[JOINT COMMITTEE PRINT]

SUMMARY OF H.R. 3838
(TAX REFORM ACT OF 1985)

As Reported

by the

COMMITTEE ON WAYS AND MEANS

ON DECEMBER 7, 1985

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a summary of the provisions of H.R. 3838 as reported by the Committee on Ways and Means on December 7, 1985 (H. Rep. No. 99-426).

The first part of the pamphlet is a title-by-title summary of the bill. The second part presents summary revenue estimates of the bill by title. The estimated revenue effects are provided for individuals, corporate, excise, and estate and gift taxes, where applicable.

This pamphlet is intended to provide a convenient summary of the tax bill provisions; the committee report and reported bill are the official legislative provisions.

The bill enacts into law the Internal Revenue Code of 1985. The 1985 Code consists of the provisions of the Internal Revenue Code of 1954 together with the amendments made by the bill.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation: Summary of H.R. 3838 (Tax Reform Act of 1985) As Reported by the Committee on Ways and Means (JCS-46-85), December 9, 1985.

I. SUMMARY OF H.R. 3838

Title I. Individual Income Tax Provisions

A. Basic Rate Structure

1. Rate reductions

The bill provides a new 4-bracket tax rate schedule based on taxable income, which will become effective on July 1, 1986. The Secretary of the Treasury is instructed to prepare blended tax schedules for 1986 tax returns which will incorporate half of the present law structure (as indexed for inflation) and half of the new tax rate structure. The new tax rate structure, which will be fully effective on January 1, 1987, is shown below.

Tax rates (%)	Taxable income			
	Married couples & surviving spouses	Heads of households	Unmarried individuals	Married individuals filing separately
15	Not over $22,500	Not over $16,000	Not over $12,500	Not over $11,250
25	22,500–43,000	16,000–34,000	12,500–30,000	11,250–21,500
35	43,000–100,000	34,000–75,000	30,000–60,000	21,500–50,000
38	Over 100,000	Over 75,000	Over 60,000	Over 50,000

The taxable income amounts in the rate schedules is indexed for inflation beginning in 1987.

2. Increase in standard deduction

The standard deduction replaces the zero bracket amount. Effective in 1987, the standard deduction amounts are $4,800 for joint returns of married couples and for surviving spouses, $4,200 for heads of households, $2,950 for unmarried individuals, and $2,400 for married individuals filing separate returns. These amounts are indexed for inflation beginning in 1988.

An additional standard deduction amount of $600 is allowed for an elderly or blind individual. For these taxpayers only, the new standard deduction amount and the additional $600 standard deduction amount are effective on January 1, 1986.

For all individual taxpayers other than elderly or blind individuals, the standard deduction amounts for 1986 are $3,670 for joint returns, $2,480 for heads of households and single persons, and $1,835 for married individuals filing separately.

Individuals who itemize deductions will reduce their total itemized deductions by $500 times the number of personal exemptions claimed.

3. Increase in personal exemption

The personal exemption is raised to $2,000 for each individual, individual's spouse, and dependent, effective January 1, 1986. (The additional exemption under present law for a blind or elderly individual is replealed.) The personal exemption amount is indexed for inflation beginning in 1987.

4. Two-earner deduction

The deduction for two-earner married couples is repealed after December 31, 1985. Adjustments made in the standard deduction for married couples filing joint returns and in the relationship of the rate schedules for unmarried individuals and married couples filing joints returns compensate for the repeal of this provision.

B. Individual Tax Credits

1. Earned income credit

Currently, an eligible individual is allowed a refundable income tax credit equal to 11 percent of the first $5,000 of earned income, for a maximum credit of $550. The maximum allowable credit is phased down, however, as adjusted gross income (or, if greater, earned income) rises above $6,500. Also, the credit is not allowed for taxpayers with adjusted gross income (AGI) or, if greater, earned income over $10,000. Currently, the credit is not adjusted for inflation.

The bill increases the maximum allowable credit to 14 percent of the first $5,000 of earned income (for a maximum credit of $700), for taxable years beginning on or after January 1, 1986. The phaseout levels for 1986 are adjusted so that the credit phases out between $6,500 and $13,500 of AGI. For taxable years beginning on or after January 1, 1987, the phaseout of the credit begins at $9,000 of AGI; it is totally phased out at $16,000 of AGI. Also, the maximum amount of the credit and the phaseout income levels are adjusted for inflation.

2. Repeal of political contributions credit

The tax credit allowed to individuals under present law for one-half the amount of contributions to political candidates and certain political campaign organizations, up to a maximum of $50 ($100 on a joint return), is repealed. The repeal is effective for taxable years beginning after December 31, 1985.

C. Provisions Related to Exclusions

1. Limit on exclusion for child care assistance

The bill limits the exclusion for employer-provided child care assistance to $5,000 a year ($2,500 in the case of a married individual filing separately), effective for taxable years beginning after December 31, 1985.

2. Unemployment compensation benefits

Under present law, a portion of unemployment compensation benefits is includible in gross income if the sum of the recipient's benefits and adjusted gross income exceeds specified amounts. The bill provides that all unemployment compensation benefits are uncludible in gross income, for taxable years beginning after December 31, 1985.

3. Scholarships and fellowships

The bill limits the exclusion for degree candidates to the amount of a scholarship or fellowship grant required to be used for tuition and fees, books, supplies, and equipment required for courses. The bill repeals the exclusion for grants received by nondegree candidates, but does not affect whether their unreimbursed educational expenses may be deductible as trade or business expenses. The bill also provides that the exclusion does not apply to any portion of amounts received as a scholarship or a tuition reduction which represents payment for teaching, research, or other services required as a condition of receiving the grant. The bill repeals the present-law exclusion for certain Federal grants where the recipient is required to perform future services as a Federal employee. The provision is effective for scholarships and fellowships granted after September 25, 1985.

4. Exclusion for prizes and awards

The exclusion for certain prizes and awards is repealed, except where the winner assigns the award to charity (see also the description above of the scholarship exclusion). Awards by employers to employees are includible in income unless qualifying for the present-law exclusion for de minimis items (such as certain traditional retirement gifts). The provision applies to taxable years beginning after December 31, 1985.

D. Individual Deductions

1. Employee expenses and miscellaneous itemized deductions

A one-percent floor is placed under itemized deductions for miscellaneous employee, investment, and certain other expenses, and nonreimbursed employee travel and other expenses that presently are deductible "above-the-line" are included in the miscellaneous itemized deduction. The provision is effective for taxable years beginning after December 31, 1985.

2. Charitable contribution deduction for nonitemizers

The bill makes permanent the deduction for charitable contributions made by individuals who do not itemize deductions. The bill modifies the deduction by providing that for taxable years beginning after 1985, the deduction is subject to a $100 floor.

3. Adoption expenses

Currently, an individual is allowed an itemized deduction for up to $1,500 of expenses incurred in the adoption of certain handicapped ("special needs") children. The bill repeals this deduction for taxable years after December 31, 1986, and modifies the Adoption Assistance Program of Title IV-E of the Social Security Act to provide assistance through that program for such adoption expenses (see also Title XIV, item 7.)

E. Other Provisions

1. Income averaging

The income averaging provision is repealed, effective for taxable years beginning after December 31, 1985.

2. Travel and entertainment expenses

The bill provides that 80 percent of meal and other entertainment expenses, to the extent otherwise allowable, can be deducted. Certain legal and substantiation requirements are added for business meal deductions. Deductions for tickets are limited to face value, and luxury "skybox" deductions are restricted. No deductions are allowed for travel as a form of education, charitable travel that serves vacation purposes, or expenses for attending investment seminars. Deductions for luxury water travel are limited. The provision applies to taxable years beginning after December 31, 1985.

3. Changes in treatment of hobby losses

Under present law, an activity other than horse breeding, training, showing, or racing is presumed not to be a hobby if it is profitable in 2 out of 5 consecutive years. Under the bill, the presumption is changed so that an activity (other than one involving horses) is presumed not to be a hobby if it is profitable in 3 out of 5 consecutive years. The provision is effective for taxable years beginning after December 31, 1985.

4. Deduction for business use of home

The bill makes several changes regarding limitations on deductions for business use of one's home. First, no deduction arises for costs associated with business use of the home (except for items allowable without reference to such use, e.g., home mortgage interest) in the case of an employee who rents a portion of the home to the employer. Second, home office costs are deductible only to the extent of net income from the business activity (rather than certain gross income, as under present law). Third, deductions disallowed because in excess of such net income can be carried forward.

The provision is effective for taxable years beginning after December 31, 1985.

5. Housing allowances for ministers and military personnel and deductions for property taxes and mortgage interest

The bill provides that the receipt of tax-free housing allowances by ministers or military personnel does not result in loss of deductions for interest or real property tax on the individual's home, effective for past and future years.

Title II. Capital Income Provisions

A. Cost Recovery Provisions

1. Depreciation

Incentive depreciation.—The Accelerated Cost Recovery System is replaced by the Incentive Depreciation System (IDS), effective generally for property placed in service after December 31, 1985, except for property covered by transition rules.

IDS groups assets into ten classes, generally according to their present class life (or "ADR midpoint life"). Assets in the same IDS class are depreciated over a common period, ranging from 3 to 30 years. The 200-percent declining balance method, switching to the straight-line method, is used for classes 1-9; the straight-line method is used for class 10, which includes primarily real property other than low-income housing.

Inflation adjustments.—IDS deductions are subject to increases for inflation adjustments, beginning in 1988. In general, the adjustments are for half the inflation rate in excess of 5 percent in applicable years.

Nonincentive depreciation.—A nonincentive depreciation system applies for assets used abroad or by tax-exempt entities, for minimum tax purposes, and for certain other purposes. Depreciation under this system is generally straight-line over an asset's present class life (40 years for real property).

Expensing.—The current $5,000 limit on the amount of personal property that may be expensed annually is raised to $10,000, and expensing is available only to taxpayers whose qualified expenditures do not exceed $200,000 for the taxable years.

2. Regular investment tax credit

Repeal.—The regular investment tax credit is repealed, effective generally for property placed in service after December 31, 1985.

Transition rules.—The credit is available for eligible property to which transition rules apply for depreciation purposes. Such credits are generally allowed ratably over a 5-year period, and a full adjustment in depreciable basis for the entire credit is required when property is placed in service.

3. Finance leasing

Finance leasing is repealed, effective for property placed in service after December 31, 1985, subject to transition rules.

B. Limitation on General Business Credit

The limitation on the amount of income tax liability (in excess of $25,000) of an individual or corporate taxpayer that may be offset by the general business credit is reduced from 85 percent to 75 percent.

C. Rapid Amortization Provisions

The bill repeals rapid amortization elections for certain costs relating to trademarks and trade names, certified pollution control facilities, and qualified railroad grading and tunnel bores, generally effective for expenditures paid or incurred after December 31, 1985. Transitional rules are provided with respect to certain binding contracts.

The bill retains and makes permanent the present law election to amortize over 60 months certain qualifying costs for rehabilitation of low-income housing. The bill replaces the present law limit of $20,000 per dwelling unit ($40,000 in some cases) with a single $30,000 per dwelling unit limit. The bill also extends for two years the present law election to expense qualified expenditures to remove architectural and transportation barriers to the handicapped and elderly.

The bill provides for a two-year extension (through 1987) of the present-law provision that allows the expensing of costs attributable to the removal of architecural and transportation barriers to the hadicapped and elderly.

D. Other Capital-Related Costs

1. Incremental research credit

The bill extends the credit for increasing research activities for an additional three years, i.e., for qualified research expenditures paid or incurred through December 31, 1988. In addition, the bill modifies the credit as follows, effective for taxable years beginning after 1985:

(a) The credit rate is reduced from 25 percent to 20 percent.

(b) Rental and similar payments for the use of personal property are not eligible for the credit, except for certain payments for computer time.

(c) The committee report modifies the definition of qualified research for purposes of the extended credit.

(d) Increased tax incentives are provided for corporate cash expenditures in excess of certain floors for basic research at universities and certain other organizations.

(e) The general limitation on use of business credits (under the bill, 75 percent of tax liability over $25,000) applies to the research credit.

2. Donations of scientific equipment

The present-law rule allowing an augmented charitable deduction for donations of newly manufactured scientific equipment to universities for research use is extended to such donations made to certain tax-exempt scientific research organizations, effective for taxable years beginning after 1985.

3. Tax credit for rehabilitation expenditures

The bill replaces the existing three-tier rehabilitation credit with a two-tier credit for qualified rehabilitation expenditures. The credit percentage is 20 percent for expenditures incurred in rehabilitation of certified historic structures and 10 percent for rehabilitation of buildings (other than certified historic structures) built before 1936. In general, the bill retains the structure of the existing rehabilitation credit, except the external walls requirement is tightened in the case of non-historic buildings and relaxed in the case of certified historic structures. In addition, the bill requires a basis adjustment for the full amount of the rehabilitation credit in the case of both historic and non-historic buildings.

The modifications to the rehabilitation credit are generally applicable to property placed in service after December 31, 1985.

4. Merchant Marine Capital Construction Fund

The Merchant Marine Act of 1936, as amended, provides Federal income tax incentives for U.S. taxpayers who own or lease vessels operated in the foreign or domestic commerce of the United States or in U.S. fisheries. The bill coordinates the application of the Internal Revenue Code of 1985 with the capital construction fund program of the Merchant Marine Act of 1936, as amended. In addition, new requirements are imposed, relating to (1) the tax treatment of nonqualified withdrawals, (2) certain reports to be made by the Secretaries of Transportation and Commerce to the Secretary of the Treasury, and (3) a time limit on the amount of time monies can remain in a fund without being withdrawn for a qualified purpose.

These rules are effective for taxable years beginning after 1985.

E. Capital Gains and Losses

1. Individual long-term gains

The bill provides a deduction for 50 percent of long-term capital gain for taxable years beginning in 1986 and 42 percent for taxable years beginning after 1986. In conjunction with the changes in the top regular individual rates, this produces a maximum long-term capital gain tax rate of 22 percent for taxable years beginning in 1986 (50 percent of 44 percent) and 22.04 percent thereafter (58 percent of 38 percent).

These provisions apply to capital gain reportable under the taxpayer's method of accounting in taxable years beginning after 1985, regardless of whether the sale or other transaction giving rise to the gain occurred in a prior year.

2. Royalty income from coal and domestic iron ore

The bill phases out the special capital gain rules for coal and domestic iron ore royalties over a three year period, beginning January 1, 1986. The provision applies to royalties taken into account after 1985.

3. Recapture of certain amounts previously reducing taxable income

The bill expands the amount of gain that must be treated as ordinary income on the disposition of oil, gas or geothermal property to include the amount of depletion deductions that have previously reduced basis, in addition to the excess intangible drilling costs which are recaptured under present law. The bill applies similar rules for mining exploration and development costs. The new provisions generally apply to property placed in service by the taxpayer after 1985.

F. Oil, Gas and Geothermal Properties

1. Intangible drilling and development costs

Under present law, intangible drilling and development costs (IDCs) generally may be expensed or capitalized at the election of the operator of an oil, gas or geothermal property. IDCs qualify for this treatment whether incurred in the United States or in a foreign country. In the case of integrated producers, 80 percent of IDCs may be expensed and the remaining 20 percent must be amortized over a 36-month period. Costs with respect to a nonproductive well ("dry hole") may be deducted by any taxpayer in the year the dry hole is completed.

Under the bill, domestic IDCs that are incurred prior to the beginning of the installation of production casing may be expensed as under present law. (For integrated producers, 80 percent of these IDCs may be expensed and the remaining 20 percent must be amortized over a 36-month period). IDCs associated with the installation of production casing, or that are incurred after the commencement of such installation, are to be amortized over a 26-month period, beginning with the month in which the costs are paid or incurred. (This rule does not apply below the lowest production level.) Unamortized IDCs associated with dry holes may be expensed in the year in which the dry hole is completed. These rules apply to oil, gas and geothermal properties.

IDCs incurred outside the United States are to be recovered (i) using 10-year, straight-line amortization, or (ii) at the taxpayer's election, as part of the basis for cost depletion.

These provisions are effective for costs paid or incurred after 1985.

2. Percentage depletion

Present law allows percentage depletion for up to 1,000 barrels of daily crude oil production (or the equivalent amount of natural gas) by an independent producer or royalty owner. The percentage depletion rate for oil and gas is equal to 15 percent of the taxpayer's gross income from the property, not to exceed (1) 50 percent of net income from the property, or (2) 65 percent of the taxpayer's overall taxable income. Percentage depletion is also allowed at a 15 percent rate for geothermal properties.

The bill generally phases out percentage depletion for oil, gas and geothermal properties over a three-year period. Taxpayers will thereafter be required to use the cost depletion method. Percentage depletion is retained at a 15 percent rate for stripper well oil (as defined for purposes of the crude oil windfall profit tax) and gas (as defined under the Natural Gas Policy Act of 1978). No percentage depletion is allowed for lease bonuses, advance royalties, or any other amounts payable without regard to the actual production from an oil, gas or geothermal property.

The phaseout of percentage depletion applies to production after December 31, 1985 (in the case of geothermal properties, in taxable years beginning after that date). The denial of percentage depletion for lease bonuses and advance royalties is effective on January 1, 1986.

3. Windfall profit tax exemption for certain exchanges of crude oil

The bill provides that certain crude oil is exempt from the crude oil windfall profit tax if it is exchanged for an equal amount of residual fuel oil which is be used on the property in enhanced recovery processes. This exception is limited to production attributable to an operating mineral interest. No depletion deduction (including cost or percentage depletion) is available with respect to oil qualifying for this exception. The exception is applicable to residual fuel used, and crude oil removed, after the date of enactment.

G. Hard Minerals

1. Depletion

Under present law, acquisition and related costs of mineral deposits must be recovered in any taxable year through cost or percentage depletion, whichever results in a larger deduction for that year. Depletion rates range from 5 to 22 percent of gross income. The depletion deduction for any property may not exceed 50-percent of net income from the property.

For most minerals, the bill ratably phases down the depletion rate to 5 percent over 3 years. In the case of minerals that have a 5-percent depletion rate under present law, the bill ratably phases down the depletion rate to zero over 3 years. Present law depletion rates are retained for dimension stone and minerals used in the production of fertilizer or animal feed. The 50 percent income limitation ratably is phased down to 25 percent over 3 years.

The phase down of depletion rates is effective for production after December 31, 1985. The phase down of the income limitation is effective for tax years beginning after 1985.

2. Exploration and development costs

Under present law, hard mineral exploration and development costs may be expensed by individual taxpayers. In the case of corporations, 80 percent of these costs may be expensed, and the remaining 20 percent is recovered in the same manner as 5-year depreciable property. At the taxpayer's election, once a mine begins production, expensed exploration (but not development) costs either (1) reduce depletion deductions, or (2) are recaptured in income and then recovered through depletion deductions.

Under the bill, the treatment of development costs generally is conformed to the treatment of exploration costs under present law. For domestic mines, development costs that are expensed would be recaptured when the mine reaches the producing stage. Recaptured amounts (and development costs incurred after production commences) would be recovered in the same manner as depreciable property in class 1 (3-year recover period). (Alternatively, these amounts could be applied to reduce depletion deductions.) The 20 percent of corporate exploration and development costs that are not expensed would be recovered in the same manner as class 2 property (5-year recovery period), beginning in the year the costs are paid or incurred.

In the case of foreign mines, exploration and development costs are recovered by (1) 10-year straight-line amortization or (2) at the election of the taxpayer, as part of the basis for cost depletion.

These provisions are effective for costs paid or incurred after December 31, 1985.

H. Energy and Fuels Tax Provisions

1. Residential tax credits.—The solar energy tax credit is extended for three years at reduced credit rates—30 percent in 1986 and 20 percent in 1987 and 1988. Expenditures for solar hot water property are limited to $5,000. The credit may not be used to create a sun room, greenhouse, or similar structure. The insulation, energy conservation, and wind energy tax credits are allowed to expire at the end of 1985.

2. Business tax credits.—Business solar and geothermal energy tax credits are extended for three years at reduced credit rates; solar credits will be 15 percent in 1986, 12 percent in 1987, and 8 percent in 1988; geothermal credits will be 15 percent in 1986 and 10 percent in 1987 and 1988. The other business energy tax credits are allowed to expire as scheduled in present law; these credits covered wind energy, ocean thermal energy and biomass properties, intercity buses, and small-scale hydroelectric projects.

3. Tax credit for fuels from nonconventional sources.—Production credits for fuels from nonconventional energy sources are repealed after 1985, except for fuels produced from wells drilled or facilities placed in service before January 1, 1986, and sold before January 1, 1990. An exception is made for methane gas produced from wood in facilities placed in service before January 1, 1990, and sold before January 1, 2001.

4. Alcohol fuels.—The 9-cents-per-gallon exemption from the gasoline and motor fuels excise taxes for neat alcohol and methanol fuels is reduced to 6 cents per gallon. The 60-cents-per-gallon nonrefundable income tax credit for blending alcohol with gasoline is repealed after December 31, 1985. The 6-cents-per-gallon excise tax exemption for gasohol is unchanged from present law.

5. *Taxicab fuel tax exemption.*—The 4-cents-per-gallon exemption from the excise taxes on gasoline and motor fuels for qualified taxicabs is reinstated as of October 1, 1985 for three years, through September 30, 1988.

I. Extension of Certain Tax Credits

1. Extension and modification of targeted jobs tax credit

Under present law, the targeted jobs credit is available with respect to individuals who begin work for the employer before 1986. The credit generally is equal to 50 percent of the first $6,000 of qualified first-year wages and 25 percent of the first $6,000 of qualified second-year wages paid to a member of a targeted group. A credit equal to 85 percent of the first $3,000 of qualified first-year wages of any disadvantaged summer youth employee is also allowed.

The bill extends the targeted jobs credit for two more years with several modifications. The bill eliminates the credit for second-year wages, reduces the first-year credit to 40 percent of the first $6,000 of qualified first-year wages (except in the case of disadvantaged summer youth employees), eliminates the credit for wages paid to an individual who works for the employer for fewer than 14 days, and extends the authorization for appropriations for administrative and publicity expenses through fiscal year 1987. Under the bill, the credit is available for wages paid to individuals who begin work for an employer before 1988. The amendments to the targeted jobs credit rules apply to taxable years beginning after 1985.

2. Orphan drug tax credit

The income tax credit for clinical testing of orphan drugs is extended for one additional year through December 31, 1988.

Title III. Corporate Taxation

A. *Corporate Tax Rates*

The bill provides a 3-bracket graduated corporate rate structure as follows:

Taxable income:	*Tax rate (percent)*
$50,000	15
Over $50,000 but not over $75,000	25
Over $75,000	36

This structure reduces from 5 to 3 the number of corporate income tax brackets, and lowers from 46 to 36 the tax rate applicable to large corporations. The benefit of graduated rates is phased out for corporations with more than $365,000 of taxable income (compared to $1,405,000 under present law).

The 28-percent alternative tax rate for net capital gains of corporations is increased to 36 percent—the regular tax rate applicable to large corporations.

The graduated income tax rates are effective for tax years beginning on or after July 1, 1986. The rate schedule for taxable years including July 1, 1986 will reflect blended rates.

The increase in the alternative tax rate on corporate capital gain's generally is effective for tax years ending after December 31, 1985. Under a transition rule, the present maximum 28-percent rate will apply to net capital gain recognized before January 1, 1986 or pursuant to a binding contract in effect on September 25, 1985.

B. Dividends Paid Deduction

The bill generally gives corporations a deduction for 10 percent of dividends paid out of corporate earnings that have been subject to tax. The deduction is not available for RICs, REITs, S corporations, cooperatives, and DISCs or FSCs, which are otherwise subject to special tax regimes. Compensatory shareholder-level taxes are imposed in certain circumstances on foreign shareholders and on tax-exempt shareholders holding 5 percent or more of the payor's stock.

The deduction is available for taxable years beginning after January 1, 1987 and is phased in over a ten-year period.

C. Dividends Received Deduction

The 85 percent dividends received deduction under present law is reduced to 80 percent for dividends received after December 31, 1985. In addition, the dividends received deduction is adjusted to reflect the phase in of the dividends paid deduction. Thus, for example, the 80 percent dividends received deduction is reduced to 79 percent in the first year that the dividends paid deduction is available, and to 70 percent after the ten year phase in.

D. Dividend Exclusion for Individuals

The $100 dividends exclusion for individuals ($200 for a joint return) is repealed, effective for taxable years beginning after December 31, 1985.

E. Clarification of Nondeductibility of Stock Redemption expenses

The bill clarifies present law by providing that no amount paid or incurred by a corporation in connection with a redemption of its stock is deductible or amortizable. This would preclude, for example, deduction of so-called "greenmail" payments made to stockholders to avert a hostile takeover.

F. Special Limitations on Net Operating Loss and Other Carryforwards

The bill alters the character of the special limitations on the use of net operating loss (NOL) and other carryforwards. After a change in ownership of more than 50 percent of the value of stock in a loss corporation, however effected, the taxable income available for offset by pre-acquisition NOLs is limited to the long-term tax-exempt rate times the value of the loss corporation's equity. In addition, NOLs are disallowed unless the loss corporation satisfies the continuity-of-business-enterprise rule that applies to tax-free reorganizations for the two-year period following an ownership change, regardless of the type of transaction that results in the change of control. The bill also expands the scope of the special limitations to include built-in losses and takes into account built-in gains. The bill includes a number of rules designed to ensure the limitations accomplish their intended objectives and makes other changes to present law, of a more technical nature, including rules relating to the measurement of beneficial ownership. The bill applies similar rules to carryforwards other than NOLs, such as net capital losses and excess foreign tax credits.

Effective dates.—In general, the bill applies to changes in ownership that occur after December 31, 1985 (unless pursuant to plans of tax-free reorganization adopted before January 1, 1986).

G. Recognition of Gain and Loss on Liquidating Distributions and Sales of Property **(Repeal of the *General Utilities* Rule)**

The bill provides that, in general, gain or loss is recognized to a corporation on a distribution of its property in complete liquidation, as if it had sold the property at fair market value. This repeals the so-called *General Utilities* rule. An exception is provided for distributions to certain controlling corporate shareholders. An exception is also provided for distributions to certain noncorporate, long-term shareholders, under rules similar to those applicable to nonliquidating distributions under present law. Under either exception, nonrecognition is available only to the extent of the qualifying shareholders' percentage interest in the liquidating corporation. The amount subject to nonrecognition is generally this percentage of gain or loss on each asset distributed, without regard to the status of the actual distributee.

Under the bill, nonrecognition is also allowed on certain liquidating sales of property to the same extent nonrecognition would have been available had the property been distributed.

Effective dates.—In general, the bill applies to distributions and sales and exchanges occurring on and or after November 20, 1985. An exception is provided in the case of certain distributions and sales made pursuant to a plan of liquidation adopted before that date. Special rules apply for purposes of determining whether a plan of liquidation has been adopted for this purpose.

Title IV. Tax Shelters

A. At-Risk Rules

The at-risk rules limit the net losses which individuals and certain corporate taxpayers may deduct with respect to an activity. Present law provides an exception from the rules for the activity of holding real estate. The bill repeals this real estate exception. However, a taxpayer will be at risk for certain unrelated third-party nonrecourse debt incurred with respect to real estate. The provision is effective for losses attributable to property acquired after December 31, 1985.

B. Investment Interest Limitation

1. General limitation.—The deduction for nonbusiness interest expense of noncorporate taxpayers, in excess of their net investment income, is the sum of (a) interest on debt secured by the taxpayer's principal residence, as well as a second residence, to the extent of their fair market value, plus (b) $10,000 ($20,000 for a joint return).

2. Interest subject to limitation.—Nonbusiness interest subject to the limitation means all interest (including consumer interest) not incurred in a trade or business, including the taxpayer's share of interest expense attributable to certain passive investments.

3. Investment income defined.—Net investment income includes dividends, interest, rents, royalties, and similar items, the taxpayer's share of income attributable to certain passive investments and the taxable portion of capital gains. Investment expenses, which are netted against this income to determine net investment income, include expenses and depreciation and depletion actually deducted.

4. Net leases.—Property subject to a net lease is considered an investment, unless the business deductions exceed 15 percent of the rental income. If the taxpayer performs personal services with respect to certain leased property, the value of his services may be included with his business deductions, in calculating 15 percent of rental income.

Effective date.—Subject to a phase-in rule, the limitation will be effective for interest paid or incurred in taxable years beginning on or after January 1, 1986, regardless of when the obligation was incurred. Interest not disallowed under present law, but which would disallowed under the bill, would become subject to disallowance ratably (10 percent per year) over 10 years commencing with taxable years beginning in 1986. Thus, the provision will be fully effective in 1995.

Title V. Individual and Corporate Minimum Taxes

A. Individual Minimum Tax

The present law individual alternative minimum tax is retained with the following modifications. The rate is increased to 25 percent; incentive depreciation on all property placed in service after 1985 is a preference; certain timing preferences (such as depreciation) are measured for post-1985 property on an aggregated basis, instead of measuring them item-by-item without netting; the maximum rate on capital gains is 22 percent and certain transfers by insolvent farmers are excluded; the net income offset to the intangible drilling cost preference is reduced to 65 percent; and the following new preferences are added: interest on newly issued nonessential function bonds, excludable income earned abroad by U.S. citizens, the benefit of the completed contract method of accounting, excludable income of foreign sales corporations (FSCs), losses in excess of twice the cash basis in passive farming activities, net losses in excess of certain cash basis in passive investment activities (with a $50,000 limit for losses from tax shelters), and charitable contributions of appreciated property (to the extent of the taxpayer's other preferences). In addition, a credit is allowed against the regular tax for prior years' minimum tax liability attributable to timing preferences. The provision applies to taxable years beginning after December 31, 1985.

B. Corporate Minimum Tax

An alternative minimum tax, similar to the individual minimum tax, replaces the present law add-on tax. The rate is 25 percent, and a $40,000 exemption is allowed. The items of tax preference include the corporate preferences under present law, incentive depreciation on all property placed in service after 1985 (with taxpayers being required instead to use the nonincentive rules for minimum tax purposes), intangible drilling costs (with the same 65 percent net income offset applying to individuals), tax-exempt interest on nongovernmental obligations, excludable FSC income, the benefit of the completed contract method of accounting, and charitable contributions of appreciated property (to the extent of the taxpayer's other preferences). Rules similar to those under the alternative minimum tax on individuals apply to incentive credits, the foreign tax credit, and net operating losses. A credit for the minimum tax paid in earlier year is allowed against the regular tax. Estimated tax payments are required with respect to corporate minimum tax liability. The provision applies to taxable years beginning after December 31, 1985.

Title VI. Foreign Tax Provisions

A. Foreign Tax Credit

1. Foreign tax credit limitation.—The overall foreign tax credit limitation of present law is retained. The separate limitation for interest income is replaced with separate limitations for passive income, shipping income, foreign currency translation gain, and banking and insurance income. Passive income includes certain categories of income subject to current taxation under the anti-tax haven rules.

These rules are effective for taxable years beginning after 1985.

2. Creditability of gross withholding taxes on interest.—Foreign gross withholding taxes on interest paid to financial institutions are treated as creditable taxes only up to the amount of the U.S. tax on the interest income.

This provision is generally effective for taxes paid in taxable years beginning after 1985, but certain transition relief is provided.

3. Deemed-paid credit.—(a) The deemed paid credit for a U.S. corporation's share of foreign taxes paid by a foreign corporation is determined with respect to the foreign corporation's multi-year pool of accumulated earnings and profits; and (b) earnings and profits generally are computed in the same manner for actual distributions as they are now for tax-haven income inclusions.

These rules are generally effective for earnings and profits accumulated in taxable years beginning after 1985.

4. Effect of losses on foreign tax credit.—Present law is generally retained with a clarification that foreign source losses reduce all types of foreign source income before reducing U.S. source income.

This provision applies to losses incurred in taxable years beginning after 1985.

B. Source Rules

1. Income derived from purchase and sale of inventory-type property.—Source is generally determined by the country of residence of the seller (the place-of-title-passage source rule of present law is repealed). When a seller has a fixed place of business outside his residence country that participates materially in a sale to an unrelated party, the sales income generally is sourced in the country in which that fixed place of business is located.

2. Income from manufacture and sale of inventory-type property.—At least 50 percent of such income must be allocated to manufacturing activity, which is sourced where the manufacturing occurs. The portion of such income allocated to sales activity is sourced under the rules for sales income described immediately above.

3. Income from intangible property.—With respect to royalty income, the bill retains the place-of-use source rule of present law. With respect to sales income, the bill generally follows the rule, described above, for income from the purchase and sale of inventory-type property, which generally depends upon the residence of the seller.

4. Income derived from sale of other personal property.—Under the bill, recapture income derived from sales of personal property used by the seller in a business is sourced where deductions with respect to such property previously offset income. Income in excess of those deductions is sourced like income from sales of inventory-type property. Income derived from sales of other personal property, including passive investment property, is sourced in the country of residence of the seller.

5. Transportation income.—The bill sources transportation income from United States-foreign routes as 50-percent U.S. source income and 50-percent foreign source income. (Present law generally treats most transportation income earned on such routes as foreign source income.) The special U.S. sourcing rule for income and expenses associated with vessels or aircraft constructed in the United States and leased to U.S. persons is repealed. The bill also repeals a similar rule for transportation income earned in leasing certain aircraft used on United States-U.S. possessions routes. The repeal of both special rules is subject to a grandfather rule for currently leased assets.

Under the bill, the reciprocal tax exemption for foreign persons' shipping and aircraft income is available only if a foreign person's country of residence gives U.S. persons an equivalent foreign tax exemption; in addition, a four-percent gross basis tax is imposed on U.S. source shipping income of foreign persons.

6. Other offshore income and income earned in space.—The bill sources other offshore income and income earned in space in the recipient's country of residence.

7. Dividend and interest income.—For withholding tax purposes, the bill generally treats interest paid to unrelated parties by a U.S. corporation that earns more than 80 percent of its income from foreign sources (an "80/20" company) as foreign source to the extent that the company's income is derived from foreign sources in the active conduct of a trade or business outside the United States. Dividend and other interest payments to foreigners by an 80/20 company are generally subject to U.S. withholding tax. For foreign tax credit purposes, the bill treats 80/20 companies' dividends as U.S. source, and their interest payments as U.S. source unless they are connected with an active financing business of an unrelated U.S. payee conducted outside the United States. The bill also restructures certain interest income exemptions.

8. Allocation of interest and other expenses.—The bill generally requires corporate members of affiliated groups to allocate all expenses between U.S. and foreign income on a consolidated group basis. Certain corporations that cannot join in filing consolidated returns can continue to allocate expenses on a separate company basis, as can some financial and similar companies, if their borrowing and lending activities are independent from their affiliates' other operations. The asset method of allocating interest expense is modified and the optional gross income method is eliminated. Tax-exempt income and assets are not taken into account for purposes of allocating expenses. The new interest allocation rules will be phased in over three years in the case of interest paid on preexisting debt amounts. Other transitional relief is provided.

9. Allocation of R&D expenses.—For two years, taxpayers are to allocate half the expenses for U.S.-performed R&D to U.S. source income, and the other half on the basis of sales or gross income. After two years, starting with taxable years beginning after August 1, 1987, a suspended Treasury Regulation generally requiring allocation on the basis of sales or gross income will take effect.

Effective date.—The rules governing the source of income are generally effective for taxable years beginning after 1985, although the bill provides certain transitional relief.

C. U.S. Taxation of Income Earned Through Foreign Corporations

1. Tax haven income generally.—Interest, dividends, and gains received by banks and insurance companies, insurance income, income earned in space or outside any country, base company rents and royalties, and gains from transactions in commodities, foreign currency, and certain other property generally are taxed currently if earned by controlled foreign corporations. Certain exceptions to the Code's rules that currently tax certain "tax-haven" income of foreign subsidiaries of U.S. companies are repealed, including the exclusion for reinvested shipping income. The subjective tax-avoidance safe-harbor rule is replaced with an objective test.

2. Determination of U.S. control of foreign corporations.—The U.S. ownership requirement for imposition of the anti-tax haven rules is amended. For the anti-tax haven rules to apply to a foreign corporation, 50 percent or more (rather than more than 50 percent) of the vote or value (not merely vote) of that corporation must belong to 10-percent U.S. shareholders. Similarly, for the foreign personal holding company rules to apply, 50 percent or more of the vote or value of a foreign corporation must be owned by five or fewer U.S. individuals. Transitional relief is provided.

3. De minimis tax haven income rule.—Present law is amended to apply the de minimis and 70-percent rules for foreign base company income on the basis of earnings and profits instead of gross income.

4. Foreign investment companies (FICs).—Present law is amended to require either current recognition of income earned by U.S. investors through passive FICs or payment of an interest charge on eventual recognition, and to apply FIC rules to U.S. investors irrespective of the degree of aggregate U.S. ownership. Transitional relief is provided.

5. Possessions-chartered corporations.—The exception to the anti-tax haven rules for possessions-chartered corporations is repealed, with appropriate transition rules provided.

Effective date.—The bill's rules applicable to income earned through foreign corporations are generally effective for taxable years beginning after 1985.

D. Special Tax Provisions for U.S. Persons

1. Possession tax credit and income from intangibles

a. Possession tax credit.—The bill retains the existing possession tax credit with certain modifications. The optional cost sharing method of allocating intangible income is changed to require that the cost sharing payment be determined as the greater of (1) 110 percent of the payment determined under present law and (2) an arm's-length royalty. The bill also requires an increase in the cost-sharing payment (20 percent above the present law payment) for purposes of the 50/50 profit split method. The active income test for possession corporation status is increased from 65 to 75 percent over 2 years. Certain passive income derived from loans made by the Government Development Bank of Puerto Rico in qualifying Caribbean Basin countries are tax-exempt in the hands of companies operating in the possessions. Identical rules apply to U.S. operations in the U.S. Virgin Islands.

b. Income from intangibles.—The payment for intangibles received from foreign corporations by related U.S. persons must be commensurate with the actual income attributable to the intangible.

Effective date.—These rules generally apply to taxable years beginning after 1985. However, the rule that looks to actual income attributable to an intangible applies to intangibles transferred after November 16, 1985.

2. Other rules with respect to U.S. possessions

a. U.S. Virgin Islands.—The Virgin Islands will continue to use the mirror code. The Virgin Islands inhabitant rule is repealed. To be exempt from U.S. withholding tax, 65 percent of a Virgin Islands corporation's income must be effectively connected with a trade or business in a possession or in the United States. Anti-abuse rules are provided.

b. Guam, the Commonwealth of the Northern Mariana Islands (CNMI), and American Samoa.—After 1985, full authority will be granted to Guam and the CNMI to determine their own income tax laws (as American Samoa currently does). To avoid U.S. withholding tax, 65 percent of a possession corporation's income must be effectively connected with a trade or business in a possession or in the United States. Anti-abuse rules are provided.

Effective date.—The bill's rules coordinating United States and possessions taxation generally apply to taxable years beginning after 1985, or as soon as the applicable possession agrees to cooperate with the United States in tax matters.

3. Taxation of U.S. employees of Panama Canal Commission

The bill clarifies that the Panama Canal Treaty and its implementing agreements do not exempt U.S. taxpayers from U.S. tax. The bill provides that Commission employees are entitled to certain tax-free allowances like those available for State Department employees.

The bill's clarification of the effect of the Panama Canal treaty is effective for all taxable years. The rule concerning taxation of employees' allowances applies for taxable years beginning after 1985.

4. Foreign Sales Corporations (FSCs)

The bill changes the reduction in taxable income for FSC shareholders from 16 percent to 14 percent of export income (from 15 percent to 13 percent for corporate shareholders). Corresponding changes are made to DISC rules. This provision is effective for taxable years beginning after 1985.

5. Private sector earnings of Americans abroad

The bill reduces the maximum annual exclusion for foreign earned income of Americans working abroad, from the present $80,000 to $75,000. The provision is effective for taxable years beginning after 1985.

E. Foreign Taxpayers

1. Branch-level tax.—The branch-level tax proposed by the President as a substitute for the present dividend and interest withholding taxes is generally adopted. The bill retains present law when a treaty allows present law to apply but would not allow a branch-level tax to apply. The bill provides anti-treaty shopping rules. These rules are effective for taxable years beginning after 1985.

2. Retain character of effectively connected income.—The bill treats income or gain as effectively connected with a U.S. trade or business if it is attributable to a different taxable year and would have been so treated if it had been taken into account in the other year. This rule applies to taxable years beginning after 1985.

3. Application of accumulated earnings tax (AET) and personal holding company (PHC) tax to foreign corporations.—Present law is amended to allow foreign corporations a net capital gain deduction for purposes of calculating the AET or PHC tax only if the gains are taxed by the United States at the corporate level. This provision applies to transactions occurring after November 15, 1985.

4. Tax-free exchanges by expatriates.—The tax-avoidance expatriate rules under present law are applied to gains on the sale of property the basis of which was determined by reference to U.S. property. This rule applies to sales or exchanges of property received in exchanges after September 25, 1985.

5. Excise tax on insurance premiums paid to foreign insurers.—The bill makes the excise tax on casualty reinsurance premiums paid to foreign insurers for U.S. risk coverage equal to that on similar casualty insurance premiums (4 percent), makes the foreign insurer liable for the tax, and requires the U.S. insured or broker obligated to transmit the premiums to withhold the tax. This rule applies to premiums paid after 1985.

F. Foreign Currency Exchange Gain or Loss

The tax treatment of exchange gain or loss, including character, source, and timing, is clarified. Generally, exchange gain or loss arises if the exchange rate fluctuates between the date an item is taken into account for tax purposes and the date it is paid. In general, exchange gain or loss is ordinary in nature. To the extent provided by regulations, a special rule will require a taxpayer to recognize gain or loss currently with respect to an item that is "hedged" by an offsetting position (e.g., a foreign currency futures contract). All business entities that account for foreign operations in a foreign currency are generally required to use a profit and loss translation method. For purposes of the foreign tax credit, a foreign tax is translated at the exchange rate in effect on the payment date. The indirect foreign tax credit is calculated on the basis of the exchange rate in effect on the date the tax was paid or accrued by the subsidiary, and the exchange gain or loss on the distributed earnings is treated as separate basket foreign source income or loss.

Effective date.—These rules are effective for taxable years beginning after 1985.

Title VII. Tax-Exempt Bonds

A. Tax-Exempt Bond Provisions

1. General restrictions on tax-exemption

Interest on State and local government bonds used to finance traditional government operations is tax-exempt. Interest on bonds to provide conduit financing for nongovernmental persons is taxable unless a specific exception is provided in the Code. A bond generally is viewed as for nongovernmental conduit financing if (a) more than 25 percent of the proceeds are used in a trade or business of a nongovernmental person (and a security interest test is satisfied), or (b) an amount equal to 5 percent or more of the bond proceeds is used to finance loans to such a person.

The bill provides that bonds are for nongovernmental conduit financing if either (a) an amount equal to or exceeding the lesser of 10 percent or $10 million of bond proceeds is used in a trade or business of a nongovernmental person or (b) an amount equal to or exceeding the lesser of 5 percent or $5 million of bond proceeds is used to finance loans to such a person. Bonds for governmental activities are referred to collectively as *essential function bonds* under the bill.

2. Exceptions for certain nonessential function bonds

Present law includes several exceptions permitting tax-exemption for interest on bonds for nongovernmental conduit financing. These exceptions are for (a) industrial development bonds (IDBs); (b) student loan bonds issued in connection with certain Department of Education guarantees; (c) qualified mortgage bonds and qualified veterans' mortgage bonds; (d) bonds for section 501(c)(3) organizations; and (e) certain bonds issued under non-Code statutes enacted before 1984, if the bonds satisfy all Code requirements for bonds the proceeds of which are used for a comparable activity.

The bill continues many of the exceptions permitting tax-exempt financing for activities of nongovernmental persons. Bonds for these activities are referred to collectively as *nonessential function bonds*. Activities for which nonessential function bonds may be issued are (a) exempt-facility bonds (bonds for airports, docks and wharves, mass commuting facilities, certain water furnishing facilities, sewage and solid waste disposal facilities, and qualified multifamily residential rental projects); (b) qualified mortgage bonds and qualified veterans' mortgage bonds; (c) qualified small-issue bonds; (d) section 501(c)(3) organization bonds; (e) qualified student loan bonds (expanded to include certain bonds not issued in connection with Department of Education guarantees); and (f) qualified redevelopment bonds. Additionally, the bill retains the option for States and local governments to elect to exchange qualified mortgage bond authority and issue mortgage credit certificates.

3. Unified State volume limitation

Present law provides three separate State volume limitations for (a) IDBs and student loan bonds, (b) qualified mortgage bonds, and (c) qualified veterans' mortgage bonds. Certain types of IDBs and bonds for secton 501(c)(3) organizations are not subject to State volume limitations.

The bill provides a unified State volume limitation for all nonessential function bonds and the nongovernmental portion (in excess of $1 million) of essential function bonds. States (and local issuers therein) may issue an aggregate annual amount of such bonds not exceeding the greater of $175 per resident of the State or $200 million.

An amount equal to $25 per capita ($30 million in the case of a State having a $200 million volume limitation) is permanently set-aside for section 501(c)(3) organization bonds. Additional set-asides are provided for bonds to finance housing and for qualified redevelopment bonds; these additional set-asides may be overridden by State legislation. Bonds for certain airport, dock, and wharf facilities are not subject to this volume limitation. In general, the new unified volume limitation is administered in a manner similar to the present-law volume limitations on IDBs and student loan bonds and on qualified mortgage bonds.

4. Arbitrage restrictions

Interest on arbitrage bonds is taxable under present law. Arbitrage bonds are bonds more than a minor portion of the proceeds of which are invested in materially higher yielding obligations. IDBs and qualified mortgage bonds are subject to additional arbitrage restrictions that require rebates to the Federal Government of arbitrage profits on obligations unrelated to the purpose of the borrowing and restrict the amount of bond proceeds that may be invested in such obligations.

The bill makes numerous technical amendments to the general arbitrage restrictions presently applicable to all tax-exempt bonds; extends to all such bonds both a requirement that certain arbitrage profits be rebated to the Federal Government and a limitation on the amount of bond proceeds that may be invested in nonpurpose obligations; restricts or prohibits advance refundings of all tax-exempt bonds; and restricts the early issuance of tax-exempt bonds; and provide that the purchase of annuity contracts with bond proceeds to fund pension plans will be subject to arbitrage restrictions in the same manner as if bond proceeds were used directly to fund such plans.

5. Modification and extension of miscellaneous restrictions

The bill extends to all nonessential function bonds present law requirements applicable to certain types of such bonds that require (a) that all net proceeds of the bonds be used for the exempt purpose of the borrowing; (b) that the maturity date of the bonds not exceed 120 percent of the economic life of any bond-financed property; (c) that substantial users of bond-financed facilities not own the bonds used in the financing; and (d) that certain public approvals occur before issuance of the bonds.

6. Changes in use of bond-finance facilities

The bill provides that in addition to loss of tax-exemption on bond interest where provided under present law, certain amounts paid in connection with bond-financed property that ceases to be used in a use qualifying for tax-exempt financing many not be deducted for Federal income tax purposes. In general, the nondeductible amount is the interest (or the equivalent thereof) paid on bond-financed loans.

7. Ownership and cost recovery deductions for bond-financed property

The bill requires certain facilities financed with tax-exempt bonds to be owned by or on behalf of a governmental unit. Exceptions are provided for sewage and solid waste disposal facilities, for qualified multifamily residential rental projects, for bond-financed owner-occupied residences, and for property financed with qualified redevelopment bonds and small-issue bonds. Additionally, facilities financed with section 501(c)(3) organization bonds may be owned either by a section 501(c)(3) organization or a governmental unit. The determination of ownership is made using general Federal income tax concepts.

Cost recovery deductions for bond-financed property generally are determined using the straight-line method and the recovery period for property in the next higher class of property under the new depreciation system included in the bill. Costs of real property are recovered over a 40-year period. Special recovery periods and methods are provided for qualified multifamily residential rental property.

8. Information reporting requirements

The bill extends to all tax-exempt bonds information reporting requirements similar to the requirements that presently apply to IDBs, student loan bonds, bonds for section 501(c)(3) organizations, and tax-exempt mortgage subsidy bonds.

9. Effective dates

The provisions of the bill generally apply to all bonds issued after December 31, 1985. Transitional exceptions are provided for certain of the amendments included in the bill.

B. General Stock Ownership Corporations (GSOCs)

The bill eliminates the Code provisions relating to General Stock Ownership Corporations as deadwood, effective upon enactment.

Title VIII. Financial Institutions

A. Reserve for Bad Debts

1. Commercial banks.—Commercial banks may continue to compute their deductions for losses on bad debts under present law, except in the case of "large banks." "Large banks" must use the specific charge off method to compute the deduction for bad debts. A bank is considered to be a "large bank" if, for any taxable year beginning after 1985, the sum of the average adjusted bases of the assets of the bank (or of the assets of any controlled group to which the bank belongs) exceeds $500 million. Large banks required to change their method of accounting for bad debts are required to recapture the balance in reserve for bad debts over a period not to exceed five years, or are required to account for bad debts on existing loans under a "cutoff" method.

2. Thrift institutions.—Thrift institutions that use the reserve method to compute their deductions for losses on bad debts may do so using either the experience method allowed to small banks or the percentage of taxable income method with the percentage reduced to 5 percent from 40 percent as under present law. In order to be eligible for the special treatment of bad debt reserves, at least 60 percent of the assets of the financial institution must be invested in qualifying assets.

The excess of the bad debt deduction of thrift institutions computed under the percentage of taxable income method over the deduction computed under the experience method is treated as a tax preference for alternative minimum tax purposes. The excess will not, however, constitute a preference item for purposes of the 20% reduction of present law for corporate tax preferences.

Effective date.—These provisions apply to taxable years beginning on or after January 1, 1986.

B. Interest on Debt to Purchase or Carry Tax-exempt Bonds

The bill disallows 100 percent (as opposed to 20 percent under present law) of deductions for interest expense allocable to tax-exempt obligations acquired after December 31, 1985. The 20-percent disallowance rule of present law continues to apply with respect to tax-exempt obligations acquired from 1983 to 1985. Transitional rules are provided for obligations acquired pursuant to a written commitment to purchase entered into before September 25, 1985 and for certain general purpose governmental bonds issued by a governmental unit in 1986, 1987, and 1988 in amounts not exceeding $10 million a year.

C. Special Rules for Net Operating Loss Carryovers of Depository Institutions

The provision of present law allowing a carryback period of 10 years and a carryforward period of 5 years for the net operating losses of depository institutions is repealed effective for losses incurred in taxable yers beginning after December 31, 1985. Losses incurred in taxable years beginning after 1985 are required to be carried back 3 years and carried forward 15 years in accordance with the general rules for net operating losses.

D. Repeal of Special Rules for Reorganizations of Financially Troubled Thrift Institutions

The bill repeals rules enacted in 1981 that provide special relief to financially troubled thrift institutions. These rules, which were designed to facilitate tax-free mergers of thrift institutions, provide that the continuity of interest requirement is met if the depositors of a financially troubled thrift are depositors of the surviving corporation; allow the carryover of net operating losses of a financially troubled thrift where its depositors continue as depositors of the acquiring corporation; and exempt certain payments from the Federal Savings and Loan Insurance Corporation to financially troubled thrift institutions from income and the general basis reduction requirements of the Code.

The repeal of the rules providing relief under the reorganization and net operating loss carryover provisions is effective for acquisitions or mergers occurring after December 31, 1985. The repeal of the exclusion for certain FSLIC payments is effective for payments received in taxable years beginning on or after January 1, 1986, except for payments made pursuant to an agreement entered into before that date.

E. Depositor Deductions in Cases of Troubled Financial Institutions

Individuals are given an election to deduct losses on deposits in qualified financial institutions as a casualty loss at the time the loss can be reasonably estimated. The election applies only where the loss arises as a result of the bankruptcy or insolvency of the financial institution and is not available to any one-percent shareholder, officer, or relative or related party of a one-percent shareholder or officer of the institution. The provision is effective for losses incurred in taxable years beginning after December 31, 1982.

Title IX. Accounting Provisions

A. General Provisions

1. Simplified dollar-value LIFO method for certain small businesses

The bill provides an election to use a simplified method of computing LIFO inventory values for taxpayers with average annual gross receipts of $5 million or less, effective for taxable years beginning after December 31, 1985. The method uses inventory pools established in accordance with general categories of inventory items published by the Bureau of Labor Statistics.

2. Limitations on the use of the cash method of accounting

The bill prohibits, with certain exceptions, the use of the cash method of accounting to any C corporation, partnership that has a C corporation as a partner, or tax-exempt trust with unrelated business income. Excepted entities, that can continue to use the cash method, are farming businesses, qualified personal service corporations, and entities with average annual gross receipts of $5 million or less. In the case of services, the time of accrual of income by the provider and deduction by the recipient generally is the time of billing. The provision is effective for taxable years beginning after December 31, 1985.

3. Pledges of installment obligations

The bill provides that the proceeds of a loan for which an installment obligation is pledged as collateral generally is treated as a payment on the obligation, resulting in the recognition of a proportionate part of the deferred gain. Exceptions are provided for the pledge of all of the assets of an active trade or business pursuant to a general lien in favor of a financial institution and for certain other situations. The provisions of the bill apply to pledges after December 31, 1985, and pledges before that date of installment obligations arising after September 25, 1985. Certain transitional rules are provided.

4. Accounting for production costs and long-term contracts

a. Uniform capitalization rules.—The bill provides that, in general, uniform rules for determining costs that must be capitalized apply to all producers of tangible property, including inventory, noninventory property held for sale to customers, and assets constructed for self-use. These comprehensive capitalization rules are based on the rules of present law applicable to extended period long-term contracts. The rules generally are effective for costs paid or incurred after December 31, 1985. In the case of inventories, the rules apply to the taxpayer's first taxable year beginning after December 31, 1985.

b. Interest.—Interest is subject to a special rule requiring capitalization only if the property is long-lived or requires more than two years (one year if the cost of the item is greater than $1 million) to produce. This rule applies to interest incurred after December 31, 1985.

c. Farming and ranching costs.—The uniform capitalization rules generally apply to costs (including interest) incurred in producing crops and livestock (other than animals held for slaughter) having a preproductive period of more than two years. An exception is provided for certain farmers, who may elect to expense preproductive period costs. Electing taxpayers must use nonincentive depreciation for all farm property, and the deducted amounts are recaptured (i.e., gain will be ordinary to the extent of the deductions) upon disposition of the property. The provision is effective for costs paid or incurred after December 31, 1985.

d. Long-term contracts.—The completed contract method of accounting is repealed except for certain contracts involving real estate construction. Contracts taking more than one year to complete must be reported on the percentage of completion method. Interest must be paid by (or to) the taxpayer if the reported profit on a contract each year is more (or less) than a portion of the actual profit on that contract allocable to that year. This provision is effective for long-term contracts entered into after December 31, 1985.

e. Timber.—The uniform capitalization rules generally apply to all costs (including interest) of producing timber. An exception is provided for certain small timber producers, who may elect to amortize costs otherwise subject to capitalization over a period of five years. An electing producer must use nonincentive depreciation for all assets used in the timber business. This provision is effective for production costs, including interest, incurred after December 31, 1985, except that costs attributable to timber planted before January 1, 1986, are subject to a special five year phase-in.

5. Reserves for bad debts

The bill generally repeals the reserve method of computing deductions for bad debts. Under the bill, taxpayers, other than certain financial institutions, are allowed a deduction for bad debts when the debt becomes wholly or partially worthless. Wholly worthless debts must be treated as worthless on a taxpayer's books in order to be allowed as a deduction for Federal income tax purposes, as is the case under present law for partially worthless debts. The balance of any reserve for bad debts or guarantees is taken into income ratably over a period of five years. The provision is effective for taxable years beginning after December 31, 1985.

6. Accrued vacation pay

The bill limits the deduction for additions to a reserve for vacation pay to amounts that are paid within the taxable year and eight and one-half months after the close of the taxable year. The provision is effective for taxable years beginning after December 31, 1985.

7. Contributions in aid of construction

The bill provides that utilities must include in gross income the value of any property, including money, that it receives to encourage it to provide services to, or for the benefit of, the person transferring the property. The provision of present law that allows certain utilities to treat these amounts as contributions to capital is repealed effective for taxable years beginning after December 31, 1985.

B. Timber Provisions

1. Capital gains treatment for timber

The bill provides that, in the case of dispositions after December 31, 1988, capital gains treatment is available only for natural persons, estates, and trusts, all of the beneficiaries of which are natural persons or estates. A modified corporate alternative capital gains rate is provided for dispositions of timber by corporate taxpayers prior to that date. Dispositions of timber grown on Federal lands do not qualify for capital gains treatment after December 31, 1985.

2. Reforestation expenditures

The bill repeals the provisions of present law allowing an election for 7-year amortization and an investment tax credit with regard to certain reforestation expenditures, effective for expenditures made after December 31, 1985.

C. Provisions Relating To Agriculture

1. Special expensing and amortization provisions affecting agriculture

The bill amends the provision allowing current deductions for certain soil and water conservation expenditures to limit current deductions to costs of improvements consistent with a soil or water conservation plan adopted by the U.S. Department of Agriculture, or in the absence of such, by a comparable State agency. The bill also repeals the provisions permitting current deductions for land clearing expenses and for certain soil conditioning activities. These provisions apply to expenditures incurred after December 31, 1985.

2. Dispositions of converted wetlands and erodible croplands

The bill provides that gain from the disposition of highly erodible land that is converted to agricultural use (other than livestock grazing) is not eligible for capital gain treatment, effective for dispositions after December 31, 1985.

3. Netting for cooperatives

Cooperatives (including tax-exempt farmers' cooperatives) are permitted to offset patronage earnings and losses in computing net earnings for the purpose of paying patronage dividends. Cooperatives that do so are required to notify affected members. The provision relating to netting is effective for taxable years beginning after December 31, 1962. The provision relating to the notice requirement is effective for taxable years beginning after the date of enactment of the bill.

4. Treatment of certain plant variety protection certificates as patents

The bill provides that plant protection certificates issued under the Plant Variety Protection Act of 1970 are treated as patents for determining the character of gain on their disposition, effective for dispositions after December 31, 1985.

Title X. Insurance Products and Companies

A. Insurance Policyholders

1. Interest on installment payments of life insurance proceeds.—The bill repeals the provision of present law under which the income on the proceeds of life insurance that are paid to a surviving spouse in periodic payments are includible in gross income only to the extent that the amount of income paid during any taxable year exceeds $1,000. The provision is effective for amounts received with respect to deaths occurring after December 31, 1985.

2. Deduction for nonbusiness casualty losses.—Under the bill, in the case of a loss covered (wholly or partially) by insurance, a taxpayer is permitted to deduct a casualty loss for damages to property not used in a trade or business or in a transaction entered into for profit only to the extent of losses not covered by insurance and only if the taxpayer files a timely insurance claim with respect to damage to that property. The provision applies to losses sustained in taxable years beginning after December 31, 1985.

3. Exclusion from income for structured settlements limited to cases involving physical injury.—The bill limits the exclusion from income for qualified assigments under structured settlement agreements to those assignments requiring the payment of damages on account of a claim for personal injuries or sickness involving physical injury or sickness (including death). The provision is effective for assignments entered into after December 31, 1985.

B. Life Insurance Companies

1. Special life insurance company deduction.—Under the bill, the special life insurance company deduction equal to 20 percent of tentative life insurance company taxable income (LICTI) is repealed, effective for taxable years beginning after December 31, 1985.

2. Status for certain organizations providing commercial-type insurance.—The bill provides, for taxable years beginning after December 31, 1985, that certain organizations (described in sec. 501(c)(3) or (4)) are entitled to tax exemption only if no substantial part of their activities is providing commercial-type insurance (including the issuance of annuity contracts). In addition, the commercial-type insurance activities of an otherwise tax-exempt organization are treated as an unrelated trade or business which is subject to tax under Subchapter L.

Commercial-type insurance does not include insurance provided at substantially below cost to a class of charitable recipients, incidental health insurance provided by a health maintenance organization of a kind customarily provided by such organizations, or property and casualty insurance (such as fire insurance) provided directly or through a wholly-owned corporation by a church or convention or association of churches.

In the case of Blue Cross and Blue Shield organizations, the bill authorizes the issuance of regulations to provide special treatment in the case of insurance provided to high risk individuals and small groups. This special treatment is not available to the extent that applicable State law requires the provision of insurance to such individuals or groups.

Further, the bill requires the Department of the Treasury to conduct a study of fraternal beneficiary associations (sec. 501(c)(8)) that received gross annual insurance premiums in excess of $25 million in 1984.

Transition rules are provided for certain organizations with respect to their pension businesses.

3. Operations loss deduction of insolvent companies.—The bill permits a life insurance company to apply unused net operating loss carryovers against the increase in its taxable income attributable to the amount deemed to be distributed from its policyholders surplus account. This provision only applies if (1) the company was insolvent on November 15, 1985, (2) the company is liquidated pursuant to a court order, and (3) as a result of the liquidation, the company's tax liability would be increased by policyholder surplus account distributions. This provision is effective for liquidations occurring after on or November 15, 1985.

C. Property and Casualty Insurance Companies

1. Inclusion in income of 20 percent of unearned premium reserve.—Under the bill, a property and casualty insurance company is required to reduce its deduction for unearned premium reserves by twenty percent. This provision is phased in over a five year period commencing with taxable years beginning after December 31, 1985. For the five taxable years beginning after that date, a total of 20 percent (4 percent each year) of a company's unearned premium reserve for its most recent taxable year beginning before January 1, 1986, is included in income. For all taxable years beginning after December 31, 1985, a company also takes into account only 80 percent of the difference in the reserve for unearned premiums at the end of the preceding year and at the end of the current year.

2. Treatment of certain dividends and tax-exempt interest.—For taxable years beginning after December 31, 1985, a property and casualty insurance company's deduction for losses incurred is reduced by a portion of the company's tax-exempt income and the deductible portion of dividends received (with special rules for dividends from affiliates). The portion taken into account is 10 percent of tax-exempt income and the deductible portion of dividends received from investments made after November 14, 1985 (increasing to 15 percent in taxable years beginning after December 31, 1987).

3. Taxable income must bear certain relationship to net gain from operation.—For taxable years beginning after December 31, 1987, the regular taxable income of a property and casualty insurance company shall not be less than 20/36 of its adjusted net gain from operations, and its regular taxable loss shall not be greater than 20/36 of its adjusted net loss from operations. Adjusted net gain or loss from operations means the net gain or loss from operations required to be set forth on the company's annual statement approved by the National Association of Insurance Commissioners, determined with regard to policyholder dividends but without regard to Federal and foreign income taxes, adjusted to exclude certain tax-exempt income and the deductible portion of certain dividends received attributable to investments made before November 15, 1985.

4. Study of treatment of loss reserves.—The Treasury Department is required to conduct a study of the tax treatment of loss reserves of property and casualty insurance companies, to be submitted no later than January 1, 1987.

5. Repeal of protection against loss account.—Effective for taxable years beginning after December 31, 1985, the deduction for contributions to the protection against loss account for mutual property and casualty companies is repealed. Balances in the account are includable in income no less rapidly than ratably over the first five years beginning after December 31, 1985, or, if more rapidly as such amounts would have been included over the five years had the PAL account provision not been repealed.

6. Revision of special treatment for small companies.—Under the bill, property and casualty companies (whether stock or mutual) with net written premiums or direct written premiums (whichever is greater) which do not exceed $500,000 for the taxable year are exempt from tax. Property and casualty companies (whether stock or mutual) with net written premiums or direct written premiums (whichever is greater) that exceed $500,000 but do not exceed $2,000,000 may elect to be taxed only on taxable investment income. In the case of a controlled group, these amounts are determined on a group basis. The provisions are effective for taxable years beginning after December 31, 1985.

7. Study of treatment of policyholder dividends by mutual property and casualty insurance companies.—Under the bill, the Treasury Department is required to conduct a study of the treatment of policyholder dividends of mutual property and casualty insurance companies, to be submitted no later than January 1, 1987.

Title XI. Pensions and Deferred Compensation; Fringe Benefits; ESOPs

Pension and Deferred Compensation Provisions

A. Limitations on Tax-Deferred Savings

1. Individual retirement accounts.—The bill provides that an individual's IRA deduction limit is reduced, dollar for dollar, by the amount of the individual's elective deferrals under a qualified cash or deferred arrangement or tax-sheltered annuity.

In addition, the bill provides special rules to ensure that electing spouses with some earned income are not precluded from receiving spousal IRA contributions.

2. Qualified cash or deferred arrangements

a. *Limit on elective deferrals.*—The bill limits the annual elective deferrals made by or on behalf of any employee under all qualified cash or deferred arrangements and tax-sheltered annuities to $7,000 and coordinates that limit with the IRA deduction limit.

b. *Nondiscrimination rules.*—In addition, the bill modifies the special nondiscrimination tests by redefining the group of highly compensated employees and modifying the percentage tests. Under the bill, the actual deferral percentage for an employer's highly compensated employees may not exceed 125 percent of the actual deferral percentage of eligible nonhighly compensated employees. Alternatively, the deferral percentage of an employer's highly compensated employees could not exceed the lesser of 200 percent of the actual deferral percentage of the nonhighly compensated employees, or the actual deferral percentage of the nonhighly compensated employees plus two percentage points.

The bill generally provides that an employee will be treated as highly compensated for a plan year if, during the current plan year, or either of the two preceding plan years he or she was:

(1) a five-percent owner of the employer;

(2) an employee earning more than $50,000; or

(3) one of the top 10 percent of employees by pay, excluding (i) employees who earn less than $20,000, and (ii) employees who earn less than $35,000 and are not among the top five percent by compensation.

The bill provides special rules for determining those employees who are to be considered highly compensated in the current plan year because they have more than $50,000 of compensation, or are in the top 10 percent of employees by compensation. A special rule also is provided for family members of five-percent owners and the top 10 employees by compensation.

c. *Withdrawal and other restrictions.*—The bill also (1) permits a qualified cash or deferred arrangement to make total distributions upon plan termination, (2) limits amounts that may be withdrawn on account of hardship to the total amounts of elective deferrals; (3) precludes a qualified cash or deferred arrangement from requiring, as a condition of eligibility, that an employee complete more than one year of service; (4) provides that no employer may (a) condition, directly or indirectly, contributions under any plan upon the employee's elective deferrals, or (b) take elective deferrals under a qualified cash or deferred arrangement into account in determining whether any other plan satisfies the general coverage or nondiscrimination rules; (5) imposes an excise tax on excess contributions to a qualified cash or deferred arrangement if the excess is not distributed in a timely manner; and (6) permits employer contributions that satisfy the vesting and distribution restrictions applicable to elective deferrals to be made whether or not the employer has current or accumulated profits.

d. *Employees of tax-exempt and public employers.*—The bill makes it clear that tax-exempt and public employers may not maintain qualified cash or deferred arrangements. However, the bill grandfathers any such plan that had been adopted before November 6, 1985, provided the sponsoring employer had requested a favorable determination letter before that date. Elective deferrals under grandfathered plans are coordinated with elective deferrals under 403(b) tax-sheltered annuities and section 457 plans.

3. Employer matching contributions and employee contributions.—The bill provides that employee contributions and qualifying employer matching contributions, as a percentage of compensation for highly compensated employees, may not exceed 125 percent of the average of such contributions as a percent of compensation for the nonhighly compensated employees. Alternatively, the average percentage for the highly compensated employees may not exceed 200 percent of the average percentage for the nonhighly compensated employees, or the average percentage for the nonhighly compensated employees plus two percentage points, if less.

The average of nonqualifying employer matching contributions as a percent of compensation for the employer's highly compensated employees may not exceed 110 percent of the average of nonqualifying employer contributions as a percent of compensation for the nonhighly compensated employees. Alternatively, the average percentage for the highly compensated employees may not exceed the lesser of 150 percent of the average percentage of the nonhighly noncompensated employees, or the average percentage of the nonhighly compensated employees plus one percentage point.

Excess contributions generally are subject to a 10-percent excise tax, unless the excess, plus earnings, are distributed (or, if nonvested, forfeited) in a timely manner.

4. Unfunded deferred compensation arrangements of State and local governments and tax-exempt employers.—The bill applies the rules governing eligible unfunded deferred compensation plans of State and local governments to unfunded deferred compensation plans for employees of tax-exempt employers.

In addition, the bill modifies the distribution requirements applicable to pre-death and post-death distributions from an eligible deferred compensation plan. Under the bill, distributions commencing during a participant's lifetime must satisfy a payout schedule under which benefits projected to be paid to the participant during life are at least two-thirds of the total benefits payable with respect to the participant. If the entire interest has not been distributed before the participant's death, the remainder must be distributed no more slowly than under the lifetime schedule in effect on the date of death. Distributions commencing after death generally must commence within a year of death and be paid over a period not to exceed 15 years, or over the life expectancy of a surviving spouse who is a beneficiary. If any benefits are payable over a period longer than one year, they must be paid on a substantially nonincreasing basis, not less frequently than annually.

5. *Deferred annuity contracts.*—Effective for amounts invested in deferred annuity contracts after September 25, 1985, the bill provides that a nonindividual owner of a deferred annuity contract must include in income any increase in the cash surrender value of the deferred annuity contract over the contract's basis during the taxable year. The owner of a deferred variable annuity contract is treated as owning a pro rata share of the assets and income of any separate account underlying the variable contract. As a result, the owner is not taxed on the unrealized appreciation of assets underlying a variable contract.

The bill also conforms the additional income tax on amounts withdrawn from deferred annuity contracts before age 59-1/2 to the 15-percent tax on early withdrawals from IRAs and other tax-favored retirement arrangements.

These provisions generally apply for years beginning after December 31, 1985. However, with respect to a plan maintained on November 22, 1985, pursuant to one or more collective bargaining agreements, these provisions will apply for years beginning after the earlier of (a) the date on which the last of the collective bargaining agreements terminates, or (b) December 31, 1990. In addition, a special effective date is provided for certain plans maintained by state and local governments.

B. Nondiscrimination Requirements

1. Coverage and nondiscrimination requirements for qualified plans and tax-sheltered annuities

a. *Qualified plans.*—The bill requires the Secretary of the Treasury to conduct a study of the effect of the present-law coverage tests, and to make recommendations on the manner in which the coverage rules might be changed. The study and recommendations must be submitted to Congress no later than July 1, 1986.

b. *Tax-sheltered annuities.*—Generally effective for years beginning after December 31, 1985 (November 21, 1987, in the case of certain programs maintained by State and local governments), the bill extends certain nondiscrimination rules to tax-sheltered annuity programs other than those maintained by churches. With respect to employer (i.e., nonelective) contributions to tax-sheltered annuity programs, the bill applies the general coverage and nondiscrimination tests of present law applicable to qualified pension plans, taking into account the special circumstances of tax-exempt organizations (including the compressed salary ranges of employees).

With respect to elective contributions to tax-sheltered annuity programs (other than programs maintained by churches), the bill requires that any entity offering the opportunity to make elective deferrals available to any employee must make the election to all employees without a minimum contribution requirement.

2. Certain social security benefits earned with prior employers.—The bill revises the manner in which a pension plan may be integrated with social security, effectively precluding an employer from taking into account benefits attributable to OASDI contributions of former employers of an employee. Pursuant to regulations to be issued by the Secretary of the Treasury, the maximum amount of social security benefits that may be taken into account by any employer may not exceed 1/40 of the total social security benefits permitted to be taken into account multiplied by the number of years of service with that employer.

3. Top-heavy plans.—The bill provides that a uniform benefit accrual rule must be applied in testing whether a defined benefit plan is top heavy. Solely for the purpose of determining whether a plan is top heavy or super top heavy, benefits will be considered to accrue no more rapidly than permitted under the fractional benefit accrual rule.

4. Modification of rules for benefit forfeitures effective for years beginning after December 31, 1985.—The bill creates uniform rules for forfeitures under any defined contribution plan. The bill permits, but does not require, forfeitures to be reallocated to other participants in a money purchase pension plan.

These provisions generally apply for years beginning after December 31, 1985. However, with respect to a plan maintained on November 22, 1985, pursuant to one or more collective bargaining agreements, these provisions will apply for years beginning after the earlier of (a) the date on which the last of the collective bargaining agreements terminates, or (b) December 31, 1990.

C. Withdrawal of Benefits

1. Uniform minimum distribution rules.—The bill establishes a uniform commencement date for benefits under all qualified plans, IRAs, tax-sheltered annuities and custodial accounts. Under the bill, distributions under a qualified retirement plan must commence no later than April 1 of the calendar year following the calendar year in which the participant or owner attains age 70-1/2, without regard to the actual date of retirement.

In addition, the bill establishes a new sanction in the form of an excise tax for failure to satisfy the minimum distribution rules.

2. Withdrawal restrictions.—The bill provides that no withdrawals may be made under any tax-sheltered annuity prior to the time an employee attains age 59-1/2, dies, becomes disabled, or separates from service. However, the bill does permit hardship withdrawals of elective contributions.

3. Additional income tax on early withdrawals.—The bill applies a 15-percent additional income tax to withdrawals from a qualified plan, qualified annuity, tax-sheltered annuity, or IRA, made before death, disability, or attainment of age 59-1/2. An exception to this rule is provided for any distribution that is part of a scheduled series of level payments under an annuity for the life of the participant (or the joint lives of the owner and the owner's beneficiary).

A transitional rule makes this tax inapplicable to distributions made to certain participants whose benefits were in pay status on November 6, 1985.

4. Taxation of distributions.—The bill (a) repeals the rule that owners of tax-sheltered annuities are subject to tax when amounts under the annuities become available, (b) repeals the present-law pre-1974 capital gains provisions; (c) replaces the present-law 10-year forward averaging with a new provision permitting one election after age 59-1/2 to claim five-year forward averaging, (d) reorders the present-law basis recovery rules for amounts withdrawn prior to a participant's annuity starting date; (e) eliminates the special three-year basis recovery rule of present law effective for participants whose annuity starting date is after July 1, 1986; and (f) modifies the general basis recovery rules for amounts paid as an annuity.

Special transition rules applicable to individuals who will have attained age 50 on or before January 1, 1986, (1) permit such individuals to make one additional election to claim five-year forward averaging treatment before attainment of age 59-1/2 and (2), solely with respect to such individuals, separately phase out over six years the pre-1974 capital gains provisions.

5. Loans.—Generally effective for loans made after December 31, 1985, the bill (a) reduces the present-law $50,000 limit on loans not treated as distributions by the highest outstanding loan balance of the prior 12 months; (b) provides an exception to the five-year repayment rule only for loans applied to the purchase of the participant's principal residence; and (c) requires level amortization of a loan over the permissible repayment period.

In addition, also effective for loans made after December 31, 1985, the bill provides a deferral of the deduction for interest paid by employees on loans secured by elective deferrals from a 401(k) plan or tax-sheltered annuity (403(b) plan), and also by key employees on loans from any qualified plan. Under the bill, the deferral would be accomplished by denying a deduction for interest, and increasing the participant's basis under the plan by the amount of nondeductible interest paid.

Except as otherwise noted, these provisions apply for years beginning after December 31, 1985.

D. Limits on Tax Deferral

1. Adjustments to limitations on contributions and benefits under qualified plans.—The bill makes several changes to the overall limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and SEPs of private and public employers. The dollar limit on annual additions under defined contribution plans is decreased from $30,000 to the greater of $25,000, or 25 percent of the defined benefit plan dollar limit. In applying this limit, the bill provides that all employee contributions are treated as annual additions.

The bill also reduces the dollar limit on the annual benefit payable under defined benefit plans from $90,000 to $77,000. If the retirement benefit under a defined benefit plan begins before age 62, the $77,000 limitation generally is reduced so that it is the actuarial equivalent of an annual benefit of $77,000 beginning at age 62.

Special rules are provided for commercial airline pilots, police and firefighters under transitional rules provided by the bill, benefits already accrued by a plan participant under an existing plan are not affected by the reductions.

In addition, the bill (1) permits contributions to a qualified cost-of-living arrangement, (2) provides a limit on compensation that may be taken into account under any qualified plan (an amount equal to seven times the defined contribution plan limit), and (3) adds a new 15-percent excise tax on certain excess retirement distributions.

2. Limits on employer deductions.—The bill makes several changes to the limits on employer deductions for contributions to qualified plans. The bill (1) repeals the limit carryforward applicable to profit-sharing and stock bonus plans; (2) extends the combined plan deduction limit to any combination of a defined benefit pension plan and a money purchase pension plan; (3) requires that certain social security taxes be taken into account in applying the 15 percent and 25 percent of compensation deduction limits; and (4) imposes a 10-percent excise tax on excess contributions to qualified plans.

3. Excise tax on reversion of qualified plan assets.—The bill imposes a 10-percent nondeductible excise tax on a reversion from a qualified plan. The tax is imposed on the person who receives the reversion. Under the bill, the tax applies to amounts received as a reversion pursuant to the termination of a plan occurring after December 31, 1985.

These provisions generally apply for years beginning after December 31, 1985. However, with respect to a plan maintained on November 22, 1985, pursuant to one or more collective bargaining agreements, these provisions will apply for years beginning after the earlier of (a) the date on which the last of the collective bargaining agreements terminates, or (b) December 31, 1990.

E. Miscellaneous Provisions Affecting Qualified Plans

1. Plan amendments.—Under the bill, the provisions affecting qualified plans generally apply as of the separately stated effective date (generally years beginning after December 31, 1985). However, a plan will not fail to be a qualified plan for any year beginning before January 1, 1988, provided

(a) the plan complies, in operation, with the changes as of the separately stated effective date;

(b) the plan is amended to comply with the changes no later than the last day of the first plan year beginning after December 31, 1987; and

(c) the amendment applies retroactively to the first day of the first plan year beginning on the separately stated effective date.

Special rules are provided for collectively bargained plans.

2. Penalty for overstatement of pension liabilities.—Effective for returns filed after December 31, 1985, the bill provides a new penalty in the form of a graduated addition to tax applicable to certain income tax overstatements of deductions for pension liabilities. As an addition to tax, this penalty will be assessed, collected, and paid in the same manner as a tax. This addition to tax applies only to the extent of any income tax underpayment that is attributable to such an overstatement. The penalty is similar to the present-law penalty for overvaluations of liabilities.

F. Fringe Benefits

1. Nondiscrimination rules for statutory fringe benefit plans.—Generally effective for years beginning after December 31, 1985, the bill establishes comprehensive nondiscrimination rules as to coverage and benefits for statutory fringe benefit plans. Statutory fringe benefit plans include employer-maintained group-term life insurance plans, health benefit plans (whether self-insured or funded through an insurance company), qualified group legal services plans, educational assistance programs, and dependent care assistance programs. In the case of accident or health plans, the provisions apply for years beginning after December 31, 1986.

2. Nondiscrimination rules for welfare benefit funds and cafeteria plans.—Generally effective December 31, 1985, the bill extends to welfare benefit plans and cafeteria plans nondiscrimination rules similar to those applicable to statutory fringe benefit plans. The bill also modifies the rules governing the year in which benefits under a discriminatory cafeteria plan must be included in income by highly compensated and key employees.

3. Study.—The bill requires that Treasury conduct a study of abuses of the health insurance provisions and make recommendations for changes in the nondiscrimination rules. No later than July 1, 1986, Treasury is required to report the results of the study, together with any recommendations it deems advisable, to the Committee on Ways and Means, the Committee on Finance and the Joint Committee on Taxation.

4. Reporting requirements.—Generally effective for years beginning after December 31, 1985, the bill imposes new reporting requirements with respect to certain fringe benefits paid as wages.

5. Exclusions for 2-year extension of educational assistance and group legal service benefits.—The bill extends for two years the present law exclusions from income for benefits provided under certain employer-maintained educational assistance programs and group legal service plans. The exclusions were scheduled to expire for taxable years beginning after December 31, 1985. Under the bill, exclusions expire for taxable years beginning after December 31, 1987.

G. Changes Relating to Employee Stock Ownership Plans

1. Repeal of employee stock ownership credit.—The bill repeals the special ESOP tax credit for years after 1985. Thus, under the bill, no tax credit is provided for compensation paid or accrued after December 31, 1985.

In addition, effective for terminations after December 31, 1984, the bill amends the tax credit ESOP distribution provisions to permit total distributions upon plan termination.

2. Termination of certain additional tax benefits.—Generally effective for taxable years beginning after December 31, 1988, the bill repeals (a) the special deduction for dividends paid on employer securities allocated to participants' accounts under an ESOP; (b) the provision permitting deferred recognition of gain on certain sales to an ESOP or eligible worker-owned cooperative, and (c) the provision permitting an ESOP or eligible worker-owned cooperative to assume estate tax liability.

In addition, effective for loans made after December 31, 1988, the bill repeals the 50-percent interest exclusion for interest earned in certain securities acquisition loans.

3. Changes in qualification requirements.—Under the bill, additional qualification requirements are provided for ESOPs. These additional qualification requirements (a) require more rapid (ten-year graded) vesting; (b) modify the ESOP nondiscrimination rules to limit the annual amount of employer contributions that may be allocated to employees who are officers, shareholders, or highly compensated; (c) expand the pass-through voting requirements applicable to employer securities held by an ESOP; (d) permit an eligible plan participant to direct the ESOP trustee to diversify a portion of the participant's ESOP account balance; and (e) modify the distribution and put option requirements, including the timing of the employer's payment of the put option price.

These provisions generally apply to ESOPs adopted after December 31, 1985 and, for ESOPs in existence on that date, to amounts contributed after that date.

Title XII. Unearned Income of Minor Children; Trusts and Estates; Generation-Skipping Transfers

A. Unearned Income of Certain Children

The bill provides special rules for calculating the tax liability of children who are under 14 years of age and whose parent or parents are still alive. The bill taxes the unearned income of a child derived from property transferred from the parents (parental-source unearned income) in excess of the child's personal exemption at the parents' marginal tax rate. Earned income and unearned income that is not parental source unearned income is taxed to the child at the child's marginal tax rate. Unearned income is not treated as parental source unearned income if the income is derived from a qualified segregated asset. A qualified segregated asset generally includes earned income, money, or property received from someone other than a parent, and property received by reason of the death of a parent. These provisions are effective for taxable years beginning after December 31, 1985.

B. Income Taxation of Trusts and Estates

Under the bill, the income of most non-grantor trusts is taxed during the lifetime of the grantor at the marginal tax rate of the grantor without a deduction for distributions to beneficiaries. After the death of the grantor, the income of all trusts created by the grantor and the grantor's estate is taxed without a distribution deduction and by allocating one set of tax brackets among the grantor's estate and all trusts created by the grantor.

If one beneficiary is entitled to all distributions from a trust and all undistributed amounts are ultimately subject to the control of the beneficiary (called a "qualified beneficiary trust"), the income of that trust is taxed at the marginal tax rate of the beneficiary.

If all beneficiaries of the trust are children of a grantor (called a "qualified children's trust"), the income of the trust may be taxed at the marginal rate of any child for any year that the child is minor.

A grantor of a trust is treated as the owner of the trust if the grantor retains a power to revoke the trust, if the grantor (or grantor's spouse) retains the right to receive the trust income or the power to use the trust income, and if the grantor retains certain administrative powers over the trust.

The provisions of the bill are effective for trusts created, and trust contributions made, on or after September 25, 1985. In the case of estates, the provisions are effective for decedents dying on or after September 25, 1985.

C. Generation-skipping Transfer Tax

The bill amends the present generation-skipping transfer tax to impose a flat-rate tax both on transfers involving a sharing in benefits in more than one generation and direct transfers that skip generations. A $1 million per transferor specific exemption is provided, with transfers in excess of that amount being subject to tax at a rate equal to the maximum gift and estate tax rate.

Title XIII. Compliance and Tax Administration

A. Penalties

1. Penalty for failure to file information returns or statements.—The bill consolidates the present-law penalty for failure to file an information return with the IRS and the present-law penalty for failure to supply a copy of the information return to the taxpayer. The bill also provides a new penalty for failure to include correct information on an information return. This applies to information returns the due date for which is after December 31, 1985.

2. Increase in penalty for failure to pay tax.—The bill increases the penalty for failure to pay taxes from one-half of one percent under present law to one percent after the IRS notifies the taxpayer that the IRS will levy upon the assets of the taxpayer. This applies to amounts assessed after December 31, 1985.

3. Negligence and fraud penalties.—The bill expands the scope of the negligence penalty by making it applicable to all taxes under the Code. The bill also provides that failure to report on a tax return any amount reported on an information return is considered negligence in the absence of clear and convincing evidence to the contrary. The bill modifies the fraud penalty by increasing the rate to 75 percent but applying the penalty only to the amount of the underpayment attributable to fraud. This is effective for returns the due date of which is after December 31, 1985.

B. Estimated Tax Payments by Individuals

The bill increases from 80 to 90 percent the proportion of the current year's tax liability that taxpayers must make as estimated tax payments in order to avoid the estimated tax penalty, effective for taxable years beginning after December 31, 1985.

C. Attorney's Fees and Exhaustion of Administrative Remedies

1. Attorney's fees.—The bill extends through the end of 1989 the provision of present law authorizing awards of attorney's fees in tax cases where the Government's position was unreasonable. The bill also provides that all or a portion of that award may be assessed against an IRS employee if the court determines that that employee's arbitrary or capricious act caused the lawsuit to occur. This applies generally to proceedings commenced after December 31, 1985.

2. Exhaustion of administrative remedies.—If a taxpayer does not use reasonable efforts in good faith to resolve a dispute through administrative proceedings (such as, for example, meeting with the Appeals Division of the IRS), the Tax Court may award damages of $120 to the United States. This applies to any action or proceeding in the Tax Court commenced after December 31, 1986.

D. Tax Administration Provisions

1. Authority to rescind notice of deficiency.—The bill gives the IRS authority, if the taxpayer consents, to rescind a statutory notice of deficiency.

2. Authority to abate interest.—The bill gives the IRS the authority to abate interest attributable to error or delay by an IRS employee in performing a ministerial act.

3. Suspension of compounding when underlying interest is suspended.—The bill suspends the compounding of interest in circumstances in which the underlying interest on the deficiency is also suspended.

4. Additional exemption from levy.—The bill exempts from IRS levy military service disability benefits.

5. Modification of amounts subject to administrative forfeiture.—The bill increases the value of property subject to administrative forfeiture because it has been used in violating Internal Revenue laws to the level applicable to similar Customs offenses.

6. Certain recordkeeping requirements.—The bill provides that IRS special agents are subject to the same income inclusion and recordkeeping rules that other law enforcement officers are with respect to use of an automobile.

E. Interest Provisions

1. Differential interest rate.—The bill provides that the Government pays interest to taxpayers at the three-month Treasury bill rate plus 2 percentage points, and that taxpayers pay interest to the Government at the three-month Treasury bill rate plus 3 percentage points. These rates are adjusted quarterly, and apply to interest for periods after December 31, 1985.

2. Interest on accumulated earnings tax.—The bill provides that interest is imposed on underpayments of the accumulated earnings tax from the due date of the tax return with respect to which that tax is imposed. This applies to returns the due date for which (determined without regard to extensions) is after December 31, 1985.

F. Modification of Withholding Schedules

The bill instructs the Treasury to modify withholding schedules to better approximate actual tax liability under the amendments made by the bill.

G. Information Reporting Provisions

1. Real estate transactions.—The bill provides that the settlement attorney or other stakeholder must provide an information report on real estate transactions. This is effective on January 1, 1986.

2. Information reporting on persons receiving Federal contracts.—The bill requires Federal executive agencies to provide information reports on contracts that they enter. Reporting is required beginning on January 1, 1986.

3. Information reporting on State and local taxes.—The bill (sec. 145) requires that State and local governments provide information reports on income taxes, real property taxes, or personal property taxes they collect, effective with respect to payments received after December 31, 1986.

4. Tax-exempt interest.—The bill requires every person who files an income tax return to report on that return the amount of tax-exempt interest received or accrued during the taxable year. This applies to taxable years beginning after December 31, 1985.

H. Report on Return-Free System

The bill requires the Treasury to report to Congress on the potential for implementing a return-free system for individuals. The report is due not later than six months after the bill's enactment.

I. Collection of Diesel Fuel Excise Tax

The bill provides that the diesel fuel excise tax may be imposed on the wholesaler (rather than the retailer) of the fuel. This applies to sales after the first calendar quarter beginning more than 60 days after the date of enactment.

Title XIV. Miscellaneous Provisions

1. Foster Care Payments

Currently, a foster parent may exclude from gross income reimbursements for expenses of caring for a foster child. The bill modifies the exclusion to apply to foster care payments, rather than expense reimbursements, so that detailed recordkeeping by the foster parents will not be necessary. This provision is effective for tax years beginning after December 31, 1985.

2. Reinstatement of Rules for Spouses of Vietnam MIA's

Under the bill, certain tax relief provisions applicable with respect to Vietnam MIA's (and their spouses) that expired after 1982 are retroactively reinstated and made permanent.

3. Olympic Trust Fund and Excise Tax on U.S. Television and Radio Olympic Broadcast Rights

a. Excise tax.—The bill imposes a new 10-percent excise tax on amounts paid for U.S. television and radio Olympic broadcast rights, effective for amounts paid after November 22, 1985, for such rights other than pursuant to binding contracts in effect on November 22, 1985. The excise tax is to apply notwithstanding any U.S. treaty provision entered into before, on, or after the date of enactment.

b. Olympic Trust Fund.—The bill establishes a new United States Olympic Trust Fund, to receive amounts from the new excise tax. Trust Fund monies are to be available, less related Treasury administrative expenses, to be paid to the U.S. Olympic Committee for training facilities, coaches, and other Olympic-related development expenditure purposes.

4. Exemption From UBIT for Certain Activities

The bill provides exemptions from the unrelated business income tax (UBIT), in the case of certain tax-exempt organizations eligible to receive charitable contributions, for income from (a) exchanges or rentals of mailing lists with or to other such organizations, and (b) certain distributions of low cost articles incidental to soliciting charitable contributions, effective on the date of enactment.

5. Allocation of Cooperative Housing Corporations

Cooperative housing corporations that charge tenant-stockholders with a portion of the cooperative's interest and taxes in a manner that reasonably reflects the cost to the cooperative of the interest and taxes allocable to each tenant-stockholder's dwelling unit, may elect to have such tenant-stockholders deduct the separately allocated amounts for income tax purposes (rather than amounts based on proportionate ownership of the shares of the cooperative). The provision is effective for taxable years beginning after December 31, 1985.

6. Personal Holding Companies

An exception from the definition of personal holding company income is provided for computer software royalties that are received by certain corporations that are actively engaged in the business of developing computer software. Another exception is provided from the definition of personal holding company income for interest on securities held in the inventory of a dealer in securities. In addition, a dealer in securities may deduct interest on "offsetting loans" in computing its interest income. The provisions are effective for royalties and interest received after December 31, 1985.

7. Adoption Assistance Program of the Social Security Act

The bill modifies the Adoption Assistance Program under Title IV-E of the Social Security Act to provide assistance for certain expenses incurred in adopting a child with special needs. These are the same expenses as qualify for the present-law itemized deduction which is repealed in Title I of the bill.

Title XV. Technical Corrections

This title contains technical, clerical, conforming and clarifying amendments to provisions enacted by the Tax Reform Act of 1984, the Retirement Equity Act of 1984, and other recently enacted tax legislation, as well as similar amendments to nontax provisions of the Deficit Reduction Act of 1984.

II.—Summary of Estimated Revenue Effects of Tax Provisions of H.R. 3838, as Reported by the Committee on Ways and Means, Fiscal Years 1986–1990

[Millions of dollars]

Title and provision	1986	1987	1988	1989	1990	1986–90
I. Individual Income Tax Provisions						
Individual	−15,076	−39,894	−53,555	−57,640	−63,523	−229,688
Corporate	668	1,070	1,117	1,246	1,346	5,447
Total	−14,408	−38,824	−52,438	−56,394	−62,177	−224,241
II. Capital Income Provisions						
Individual	1,295	3,818	5,740	8,275	12,264	31,392
Corporate	9,064	17,179	23,531	29,842	39,799	119,415
Excise	−2	−3	−3	−1	....	−9
Total	10,357	20,994	29,268	38,116	52,062	150,797
III. Corporate Provisions						
Individual	227	618	593	539	539	2,516
Corporate	−5,531	−15,958	−20,988	−21,662	−21,999	−86,138
Total	−5,304	−15,340	−20,395	−21,123	−21,460	−83,622
IV. Tax Shelters						
Individual	28	129	234	363	460	1,214
Corporate	−26	−65	−140	−212	−311	−754
Total	2	64	94	151	149	460
V. Minimum Tax Provisions						
Individual	800	4,255	5,170	4,679	4,235	19,139

II.—Summary of Estimated Revenue Effects of Tax Provisions of H.R. 3838, as Reported by the Committee on Ways and Means, Fiscal Years 1986-1990—Continued

[Millions of dollars]

Title and provision	1986	1987	1988	1989	1990	1986-90
Corporate	1,171	1,551	909	920	1,247	5,798
Total	1,971	5,806	6,079	5,599	5,482	24,937
VI. Foreign Tax Provisions						
Individual	22	38	42	49	52	203
Corporate	979	1,647	2,222	2,899	3,376	11,123
Excise	23	39	44	49	55	210
Total	1,024	1,724	2,308	2,997	3,483	11,536
VII. Tax-Exempt Bonds						
Individual	118	461	799	1,025	1,269	3,672
Corporate	14	−66	−162	−194	−169	−577
Total	132	395	637	831	1,100	3,095
VIII. Financial Institutions						
Individual	−43	−192	−406	−619	−836	−2,096
Corporate	944	1,476	1,389	1,484	1,803	7,096
Total	901	1,284	983	865	967	5,000
IX. Accounting Provisions						
Individual	602	1,639	1,401	1,696	1,503	6,841
Corporate	6,147	11,864	15,399	14,285	12,288	59,983
Total	6,749	13,503	16,800	15,981	13,791	66,824

X. Insurance Products and Companies						
Individual	2	5	5	5	5	22
Corporate	979	1,891	2,193	2,547	2,855	10,465
Total	981	1,896	2,198	2,552	2,860	10,487
XI. Pensions and Deferred Compensation; Fringe Benefits; ESOPs						
Individual	851	2,262	3,662	4,851	5,594	17,220
Corporate	1,065	2,132	1,405	740	595	5,937
Excise	20	56	58	60	62	256
Total	1,936	4,450	5,125	5,651	6,251	23,413
XII. Minor Children; Trusts and Estates; GST						
Individual	194	617	634	703	789	2,937
Estate and gift		−3	−7	−7	−8	−25
Total	194	614	627	696	781	2,912
XIII. Compliance and Tax Administration						
Individual	2,840	847	1,014	1,091	1,263	7,055
Corporate	110	239	270	187	392	1,198
Excise	13	8	8	8	8	45
Estate and gift	12	12	12	12	12	60
Total	2,975	1,106	1,304	1,298	1,675	8,358
XIV. Miscellaneous Provisions						
Individual	(*)	(*)	(*)	(*)	(*)	(*)
Corporate	−8	−17	−18	−19	−21	−83
Excise				10	15	25
Total	−8	−17	−18	−9	−6	−58

II.—Summary of Estimated Revenue Effects of Tax Provisions of H.R. 3838, as Reported by the Committee on Ways and Means, Fiscal Years 1986–1990—Continued

[Millions of dollars]

Title and provision	1986	1987	1988	1989	1990	1986–90
XV. Technical Corrections						
Individual	−182	−18	−17	−14	−13	−244
Corporate	−2	(*)	−22	−24	(*)	−48
Excise	10	5	5	5	5	30
Total	−174	−13	−34	−33	−8	−262
Totals:						
Individual	**−8,322**	**−25,415**	**−34,684**	**−34,997**	**−36,400**	**−139,818**
Corporate	**15,574**	**22,943**	**27,105**	**32,039**	**41,201**	**138,862**
Excise	**64**	**105**	**112**	**131**	**145**	**557**
Estate and gift	**12**	**9**	**5**	**5**	**4**	**35**
Grand total	**7,328**	**−2,358**	**−7,462**	**−2,822**	**4,950**	**−364**

*Loss of less than $5 million.

NOTE.—Detail does not add to total due to rounding.