DESCRIPTION OF THE TAX AND HEALTH INSURANCE REFORM PROVISIONS IN THE PRESIDENT'S SEVEN-YEAR BALANCED BUDGET PROPOSAL RELEASED ON DECEMBER 7, 1995

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of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the tax- and health-related provisions contained in the President's seven-year balanced budget proposal. This proposal was released on December 7, 1995.

For each of the tax- and health-related provisions in the President's proposal, the document includes a description of present law, the proposal, the effective date, and any recent related legislative background. The description of the proposal is based on the Joint Committee's understanding of Administration materials as of December 14, 1995.

Part I of the document describes the "Middle-Class Bill of Rights" provisions. Part II describes the provisions in the "Corporate Subsidy, Loophole Closers, and Other Measures" section of the President's seven-year balanced budget proposal. Part III describes certain health insurance reform provisions. Part IV shows the estimated budget effects of the tax and health insurance provisions of the President's proposal.

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I. MIDDLE-CLASS BILL OF RIGHTS, TAX COMPLIANCE, AND SUPERFUND TAX PROVISIONS

1. Credit for families with young children

Present Law

In general

Present law does not provide tax credits based solely on the taxpayer's number of dependent children. Taxpayers with dependent children, however, generally are able to claim a personal exemption for each of these dependents. The total amount of personal exemptions is subtracted (along with certain other items) from adjusted gross income (AGI) in arriving at taxable income. The amount of each personal exemption is $2,500 for 1995, and is adjusted annually for inflation. In 1995, the amount of the personal exemption is phased out for taxpayers with AGI in excess of $114,700 for single taxpayers, $143,350 for heads of household, and $172,050 for married couples filing joint returns. These phaseout thresholds are adjusted annually for inflation.

In addition, eligible low-income workers are able to claim a refundable earned income tax credit. The amount of the credit an eligible taxpayer may claim depends upon whether the taxpayer has one, more than one, or no qualifying children and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income amount. The maximum amount of the credit is the product of the credit rate and the earned income amount. For taxpayers with earned income (or adjusted gross income (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 AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

Mathematical or clerical errors

The Internal Revenue Service may summarily assess additional tax due as a result of a mathematical or clerical error without sending the taxpayer a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and a period of 60 days to request that the IRS abate its assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60-day period for objecting to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. The request for abatement of the assessment is the only procedure a taxpayer may use prior to paying the assessed amount in order to contest an assessment arising out of a mathematical or clerical error. Once the assessment is satisfied, however, the taxpayer may file a claim for refund if he or she believes the assessment was made in error.

Description of Proposal

The proposal would provide taxpayers with an income tax credit of $300 for each qualifying child under the age of 13 (as of the close of the calendar year in which the taxpayer's taxable year begins) for taxable years 1996, 1997 and 1998. The amount of the credit would be increased to $500 for each qualifying child for taxable years beginning after December 31, 1998.

The credit would be phased out ratably for taxpayers with AGI over $60,000 and would be fully phased out at AGI of $75,000. In the case of a taxable year beginning after calendar year 1999, the maximum credit and the beginning point of the phaseout range would be indexed annually for inflation. For each year in which the maximum amount of the credit exceeds $500, the size of the phaseout range would be increased from $15,000 (i.e., $75,000 minus $60,000) to 30 times the maximum amount of the credit in that year. For purposes of all these AGI tests, the taxpayer's AGI would be increased by any 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, the Northern Mariana Islands, and American Samoa; and residents of Puerto Rico, respectively).

To be a qualifying child, an individual has to satisfy a relationship test, a dependency test, and an identification test. An individual would satisfy the relationship test if the individual is a son or daughter of the taxpayer, a stepson or stepdaughter of the taxpayer, or an adopted child of the taxpayer. An adopted child would include a child who is legally adopted or who is placed with the taxpayer by an authorized placement agency for adoption by the taxpayer. A foster child also would satisfy the relationship test if, for the taxpayer's entire taxable year, the foster child (1) is a member of the taxpayer's household and (2) has as his principal place of abode the home of the taxpayer.

An individual would satisfy the dependency test if the individual is a dependent of the taxpayer with respect to whom the taxpayer is entitled to claim a dependency deduction.

An individual would satisfy the identification test if the individual's taxpayer identification number is included on the taxpayer's return for such taxable year. Rules similar to those made applicable by the Administration proposals to the EITC would apply. If a taxpayer fails to provide a correct taxpayer identification number, such omission would be treated as a mathematical or clerical error and thus any notification that the taxpayer owes additional tax because of that omission would not be treated as a notice of deficiency.

The maximum amount of the credit for each taxable year could not exceed an amount equal to the sum of: (1) the taxpayer's regular income tax liability (net of applicable credits) less (2) the sum of the taxpayer's tentative minimum tax liability and earned income tax credit allowed.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995.

Legislative Background

H.R. 980 and S. 452

An identical provision was included in the President's fiscal year 1996 budget proposal (the "Middle-Class Bill of Rights Tax Relief Act of 1995," introduced on February 16, 1995, as H.R. 980 by Representatives Gephardt and Gibbons and as S. 452 by Senators Moynihan and Daschle).

H.R. 2491

The Balanced Budget Act of 1995 (H.R. 2491 -- hereinafter referred to as "BBA of 1995"), as passed by the Congress and vetoed by President Clinton, would have allowed taxpayers a nonrefundable tax credit of $500 for each qualifying child under the age of 18. The credit amount would not have been indexed for inflation.

To be a qualifying child, an individual would have to have satisfied a relationship test and a dependency test. The relationship test was the same as in the President's proposal, except that an individual could also have been a descendant of a son or daughter of the taxpayer. The dependency test was the same as in the President's proposal, except that the term "dependent" would not have included an individual who was a resident of a country contiguous to the United States unless (1) that individual was an adopted child of a taxpayer who is a U.S. citizen or national and (2) for the taxpayer's entire taxable year, the individual was a member of the taxpayer's household and had as his or her principal place of abode the home of the taxpayer.

For taxpayers with AGI in excess of certain thresholds, the allowable child credit would have been reduced by $25 for each $1,000 of AGI (or fraction thereof) in excess of the threshold. Thus, the size of the phaseout range would have been proportional to the number of qualifying children. For married taxpayers filing joint returns, the threshold would have been $110,000. For taxpayers filing single or head of household returns, the threshold would have been $75,000. For married taxpayers filing separate returns, the threshold would have been $55,000. These thresholds would not have been indexed for inflation.

The credit would have been effective October 1, 1995. The portion of the child credit that would have been effective for the period from October 1, 1995, through December 31, 1995, would have been provided to taxpayers through a special procedure.

2. Deduction for higher education expenses

Present Law

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5). Education expenses are 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. 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 relate to the employee's current job and only to the extent that the expenses, along with other miscellaneous deductions, exceed two percent of the taxpayer's adjusted gross income (AGI).

Education expenses that are reimbursed by the employer are excludable from the employee's gross income as a working condition fringe benefit (sec. 132(d)) if the education qualifies as work related under section 162. A special rule allowed an employee to exclude from gross income up to $5,200 paid by his or her employer for educational assistance, regardless of whether the education maintained or improved a skill required by the employee's current position (sec. 127). That special rule for employer-provided educational assistance expired after 1994.

Another special rule, section 135, provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[2] "Qualified higher education expenses" include tuition and required fees for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools. The exclusion provided by section 135 is phased out for certain higher-income taxpayers, determined by the taxpayer's AGI during the year the bond is redeemed. To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds directly in the child's name, section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

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

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[2] If the aggregate redemption amount (i.e., principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses incurred, then the excludable portion of interest income is based on the ratio that the education expenses bears to the aggregate redemption amount (sec. 135(b)).

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 education below the graduate level provided to employees of certain educational organizations.

Description of Proposal

A taxpayer would be allowed an above-the-line deduction for qualified educational expenses paid during the taxable year for the education or training of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents at an institution of higher education. The deduction would be allowed in computing a taxpayer's AGI and could be claimed regardless of whether the taxpayer itemizes deductions. In 1996, 1997, and 1998, the maximum deduction allowed per taxpayer return would be $5,000. In 1999 and thereafter, the maximum deduction would be increased to $10,000. The deduction would be phased out ratably for taxpayers with modified AGI between $70,000 and $90,000 ($100,000 and $120,000 for joint returns). Modified AGI would include taxable Social Security benefits and amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions). Beginning in 2000, the income phaseout ranges would be indexed for inflation.

Qualified educational expenses would be defined as tuition and fees required for the enrollment or attendance of an eligible student (e.g., registration fees, laboratory fees, and extra charges for particular courses) at an institution of higher education. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, and similar personal expenses unrelated to a student's academic course of instruction would not be deductible. The expenses of education involving sports, games, or hobbies would not be qualified educational expenses unless the education is part of a degree program (or relate to the student's current profession).

An "eligible student" would be one who is enrolled or accepted for enrollment in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an institution of higher education. The student must pursue a course of study on at least a half-time basis or must be enrolled in a course which enables the student to improve current job skills or to acquire new job skills. In addition, the student cannot be enrolled in an elementary or secondary school, and cannot be a nonresident alien. Educational institutions would determine what constituted a half-time basis for individual programs.

The term "institution of higher education" would be defined by reference to section 481 of the Higher Education Act of 1965. Such institutions must have entered into an agreement with the Department of Education to participate in the student loan program. This definition includes colleges and universities, and certain vocational and proprietary institutions.

Any amount taken into account as a qualified educational expense would be reduced by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the deduction. Thus, qualified educational expenses would be reduced by scholarship or fellowship grants excludable from gross income under section 117 (even if the grants are used to pay expenses other than qualified educational expenses) and any educational assistance received as veterans' benefits. Similarly, qualified educational expenses would be reduced by proceeds from Series EE savings bonds that are excludable by the taxpayer under present-law section 135. However, no reduction would be required for a gift, bequest, devise or inheritance within the meaning of section 102(a).

Qualified educational expenses would be deductible in the year the expenses are paid, subject to the requirement that the education commences or continues during that year or during the first three months of the next year. Qualified educational expenses paid with the proceeds of a loan generally would be deductible (rather than repayment of the loan itself). Normal tax benefit rules would apply to refunds (and reimbursements through insurance) of previously deducted tuition and fees.

The proposal would not affect deductions claimed under any other section of the Code, except that any amount deducted under another section of the Code could not also be deducted under this provision. A student would not be eligible to claim a deduction under this provision on his or her own tax return if that student could be claimed as a dependent of another taxpayer.

Effective Date

The proposal would be effective for qualified educational expenses paid after December 31, 1995.

Legislative Background

The proposal is identical to the proposal contained in the President's fiscal year 1996 budget proposal (the "Middle-Class Bill of Rights Tax Relief Act of 1995," introduced on February 16, 1995, as H.R. 980 by Representatives Gephardt and Gibbons and as S. 452 by Senators Moynihan and Daschle).

The BBA of 1995 provided that certain individuals who have paid interest on qualified education loans could claim an above-the-line deduction for such interest expenses, up to a maximum deduction of $2,500 per year. In order for the interest to be deductible under this provision, the indebtedness must have been incurred to pay for the qualified higher education expenses of the taxpayer or the taxpayer's spouse. The deduction was to have been allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments were required. The deduction was phased out ratably over the following modified adjusted gross income ranges: joint filers ($65,000-$85,000) and unmarried individuals ($45,000-$65,000). For taxable years beginning after 1996, the income phaseout ranges were to be indexed for inflation.

3. Provisions relating to individual retirement plans

Present Law

In general

Under certain circumstances, an individual is allowed a deduction for contributions (within limits) to an individual retirement account or an individual retirement annuity (an "IRA"). An individual generally is not subject to income tax on amounts held in an IRA, including earnings on contributions, until the amounts are withdrawn from the IRA. No deduction is permitted with respect to contributions made to an IRA for a taxable year after the IRA owner attains age 70-1/2.

Under present law, the maximum deductible contribution that can be made to an IRA generally is the lesser of $2,000 or 100 percent of an individual's compensation (earned income in the case of self-employed individuals). A single taxpayer is permitted to make the maximum deductible IRA contribution for a year if the individual is not an active participant in an employer-sponsored retirement plan for the year or the individual has adjusted gross income ("AGI") of less than $25,000. A married taxpayer filing a joint return is permitted to make the maximum deductible IRA contribution for a year if neither spouse is an active participant in an employer-sponsored plan or the couple has combined AGI of less than $40,000.

If a single taxpayer or either spouse (in the case of a married couple) is an active participant in an employer-sponsored retirement plan, the maximum IRA deduction is phased out over certain AGI levels. For single taxpayers, the maximum IRA deduction is phased out between $25,000 and $35,000 of AGI. For married taxpayers, the maximum deduction is phased out between $40,000 and $50,000 of AGI.

Spousal IRAs

In the case of a married individual whose spouse has no compensation (or elects to be treated as having no compensation), the $2,000 limit on IRA contributions is increased to the lesser of $2,250 or the individual's compensation.

Nondeductible IRA contributions

Individuals may make nondeductible IRA contributions to the extent deductible contributions are not allowed because of the AGI phaseout and active participant rules. A taxpayer may also elect to make nondeductible contributions in lieu of deductible contributions. Thus, any individual may make nondeductible contributions up to the excess of (1) the lesser of $2,000 or 100 percent of compensation over (2) the IRA deduction claimed by the individual. As is the case with earnings on deductible IRA contributions, earnings on nondeductible contributions are not subject to income tax until withdrawn.

Taxation of withdrawals

Amounts withdrawn from IRAs (other than amounts that represent a return of nondeductible contributions) are includible in income when withdrawn.

To discourage the use of amounts contributed to an IRA for nonretirement purposes, withdrawals from an IRA prior to age 59-1/2, death, or disability are generally subject to an additional 10-percent income tax. The 10-percent tax is intended to recapture at least a portion of the tax benefit of the IRA. The 10-percent tax does not apply to withdrawals that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of the taxpayer and the taxpayer's designated beneficiary. A similar early withdrawal tax applies to withdrawals from qualified retirement plans.

Elective deferrals

Under a qualified cash or deferred arrangement, an individual can elect to have compensation paid in cash or contributed to a tax-qualified retirement plan. Amounts contributed at the election of the employee are referred to as elective deferrals. Like other qualified plan contributions, elective deferrals are not includible in income until withdrawn from the plan. Qualified cash or deferred arrangements are subject to the same rules applicable to qualified plans generally, and are also subject to additional requirements. One of these additional requirements is that the maximum amount of elective deferrals that can be made in a year by an individual is limited to $9,240 in 1995. This dollar limit is indexed for inflation in $500 increments. A similar limit applies to elective deferrals under similar arrangements (e.g., tax-sheltered annuities).

Description of Proposal

In general

In general, the proposal would (1) double the present-law income limits on deductible IRA contributions and increase the income phase-out range to $20,000 (so that, in 1996, the income phase-out range would be $80,000 to $100,000 of AGI for married taxpayers and $50,000 to $70,000 for single taxpayers); (2) index the $2,000 IRA contribution limit in $500 increments; (3) coordinate the IRA contribution limit with the elective deferral limit; (4) create nondeductible tax-free IRAs called "Special IRAs"; and (5) provide an exception from the 10-percent early withdrawal tax for IRA distributions used for higher education expenses, first-time homebuyer expenses, extraordinary medical expenses and distributions to individuals who have been receiving unemployment compensation for at least 12 weeks.

Deductible IRA contributions

The proposal would increase the income limits at which the IRA deduction is phased out for active participants in employer-sponsored retirement plans. In 1996, the maximum IRA deduction would be phased out between $80,000 and $100,000 of AGI for married taxpayers and between $50,000 and $70,000 of AGI for single taxpayers. The income thresholds would be indexed for inflation in $5,000 increments, beginning after 1996.

The IRA deduction limit would be coordinated with the limit on elective deferrals so that the maximum allowable IRA deduction for a year could not exceed the excess of the elective deferral limit over the amount of elective deferrals made by the individual.

The proposal would provide that the exception to the early withdrawal tax for distributions after age 59-1/2 does not apply to amounts that have been held in an IRA for less than 5 years.

Inflation adjustment for IRA contribution limit

The $2,000 IRA deduction limit would be indexed for inflation in $500 increments, beginning after 1996.

Nondeductible tax-free IRAs

Under the proposal, individuals who are eligible to make deductible IRA contributions would also be eligible to make nondeductible contributions to a Special IRA. Special IRAs generally would be treated the same as IRAs, but also would be subject to special rules. The IRA deduction limit and the limit on contributions to Special IRAs would be coordinated. Thus, the maximum contribution that could be made in a year to a Special IRA would be the excess of the IRA deduction limit applicable to the individual over the amount of the individual's deductible IRA contributions. Distributions from Special IRAs would not be includible in income to the extent attributable to contributions that had been in the Special IRA for at least five years. Withdrawals of earnings from Special IRAs before five years would be subject to income tax, and would also be subject to the 10-percent tax on early withdrawals unless used for one of the special purposes described below (or a present-law exception to the tax, other than the exception for distributions after age 59-1/2 applies).

An individual whose AGI for a year falls below the upper end of the eligibility thresholds for deductible IRAs could convert an existing IRA into a Special IRA without being subject to the 10-percent tax on early withdrawals. The amount transferred from the deductible IRA to the Special IRA generally would be includible in the individual's income in the year of the transfer. However, if a transfer is made before 1997, the amount to be included in the individual's income with respect to the transfer would be spread evenly over four taxable years.

Special purpose withdrawals

The proposal would provide exemptions from the 10-percent early withdrawal tax for distributions from IRAs or Special IRAs used for certain special purposes. Penalty-free withdrawals would be withdrawals (1) for qualified higher education expenses, (2) for acquisition of a principal residence for a first-time homebuyer, (3) for medical expenses (including long-term care expenses) in excess of 7.5 percent of AGI, and (4) made by individuals who have been receiving unemployment compensation for at least 12 consecutive weeks.

Effective Date

The proposal would generally be effective for taxable years beginning after December 31, 1995.

Legislative Background

In general

The proposal is the same as the President's budget proposal, as contained in the "Middle-Class Bill of Rights Tax Relief Act of 1995," introduced on February 16, 1995, as H.R. 980 by Representatives Gephardt and Gibbons and as S. 452 by Senators Moynihan and Daschle.

The proposal is similar to the provisions of the BBA of 1995 relating to IRAs (secs. 11011 - 11016). The BBA of 1995 would (1) increase the income limits on deductible IRA contributions and provide that an individual is not an active participant in an employer-sponsored plan merely because his or her spouse is an active participant; (2) index the $2,000 IRA contribution limit in $500 increments; (3) permit married couples to contribute up to $2,000 to an IRA for each spouse; (4) create nondeductible tax-free IRAs, called American Dream IRAs ("AD IRAs"); and (5) permit penalty-free withdrawals from deductible and nondeductible IRAs for first-time home purchase, higher education expenses, extraordinary medical expenses (including long-term care expenses), and persons who have been receiving unemployment compensation for at least 12 weeks. The provisions of the BBA of 1995 are described in more detail below.

Deductible IRA contributions

The BBA of 1995 phases up the income limits on deductible IRA contributions in $5,000 increments, and increases the income phase-out range for married couples to $20,000 in $2,500 increments. After the income thresholds are $85,000 for single taxpayers and $100,000 for married taxpayers, the thresholds are indexed for inflation in $1,000 increments.

In addition, the BBA of 1995 provides that a spouse is not considered an active participant in an employer-sponsored retirement plan merely because his or her spouse is an active participant.

Inflation adjustment for IRA contribution limit

The Administration proposal is the same as the BBA of 1995.

Spousal IRAs

The BBA of 1995 provides that contributions of up to $2,000 can be made to an IRA for each spouse in a married couple.

Nondeductible tax-free IRAs

The BBA of 1995 creates a nondeductible tax-free IRA similar to the Special IRA, called an AD IRA. An AD IRA is generally subject to the same rules as a deductible IRA, but some special rules apply. Contributions to an AD IRA are nondeductible. Withdrawals from an AD IRA are not taxable if made (1) after the 5-taxable year period beginning with the taxable year for which the individual first made a contribution to an AD IRA and (2) either (a) the individual has attained age 59-1/2, died, or become disabled, or (b) the withdrawal is a special purpose withdrawal. Special purpose withdrawals made within the 5-taxable year period are includible in income (to the extent attributable to earnings), but are not subject to the 10-percent early withdrawal tax. Other withdrawals are includible in income to the extent attributable to earnings on contributions and subject to the 10-percent early withdrawal tax.

No more than $2,000 can be contributed annually to all IRAs of an individual. However, the income limits applicable to deductible IRAs do not apply to AD IRAs.

If an individual converts a present-law IRA into an AD IRA after December 31, 1995, and before January 1, 1998, the amount that would have been includible in income had the individual withdrawn the amount converted is includible in income ratably over 4 years. The early withdrawal tax does not apply to such conversions.

Special purpose withdrawals

The Administration proposal is generally the same as the BBA of 1995, except that, under the BBA of 1995, only first-time home buyer expenses up to $10,000 qualify as a special purpose withdrawal.

Effective Date

The Administration proposal is the same as the BBA of 1995.

4. Earned income credit provisions

Present Law

In general

Certain eligible low-income workers are entitled to claim a refundable credit on their income tax return. The amount of the credit an eligible individual may claim depends upon whether the individual has one, more than one, or no qualifying children and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income amount. The maximum amount of the credit is the product of the credit rate and the earned income amount. For taxpayers with earned income (or adjusted gross income (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 AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

For taxable years beginning after December 31, 1995, an individual is not eligible for the credit if the aggregate amount of "disqualified income" of the taxpayer for the taxable year exceeds $2,350. Disqualified income is the sum of:

(1) interest (taxable and tax-exempt),
(2) dividends, and
(3) net rent and royalty income (if greater than zero).

The parameters for the credit depend upon the number of qualifying children the individual claims. For 1996, the parameters are given in the following table (dollar amounts are projections expressed in 1996 dollars):

	Two or more qualifying children--	One qualifying child--	No qualifying children--
Credit rate	40.00%	34.00%	7.65%
Earned income amount	$8,890	$6,330	$4,220
Maximum credit	$3,556	$2,152	$323
Phaseout begins	$11,610	$11,610	$5,280
Phaseout rate	21.06%	15.98%	7.65%
Phaseout ends	$28,495	$25,078	$9,500

For years after 1996, the credit rates and the phaseout rates will be the same as in the preceding table. The earned income amount and the beginning of the phaseout range are indexed for inflation; because the end of the phaseout range depends on those amounts as well as the phaseout rate and the credit rate, the end of the phaseout range will also increase if there is inflation.

In order to claim the credit, an individual must either have a qualifying child or meet other requirements. A qualifying child must meet a relationship test, an age test, an identification test, and a residence test. In order to claim the credit without a qualifying child, an individual must not be a dependent and must be over age 24 and under age 65.

To satisfy the identification test, individuals must include on their tax return the name and age of each qualifying child. For returns filed with respect to tax year 1996, individuals must provide a taxpayer identification number (TIN) for all qualifying children born on or before November 30, 1996. For returns filed with respect to tax year 1997 and all subsequent years, individuals must provide TINs for all qualifying children, regardless of their age. An individual's TIN is generally that individual's social security number.

Mathematical or clerical errors

The IRS may summarily assess additional tax due as a result of a mathematical or clerical error without sending the taxpayer a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and a period of 60 days to request that the IRS abate its assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60-day period for objecting to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. The request for abatement of the assessment is the only procedure a taxpayer may use prior to paying the assessed amount in order to contest an assessment arising out of a mathematical or clerical error. Once the assessment is satisfied, however, the taxpayer may file a claim for refund if he or she believes the assessment was made in error.

Description of Proposal

Deny credit to individuals not authorized to be employed in the United States

Individuals would not be eligible for the credit if they do not include their taxpayer identification number (and, if married, their spouse's taxpayer identification number) on their tax return. Solely for these purposes and for purposes of the present-law identification test for a qualifying child, a taxpayer identification number would be defined as a social security number issued to an individual by the Social Security Administration other than a number issued under section 205(c)(2)(B)(i)(II) (or that portion of sec. 205(c)(2)(B)(i)(III) relating to it) of the Social

Security Act (regarding the issuance of a number to an individual applying for or receiving Federally funded benefits).

Use mathematical or clerical error procedures for certain omissions

If an individual fails to provide a correct taxpayer identification number, such omission would be treated as a mathematical or clerical error. If an individual who claims the credit with respect to net earnings from self-employment fails to pay the proper amount of self-employment tax on such net earnings, the failure would be treated as a mathematical or clerical error for purposes of the amount of credit allowed.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995.

Legislative Background

A similar proposal was included in the President's fiscal year 1996 budget proposal (the the "Tax Compliance Act of 1995," introduced on February 16, 1995, as H.R. 981 by Representatives Gephardt and Gibbons and as S. 453 by Senators Moynihan and Daschle).

The BBA of 1995 (H.R. 2491), as vetoed by President Clinton, contained identical provisions within a set of broader changes to the credit.

5. Revision of tax rules on expatriation

Present Law

U.S. citizens and residents generally are subject to U.S. income tax on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. business.

A U.S. citizen who relinquishes citizenship with a principal purpose of avoiding U.S. taxes is subject to special tax rules for ten years after expatriation. The determination of who is a U.S. citizen for tax purposes, and when such citizenship is lost, is governed by the provisions of the Immigration and Nationality Act, 8 U.S.C. section 1401, et. seq.

An individual who relinquishes U.S. citizenship with a principal purpose of avoiding U.S. taxes is subject to tax on his or her U.S. source income at the rates applicable to U.S. citizens, rather than the rates applicable to other nonresident aliens, for ten years after expatriation. Solely for this purpose, gains on the sale of property located in the United States and stocks and securities issued by U.S. persons are treated as U.S. source income. This alternative method of income taxation applies only if it results in a higher U.S. tax liability than the amount otherwise determined for nonresident aliens.

Rules applicable in the estate and gift tax contexts expand the categories of items that are subject to estate and gift taxes in the case of a U.S. citizen who relinquished citizenship with a principal purpose of avoiding U.S. taxes within the ten-year period ending on the date of transfer. Certain U.S. property controlled by such individuals and related persons is included in the individual's estate and gifts of U.S.-situs tangible property by such individuals are subject to the gift tax.

Description of Proposal

Under the proposal, a U.S. citizen who relinquishes U.S. citizenship generally would be treated as having sold all of his or her property at fair market value immediately prior to expatriation. Gain or loss from the deemed sale would be recognized at that time. Further, any period for the deferral of tax or recognition of income or gain for U.S. tax purposes (e.g., due to the installment method) would terminate on the date of the deemed sale. The first $600,000 of net gain recognized on the deemed sale would be exempt from tax.

The tax would not apply to an individual who relinquishes U.S. citizenship before attaining age 18-1/2 if the individual lived in the United States for less than five taxable years. The tax would apply to "long-term residents" who cease to be subject to tax as residents of the United States. The proposal would define a long-term resident as an individual who had been a lawful permanent resident of the United States (i.e., a green-card holder), other than an individual who was taxed as a resident by another country under a treaty tie-breaker rule, in at least eight of the prior fifteen taxable years.

Assets within the scope of the proposal generally would include all property interests that would be included in the individual's gross estate under the Federal estate tax if the individual were to die on the day of the deemed sale, plus certain trust interests that are not otherwise included in the gross estate and other interests specified by the Secretary of the Treasury. U.S. real property interests, which remain subject to U.S. taxing jurisdiction in the hands of nonresident aliens, generally would be excepted from the proposal. The exception also would apply to interests in qualified retirement plans and, subject to a limit of $500,000, interests in certain foreign pension plans.

Special rules would apply in the case of trust interests. A beneficiary's interest in a trust would be determined based on all the facts and circumstances. In a case where the ownership of trust interests cannot be determined under the general facts and circumstances test, any remaining interests would be allocated to the grantor if the grantor is a beneficiary of the trust, and otherwise ownership would be determined based on the rules of intestate succession A trust beneficiary would be deemed to be the sole beneficiary of a separate trust consisting of the assets allocable to his or her share of the trust, in accordance with his or her interest in the trust. The separate trust would be treated as selling its assets for fair market value immediately before the beneficiary expatriates and distributing all resulting income and corpus to the beneficiary. The beneficiary would be treated as subsequently recontributing the assets to the trust. Consequently, the separate trust's basis in the assets would be stepped up and all assets held by the separate trust would be treated as corpus. Constructive ownership rules would apply in the case of a trust beneficiary that is a corporation, partnership, trust or estate.

The expatriate would be required to pay a tentative tax equal to the amount of tax that would have been due for a hypothetical short tax year ending on the expatriation date. The tentative tax would be due on the 90th day after the expatriation date.

The time for payment of the expatriation tax would be permitted to be deferred to the same extent, and in the same manner, as any estate taxes may be deferred under the present-law provisions of section 6161 (without regard to the ten-year limitation contained therein). In addition, the expatriation tax could be deferred on interests in closely-held businesses as provided in present law section 6166. The expatriation tax could be deferred for reversionary or remainder interests in property as provided in section 6163. Payment of the expatriation tax could also be deferred under section 6159 to facilitate the collection of tax liabilities.

An expatriate would be permitted to elect irrevocably, on an asset-by-asset basis, to continue to be taxed as a U.S. citizen with respect to any assets specified by the taxpayer. The expatriate would continue to pay U.S. income taxes following expatriation on any income generated by the asset and on any gain realized on the disposition of the asset, as well as any excise tax imposed with respect to the asset. In addition, the asset would continue to be subject to U.S. gift, estate, and generation-skipping transfer taxes. However, the amount of any transfer tax so imposed would be limited to the amount of income tax that would have been due if the property had been sold for its fair market value immediately before the transfer or death, taking into account any remaining portion of the expatriate's $600,000 exemption. An expatriate would be required to waive treaty benefits with respect to the specific asset and to provide adequate security in order to make this election.

The expatriation tax would be allowed as a credit against any U.S. estate or gift taxes subsequently imposed on the same property solely by reason of the special rules imposing an estate or gift tax on property transferred by an individual who relinquished his or her U.S. citizenship with a principal purpose of avoiding U.S. taxes within ten years prior to the transfer.

A nonresident alien who becomes a citizen or resident of the United States would be required to utilize a fair market value basis, rather than a historical cost basis, in determining any subsequent gain or loss on the disposition of any property held on the date the individual became a U.S. citizen or resident. The fair market value basis would be equal to the fair market value of the property on the earlier of (1) the date the individual first became a U.S. citizen or resident, or (2) the date the property first became subject to U.S. tax because it was used in a U.S. trade or business or was a U.S. real property interest. The fair market value basis would apply for all purposes of computing gain or loss on actual or deemed dispositions, but would not apply for purposes of computing depreciation. An individual could make an irrevocable election not to have the fair market value provision apply to any specific property, solely for purposes of determining gain with respect to that property.

A U.S. citizen who relinquishes citizenship by formally renouncing his or her citizenship before a diplomatic or consular officer of the United States would be treated as having relinquished his or her citizenship on that date, provided that the U.S. Department of State confirms the renunciation by issuing a certificate of loss of nationality (CLN). A U.S. citizen who furnishes the State Department with a signed statement of voluntary relinquishment of U.S. nationality would be treated as having relinquished his or her citizenship on the date the statement is furnished, provided that the voluntary relinquishment is later confirmed by the issuance of a CLN. If neither of these circumstances exist, the individual would be treated as having relinquished citizenship on the date the CLN is issued or a certificate of naturalization is canceled. A long-term resident would terminate his or her residency by ceasing to be a lawful permanent resident or by becoming a resident of a foreign country under a treaty tie-breaker rule.

The State Department would be required to provide the Secretary of the Treasury with a copy of each CLN approved by the State Department. Similarly, the agency administering the immigration laws would be required to provide the Secretary of the Treasury with the name of each individual whose status as a lawful permanent resident has been revoked or has been determined to have been abandoned.

Effective Date

The proposal would be effective for U.S. citizens who are treated as having relinquished their U.S. citizenship on or after February 6, 1995, and for long-term residents who terminate their U.S. residency on or after February 6, 1995. The tentative tax would not be required to be paid earlier than 90 days after enactment. The fair market value basis provision would apply to any deemed dispositions of property resulting from expatriations occurring on or after February 6, 1995, and any actual dispositions of property after the enactment date.

Legislative Background

The BBA of 1995 included provisions to expand the present law provisions that subject U.S. citizens who lose citizenship for tax avoidance purposes to special tax rules for ten years after such loss of citizenship. The bill would extend the expatriation provisions to apply not only to U.S. citizens who lose citizenship but also to certain long-term residents of the United States whose U.S. residency is terminated. The bill would subject certain individuals to the expatriation tax provisions without inquiry as to their motive for expatriating, and would allow certain categories of citizens to show an absence of tax-avoidance motives only if they request a ruling from the Secretary of the Treasury. The bill would expand the categories of income and gains that are subject to tax under the expatriation tax provisions and includes provisions designed to eliminate the ability to engage in certain transactions that under present law partially or completely circumvent the reach of the expatriation tax provisions. In addition, the bill contains information reporting and information sharing provisions to enhance compliance with the expatriation tax provisions.

6. Modifications of rules relating to foreign trusts having one or more United States beneficiaries

Present Law

Income taxation of trusts and their beneficiaries

Taxation of trusts

A trust is treated as a separate taxable entity, except in cases where the grantor (or a person with a power to revoke the trust) has certain powers with respect to the trust (discussed below). A trust generally is taxed like an individual with certain modifications. These modifications include: (1) a separate tax rate schedule applicable to trusts; (2) an unlimited charitable deduction for amounts paid to charity; (3) a personal exemption of $300 for a trust that is required to distribute all of its income currently, or $100 for any other trust; (4) no standard deduction for trusts; and (5) a deduction for distributions to beneficiaries. A trust is required to use the calendar year as its taxable year. Trusts generally are required to pay estimated income tax.

Taxation of distributions to beneficiaries

Distributions from a trust to a beneficiary generally are includible in the beneficiary's gross income to the extent of the distributable net income ("DNI") of the trust for the taxable year ending with, or within, the taxable year of the beneficiary. DNI is taxable income (1) increased by any tax-exempt income (net of disallowed deductions attributable to such income), and (2) computed without regard to personal exemptions, the distribution deduction, capital gains that are allocated to corpus and are neither distributed to any beneficiary during the taxable year nor set aside for charitable purposes, capital losses other than capital losses taken into account in determining the amount of capital gains which are paid to beneficiaries, and (with respect to simple trusts) extraordinary dividends which are not distributed to beneficiaries (sec. 643). The exclusion for small business capital gains under section 1202 is not taken into account in determining DNI.

Distributions to trust beneficiaries out of previously accumulated income are taxed to the beneficiaries under a throwback rule (sec. 667). The effect of the throwback rule is to impose an additional tax on the distribution of previously accumulated income in the year of distribution at the beneficiary's average marginal rate for the 5 years prior to the distribution. The amount of the distribution is grossed-up by the amount of the taxes paid by the trust on the accumulated income and a nonrefundable credit is allowed to the beneficiary for such taxes. In order to prevent trusts from accumulating income for a year, the fiduciary of a trust may elect to treat distributions within the first 65 days after the close of its taxable year as having occurred at the end of the preceding taxable year.

If a trust makes a loan to one of its beneficiaries, the principal of such a loan is generally not taxable as income to the beneficiary.

Grantor trust rules

Under the grantor trust rules (secs. 671-679), the grantor of a trust will continue to be taxed as the owner of the trust (or a portion thereof) if it retains certain rights or powers. A grantor of a trust generally is treated as the owner of any portion of a trust when the following circumstances exist:

(1) The grantor has a reversionary interest that has more than a 5-percent probability of returning to the grantor.

(2) The grantor has power to control beneficial enjoyment of the income or corpus. Certain powers are disregarded for this purpose--(a) a power to apply income to support a dependent; (b) a power affecting beneficial enjoyment that can be exercised only after an event that has a 5 percent or less probability of occurring; (c) a power exercisable only by will; (d) a power to allocate among charities; (e) a power to distribute corpus under an ascertainable standard or as an advancement; (f) a power to withhold income temporarily; (g) a power to withhold income during disability; (h) a power to allocate between corpus and income; (i) a power to distribute, apportion, or accumulate income or corpus among a class of beneficiaries that is held by an independent trustee or trustees; and, (j) a power to distribute, apportion, or accumulate income among beneficiaries that is limited by an ascertainable standard.

(3) The grantor retains any of the following administrative powers--(a) a power to deal at non-arms' length; (b) a power to borrow trust funds without adequate interest or security; (c) a borrowing that extends over one taxable year; (d) a power to vote stock of a controlled corporation held in the trust; (e) a power to control investment of trust funds in a controlled corporation; and (f) a power to reacquire trust corpus by substituting property with equivalent value.

(4) The grantor has a power to revoke, unless such power may not be exercised any time before an event that has a 5-percent or less probability of occurring.

(5) The income is or may be distributed to, held for the future benefit of, or used to pay for life insurance on the lives of, the grantor or the grantor's spouse, unless such power may not be exercised any time before an event that has a 5-percent or less probability of occurring. (An exception is provided for income that may be used to discharge an obligation of support, unless the income is so used.)

If the grantor is not treated as the owner of any portion of a trust, another person generally will be treated as the owner of that portion of the trust if he or she has the power to revoke that portion of the trust or gave up a power to revoke and retained any of the powers set forth above, unless the retained power is disclaimed within a reasonable time.

Under the grantor trust rules, a U.S. person who transfers property to a foreign trust generally is treated as the owner of the portion of the trust comprising that property for any taxable year in which there is a U.S. beneficiary of any portion of the trust. This treatment generally does not apply, however, to transfers by reason of death, to sales or exchanges of property at fair market value where gain is recognized to the transferor, or to transfers made before the transferor became a U.S. person (sec. 679).

Payments from foreign trusts through nominees

Under a special rule, intermediaries or nominees interposed between certain foreign trusts and their beneficiaries are disregarded. This special rule treats any amount paid from a foreign person to a U.S. person, where the amount was derived (directly or indirectly) from a foreign trust that was created by a U.S. person, as if paid to the recipient directly by the foreign trust (sec. 665(c)).

Grantor trusts established by non-U.S. persons

Under the grantor trust rules, a grantor generally is treated as the owner of the trust's assets without regard to whether the grantor is a domestic or foreign person. Under these rules, U.S. trust beneficiaries can avoid U.S. tax on distributions from a trust where a foreign grantor is treated as owner of the trust, even though no tax may be imposed on the trust income by any jurisdiction.[3]

A special rule applies in the case of a grantor trust with a U.S. beneficiary, where the grantor trust rules otherwise would treat a foreign person as the owner of a portion of the trust, and the U.S. beneficiary had made gifts at any time, directly or indirectly, to the foreign person. In such a case, the U.S. beneficiary generally is treated as the grantor and owner of that portion to the extent of the gifts to the foreign person (sec. 672(f)).

Foreign trusts that are not grantor trusts

In cases where the grantor trust rules do not apply to a foreign trust, its U.S. beneficiaries generally are taxable on their respective shares of the income of the trust that is required to be distributed, as well as any other income of the trust that is paid, credited, or distributed to them

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[3] See Rev. Rul. 69-70, 1969-1 C.B. 182.

(secs. 652, 662). Distributions from a trust in excess of the trust's DNI[4] for the taxable year generally are treated as accumulation distributions (sec. 665(b)), subject to the throwback rules. Under these rules, a distribution by a foreign trust of previously accumulated income generally is taxed at the beneficiary's average marginal rate for the prior 5 years, plus interest (secs. 666, 667). Interest is computed at a fixed annual rate of 6 percent, with no compounding (sec. 668).

If adequate records of the trust are not available to determine the proper application of the rules relating to accumulation distributions to any distribution from a trust, the distribution is treated as an accumulation distribution out of income earned during the first year of the trust (sec. 666(d)).

Residence of estates and trusts

An estate or trust is treated as foreign if it is not subject to U.S. income taxation on its income that is neither derived from U.S. sources nor effectively connected with the conduct of a trade or business within the United States (sec. 7701(a)(31)). Thus, if a trust is taxed in a manner similar to a nonresident alien individual, it is considered to be a foreign trust. Any other estate or trust is treated as domestic (sec. 7701(a)(30)).

The Code does not specify what characteristics must exist before a trust is treated as being comparable to a nonresident alien individual. Internal Revenue Service ("IRS") rulings and court cases, however, indicate that this status depends on various factors, such as the residence of the trustee, the location of the trust assets, the country under whose laws the trust is created, the nationality of the grantor, and the nationality of the beneficiaries.[5] If an examination of these factors indicates that a trust has sufficient foreign contacts, it is deemed comparable to a nonresident alien individual and, thus, is a foreign trust.

Section 1491 generally imposes a 35-percent excise tax on a U.S. person that transfers appreciated property to certain foreign entities, including a foreign trust.[6] In the case of a domestic trust that changes its situs and becomes a foreign trust, it is unclear whether property has been transferred from a U.S. person to a foreign entity, and, thus, whether the transfer is subject to section 1491.

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[4] In the case of a foreign trust, DNI also includes foreign-source income net of related deductions, income that is exempt under treaties, and capital gains reduced (but not below zero) by capital losses.

[5] For example, see Rev. Rul. 87-61, 1987-2 C.B. 219, Rev. Rul. 81-112, 1981-1 C.B. 598, Rev. Rul. 60-181, 1960-1 C.B. 257, and B.W. Jones Trust v. Commissioner, 46 B.T.A. 531 (1942), aff'd, 132 F.2d 914 (4th Cir. 1943).

[6] In Rev. Rul. 87-61 the IRS held that a U.S. citizen who transferred appreciated property to a foreign grantor trust is not subject to the section 1491 excise tax because the grantor continues to own the property for income tax purposes.

Information reporting requirements and associated penalties

Any U.S. person who creates a foreign trust or transfers money or property to a foreign trust is required to report that event to the Treasury Department (sec. 6048(a)). Current regulations require reporting of, inter alia, the name, address and identification number (if any) of the transferor, the trust, the fiduciary and trust beneficiaries; the interest of each beneficiary; the location of the trust records; and the value of each item transferred (Treas. Reg. sec. 16.3-1(c)). Similarly, any U.S. person who transfers property to a foreign trust that has one or more U.S. beneficiaries is required to report annually to the Treasury Department (sec. 6048(c)). In addition, if the transfer of any appreciated property by a U.S. person is subject to section 1491, the transferor is required to report the transfer to the Treasury Department (Treas. Reg. sec. 1.1494-1(a)).

Any person who fails to file a required report with respect to the creation of, or a transfer to, a foreign trust may be subjected to a penalty of 5 percent of the amount transferred to the foreign trust (sec. 6677). Similarly, any person who fails to file a required annual report with respect to a foreign trust with U.S. beneficiaries may be subjected to a penalty of 5 percent of the value of the corpus of the trust at the close of the taxable year. The maximum amount of the penalty imposed under either case may not exceed $1,000. A reasonable cause exception is available. These civil penalties are determined separately from any applicable criminal penalties.

Description of Proposals

Overview

The Administration proposal would modify certain aspects of the tax treatment of foreign trusts with U.S. beneficiaries as follows:

a. The grantor trust rules generally would apply only to the extent that they result, directly or indirectly, in amounts being currently taken into account in computing the income of a U.S. person. Certain exceptions would apply.

b. Beginning on January 1, 1996, the interest rate applicable to accumulation distributions from foreign nongrantor trusts would be the rate imposed on underpayment of tax under section 6621(a)(2), with compounding. The accumulation distribution generally would be allocated proportionately to prior trust years in which the trust had undistributed net income.

The full amount of a loan of cash or marketable securities by a foreign nongrantor trust to a U.S. grantor or a U.S. beneficiary (or a U.S. person related to such a grantor or beneficiary) would be treated as a distribution to the grantor or beneficiary. In addition, the value of the use of other trust property by the U.S. grantor, U.S. beneficiary (or a person related to such a grantor or beneficiary) as a distribution to the grantor or beneficiary in an amount equal to the fair market value of the use of the property.

c. A nonresident alien who transfers property to a foreign trust and then becomes a U.S. resident within 5 years after the transfer is treated as making a transfer to the foreign trust on his residency starting date. In determining whether a foreign trust paid fair market value to the transferor for property transferred to the trust, obligations issued by the trust, any person related to any grantor or beneficiary generally would not be taken into account.

d. A two-part objective test would be established for determining whether a trust is foreign or domestic for tax purposes. If both parts of the test are satisfied, the trust would be treated as domestic. Only the first part of the test would apply to estates.

e. The Administration proposal would expand the reporting requirements with respect to foreign trusts if there is a U.S. grantor of the foreign trust or a distribution from the foreign trust to a U.S. person. The Administration proposal would require the responsible parties to file the designated information reports with the Treasury Department upon the occurrence of certain events. A failure to comply with the reporting requirements would result in increased monetary penalties under the Administration proposal. Unless a U.S. owner of any portion of a foreign trust appoints a limited agent to accept service of process with respect to requests and summons by the Treasury Department in connection with the tax treatment of items relating to the trust, special sanctions would apply.

f. Any U.S. person (other than certain tax-exempt organizations) that receives purported gifts or bequests from foreign sources totalling more than $10,000 during the year would be required to report the gift to the Treasury Department. Monetary penalties and certain sanctions would apply to a failure to comply with the reporting requirement.

The Administration proposals are described below.

a. <u>Inbound foreign grantor trust rules</u>

<u>Foreign grantors not treated as owners</u>

Under the Administration proposal, the grantor trust rules generally would apply only to the extent that they result, directly or indirectly, in amounts being currently taken into account in computing the income of a U.S. citizen or resident or a domestic corporation. Thus, the grantor trust rules generally would not apply to any portion of a trust where their effect would be to treat a foreign person as owner of that portion. The Administration proposal would provide certain exceptions to this general rule. The Administration proposal generally would not apply in the case of revocable trusts and trusts where the only amounts distributable during the lifetime of the grantor are to the grantor or the grantor's spouse. These exceptions would not apply to the extent of gifts made by a U.S. beneficiary of the trust to the foreign grantor. The Administration proposal also would not apply to trusts established to pay compensation, and certain trusts in existence as of September 19, 1995.[7] In addition, the Administration proposal generally would not apply where the grantor is a controlled foreign corporation, foreign personal holding company or passive foreign investment company.

In a case where the foreign grantor, who would be treated as the owner of the trust but for the above rule, actually pays tax on the income of the trust to a foreign country, it is anticipated that Treasury regulations would provide that U.S. beneficiaries who are subject to U.S. income tax on that income would be treated for foreign tax credit purposes as having paid the foreign taxes that were paid by the foreign grantor. Any resulting foreign tax credits would be subject to applicable foreign tax credit limitations.

The Administration proposal would provide a transition rule for any domestic trust that has a foreign grantor who is treated as the owner of the trust under present law. If such a trust becomes a foreign trust before January 1, 1997, or if the assets of such a trust are transferred to a foreign trust before that date, such trust would be exempt from the excise tax on transfers to a foreign trust otherwise imposed by section 1491. However, the Administration proposal's new reporting requirements and penalties would be applicable.

Distributions by foreign trusts through nominees

The Administration proposal would treat any amount paid to a U.S. person, where the amount was derived (directly or indirectly) from a foreign trust of which the payor is not the grantor, as if paid by the foreign trust directly to the U.S. person. This rule would disregard the role of an intermediary or nominee that may be interposed between a foreign trust and a U.S. beneficiary. Unlike present law, however, the rule would apply whether or not the trust was created by a U.S. person. The rule would not apply to a withdrawal from a foreign trust by its grantor, with a subsequent gift or other payment to a U.S. person.

Effective Date

The proposal would be effective on the date of enactment.

b. Foreign trusts that are not grantor trusts

Interest charge on accumulation distributions

The Administration proposal would change the interest rate applicable to accumulation distributions from foreign trusts from simple interest at a fixed rate of 6 percent to compound interest determined in the manner of the interest imposed on underpayments of tax under section 6621(a)(2). Simple interest would continue to accrue at the rate of 6 percent through 1995.

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[7] The exception would not apply to the portion of any such trust attributable to any transfers made after September 19, 1995.

Beginning on January 1, 1996, however, compound interest based on the underpayment rate would be imposed not only on tax amounts determined under the accumulation distribution rules but also on the total simple interest for pre-1996 periods, if any. For purposes of computing the interest charge, the accumulation distribution would be allocated proportionately to prior trust years in which the trust had undistributed net income (and the beneficiary receiving the distribution was a U.S. citizen or resident), rather than to the earliest of such years. An accumulation distribution would be treated as reducing proportionately the undistributed income net income from prior years.

The Administration proposal would include an anti-abuse rule which authorizes the Secretary of the Treasury to issue regulations, on or after the date of enactment, that may be necessary or appropriate to carry out the purposes of the rules applicable to accumulation distributions, including regulations to prevent the avoidance of those purposes.

Loans to grantors or beneficiaries and use of trust property

In the case of a loan of cash or marketable securities by the foreign trust to a U.S. grantor or a U.S. beneficiary (or a U.S. person related to such grantor or beneficiary[8]), the Administration proposal would treat the full amount of the loan as distributed to the grantor or beneficiary, even if the loan bears interest at an adequate rate and is subsequently repaid. In addition, any subsequent transaction between the trust and the original borrower regarding the principal of the loan (e.g., repayment) would be disregarded for all purposes of the Code.

In the case of a use of other trust property, the Administration proposal generally would treat the value of the use of such property by a U.S. grantor or a U.S. beneficiary (or a U.S. person related to such grantor or beneficiary[9]) as a distribution to the grantor or beneficiary in an amount equal to the fair market value of the use of the property.

Effective Date

The proposal to modify the interest charge on accumulation distributions would apply to distributions after the date of enactment. The proposal with respect to loans to U.S. grantors or U.S. beneficiaries would apply to loans made after September 19, 1995. The proposal with respect to use of other trust property by U.S. grantors or U.S. beneficiaries would apply to transactions after December 31, 1995.

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[8] For this purpose, a person generally would be treated as related to the grantor or beneficiary if the relationship between such person and the grantor or beneficiary would result in a disallowance of losses under section 267 or 707(b).

[9] For this purpose, a person generally would be treated as related to the grantor or beneficiary if the relationship between such person and the grantor or beneficiary would result in a disallowance of losses under section 267 or 707(b).

c. **Outbound foreign grantor trust rules**

The Administration proposal would make several modifications to the rules of section 679 under which foreign trusts with U.S. grantors and U.S. beneficiaries are treated as grantor trusts.

Sale or exchange at market value

Present law contains an exception from grantor trust treatment for property transferred by a U.S. person to a foreign trust in the form of a sale or exchange at fair market value where gain is recognized to the transferor. In determining whether the trust paid fair market value to the transferor, the Administration proposal would provide that obligations issued (or, to the extent provided by regulations, guaranteed) by the trust, by any grantor or beneficiary of the trust, or by any person related to a grantor or beneficiary[10] generally would not be taken into account.

Other transfers

Under the Administration proposal, a transfer of property to certain charitable trusts would be exempt from the application of the rules treating foreign trusts with U.S. grantors and U.S. beneficiaries as grantor trusts.

Transferors or beneficiaries who become U.S. persons

The Administration proposal would apply the rules of section 679 to certain foreign persons who transfer property to a foreign trust and subsequently become U.S. persons. A nonresident alien individual who transfers property, directly or indirectly, to a foreign trust and then becomes a resident of the United States within 5 years after the transfer generally would be treated as making a transfer to the foreign trust at the time the individual becomes a U.S. resident. The amount of the deemed transfer would be the portion of the trust (including undistributed earnings) attributable to the property previously transferred. Consequently, the individual generally would be treated under the rules of section 679 as the owner of that portion of the trust in any taxable year in which the trust has U.S. beneficiaries. The Administration proposal's new reporting requirements and penalties (discussed below) also would be applicable.

Under the Administration proposal, a beneficiary would not be treated as a U.S. person for purposes of determining whether the transferor of property to a foreign trust would be taxed as a grantor with respect to any portion of a foreign trust if such beneficiary first became a U.S. resident more than 5 years after the transfer.

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[10] For this purpose, a person generally would be treated as related to the grantor or beneficiary if the relationship between such person and the grantor or beneficiary would result in a disallowance of losses under section 267 or 707(b).

Treatment of former U.S. persons

The Administration proposal would grant broad authority to the Treasury Secretary to treat any person who was a U.S. person at any time during the existence of the trust as a U.S. person in determining whether there are U.S. beneficiaries of the trust for purposes of section 679.

Outbound trust migrations

The Administration proposal would apply the rules of section 679 to a U.S. person that transferred property to a domestic trust if the trust subsequently became a foreign trust while the transferor was still alive. Such a person would be deemed to make a transfer to the foreign trust on the date of the migration. The amount of the deemed transfer would be the portion of the trust (including undistributed earnings) attributable to the property previously transferred. Consequently, the individual generally would be treated under the rules of section 679 as the owner of that portion of the trust in any taxable year in which the trust has U.S. beneficiaries. The Administration proposal's reporting requirements and penalties (discussed below) also would be applicable.

Effective Date

The proposals described in this part would apply to transfers of property after February 6, 1995.

d. Residence of estates and trusts

Treatment as U.S. person

The Administration proposal would establish a two-part objective test for determining for tax purposes whether a trust is foreign or domestic. If both parts of the test are satisfied, the trust would be treated as domestic. Only the first part of the test would apply to estates.

Under the first part of the proposed test, in order for an estate or trust to be treated as domestic, a U.S. court (i.e., Federal, State, or local) must be able to exercise primary supervision over the administration of the estate or trust. It is expected that this test would be satisfied by any trust instrument that specifies that it is to be governed by the laws of any State. In addition, an estate or trust may be able to subject itself voluntarily to the jurisdiction of a U.S. court through registration of the estate or trust under a State law similar to Article VII of the American Law Institute's Uniform Probate Code.

Under the second part of the proposed test, in order for a trust to be treated as domestic, one or more U.S. fiduciaries must have the authority to control all substantial decisions of the trust. It is expected that this test would be satisfied in any case where fiduciaries who are U.S. persons hold a majority of the fiduciary power (whether by vote or otherwise), and where no foreign fiduciary, such as a "trust protector" or other trust advisor, has the power to veto important decisions of the U.S. fiduciaries. It is further expected that, in applying this test, a reasonable period of time would be allowed for a trust to replace a U.S. fiduciary who resigns or dies before the trust would be treated as foreign.

Under the Administration proposal, a foreign estate would be defined as an estate other than an estate that is determined to be domestic under the court-supervision test. A foreign trust would be defined as a trust other than a trust that is determined to be domestic under both the court-supervision test and the U.S. fiduciary test.

Outbound migration of domestic trusts

Under the Administration proposal, if a domestic trust changes its situs and becomes a foreign trust, the trust would be treated as having made a transfer of its assets to the foreign trust and would be subject to the 35-percent excise tax imposed by present-law section 1491 unless one of the exceptions to this excise tax were applicable. The U.S. grantor also would be required to report the transfer under the reporting requirements described below. Failure to report such a transfer, or any transfer described in section 1491 (e.g., a transfer to a foreign partnership) would result in penalties (discussed below).

Effective Date

The proposal to modify the treatment of a trust or estate as a U.S. person would apply to taxable years beginning after December 31, 1996. In addition, if the trustee of a trust so elects, the proposal would apply to taxable years ending after the date of enactment. The proposed amendment to section 1491 would be effective on the date of enactment.

e. Information reporting relating to foreign trusts

The Administration proposal would expand the reporting requirements with respect to foreign trusts if there is a U.S. grantor of the foreign trust or a distribution from the foreign trust to a U.S. person. The Administration proposal would require the responsible parties to file the designated information reports with the Treasury Department upon the occurrence of certain events. A failure to comply with the reporting requirements would result in increased monetary penalties under the Administration proposal.

Information reporting requirements

First, the Administration proposal would require the grantor, transferor or executor (i.e., the "responsible party") to notify the Treasury Department upon the occurrence of certain reportable events. The reportable events include direct and indirect transfers of property to a foreign trust and the death of a U.S. citizen or resident if any portion of a foreign trust was included in the gross estate of the decedent. The required notice would identify the money or other property transferred and report information regarding the trustee and beneficiaries of the foreign trust.

Second, a U.S. person that is treated as the owner of any portion of a foreign trust would be required to ensure that the trust files an annual report to provide full accounting of all the trust activities for the taxable year, the name of the U.S. agent for the trust, and other information as prescribed by the Secretary of the Treasury.[11] In addition, unless a U.S. person is authorized to accept service of process as the trust's limited agent with respect to any request by the Treasury Department to examine records or to take testimony and any summons for such records or testimony in connection with the tax treatment of any items related to the trust, the Treasury Secretary would be entitled to determine, in its sole discretion, the amount to be taken into account under the grantor trust rules (secs. 671 through 679). This limited agency relationship would not constitute an agency relationship for any other purpose under Federal or State law.

Third, any U.S. person who receives (directly or indirectly) any distribution from a foreign trust would be required to file a notice to report the name of the trust, the aggregate amount of the distributions received, and other information that the Secretary of the Treasury may prescribe.

Monetary penalties for failure to report

Under the Administration proposal, a person who fails to provide the required notice in cases involving the transfer of property to a new or existing foreign trust, or a distribution by a foreign trust to a U.S. person, would be subject to an initial penalty equal to 35 percent of the gross reportable amount. A failure to provide an annual reporting of trust activities would result in an initial penalty equal to 5 percent of the gross reportable amount. In cases involving a transfer of property to a foreign trust, the gross reportable amount would be the gross value of the property transferred. In cases involving the death of a U.S. citizen or resident whose estate includes any portion of a foreign trust, the gross amount would be the value of the property includible in the gross estate of the decedent. In cases where annual reporting of trust activities is required, the gross reportable amount would be the gross value of the portion of the foreign trust's assets treated as owned by the U.S. grantor at the close of the year, and in cases involving a distribution to a U.S. beneficiary of a foreign trust, the gross reportable amount would be the amount of the distribution to the beneficiary. An additional $10,000 penalty would be imposed for continued failure for each 30-day period (or fraction thereof) beginning 90 days after the Treasury Department notifies the responsible party of such failure. Such penalties would be subject to a reasonable cause exception.

[11] It is intended that the regulations would require the trust to furnish information to U.S. grantors and beneficiaries concerning income reportable by such persons that is similar to the items on schedule K-1 of Form 1041.

Effective Date

The reporting requirements and applicable penalties generally would apply to reportable events occurring or distributions received after the date of enactment. The annual reporting requirement and penalties applicable to U.S. grantors would apply to taxable years of such persons beginning after the date of enactment.

f. Reporting of certain foreign gifts

The Administration proposal generally would require any U.S. person (other than certain tax-exempt organizations) that receives purported gifts or bequests from foreign sources totaling more than $10,000 during the taxable year to report them to the Treasury Department. The definition of a gift to a U.S. person for this purpose would exclude qualified tuition or medical payments made on behalf of the U.S. person, as defined for gift tax purposes (sec. 2503(e)(2)). If the U.S. person fails, without reasonable cause, to report foreign gifts as required, the Treasury Secretary would be authorized to determine, in its sole discretion, the tax treatment of the unreported gifts, based on information in its possession or as it may obtain. In addition, the U.S. person would be subject to a penalty equal to 5 percent of the amount of the gift for each month that the failure continues, with the total penalty not to exceed 25 percent of such amount.

Effective Date

The proposal would apply to amounts received after the date of enactment.

Legislative Background

The President's fiscal year 1996 budget proposal (referred to as the "1996 budget proposal") was submitted to the Congress on February 6, 1995. The 1996 budget proposal includes amendments to the foreign trust provisions; such amendments were included in H.R. 981, introduced by Representatives Gephardt and Gibbons, and S. 453, introduced by Senators Moynihan and Daschle. Representative Gibbons and Senator Moynihan subsequently introduced identical bills, H.R. 2356 and S. 1261, on September 19, 1995. These subsequent bills revised the foreign trust amendments included in the 1996 budget proposal. The provisions of H.R. 2356 and S. 1261 are resubmitted as the Administration foreign trust proposal described above. The BBA of 1995, passed by the House and Senate in November 1995, and vetoed by the President on December 6, 1995, would have further modified the provisions of H.R. 2356 and S. 1261.

The following is a summary of the differences between the Administration foreign trust proposal and the provisions of the BBA of 1995:

a. Inbound foreign grantor trust rules

The BBA of 1995 contains two technical corrections to the Administration proposal with respect to the inbound foreign grantor trust rules.

As amended by the BBA of 1995, the grantor trust rules apply in determining whether a foreign corporation is characterized as a passive foreign investment company ("PFIC"). Thus, a foreign corporation may not avoid PFIC status by transferring its assets to a grantor trust.

As amended by the BBA of 1995, a U.S. beneficiary of an inbound grantor trust that transferred property to the foreign grantor by gift would be treated as a grantor of a portion of the trust to the extent of the transfer. This rule applies without regard to whether the foreign grantor would otherwise be treated as the owner of any portion of such trust.

b. Foreign trusts that are not grantor trusts

Interest charge on accumulation distributions

The BBA of 1995, contains a technical correction to the Administration proposal with respect to the accumulation distribution rules. As amended by the BBA of 1995, an accumulation distribution to a U.S. beneficiary of a foreign nongrantor trust is treated as reducing proportionately the undistributed net income for prior taxable years in which the trust had undistributed net income and the beneficiary receiving the distribution was a U.S. citizen or resident. In determining the interest payable with respect to a trust distribution, the distribution is deemed to be from years in which both such conditions are satisfied.

Use of trust property

The Administration proposal generally would treat the value of the use of trust property (other than cash or marketable securities) by any U.S. grantor, U.S. beneficiary of the trust, or by a U.S. person related to such a grantor or beneficiary, as a distribution equal to the fair market value of the use of the property. The BBA of 1995 does not contain such a provision.

Loans to grantors or beneficiaries

The Administration proposal would treat any loan of cash or marketable securities to any U.S. grantor or U.S. beneficiary of the trust, or to a U.S. person related to a such a grantor or beneficiary as a distribution by the trust. The BBA of 1995 grants the Treasury Secretary regulatory authority to exempt certain arm's-length loans from these rules.

c. Outbound foreign grantor trust rules

Sale or exchange at fair market value

The Administration proposal would disregard all obligations issued by the trust, any grantor or beneficiary of the trust, or by anyone related to a grantor or beneficiary, in determining whether fair market value is provided in exchange for the property transferred. Thus, a U.S. person that transfers property to a foreign trust in exchange for such an obligation would be treated as the owner of the portion of the trust comprising that property for any taxable year in which there is a U.S. beneficiary, even if the obligation reflects a genuine indebtedness bearing a market rate of interest. The BBA of 1995 grants the Treasury Secretary regulatory authority to exempt certain arm's-length loans from these rules.

Treatment of former U.S. persons

The Administration proposal would grant broad authority to the Treasury Secretary to treat anyone who was a U.S. person at any time during the existence of the trust as a U.S. person in determining whether there are U.S. beneficiaries of the trust for purposes of section 679. The BBA of 1995 does not contain such a provision.

d. Residence of estates and trusts

The Administration proposal would impose reporting obligations and penalties for a failure to report on any outbound transfer subject to section 1491, even though the transaction does not involve a foreign trust (e.g., a transfer to a foreign partnership). The BBA of 1995 imposes reporting obligations and penalties for a failure to report only transfers involving a foreign trust (e.g., a transfer from a domestic trust to a foreign trust).

e. Information reporting relating to foreign trusts

Transfers to certain nonexempt trusts

The Administration proposal would require the grantor, transferor, or executor to notify the Treasury Department upon the occurrence of certain reportable events: the creation of a foreign trust by a U.S. person, the transfer of money or property to a foreign trust by a U.S. person, and the death of a U.S. citizen or U.S. resident if any portion of a foreign trust was included in the gross estate of the decedent. The Administration proposal would exclude from the definition of reportable events any such occurrence with respect to exempt pension trusts or certain charitable trusts. The BBA of 1995 excludes from the definition of reportable events any such occurrence with respect to a nonexempt employees' trust that is described in section 402(b).

Sanction for failure to appoint limited U.S. agent

Under the Administration proposal, unless a U.S. person is authorized to accept service of process as the trust's limited agent with respect to any request by the Treasury Department to examine records or take testimony and any summons for such records or testimony in connection with the tax treatment of any items related to the trust, the Treasury Secretary would be entitled to determine, in its sole discretion, the amount to be taken into account under the grantor trust rules.

Under the BBA of 1995, the Treasury Secretary's exercise of its authority to make such a determination will be subject to judicial review under an arbitrary or capricious standard, which accordingly provides a high degree of deference to such determination.

Sanction for failure to maintain adequate records

The BBA of 1995 contains a technical correction to the Administration proposal regarding a U.S. distributee that fails to provide adequate records to the Treasury Department to determine the proper treatment of any distributions from a foreign trust. As amended by the BBA of 1995, when a U.S. distributee does not provide sufficient records, the accumulation distribution is deemed to come from the trust's average year (i.e., the number of years that the trust has been in existence divided by 2) for purposes of computing the interest charge applicable to such distribution.

Penalties for failure to report

The Administration proposal would not provide a cap on penalties imposed for the failure to report certain transactions between a foreign trust and its U.S. grantor or U.S. beneficiary. Thus, the penalties could exceed the value of the property involved in the transaction. The BBA of 1995 limits the amount of monetary penalties to the gross reportable amount (i.e., generally the value of the property involved in the transaction).

f. Information reporting on foreign gifts

The Administration proposal would not index for inflation the annual amount of gifts or bequests ($10,000) that are exempt from certain reporting requirements. Under the BBA of, the $10,000 threshold for such reporting requirement is indexed for inflation.

7. Additional empowerment zones

Present Law

Pursuant to the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), the Secretaries of the Department of Housing and Urban Development (HUD) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on

December 21, 1994. As required by law, six empowerment zones are located in urban areas (with aggregate population for the six designated urban empowerment zones limited to 750,000) and three empowerment zones are located in rural areas.[12] Of the enterprise communities, 65 are located in urban areas and 30 are located in rural areas (sec. 1391). Designated empowerment zones and enterprise communities were required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations (sec. 1392). The designated areas were selected from among over 500 areas nominated by State and local governments, which submitted proposed strategic plans to promote economic development in these areas.

The following tax incentives are available for certain businesses located in empowerment zones: (1) a 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the zone; (2) an additional $20,000 of section 179 expensing for certain zone business property (accordingly, certain businesses operating in empowerment zones are allowed up to $37,500 of expensing); and (3) expanded tax-exempt financing for certain zone facilities. In contrast, the 95 enterprise communities are eligible for the expanded tax-exempt financing benefits, but not the other tax incentives available in the nine empowerment zones. In addition to these tax incentives, OBRA 1993 provided that Federal grants would be made to designated empowerment zones and enterprise communities.

The tax incentives for empowerment zones and enterprise communities generally will be available during the period that the designation remains in effect, i.e., a 10-year period.

Description of Proposal

The Secretary of HUD would be authorized to designate two additional empowerment zones located in urban areas (thereby increasing to eight the total number of empowerment zones located in urban areas). The two additional empowerment zones would be subject to the same eligibility criteria under present-law section 1392 that applied to the original six urban empowerment zones. In order to permit designation of two additional empowerment zones, the proposal would increase the present-law 750,000 aggregate population cap applicable to all empowerment zones located in urban areas to a cap of 1 million aggregate population for the eight urban empowerment zones. No additional Federal grants would be authorized.

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[12] The six designated urban empowerment zones are located in New York City, Chicago, Atlanta, Detroit, Baltimore, and Philadelphia-Camden (N.J.).

The three designated rural empowerment zones are located in Kentucky Highlands (Clinton, Jackson, Wayne counties, Ky.), Mid-Delta Mississippi (Bolivar, Holmes, Humphreys, Leflore counties, Miss.), and Rio Grande Valley Texas (Cameron, Hidalgo, Starr, Willacy counties, Texas).

Effective Date

The proposal would be effective on the date of enactment.

Legislative Background

The proposal is identical to the proposal contained in the President's fiscal year 1996 budget proposal (the "Tax Compliance Act of 1995," introduced on February 16, 1995, as H.R. 981 by Representatives Gephardt and Gibbons and as S. 453 by Senators Moynihan and Daschle).

8. Intermediate sanctions for certain tax-exempt organizations

Present Law

Private inurement

Charities.--Section 501(c)(3) specifically conditions tax-exempt status for all organizations described in that section on the requirement that no part of the net earnings of the organization inures to the benefit of any private shareholder or individual (the so-called "private inurement test").

Social welfare organizations.--A tax-exempt social welfare organization described in section 501(c)(4) must be organized on a non-profit basis and must be operated exclusively for the promotion of social welfare. In contrast to section 501(c)(3), however, there is no specific statutory rule in section 501(c)(4) prohibiting the net earnings of a social welfare organization described in section 501(c)(4) from inuring to the benefit of a private shareholder or individual.[13]

Other organizations.--Other tax-exempt organizations, such as labor and agricultural organizations described in section 501(c)(5) and business leagues described in section 501(c)(6) are subject to the private inurement test, as a result of explicit statutory language or Treasury Department regulations.

Sanctions for private inurement and other violations of exemption standards

Organizations described in section 501(c)(3) are classified as either public charities or private foundations. Penalty excise taxes may be imposed under the Code when a public charity

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[13] Even where no prohibited private inurement exists, however, more than incidental private benefits conferred on individuals may result in the organization not being operated "exclusively" for an exempt purpose. See, e.g., American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989).

makes political expenditures (sec. 4955) or excessive lobbying expenditures (secs. 4911 and 4912). However, the Code generally does not provide for the imposition of penalty excise taxes in cases where a 501(c)(3) public charity or a section 501(c)(4) social welfare organization engages in a transaction that results in private inurement. In such cases, the only sanction that specifically is authorized under the Code is revocation of the organization's tax-exempt status. A transaction engaged in by a private foundation (but not a public charity) is subject to special penalty excise taxes under the Code if the transaction is a prohibited "self-dealing" transaction (sec. 4941) or does not accomplish a charitable purpose (sec. 4945).

Filing and public disclosure rules

Tax-exempt organizations (other than churches and certain small organizations) are required to file an annual information return (Form 990) with the Internal Revenue Service ("IRS"), setting forth the organization's items of gross income and expenses attributable to such income, disbursements for tax-exempt purposes, plus certain other information for the taxable year. Private foundations are required to allow public inspection at the foundation's principal office of their current annual information return. Other tax-exempt organizations, including public charities, are required to allow public inspection at the organization's principal office (and certain regional or district offices) of their annual information returns for the three most recent taxable years (sec. 6104(e)). The Code also requires that tax-exempt organizations allow public inspection of the organization's application to the IRS for recognition of tax-exempt status, the IRS determination letter, and certain related documents. In addition, upon written request to the IRS, members of the general public are permitted to inspect annual information returns of tax-exempt organizations and applications for recognition of tax-exempt status (and related documents) at the National Office of the IRS in Washington, D.C. A person making such a written request is notified by the IRS when the material is available for inspection at the National Office, where notes may be taken of the material open for inspection, photographs taken with the person's own equipment, or copies of such material obtained from the IRS for a fee (Treas. Reg. secs. 301.6104(a)-6 and 301.6104(b)-1).

Section 6652(c)(1)(A) provides that a tax-exempt organization that fails to file a complete and accurate Form 990 is subject to a penalty of $10 for each day during which such failure continues (with a maximum penalty with respect to any one return of the lesser of $5,000 or five percent of the organization's gross receipts for the year). Section 6652(c)(1)(C) provides that tax-exempt organizations that fail to make certain annual returns and applications for exemption available for public inspection are subject to a penalty of $10 for each day the failure continues (with a maximum penalty with respect to any one return not to exceed $5,000, and without limitation with respect to applications). In addition, section 6685 provides a penalty for willfully failing to make an annual return or application available for public inspection of $1,000 per return or application.

Organizations that have tax-exempt status but that are not eligible to receive tax-deductible charitable contributions are required expressly to state in certain fundraising solicitations that contributions or gifts to the organization are not deductible as charitable contributions for Federal income tax purposes (sec. 6113). Penalties may be imposed on such organizations for failure to comply with this requirement (sec. 6710).

Description of Proposal

Extend private inurement prohibition to social welfare organizations

The proposal would amend section 501(c)(4) explicitly to provide that a social welfare organization or other organization described in that section would be eligible for tax-exempt status only if no part of its net earnings inures to the benefit of any private shareholder or individual.

In addition, the proposal would provide that the private inurement rule will not be violated solely because of an allocation or return of net margins or capital to the members of a nonprofit association or organization that operates on a cooperative basis in accordance with its incorporating statute and bylaws (substantially as in existence on the date of enactment) and was determined to be exempt from Federal income tax under section 501(c)(4) prior to the date of enactment. However, such cooperative organizations would be subject to the general private inurement proscription with respect to any other type of transaction.

Effective date.--This provision generally would be effective on September 14, 1995. However, under a special transition rule, the provision would not apply to inurement occurring prior to January 1, 1997, if such inurement results from a written contract that was binding on September 13, 1995, and at all times thereafter before such inurement occurred, and the terms of which have not materially changed.

Intermediate sanctions for excess benefit transactions

The proposal would impose penalty excise taxes as an intermediate sanction in cases where organizations exempt from tax under section 501(c)(3) or 501(c)(4) (other than private foundations, which are subject to a separate penalty regime under current law) engage in an "excess benefit transaction." In such cases, intermediate sanctions could be imposed on certain disqualified persons (i.e., insiders) who improperly benefit from an excess benefit transaction and on organization managers who participate in such a transaction knowing that it is improper.

An "excess benefit transaction" would be defined as: (1) any transaction in which an economic benefit is provided to, or for the use of, any disqualified person if the value of the economic benefit provided directly by the organization (or indirectly through a controlled entity[14]) to such person exceeds the value of consideration (including performance of services)

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[14] A tax-exempt organization could not avoid the private inurement proscription by causing a controlled entity to engage in an excess benefit transaction. Thus, for example, if a tax-exempt organization causes its taxable subsidiary to pay excessive compensation to an

received by the organization for providing such benefit; and (2) to the extent provided in Treasury Department regulations, any transaction in which the amount of any economic benefit provided to, or for the use of, any disqualified person is determined in whole or in part by the revenues of the organization, provided that the transaction constitutes prohibited inurement under present-law section 501(c)(3) or under section 501(c)(4), as amended. Thus, "excess benefit transactions" subject to excise taxes would include transactions in which a disqualified person engages in a non-fair-market-value transaction with an organization or receives unreasonable compensation, as well as financial arrangements (to the extent provided in Treasury regulations) under which a disqualified person receives payment based on the organization's income in a transaction that violates the present-law private inurement prohibition. The Treasury Department would be instructed to issue prompt guidance providing examples of revenue-sharing arrangements that violate the private inurement prohibition, and such guidance would be applicable on a prospective basis.[15]

Existing tax-law standards (see sec. 162) would apply in determining reasonableness of compensation and fair market value. In applying such standards, it is intended that the parties to a transaction would be entitled to rely on a rebuttable presumption of reasonableness with respect to a compensation arrangement with a disqualified person if such arrangement was approved by an independent board (or an independent committee authorized by the board) that: (1) was composed entirely of individuals unrelated to and not subject to the control of the disqualified person(s) involved in the arrangement; (2) obtained and relied upon appropriate data as to comparability (e.g., compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the location of the organization, including the availability of similar specialties in the geographic area; independent compensation surveys by nationally recognized independent firms; or actual written offers from similar institutions competing for the services of the disqualified person); and (3) adequately documented the basis for its determination (e.g., the record includes an evaluation of the individual whose compensation was being established and the basis for determining that the individual's compensation was reasonable in light of that evaluation and data).[16] If these three

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individual who is a disqualified person with respect to the parent organization, such transaction would be an excess benefit transaction.

[15] Under present law, certain revenue sharing arrangements have been determined not to constitute private inurement (see e.g., GCM 38283; GCM 38905; and GCM 39674) and, under the proposal, it would continue to be the case that not all revenue sharing arrangements would be improper private inurement. However, legislative history would indicate that no inference is intended that Treasury or the Internal Revenue Service are bound by any particular prior unpublished rulings in this area.

[16] The fact that a State or local legislative or agency body may have authorized or approved of a particular compensation package paid to a disqualified person would not be determinative of the reasonableness of compensation paid for purposes of the excise tax penalties provided for by the proposal. Similarly, such authorization or approval would not be

criteria are satisfied, penalty excise taxes could be imposed under the proposal only if the IRS develops sufficient contrary evidence to rebut the probative value of the evidence put forth by the parties to the transaction (e.g., the IRS could establish that the compensation data relied upon by the parties was not for functionally comparable positions or that the disqualified person, in fact, did not substantially perform the responsibilities of such position). A similar rebuttable presumption would arise with respect to the reasonableness of the valuation of property sold or otherwise transferred (or purchased) by an organization to (or from) a disqualified person if the sale or transfer (or purchase) is approved by an independent board that uses appropriate comparability data and adequately documents its determination. The Secretary of the Treasury and IRS would be instructed to issue guidance in connection with the reasonableness standard that incorporates this presumption.

The proposal would specifically provide that the payment of personal expenses and benefits to or for the benefit of disqualified persons, and non-fair-market-value transactions benefiting such persons, would be treated as compensation only if it is clear that the organization intended and made the payments as compensation for services. In determining whether such payments or transactions are, in fact, compensation, the relevant factors would include whether the appropriate decision-making body approved the transfer as compensation in accordance with established procedures and whether the organization and the recipient reported the transfer (except in the case of non-taxable fringe benefits) as compensation on the relevant forms (i.e., the organization's Form 990, the Form W-2 or Form 1099 provided by the organization to the recipient, the recipient's Form 1040, and other required returns).[17]

Consistent with the rule that payment of personal expenses and benefits to or for the benefit of disqualified persons and nonfair-market value transactions benefiting such persons are treated as compensation only if it is clear that the organization intended and made the payments as compensation for services, any reimbursements by the organization of excise tax liability would be treated as an excess benefit unless they are included in the disqualified person's compensation during the year the reimbursement is made. The total compensation package, including the amount of any reimbursement, would be subject to the reasonableness requirement. Similarly, the payment by an applicable tax-exempt organization of premiums for an insurance

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determinative of whether a revenue sharing arrangement violates the private inurement proscription.

[17] With the exception of nontaxable fringe benefits described in present-law section 132 and other types of nontaxable transfers such as employer-provided health benefits and contributions to qualified pension plans, an organization could not demonstrate at the time of an IRS audit that it clearly indicated its intent to treat economic benefits provided to a disqualified person as compensation for services merely by claiming that such benefits may be viewed as part of the disqualified person's total compensation package. Rather, the organization would be required to provide substantiation that is contemporaneous with the transfer of economic benefits at issue.

policy providing liability insurance to a disqualified person for excess benefit taxes would be an excess benefit transaction unless such premiums are treated as part of the compensation paid to such disqualified person.[18]

"Disqualified person" would mean any individual who is in a position to exercise substantial influence over the affairs of the organization, whether by virtue of being an organization manager or otherwise.[19] In addition, "disqualified persons" include certain family members and 35-percent owned entities[20] of a disqualified person, as well as any person who was a disqualified person at any time during the five-year period prior to the transaction at issue. A person having the title of "officer, director, or trustee" would not automatically have the status of a disqualified person.[21] In addition, the Secretary of Treasury would have authority to promulgate rules exempting broad categories of individuals from the category of "disqualified persons" (e.g., full-time bona fide employees who receive economic benefits of less than a threshold amount or persons who have taken a vow of poverty).

A disqualified person who benefits from an excess benefit transaction would be subject to a first-tier penalty tax equal to 25 percent of the amount of the excess benefit (i.e., the amount by which a transaction differs from fair market value, the amount of compensation exceeding reasonable compensation, or (under Treasury regulations) the amount of a prohibited transaction

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[18] In addition, because individuals may be both members of, and disqualified persons with respect to, a non-exclusive applicable tax-exempt organization (e.g., a museum or neighborhood civic organization) and receive certain benefits (e.g., free admission, discounted gift shop purchases) in their capacity as members (rather than in their capacity as disqualified persons), legislative history would express the expectation that the Treasury Department would provide guidance clarifying that such membership benefits may be excluded from consideration under the private inurement proscription and intermediate sanction rules.

[19] Under the proposal, a person could be in a position to exercise substantial influence over a tax-exempt organization despite the fact that such person is not an employee of (and receives no compensation directly from) a tax-exempt organization, but is formally an employee of (and is directly compensated by) a subsidiary -- even a taxable subsidiary -- controlled by the parent tax-exempt organization

[20] Family members would be determined under present-law section 4946(d), except that such members also would include siblings (whether by whole or half blood) of the individual, and spouses of such siblings. "35-percent owned entities" would mean corporations, partnerships, and trusts or estates in which a disqualified person owns more than 35 percent of the combined voting power, profits interest, or beneficial interest.

[21] The IRS has issued a general counsel memorandum indicating that all physicians are considered "insiders" for purposes of applying the private inurement proscription. Legislative history would express the intent that physicians will be disqualified persons only if they are in a position to exercise substantial influence over the affairs of an organization.

based on the organization's gross or net income). Organization managers who participate in an excess benefit transaction knowing that it is an improper transaction would be subject to a first-tier penalty tax of ten percent of the amount of the excess benefit (subject to a maximum penalty of $10,000).[22]

Additional, second-tier taxes could be imposed on a disqualified person if there is no correction of the excess benefit transaction within a specified time period.[23] In such cases, the disqualified person would be subject to a penalty tax equal to 200 percent of the amount of excess benefit. For this purpose, the term "correction" would mean undoing the excess benefit to the extent possible and, where fully undoing the excess benefit is not possible, taking such additional corrective action as is prescribed by Treasury regulations.

The intermediate sanctions for "excess benefit transactions" could be imposed by the IRS in lieu of (or in addition to) revocation of an organization's tax-exempt status.[24] If more than one disqualified person or manager is liable for a penalty excise tax, then all such persons would be jointly and severally liable for such tax. As under current law, a three-year statute of limitations would apply, except in the case of fraud (sec. 6501). Under the proposal, the IRS would have authority to abate the excise tax penalty (under present-law section 4962) if it is established that the violation was due to reasonable cause and not due to willful neglect and the transaction at issue was corrected within the specified period.

To prevent avoidance of the penalty excise taxes in cases of private inurement of assets of a previously tax-exempt organization, the proposal would provide that an organization will be treated as an applicable tax-exempt organization subject to the excise taxes on excess benefit transactions if, at any time during the ten-year period preceding the transaction, it was a tax-exempt organization described in section 501(c)(3) or 501(c)(4), or a successor to such an organization.

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[22] In determining who is an organization manager, it is intended that principles similar to those set forth in regulations issued under sections 4946 and 4955 with respect to final authority or responsibility for an expenditure be applied. (See Treas. Reg. secs. 53.4946-1(f)(1)(ii), 53.4946-1(f)(2), 53.4955-1(b)(2)(ii)(B), and 53.4955-1(b)(2)(iii)).

[23] Correction would be required to be made on or prior to the earlier of (1) the date of mailing of a notice of deficiency under section 6212 with respect to the first-tier penalty excise tax imposed on the disqualified person, or (2) the date on which such tax is assessed.

[24] In general, the intermediate sanctions would be the sole sanction imposed in those cases in which the excess benefit does not rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization. In practice, revocation of tax-exempt status, with or without the imposition of excise taxes, would occur only when the organization no longer operates as a charitable organization.

Effective date.--The provision generally would apply to excess benefit transactions occurring on or after September 14, 1995. The provision does not apply, however, to any benefits arising out of a transaction pursuant to a written contract which was binding on September 13, 1995, and at all times thereafter before such benefits arose, and the terms of which have not materially changed.

In addition, legislative history would indicate that parties to transactions entered into after September 13, 1995, and before January 1, 1997, would be entitled to rely on the rebuttable presumption of reasonableness if, within a reasonable period (e.g., 90 days) after entering into the compensation package, the parties satisfy the three criteria that give rise to the presumption. After December 31, 1996, the rebuttable presumption should arise only if the three criteria are satisfied prior to payment of the compensation (or, to the extent provided by the Secretary of the Treasury, within a reasonable period thereafter).

Additional filing and public disclosure rules

Reporting of identity of certain disqualified persons, excise tax penalties and excess benefit transactions.-- Tax-exempt organizations would be required to disclose on their Form 990 the name of each individual who was in a position to exercise substantial influence over the affairs of the organization (but not their family members and 35-percent owned entities) or such other information with respect to disqualified persons as the Secretary of the Treasury may prescribe. In addition, exempt organizations would be required to disclose on their Form 990 such information as the Secretary of the Treasury may require with respect to "excess benefit transactions" (described above) and any other excise tax penalties paid during the year under present-law sections 4911 (excess lobbying expenditures), 4912 (disqualifying lobbying expenditures), or 4955 (political expenditures), including the amount of the excise tax penalties paid with respect to such transactions, the nature of the activity, and the parties involved.[25]

Penalties for failure to file timely or complete return.--The section 6652(c)(1)(A) penalty imposed on a tax-exempt organization that either fails to file a Form 990 in a timely manner or fails to include all required information on a Form 990 would be increased from the present-law level of $10 for each day the failure continues (with a maximum penalty with respect to any one return of the lesser of $5,000 or five percent of the organization's gross receipts) to $20 for each day the failure continues (with a maximum penalty with respect to any one return of the lesser of $10,000 or five percent of the organization's gross receipts). Under the proposal, organizations with annual gross receipts exceeding $1 million would be subject to a penalty under section

[25] The penalties applicable to failure to file a timely, complete, and accurate return would apply for failure to comply with these requirements. In addition, it would be intended that the IRS implement its plan to require additional Form 990 reporting regarding (1) changes to the governing board or the certified accounting firm, (2) such information as the Treasury Secretary may require relating to professional fundraising fees paid by the organization, and (3) aggregate payments (by related entities) in excess of $100,000 to the highest-paid employees.

6652(c)(1)(A) of $100 for each day the failure continues (with a maximum penalty with respect to any one return of $50,000). As under present law, no penalty may be imposed under section 6652(c)(1)(A) if it were shown that the failure to file a complete return was due to reasonable cause (sec. 6652(c)(3)).

Effective dates.--The filing and disclosure provisions governing tax-exempt organizations generally would take effect on January 1, 1996 (or, if later, 90 days after enactment). However, the provisions regarding the reporting on annual returns of excise tax penalties and excess benefit transactions would be effective for returns with respect to taxable years beginning on or after January 1, 1995.

Legislative Background

The Administration's proposal is virtually identical to the intermediate sanction provisions contained in the BBA of 1995 (sec. 11271) and described in the accompanying Conference Report, except that the Adminstration proposal would provide that an organization will be treated as an applicable tax-exempt organization subject to the excise taxes on excess benefit transactions if, at any time during the ten-year period preceding the transaction, it was a tax-exempt organization described in section 501(c)(3) or 501(c)(4), or a successor to such an organization. The BBA of 1995 contains a similar provision, but provides for a two-year, rather than a ten-year, period.

9. Reinstatement of authority for undercover operations

Present Law

The Anti-Drug Abuse Act of 1988 exempted IRS undercover operations from the otherwise applicable statutory restrictions controlling the use of Government funds (which generally provide that all receipts be deposited in the general fund of the Treasury and all expenses be paid out of appropriated funds). In general, the exemption permits the IRS to "churn" the income earned by an undercover operation to pay additional expenses incurred in the undercover operation. The IRS is required to conduct a detailed financial audit of large undercover operations in which the IRS is churning funds and to provide an annual audit report to the Congress on all such large undercover operations. The exemption originally expired on December 31, 1989, and was extended by the Comprehensive Crime Control Act of 1990 to December 31, 1991. The IRS has not had the authority to churn funds from its undercover operations since 1991.

Description of Proposal

The proposal would permanently reinstate the IRS's offset authority under section 7608(c). The proposal would amend the IRS annual reporting requirement under section 7608(c)(4)(B) to require the provision of the following data: (1) the date the operation was initiated; (2) the date offsetting was approved; (3) the total current expenditures and the amount and use of proceeds of the operation; (4) a detailed description of the undercover operation projected to generate proceeds, including the potential violation being investigated, and whether the operation is being conducted under grand jury auspices; and (5) the results of the operation to date, including the results of criminal proceedings.

Effective Date

The proposal would be effective on the date of enactment.

Legislative Background

A five-year extension of this provision was contained in the Revenue Reconciliation Act of 1995 as passed by the House of Representatives.

10. Disclosure of returns concerning cash transactions

Present Law

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 IRS to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Under section 6050I, any person who receives more than $10,000 in cash in one transaction (or two or more related transactions) in the course of a trade or business generally must file an information return (Form 8300) with the IRS specifying the name, address, and taxpayer identification number of the person from whom the cash was received and the amount of cash received.

The Anti-Drug Abuse Act of 1988 provided a special rule permitting the IRS to disclose these information returns to other Federal agencies for the purpose of administering Federal criminal statutes. The special rule originally was to expire after November 18, 1990, and was extended by the Comprehensive Crime Control Act of 1990 to November 18, 1992.

Description of Proposal

The proposal would permanently extend the special rule for disclosing Form 8300 information. Moreover, the proposal would permit disclosures not only to Federal agencies but also to State, local and foreign agencies and for civil, criminal and regulatory purposes (i.e., generally in the same manner as CTRs filed by financial institutions under the Bank Secrecy Act.) Disclosure, however, is not permitted to any such agency for purposes of tax administration. The proposal would also (1) extend the dissemination policies and guidelines under section 6103 to people having access to Form 8300 information, and (2) apply section 6103 sanctions to persons having access to Form 8300 information that disclose this information without proper authorization.

Effective Date

The proposal would be effective on the date of enactment.

Legislative Background

An identical proposal was contained in the Revenue Reconciliation Act of 1995 as passed by the House of Representatives.

11. Extend Superfund excise taxes and corporate environmental income tax

Present Law

Four different Superfund taxes are imposed under present law. These are:

(1) An excise tax on petroleum, imposed at a rate of 9.7 cents per barrel, on domestic or imported crude oil or refined products;

(2) An excise tax on listed hazardous chemicals, imposed at a rate that varies from $0.22 to $4.87 per ton;

(3) An excise tax on imported substances that use as materials in their manufacture or production one or more of the hazardous chemicals subject to the excise tax described in (2), above; and

(4) A corporate environmental income tax equal to 0.12 percent of the amount of modified alternative minimum taxable income of a corporation that exceeds $2 million.

Modified alternative minimum taxable income is defined as a corporation's alternative minimum taxable income, but determined without regard to the alternative tax net operating loss deduction and the deduction for the corporate environmental income tax (sec. 59A).

Amounts equivalent to the revenues from these taxes are dedicated to the Hazardous Substance Superfund Trust Fund ("Superfund Trust Fund"), established in the Trust Fund Code of the Internal Revenue Code. Amounts in the Superfund Trust Fund generally are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment under specified provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (as amended).

The Superfund taxes are scheduled to expire after December 31, 1995. However, the taxes would have terminated earlier if either (1) the unobligated balance in the Superfund Trust Fund exceeded $3.5 billion on December 31, 1994, and the Treasury Department estimated that the unobligated balance would exceed $3.5 billion at the end of 1995 (assuming no Superfund taxes had been imposed during 1995), or (2) the Treasury Department had estimated that more than $11.97 billion of revenues from these taxes would have been credited into the Superfund Trust Fund before January 1, 1996.

Description of Administration Proposal

The present-law Superfund excise taxes on petroleum, chemicals, and imported substances would be extended through September 30, 2002. The corporate environmental income tax would be extended through taxable years beginning before January 1, 1998.

Effective Date

The proposal would be effective on enactment.

Legislative Background

The proposal was included in the BBA of 1995, as passed by the Senate. The conference report on the BBA of 1995 included a similar provision.

II. CORPORATE SUBSIDIES, LOOPHOLE CLOSERS AND OTHER MATTERS

1. Reform depreciation under the income forecast method

Present Law

Depreciation and amortization, in general

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through allowances for depreciation or amortization. Depreciation deductions are allowed under section 167 and the amounts of such deductions are determined under the modified Accelerated Cost Recovery System ("MACRS") of section 168 for most tangible property. MACRS determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property. Intangible property generally is amortized under section 197, which applies a 15-year recovery period and the straight-line method to the cost of applicable property.

Treatment of film, video tape, and similar property

MACRS does not apply to certain property, including (1) any motion picture film, video tape, or sound recording or (2) any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer applies a unit-of-production method or other method of depreciation not expressed in a term of years. Likewise, section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property unless acquired as part of a trade or business. Thus, the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be recovered under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost of such property may be depreciated under the general depreciation provision of section 167, which allows deductions for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property.

The "income forecast" method is an allowable method for calculating depreciation under section 167 for certain property. The income forecast method attempts to match allocable portions of the cost of property with the income expected to be generated by the property. Specifically, under the income forecast method, the depreciation deduction for a taxable year for a property is determined by multiplying the cost of the property (less estimated salvage value) by a fraction, the numerator of which is the income generated by the property during the year and the denominator of which is the total forecasted or estimated income to be derived from the property during its useful life. The income forecast method has been held to be applicable for computing depreciation deductions for motion picture films, television films and taped shows, books, patents, master sound recordings and video games. The total forecasted or estimated income to be derived from a property is to be based on the conditions known to exist at the end of the period for which depreciation is claimed. This estimate can be revised upward or downward at the end of a subsequent taxable period based on additional information that becomes available after the last prior estimate. These revisions, however, do not affect the amount of depreciation claimed in a prior taxable year. Thus, unforeseen income that is generated after the property is fully depreciated is never taken into account under the income forecast method.

In the case of a film, income to be taken into account under the income forecast method means income from the film less the expense of distributing the film, including estimated income from foreign distribution or other exploitation of the film. In the case of a motion picture released for theatrical exhibition, income does not include estimated income from future television exhibition of the film (unless an arrangement for domestic television exhibition has been entered into before the film has been depreciated to its reasonable salvage value). In the case of a series or a motion picture produced for television exhibition, income does not include estimated income from domestic syndication of the series or the film (unless an arrangement for syndication has been entered into before the series or film has been depreciated to its reasonable salvage value). The Internal Revenue Service also has ruled that income does not include net merchandising revenue received from the exploitation of film characters.

Description of Proposal

The proposal would make several amendments to the income forecast method of determining depreciation deductions.

First, the proposal would provide that income to be taken into account under the income forecast method includes all estimated income generated by the property. In applying this rule (and the look-back method described below), a taxpayer generally need not take into account income expected to be generated more than ten years after the year the property was placed in service. In addition, pursuant to a special rule, if a taxpayer produces a television series and initially does not anticipate syndicating the episodes from the series, the forecasted income for the episodes of the first three years of the series need not take into account any future syndication fees (unless the taxpayer enters into an arrangement to syndicate such episodes during such period). The 10-year rule and the syndication rule would apply for purposes of the look-back method described below. Income realized by a taxpayer from a related party with respect to a property subject to the income forecast method would not be taken into account, but income realized by a related party from an unrelated party with respect to the party would be taken into account.

In addition, the cost of property subject to depreciation would only include amounts that satisfy the economic performance standard of section 461(h). Except as provided in regulations, any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year.

Finally, taxpayers that claim depreciation deductions under the income forecast method would be required to pay (or would receive) interest based on the recalculation of depreciation under a "look-back" method. The "look-back" method would be applied in any "recomputation year" by: (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of the Code. Except as provided in regulations, a "recomputation year" would be the third and tenth taxable year after the taxable year the property was placed in service unless the actual income from the property for each period before the close of such years was within 10 percent of the estimated income from the property for such periods. The Secretary of the Treasury would have the authority to allow a taxpayer to delay the initial application of the look-back method where the taxpayer may be expected to have significant income from the property after the third taxable year after the taxable year the property was placed in service (e.g., the Secretary may exercise such authority where the depreciable life of the property is expected to be longer than three years). Property with an adjusted basis of $100,000 or less when the property was placed in service would not be subject to the look-back method. The proposal would provide a simplified look-back method for pass-through entities.

Effective Date

The proposal would be effective for property placed in service after September 13, 1995, unless placed in service pursuant to a binding written contract in effect before such date and all times thereafter.

Legislative Background

The proposal is substantially identical to a provision contained in the BBA of 1995.

2. Phase out preferential treatment for certain large farm corporations required to use accrual accounting

Present Law

A corporation (or a partnership with a corporate partner) engaged in the trade or business of farming must use an accrual method of accounting for such activities unless such corporation (or partnership), for each prior taxable year beginning after December 31, 1975, did not have gross receipts exceeding $1 million. If a farm corporation is required to change its method of accounting, the section 481 adjustment resulting from such change is included in gross income ratably over a 10-year period, beginning with the year of change. This rule does not apply to a family farm corporation.

A provision of the Revenue Act of 1987 ("1987 Act") requires a family corporation (or a partnership with a family corporation as a partner) to use an accrual method of accounting for its farming business unless, for each prior taxable year beginning after December 31, 1985, such corporation (and any predecessor corporation) did not have gross receipts exceeding $25 million. A family corporation is one where at 50 percent or more of the stock of the corporation is held by one (or in some limited cases, two or three) families.

A family farm corporation that must change to an accrual method of accounting as a result of the 1987 Act provision is to establish a suspense account in lieu of including the entire amount of the section 481 adjustment in gross income. The initial balance of the suspense account equals the lesser of (1) the section 481 adjustment otherwise required for the year of change, or (2) the section 481 adjustment computed as if the change in method of accounting had occurred as of the beginning of the taxable year preceding the year of change.

The amount of the suspense account is required to be included in gross income if the corporation ceases to be a family corporation. In addition, if the gross receipts of the corporation attributable to farming for any taxable year decline to an amount below the lesser of (1) the gross receipts attributable to farming for the last taxable year for which an accrual method of accounting was not required, or (2) the gross receipts attributable to farming for the most recent taxable year for which a portion of the suspense account was required to be included in income, a portion of the suspense account is required to be included in gross income.

Description of Proposal

The proposal would repeal the ability of a family farm corporation to establish a suspense account when it is required to change to an accrual method of accounting. Thus, under the proposal, any family farm corporation required to change to an accrual method of accounting would restore the section 481 adjustment applicable to the change in gross income ratably over a 10-year period beginning with the year of change. In addition, any taxpayer with an existing suspense account would be required to restore the account into income ratably over a 20-period.

Effective Date

The proposal would be effective for taxable years ending after September 13, 1995.

Legislative Background

The proposal is substantially identical to the provision contained in the BBA of 1995.

3. Disallow interest deduction for corporate-owned life insurance policy loans

Present Law

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup").[26] Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured (sec. 101(a)). The policyholder may borrow with respect to the life insurance contract without affecting these exclusions, subject to certain limitations.

The limitations on borrowing with respect to a life insurance contract under present law provide that no deduction is allowed for any interest paid or accrued on any indebtedness with respect to one or more life insurance policies owned by the taxpayer covering the life of any individual who (1) is an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer to the extent that the aggregate amount of such debt with respect to policies covering the individual exceeds $50,000 (sec. 264(a)(4)).

Further, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, endowment or annuity contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract.[27] An exception to the latter rule is provided, permitting deductibility of interest on bona fide debt that is part of such a plan, if

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[26] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional ten percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

[27] The statute provides that the $50,000 limitation applies only with respect to contracts purchased after June 20, 1986. However, additional limitations are imposed on the deductibility of interest with respect to single premium contracts (sec. 264(a)(2)), and on the deductibility of premiums paid on a life insurance contract covering the life of any officer or employee or person financially interested in a trade or business of the taxpayer when the taxpayer is directly or indirectly a beneficiary under the contract (sec. 264(a)(1)).

no part of 4 of the annual premiums due during the first 7 years is paid by means of debt (the "4-out-of-7 rule") (sec. 264(c)(1)). Provided the transaction gives rise to debt for Federal income tax purposes and provided the 4-out-of-7 rule is met,[28] a company may under present law borrow up to $50,000 per employee, officer, or financially interested person to purchase or carry a life insurance contract covering such a person, and is not precluded under section 264 from deducting the interest on the debt, even though the earnings inside the life insurance contract (inside buildup) are tax-free, and in fact the taxpayer has full use of the borrowed funds.

Description of Proposal

Under the proposal, no deduction would be allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance policies or annuity or endowment contracts owned by the taxpayer covering any individual who is (1) an officer or employee of, or (2) financially interested in any trade or business carried on by the taxpayer, regardless of the aggregate amount of debt with respect to policies or contracts covering the individual.

Effective Date

The proposal generally would be effective with respect to interest paid or accrued after December 31, 1995 (subject to a phase-in rule). In addition, interest paid or accrued after September 18, 1995, would be allowable only to the extent the rate of interest does not exceed the lesser of (1) the borrowing rate specified in the contract as of September 18, 1995, or (2) Moody's Corporate Bond Yield Average--Monthly Average Corporates for the month the interest is paid or accrued.

The phase-in of the proposal would permit a deduction for 50 percent of the otherwise deductible interest paid or accrued in 1996 (that would, but for the phase-in, be disallowed). Interest paid or accrued in 1997 and thereafter would not deductible. The interest deduction allowed under the phase-in would be for interest on debt incurred before September 18, 1995, with respect to a life insurance policy that was in effect on that date and that covers only the individual who was insured under that policy on that date. Only interest that would have been allowed as a deduction but for the amendment made by the proposal would be allowed under the phase-in. Interest that is deductible under the phase-in rule would not include interest on borrowings by the taxpayer with respect to contracts on the lives of more than 20,000 insured individuals, effective for interest paid or accrued after December 31, 1995. For this purpose, all persons treated as a single employer would be treated as one taxpayer.

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[28] Interest deductions are disallowed if any of the disallowance rules of section 264(a)(2) - (4) apply. The disallowance rule of section 264(a)(3) is not applicable if one of the exceptions of section 264(c), such as the 4-out-of-7 rule (sec. 264(c)(1)) is satisfied. In addition to the specific disallowance rules of section 264, generally applicable rules of tax law apply.

Any amount included in income during 1996 or 1997, that is received under a contract described in the proposal on the complete surrender, redemption or maturity of the contract or in full discharge of the obligation under the contract that is in the nature of a refund of the consideration paid for the contract, would be includable ratably over the first four taxable years beginning with the taxable year the amount would otherwise have been includable.

The proposal would not affect the determination of whether interest is deductible under present-law rules (including whether interest paid or accrued during the phase-in period is otherwise deductible), and the IRS would not be precluded from applying common-law doctrines or statutory or other tax rules to challenge corporate-owned life insurance plans to which present-law rules apply.

Legislative Background

The proposal is similar to the provision relating to disallowance of the interest deduction for corporate-owned life insurance policy loans that was included in the BBA of 1995.

4. Require gain recognition for certain extraordinary dividends

Present Law

A corporate shareholder is generally allowed to deduct a certain percentage of dividends received from another corporation. A corporate shareholder who receives an "extraordinary" dividend is required to reduce the basis of the stock with respect to which the dividend was received by the non-taxed portion of the dividend (section 1059). Whether a dividend is "extraordinary" is determined by reference to, among other things, the size of the dividend in relation to the adjusted basis of the shareholder's stock. Also, a dividend resulting from a non prorata redemption or partial liquidation is an extraordinary dividend. If the reduction in basis of stock exceeds the basis in stock with respect to which an extraordinary dividend is received, the excess is taxed as gain at the time of a sale or disposition of such stock.

In general, a distribution in redemption of stock is treated as a dividend, rather than as a sale of the stock, if it is essentially equivalent to a dividend. A redemption of the stock of a shareholder generally is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. The determination whether a redemption is essentially equivalent to a dividend includes a reference to the constructive ownership rules of section 318, including the option attribution rules of section 318(a)(4). The rules relating to treatment of other property received in a reorganization contain a similar reference (section 356(a)(2)).

Description of Proposal

The extraordinary dividend rules of section 1059 would be amended to provide that a corporate shareholder will recognize gain immediately with respect to any redemption treated as a dividend (in whole or in part) when the nontaxed portion of the dividend exceeds the basis of the shares surrendered, if the redemption is treated as a dividend due to options being counted as stock ownership. In addition, immediate gain recognition is required whenever the basis of stock with respect to which any extraordinary dividend was received is reduced below zero. Reorganizations or other exchanges involving amounts that are treated as dividends under section 356(a)(2) of the Code are treated as redemptions for purposes of applying the rules relating to redemptions under section 1059(e).

Effective Date

The provision is effective generally for distributions after May 3, 1995.

Legislative Background

A substantially similar proposal is contained in the BBA of 1995 as passed by Congress.

5. Modify basis adjustment rules under section 1033

Present Law

Gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases similar property within a specified period of time. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns similar replacement property. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property. In cases in which a taxpayer purchases stock as replacement property, the taxpayer reduces the basis of the stock, but does not reduce the basis of the underlying assets. Thus, the reduction in the basis of the stock generally does not result in reduced depreciation deductions where the corporation holds depreciable property, and may result in the taxpayer having more aggregate depreciable basis after the acquisition of replacement property than before the involuntary conversion.

Description of Proposal

The proposal would provide that where the taxpayer satisfies the replacement property requirement by acquiring stock in a corporation, the corporation generally would reduce its adjusted bases in its assets by the amount by which the taxpayer reduces its basis in the stock. The corporation's adjusted bases in its assets would not be reduced, in the aggregate, below the taxpayer's basis in its stock (determined after the appropriate basis adjustment for the stock). In addition, the basis of any individual asset would not be reduced below zero. The basis reduction would be first applied to property that is similar or related in service or use to the converted property, then to other depreciable property, and finally to any other property.

The application of these rules can be demonstrated by the following examples:

Example 1.--Assume that a taxpayer owned a commercial building with an adjusted basis of $100,000 that was involuntarily converted, causing the taxpayer to receive $1 million in insurance proceeds. Further assume that the taxpayer acquires, as replacement property, all of the stock of a corporation, the sole asset of the corporation is a building with a value and an adjusted basis of $1 million. Under the proposal, the taxpayer would reduce his or her basis in the stock to $100,000 (as under present law) and the corporation would reduce its adjusted basis in the building to $100,000.

Example 2.--Assume the same facts as in Example 1, except that on the date of acquisition, the corporation has an adjusted basis of $100,000 (rather than $1 million) in the building. Under the proposal, the taxpayer would reduce his or her basis in the stock to $100,000 (as under present law) and the corporation would not be required to reduce its adjusted basis in the building.

Effective Date

The proposal would apply to involuntary conversions occurring after September 13, 1995.

Legislative Background

The proposal is substantially identical to a provision in the BBA of 1995.

6. Registration of confidential corporate tax shelters

Present Law

An organizer of a tax shelter is required to register the shelter with the Internal Revenue Service (IRS) (sec. 6111). If the principal organizer does not do so, the duty may fall upon any other participant in the organization of the shelter or any person participating in its sale or management. The shelter's identification number must be furnished to each investor who purchases or acquires an interest in the shelter. Failure to furnish this number to the tax shelter investors will subject the organizer to a $100 penalty for each such failure (sec. 6707(b)).

A penalty may be imposed against an organizer who fails without reasonable cause to timely register the shelter or who provides false or incomplete information with respect to it. The penalty is the greater of one percent of the aggregate amount invested in the shelter or $500. Any person claiming any tax benefit with respect to a shelter must report its registration number on her return. Failure to do so without reasonable cause will subject that person to a $250 penalty (sec. 6707(b)(2)).

A person who organizes or sells an interest in a tax shelter subject to the registration rule or in any other potentially abusive plan or arrangement must maintain a list of the investors (sec. 6112). A $50 penalty may be assessed for each name omitted from the list. The maximum penalty per year is $100,000 (sec. 6708).

For this purpose, a tax shelter is defined as any investment that meets two requirements. First, the investment must be (1) required to be registered under a Federal or state law regulating securities, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or state agency regulating the offering or sale of securities, or (3) a substantial investment. Second, it must be reasonable to infer that the ratio of deductions and 350% of credits to investment for any investor (i.e., the tax shelter ratio) may be greater than two to one as of the close of any of the first five years ending after the date on which the investment is offered for sale. An investment that meets these requirements will be considered a tax shelter regardless of whether it is marketed or customarily designated as a tax shelter (sec. 6111(c)(1)).

Description of Proposal

The proposal would require a promoter of a corporate tax shelter to register the shelter with the Secretary. Registration would be required not later than the next business day after the day when the tax shelter is first offered to potential users. If the promoter is not a U.S. person, or if a required registration is not otherwise made, then any U.S. participant would be required to register the shelter. An exception to this special rule provides that registration would not be required if the U.S. participant notifies the promoter in writing not later than 90 days after discussions began that the U.S. participant will not participate in the shelter and the U.S. person does not in fact participate in the shelter.

A corporate tax shelter is any investment, plan, arrangement or transaction (1) a significant purpose of the structure of which is tax avoidance or evasion by a corporate participant, (2) that is offered to any potential participant under conditions of confidentiality, and (3) for which the tax shelter promoters may receive total fees in excess of $100,000.

A transaction is offered under conditions of confidentiality if: (a) an offeree (or any person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to restrict or limit its disclosure of the transaction or any significant tax features of the transaction; or (b) the promoter claims, knows or has reason to know (or the promoter causes another person to claim or otherwise knows or has reason to know that a party other than the potential offeree claims) that the transaction (or one or more aspects of its structure) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use. The promoter includes specified related parties.

Registration will require the submission of information identifying and describing the tax shelter and the tax benefits of the tax shelter, as well as such other information as the Treasury Department may require.

Tax shelter promoters are required to maintain lists of those who have signed confidentiality agreements, or otherwise have been subjected to nondisclosure requirements, with respect to particular tax shelters. In addition, promoters must retain lists of those paying fees with respect to plans or arrangements that have previously been registered (even though the particular party may not have been subject to confidentiality restrictions).

All registrations will be treated as taxpayer information under the provisions of section 6103 and will therefore not be subject to any public disclosure.

The penalty for failing to timely register a corporate tax shelter is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration (i.e., this part of the penalty does not apply to fee payments with respect to offerings after late registration). A similar penalty is applicable to actual participants in any corporate tax shelter who were required to register the tax shelter but did not. With respect to participants, however, the 50-percent penalty is based only on fees paid by that participant. Intentional disregard of the requirement to register by either a promoter or a participant increases the 50-percent penalty to 75 percent of the applicable fees.

Effective Date

The proposal would apply to any tax shelter offered to potential participants after the date the Treasury Department issues guidance with respect to the filing requirements.

Legislative Background

An identical proposal is contained in the BBA of 1995 as passed by Congress.

7. Treatment of bad debt deductions of thrift institutions

Present Law and Background

Reserve method of accounting for bad debts of thrift institutions

Generally, a taxpayer engaged in a trade or business may deduct the amount of any debt that becomes wholly or partially worthless during the year (the "specific charge-off" method of sec. 166). Certain thrift institutions (building and loan associations, mutual savings banks, or cooperative banks) are allowed deductions for bad debts under rules more favorable than those granted to other taxpayers (and more favorable than the rules applicable to other financial institutions). Qualified thrift institutions may compute deductions for bad debts using either the specific charge-off method or the reserve method of section 593. To qualify for this reserve method, a thrift institution must meet an asset test, requiring that 60 percent of its assets consist of "qualifying assets" (generally cash, government obligations, and loans secured by residential real property). This percentage must be computed at the close of the taxable year, or at the option of the taxpayer, as the annual average of monthly, quarterly, or semiannual computations of similar percentages.

If a thrift institution uses the reserve method of accounting, it must establish and maintain a reserve for bad debts and charge actual losses against the reserve, and is allowed a deduction for annual additions to restore the reserve to its permitted balance. Under section 593, a thrift institution annually may elect to calculate its addition to its bad debt reserve under either (1) the "percentage of taxable income" method applicable only to thrift institutions, or (2) the "experience" method that also is available to small banks.

Under the "percentage of taxable income" method, a thrift institution generally is allowed a deduction for an addition to its bad debt reserve equal to 8 percent of its taxable income (determined without regard to this deduction and with additional adjustments). Under the experience method, a thrift institution generally is allowed a deduction for an addition to its bad debt reserve equal to the greater of: (1) an amount based on its actual average experience for losses in the current and five preceding taxable years, or (2) an amount necessary to restore the reserve to its balance as of the close of the base year. For taxable years beginning before 1988, the "base year" was the last taxable year before the most recent adoption of the experience method (i.e., generally, the last year the taxpayer was on the percentage of taxable income method). For taxable years beginning after 1987, the base year is the last taxable year beginning before 1988. Prior to 1988, computing bad debts under a "base year" rule allowed a thrift institution to claim a deduction for bad debts for an amount at least equal to the institution's actual losses that were incurred during the taxable year.

Bad debt methods of commercial banks

A small commercial bank (i.e., one with adjusted bases of assets of $500 million or less) may use the experience method or the specific charge-off method for purposes of computing its deduction for bad debts. A large commercial bank only may use the specific charge-off method of section 166. If a small bank becomes a large bank, it must recapture its existing bad debt reserve (i.e., include the amount of the reserve in income) through one of two elective methods. Under the 4-year recapture method, the bank generally includes 10 percent of the reserve in income in the first taxable year, 20 percent in the second year, 30 percent in the third year, and 40 percent in the fourth year. Under the cut-off method, the bank generally neither restores its bad debt reserve to income nor may it deduct losses relating to loans held by the bank as of the date of the required change in the method of accounting. Rather, the amount of such losses are charged against and reduce the existing bad debt reserve; any losses in excess of the reserve are deductible. Any reserve balance in excess of the balance of related loans is includible in income.

Recapture of bad debt reserves by thrift institutions

If a thrift institution becomes a commercial bank, or if the institution fails to satisfy the 60-percent qualified asset test, it is required to change its method of accounting for bad debts and, under proposed Treasury regulations,[29] is required to recapture its bad debt reserve. The percentage-of-taxable-income portion of the reserve generally is included in income ratably over a 6-taxable year period. The experience method portion of the reserve is not restored to income if the former thrift institution qualifies as a small bank. If the former thrift institution is treated as a large bank, the experience method portion of the reserve is restored to income ratably over a 6-taxable year period, or under the 4-year recapture method or the cut-off method described above.

In addition, a thrift institution may be subject to a form of reserve recapture even if the institution continues to qualify for the percentage of taxable income method. Specifically, if a thrift institution distributes to its shareholders an amount in excess of its post-1951 earnings and profits, such excess is deemed to be distributed from the institution's bad debt reserve and is restored to income. In the case of any distribution in redemption of stock or in partial or complete liquidation of an institution, the distribution is treated as first coming out of the bad debt reserves of the institution (sec. 593(e)).

Financial accounting treatment of tax reserves of bad debts of thrift institutions

In general, for financial accounting purposes, a corporation must record a deferred tax liability with respect to items that are deductible for tax purposes in a period earlier than they are expensed for book purposes. The deferred tax liability signifies that, although a corporation may be reducing its current tax expense because of the accelerated tax deduction, the corporation will become liable for tax in a future period when the timing item "reverses" (i.e., when the item is expensed for book purposes but for which the tax deduction had already been allowed). Under the applicable accounting standard (Accounting Principles Board Opinion 23), deferred tax liabilities generally were not required for pre-1988 tax deductions attributable to the bad debt reserve method of thrift institutions because the potential reversal of the bad debt reserve was indefinite (i.e., generally, a reversal only would occur by operation of sec. 593(e), a condition within the control of a thrift institution). However, the establishment of 1987 as a base year increased the likelihood of bad debt reserve reversals with respect to post-1987 additions to the reserve and the conferees understand that thrift institutions generally have recorded deferred tax liabilities for these additions under the current generally accepted accounting principles.

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[29] Prop. Treas. reg. sec. 1.593-13.

Description of Proposal

Repeal of section 593

The proposal would repeal the section 593 reserve method of accounting for bad debts by thrift institutions, effective for taxable years beginning after 1995. Under the proposal, thrift institutions that qualify as small banks would be allowed to utilize the experience method applicable to such institutions, while thrift institutions that are treated as large banks are required to use only the specific charge-off method.

Treatment of recapture of bad debt reserves

In general

A thrift institution required to change its method of computing reserves for bad debts would treat such change as a change in a method of accounting, initiated by the taxpayer, and having been made with the consent of the Secretary of the Treasury. Any section 481(a) adjustment required to be taken into account with respect to such change generally would be determined solely with respect to the "applicable excess reserves" of the taxpayer. The amount of applicable excess reserves would be taken into account ratably over a 6-taxable year period, beginning with the first taxable year beginning after 1995, subject to the residential loan requirement described below. In the case of a thrift institution that becomes a "large bank" (as determined under sec. 585(c)(2)), the amount of the institution's applicable excess reserves will be the excess of (1) the balance of its reserves described in section 593(c)(1) (i.e., its supplemental reserve for losses on loans, its reserve for losses on qualifying real property loans, and its reserve for losses on nonqualifying loans) as of the close of its last taxable year beginning before January 1, 1996, over (2) the balance of such reserves as of the close of its last taxable year beginning before January 1, 1988 (i.e., the "pre-1988 reserves"). Similar rules would be provided for "small banks" and for small banks that subsequently become large banks.

The balance of the pre-1988 reserves would continue to be subject to the provisions of present-law section 593(e) (requiring recapture in the case of certain excess distributions to, and redemptions of, shareholders).

Residential loan requirement

Under a special rule, if the taxpayer meets the "residential loan requirement" for a taxable year, the recapture of the applicable excess reserves otherwise required to be taken into account as a section 481(a) adjustment for such year would be suspended. A taxpayer would meet the residential loan requirement if, for the taxable year, the principal amount of residential loans made by the taxpayer during the year is not less than its base amount. The residential loan requirement would be applicable only for taxable years that begin after December 31, 1995, and before January 1, 1998, and must be applied separately with respect to each such year. Thus, all taxpayers would be required to recapture their applicable excess reserves within six, seven, or eight years after the effective date of the provision.

The "base amount" of a taxpayer would mean the average of the principal amounts of the residential loans made by the taxpayer during the six most recent taxable years beginning before January 1, 1996. At the election of the taxpayer, the base amount may be computed by disregarding the taxable years within that 6-year period in which the principal amounts of loans made during such years were highest and lowest. The test would be applied on a controlled group basis. The balance of a taxpayer's applicable excess reserve would be treated as a tax attribute to which section 381 applies. Thus, if an institution with an applicable excess reserve is acquired in a tax-free reorganization, the balance of such reserve would not be immediately restored to income but will continue to be subject to the residential loan requirement in the hands of the acquirer.

Effective Date

The proposal generally would be effective for taxable years beginning after December 31, 1995.

Legislative Background

The proposal is substantially similar to a provision in the BBA of 1995.

8. Reinstate oil spill liability trust fund excise tax

Present Law

A five-cents-per-barrel excise tax was imposed on crude oil received at United States refineries and refined petroleum products imported into the United States before January 1, 1995. Revenues from this tax were dedicated to the Oil Spill Liability Trust Fund ("Oil Spill Trust Fund"). In addition to the January 1, 1995 expiration date, imposition of this tax was suspended during any calendar quarter (before 1995) when the unobligated balance of the Oil Spill Trust Fund, as of the close of the preceding quarter, exceeded $1 billion.

Description of Proposal

The five-cents-per-barrel excise tax would be reimposed during the period January 1, 1996, through September 30, 2002. The $1 billion unobligated balance limit on the Oil Spill Trust Fund would be retained.

Effective Date

The proposal would be effective after December 31, 1995.

Legislative Background

The proposal was included in the BBA of 1995.

9. Repeal percentage depletion for minerals mined on certain Federal lands

Present law

Taxpayers are allowed to deduct a reasonable allowance for depletion relating to the acquisition and certain related costs of mines or other hard mineral deposits. The depletion deduction for any taxable year is calculated under either the cost depletion method or the percentage depletion method, whichever results in the greater allowance for depletion for the year.

Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the property which is equal to the ratio of the units sold from that property during the taxable year, to the estimated total units remaining at the beginning of that year.

Under the percentage depletion method, a deduction is allowed in each taxable year for a statutory percentage of the taxpayer's gross income from the property. The statutory percentage for gold, silver, copper, and iron ore is 15 percent; the statutory percentage for uranium, lead, tin, nickel, tungsten, zinc, and most other hard rock minerals is 22 percent. The percentage depletion deduction for these minerals may not exceed 50 percent of the net income from the property for the taxable year (computed without allowance for depletion). Percentage depletion is not limited to the taxpayer's basis in the property; thus, the aggregate amount of percentage depletion deductions claimed may exceed the amount expended by the taxpayer to acquire and develop the property.

The Mining Law of 1872 permits U.S. citizens and businesses to freely prospect for hard rock minerals on Federal lands, and allows them to mine the land if an economically recoverable deposit is found. No Federal rents or royalties are imposed upon the sale of the extracted minerals. A prospecting entity may establish a claim to an area that it believes may contain a mineral deposit of value and preserve its right to that claim by paying an annual holding fee of $100 per claim. Once a claimed mineral deposit is determined to be economically recoverable, and at least $500 of development work has been performed, the claim holder may apply for a "patent" to obtain title to the surface and mineral rights. If approved, the claimant can obtain full title to the land for $2.50 or $5.00 per acre.

Description of Proposal

The proposal would repeal the present-law percentage depletion provisions for minerals extracted from any land where title to the land or the right to extract minerals from such land was originally obtained pursuant to the provisions of the Mining Law of 1872.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995.

10. Deny interest deduction on certain debt instruments

Present Law

Whether an instrument qualifies for tax purposes as debt or equity is determined under all the facts and circumstances based on principles developed in case law. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid. If an instrument qualifies as debt, the issuer may receive a deduction for accrued interest and the holder generally includes interest in income, subject to certain limitations.

Original issue discount ("OID") on a debt instrument is the excess of the stated redemption price at maturity over the issue price of the instrument. An issuer of a debt instrument with OID generally accrues and deducts the discount as interest over the life of the instrument even though interest may not be paid until the instrument matures. The holder of such a debt instrument also generally includes the OID in income on an accrual basis.

Section 385(c) provides rules for when an issuer's characterization of an interest in a corporation shall be binding on the issuer and the holders.

Description of Proposal

Under the proposal no deduction would be allowed for interest or OID on an instrument (other than a demand loan) issued by a corporation (or issued by a partnership to the extent of its corporate partners) that (i) has a maximum term of more than 40 years, or (ii) is payable in stock of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), including an instrument that is mandatorily convertible or convertible at the issuer's option. In addition, an instrument would be treated as payable in stock of the issuer or a related party if it is part of an arrangement designed to result in the payment of debt with such stock, such as certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such stock, or certain debt instruments that are convertible at the holder's option when it is substantially certain that the right will be exercised.

The proposal would also clarify that for purposes of section 385(c), an issuer will be treated as having characterized an instrument as equity if the instrument (other than a demand loan) (i) has a maximum term of more than 20 years, and (ii) is not shown as indebtedness on the separate balance sheet of the issuer. For this purpose, in the case of an instrument with a maximum term of more than 20 years (other than a demand loan) issued to a related party (other than a corporation) that is eliminated in the consolidated balance sheet that includes the issuer and the holder, the issuer will be treated as having characterized the instrument as equity if the holder issues a related instrument that is not shown as indebtedness on the consolidated balance sheet. For this purpose, an instrument would not be treated as shown as indebtedness on a balance sheet because it is described as such in footnotes or other narrative disclosures. The proposal would apply only to corporations that file annual financial statements (or are included in financial statements filed) with the Securities and Exchange Commission (SEC), and the relevant balance sheet is the balance sheet filed with the SEC.

The proposal is not intended to affect the characterization of instruments as debt or equity under current law.

Effective Date

The proposal would generally be effective for instruments issued on or after the date of announcement (December 7, 1995). However, instruments issued pursuant to a commitment that was binding before December 7 will not be subject to the proposal. For this purpose, a binding commitment includes an underwriting, purchase, distribution, over-allotment option or merger agreement. In addition, an instrument that was priced before December 7, or issued pursuant to an exchange offer that was outstanding before December 7, will not be subject to the proposal.

11. Defer interest deduction on certain convertible debt

Present Law

Certain debt instruments contain a feature that allows the holder or the issuer, at certain future dates, to convert the instrument into shares of stock of the issuer or an affiliate. Some of these instruments may be issued at a discount and are convertible into a fixed number of shares of the issuer, regardless of the amount of original issue discount ("OID") accrued as of the date of conversion. Treasury regulations governing the accrual and deductibility of OID ignore options to convert a debt instrument into stock or debt of the issuer or a related party or into cash or other property having a value equal to the approximate value of such stock or debt (Treas. reg. sec. 1.1272-1(c)). Thus, OID on a convertible debt instrument generally is deductible as interest as such OID accrues, regardless of whether or not the debt is converted. The treatment of a holder of a discount instrument is similar to that of the issuer, i.e., a holder includes OID in income on an accrual basis.

Other convertible instruments may be issued with coupon interest, rather than OID, and may provide that if the debt is converted into stock, the holder does not receive any interest that accrued but was unpaid between the latest coupon date and the conversion date. Under present law, the issuer of such instrument generally cannot deduct such accrued but unpaid interest.[30]

Description of Proposal

The proposal would defer interest deductions on convertible debt until such time as the interest is paid. For this purpose, payment would not include the conversion of the debt into equity of the issuer or a related person (as determined under secs. 267(b) and 707(b)). Convertible debt would include debt: (1) exchangeable into the stock of a party related to the issuer, (2) with cash-settlement conversion features, or (3) issued with warrants (or similar instruments) as part of an investment unit in which the debt instrument may be used to satisfy the exercise price of the warrant. Holders of convertible debt would continue to include the interest on such instruments in gross income as under present law.

Effective Date

The proposal would be effective for debt issued on or after December 7, 1995. The proposal would not apply, however, to any debt instrument issued pursuant to a commitment that was binding before December 7, 1995. For this purpose, a binding commitment includes an underwriting, purchase, distribution, over-allotment option or merger agreement. In addition, any instrument that was priced before December 7, 1995 will not be subject to this proposal.

12. Limit dividends received deduction

a. Reduce dividends received deduction to 50 percent

Present Law

If an instrument issued by a U.S. corporation is classified for tax purposes as equity, a corporate holder of that instrument generally is entitled to a deduction for dividends received on that instrument. This deduction is 70 percent of dividends received if the recipient owns less than 20 percent (by vote and value) of stock of the payor. If the recipient owns more than 20 percent of the stock the deduction is increased to 80 percent. If the recipient owns more than 80 percent of the payor's stock, the deduction is further increased to 100 percent for qualifying dividends.

Description of Proposal

Under the proposal, the dividends-received deduction available to corporations owning less than 20 percent (by vote and value) of the stock of a U.S. corporation would be reduced to 50 percent of the dividends received.

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[30] See, Rev. Rul. 74-127, 1974-1 C.B. 47 and Scott Paper v. Comm.,74 T.C. 137 (1980).

Effective Date

The proposal would be effective for dividends paid or accrued after January 31, 1996.

Legislative Background

A similar proposal was contained in a provision passed by the House in 1988 but not adopted in the final version of the Technical and Miscellaneous Revenue Act of 1988. (See, H.R. Rep.100-795, 100th Cong. 2d Sess. at pp. 467-68 and H.R. Rep. 100-1104, 100th Cong. 2d Sess. at p. 120).

b. Modify holding period for dividends received deduction

Present Law

If an instrument issued by a U.S. corporation is classified for tax purposes as equity, a corporate holder of the instrument generally is entitled to a dividends received deduction for dividends received on that instrument.

The dividends-received deduction is allowed to a corporate shareholder only if the shareholder satisfies a 46-day holding period for the dividend-paying stock (or a 91-day period for certain dividends on preferred stock). The 46- or 91-day holding period generally does not include any time in which the shareholder is protected from the risk of loss otherwise inherent in the ownership of an equity interest.

Description of Proposal

The proposal would provide that a taxpayer is not entitled to a dividends-received deduction if the taxpayer's holding period for the dividend-paying stock is not satisfied over a period immediately before or immediately after the taxpayer becomes entitled to receive the dividend.

Effective Date

The proposal would be effective for dividends paid or accrued after January 31, 1996.

13. Treat certain preferred stock as "boot"

Present Law

In reorganization transactions within the meaning of section 368, no gain or loss is recognized except to the extent "other property" is received, that is, property other than certain stock, including preferred stock. Thus, preferred stock can be received tax-free in a reorganization, notwithstanding that many preferred stocks are functionally equivalent to debt securities. Upon the receipt of other property, gain but not loss can be recognized. A special rule permits debt securities to be received tax-free, but only to the extent debt securities of no lesser principal amount are surrendered in the exchange. Other than this debt-for-debt rule, similar rules generally apply to transactions described in section 351.

Description of Proposal

The proposal would amend both sections 351 and 356 (which applies in the case of reorganizations under section 368) to treat certain preferred stock as "other property" (boot), subject to certain exceptions. Thus, when a taxpayer exchanges property for this preferred stock in a transaction that qualifies under either section 351 or 368, gain but not loss would be recognized.

The proposal would apply to preferred stock (i.e., stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, including through a conversion privilege) , where (i) the holder has the right to put the stock to the issuer or a related party (within the meaning of sections 267(b) and 707(b)), (ii) the stock is subject to mandatory redemption by the issuer or a related party, (iii) the issuer (or a related party) has the right to call the stock and, as of the issue date, it is more likely than not that the right will be exercised, or (iv) the dividend rate varies in whole or in part directly or indirectly with reference to interest rates, commodity prices, or similar indices, regardless of whether such varying rate is provided as an express term of the stock (for example, in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (for example, in the case of auction rate stock). For this purpose, clauses (i), (ii), and (iii) are not satisfied if the put or call cannot be exercised, or the redemption cannot occur, within 20 years of the date the instrument is issued.

The following exchanges would be excluded from this gain recognition: (1) an exchange of preferred stock for comparable preferred stock of the same or lesser value; (2) an exchange of preferred stock for common stock, (3) an exchange of debt securities for preferred stock of the same or lesser value as the adjusted issue price of the debt; and (4) exchanges of stock in certain recapitalizations of family-owned corporations. For this purpose, a family-owned corporation would be 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 members of 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. Members of the same family would be defined by reference to the definition in section 447(e). Thus, a family would include children, parents, brothers, sisters, and spouses, with a limited attribution for directly and indirectly owned stock of the corporation. Shares held by a family member would be treated as not held by a family member to the extent a non-family member had a right, option or agreement to acquire the shares (directly or indirectly, for example, through redemptions by the issuer), or with respect to shares as to which a family member has reduced its risk of loss with respect to the share, for example, through an equity swap. Even though the provision excepts certain family recapitalizations, the special valuation rules of section 2701 for estate and gift tax consequences still apply.

The Treasury Secretary would have regulatory authority to (i) apply installment-sale type rules to preferred stock that is subject to this proposal in appropriate cases, and (ii) prescribe treatment of preferred stock subject to this provision under other provisions of the Code (e.g., sections 304, 306 and 318).

Effective Date

The proposal would be effective for transactions on or after the date of announcement (December 7, 1995). However, preferred stock issued pursuant to a commitment that was binding before December 7 will not be subject to the proposal.. For this purpose, a binding commitment includes an underwriting, purchase, distribution, over-allotment option or merger agreement. In addition, an instrument that was priced before December 7, or issued pursuant to an exchange offer that was outstanding before December 7, will not be subject to the proposal.

14. Disallowance of interest on indebtedness allocable to tax-exempt obligations

Present Law

In general

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is not subject to tax (tax-exempt obligations) (sec. 265). This rule applies to tax-exempt obligations held by individual and corporate taxpayers. The rule also applies to certain cases in which a taxpayer incurs or continues indebtedness and a related person acquires or holds tax-exempt obligations.[31]

Application to non-financial corporations

In Rev. Proc. 72-18, 1972-1 C.B. 740, the IRS provided guidelines for application of the disallowance provision to individuals, dealers in tax-exempt obligations, other business enterprises, and banks in certain situations. Under Rev. Proc. 72-18, a deduction

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[31] Section 7701(f) (as enacted in the Deficit Reduction Act of 1984 (sec. 53(c) of Public Law 98-369)) provides that the Treasury Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of any income tax rules which deal with linking of borrowing to investment or diminish risk through the use of related persons, pass-through entities, or other intermediaries.

is disallowed only when indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt obligations.

This purpose may be established either by direct or circumstantial evidence. Direct evidence of a purpose to purchase tax-exempt obligations exists when the proceeds of indebtedness are directly traceable to the purchase of tax-exempt obligations or when such obligations are used as collateral for indebtedness. In the absence of direct evidence, a deduction is disallowed only if the totality of facts and circumstances establishes a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations.

Two-percent de minimis exception.-- In the case of an individual, interest on indebtedness generally is not disallowed if during the taxable year the average adjusted basis of the tax-exempt obligations does not exceed 2 percent of the average adjusted basis of the individual's portfolio investments and trade or business assets. In the case of a corporation other than a financial institution or a dealer in tax-exempt obligations, interest on indebtedness generally is not disallowed if during the taxable year the average adjusted basis of the tax-exempt obligations does not exceed 2 percent of the average adjusted basis of all assets held in the active conduct of the trade or business. These safe harbors are inapplicable to financial institutions and dealers in tax-exempt obligations.

Interest on installment sales to State and local governments.--If a taxpayer sells property to a State or local government in exchange for an installment obligation, interest on the obligation may be exempt from tax. Present law has been interpreted to not disallow interest on a taxpayer's indebtedness if the taxpayer acquires nonsalable tax-exempt obligations in the ordinary course of business in payment for services performed for, or goods supplied to, State or local governments.[32]

Application to financial corporations

In the case of a financial institution, the allocation of the interest expense of the financial institution (which are not otherwise allocable to tax-exempt obligations) is based on the ratio of the average adjusted basis of the tax-exempt obligations acquired after August 7, 1987, to the average adjusted basis of all assets of the taxpayer (Code sec. 265). In the case of an issuer which reasonably anticipates to issue not more than $10 million of tax-exempt obligations (other than private activity bonds), only 20 percent of the interest allocable to such tax-exempt obligations (Code sec. 291(a)(3)).

[32] R.B. George Machinery Co., 26 B.T.A. 594 (1932) acq. C.B. XI-2, 4; Rev. Proc. 72-18, as modified by Rev. Proc. 87-53, 1987-2 C.B. 669.

Description of Proposal

The Administration proposal would extend to all corporations the rule that applies to financial institutions that disallows interest deductions of a taxpayer (that are not otherwise disallowed as allocable under present law to tax-exempt obligations) in the proportion as the average basis of its tax-exempt obligations bears to the average basis of all of the taxpayer's assets. The proposal would not extend the $10 million small-issuer exception to taxpayers which are not financial institutions. Nonetheless, the proposal would not apply, however, to nonsalable tax-exempt debt acquired by a corporation in the ordinary course of business in payment for goods or services sold to a State or local government. Finally, the proposal would apply the interest disallowance provision to all related persons (within the meaning of section 267(f)). Accordingly, in the case of related parties that are members of the same consolidated group, the pro rata disallowance rule would apply as if all the members of the group were a single taxpayer. In the case of related persons that are not members of the same consolidated group, the tracing rules would be applied as if the all of the related persons were treated as a single entity.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995, with respect to obligations acquired after that December 7, 1995.

Legislative Background

Section 10116 of the Omnibus Budget Reconciliation Act of 1987 as reported by the Committee of the Budget of the House of Representatives would have disallowed a deduction for interest on indebtedness allocable to tax-exempt installment obligations. In addition, that section would have reduced the non-statutory two-percent de minimis test to the lesser of $1 million or two-percent of the taxpayer's adjusted basis of all of the taxpayer's assets. That bill passed the House of Representatives, but the provision disallowing a deduction for interest allocable to tax-exempt obligations was subsequently deleted in conference.

15. Repeal section 1374 for large corporations

Present Law

The income of a corporation described in subchapter C of the Internal Revenue Code (a "C corporation") is subject to corporate-level tax when the income is earned and individual-level tax when the income is distributed. The income of a corporation described in subchapter S of the Internal Revenue Code (an "S corporation") generally is subject to individual-level, but not corporate-level, tax when the income is earned. The income of an S corporation generally is not subject to tax when it is distributed to the shareholders. The tax treatment of an S corporation is similar to the treatment of a partnership or sole proprietorship.

The liquidation of a subchapter C corporation generally is a taxable event to both the corporation and its shareholders. Corporate gain is measured by the difference between the aggregate fair market value and the adjusted bases of the corporation's assets. The shareholder gain is measured by the difference between the value of the assets distributed and the shareholder's adjusted basis in his or her stock. The conversion of a C corporation into a partnership or sole proprietorship is treated as the liquidation of the corporation.

The conversion from C to S corporation status (or the merger of a C corporation into an S corporation) generally is not a taxable event to either the corporation or its shareholders.

Certain rules attempt to limit the potential for C corporations to avoid corporate-level tax by shifting appreciated assets to S corporation status prior to the recognition of such gains. Specifically, an S corporation is subject to a tax computed by applying the highest marginal corporate tax rate to the lesser of (1) the S corporation's recognized built-in gains or (2) the amount that would be taxable income if such corporation was not an S corporation (sec. 1374). For this purpose, a recognized built-in gain generally is any gain the S corporation recognizes from the disposition of any asset within a 10-year recognition period after the conversion from C corporation status or any income that is properly taken into account during the recognition period that is attributable to prior periods. However, a gain is not a recognized built-in gain if the taxpayer can establish that the asset was not held by the corporation on the date of conversion or to the extent the gain exceeds the amount of gain that would have been recognized on such date. In addition, the cumulative amount of recognized built-in gains that an S corporation must take into account may not exceed the amount by which the fair market value of the corporation's assets exceeds the aggregated adjusted basis of such assets on the date of conversion from C corporation status. Finally, net operating loss or tax credit carryovers from years in which the corporation was a C corporation may reduce or eliminate the tax on recognized built-in gains.

The amount of built-in gain that is subject to corporate-level tax also flows-through to the shareholders of the S corporation as an item of income subject to individual-level tax. The amount of tax paid by the S corporation on built-in gains flows-through to the shareholders as an item of loss that is deductible against such built-in gain income on the individual level.

Description of Proposal

The proposal would repeal section 1374 for large S corporations. Thus, a C to S corporation conversion (whether by a C corporation electing S corporation status or by a C corporation merging into an S corporation) would be treated as a liquidation of the C corporation followed by a contribution of the assets to an S corporation by the recipient shareholders. Thus, the proposal would require immediate gain recognition by both the corporation (with respect to its appreciated assets) and its shareholders (with respect to their stock) upon the conversion to S corporation status.

For this purpose, a large S corporation is one with a value of more than $5 million at the time of conversion. The value of the corporation would be the fair market value of all the stock of the corporation on the date of conversion.

Effective Date

The proposal would be effective for conversions on or after December 7, 1995.

16. Inventory reforms

a. Repeal lower of cost or market inventory accounting method

Present Law

A taxpayer that sells goods in the active conduct of its trade or business generally must maintain inventory records in order to determine the cost of goods it sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.

Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows. Among these conventions are the "first-in-first-out" ("FIFO") method which assumes that the items in ending inventory are those most recently acquired by the taxpayer, and the "last-in-first-out" ("LIFO") method which assumes that the items in ending inventory are those earliest acquired by the taxpayer.

Treasury regulations provide that taxpayers that maintain inventories under the FIFO method may determine the value of ending inventory under a (1) cost method or (2) "lower of cost or market" ("LCM") method (Treas. reg. sec. 1.471-2(c)). Under the LCM method, the value of ending inventory is written down if its market value is less than its cost.

Description of Proposal

The proposal would repeal the LCM method. Appropriate wash-sale rules would be provided. The proposal would not apply to taxpayers with average annual gross receipts over a three-year period of $5 million or less.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995. Any section 481(a) adjustment required to be taken into account pursuant to the change of method of accounting under the proposal would be taken into account ratably over four taxable years beginning with the first taxable year beginning after December 31, 1995.

Legislative Background

The proposal had been proposed by the Administration in 1994 as a revenue provision in conjunction with the passage of the General Agreement on Tariffs and Trade and had been reported favorably by the Senate Finance Committee, but was not included in the final legislation as passed by the Congress.

b. Repeal components of cost inventory accounting method

Present Law

Taxpayers using the LIFO method to account for inventories may use the "dollar-value" LIFO method. Under the dollar-value LIFO method, inventory items are expressed in terms of "base-year" costs and are grouped in inventory pools. Total base-year costs by pool, rather than the quantity of specific goods, are used to measure inventory increases and decreases. If ending inventory at base-year costs is greater than beginning inventory at base-year costs (i.e., there has been an increase in inventory), such increase is valued at current-year costs. Taxpayers define items in the pool under the "total product cost" ("TPC") method or the "components of cost" ("COC") method. Under the TPC method, ending inventory is determined by valuing the items in ending inventory by the base-year cost of producing such items. Under the COC method, taxpayers measure ending inventory not with reference to the total product cost of producing the items in ending inventory, but rather treat the units of production (i.e., the amount of material, labor, and overhead) that were used to produce the inventory as separate items.

The proper application of the COC method to labor and overhead is unclear under present law.[33] Accordingly, the COC method as applied by some taxpayers may produce

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[33] The use of the COC method as applied by some taxpayers with respect to labor and overhead costs is not specifically provided for in the Code or regulations, but such method may be used for financial accounting purposes. Treasury regulations allow taxpayers to treat raw materials (and the raw material content of work-in-process and finished goods) as a separate item under the LIFO method (Treas. reg. sec. 1.472-1(c)). The Internal Revenue Service ("IRS") has ruled under the particular facts and circumstances of one taxpayer that the application of the COC method by that taxpayer did not clearly reflect income (Technical Advice Memorandum 9405005).

different results than the TPC method whenever a taxpayer's production processes change between the base year and the current year. For example, assume that in the base year the taxpayer can produce an item by applying 5 units of material at $8 a unit, 10 hours of labor at $10 an hour, and 10 hours of overhead at $5 an hour.[34] Thus, it costs $190 to produce an item in the base year (5 times $8, plus 10 times $10, plus 10 times $5). Further assume that: (1) the taxpayer's production processes change such that in the current year it now takes 5 units of materials, 5 hours of labor, and 5 hours of overhead to produce the same item; (2) the prices for materials, labor, and overhead have remained constant from the base year to the current year; and (3) one item of inventory remains at the end of the current year. Under the TPC method, because prices have remained constant, ending inventory would be valued at $190 (the total product cost of producing one item in the base year). Under the COC method as applied by some taxpayers, ending inventory could be valued at $115 (5 units of materials times $8, plus 5 hours of labor times $10, plus 5 hours of overhead times $5).

Thus, in this example, application of the COC method in this manner would reduce taxable income by $75 ($190 less $115) in the current year as compared to the TPC method. The $75 reduction in taxable income is comprised of the following: (1) $50 of labor reductions (5 less labor hours times the $10 per hour labor rate) and (2) $25 of overhead reductions. In this case, the reduction in labor hours is demonstrable. However, the reduction in overhead results because of the use of the burden rate that allocates overhead based on labor hours rather than because of a demonstrable reduction of the appropriate amount of overhead to be applied to inventory. In fact, a reduction of labor hours in the current year may be attributable to an increased reliance upon overhead costs in the production process (e.g., reductions in workforce may result because of increased mechanization.)

Description of Proposal

The proposal would repeal the COC method. The proposal is not intended to affect the determination of whether the COC method is an appropriate method and the IRS would not be precluded from challenging its use.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995. For taxpayers continuing to use a LIFO method of valuing inventory, the proposal would be applied on a cut-off basis.

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[34] In this example, overhead is allocated to inventory pursuant to a burden rate based on labor hours. Such allocations are common.

Legislative Background

The proposal had been proposed by the Administration in 1994 as a revenue provision in conjunction with the passage of the General Agreement on Tariffs and Trade and had been reported favorably by the Senate Finance Committee, but was not included in the final legislation as passed by the Congress.

17. Information reporting on persons receiving contracts from certain Federal agencies

Present Law

A service recipient (i.e., a person for whom services are performed) engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must file with the IRS an information return reporting such payments (and the name, address, and taxpayer identification number of the recipient) if the remuneration paid to the person during the calendar year is $600 or more (sec. 6041A(a)). A similar statement must also be furnished to the person to whom such payments were made (sec. 6041A(e)). Treasury regulations explicitly exempt from this reporting requirement payments made to a corporation (Treas. Reg. 1.6041A-1(d)(2)).

The head of each Federal executive agency must file an information return indicating the name, address, and taxpayer identification number (TIN) of each person (including corporations) with which the agency enters into a contract (sec. 6050M). The Secretary of the Treasury has the authority to require that the returns be in such form and be made at such time as is necessary to make the returns useful as a source of information for collection purposes. The Secretary is given the authority both to establish minimum amounts for which no reporting is necessary as well as to extend the reporting requirements to Federal license grantors and subcontractors of Federal contracts. Treasury regulations provide that no reporting is required if the contract is for $25,000 or less (Treas. Reg. 1.6050M-1(c)(1)(i)).

Description of Proposal

The proposal would require reporting of all payments of $600 or more made by a Federal executive agency to any person (including a corporation) for services. In addition, the proposal would require that a copy of the information return be sent by the Federal agency to the recipient of the payment.

Effective Date

The proposal would be effective for returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment.

18. Increase penalties for failure to file correct information returns

Present Law

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

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

In addition, there are special, lower maximum levels for this penalty for small businesses. For this purpose, a small business is any person having average annual gross receipts for the most recent three taxable years ending before the calendar year that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

If a failure to file a correct information return with the IRS is due to intentional disregard of the filing requirement, the penalty for each such failure is generally increased to the greater of $100 or ten percent of the amount required to be reported correctly, with no limitation on the maximum penalty per calendar year (sec. 6721(e)). The increase in the penalty applies regardless of whether a corrected information return is filed, the failure is de minimis, or the person subject to the penalty is a small business.

Description of Proposal

The proposal would increase the penalty for failure to file information returns correctly on or before August 1 from $50 for each return to the greater of $50 or five percent of the amount required to be reported correctly but no so reported. The $250,000 maximum penalty for failure to file correct information returns during any calendar year ($100,000 with respect to small businesses) would continue to apply under the proposal.

The proposal also would provide for an exception to this increase where substantial compliance has occurred. The proposal would provide that this exception would apply with respect to a calendar year if the aggregate amount that is timely and correctly reported for that calendar year is at least 97 percent of the aggregate amount required to be reported under that section of the Code for that calendar year. If this exception applies, the present-law penalty of $50 for each return would continue to apply.

The proposal would not affect the following provisions of present law: (1) the reduction in the $50 penalty where correction is made within a specified period; (2) the exception for de minimis failures; (3) the lower limitations for persons with gross receipts of not more than $5,000,000; (4) the increase in the penalty in cases of intentional disregard of the filing requirement; (5) the penalty for failure to furnish correct payee statements under section 6722; (6) the penalty for failure to comply with other information reporting requirements under section 6723; and (7) the reasonable cause and other special rules under section 6724.

Effective Date

The proposal would apply to information returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment.

Legislative Background

A similar but narrower proposal was contained in the Health Security Act. That proposal applied only to returns relating to payments for services under either section 6041 or section 6041A.

19. Further restrict like-kind exchanges involving personal property

Present Law

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in trade or business or for investment is exchanged for property of a "like-kind" which is to be held for productive use in trade or business or for investment (sec. 1031). In general, any kind of real estate is treated as of a like-kind with other real property as long as the properties are both located either within or outside the United States. Different types of personal property are not treated as like-kind unless such properties are of a "like class." In addition, certain types of property, such as inventory, stocks and bonds, and partnership interests, are not eligible for nonrecognition treatment under section 1031.

If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred, decreased by any money received by the taxpayer, and further adjusted for any gain or loss recognized on the exchange.

Description of Proposal

The proposal would provide that personal property located in the United States and personal property located outside the United States are not "like-kind" properties. For this purpose, the location of the properties would be determined at the time of the exchange. In addition, the property surrendered in the exchange must have been used during the 24 months immediately prior to the exchange in predominantly the same use (i.e., foreign or domestic) as at the time of the exchange. Similarly, for section 1031 to apply, property received in the exchange must continue in the same use (i.e., foreign or domestic) for the 24 months immediately after the exchange.

Effective Date

The proposal would be effective for exchanges on or after December 7, 1995.

Legislative Background

The present-law provision that requires exchanged real properties to be both located in or outside the United States for section 1031 to apply was enacted as part of the Omnibus Budget Reconciliation Act of 1989.

20. Modify net operating loss carryback and carryforward rules

Present Law

The net operating loss ("NOL") of a taxpayer (generally, the amount by which the business deductions of a taxpayer exceeds its gross income) may be carried back three years and carried forward fifteen years to offset taxable income in such years. A taxpayer may elect to forgo the carryback of an NOL Special rules apply to REITs (no carrybacks), specified liability losses (10-year carryback), excess interest losses (no carrybacks), and net capital losses of corporations (carryforward limited to five years).

Description of Proposal

The proposal would limit the NOL carryback period to one year and extend the NOL carryforward period to 20 years.

Effective Date

The proposal would be effective for NOLs arising in taxable years beginning after December 31, 1995.

21. Improve diesel fuel tax compliance by treating kerosene as diesel fuel for excise tax purposes

Present Law

Diesel fuel used as a transportation motor fuel generally is taxed at 24.4 cents per gallon (Code sec. 4081). This tax is collected on all diesel fuel upon removal from a pipeline or barge terminal unless the fuel is indelibly dyed and is destined for a nontaxable use. Diesel fuel also is commonly used as heating oil; diesel fuel used as heating oil is not subject to tax. Certain other uses also are exempt from tax, and some transportation uses (e.g., rail and intercity buses) are taxed at reduced rates. Both exemptions and reduced-rates are realized through refund claims if undyed diesel fuel is used in a qualifying use.

Non-gasoline aviation fuels are taxed at rates of 21.9 cents per gallon (noncommercial aviation) or 4.4 cents per gallon (commercial aviation). This tax is imposed on sale of the fuel by a "producer," typically a wholesale distributor. This tax is imposed at a level in the distribution chain subsequent to removal from a terminal facility.

Kerosene is used both as a transportation fuel and as an aviation fuel. Kerosene also is blended with diesel fuel destined both for taxable and nontaxable uses (e.g. as heating oil) to, among other things, prevent gelling of the diesel fuel in cold temperatures. Under present law, kerosene is not subject to tax unless it is blended with taxable diesel fuel or is sold for use as aviation fuel. When kerosene is blended with dyed diesel fuel to be used in a nontaxable use, the dye concentration of the fuel mixture must be adjusted to ensure that it meets Treasury Department requirements for untaxed, dyed diesel fuel.

Clear, low-sulphur kerosene (K-1) also is used in space heaters, and often is sold for this purpose at retail service station pumps Kerosene used in space heaters is not subject to Federal excise tax.

Wholesale distributors have reported that, because of improved diesel fuel tax compliance resulting from tax changes enacted by the Omnibus Budget Reconciliation Act of 1993, greatly increased amounts of kerosene are being blended with diesel fuel for use in taxable uses without payment of excise tax.

Description of Proposal

The Administration proposal would, subject to certain modifications, extend the diesel fuel tax rules to kerosene. Under these rules, kerosene would be subject to tax whenever it was removed from a terminal facility unless (1) it was indelibly dyed and destined for a nontaxable use or (2) it was removed by a registered aviation dealer for use as aviation fuel.

To accommodate State safety regulations requiring that only K-1 kerosene be used in certain space heaters, a new refund procedure would be established under which registered ultimate vendors would be eligible for refunds of any tax paid earlier in the fuel distribution chain on kerosene sold for that use.

Effective Date

The proposal would be effective for kerosene removed from terminal facilities after March 31, 1996. Appropriate floor stocks taxes would be imposed on kerosene held beyond the point of taxation on April 1, 1996.

22. Expand subpart F provisions regarding income from notional principal contracts and stock lending transactions

Present Law

Under the rules of subpart F, United States shareholders (as defined in sec. 951(b)) of a controlled foreign corporation ("CFC") are required to include in income currently certain types of income of the CFC, whether or not such income is distributed to the shareholders. The types of income subject to this current inclusion rule (generally referred to as "subpart F income") include, among other things, "foreign personal holding company income."

Foreign personal holding company income generally consists of passive income in the following categories: dividends, interest, royalties, rents and annuities; net gains from sales or exchanges (a) of property that gives rise to the foregoing types of income, (b) of property that does not give rise to income, or (c) of an interest in a trust, partnership or REMIC; net gains from commodities transactions; net gains from foreign currency transactions; and income that is equivalent to interest. Income from notional principal contracts is treated as foreign personal holding company income only if it is referenced to commodities, foreign currency, interest rates, or to indices thereon. In addition, income derived from transfers of debt securities, but not equity securities, that are subject to the rules governing securities lending (sec. 1058) is treated as foreign personal holding company income.

A variety of exceptions from foreign personal holding company income are provided for income earned by a CFC that is a regular dealer in the property that is sold or exchanged, or income arising out of certain hedging transactions. However, no exception is available for a CFC that is a regular dealer with respect to financial instruments referenced to commodities.

Under section 956A, United States shareholders of a CFC are required to include in income currently their shares of the CFC's earnings invested in excess passive assets. A CFC generally has excess passive assets if its passive assets exceed 25 percent of its total assets. A passive asset is any asset that produces passive income. For this purpose, passive income is defined as foreign personal holding company income.

Under section 1296, a foreign corporation is a passive foreign investment company ("PFIC") if the corporation satisfies either a passive income test or a passive asset test. Any U.S. person owning stock in a PFIC is subject to an interest charge with respect to certain distributions from the PFIC and gains on dispositions of the stock of the PFIC, unless the shareholder elects to include in income currently for U.S. tax purposes its share of the earnings of the PFIC. For this purpose, passive income is defined by reference to foreign personal company income.

Description of Proposal

The Administration proposal would add a new category of foreign personal holding company income for purposes of subpart F to include income from notional principal contracts. In addition, dividend equivalent payments (i.e., in-lieu-of dividend payments made pursuant to a securities lending transaction that qualifies under sec. 1058) would be included in the existing category of foreign personal holding company income that includes interest, dividends, rents and royalties, and annuities.

An exception from subpart F income would be provided for income derived from notional principal contracts, forward contracts, options and similar financial instruments (including instruments referenced to commodities) by a CFC that is a regular dealer in such instruments.

Under the proposal, income, gain, deduction or loss from a notional principal contract entered into to hedge an item of income in a category of foreign personal holding company income, other than dividends, interest, royalties, rents, annuities or dividend equivalent payments, would be allocated to that category.

Foreign personal holding company income from notional principal contracts and the transfers of equity securities that are subject to the rules governing securities lending transactions (sec. 1058) would constitute passive income for purposes of determining whether a foreign corporation is a PFIC. The notional principal contracts and equity securities subject to section 1058 that give rise to foreign personal holding company income under the proposal would constitute passive assets for purposes of sections 956A and 1296.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995.

23. Provide rules regarding treatment of captive insurance arrangements

Present Law

The term "insurance" is not defined in the Code. In general, courts have held that an insurance transaction involves risk shifting and risk distribution. See Helvering v. LeGierse, 312 U.S. 531 (1941).

Under the subpart F rules, the United States shareholders (as defined in sec. 951(b)) of a controlled foreign corporation (CFC) are required to include in income currently their shares of certain income of the CFC, whether or not such income is actually distributed to the shareholders. This current inclusion rule applies to certain insurance income of the CFC. In addition, special provisions under the subpart F rules apply to the "related person insurance income" of a CFC.

Description of Proposal

The proposal would provide that an insurance arrangement between a company and any other person would be treated as an insurance arrangement for tax purposes if less than 50 percent of the company's net written premiums are attributable to the insurance or reinsurance of risks of related parties. The rules of subchapter L would apply to a company that satisfies this threshold, and amounts paid to the company for the insurance or reinsurance of risks would be treated as insurance premiums. The subpart F insurance provisions would apply to a CFC that satisfies this threshold.

The tax treatment of a company that does not satisfy the threshold would be governed by the general provisions of the Code (including subpart F, where applicable) rather than by subchapter L. The company would not be eligible for tax exemption under section 501(c)(15). Amounts paid to the company by related persons for the insurance or reinsurance of risks would be characterized as payments for risk management services and would not be subject to the federal insurance premium excise tax. Amounts paid to the company by unrelated persons for the insurance or reinsurance of risks would be characterized as insurance premiums and would be subject to the federal insurance premium excise tax. Subpart F would be amended so that amounts received by a CFC that does not satisfy the threshold would be included in subpart F income and income from transactions with related persons would be subject to rules similar to the related party insurance income rules.

For purposes of this provision, related persons would include any 10-percent shareholder of the company and any person that would be a related person under rules similar to the rules of section 954(d)(3). For purposes of applying the threshold, net written premiums would be determined based on a three-year rolling average (excluding premiums written in taxable years beginning before 1996).

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995.

Legislative Background

The BBA of 1995 includes a provision that would apply a look-through rule in characterizing for unrelated business taxable income purposes certain subpart F insurance income of a CFC with respect to a United States shareholder that is a tax-exempt organization. The look-through rule would apply to amounts that constitute insurance income currently includible in gross income under the subpart F rules and that are not attributable to the insurance of risks of (1) the tax-exempt organization itself, (2) certain tax-exempt affiliates of such organization, and (3) any individual who performs services for the benefit of the tax-exempt organization (or certain tax-exempt affiliates) provided that the insurance covers primarily risks associated with the individual's performance of services for the benefit of the tax-exempt organization (or tax-exempt affiliates).

24. Reformulate Puerto Rico and possessions tax credit (sec. 936)

Present Law

Certain domestic corporations with business operations in the U.S. possessions (including, for this purpose, Puerto Rico and the U.S. Virgin Islands) may elect the section 936 credit which significantly reduces the U.S. tax on certain income related to their operations in the possessions. In contrast to the foreign tax credit, the possessions tax credit is a "tax sparing" credit. That is, the credit is granted whether or not the electing corporation pays income tax to the possession. Income exempt from U.S. tax under this provision falls into two broad categories: (1) possession business income, which is derived from the active conduct of a trade or business within a U.S. possession or from the sale or exchange of substantially all of the assets that were used in such a trade or business; and (2) qualified possession source investment income ("QPSII"), which is attributable to the investment in the possession or in certain Caribbean Basin countries of funds derived from the active conduct of a possession business.

In order to qualify for the section 936 credit for a taxable year, a domestic corporation must satisfy two conditions. First, the corporation must derive at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year from sources within a possession. Second, the corporation must derive at least 75 percent of its gross income for that same period from the active conduct of a possession business.

A domestic corporation that has elected the section 936 credit and that satisfies these two conditions for a taxable year generally is entitled to a credit based on the U.S. tax attributable to the sum of the taxpayer's possession business income and its QPSII. However, the amount of the credit attributable to possession business income is subject to the limitations enacted by the Omnibus Budget Reconciliation Act of 1993. Under the economic activity limit, the amount of the credit with respect to such income cannot exceed the sum of a portion of the taxpayer's wage and fringe benefit expenses and depreciation allowances (plus, in certain cases, possession income taxes). In the alternative, the taxpayer may elect to apply a limit equal to the applicable percentage of the credit that would otherwise be allowable with respect to possession business income; the applicable percentage is phased down, beginning at 60 percent for 1994 and reaching 40 percent for 1998 and thereafter. The amount of the section 936 credit attributable to QPSII is not subject to these limitations.

Description of Proposal

The proposal would phase out the section 936 credit determined under the applicable percentage limit ratably over five years beginning in 1997. Under the proposal, taxpayers using the applicable percentage limit would continue to be subject to present law for 1996; accordingly, the section 936 credit attributable to possession business income for 1996 would be subject to the present-law applicable percentage limit of 50 percent of the amount otherwise allowed. For 1997, the section 936 credit attributable to possession business income would be reduced to 80 percent of the present-law applicable 45-percent limit; accordingly, the section 936 credit attributable to possession business income for 1997 would be limited to 36 percent of the amount otherwise allowed. For 1998, the section 936 credit attributable to possession business income would be reduced to 60 percent of the present-law applicable 40-percent limit; accordingly, the section 936 credit attributable to possession business income for 1998 would be limited to 24 percent of the amount otherwise allowed. For 1999, the section 936 credit attributable to possession business income would be reduced to 40 percent of the present-law applicable 40-percent limit; accordingly, the section 936 credit attributable to possession business income for 1999 would be limited to 16 percent of the amount otherwise allowed. For 2000, the section 936 credit attributable to possession business income would be reduced to 20 percent of the present-law applicable 40-percent limit; accordingly, the section 936 credit attributable to possession business income for 2000 would be limited to 8 percent of the amount otherwise allowed. For 2001 and thereafter, the section 936 credit determined under the applicable percentage limit would no longer be available.

In addition, the proposal would permit taxpayers whose economic activity limit exceeds its possession business income for a taxable year to carry forward such excess limit for up to five years.

Finally, the proposal provides that the revenue attributable to the proposed changes to the section 936 credit would be used for the purposes of carrying out programs authorized under the Social Security Act and to promote the creation of jobs.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995.

Legislative Background

The BBA of 1995 would generally repeal section 936 for taxable years beginning in 1996 and thereafter. However, the bill would provide transition rules under which certain taxpayers would be eligible to claim section 936 credits for a ten-year period.

During the ten-year transition period, the section 936 credit would apply only to taxpayers that were engaged in the active conduct of a trade or business within a possession on October 13, 1995, and elected the section 936 credit for the year that includes such date. A taxpayer that adds a substantial new line of business after such date would cease to be eligible for section 936 credits during the transition period. A binding contract rule would be applicable in applying these rules.

In the case of the section 936 credit attributable to possession business income determined under the economic activity limit, present law would continue to apply for the first six years of the transition period; for the remaining four years of the transition period, the possession business income that is eligible for the credit would be subject to a cap. In the case of the section 936 credit attributable to possession business income determined under the applicable percentage limit, present law would continue to apply for the first two years of the transition period; for the remaining eight years of the transition period, the possession business income that is eligible for the credit would be subject to a cap. A corporation that had elected to use the applicable percentage limit would be permitted to revoke that election not later than with respect to its first taxable year beginning in 1997. The section 936 credit attributable to QPSII could not be claimed for taxable years beginning on or after January 1, 1996.

The cap on a taxpayer's possession business income that is eligible for the section 936 credit during the later years of the transition period generally would be equal to the average of the taxpayer's possession business income, adjusted by an inflation factor and a growth factor, for three of the taxpayer's five most recent taxable years ending before October 14, 1995, determined by disregarding the years in which the taxpayer's adjusted possession business income was highest and lowest. Special rules for computing the cap would apply in the case of a taxpayer that does not have significant possession business income for each of such five most recent taxable years. As an alternative, a taxpayer could elect to use as its cap its adjusted possession business income for its taxable year ending in 1992. As another alternative, a taxpayer could elect to use as its cap the annualized amount of its possession business income for the first ten months of calendar year 1995 (calculated by excluding extraordinary items).

If a corporation's possession business income in a year for which the cap would be applicable exceeds the cap, then the corporation's possession business income for such year would be an amount equal to the cap. The corporation's section 936 credit would continue to be subject to either the economic activity limit or the applicable percentage limit, with such limit applied to the corporation's possession business income as reduced to reflect the application of the cap.

Special rules would apply to the section 936 credit with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. Income attributable to operations in these possessions would not be taken into account in computing the cap. During the ten-year transition period, the section 936 credit with respect to operations in one of these possessions would be available only to corporations that were actively conducting business in such possession on October 13, 1995 (or are treated as so engaged under the binding contract rule); for such a corporation, the section 936 credit with respect to operations in such possession would continue to be computed as under present law for the ten-year transition period (provided that the corporation does not add a substantial new line of business).

III. HEALTH INSURANCE REFORM

1. Deduction for health insurance expenses of self-employed individuals

Present Law

Under present law, self-employed individuals can deduct up to 30 percent of the cost of health insurance expenses for themselves and their spouse and dependents.

Description of Proposal

The proposal would increase the deduction for health insurance expenses of self-employed individuals as follows: 35 percent in 1996 and 1997, 40 percent in 1998, 45 percent in 1999, and 50 percent in 2000 and thereafter.

Effective Date

The proposal would be effective on the date of enactment.

Legislative Background

The Administration proposal is similar to a provision in the BBA. Under the BBA, the 30-percent deduction would be increased as follows: 35 percent in 1998 and 1999, 40 percent in 2000 and 2001, and 50 percent in 2002 and thereafter.

2. Health care amendments to the Employee Retirement Income Security Act of 1974

Present Law

The Employee Retirement Income Security Act of 1974 ("ERISA"), imposes certain reporting, disclosure, and fiduciary requirements on employers who maintain group health plans on behalf of their employees. For example, an employer is generally required to report certain information about its group health plan to the Internal Revenue Service and the Department of Labor, an employer is required to provide participants with a summary plan description containing information regarding a participant's benefits and rights under the plan, and an employer is required to operate a group health plan in the sole interest of plan participants and in accordance with the terms of the plan document. Employers that do not comply with these requirements are subject to civil, and perhaps criminal, penalties. The Secretary of Labor is primarily responsible for the enforcement of these requirements. Participants may also take action against an employer to enforce their rights under a group health plan.

ERISA also requires employers with 20 or more employees who maintain group health plans to provide certain employees and their dependents the option of purchasing continued health coverage in the case of certain qualifying events (called "COBRA coverage").[35] These qualifying events include: termination or reduction in hours of employment, death, divorce or legal separation, eligibility for Medicare, or the end of a child's dependency under a parent's health plan. The maximum period of COBRA coverage that may be elected is 36 months, except in the case of termination of employment or reduction in hours for which the maximum period is 18 months. An employer is permitted to charge qualified beneficiaries 102 percent of the applicable premium for COBRA coverage. COBRA coverage may be terminated before the maximum 18 or 36 months in the case of certain events. These include: the employer ceases to maintain any group health plan, the qualified beneficiary fails to pay the premium, the qualified beneficiary becomes covered under another group health plan with no preexisting condition limitation or exclusion, or the qualified beneficiary becomes entitled to Medicare.

The Omnibus Budget Reconciliation Act of 1989, amended the COBRA rules to extend the 18 month maximum COBRA coverage period to 29 months if the qualified beneficiary is determined under title II or XVI of the Social Security Act to have been disabled at the time of the qualifying event and the qualified beneficiary provides notice of such determination to the employer before the end of the 18-month period. This extended COBRA coverage for 11 months may be terminated in the month that begins more than 30 days after the date of the final determination under title II or XVI of the Social Security Act that the qualified beneficiary is no longer disabled. A qualified beneficiary has 60 days to notify the employer of a disability determination and must notify the employer within 30 days after a determination that the qualified beneficiary is no longer disabled. During the 11-month period of extended COBRA coverage, the qualified beneficiary may be charged 150 percent of the applicable premium.

The Code imposes an excise tax of $100 per day if an employer fails to comply with the COBRA coverage rules (sec. 4980B). The tax applies separately with respect to each qualified beneficiary for whom a failure occurs. In addition, ERISA imposes a penalty of up to $100 per day if an employer fails to make certain disclosures regarding COBRA coverage to employees.

Other than the requirements pertaining to COBRA coverage and certain requirements relating to group health plan coverage of dependent children in cases of adoption, ERISA does not generally impose any requirements on employers maintaining group health plans relating to health care access, portability, and renewability of health plan coverage.

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[35] Identical provisions are contained in the Code (sec. 4980B).

Description of Proposal

In general

The proposal would create a new part 7 of subtitle B of title I of ERISA. Under this new part 7, employers sponsoring group health plans[36] would have to satisfy certain requirements relating to the availability and renewability of group health plan coverage. In addition, the proposal would establish rules regarding the portability of group health plan coverage and the ability of a group health plan to limit or exclude benefits on account of a preexisting condition. The proposal would also require employer-provided group health plans to provide special enrollment periods in the case of certain events in which an employee may enroll or change coverage under a group health plan. Employer-provided group health plans would be prohibited from maintaining lifetime limits or specific disease exclusions under the proposal. The Secretary of Labor would generally be given the authority to enforce the requirements contained in the proposal.

The proposal would also make certain technical changes to ERISA's reporting and disclosure rules and certain changes to the COBRA coverage rules.

Guaranteed availability of health coverage

Under the proposal, the terms of an employer-provided group health plan could include eligibility, continuation of eligibility, enrollment, or premium contribution requirements. However, such requirements generally could not be based on an employee's health status, medical condition, claims experience, receipt of health care, medical history, evidence of insurability, or disability. The proposal would allow a group health plan to provide premium discounts or modify otherwise applicable co-payments or deductibles for adherence to programs of health promotion or disease prevention. In addition, as discussed in more detail below, the proposal would permit certain limits or exclusions of benefits on account of a preexisting condition.

Guaranteed renewability of health coverage

Under the proposal, a participant (or beneficiary, if applicable) generally would have to be permitted, at his or her option, to renew or continue coverage under a group health plan if the employer elects to continue to maintain such plan. This requirement would not apply in the following circumstances: the failure of a participant (or beneficiary)

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[36] The term group health plan would be defined as an employee welfare benefit plan providing medical care (as defined in sec. 213(d)) to participants or beneficiaries directly or through insurance, reimbursement or otherwise. For purposes of these requirements, the term specifically would include a group health plan maintained by a church or a convention or association of churches. However, these requirements would not apply to a group health plan maintained by a Federal, State, or local governmental entity.

to timely pay premiums, fraud or misrepresentation by a participant (or beneficiary) with respect to an application for coverage or a claim for benefits, the termination of the group health plan, the expiration of eligibility for COBRA coverage under the plan, or the failure of the participant (or beneficiary) to meet the requirements for continuation of coverage under the terms of the group health plan. In addition, a network plan (a group health plan that arranges for the financing and delivery of any health care services through arrangements with providers) would be permitted to deny continued coverage to participants (and beneficiaries) who do not live, reside, or work in an area in which such network plan is offered, provided such denial is applied uniformly, without regard to the health status or the insurability of participants (or beneficiaries).

The rules relating to the renewability of group health plan coverage would not permit an individual to decline coverage under a group health plan if such right did not otherwise exist under the terms of the plan. Further, the rules would not preclude a multiemployer group health plan from establishing employer contribution rules or group participation rules that satisfy the requirements of the proposal. The rules relating to the renewability of group health plan coverage would also not affect any existing right to COBRA coverage under the group health plan.

If an employer terminates a group health plan, the proposal would require that the employer notify the Secretary of Labor, and participants (and beneficiaries) covered under the plan, at least 180 days prior to the date of termination.

Portability of group health plan coverage

The proposal would allow a group health plan to impose a limitation or exclusion of benefits relating to the treatment of a preexisting condition[37] based on the fact that the condition existed prior to the coverage of the participant (or beneficiary), provided the limitation or exclusion: (1) extends for a period of not more than 12 months after the date of enrollment;[38] (2) does not apply to an individual who, within 30 days of the date of birth or placement for adoption (as determined under ERISA section 609(c)(3)(B)), was covered

[37] The term preexisting condition would be defined as a condition, regardless of the cause of the condition, for which medical advice, diagnosis, care, or treatment was recommended or received within the six-month period ending on the day before the effective date of coverage under the group health plan (without regard to any waiting period).

[38] 18 months in the case of a participant (or beneficiary) enrolling in a group health plan after the first opportunity to enroll during an enrollment period of at least 30 days has expired, except enrollments during certain special enrollment periods discussed in more detail below.

under the plan; and (3) does not apply to a pregnancy.[39] However, under the proposal a group health plan would be permitted to impose a preexisting condition limitation or exclusion only to the extent that such service or benefit was not previously covered under the group health plan or individual health plan[40] in which the participant (or beneficiary) was enrolled immediately prior to enrollment in the current group health plan.

The proposal would further limit the ability of a group health plan to apply a preexisting condition limitation or exclusion to the extent the participant (or beneficiary) is in a period of previous qualifying coverage as of the date of enrollment under the group health plan. In such a case, the period of limitation or exclusion would have to be reduced by one month for each month the participant (or beneficiary) was in the period of previous qualifying coverage. Further, in such a case no preexisting condition limitation or exclusion could be applied with respect to a child whose previous qualifying coverage began within 30 days of birth or placement for adoption during the child's first 12 months of life or within 12 months after the placement of the child for adoption. Previous qualifying coverage would mean a continuous period of at least 60 days (without regard to any waiting period) beginning on the date a participant (or beneficiary) is enrolled under a group health plan, an individual health plan, or a public or private health plan established under Federal or State law, and ending on the date the individual is no longer so enrolled.[41]

In order to facilitate the crediting of previous qualifying coverage, a group health plan would be required to provide a participant (and beneficiary) whose coverage is terminated documentation which includes the dates the participant (or beneficiary) was

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[39] The present law rule prohibiting the application of a preexisting condition limitation or exclusion to an adopted child adopted while the participant (or beneficiary) is covered under the group health plan would continue to apply (ERISA sec. 609(c)(2)).

[40] The term individual health plan would be defined as any contract, policy, certificate, or other arrangement offered to individuals by a health plan issuer (an entity licensed by a State to offer a group health plan or an individual health plan) that provides or pays for health benefits and that is not a group health plan. The term individual health plan specifically does not include: (1) coverage only for accident or disability income insurance; (2) Medicare supplemental health insurance; (3) coverage issued as a supplement to liability insurance; (4) liability insurance (including general and automobile liability insurance); (5) workers' compensation or similar insurance; (6) automobile medical payment insurance; (7) coverage for a specified disease or illness; (8) hospital or fixed indemnity insurance; (9) short-term limited duration insurance; (10) credit-only, dental-only, or vision-only insurance; (11) insurance providing benefits for long-term care, nursing home care, home health care, or community-based care.

[41] The proposal would not preempt any State law (that was not otherwise preempted by ERISA sec. 514) which allows a participant (or beneficiary) to be considered in a period of previous qualifying coverage even if such participant (or beneficiary) experiences a lapse in coverage that is greater than 60 days.

covered under the plan, and the benefits and cost-sharing arrangement available to the participant (or beneficiary) under the plan. The group health plan would be required to retain this documentation for at least 12 months following the date the participant (or beneficiary) ceases to be covered. Upon request, the group health plan would be required to provide a second copy of such documentation within such 12-month period.

Under the proposal, if a group health plan does not provide for a limitation or exclusion of benefits relating to the treatment of a preexisting condition, such plan may impose an affiliation period not to exceed 60 days on a participant (or beneficiary) who would otherwise be eligible to receive benefits under the plan but for the operation of a preexisting condition limitation or exclusion. During the affiliation period, the plan would not be required to provide health care services or benefits and no premium could be charged to the participant (or beneficiary). The proposal would permit a group health plan to use alternative methods to address adverse selection, provided they are approved by the "applicable certifying authority."[42]

Special enrollment periods

Under the proposal, if a participant, beneficiary, or family member[43] experiences a special event, a group health plan would be required to provide a special enrollment period (extending for a reasonable time after such event) which would permit the participant to change the individual or family basis of coverage or to enroll in the plan if the individual (or beneficiary) had not enrolled during a previous enrollment period. Such a special enrollment period would be required to deem a child born or placed for adoption as being covered under the plan as of the date of birth or placement for adoption if such child is enrolled within 30 days of such date. Under the proposal, a special event would occur if a participant, beneficiary, or family member: (1) through marriage, separation, divorce, death, birth, or placement of a child for adoption, experiences a change in family composition affecting eligibility under a group or individual health plan; (2) experiences a change in employment status (by termination or by a reduction in hours) that causes the loss of eligibility for group or individual health plan coverage, other than COBRA coverage; (3) experiences a loss of eligibility under a group or individual health plan because of a change in the employment status of a family member.

[42] The term applicable certifying authority would be defined as: (1) with respect to a group health plan, the Secretary of Labor, and (2) with respect to health plan issuers, the State insurance commissioner or designated State officials with the authority to enforce the requirements contained in the proposal.

[43] The term family member would be defined to include an individual, the individual's spouse, the children of the individual, and any dependent of the individual (within the meaning of sec. 152).

The proposal also would require that a special enrollment period be provided (after any waiting period imposed) to a new employee eligible to enroll in a group health plan.

Prohibition of lifetime limits and specific disease exclusions

An employer-provided group health plan would not be permitted to impose a catastrophic or lifetime limit with respect to coverage under the plan. Further, although a group health plan could limit the duration or scope of plan benefits, it could not limit coverage of services or benefits with respect to specific enumerated diseases, illnesses, or medical conditions.

Applicability and enforcement of standards

The new provisions contained in the proposal would not prevent a State from establishing, implementing, or continuing in effect standards and requirements that are not described in the proposal or relate to the issuance, renewability, or portability of health insurance, or the establishment or operation of group purchasing arrangements, provided such standards and requirements are not inconsistent or in direct conflict with the requirements contained in the proposal and provide better protection or benefits to participants, beneficiaries, or individuals. Further, the provisions contained in the proposal would not affect section 514 of ERISA which generally preempts State laws. The proposal would also not require a group health plan to provide benefits to a participant (or beneficiary) in excess of those provided under the terms of the plan.

In general, the requirements contained in the proposal would be enforced by the Secretary of Labor under the present-law enforcement provisions contained in ERISA. The Secretary of Labor would be given authority to issue regulations necessary or appropriate to carry out the proposal.

Technical Amendments to ERISA

The proposal would change the definition of governmental plan in ERISA to mean a plan established and maintained predominantly for its employees by a Federal, State or local governmental entity. Under present law, a governmental plan can cover only government employees. The proposal would also modify the ERISA provision governing which plans are subject to ERISA's requirements so that ERISA's reporting, disclosure, and fiduciary requirements apply to group health plans maintained by a church or an association or convention of churches.

The proposal would also change ERISA's rules regarding the disclosure of information to participants (and beneficiaries) so that if there is a modification to the terms of an employee benefit plan, including a group health plan, that results in a material reduction in covered services or benefits provided under the plan, a summary description of such modification must be provided to participants (and beneficiaries) no later than 60 days after the date of the adoption of the modification. This requirement could alternatively be satisfied if a summary description is provided to participants (and beneficiaries) at regular intervals of not more than 90 days. Under present law, a summary description of such a material modification generally must be provided within 90 days.

COBRA changes

The proposal would modify the rule extending the maximum COBRA coverage period to 29 months in case of disability by providing that it also applies if a beneficiary-family member of the covered employee is disabled. In addition, the proposal would provide the extended coverage if the disability determination is made at any time during the initial 18-month COBRA coverage period as opposed to requiring the determination to have been made at the time of the qualifying event as under present law, and would clarify that the election period for electing COBRA coverage begins on the date of such disability determination.

The proposal would also coordinate the COBRA rules with the new requirements contained in the proposal so that COBRA coverage can be terminated if a qualified beneficiary becomes covered under another group health plan even if such group health plan contains a preexisting condition limitation or exclusion, provided the preexisting condition limitation or exclusion does not apply to the qualified beneficiary by reason of the new requirements contained in the proposal.

The proposal would modify the definition of qualified beneficiary to include a child born to or placed for adoption with the covered employee during the period of COBRA coverage. Under present law, qualified beneficiary only includes individuals who were dependent children of the covered employee at the time of the qualifying event.

The proposal would require a group health plan to notify each qualified beneficiary who has elected COBRA coverage of the changes to the COBRA rules contained in the proposal no later than 60 days prior to the date the changes become effective.

Effective Date

The proposal generally would apply to plan years beginning after December 31, 1995. The COBRA changes would apply to qualifying events occurring on or after the date of enactment for plan years beginning after December 31, 1996.

IV. ESTIMATED BUDGET EFFECTS OF THE PRESIDENT'S 7-YEAR BALANCED BUDGET PROPOSAL
RELEASED ON DECEMBER 7, 1995

Fiscal Years 1996-2005

[Millions of Dollars]

Provision	Effective	1996	1997	1998	1999	2000	2001	2002	1996-00	1996-02	1996-05
I. MIDDLE-CLASS BILL OF RIGHTS, TAX COMPLIANCE, AND SUPERFUND TAX PROVISIONS											
1. Credit for families with young children	1/1/96	-1,451	-7,228	-7,081	-7,763	-11,096	-11,400	-11,697	-34,619	-57,716	-94,667
2. Deduction for higher education expenses	1/1/96	-1,736	-5,010	-5,996	-6,679	-6,995	-7,216	-7,452	-26,416	-41,084	-65,512
3. Provisions relating to individual retirement plans	1/1/96	235	-445	-964	-1,674	-3,443	-4,839	-5,581	-6,290	-16,710	-39,512
4. EIC compliance and self-employment taxes	tyba 12/31/95	13	252	261	265	272	276	282	1,062	1,619	2,505
5. Revision of tax rules on expatriation	2/6/95	18	29	46	65	86	102	109	244	455	812
6. Modification of rules relating to foreign trusts having one or more United States beneficiaries	2/6/95	93	162	171	180	188	197	206	794	1,197	1,879
7. Additional empowerment zones	DOE	-35	-66	-70	-77	-82	-87	-73	-331	-490	-608
8. Intermediate sanctions	9/14/95 & 1/1/96	4	4	4	5	5	5	6	22	33	52
9. Reinstatement of authority for undercover operations	DOE	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[2]	[2]	[3]
10. Disclosure of returns concerning cash transactions	DOE	*No Revenue Effect*									
11. Superfund tax extension	DOE	860	1,307	959	721	736	752	742	4,582	6,075	6,112
SUBTOTAL: MIDDLE-CLASS BILL OF RIGHTS, TAX COMPLIANCE, AND SUPERFUND TAX PROVISIONS		**-1,999**	**-10,995**	**-12,670**	**-14,957**	**-20,329**	**-22,210**	**-23,458**	**-60,949**	**-106,618**	**-188,934**
II. "REVENUE RECONCILIATION ACT OF 1995" PROVISIONS											
1. Reform depreciation under the income forecast method	ppisa 9/13/95	18	83	29	13	14	16	19	157	192	273
2. Phase out preferential tax deferral for certain large farm corporations required to use accrual accounting	[4]	26	37	38	39	40	41	42	179	261	392
3. Disallow interest deduction for corporate-owned life insurance policy loans (Administration version)	ipoaa 9/18/95	383	1,089	1,508	1,674	1,795	1,852	1,880	6,448	10,180	15,993
4. Gain recognition for certain extraordinary dividends (Seagrams)	da 5/3/95	-56	-100	-71	-33	13	69	104	-247	-74	294
5. Modify basis adjustment rules under section 1033	icoa 9/13/95	2	4	7	11	16	23	31	40	94	243
6. Registration of certain confidential corporate tax shelters	aioIRSg	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[5]	[5]	[6]
7. Require thrifts to account for bad debts in the same manner as banks	tyba 12/31/95	63	95	216	280	277	272	260	931	1,462	1,857
8. Extend Oil Spill Liability Trust Fund tax through 9/30/02	1/1/96	---	---	---	---	---	63	65	---	128	128
SUBTOTAL: "REVENUE RECONCILIATION ACT OF 1995" PROVISIONS		**439**	**1,211**	**1,730**	**1,987**	**2,158**	**2,339**	**2,404**	**7,523**	**12,264**	**19,210**

Provision	Effective	1996	1997	1998	1999	2000	2001	2002	1996-00	1996-02	1996-05
III. ADDITIONAL TAX PROPOSALS											
1. Repeal percentage depletion for non-fuel mineral mined on Federal lands	tyba 12/31/95	33	61	63	64	66	67	69	287	423	640
2. Deny interest deduction on certain debt instruments	dia 12/7/95	25	76	136	212	262	288	303	711	1,302	2,287
3. Interaction with 50% DRD proposal	dia 12/7/95	1	3	5	8	11	12	12	28	52	92
4. Defer original issue discount deduction on convertible debt	dia 12/7/95	5	17	36	53	64	78	90	175	343	669
5. Limit dividends-received deduction (DRD):											
a. Reduce DRD to 50%	dpa 1/31/96	241	383	402	422	443	465	488	1,891	2,844	4,461
b. Modify holding period for DRD [7]	dpa 1/31/96	6	14	16	17	18	19	20	71	109	174
6. Treat certain preferred stock as "boot"	12/7/95	80	147	150	154	160	104	33	692	829	937
7. Extend pro rata disallowance of tax-exempt interest expense to all corporations	[8]	24	43	49	56	64	70	73	238	381	619
8. Repeal section 1374 for large corporations ($5 million fair market value)	12/7/95	21	42	44	47	49	51	54	203	308	487
9. Inventory reforms:											
a. Repeal lower of cost or market method	tyba 12/31/95	51	292	314	320	299	132	65	1,276	1,473	1,625
b. Repeal components of cost method	tyba 12/31/95	59	131	140	150	161	172	183	641	996	1,611
10. Require reporting of payments to corporations rendering services to Federal agencies	rda 90 daDOE	---	5	7	7	8	9	10	28	48	81
11. Increase penalties for failure to file correct information returns	rda 90 daDOE	12	20	21	22	23	24	25	97	147	230
12. Further restrict like-kind exchanges involving foreign property	eoa 12/31/95	2	5	8	11	13	15	17	39	71	134
13. Modification of loss carry-back and carry-forward rules; restrict to 1-year carry-back	NOLgtyba 12/31/95	-155	1,237	1,541	1,095	774	522	410	4,492	5,425	6,513
14. Improve diesel fuel tax compliance by treating kerosene as diesel fuel for excise tax purposes	4/1/96	46	44	42	40	38	38	39	210	287	419
15. Expand subpart F provisions regarding income from notional principal contracts and stock lending transactions	tyba 12/31/95	11	15	10	10	11	12	12	57	80	119
16. Provide rules regarding treatment of "captive" insurance arrangements	tyba 12/31/95	65	56	12	-31	-25	-20	-18	77	39	2
17. Reformulate Puerto Rico and possessions tax credit (section 936)	tyba 12/31/96	---	56	175	308	455	616	718	994	2,328	4,705
SUBTOTAL: ADDITIONAL TAX PROPOSALS		**527**	**2,647**	**3,171**	**2,965**	**2,894**	**2,674**	**2,603**	**12,207**	**17,485**	**25,805**
IV. HEALTH INSURANCE REFORM PROVISION											
1. Increase the self-employed health insurance deduction (35% in 1996 and 1997; 40% in 1998; 45% in 1999; and 50% in 2000 and thereafter)	tyba 12/31/95	-29	-91	-137	-267	-422	-549	-596	-945	-2,090	-4,173
SUBTOTAL: HEALTH INSURANCE REFORM PROVISION		**-29**	**-91**	**-137**	**-267**	**-422**	**-549**	**-596**	**-945**	**-2,090**	**-4,173**
NET TOTAL		**-1,062**	**-7,228**	**-7,906**	**-10,272**	**-15,699**	**-17,746**	**-19,047**	**-42,164**	**-78,959**	**-148,092**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

[Legend and Footnotes appear on the following page]

Legend and Footnotes:

Legend for "Effective" column:
aioIRSg = after issuance of Internal Revenue Service guideline
da = distributions after
dia = debt issued after
DOE = date of enactment
dpa = dividends paid after
eoa = exchanges on or after
ipoaa = interest paid or accrued after
icoa = involuntary conversions occurring after
NOLgtyba = NOLs generated taxable years beginning after
ppisa = property placed in service after
rda 90 daDOE = returns due after 90 days after date of enactment
tyba = taxable years beginning after

[1] Gain of less than $1 million.
[2] Gain of less than $5 million.
[3] Gain of less than $10 million.
[4] No new suspense accounts could be established in taxable years ending after 9/13/95. The income in existing suspense accounts would be recognized in equal installments over a 20-years period beginning with the first taxable year beginning after 9/13/95.
[5] Gain of less than $25 million.
[6] Gain of less than $30 million.
[7] Includes interaction with 50% DRD provision.
[8] Effective for taxable years beginning after 12/31/95 with respect to obligations acquired after 12/7/95.