gross income if received by a member or former member of the uniformed services if such benefit was excludable from gross income on September 9, 1986.

The National Health Service Corps Scholarship Program (the "NHSC Scholarship Program") and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the "Armed Forces Scholarship Program") provide education awards to participants on condition that the participants provide certain services. In the case of the NHSC Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health-care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility. These education awards generally involve the payment of higher education expenses (under the NHSC Program, the awards may be also used for the repayment or cancellation of existing or future student loans). Because the recipients are required to perform services in exchange for the education awards, the awards used to pay higher education expenses are taxable income to the recipient.

Description of Proposal

The proposal would provide that amounts received by an individual under the NHSC Scholarship Program or the Armed Forces Scholarship Program are eligible for tax-free treatment as qualified scholarships under section 117, without regard to any service obligation by the recipient.

Effective Date

The proposal would be effective for education awards received after December 31, 1993.

F. Liberalize Tax-Exempt Financing Rules for Public School Construction

Present Law

1. Tax-exempt bonds

In general

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103). Like other activities carried out and paid for by States and local governments, the construction, renovation, and operation of public schools is an activity eligible for financing with the proceeds of tax-exempt bonds.

Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called "private activity bonds." The term "private person" includes the Federal Government and all other individuals and entities other than States or local governments.

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

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

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

Finally, tax-exempt private activity bonds may be issued to finance limited non-business purposes: student loans and mortgage loans for owner-occupied housing ("qualified mortgage bonds" and "qualified veterans' mortgage bonds").

In most cases, the volume of tax-exempt private activity bonds is restricted by aggregate annual limits imposed on bonds issued by issuers within each State. These annual volume limits equal $50 per resident of the State, or $150 million if greater. The annual State private activity bond volume limits are scheduled to increase to the greater of $75 per resident of the State or $225 million in calendar year 2007. The increase will be phased in ratably beginning in calendar year 2003. This increase was enacted by the Tax and Trade Relief Extension Act of 1998. Qualified 501(c)(3) bonds are among the tax-exempt private activity bonds that are not subject to these volume limits.

Private activity tax-exempt bonds may not be used to finance schools owned or operated by private, for-profit businesses.

Arbitrage restrictions on tax-exempt bonds

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

The Code includes three exceptions applicable to education-related bonds. First, issuers of all types of tax-exempt bonds are not required to rebate arbitrage profits if all of the proceeds of the bonds are spent for the purpose of the borrowing within six months after issuance. In the case of governmental bonds (including bonds to finance public schools) the six-month expenditure exception is treated as satisfied if at least 95 percent of the proceeds is spent within six months and the remaining five percent is spent within 12 months after the bonds are issued.

Second, in the case of bonds to finance certain construction activities, including school construction and renovation, the six-month period is extended to 24 months for construction proceeds. Arbitrage profits earned on construction proceeds are not required to be rebated if all such proceeds (other than certain retainage amounts) are spent by the end of the 24-month period and prescribed intermediate spending percentages are satisfied.

Third, governmental bonds issued by "small" governments are not subject to the rebate requirement. Small governments are defined as general purpose governmental units that issue no more than $5 million of tax-exempt governmental bonds in a calendar year. The $5 million limit is increased to $10 million if at least $5 million of the bonds are used to finance public schools.

Restriction on Federal guarantees of tax-exempt bonds

Unlike interest on State or local government bonds, interest on Federal debt (e.g., Treasury bills) is taxable. Generally, interest on State and local government bonds that are Federally guaranteed does not qualify for tax-exemption. This restriction was enacted in 1984. The 1984 legislation included exceptions for housing bonds and for certain Federal insurance programs that were in existence when the restriction was enacted.

2. Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, certain States and local governments are given the authority to issue "qualified zone academy bonds." Under present law, a total of $400 million of qualified zone academy bonds may be issued in each of 1998 and 1999. The $400 million aggregate bond authority is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit to qualified zone academies within such State. A State may carry over any unused allocation into subsequent years.

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 Treasury Department regulation at 110 percent of the applicable Federal rate for the month in which the bond is issued) 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 credit. The credit amount is includible in gross income (as if it were a taxable interest payment on the bond), and credit may be claimed against regular income tax and alternative minimum tax liability.

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

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

Description of Proposals

1. Increase amount of governmental bonds that may be issued by governments qualifying for the "small governmental unit" arbitrage rebate exception

The additional amount of governmental bonds for public schools that small governmental units may issue without being subject to the arbitrage rebate requirement would be increased from \$5 million to \$10 million. Thus, these governmental units could issue up to \$15 million of governmental bonds in a calendar year provided that at least \$10 million of the bonds were used for public schools.

2. Allow issuance of tax-exempt private activity bonds for public school facilities

The private activities for which tax-exempt bonds may be issued would be expanded to include elementary and secondary public school facilities which are owned by private, for-profit corporations pursuant to public-private partnership agreements with a State or local educational agency. The school facilities for which these bonds were issued would be required to be operated by a public educational agency as part of a system of public schools. Issuance of these bonds would be subject to an annual per-State volume limit equal to the greater of \$10 per resident (\$5 million, if greater) in lieu of the present-law State private activity bond volume limits.

3. Permit limited Federal guarantees of school construction bonds by the Federal Housing Finance Board

The Federal Housing Finance Board would be permitted to guarantee (through the 12 regional Federal Home Loan Banks in its system) up to \$500 million per year of governmental bonds 95 percent or more of the proceeds of which are used for public school construction.

Effective Dates

The proposals would be effective for bonds issued after December 31, 1999.

II. REVENUE OFFSETS

A. Modify Foreign Tax Credit Carryover Rules

Present Law

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

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

Description of Proposal

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

Effective Date

The proposal would apply to foreign tax credits arising in taxable years beginning after December 31, 2001.

B. Limit Use of Non-Accrual Experience Method of Accounting to Amounts to be Received for the Performance of Qualified Personal Services

Present Law

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

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

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

Description of Proposal

The proposal would limit the use of the non-accrual experience method to amounts that are to be received for the performance of qualified personal services. Amounts to be received for the performance of all other services would be subject to the general rule regarding inclusion in income. Qualified personal services are personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. As under present law, the availability of the non-accrual experience method would be conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount.

Effective Date

The proposal would be effective for taxable years ending after the date of enactment. Any change in the taxpayer's method of accounting necessitated as a result of the proposal would be treated as a voluntary change initiated by the taxpayer with the consent of the Secretary of the Treasury. Any required section 481(a) adjustment would be taken into account over a period not to exceed four years under principles consistent with those in Rev. Proc. 98-60.[10]

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[10] 1998-51 I.R.B. 16.

C. Expand Reporting of Cancellation of Indebtedness Income

Present Law

Under section 61(a)(12), a taxpayer's gross income includes income from the discharge of indebtedness. Section 6050P requires "applicable entities" to file information returns with the IRS regarding any discharge of indebtedness of $600 or more.

The information return must set forth the name, address, and taxpayer identification number of the person whose debt was discharged, the amount of debt discharged, the date on which the debt was discharged, and any other information that the IRS requires to be provided. The information return must be filed in the manner and at the time specified by the IRS. The same information also must be provided to the person whose debt is discharged by January 31 of the year following the discharge.

"Applicable entities" include: (1) the FDIC, the RTC, the National Credit Union Administration, and any successor or subunit of any of them; (2) any financial institution (as described in sec. 581 (relating to banks) or sec. 591(a) (relating to savings institutions)); (3) any credit union; (4) any corporation that is a direct or indirect subsidiary of an entity described in (2) or (3) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a Federal or State agency regulating such entities; and (5) an executive, judicial, or legislative agency (as defined in 31 U.S.C. sec. 3701(a)(4)).

The penalties for failure to file correct information reports with the IRS and to furnish statements to taxpayers are similar to those imposed with respect to a failure to provide other information returns. For example, the penalty for failure to furnish statements to taxpayers is generally $50 per failure, subject to a maximum of $100,000 for any calendar year. These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

Description of Proposal

The proposal would require that information reporting on discharges of indebtedness also be done by any organization a significant trade or business of which is the lending of money (such as finance companies and credit card companies whether or not affiliated with financial institutions).

Effective Date

The proposal would be effective with respect to discharges of indebtedness after December 31, 1999.

D. Extension of IRS User Fees

Present Law

The IRS provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination. Public Law 104-117[11] extended the statutory authorization for these user fees[12] through September 30, 2003.

Description of Proposal

The proposal would extend the statutory authorization for these user fees through September 30, 2009.

Effective Date

The proposal would be effective on the date of enactment.

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[11] An Act to provide that members of the Armed Forces performing services for the peacekeeping efforts in Bosnia and Herzegovina, Croatia, and Macedonia shall be entitled to tax benefits in the same manner as if such services were performed in a combat zone, and for other purposes (March 20, 1996).

[12] These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Public Law 100-203, December 22, 1987).

E. Clarify Definition of "Subject to" Liabilities Under Code Section 357(c)

Present Law

Present law provides that the transferor of property recognizes no gain or loss if the property is exchanged solely for qualified stock in a controlled corporation (sec. 351). The assumption by the controlled corporation of a liability of the transferor (or the acquisition of property "subject to" a liability) generally will not cause the transferor to recognize gain. However, under section 357(c), the transferor does recognize gain to the extent that the sum of the assumed liabilities, together with the liabilities to which the transferred property is subject, exceeds the transferor's basis in the transferred property. If the transferred property is "subject to" a liability, Treasury regulations indicate that the amount of the liability is included in the calculation regardless of whether the underlying liability is assumed by the controlled corporation. Treas. Reg. sec. 1.357-2(a). Similar rules apply to reorganizations described in section 368(a)(1)(D).

The gain recognition rule of section 357(c) is applied separately to each transferor in a section 351 exchange.

The basis of the property in the hands of the controlled corporation equals the transferor's basis in such property, increased by the amount of gain recognized by the transferor, including section 357(c) gain.

Description of Proposal

Under the proposal, the distinction between the assumption of a liability and the acquisition of an asset subject to a liability is generally eliminated. First, except as provided in regulations, a recourse liability or any portion thereof is treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to, satisfy the liability or portion thereof (whether or not the transferor has been relieved of the liability). Thus, where more than one person agrees to satisfy a liability or portion thereof, only one would be expected to satisfy such liability or portion thereof. Second, except as provided in regulations, a nonrecourse liability is treated as having been assumed by the transferee of any asset subject to such liability; except that the amount treated as assumed shall be reduced by the amount of such liability which an owner of other assets not transferred to the transferee and also subject to such liability has agreed with the transferee to, and is expected to satisfy, up to the fair market value of such other assets (determined without regard to section 7701(g)).

In determining whether any person has agreed to and is expected to satisfy a liability, all facts and circumstances are to be considered. In any case where the transferee does agree to satisfy a liability, the transferee will also be expected to satisfy the liability in the absence of facts indicating the contrary.

In determining any increase to the basis of property transferred to the transferee as a result of gain recognized because of the assumption of liabilities under section 357, such increase shall not cause the basis to exceed the fair market value of the property (determined without regard to sec. 7701(g)). In addition, if gain is recognized to the transferor as the result of an assumption by a corporation of a nonrecourse liability that is also secured by any assets not transferred to the corporation, and if no person is subject to tax under the Internal Revenue Code on such gain, then for purposes of determining the basis of assets transferred, the amount of gain treated as recognized as the result of such assumption of liability shall be determined as if the liability assumed by the transferee equaled such transferee's ratable portion of the liability, based on the relative fair market values (determined without regard to sec. 7701(g)) of all assets subject to such nonrecourse liability.

The Treasury Department has authority to prescribe such regulations as may be necessary to carry out the purposes of the provision. Where appropriate, the Treasury Department may also prescribe regulations which provide that the manner in which a liability is treated as assumed under the provision is applied elsewhere in the Code.

The Miscellaneous Trade and Technical Corrections Act of 1999 (S. 262), as reported by the Senate Finance Committee on January 22, 1999, contains a substantially identical provision.

Effective Date

The proposal would be effective for transfers on or after October 19, 1998. No inference regarding the tax treatment under present law is intended.

F. Denial of Charitable Contribution Deduction for Transfers Associated with Split-Dollar Insurance Arrangements

Present Law

Under present law, a deduction is allowed for a charitable contribution paid during the taxable year. A charitable contribution is defined to mean a contribution or gift to or for the use of specified types of organizations or governmental entities (sec. 170(c)).

Some taxpayers may be taking the position that a charitable contribution deduction is permitted under an arrangement whereby taxpayers transfer money to a charity, which the charity then uses to pay premiums for life insurance on the transferor or another person. Under these arrangements, the beneficiaries under the life insurance contract typically include members of the transferor's family (either directly or through a family trust or family partnership). The charitable organization does not have unfettered use of the transferred funds.

Description of Proposal

Deduction denial

The proposal[13] restates present law to provide that no charitable contribution deduction is allowed for purposes of Federal tax, for a transfer to or for the use of an organization described in section 170(c) of the Internal Revenue Code, if in connection with the transfer (1) the organization directly or indirectly pays, or has previously paid, any premium on any "personal benefit contract" with respect to the transferor, or (2) there is an understanding or expectation that any person will directly or indirectly pay any premium on any "personal benefit contract" with respect to the transferor. It is intended that an organization be considered as indirectly paying premiums if, for example, another person pays premiums on its behalf.

A personal benefit contract with respect to the transferor is any life insurance, annuity, or endowment contract, if any direct or indirect beneficiary under the contract is the transferor, any member of the transferor's family, or any other person (other than a section 170(c) organization) designated by the transferor. For example, such a beneficiary would include a trust having a direct or indirect beneficiary who is the transferor or any member of the transferor's family, and would include an entity that is controlled by the transferor or any member of the transferor's family. It is intended that a beneficiary under the contract include any beneficiary under any side agreement relating to the contract. If a transferor contributes a life insurance contract to a section 170(c) organization and designates one or more section 170(c) organizations as the sole beneficiaries under the contract, generally, it is not intended that the deduction denial rule under

[13] The proposal is similar to H.R. 630, introduced by Mr. Archer for himself and for Mr. Rangel (106th Cong., 1st Sess.).

the proposal apply. If, however, there is an outstanding loan under the contract upon the transfer of the contract, then the transferor is considered as a beneficiary. The fact that a contract also has other direct or indirect beneficiaries (persons who are not the transferor or a family member, or designated by the transferor) does not prevent it from being a personal benefit contract. The proposal is not intended to affect situations in which an organization pays premiums under a legitimate fringe benefit plan for employees.

It is intended that a person be considered as an indirect beneficiary under a contract if, for example, the person receives or will receive any economic benefit as a result of amounts paid under or with respect to the contract. For this purpose, an indirect beneficiary is not intended to include a person that benefits exclusively under a bona fide charitable gift annuity (within the meaning of sec. 501(m)).

In the case of a charitable gift annuity, if the charitable organization purchases an annuity contract issued by an insurance company to fund the payment of the charitable gift annuity, a person receiving payments under the charitable gift annuity from the charitable organization that are funded by the contract is not treated as an indirect beneficiary, provided certain requirements are met. The requirements are that (1) the charitable organization possess all of the incidents of ownership under the contract; (2) the charitable organization be entitled to all the payments under the contract; and (3) the timing and amount of payments under the contract be substantially the same as the timing and amount of payments to each person under the organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization). Only in the case in which the charitable organization purchases an annuity contract issued by an insurance company to fund the payment of the charitable gift annuity and the contract is purchased pursuant to the laws of a State that requires each annuitant under the charitable gift annuity to be an annuitant under the contract (in order for the State insurance laws not to apply to the charitable gift annuity), then the foregoing requirements (1) and (2) are treated as if they are met, provided that the State law requirement was in effect on February 8, 1999, each annuitant under the charitable gift annuity is a bona fide resident of the State, the only persons entitled to payments under the contract are persons entitled to payments under the charitable gift annuity, and the timing and amount of payments under the contract to each person are substantially the same as the timing and amount of payments to the person under the charitable organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

In the case of a charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)) that purchases a contract issued by an insurance company, a person who is a recipient of an annuity or unitrust amount paid by the trust is not treated as an indirect beneficiary under the contract purchased by the trust, provided the foregoing requirements (1) and (2) (applied with respect to the trust) are met.

Nothing in the proposal is intended to suggest that a life insurance, endowment, or annuity contract would be a personal benefit contract, solely because an individual who is a recipient of an annuity or unitrust amount paid by a charitable remainder annuity trust or charitable remainder unitrust uses such a payment to purchase a life insurance, endowment or annuity contract, and a beneficiary under the contract is the recipient, a member of his or her family, or another person he or she designates.

Excise tax

The proposal imposes on any organization described in section 170(c) of the Code an excise tax, in the amount of the premiums paid by the organization on any life insurance, annuity, or endowment contract, if the payment of premiums on the contract is in connection with a transfer for which a deduction is not allowable under the deduction denial rule of the proposal. The excise tax does not apply if all of the direct and indirect beneficiaries under the contract (including any related side agreement) are organizations described in section 170(c). Under the proposal, payments are treated as made by the organization, if they are made by any other person pursuant to an understanding or expectation of payment. The excise tax is to be applied taking into account rules ordinarily applicable to excise taxes in chapter 41 or 42 of the Code (e.g., statute of limitation rules).

Reporting

The proposal requires that the organization annually report the amount of premiums that is paid during the year and that is subject to the excise tax imposed under the provision, and the name and taxpayer identification number of each beneficiary under the contract to which the premiums relate, as well as other information required by the Secretary of the Treasury. For this purpose, it is intended that a beneficiary include the beneficiary under any side agreement to which the section 170(c) organization is a party (or of which it is otherwise aware). Penalties applicable to returns required under Code section 6033 apply to returns under this reporting requirement. Returns required under this provision are to be furnished at such time and in such manner as the Secretary shall by forms or regulations require.

Regulations

The proposal provides for the promulgation of regulations necessary to carry out the purposes of the provisions.

Effective Date

The deduction denial provision of the proposal applies to transfers after February 8, 1999 (as provided in H.R. 630). The excise tax provision of the proposal applies to premiums paid after the date of enactment. The reporting provision applies to premiums (that would be subject to the excise tax were it then effective) paid after February 8, 1999.

No inference is intended that a charitable contribution deduction is allowed under present law in the circumstances to which this proposal applies. The proposal does not change the rules with respect to fraud or criminal or civil penalties under present law; thus, actions constituting fraud or that are subject to penalties under present law would still constitute fraud or be subject to the penalties after enactment of the proposal.

G. Treatment of Excess Pension Assets Used for Retiree Health Benefits

Present Law

Defined benefit pension plan assets generally may not revert to an employer prior to the termination of the plan and the satisfaction of all plan liabilities. A reversion prior to plan termination may constitute a prohibited transaction and may result in disqualification of the plan. Certain limitations and procedural requirements apply to a reversion upon plan termination. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax. The excise tax rate, which may be as high as 50 percent of the reversion, varies depending upon whether or not the employer maintains a replacement plan or makes certain benefit increases. Upon plan termination, the accrued benefits of all plan participants are required to be 100-percent vested.

A pension plan may provide medical benefits to retired employees through a section 401(h) account that is a part of such plan. A qualified transfer of excess assets of a defined benefit pension plan (other than a multiemployer plan) into a section 401(h) account that is a part of such plan does not result in plan disqualification and is not treated as a reversion to the employer or a prohibited transaction. Therefore, the transferred assets are not includible in the gross income of the employer and are not subject to the excise tax on reversions.

Qualified transfers are subject to amount and frequency limitations, use requirements, deduction limitations, vesting requirements and minimum benefit requirements. Excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No more than one qualified transfer with respect to any plan may occur in any taxable year.

The transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities (either directly or through reimbursement) for the taxable year of the transfer. Transferred amounts generally must benefit all pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the section 401(h) account. Retiree health benefits of key employees may not be paid (directly or indirectly) out of transferred assets. Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned at the end of the taxable year to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20-percent excise tax.

No deduction is allowed for (1) a qualified transfer of excess pension assets into a section 401(h) account, (2) the payment of qualified current retiree health liabilities out of transferred assets (and any income thereon) or (3) a return of amounts not used to pay qualified current retiree health liabilities to the general assets of the pension plan.

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100-percent vested as if the plan terminated immediately before the transfer.

The minimum benefit requirement requires each group health plan under which applicable heath benefits are provided to provide substantially the same level of applicable health benefits for the taxable year of the transfer and the following 4 taxable years. The level of benefits that must be maintained is based on benefits provided in the year immediately preceding the taxable year of the transfer. Applicable health benefits are health benefits or coverage that are provided to (1) retirees who, immediately before the transfer, are entitled to receive such benefits upon retirement and who are entitled to pension benefits under the plan and (2) the spouses and dependents of such retirees.

The provision permitting a qualified transfer of excess pension assets to pay qualified current retiree health liabilities expires for taxable years beginning after December 31, 2000.

Description of Proposal

The present-law provision permitting qualified transfers of excess defined benefit pension plan assets to provide retiree health benefits under a section 401(h) account would be extended through September 30, 2009.[14] In addition, the present-law minimum benefit requirement would be replaced by the minimum cost requirement that applied to qualified transfers before December 9, 1994, to section 401(h) accounts. Therefore, each group health plan or arrangement under which applicable health benefits are provided would be required to provide a minimum dollar level of retiree health expenditures for the taxable year of the transfer and the following 4 taxable years. The minimum dollar level would be the higher of the applicable employer costs for each of the 2 taxable years immediately preceding the taxable year of the transfer. The applicable employer cost for a taxable year would be determined by dividing the employer's qualified current retiree health liabilities by the number of individuals to whom coverage for applicable health benefits was provided during the taxable year.

Effective Date

The proposal would be effective with respect to qualified transfers of excess defined benefit pension plan assets to section 401(h) accounts after December 31, 2000, and before October 1, 2009.

[14] In addition to amendments to the Internal Revenue Code, the proposal would make conforming amendments to applicable sections of the Employee Retirement Income Security Act ("ERISA").

H. Impose Limitation on Prefunding of Certain Employee Benefits

Present Law

Under present law, contributions to a welfare benefit fund generally are deductible when paid, but only to the extent permitted under the rules of Code sections 419 and 419A. The amount of an employer's deduction in any year for contributions to a welfare benefit fund cannot exceed the fund's qualified cost for the year. The term qualified cost means the sum of (1) the amount that would be deductible for benefits provided during the year if the employer paid them directly and was on the cash method of accounting, and (2) within limits, the amount of any addition to a qualified asset account for the year. A qualified asset account includes any account consisting of assets set aside for the payment of disability benefits, medical benefits, supplemental unemployment compensation or severance pay benefits, or life insurance benefits. The account limit for a qualified asset account for a taxable year is generally the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for benefits with respect to which the account is maintained and the administrative costs incurred with respect to those claims. Specific additional reserves are allowed for future provision of post-retirement medical and life insurance benefits.

The present-law deduction limits for contributions to welfare benefit funds do not apply in the case of certain 10-or-more employer plans. A plan is a 10-or-more employer plan if (1) more than one employer contributes to it, (2) no employer is normally required to contribute more than 10 percent of the total contributions under the plan by all employers, and (3) the plan does not maintain experience-rating arrangements with respect to individual employers.

Description of Proposal

Under the proposal, the present-law exception to the deduction limit for 10-or-more employer plans would be limited to plans that provide only medical, disability, and group-term life insurance benefits. This exception would no longer be available with respect to plans that provide supplemental unemployment compensation, severance pay and life insurance (other than group-term life) benefits. Thus, the generally applicable deduction limits (sections 419 and 419A) would apply to plans providing these benefits.

In addition, rules would be included to prevent amounts that are deductible pursuant to the 10-or-more employer exception (and earnings thereon) from being used to provide benefits other than medical, disability, and group-term life insurance.

Under the proposal, no inference would be intended with respect to the validity of any 10-or-more employer arrangement under the provisions of present law.

Effective Date

The proposal would be effective with respect to contributions paid after the date of enactment.

I. Modify Installment Method and Prohibit its Use by Accrual Method Taxpayers

Present Law

An accrual method taxpayer is generally required to recognize income when all events have occurred that fix the right to the receipt of the income and the amount of the income can be determined with reasonable accuracy. The installment method of accounting provides an exception to this general principle if income recognition by allowing a taxpayer to defer the recognition of income from the disposition of certain property until payment is received. Sales to customers in the ordinary course of business are not eligible for the installment method, except for sales of property that is used or produced in the trade or business of farming and sales of timeshares and residential lots if an election to pay interest under section 453(l)(2)(b)) is made.

A pledge rule provides that if an installment obligation is pledged as security for any indebtedness, the net proceeds[15] of such indebtedness are treated as a payment on the obligation, triggering the recognition of income. Actual payments received on the installment obligation subsequent to the receipt of the loan proceeds are not taken into account until such subsequent payments exceed the loan proceeds that were treated as payments. The pledge rule does not apply to sales of property used or produced in the trade or business of farming, to sales of timeshares and residential lots where the taxpayer elects to pay interest under section 453(l)(2)(b), or to dispositions where the sales price does not exceed $150,000.

An additional rules require the payment of interest on the deferred tax that is attributable to most large installment sales.

Description of Proposal

Prohibit use of installment method for accrual method dispositions

The proposal generally would prohibit the use of the installment method of accounting for dispositions of property that would otherwise be reported for Federal income tax purposes using an accrual method of accounting.

The proposal does not change present law regarding the availability of the installment method for dispositions of property used or produced in the trade or business of farming. The proposal also does not change present law regarding the availability of the installment method for dispositions of timeshares and residential taxpayers if the taxpayer elects to pay interest under section 453(l)(3).

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[15] The net proceeds equal the gross loan proceeds less the direct expenses of obtaining the loan.

The proposal does not change the ability of a cash method taxpayer to use the installment method. For example, a cash method individual owns all of the stock of a closely held accrual method corporation. This individual sells his stock for cash, a ten year note, and a percentage of the gross revenues of the company for next ten years. The proposal would not change the ability of this individual to use the installment method in reporting the gain on the sale of the stock.

Modify pledge rule

The proposal would also modify the pledge rule to provide that entering into any arrangement that gives the taxpayer the right to satisfy an obligation with an installment note will be treated in the same manner as the direct pledge of the installment note. For example, a taxpayer disposes of property for an installment note. The disposition is properly reported using the installment method. The taxpayer only recognizes gain as it receives the deferred payment. However, were the taxpayer to pledge the installment note as security for a loan, it would be required to treat the proceeds of such loan as a payment on the installment note, and recognize the appropriate amount of gain. Under the proposal, the taxpayer would also be required to treat the proceeds of a loan as payment on the installment note to the extent the taxpayer had the right to repay the loan by transferring the installment note to the taxpayer's creditor. Other arrangements that have a similar effect would be treated in the same manner.

The proposed modification of the pledge rule would only apply to installment sales where the pledge rule of present law applies. Accordingly, the proposal would not apply to installment method sales made by a dealer in timeshares and residential lots where the taxpayer elects to pay interest under section 453(l)(2)(b), to sales of property used or produced in the trade or business of farming, or to dispositions where the sales price does not exceed $150,000, since such sales are not subject to the pledge rule under present law.

Effective Date

The proposal would be effective for installment sales entered into on or after the date of enactment.

J. Add Certain Vaccines Against Streptococcus Pneumonia to the List of Taxable Vaccines

Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose (sec. 4131) on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), and rotavirus gastroenteritis. The tax applies to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

Description of Proposal

The proposal would add conjugated streptococcus pneumonia vaccines to the list of taxable vaccines.

Effective Date

The proposal would be effective for vaccine purchases beginning on the day after the date on which the Centers for Disease Control make final recommendation for routine administration of conjugated streptococcus pneumonia vaccines to children. No floor stocks tax would be collected for amounts held for sale on that date.