DESCRIPTION OF AN AMENDMENT IN THE NATURE OF A SUBSTITUTE TO THE CHAIRMAN'S MARK RELATING TO CORPORATE AND OTHER TAX REFORMS

Scheduled for Markup

by the

HOUSE COMMITTEE ON WAYS AND MEANS

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JOINT COMMITTEE ON TAXATION

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CONTENTS

INTRODUCTION

The House Committee on Ways and Means has scheduled a markup on certain corporate and other tax reforms on September 18, 1995. This document, prepared by the staff of the Joint Committee on Taxation, provides a description of present law and the proposed reforms.[1]

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of an Amendment in the Nature of a Substitute to the Chairman's Mark Relating to Corporate and Other Tax Reforms* (JCX-39-95), September 18, 1995.

DESCRIPTION OF CORPORATE AND OTHER TAX REFORMS

1. Reform the tax treatment of certain corporate stock redemptions

Present Law

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

Section 1059 of the Code requires a corporate shareholder that receives an "extraordinary dividend" to reduce the basis of the stock with respect to which the dividend was paid by the nontaxed portion of the dividend. Whether a dividend is "extraordinary" is determined, among other things, by reference to the size of the dividend in relation to the adjusted basis of the shareholder's stock. Also, a dividend resulting from a non pro rata redemption or a partial liquidation is an extraordinary dividend. If the reduction in basis of stock exceeds the basis in the stock with respect to which an extraordinary dividend is paid, the excess is taxed as gain on the sale or disposition of such stock, but not until that time.(sec. 1059(a)(2)).

In general, a distribution in redemption of stock is treated as a dividend, rather than as a sale of the stock, if it is essentially equivalent to a dividend. (sec. 302). A redemption of the stock of a shareholder is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. The determination of the extent to which a shareholder's proportionate interest is reduced is subject to the constructive ownership rules of section 318, including the option attribution rules of section 318(a)(4).

Description of Proposal

Under the proposal, except as provided in regulations, a corporate shareholder would recognize gain immediately in any redemption treated as a dividend when the nontaxed portion of the dividend exceeds the basis of the shares surrendered, if the redemption is treated as a dividend in whole or in part due to options being counted as stock ownership in applying the rules of section 302.[2]

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[2] Thus, for example, where a portion of such a distribution would not have been treated as a dividend due to insufficient earnings and profits, and the remaining portion is treated as a dividend due to the inclusion of options, the rule applies to the portion treated as a dividend. Also, the rule applies not only to amounts to which section 302 applies directly, but also to cases where the rules of section 302 apply indirectly (for example, in the case of transactions to which section 356 would apply, such as recapitalizations or other reorganizations).

In addition, the proposal would require immediate gain recognition whenever the basis of stock with respect to which any extraordinary dividend was received is reduced below zero.

Effective Date

The proposal would generally be effective for distributions after May 3, 1995, unless made pursuant to the terms of a written binding contract in effect on that date or a tender offer outstanding on that date. However, in applying the new gain recognition rules to any distribution that is not a partial liquidation, a non pro rata redemption, or a redemption that is treated as a dividend by reason of options, September 13, 1995 would be substituted for May 3, 1995 in applying the transition rules.

No inference is intended regarding the tax treatment under present law of any transaction within the scope of the bill, including transactions utilizing options.

2. Require corporate tax shelter reporting

Present Law

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

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

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

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

Description of Proposal

The proposal would require an organizer of a corporate tax shelter to register the shelter with the Secretary. Registration would be required not later than the next business day after the day when the tax shelter is first offered to potential users. If an organizer is not a U.S. person, or if a required registration is not otherwise made, then any U.S. participant is required to register the shelter.

A corporate tax shelter is any investment, plan, arrangement or transaction (1) that has a significant purpose of tax avoidance or evasion by a corporate participant, (2) that is offered to any potential participant under conditions of confidentiality, and (3) for which the tax shelter organizers may receive total fees in excess of $100,000. A transaction is offered under conditions of confidentiality if: (a) an offeree (or any person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to restrict or limit its disclosure of the transaction or any significant tax features of the transaction; or (b) the promoter claims, knows or has reason to know (or the promoter causes another person to claim or otherwise knows or has reason to know that a party other than the potential offeree claims) that the transaction (or one or more aspects of its structure) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use.

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

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

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

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

Effective Date

The proposal would apply to any tax shelter offered to potential participants after the date of enactment. No filings would be due, however, until the Treasury Department issues guidance with respect to the filing requirements.

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

Present Law

No Federal income tax generally is imposed on a policyholder with respect to the earnings on premiums paid for a life insurance contract ("tax-free inside buildup").[3] Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured. The policyholder may borrow with respect to the life insurance contract without affecting these exclusions, subject to certain limitations. By contrast, other provisions of present law limit expense and interest deductions relating to tax-exempt income. In particular, no deduction is allowed for interest on debt incurred or continued to purchase or carry tax-exempt bonds. As a result, there is a significant tax incentive under present law for companies to purchase life insurance contracts rather than investing in other assets.

Considerable publicity has been focused on the magnitude of business borrowings with respect to life insurance, and the scale of the tax benefits. In a recent article describing corporate-owned life insurance ("COLI"), it was stated, "COLIs can net big bucks. After 40 years, a COLI program that pays a $10,000 annual premium on each of 5,000 employees will produce about $450 million in death benefits and $300 million in tax benefits -- netting the company $230 million."[4]

A company that sets up a COLI program typically purchases life insurance on the lives of

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[3] Inside buildup is subject to tax under present law, for example, when the life insurance contract is partially or fully cancelled, redeemed, or surrendered, and upon certain distributions under the life insurance contract.

[4] Solov, Diane, "Companies Profit By Insurance," St. Paul Pioneer Press, p. 2E, March 20, 1995.

its employees, in many cases thousands or tens of thousands of employees.[5] The company, not the employee or his family, is the beneficiary and receives proceeds on the employee's death. The company borrows against the value of the life insurance policies at an interest rate just above the rate at which inside buildup is credited under the policy. By deducting the interest expense, the company is able to obtain a positive rate of return, because the after-tax interest it pays on the policy loan is less than the interest income being credited under the policy. In addition, tax-free death benefits that the company receives on the death of insured employees subsidize future years' premiums. Thus, the company is able to increase the value of its life insurance investment while using funds borrowed under that investment for other purposes.[6]

The limitations on borrowing with respect to a life insurance contract under present law provide that no deduction is allowed for any interest paid or accrued on any indebtedness with respect to one or more life insurance policies owned by the taxpayer covering the life of any individual who (1) is an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer to the extent that the aggregate amount of such debt with respect to policies covering the individual exceeds $50,000. Further, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, endowment or annuity contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract.[7] An exception to the latter rule is provided, permitting deductibility of interest on bona fide debt that is part of such a plan, if no part of 4 of the annual premiums due during the first 7 years is paid by means of debt (the "4-out-of-7 rule"). Provided the transaction gives rise to debt for Federal income tax purposes and is not otherwise a sham or lacking in economic substance, and provided the 4-out-of-7 rule is met, a company may under present law borrow up to $50,000 per employee, officer, or financially interested person to purchase or carry a life insurance contract covering such a person, and deduct the interest on the debt, even though the earnings inside the life insurance contract are tax-free (tax-free inside buildup), and in fact the taxpayer has full use of the borrowed funds.

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[5] In some cases, this life insurance coverage is continued after an employee terminates employment with an employer, creating an ever-increasing pool of lives.

[6] Companies sometimes use the funds borrowed under the life insurance contracts for tax-advantaged funding of expenses such as retiree health benefits and nuclear decommissioning expenses, even though Congress has already provided special tax benefits specifically for funding these expenses.

[7] Additional limitations are imposed on the deductibility of interest with respect to single premium contracts, and on the deductibility of premiums paid on a life insurance contract covering the life of any officer or employee or person financially interested in a trade or business of the taxpayer when the taxpayer is directly or indirectly a beneficiary under the contract.

Description of Proposal

The proposal would phase out the deduction for any amount paid or accrued on any indebtedness with respect to one or more life insurance policies owned by the taxpayer covering the life of any individual who is (1) an officer or employee of, or (2) financially interested in any trade or business carried on by the taxpayer, regardless of the aggregate amount of debt with respect to policies covering the individual.

Effective Date

The proposal would be effective with respect to interest paid or accrued after December 31, 1995. Under the phase-out, for interest paid or accrued in 1996, 80 percent of such interest would be deductible; for 1997, the percentage would be 60 percent; for 1998, 40 percent; for 1999, 20 percent; and for 2000 and thereafter, no deduction would be allowed. Any amount included in income during 1996 that is received under a contract described in the proposal on the complete surrender, redemption or maturity of the contract in 1996, or in full discharge of the obligation under the contract that is in the nature of a refund of the consideration paid for the contract in 1996, would be includable ratably over the first four taxable years beginning with the taxable year the amount would otherwise have been includable. Utilization of this four-year spread would not cause interest paid or accrued prior to the effective date to be nondeductible solely by reason of failure to meet the 4-out-of-7 rule. The proposal would not apply to contracts purchased on or before June 20, 1986, with respect to individuals insured under such contracts on that date (thus leaving unaffected the effective date provision of the $50,000 limitation enacted in the 1986 Act).

4. Phase out preferential treatment for certain large farm corporations

Present Law

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

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

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

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

Description of Proposal

The proposal would repeal the ability of a family farm corporation to establish a suspense account when it is required to change to an accrual method of accounting. Thus, under the proposal, any family farm corporation required to change to an accrual method of accounting would restore the section 481 adjustment applicable to the change in gross income ratably over a 10-year period beginning with the year of change. In addition, any taxpayer with an existing suspense account would be required to restore the account into income ratably over a 20-year period beginning in the first taxable year beginning after September 13, 1995, subject to the present-law requirements to restore such accounts more rapidly.

Effective Date

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

5. Phased-in repeal of section 936

Present Law

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

In order to qualify for the section 936 credit for a taxable year, a domestic corporation must satisfy two possession income requirements (sec.936(a)(2)). First, the corporation must derive at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year from sources within a possession. Second, the corporation must derive at least 75 percent of its gross income for that same period from the active conduct of a possession business.

The amount of the credit attributable to possession business income is subject to one of two limitations enacted by the Omnibus Budget Reconciliation Act of 1993 ("1993 Act") (sec. 936(a)(4)). Under the economic activity limit, the amount of the credit with respect to such income cannot exceed the sum of a portion of the taxpayer's wage and fringe benefit expenses and depreciation allowances (plus, in certain cases, possession income taxes). In the alternative, the taxpayer may elect to apply a limit equal to the applicable percentage of the credit that would otherwise be allowable with respect to possession business income; the applicable percentage is phased down, beginning at 60 percent for 1994 and reaching 40 percent for 1998 and thereafter. The amount of the section 936 credit attributable to QPSII is not subject to these limitations.

<u>**Description of Proposal**</u>

The proposal generally would repeal section 936 for taxable years beginning after December 31, 1995. However, a corporation that claimed the section 936 credit for any base period year (defined below) would be eligible to continue to claim a section 936 credit for an additional 10 years under a special grandfather rule. A corporation that adds a substantial new line of business after September 13, 1995, would cease to be eligible to claim the section 936 credit under this grandfather rule beginning with the taxable year in which such new line of business is added.

The taxpayer's possession income that would be eligible for the section 936 credit in each of the years during the grandfather period would be subject to a cap equal to the corporation's average possession income for the base period years, adjusted for inflation ("average inflation-adjusted possession income"). A taxpayer's possession income equals the sum of its possession business income and QPSII.

The average inflation-adjusted possession income is the average of the adjusted possession incomes for each of the taxpayer's base period years. For the purpose of this computation, as a proxy for real growth in income throughout the base period, the taxpayer's possession income for a taxable year is increased by five percent compounded for each year between such year and the 1995 taxable year. This adjusted amount is then further adjusted for inflation through the year to which the cap is being applied.

The taxpayer's base period years generally are three of the taxpayer's five most recent years ending before September 13, 1995, determined by disregarding the taxable years in which the inflation-adjusted possession incomes were highest and lowest. For purposes of this computation, only years in which the taxpayer had significant possession income would be taken into account; a taxpayer would be considered to have significant possession income for a taxable year if such income exceeds 2 percent of the taxpayer's possession income for the taxable year, of the six taxable years ending with the first taxable year ending on or after September 13, 1995, which has the highest possession income. If the taxpayer has significant possession income for only four of the five most recent taxable years ending before September 13, 1995, the base period years would be determined by disregarding the year in which the taxpayer's possession income was lowest. If the taxpayer has significant possession income for three years or fewer of such five years, then the base period years would include all such years. If there is no year of such five taxable years in which the taxpayer has significant possession income, then the taxpayer may use as its base period its 1995 taxable year; for this purpose, the amount of possession income taken into account would be the annualized amount of such income for the portion of the year ended August 31, 1995. As an alternative, the taxpayer may elect to use its taxable year ending in 1992 as its base period (with the inflation-adjusted possession income for such year constituting its cap). If such an election is made, it would apply to all the years within the grandfather period unless revoked. Such an election must be made for all possession corporations that are members of an affiliated group.

If a taxpayer's possession income in a year during the grandfather period exceeds the cap, then the taxpayer's possession income for purposes of computing its section 936 credit for the year would be an amount equal to the cap. The reduction in the taxpayer's income to the cap would be allocated between the taxpayer's possession business income and QPSII for the year in question based upon the relative amounts of possession business income and QPSII. The taxpayer's section 936 credit for each year during the grandfather period would continue to be subject to either the economic activity limit or the percentage phase-down imposed by the 1993 Act.

A special rule would be provided to take into account acquisitions (within the same line of business) and dispositions by a possession corporation during the grandfather period. The effect of the special rule would be, for example, to allow a possession corporation that merges with another possession corporation that engages in the same line of business to be subject to a cap that reflects the average inflation-adjusted possession income of both companies.

Effective Date

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

6. Corporate accounting--reform of income forecast method

Present Law

In general

A taxpayer generally recovers the cost of property used in a trade or business through depreciation or amortization deductions over time. Tangible property generally is depreciated under the modified Accelerated Cost Recovery System ("MACRS") of section 168, which applies specific recovery periods and depreciation methods to the cost of various types of depreciable property. Intangible property generally is amortized under section 197, which applies a 15-year recovery period and the straight-line method to the cost of applicable property.

Treatment of film, video tape, and similar property

MACRS does not apply to certain property, including any motion picture film, video tape, or sound recording or to other any property if the taxpayer elects to exclude such property from MACRS and the taxpayer applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be recovered under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost of such property may be depreciated under the "income forecast" method.

Under the income forecast method, the depreciation deduction for a taxable year for a property is determined by multiplying the cost of the property[8] (less estimated salvage value) by a fraction, the numerator of which is the income generated by the property during the year and the denominator of which is the total forecasted or estimated income to be derived from the property during its useful life. The income forecast method has been held

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[8] In Transamerica v. U.S., 999 F.2d 1362, (CA 9, 1993), the Appellate Court overturned the District Court and held that for purposes of applying the income forecast method to a film, the "cost of a film" includes "participation" and "residual" payments (i.e., payments to producers, writers, directors, actors, guilds, and others based on a percentage of the profits from the film) even though these payments were contingent on the occurrence of future events. It is unclear to what extent, if any, the Transamerica decision applies to amounts incurred after the enactment of the economic performance rules of Code section 461(h), as contained in the Tax Reform Act of 1984.

to be applicable for computing depreciation deductions for motion picture films, television films and taped shows, books, patents, master sound recordings and video games.[9] The total forecasted or estimated income to be derived from a property is to be based on the conditions known to exist at the end of the period for which depreciation is claimed. This estimate can be revised upward or downward at the end of a subsequent taxable period based on additional information that becomes available after the last prior estimate. These revisions, however, do not affect the amount of depreciation claimed in a prior taxable year.

In the case of a film, income to be taken into account under the income forecast method means income from the film less the expense of distributing the film, including estimated income from foreign distribution or other exploitation of the film.[10] In the case of a motion picture released for theatrical exhibition, income does not include estimated income from future television exhibition of the film (unless an arrangement for domestic television exhibition has been entered into before the film has been depreciated to its reasonable salvage value). In the case of a series or a motion picture produced for television exhibition, income does not include estimated income from domestic syndication of the series or the film (unless an arrangement for syndication has been entered into before the series or film has been depreciated to its reasonable salvage value).[11] The Internal Revenue Service also has ruled that income does not include net merchandising revenue received from the exploitation of film characters.[12]

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[9] See, e.g., Rev. Rul. 60-358, 1960-2 C.B. 68; Rev. Rul. 64-273, 1964-2 C.B. 62; Rev. Rul 79-285, 1979-2 C.B. 91; and Rev. Rul. 89-62, 1989-1 C.B. 78. Conversely, the courts have held that certain tangible personal property was not of a character to which the income forecast method was applicable. See, e.g., ABC Rentals of San Antonio v. Comm., TCM 1994-601 and El Charro TV Rental v. Comm., No. 95-60301 (5th Cir., May 16, 1995) (consumer durable property subject to short-term "rent-to-own" leases) and Carland, Inc. v. Comm., 90 T.C. 505 (1988), aff'd on this issue, 909 F.2d 1101 (8th Cir 1990) (railroad rolling stock subject to a lease).

[10] Rev. Rul. 60-358, 1960-2 C.B. 68.

[11] Rev. Proc. 71-29, 1971-2 C.B. 568.

[12] PLR 7918012, January 24, 1979. Private letter rulings do not have precedential authority and may not be relied upon by any taxpayer other than the taxpayer receiving the ruling but are some indication of IRS administrative practice.

Description of Proposal

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

First, the proposal would provide that income to be taken into account under the income forecast method includes all estimated income derived from the property. In the case of a film, television show, or similar property, such income would include, but would not necessarily be limited to, income from foreign and domestic theatrical, television, and other releases and syndications; video tape releases, sales, rentals, and syndications; and the exploitation of film or program characters, prints, scripts, and scores.

In addition, the cost of property subject to depreciation would only include amounts that satisfy the economic performance standard of section 461(h).[13] Any costs that are taken into account after the property is placed in service would be treated as a separate piece of property to the extent (1) such amounts are expected to give rise to significant future income not reasonably anticipated with respect to the property originally placed in service or (2) such costs are incurred more than 10 years after the property was placed in service. Whether and to what extent costs incurred after the property is placed in service give rise to significant future income not reasonably anticipated would depend on the underlying facts and circumstances. For example, Treasury regulations may provide that if a taxpayer produces a new television series and initially does not anticipate syndicating such series, the forecasted income for the initial cost of the new series need not take into account any syndication fees. However, to the extent syndication becomes more likely as more costs are incurred to produce more shows (e.g., after the series has run for two or three years), the cost of producing the series after this initial period may constitute a new property, the forecasted income for which would include any syndication fees (even if no syndication has, in fact, taken place by such time). Except as provided in regulations, any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year.

Finally, taxpayers that claim depreciation deductions under the income forecast method would be required to pay (or would receive) interest based on the recalculation of deprecation under a "look-back" method.[14] The "look-back" method would be applied in any "recomputation year" by (1) comparing depreciation deductions that had been claimed in prior periods to deprecation deductions that would have been claimed had the taxpayer

[13] No inference would be intended as to the proper application of section 461(h) to the income forecast method under present law.

[14] The "look-back" method of the proposal would resemble the look-back method applicable to long-term contracts accounted for under the percentage-of-completion method of present-law sec. 460.

used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of the Code. Except as provided in regulations, a "recomputation year" would be the third and tenth taxable year after the taxable year the property was placed in service unless the actual income from the property for each period before the close of such years was within 10 percent of the estimated income from the property for such periods. The Secretary of the Treasury would have the authority to allow a taxpayer to delay the initial application of the look-back method where the taxpayer may be expected to have significant income from the property after the third taxable year after the taxable year the property was placed in service (e.g., the Secretary may exercise such authority where the depreciable life of the property is expected to be longer than three years). In applying the look-back method, any cost that is taken into account after the property was placed in service may be taken into account by discounting (using the Federal mid-term rate determined under sec. 1274(d) as of the time the costs were taken into account) such cost to its value as of the date the property was placed in service. Property with an adjusted basis of $100,000 or less when the property was placed in service would not be subject to the look-back method. The proposal would provide a simplified look-back method for pass-through entities.

<u>Effective Date</u>

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

7. Phaseout of tax credits for wind energy and "closed loop" biomass

<u>Present Law</u>

An income tax credit is allowed for the production of electricity from either qualified wind energy or qualified "closed-loop" biomass facilities (sec. 45). The credit is equal to 1.5 cents (adjusted for inflation since 1992) per kilowatt hour of electricity produced from these qualified sources during the 10-year period after the facility is placed in service.

The credit applies to electricity produced by a qualified wind energy facility placed in service after December 31, 1993, and before July 1, 1999, and to electricity produced by a qualified closed-loop biomass facility placed in service after December 31, 1992, and before July 1, 1999. Closed-loop biomass is the use of plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not apply to the use of waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). It also does not apply to taxpayers who use standing timber to produce electricity. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party.

The credit for electricity produced from wind or closed-loop biomass is a component of the general business credit (sec. 38(b)(1)). This credit, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. An unused general business credit generally may be carried back 3 taxable years and carried forward 15 taxable years.

Description of Proposal

Under the proposal, the income tax credit for electricity produced from wind and closed-loop biomass would be available only for qualifying electricity produced from facilities placed in service before September 14, 1995, with an exception for facilities placed in service before September 14, 1996, pursuant to a binding contract in existence on September 13, 1995, and at all times thereafter. The credit would not be available for electricity produced after December 31, 2005.

Effective Date

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

8. Modify basis adjustment rules under section 1033

Present Law

Under section 1033, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified period of time. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns replacement property.[15] The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion. In cases in which a taxpayer purchases stock as replacement property, section 1033 permits the taxpayer to reduce the basis of the stock, but does not require any reduction in the basis of the underlying assets. Thus, the reduction in the basis of the stock generally does not result

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[15] Although section 1033 and the underlying Treasury regulations do not provide the extent to which the assets of a corporation must qualify as similar use property in order for the acquisition of the corporation to qualify as replacement property, the law has developed to require that the assets of the corporation must "primarily" or "principally" be similar use property. See, e.g., Templeton v. Comm., 67 T.C. 518, at 521 (1977) and Rev. Rul. 82-70, 1982-1 C.B. 114 (relating to broadcast property).

in reduced depreciation deductions.

Description of Proposal

The proposal would provide that where the taxpayer satisfies the replacement property requirement of section 1033 by acquiring stock in a corporation, the corporation generally would reduce its adjusted bases in its assets by the amount by which the taxpayer reduces its basis in the stock. The corporation's adjusted bases in its assets would not be reduced, in the aggregate, below the taxpayer's basis in its stock (determined after the appropriate basis adjustment for the stock). In addition, the basis of any individual asset would not be reduced below zero. The basis reduction first would be applied to (1) property that is similar or related in service or use to the converted property, then (2) to other depreciable property, then (3) to other property.

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

Example 1.--Assume that a taxpayer owned a commercial building with an adjusted basis of $100,000 that was involuntarily converted, causing the taxpayer to receive $1 million in insurance proceeds. Further assume that the taxpayer acquires all of the stock of a corporation, the sole asset of the corporation is a building with a value and an adjusted basis of $1 million, and the stock acquisition qualifies as the acquisition of replacement property. Under the proposal, for section 1033 to apply, the taxpayer would reduce its basis in the stock to $100,000 (as under present law) and the corporation would reduce its adjusted basis in the building to $100,000.

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

Effective Date

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

9. Corporate pension reversions

Present Law

Under present law, defined benefit pension plan assets generally may not revert to an employer prior to the termination of the plan and the satisfaction of all plan liabilities. Any assets that revert to the employer upon such termination are includible in the gross income of the employer and subject to an excise tax (sec. 4980). The rate of the excise tax generally is 20 percent, and is increased to 50 percent unless the employer maintains a replacement plan or makes certain benefit increases in connection with the plan termination. Upon plan termination, the accrued benefits of all plan participants are required to be 100-percent vested.

Under present law, a pension plan may provide medical benefits to retirees through a section 401(h) account that is part of such plan. Present law permits certain qualified transfers of excess assets from the plan assets in a defined benefit pension plan (other than a multiemployer plan) to a section 401(h) account that is part of such plan to pay for qualified current retiree health liabilities (sec. 420). Such a transfer does not affect a plan's tax-qualified status and is not a prohibited transaction (sec. 4975). Further, the assets transferred are not includible in the gross income of the employer and are not subject to the excise tax on reversions. Only one qualified transfer with respect to a plan may be made during a taxable year.

Qualified transfers must satisfy several requirements and the assets transferred must not exceed certain limits. Under one of these requirements, the accrued retirement benefits of participants (including participants who separated from service during the one-year period ending on the date of the transfer) under the pension plan must be nonforfeitable as if the plan terminated immediately before the transfer. In addition, the transferred assets (and any income thereon) are required to be used to pay qualified current retiree health liabilities (either directly or through reimbursement) for the taxable year of transfer. Transferred amounts are generally required to benefit all participants in the pension plan who are entitled upon retirement to receive retiree medical benefits (other than key employees) through the section 401(h) account. Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer must be returned at the end of the taxable year to the general pension assets of the plan. Under a so-called maintenance of effort requirement, the employer is required to maintain current health benefit levels for a period of time after the transfer.

Only excess assets may be transferred under section 420. Excess assets are defined to be the excess of the value of plan assets (calculated as under the full funding limitation) over the greater of (1) the lesser of (a) 150 percent of current liability or (b) the accrued liability under the plan, or (2) 125 percent of current liability. For example, in the case of a plan subject to the accrued liability full funding limitation, the value of assets remaining in the plan following a transfer must be at least the greater of the plan's accrued liability or 125 percent of current liability. The calculation of excess assets is generally made as of the most recent valuation date preceding the transfer.

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

Description of Proposal

The proposal would provide an additional method under which employers could transfer excess assets from a defined benefit plan. The proposal would permit a qualified transfer of excess assets from a defined benefit pension plan (other than a multiemployer plan) to the employer. Amounts transferred could be used by the employer for any purpose. Amounts transferred would be includible in the gross income of the employer and generally would be subject to a 6.5-percent excise tax. No excise tax would apply in the case of transfers occurring before July 1, 1996.

A transfer would not affect the plan's qualified status and would not be considered a prohibited transaction. There would be no limit on the number of such transfers that could be made during any taxable year.

In order for the transfer to be qualified, the accrued retirement benefits of participants (including participants who separated from service during the 1-year period ending on the date of the transfer) under the pension plan must be nonforfeitable as if the plan terminated immediately before the transfer. The other requirements under present law for qualified transfers to pay qualified current retiree health liabilities (e.g., the maintenance of effort requirement) generally would not apply.

Excess assets would be defined as under present law, and would be determined as of January 1, 1995, or, if January 1, 1995, is not a plan valuation date, as of the last plan valuation date preceding January 1, 1995.

The proposal would not apply to transfers in taxable years beginning after December 31, 2000.

Effective Date

The proposal would be effective January 1, 1995.

10. Modify tax benefits for ethanol and methanol from renewable sources

Present Law

Present law provides several tax benefits for ethanol and methanol produced from renewable sources (e.g., biomass) that is used as a motor fuel or that is blended with other fuels (e.g., gasoline) for such a use. These benefits are--

(1) A 54-cents-per-gallon (60 cents per gallon for methanol) blender income tax credit;

(2) A 5.4-cents-per-gallon (6 cents per gallon for methanol) excise tax exemption from the motor fuels excise taxes; and

(3) In the case of ethanol, a separate 10-cents-per-gallon credit for small producers, defined generally as persons whose production does not exceed 15 million gallons per year and whose production capacity does not exceed 30 million gallons per year.

The benefits of the blender income tax credit and the excise tax exemption are integrated so that they are not cumulative beyond an aggregate amount of 54 cents (or 60 cents) per gallon of alcohol.

Treasury Department regulations provide that ethyl tertiary butyl ether ("ETBE"), which is made using ethanol, qualifies for the blender income tax credit and the excise tax exemption.

These alcohol fuels tax benefits are scheduled to expire after December 31, 2000.

Description of Proposals

ETBE and similar ethers not to qualify

Statutory clarification would be provided that ETBE and similar ethers (and alcohol used to produce these ethers) are not qualified alcohol fuels for either the ethanol or methanol from renewable sources tax benefits.

Limit on eligible production

The 54-cents-per-gallon (60 cents per gallon for methanol) blender income tax credit and the excise tax exemptions for ethanol and methanol from renewable sources, as modified by the proposal, would be available only for alcohol fuels produced by distilling equipment placed in service before September 14, 1995. Additionally, producers other than small producers (defined as under present law), would receive tax benefits only to the extent that annual production after September 13, 1995, from equipment placed in service before that date did not exceed average annual production of fuel alcohol by the equipment during the three-year period ending on August 31, 1995. Production from equipment placed in service before September 1, 1995, that was in service for at least the three-month period ending on August 31, 1995, would be allowed to annualize their actual production in applying this limit. A safe-harbor production level equal to 50 percent of capacity also would be provided for equipment that was not in service for the entire three-year base period.

The current December 31, 2000, general production sunset for these benefits would be retained.

Excise tax compliance provisions

To ensure that tax benefits are available only to eligible alcohol, fuel alcohol generally would be subject to the same excise tax rules as gasoline, with the addition of a provision allowing alcohol designated as eligible for tax benefits under the revised rules to be sold tax-free. Under these rules, fuel alcohol plants would be registered by the Internal Revenue Service as refineries and alcohol bulk plants would be registered as terminals. Fuel alcohol would be taxed at the gasoline tax rate on removal from the distilling plant unless it was (a) designated by a registered producer as eligible for tax benefits, or (b) removed in bulk to a registered bulk plant. Alcohol not designated as qualifying for tax benefits would be subject to tax at the gasoline tax rate on removal from the bulk plant; alcohol eligible for tax benefits could be removed tax-free.

Tax benefits in excess of the gasoline excise tax rate would be claimed by blenders through the present-law income tax credit (sec. 40). Conforming amendments would be made repealing the present excise tax reduced rate sales and special alcohol blender refund provisions.

Reduce ethanol tax benefits to reflect carbon dioxide by-product value; offset for small producers

Carbon dioxide is a naturally occurring by-product of ethanol production. This carbon dioxide is commercially valuable and currently is being captured and sold by ethanol producers. The 54-cents-per-gallon ethanol income tax credit and the 5.4-cents-per-gallon ethanol excise tax exemptions would be reduced to 51 cents per gallon and 5.1 cents per gallon, respectively, to reflect the value of carbon dioxide recovered as a by-product in ethanol production.

The present-law small ethanol producers credit would be increased from 10 cents per gallon to 13 cents per gallon.

Effective Dates

ETBE and similar ethers not to qualify

The provision reversing the Treasury Department regulations defining ethers as qualified alcohol fuels would be effective for fuels produced after December 31, 1995.

Limit on eligible production

The provision limiting distilling equipment the production from which is eligible for tax benefits would apply to distilling equipment placed in service after September 13, 1995, with an exception for property placed in service before September 14, 1996, pursuant to a binding contract in existence on September 13, 1995, and at all times thereafter.

The limit on production eligible for tax benefits from distilling equipment placed in service generally before September 14, 1995, to amounts based on average production during the three-year period ending on August 31, 1995, would be effective for production occurring after September 13, 1995.

Excise tax compliance provisions

The excise tax compliance provisions would be effective on and after January 1, 1996.

Reduce ethanol tax benefits to reflect carbon dioxide by-product value

The reduction in the ethanol blenders credit and excise tax exemption to reflect the value of carbon dioxide produced as a by-product would be effective on and after January 1, 1996. The offsetting increase in the small ethanol producers credit would be effective for production occurring on and after January 1, 1996.

11. Remove business exclusion for energy subsidies provided by public utilities

Present Law

Internal Revenue Code section 136, as added by the Energy Policy Act of 1992, provides an exclusion from the gross income of a customer of a public utility for the value of any subsidy provided by the utility for the purchase or installation of an energy conservation measure with respect to a dwelling unit (as defined by sec. 280A(f)(1)). In addition, for subsidies received after 1994, section 136 provides a partial exclusion from gross income for the value of any subsidy provided by a utility for the purchase or installation of an energy conservation measure with respect to property that is not a dwelling unit. The amount of the exclusion is 40 percent of the value for subsidies received in 1995, 50 percent of the value for subsidies received in 1996, and 65 percent of the value for subsidies received after 1996.

For this purpose, an energy conservation measure is any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to property. With respect to property other than a dwelling unit, an energy conservation measure includes "specially defined energy property" (generally, property described in sec. 48(l)(5) of the Code as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990).

The exclusion does not apply to payments made to or from a qualified cogeneration facility or a qualifying small power production facility pursuant to section 210 of the Public

Utility Regulatory Policy Act of 1978.

Section 136 denies a deduction or credit to a taxpayer (or in appropriate cases requires a reduction in the adjusted basis of property of a taxpayer) for any expenditure to the extent that a subsidy related to the expenditure was excluded from the gross income of the taxpayer.

Description of Proposal

The proposal would repeal the partial exclusion for any subsidy provided by a utility for the purchase or installation of an energy conservation measure with respect to property that is not a dwelling unit.

Effective Date

The proposal would be effective for subsidies received after September 13, 1995, unless received pursuant to a binding written contract in effect on that date and all times thereafter.

12. Modify the exception to the related party rule of section 1033 for individuals to only provide an exception for de minimis amounts

Present Law

Under section 1033, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified period of time. Pursuant to a provision of H.R. 831 (P.L.104-7), as passed by the Congress and signed by the President on April 1, 1995, subchapter C corporations (and certain partnerships with corporate partners) are not entitled to defer gain under section 1033 if the replacement property or stock is purchased from a related person. A person is treated as related to another person if the person bears a relationship to the other person described in section 267(b) or 707(b)(1). An exception to this related party rule provides that a taxpayer could purchase replacement property or stock from a related person and defer gain under section 1033 to the extent the related person acquired the replacement property or stock from an unrelated person within the period prescribed under section 1033.

Description of Proposal

The proposal would expand the present-law denial of the application of section 1033 to any other taxpayer (including an individual) that acquires replacement property from a related party (as defined by secs. 267(b) and 707(b)(1)) unless the taxpayer has aggregate realized gain of $100,000 or less for the taxable year with respect to converted property with aggregate realized gains. In the case of a partnerships (or S corporation), the annual $100,000 limitation would apply to both the partnership (or S corporation) and each partner (or shareholder).

Effective Date

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

13. Disallow rollover under section 1034 to extent of previously claimed depreciation for home office or other depreciable use of residence

Present Law

Rollover

Generally, no gain is recognized on the sale or exchange of a principal residence to the extent that the amount of the sales price of the old residence is reinvested in a new residence within a specified period ("the rollover"). The specified period generally is a period beginning two years before the sale of the old residence and ending two years after the sale of the old residence.

One-time exclusion

In general, a taxpayer may exclude from gross income up to $125,000 of gain from the sale of exchange of a principal residence if the taxpayer (1) has attained age 55 before the sale, and (2) has used the residence as a principal residence for three or more years of the five years preceding the sale. This election is allowed only once in a lifetime unless all previous elections are revoked. For these purposes, sales on or before July 26, 1978, are not counted against the once-in-a-lifetime limit.

In the case of a mixed use of a residence the exclusion is limited only to that portion of the residence that is owned and used by the individual as his principal residence for at least three of the previous five years before the date of sale. Gain on the portion not qualifying as a principal residence is not eligible for this exclusion.

Description of Proposal

Rollover

The proposal would provide that gain shall be recognized on the sale of a principal residence to the extent of any depreciation allowable with respect to such principal residence for periods after December 31, 1995.

One-time exclusion

The proposal would impose an additional restriction on the availability of the one-time exclusion. Specifically, the proposal would provide that the amount of the otherwise allowable one-time exclusion would be reduced and therefore the amount of recognized gain would be increased to the extent of depreciation allowable with respect to such principal residence for periods after December 31, 1995. The proposal would not change the amount of the allowable depreciation or the gain recognition treatment on the rental portion of the building under present law. To illustrate the proposal assume the following facts: a taxpayer purchased a three-floor building on January 1, 1995, for $150,000, one-third of which was rented to an unrelated person and two-thirds of which was used as the taxpayer's principal residence for at least three of the next five years. Further, assume that the taxpayer used one-tenth of the nonrental space as a qualified home office with allowable annual depreciation of $256. Finally, assume that the taxpayer sells the building for $300,000 on January 1, 2000. The taxpayer's realized gain is $150,000 of which $100,000 (representing the portion of the building used as a principal residence) is eligible for the one-time exclusion under present-law. Under the proposal that $100,000 is reduced by the amount of depreciation allowable with respect to that residence after December 31, 1995 ($1,024).

Effective Date

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

14. Tax gambling income of Indian tribes

Present Law

Tax treatment of Indian tribes

There is no specific statutory provision governing the Federal income tax liability of Indian tribes.[16] However, the IRS has long taken the position that Indian tribes, as well as wholly owned tribal corporations chartered under Federal law, are not taxable entities and, thus, are exempt from Federal income taxes. (See Rev. Rul. 67-284, 1967-2 C.B. 55; Rev. Rul. 81-295, 1981-2 C.B. 15.) More recently, the IRS has ruled that Indian tribes and Federally chartered tribal corporations are exempt from Federal income taxes on all income earned from commercial activities conducted on or off the tribe's reservation. (See Rev.

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[16] Section 7871 provides that Indian tribes are treated like States for certain limited tax purposes, such as for purposes of the issuance of certain tax-exempt bonds, certain excise tax exemptions, and in order to be eligible to receive deductible charitable contributions.

Rul. 94-16, 1994-12 I.R.B. 1; Rev. Rul. 94-65, 1994-42 I.R.B. 10.[17]) In ordinary matters not governed by specific treaties or remedial legislation, individual members of Indian tribes are subject to the payment of Federal income tax (even if the income is distributed to individual tribal members out of income otherwise exempt from tax when first received by the tribe).[18]

Tribal governments and corporations, as well as individual Indians and their property, generally are exempt from State taxation within their reservations, unless Congress clearly manifests its consent to such taxation.[19] In contrast, property and income earned by Indians outside the reservation generally have been held to be subject to State taxation.[20] In addition, the Supreme Court has upheld a State's right to impose taxes on commercial activities conducted on reservation lands, provided that the legal incidence of the tax falls on non-Indians and the balance of Federal, State, and tribal interests favors the State.[21]

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[17] These rulings further hold, however, that a corporation organized by an Indian tribe under State law is subject to Federal income tax on the income earned from commercial activities conducted on or off the tribe's reservation.

[18] See Squire v. Capoeman, 351 U.S. 1, 6 (1956). One exception to this general rule is the exclusion from income provided for income received by Indians from the exercise of certain fishing rights guaranteed by treaties, Federal statute or Executive order (sec. 7873). See also 25 U.S.C. sections 1401-1407 (funds appropriated in satisfaction of a judgment of the United States Court of Federal Claims in favor of an Indian tribe which are then distributed per capita to tribal members pursuant to a plan approved by the Secretary of Interior are exempt from Federal income taxes); 25 U.S.C. section 117b(a) (per capita distributions made to tribal members from Indian trust fund revenues are exempt from tax if the Secretary of the Interior approves of such distributions).

[19] See, e.g., Oklahoma Tax Comm'n v. Chickasaw Nation, 115 S.Ct. 2214 (1995); Montana v. Blackfeet Tribe of Indians, 471 U.S. 759 (1985); McClanahan v. Arizona State Tax Comm'n, 411 U.S. 164 (1973).

[20] See, e.g., Mescalero Apache Tribe v. Jones, 411 U.S. 145 (1973)(tribe held to be subject to State gross receipts tax on income earned from a ski resort operated by the tribe off-reservation). The Supreme Court also has ruled that a State may impose income tax on members of an Indian tribe who are employed by the tribe on tribal lands but who reside in the State outside of Indian country. Oklahoma Tax Comm'n v. Chickasaw Nation, supra.

[21] See Oklahoma Tax Comm'n v. Chickasaw Nation, supra; Cotton Petroleum v. New Mexico, 490 U.S. 163 (1989)(upholding imposition of State severance tax on private producers of oil and gas on reservation lands).

In 1993, Congress enacted two Federal tax incentives for commercial activities conducted (by Indians or non-Indians) on any Indian reservation. These tax incentives are: (1) enhanced accelerated depreciation (generally, 60 percent of the normal recovery period) for certain property used in the conduct of a trade or business on a reservation (and certain connecting infrastructure property); and (2) a 20-percent incremental wage credit for wages and health insurance costs (up to $20,000 per employee) paid to tribal members and spouses who work on, and live on or near, a reservation.[22] Neither of these tax incentives is available with respect to gambling activities (secs. 45A and 168(j)).

<u>Taxation of gambling activities of nonprofit organizations</u>

Although generally exempt from Federal income tax, tax-exempt organizations are subject to the unrelated business income tax (UBIT) on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions (secs. 511-514). Certain income, however, is exempted from the UBIT (such as interest, dividends, royalties, and certain rents), unless derived from debt-financed property (sec. 512(b)). Other exemptions from the UBIT are provided for activities in which substantially all the work is performed by volunteers and for income from the sale of donated goods (sec. 513(a)). In addition, a specific exemption from the UBIT is provided for bingo games[23] conducted by tax-exempt organizations, provided that the conducting of the bingo games is not an activity ordinarily carried out on a commercial basis and the conducting of which does not violate any State or local law (sec. 513(f)).[24] A specific exemption from the UBIT also is provided for qualified public entertainment activities (meaning entertainment or recreation activities of a kind traditionally conducted at fairs or expositions promoting agricultural and educational purposes) conducted by an organization described in section 501(c)(3), (c)(4), or (c)(5) which regularly conducts an agricultural and educational fair or exposition as one of its substantial exempt purposes

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[22] The wage credit is available only to the extent that the sum of current-year qualified wages and health costs exceeds the sum of comparable costs for 1993.

[23] For purposes of this exemption, the term "bingo game" is defined as any game of bingo of a type in which usually (1) the wagers are placed, (2) the winners are determined, and (3) the distribution of prizes or other property is made in the presence of all persons placing wagers in such game (sec. 513(f)(2)).

[24] In 1978, at the same time that Congress enacted section 513(f), section 527 was modified to provide that bingo income of political organizations is to be treated as "exempt function income" and, thus, not subject to tax if such income is used for certain political purposes (sec. 527(c)(3)(D)).

(sec. 513(d)).[25]

In South End Italian Independent Club, Inc. v. Commissioner, 87 T.C. 168 (1986), acq. 1987-2 C.B. 1, the court held that gambling profits of a social club described in section 501(c)(7) that were required by State law to be used for charitable purposes were fully deductible under section 162 in computing the UBIT liability of the social club. The effect of this decision was to exempt gambling income of that social club from UBIT. The IRS has indicated that, until further guidance is available with respect to this issue, the issue of the deductibility of amounts required under State law to be used for charitable or other so-called "lawful" purposes should be resolved consistent with the South End case, regardless of whether the gaming proceeds are donated to other charitable organizations or spent internally on the organization's own charitable activities.[26]

Description of Proposal

The proposal would subject to Federal income tax as unrelated business income ("UBI") income earned by an Indian tribe, or any corporate entity that is a tax-exempt entity by reason of being owned or controlled by an Indian tribe, from the conduct of class II or class III gaming activities (as defined under the Indian Gaming Regulatory Act, 25 U.S.C. secs. 2701-2721). Thus, Indian tribes would be subject to Federal income tax on income derived from class II gaming operations (e.g., bingo, pull-tabs, lotto) or class III gaming operations (e.g., a casino operated pursuant to a compact between the State government and Indian tribe).[27]

Under the proposal, if an Indian tribe is required (by Federal, State, or local law) to use any portion of the net proceeds of gaming activities for charitable or other specified purposes, any portion so used may be deductible only as a charitable contribution, and (under present-law sec. 512(b)(10)) such deduction may not exceed 10 percent of the taxable income from the gaming activities. This 10-percent limitation, however, would not apply to any proceeds from gaming activities that are required to be paid as general revenues to the United States or any State or local government (which generally would be fully deductible in computing the tribe's taxable income from gaming).

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[25] In addition, section 311 of the Deficit Reduction Act of 1984 (as modified by the Tax Reform Act of 1986) provides a special, off-Code exemption from the UBIT for games of chance conducted by nonprofit organizations in the State of North Dakota.

[26] See IRS, Exempt Organizations: Technical Instruction Program for FY 1996 (Training 4277-048 (7-95)) at page 96.

[27] As under present-law UBIT rules, a gaming activity would be subject to tax under the proposal only if the activity is regularly carried on.

In addition, the proposal would repeal the special, off-Code provision that exempts from the UBIT gaming income earned by nonprofit organizations in North Dakota. With respect to other gaming activities conducted by tax-exempt organizations, the proposal would direct the Treasury Department to conduct a study on the nature and extent of gaming activities conducted by organizations exempt from tax under section 501(a), including an examination of: (1) the types of gaming activities (e.g., bingo, pull tabs, casino nights) engaged in by charities and other nonprofit organizations and the frequency of such activities; (2) the dollar volume of such gaming activities; (3) the nature and extent of the involvement of for-profit entities and private parties in the management or operation of gaming activities of nonprofits; (4) competition between taxable gaming activities and gaming activities that are exempt from Federal income tax; and (5) an analysis of the present-law tax treatment of gaming activities of tax-exempt organizations and any recommendations for change, including examination of the South End decision and special UBIT exception for bingo games. The Treasury Department would be required to report the results of this study to Congress no later than July 1, 1996.

Effective Date

The proposal would be effective on after January 1, 1996.

15. Allow conversion of scholarship funding corporation to taxable corporation

Present Law

Qualified scholarship funding corporations

Qualified scholarship funding corporations are nonprofit corporations established and operated exclusively for the purpose of acquiring student loan notes incurred under the Higher Education Act of 1965 (sec. 150(d)). Such corporations must be organized at the request of a State or political subdivision thereof. In addition, a qualified scholarship funding corporation must be required by its corporate charter and bylaws, or under State law, to devote any income (after payment of expenses, debt service and the creation of reserves for the same) to the purchase of additional student loan notes or to pay over any income to the United States.

Qualified student loan bonds

In general, State and local government bonds issued to finance private loans (e.g., student loans) are taxable private activity bonds. However, interest on qualified student loan bonds is tax-exempt.

Qualified student loan bonds are obligations that are part of an issue all, or a major portion, of the proceeds of which are used, directly or indirectly, to finance loans to students who meet certain requirements. Such loans must be made under a program of general application to which the Higher Education Act of 1965 applies and with respect to which special allowance payments (SAP) under the Higher Education Act of 1965 are authorized. In addition, the program must restrict the maximum amount of loans that may be outstanding to any student and the maximum rate of interest payable on any loan, and the loans must be guaranteed by the Federal government. Finally, the financing of loans under the program must not be limited by Federal law to the proceeds of tax-exempt bonds.

Qualified scholarship funding corporations are eligible issuers of qualified student loan bonds.

Arbitrage restrictions and rebate requirement

The Internal Revenue Code restricts the direct and indirect investment of bond proceeds in higher yielding investments and requires that profits on investments that are unrelated to the government purpose for which the bonds are issued be rebated to the United States.

These arbitrage restrictions limit, for example, the amount by which interest charged on loans to students may exceed interest paid on qualified student loan bonds. This amount generally is limited to a spread between the interest on the bonds and the interest on the acquired program obligations equal to the greater of (1) two percentage points plus reasonable administrative costs or (2) all reasonable direct costs of the loan program (including issuance costs and bad debt losses). Special allowance payments (SAP) made by the Department of Education are treated as interest on notes and, therefore, are included within the 2-percent limit.

Private foundation excess business holding restrictions

The activities and assets of private foundations are subject to certain restrictions, including the "excess business holding" limitations of section 4943. These rules limit the combined ownership of a business enterprise by a private foundation and all disqualified persons by imposing a tax on the "excess business holdings" of any private foundation. Generally, a private foundation and disqualified persons may, in the aggregate, own 20 percent of the voting stock of a functionally unrelated corporation. If third parties control the unrelated corporation, such aggregate percentage interest may be increased to 35 percent.

The excess business holding rules do not apply if a private foundation owns an interest in a "functionally-related business." A "functionally-related business" is one that is (1) not an unrelated trade or business within the meaning of section 513 or (2) carried on within a larger aggregate of similar activities or within a larger complex of other endeavors that are related to the foundation's exempt purposes.

Description of Proposal

In general

The proposal would provide that a nonprofit student loan funding corporation may elect to cease status as a qualified scholarship funding corporation. If the corporation meets the requirements outlined below, such an election would not cause any bond outstanding as of the date of the issuer's election and any bond issued to refund such a bond to fail to be a qualified student loan bond. Accordingly, the interest on such bonds would remain tax-exempt to the bondholders. Once made, an election may be revoked only with the consent of the Secretary of Treasury.

Requirements

First, the issuer would be required to transfer all of the student loan notes to another, taxable, corporation in exchange for senior stock of such corporation within a reasonable period of time after the election is made. Immediately after the transfer, the issuer, and any other issuer who made the election, would be required to hold all of the senior stock of the corporation. Senior stock would be stock whose rights to dividends, liquidation or redemption rights are not inferior to those of any other class of stock and that (1) participates pro rata and fully in the equity value of any other common stock of the corporation, (2) has the right to payments receivable in liquidation prior to any other stock in the corporation, (3) upon liquidation or redemption, has a fixed right to receive the greater of (a) the fair market value of the stock at the date of liquidation or redemption or (b) the net fair market value of all assets transferred to corporation by the issuer, and (4) has a right to require its redemption by a date which is not 10 years after the date that the election is made.

In addition, the transferee corporation would be required to assume or otherwise provide for the payment of all the qualified scholarship funding bond indebtedness of the issuer within a reasonable period after the election. To the extent permitted by law, the transferee corporation would be required to assume all of the responsibilities and succeed to all of the rights of the issuer under the issuer's agreements with the Secretary of Education with respect to student loans.

Finally, immediately after the transfer, the issuer (i.e., the nonprofit student loan funding corporation) would be required to become a charitable organization (described in section 501(c)(3) that is exempt from tax under section 501(a)), at least 80 percent of the members of its board of directors are independent members, and which holds all of the senior stock of the corporation.

Consequences of election

After making the election, the issuer would not be authorized to issue any new bonds. On the other hand, any bonds issued to refund such bonds must be issued by a governmental entity because a qualified scholarship funding corporation would no longer exist.

Application of restriction on excess business holdings

For purposes of the excess business holding restrictions imposed on a private foundation, the corporation to which the issuer makes the transfer would be treated as a "functionally-related business" with respect to the issuer if more than 50 percent of the gross income of such corporation is derived from, or more than 50 percent of the assets (by value) of such corporation consists of, student loan notes incurred under the Higher Education Act of 1965.

Effective Date

The proposal would be effective on the date of enactment.

16. Apply look-through rule for purposes of characterizing certain subpart F insurance income as unrelated business taxable income

Present Law

An organization that is exempt from tax by reason of Code section 501(a) (e.g., a charity, business league, or qualified pension trust) is nonetheless subject to tax on its unrelated business taxable income (UBTI) (sec. 511). Unrelated business taxable income generally excludes dividend income (sec. 512(b)(1)).

Special rules apply to a tax-exempt organization described in section 501(c)(3) or (c)(4) (i.e., a charity or social welfare organization) that is engaged in commercial-type insurance activities. Such activities are treated as an unrelated trade or business and the tax-exempt organization is subject to tax on the income from such insurance activities (including investment income that might otherwise be excluded from the definition of unrelated business taxable income) under subchapter L (sec. 501(m)(2)).[28] Accordingly, a tax-exempt organization described in section 501(c)(3) or (c)(4) is generally subject to tax on its income from commercial-type insurance activities in the same manner as a taxable insurance company.

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[28] If the commercial-type insurance activities constitute a substantial part of the organization's activities, the organization will not be tax-exempt (sec. 501(m)(1)).

A tax-exempt organization that conducts insurance activities through a foreign corporation is not subject to this U.S. tax with respect to such activities. Under the subpart F rules, the United States shareholders (as defined in sec. 951(b)) of a controlled foreign corporation (CFC) are required to include in income currently certain income of the CFC, whether or not such income is actually distributed to the shareholders. This current inclusion rule applies to certain insurance income of the CFC (sec. 953). However, income inclusions under subpart F generally are characterized as dividends for unrelated business income tax purposes.[29] Accordingly, insurance income earned by the CFC that is includible in income currently under subpart F by the taxable United States shareholders of the CFC is excluded from unrelated business taxable income in the case of a shareholder that is a tax-exempt entity.

Description of Proposal

The proposal would apply a look-through rule in characterizing certain subpart F insurance income for unrelated business income tax purposes. The proposal would apply to amounts that constitute insurance income currently includible in gross income under the subpart F rules and that are not attributable to the insurance of risks of (1) the tax-exempt organization itself, (2) affiliates of the tax-exempt organization that are themselves tax-exempt, or (3) employees of the tax-exempt organization if such insurance covers solely risks associated with the performance of services for the benefit of such organization. Such amounts would be treated as income from an unrelated trade or business to the extent that such amounts would constitute income from an unrelated trade or business if received directly by the tax-exempt organization. Deductions connected with amounts treated as unrelated business taxable income would be allowed to the same extent as such deductions would be allowed to a taxable entity.

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[29] There is currently some uncertainty regarding the characterization of subpart F inclusions as dividends for unrelated business income tax purposes. The Internal Revenue Service has generally concluded in private letter rulings, which are not to be used or cited as precedent, that subpart F inclusions are treated as dividends received by the United States shareholder (a tax-exempt entity) for purposes of computing the shareholder's UBTI (see LTRs 9407007 (November 12, 1993), 9027051 (April 13, 1990), 9024086 (March 22, 1990), 9024026 (March 15, 1990), 8922047 (March 6, 1989), 8836037 (June 14, 1988), 8819034 (February 10, 1988)). However, the IRS issued one private ruling in which it concluded that subpart F inclusions are treated as if the underlying income were realized directly by the United States shareholder (a tax-exempt entity) for purposes of computing the shareholder's UBTI (see LTR 9043039 (July 30, 1990)). This ruling gave no explanation for the IRS's departure from the position in its prior rulings, and the IRS reiterated in a subsequent ruling the position that subpart F inclusions are characterized as dividends for purposes of computing UBTI. Moreover, the application of the look-through rule in the ruling in question did not affect the ultimate result in the ruling because the income to which the subpart F inclusion was attributable was of a type that was excludible from UBTI.

The Committee report would also clarify that present law characterizes income inclusions under subpart F as dividends for unrelated business income tax purposes.

Effective Date

The proposal would be effective for amounts includible in gross income in any taxable year beginning after December 31, 1995.

17. Modify exclusion of damages received on account of personal injury or sickness

Present Law

Under present law, gross income does not include any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injury
or sickness (sec. 104(a)(2)). This exclusion specifically does not apply to punitive damages received in connection with a case not involving physical injury or sickness.

Courts have interpreted the exclusion from gross income of damages received on account of personal injury or sickness broadly in some cases to cover awards for personal injury that do not relate to a physical injury or sickness. For example, some courts have held that the exclusion applies to damages in cases involving certain forms of employment discrimination and injury to reputation where there is no physical injury or sickness. The damages received in these cases generally consist of back pay and other awards intended to compensate the claimant for lost wages or lost profits. The Supreme Court recently held that damages received based on a claim under the Age Discrimination in Employment Act could not be excluded from income. In light of the Supreme Court decision, the Internal Revenue Service has suspended existing guidance on the tax treatment of damages received on account of other forms of employment discrimination.

Description of Proposals

Treat all punitive damage income as taxable

The proposal would provide that the exclusion from gross income does not apply to any punitive damages received on account of personal injury or sickness whether or not related to a physical injury or sickness. No inference would be intended as to the application of the exclusion to punitive damages received prior to the effective date of this proposal in connection with a case involving a physical injury or sickness.

Include in income damage recoveries for nonphysical injuries

The proposal would provide that the exclusion from gross income only applies to damages received on account of a personal physical injury or physical sickness. If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom would be treated as payments involving physical injury or physical sickness.

The proposal would also provide that the exclusion from gross income does not apply to damages received based on a claim of emotional distress unless the emotional distress is attributable to the recipient's physical injury or physical sickness. This rule would not apply to the amount of damages received that is not in excess of the amount paid for medical care attributable to emotional distress. For example, the exclusion from gross income would not apply to any damages received (other than for medical expenses) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress.

Effective Date

The proposals generally would be effective with respect to amounts received after December 31, 1995. The proposals would not apply to amounts received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

18. Require tax reporting for payments to attorneys

Present Law

Information reporting is required by persons engaged in a trade or business and making payments in the course of that trade or business of "rent, salaries, wages, ... or other fixed or determinable gains, profits, and income" (Code sec. 6041(a)). Treas. Reg. sec. 1.6041-1(d)(2) provides that attorney's fees are required to be reported if they are paid by a person in a trade or business in the course of a trade or business. Reporting is required to be done on Form 1099-Misc. If, on the other hand, the payment is a gross amount and it is not known what portion is the attorney's fee, no reporting is required on any portion of the payment.

Description of Proposal

The proposal would require gross proceeds reporting on all payments to attorneys made by a trade or business in the course of that trade or business. It is anticipated that gross proceeds reporting would be required on Form 1099-B (currently used by brokers to report gross proceeds). The only exception would be for any payments reported on Form 1099-Misc under section 6041 (reports of payment of income).

In addition, the present exception in the regulations exempting from reporting any payments made to corporations would not apply to payments made to attorneys. Treas. Reg. sec. 1.6041-3(c) exempts payments to corporations generally (although payments to most corporations providing medical services must be reported). Reporting would be required under both 6041 and 6045 (as proposed) for payments to corporations that provide legal services. The exception of Treas. Reg. sec. 1.6041-3(g) exempting from reporting payments of salaries or profits paid or distributed by a partnership to the individual partners would continue to apply to both sections (since these amounts are required to reported on Form K-1).

Effective Date

The proposal would be effective for payments made after December 31, 1995. Consequently, the first information reports would be filed with the IRS (and copies would be provided to recipients of the payments) in 1997, with respect to payments made in 1996.

19. Expatriation tax proposal (H.R. 1812 as reported)

Present Law

A United States citizen generally is subject to the U.S. individual income tax on his or her worldwide taxable income. All income earned by a U.S. citizen, whether from sources inside or outside the United States, is taxable, whether or not the individual lives within the United States. Non-U.S. citizens who are residents of the United States generally are taxed in the same manner as U.S. citizens. Nonresident aliens are subject to U.S. tax only to the extent their income is from U.S. sources or is effectively connected with the conduct of a trade or business within the United States.

An individual who relinquishes U.S. citizenship with a principal purpose of avoiding U.S. taxes is subject to an alternative method of income taxation for 10 years after expatriation under section 877 of the Code. The alternative method modifies the rules generally applicable to the taxation of nonresident aliens in two ways. First, the expatriate is subject to tax on his or her U.S. source income at the rates applicable to U.S. citizens rather than the rates applicable to other nonresident aliens. (Unlike U.S. citizens, however, individuals subject to section 877 are not taxed on any foreign source income.) Second, the scope of items treated as U.S. source income for section 877 purposes is broader than those items generally considered to be U.S. source income under the Code. For example, gains on the sale of personal property located in the United States, and gains on the sale or exchange of stocks and securities issued by U.S. persons, generally are not considered to be U.S. source income under the Code if they are realized by a nonresident alien. However, if an individual is subject to the alternative taxing method of section 877, such gains are treated as U.S. source income with respect to that individual. The alternative method applies only if it results in a higher U.S. tax liability than would otherwise be determined if the individual were taxed as a nonresident alien. Section 877 does not apply to resident aliens who terminate their U.S. residency.

Similar rules apply in the context of estate and gift taxation if the transferor relinquished U.S. citizenship with a principal purpose of avoiding U.S. taxes within the 10-year period ending on the date of the transfer. A special rule is applied to the estate tax treatment of any decedent who relinquished his U.S. citizenship within 10 years of death, if the decedent's loss of U.S. citizenship had as one of its principal purposes a tax avoidance motive (sec. 2107). The special rule provides that the individual's gross estate includes his pro-rata share of any U.S.-situs property held through a foreign corporation in which the decedent had a 10-percent or greater voting interest, provided that the decedent and related parties together owned more than 50 percent of the voting power of the corporation. A special gift tax rule also provides that gifts of intangible property having a situs within the United States (e.g., stocks and bonds) made by a nonresident alien who relinquished his U.S. citizenship within the 10-year period ending on the date of transfer are subject to U.S. gift tax, if the loss of U.S. citizenship had as one of its principal purposes a tax avoidance motive (sec. 2501(a)(3)).

Description of Proposal

The proposal (H.R. 1812, as reported by the Committee on June 13, 1995) would expand and substantially strengthen in several ways the present-law provisions that subject U.S. citizens who lose their citizenship for tax avoidance purposes to special tax rules for 10 years after such loss of citizenship (secs. 877, 2107, and 2501(a)(3)). First, the proposal would extend the expatriation tax provisions to apply not only to U.S. citizens who lose their citizenship, but also to certain long-term residents of the United States whose U.S. residency is terminated. Second, the proposal would subject certain individuals to the expatriation tax provisions without inquiry as to their motive for losing their U.S. citizenship or residency, but would allow certain categories of citizens to show an absence of tax-avoidance motives if they request a ruling from the Secretary of the Treasury as to whether the loss of citizenship had a principal purpose of tax avoidance. Third, the proposal would expand the categories of income and gains that are treated as U.S. source (and therefore subject to U.S. income tax under section 877) if earned by an individual who is subject to the expatriation tax provisions and would include provisions designed to eliminate the ability to engage in certain transactions that under current law partially or completely circumvent the 10-year reach of section 877. Further, the proposal would provide relief from double taxation in circumstances where another country imposes tax on items that would be subject to U.S. tax under the expatriation tax provisions.

The proposal also contains provisions to enhance compliance with the expatriation tax provisions. The proposal would impose information reporting obligations on U.S. citizens who lose their citizenship and long-term residents whose U.S. residency is terminated at the time of expatriation. In addition, the proposal would direct the Treasury Department to undertake a study regarding compliance by individuals living abroad with their U.S. tax reporting obligations and to make recommendations with respect to improving such compliance.

Effective Date

The modified expatriation tax provisions generally would apply to any individual who loses U.S. citizenship on or after February 6, 1995, and any long-term residents whose U.S. residency is terminated on or after June 13, 1995. For citizens, the determination of the date of loss of citizenship would remain the same as under present law (i.e., the date of loss of citizenship would be the date of the expatriating act). However, a special transition rule would apply to individuals who committed an expatriating act within one year prior to February 6, 1995, but had not applied for a certificate of loss of nationality ("CLN") as of such date. Such an individual would be subject to the modified expatriation tax provisions as of the date of application for the CLN, but would not be retroactively liable for U.S. income taxes on his or her worldwide income. In order to qualify for the exceptions provided for individuals who fall within one of the specified categories, such individuals would be required to submit a ruling request within 1 year after the date of enactment of the bill. The information reporting provisions would apply to U.S. citizens who lose their citizenship and long-term residents whose U.S. residency is terminated after the date of enactment.

20. Provide that rollover of gain on sale of a principal residence cannot be elected unless the replacement property purchased is located in the United States

Present Law

Generally, no gain is recognized on the sale or exchange of a principal residence to the extent that the amount of the sales price of the old residence is reinvested in a new residence within a specified period ("the rollover"). The specified period generally is a period beginning two years before the sale of the old residence and ending two years after the sale of the old residence. There is no requirement that either the old residence or new residence be located within the United States or its possessions.

Description of Proposal

Generally, the proposal would recognize gain on the sale or exchange of a principal residence by a resident alien unless the resident alien (1) retains resident alien status for at least two years after the date of sale, (2) becomes a U.S. citizen within two years of the date of sale, or (3) acquires a replacement residence located in the U.S. or its possessions within the specified time period.

The proposal would not apply where (1) the old residence is held jointly by the resident alien and the resident alien's spouse, (2) they file a joint tax return, and (3) the spouse is a U.S. citizen on the date of sale of the old residence.

Effective Date

The proposal would apply to the sale of old residences after December 31, 1995, unless a replacement residence was purchased before September 13, 1995, or purchased on or after such date pursuant to a binding contract in effect on such date and at all times thereafter before such purchase.

21. Sunset the low-income housing tax credit after December 31, 1997

Present Law

A tax credit having a 70-percent present value is allowed on qualified low-income rental housing. The credit is reduced to 30 percent for housing receiving most other Federal subsidies. In certain difficult-to-develop areas, the credit is increased by 30 percent (e.g., from 70 percent to 91 percent). The credit applies to the eligible basis of low-income housing units.

Credits are subject to annual allocations of $1.25 per resident of each State. State housing agencies allocate this amount among eligible projects. Credit amounts that are not allocated in the year in which the cap amount arises may be carried forward by the State for allocation in the following year. Any amounts remaining unallocated after that time revert to a national pool and are reallocated among States that allocated their entire credit amount in the preceding year.

In response to reports that substantial amounts of low-income housing credit possibly are being improperly claimed, and that the Internal Revenue Service and State administering agencies are not adequately monitoring the credit program, the Chairman on July 5, 1995, requested the General Accounting Office to review the administration of the credit and report to the Committee during 1996. This study will examine issues such as: (1) whether the credit it being allocated to projects in which low-income tenants are charged full market rents; (2) whether inappropriate amounts of the subsidy are being diverted from low-income tenants to developers and syndicators through their fees or to owners through higher than necessary rates of return on their investments; (3) what controls, if any, exist at the State level to ensure that the credit is allocated as intended and that costs are reasonable; and (4) how efficiently the IRS is administering the credit program. The Chairman has requested that the Subcommittee on Oversight oversee the study and review its findings.

Description of Proposal

The low-income housing tax credit would be sunset after December 31, 1997, to facilitate a review by the Committee of whether it should be modified and/or retained after receiving the report by the General Accounting Office, described above.

Credits allocated from annual State credit caps arising before this expiration date would be unaffected. Similarly, credits for projects financed with tax-exempt bonds issued before January 1, 1998, which are (a) placed in service before that date or (b) during a transition period after December 31, 1997 would be unaffected.

The provisions under which certain unused credit cap amounts are redistributed among States by a national pool would be repealed after December 31, 1995. Thus, no national pool allocations would be made in 1996 and subsequent years.

Effective Date

The proposal would be effective on the date of enactment.

22. Repeal tax credit for contributions to community development corporations

Present Law

Taxpayers are entitled to claim a tax credit for certain contributions made to one of 20 non-profit community development corporations (CDCs) selected by the Secretary of HUD to provide assistance in economically distressed areas. If a taxpayer makes a qualified contribution (i.e., a cash payment to a CDC, which can be made in the form of an equity investment or 10-year loan, the principal of which is to be returned to the taxpayer no sooner than after 10 years), the credit may be claimed by the taxpayer for each taxable year during the 10-year period beginning with the taxable year during which the contribution was made. The credit that may be claimed for each year is equal to 5 percent of the amount of the contribution to the CDC. Thus, during the 10-year credit period, the taxpayer may claim aggregate credit amounts totalling 50 percent of his or her contribution.[30] The aggregate amount of contributions that may be designated by any one CDC as eligible for the credit may not exceed $2 million. (Thus, a total amount of $40 million in contributions will be available for the credit with respect to all 20 selected CDCs--and the maximum credit amounts will total $20 million over the 10-year credit period.) The CDCs must use the

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[30] The contribution to the CDC must be available for use by the CDC for at least ten years, but need not meet the requirements of a "contribution or gift" for purposes of section 170. In other words, a contribution eligible for the credit may be made in the form of a 10-year loan (or other long-term investment), the principal of which is to be returned to the taxpayer after the 10-year period. However, in the case of a donation of cash made by a taxpayer to an eligible CDC, the taxpayer is allowed to claim a charitable contribution deduction (subject to other present-law rules under section 170), in addition to the special credit for qualified contributions to a selected CDC.

contributions to provide employment and business opportunities to low-income residents who live in an area where the unemployment rate is not less than the national unemployment rate and the median family income does not exceed 80 percent of the median gross income of residents of the jurisdiction of the local government which includes such area.

On June 30, 1994, the Secretary of HUD announced the 20 CDCs selected to receive contributions that qualify the for the credit. The eligible CDCs are located in the following areas: (1) Atlanta, (2) Baltimore, (3) Boston, (4) Chicago, (5) Cleveland, (6) Dallas, (7) Washington D.C., (8) Los Angeles, (9) Memphis, (10) Miami, (11) Brooklyn, (12) Newark, (13) Watsonville, Ca., (14) London, Ky., (15) Wiscasset, Maine, (16) Greenville, Miss., (17) Mayville, N.Y., (18) Barnesboro, Pa., (19) San Antonio, Texas, and (20) Christiansburg, Va.

Description of Proposal

The special credit for qualified contributions to selected community development corporations would be repealed.

Effective Date

The proposal would be effective for contributions made after the date of enactment (other than a contribution made pursuant to a legally enforceable agreement to make such contribution, if such agreement is in effect on the date of enactment).

23. Repeal advance refunds of diesel fuel tax for diesel cars and light trucks

Present Law

Excise taxes are imposed on gasoline (11.5 cents per gallon) and diesel fuel (17.5 cents per gallon) to fund the Federal Highway Trust Fund. Before 1985, the gasoline and diesel fuel tax rates were the same. The predominate highway use of diesel fuel is by trucks. In 1984, the diesel excise tax rate was increased above the gasoline tax as the revenue offset for a reduction in the annual heavy truck use tax. Because automobiles, vans, and light trucks, did not benefit from the use tax reductions, a provision was enacted allowing first purchasers of model year 1979 and later diesel-powered automobiles and light trucks a tax credit to offset this increased diesel fuel tax. The credit is $102 for automobiles, and $198 for vans and light trucks.

Description of Proposal

The tax credit for purchasers of diesel-powered automobiles and light trucks would be repealed.

Effective Date

The proposal would be effective for vehicles purchased after December 31, 1995.

24. Apply failure to pay penalty to substitute returns

Present Law

Section 6651(a)(2) provides that the IRS may assess a penalty for failure to pay tax from the due date of the return until the tax is paid. If no return is filed by the taxpayer and the IRS files a substitute return under section 6020, the tax on which the penalty is measured is considered a deficiency assessable under section 6212 or 6213, and the failure to pay penalty begins to accumulate ten days after the IRS sends the taxpayer a notice and demand for payment of the tax.

Description of Proposal

The proposal would apply the failure to pay penalty to substitute returns in the same manner as the penalty applies to delinquent filers.

Effective Date

The proposal would apply in the case of any return the due date for which (determined without regard to extensions) is after the date of enactment.

25. Repeal section 280A(g) relating to exclusion for certain rental income

Present Law

Gross income for purposes of the Internal Revenue Code generally includes all income from whatever source derived, including rents. The Code (sec. 280A(g)) provides a *de minimis* exception to this rule where a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year. In this case, the income from such rental is not included in gross income and no deductions arising from such rental use are allowed as a deduction.

Description of Proposal

The proposal would repeal the 15-day rules of section 280A(g). The proposal also would provide that no reduction in basis is required if the taxpayer: (1) rented the dwelling unit for less than 15 days during the taxable year, and (2) did not claim depreciation on the dwelling unit for the period of rental.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

26. Intermediate sanctions for certain tax-exempt organizations

Present Law

Private inurement

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

Social welfare organizations.--A tax-exempt social welfare organization described in section 501(c)(4) must be organized on a non-profit basis and must be operated exclusively for the promotion of social welfare. In contrast to section 501(c)(3), however, there is no specific statutory rule in section 501(c)(4) prohibiting the net earnings of a social welfare organization described in section 501(c)(4) from inuring to the benefit of a private shareholder or individual.[31]

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

Sanctions for private inurement and other violations of exemption standards

Organizations described in section 501(c)(3) are classified as either public charities or private foundations. Penalty excise taxes may be imposed under the Code when a public charity makes political expenditures (sec. 4955) or excess or disqualifying lobbying expenditures (secs. 4911 and 4912). However, the Code generally does not provide for the imposition of penalty excise taxes in cases where a 501(c)(3) public charity or a section 501(c)(4) social welfare organization engages in a transaction that results in private inurement. In such cases, the only sanction that specifically is authorized under the Code is revocation of the organization's tax-exempt status. A transaction engaged in by a private foundation (but not a public charity) is subject to special penalty excise taxes under the

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

Code if the transaction is a prohibited "self-dealing" transaction (sec. 4941) or does not accomplish a charitable purpose (sec. 4945).

Filing and public disclosure rules

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

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

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

Description of Proposals

Extend private inurement prohibition to social welfare organizations

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

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

Intermediate sanctions for excess benefit transactions

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

An "excess benefit transaction" would be defined as: (1) any transaction in which an economic benefit is provided to, or for the use of, any disqualified person if the value of the economic benefit provided directly by the organization (or indirectly through a controlled entity[32]) to such person exceeds the value of consideration (including performance of services) received by the organization for providing such benefit; and (2) to the extent provided in Treasury Department regulations, any transaction in which the amount of any economic benefit provided to, or for the use of, any disqualified person is determined in whole or in part by the revenues of the organization, provided that the transaction constitutes prohibited inurement under present-law section 501(c)(3) or under section 501(c)(4), as amended. Thus, "excess benefit transactions" subject to excise taxes would include transactions in which a disqualified person engages in a non-fair-market-value transaction with an organization or receives unreasonable compensation, as well as financial

[32] A tax-exempt organization could not avoid the private inurement proscription by causing a controlled entity to engage in an excess benefit transaction. Thus, for example, if a tax-exempt organization causes its taxable subsidiary to pay excessive compensation to an individual who is a disqualified person with respect to the parent organization, such transaction would be an excess benefit transaction.

arrangements (to the extent provided in Treasury regulations) under which a disqualified person receives payment based on the organization's income in a transaction that violates the present-law private inurement prohibition. The Committee would express its intent that the Treasury Department will issue prompt guidance providing examples of revenue-sharing arrangements that violate the private inurement prohibition.

Existing tax-law standards would apply in determining reasonableness of compensation and fair market value. Consistent with such standards, the parties to a transaction would be entitled to rely on a rebuttable presumption of reasonableness with respect to a compensation arrangement with a disqualified person if such arrangement was approved by an independent board (or an independent committee authorized by the board) that: (1) was composed entirely of individuals unrelated to and not subject to the control of the disqualified person(s) involved in the arrangement; (2) obtained and relied upon appropriate data as to comparability (e.g., compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the location of the organization, including the availability of similar specialties in the geographic area; independent compensation surveys by nationally recognized independent firms; or actual written offers from similar institutions competing for the services of the disqualified person); and (3) adequately documented the basis for its determination (e.g., the record includes an evaluation of the individual whose compensation was being established and the basis for determining that the individual's compensation was reasonable in light of that evaluation and data).[33] If these three criteria are satisfied, penalty excise taxes could be imposed under the bill only if the IRS develops sufficient contrary evidence to rebut the probative value of the evidence put forth by the parties to the transaction (e.g., the IRS could establish that the compensation data relied upon by the parties was not for functionally comparable positions or that the disqualified person, in fact, did not substantially perform the responsibilities of such position). A similar rebuttable presumption would arise with respect to the reasonableness of the valuation of property sold or otherwise transferred (or purchased) by an organization to (or from) a disqualified person if the sale or transfer (or purchase) is approved by an independent board that uses appropriate comparability data and adequately documents its determination.

The proposal specifically would provide that the payment of personal expenses and benefits to or for the benefit of disqualified persons, and non-fair-market-value transactions benefiting such persons, would be treated as compensation only if it is clear that the organization intended and made the payments as compensation for services. In determining

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

whether such payments or transactions are, in fact, compensation, the relevant factors would include whether the appropriate decision-making body approved the transfer as compensation in accordance with established procedures and whether the organization and the recipient reported the transfer (except in the case of non-taxable fringe benefits) as compensation on the relevant forms (i.e., the organization's Form 990, the Form W-2 provided by the organization to the recipient, the recipient's Form 1040, and other required returns).[34]

"Disqualified person" would mean any person who is (1) an "organization manager" (meaning any officer, director, or trustee of an organization or any individual having powers or responsibilities similar to those of officers, directors, or trustees) or (2) any individual (other than an organization manager) who is in a position to exercise substantial influence over the affairs of the organization.[35] In addition, "disqualified persons" would include certain family members and 35-percent owned entities[36] of any person described in (1) or (2) above, as well as any person who was a disqualified person at any time during the five-year period prior to the transaction at issue.

A disqualified person who benefits from an excess benefit transaction would be subject to a first-tier penalty tax equal to 25 percent of the amount of the excess benefit (i.e., the amount by which a transaction differs from fair market value, the amount of compensation exceeding reasonable compensation, the amount of a loan to an organization manager, or the amount of a prohibited transaction based on the organization's gross or net income). Organization managers who participate in an excess benefit transaction knowing

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[34] With the exception of nontaxable fringe benefits described in present-law section 132 and other types of nontaxable transfers such as employer-provided health benefits and contributions to qualified pension plans, an organization could not demonstrate that it clearly indicated its intent to treat economic benefits provided to a disqualified person as compensation for services merely by claiming, at the time of an IRS audit and without substantiation that is contemporaneous with the transfer of economic benefits at issue, that such benefits may be viewed as part of the disqualified person's total compensation package.

[35] The Committee would express its intent that a person could be in a position to exercise substantial influence over a tax-exempt organization despite the fact that such person is not an employee of (and receives no compensation directly from) a tax-exempt organization but is formally an employee of (and is directly compensated by) a subsidiary -- even a taxable subsidiary -- controlled by the parent tax-exempt organization.

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

that it is an improper transaction would be subject to a first-tier penalty tax of ten percent of the amount of the excess benefit (subject to a maximum penalty of $10,000).

Additional, second-tier taxes could be imposed on a disqualified person if there is no correction of the excess benefit transaction within a specified time period.[37] In such cases, the disqualified person would be subject to a penalty tax equal to 200 percent of the amount of excess benefit. For this purpose, the term "correction" would mean undoing the excess benefit to the extent possible and, where fully undoing the excess benefit is not possible, taking such additional corrective action as is prescribed by Treasury regulations.

The intermediate sanctions for "excess benefit transactions" could be imposed by the IRS in lieu of (or in addition to) revocation of an organization's tax-exempt status.[38] If more than one disqualified person or manager is liable for a penalty excise tax, then all such persons would be jointly and severally liable for such tax. As under current law, a three-year statute of limitations would apply, except in the case of fraud (sec. 6501). Under the proposal, the IRS would have authority to abate the excise tax penalty (under present-law section 4962) if it is established that the violation was due to reasonable cause and not due to willful neglect and the transaction at issue was corrected within the specified period.

To prevent an organization from avoiding the penalty excise taxes through termination of its tax-exempt status, the proposal also would impose a tax on tax-exempt organizations that terminate their tax-exempt status. The amount of the tax would be equal to the lesser of (1) the aggregate tax benefits that an organization can substantiate that it has received from its exemption from tax under Code section 501(a), or (2) the value of the net assets of such organization.[39] The Secretary of the Treasury would be permitted to abate all or a portion of the tax if a tax-exempt organization distributes all of its net assets to one or more charitable organizations described in Code section 501(c)(3) that have been in existence for a continuous 5-year period. Tax-exempt organizations that are described in Code section 501(c)(4) would be permitted to distribute their net assets to one or more

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

[38] The Committee would express its general expectation that the intermediate sanctions would be the sole sanction available in those cases in which the excess benefit does not rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization. In general, revocation of tax-exempt status, with or without the imposition of excise taxes, would be an appropriate sanction only when the organization no longer operates for a charitable or other tax-exempt purpose.

[39] In calculating these amounts, rules similar to the rules applicable to private foundations set forth in Code section 507(d),(e), and (f) would apply.

organizations described in Code section 501(c)(3) or 501(c)(4) that have been in existence for a continuous 5-year period. An organization would be permitted to terminate its exempt status only if it has paid the tax (or any portion thereof that is not abated) and the organization has notified the Secretary of its intent to terminate its exempt status (or the Secretary has made a final determination that such status has terminated).

Effective date.--The proposal generally would apply to excess benefit transactions occurring on or after September 14, 1995. The proposal would not apply, however, to any transaction pursuant to a written contract for the performance of personal services which was binding on September 13, 1995, and at all times thereafter before such transaction occurred, and the terms of which have not materially changed.

Additional filing and public disclosure rules

Reporting of identity of certain disqualified persons, excise tax penalties and excess benefit transactions.--Tax-exempt organizations would be required to disclose on their Form 990 the names of each disqualified person who received an economic benefit during the taxable year and such other information as may be required by the Secretary of the Treasury. In addition, exempt organizations would be required to disclose on their Form 990 such information as the Secretary of the Treasury may require with respect to "excess benefit transactions" (described above) and any other excise tax penalties paid during the year under present-law sections 4911 (excess lobbying expenditures), 4912 (disqualifying lobbying expenditures), or 4955 (political expenditures), including the amount of the excise tax penalties paid with respect to such transactions, the nature of the activity, and the parties involved.[40]

Furnishing copies of documents.--The proposal also would provide that a tax-exempt organization that is subject to the public inspection rules of present-law section 6104(e)(1) (i.e., any tax-exempt organization, other than a private foundation, that files a Form 990) would be required to comply with requests from individuals who seek a copy of the organization's Form 990 or the organization's application for recognition of tax-exempt status and certain related documents. Upon such a request, the organization would be required to supply copies without charge other than a reasonable fee for reproduction and mailing costs. If so requested, copies must be supplied of the Forms 990 for any of the organization's three most recent taxable years. If the request for copies were made in

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

person, then the organization would have to immediately provide such copies. If the request for copies were made other than in person (e.g., by mail or telephone), then copies would have to be provided within 30 days. However, an organization could be relieved, for a limited period of time, of its obligation to provide copies if the Secretary of the Treasury determined, upon application by the organization, that the organization was subject to a harassment campaign such that waiver of the obligation to provide copies would be in the public interest.

Advertisements and solicitations.--The proposal further would require that written advertisements or solicitations made by (or on behalf of) a tax-exempt organization that is subject to the public inspection rules of present-law section 6104(e)(1) must contain an express statement, in a conspicuous and easily recognizable format, that the organization's Forms 990 are available to individuals upon request.[41] Failure to make the required disclosure in an advertisement or solicitation would subject the organization to a penalty of $100 for each day on which the failure occurred. However, no penalty could be imposed with respect to a failure if it is shown that such failure was due to reasonable cause. The proposal generally would limit the maximum penalty to $10,000 for all such failures by an organization during any calendar year.[42]

In addition, the proposal would require entities that do not have Federal tax-exempt status but that describe themselves in advertisements or solicitations as "nonprofit" to disclose in an express statement that contributions to the entity are not deductible as charitable contributions for Federal income tax purposes. Failure to make the disclosure would subject the entity to penalties under section 6710.

Electronic dissemination of information.--The proposal would require the Treasury Department to provide copies of annual returns and applications for recognition of tax-exempt status filed by exempt organizations to any organization that agrees to accept broad categories of such returns and applications and to provide electronic access to all such documents on an electronic network to the general public. Such returns and applications would be provided free of charge to organizations that do not charge a fee for public access; if an organization charges a fee for public electronic access, the Treasury Department would be allowed to charge a reasonable fee for reproduction and mailing costs.

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[41] The Committee would express its intent that the Department of Treasury will provide prompt guidance on this requirement.

[42] However, if a failure to comply with the disclosure requirement for solicitations were due to intentional disregard, then the $10,000 limitation would not apply, and the penalty for each day on which such an intentional failure occurred would be the greater of (1) $1,000 or (2) 50 percent of the aggregate cost of the solicitations which occurred on such day and with respect to which there was intentional disregard of the disclosure requirement.

Penalties for failure to file timely or complete return.--The section 6652(c)(1)(A) penalty imposed on a tax-exempt organization that either fails to file a Form 990 in a timely manner or fails to include all required information on a Form 990 would be increased from the present-law level of $10 for each day the failure continues (with a maximum penalty with respect to any one return of the lesser of $5,000 or five percent of the organization's gross receipts) to $20 for each day the failure continues (with a maximum penalty with respect to any one return of the lesser of $10,000 or five percent of the organization's gross receipts). Under the proposal, organizations with annual gross receipts exceeding $1 million would be subject to a penalty under section 6652(c)(1)(A) of $100 for each day the failure continues (with a maximum penalty with respect to any one return of $50,000). As under present law, no penalty could be imposed under section 6652(c)(1)(A) if it were shown that the failure to file a complete return was due to reasonable cause (sec. 6652(c)(3)).

Penalties for failure to allow public inspection.--The section 6652(c)(1)(C) penalty imposed on tax-exempt organizations that fail to allow public inspection of certain annual returns or applications for exemption would be increased from the present-law level of $10 per day (with a maximum of $5,000) to $20 per day (with a maximum of $10,000). In addition, the section 6685 penalty for willful failure to allow public inspections would be increased from the present-law level of $1,000 to $5,000.

Treasury Department studies.--The proposal would direct the Treasury Department to: (1) study and make recommendations regarding application of an explicit statutory private inurement prohibition, and intermediate sanctions, to other tax-exempt organizations; (2) study and make recommendations to the Congress on whether certain State officers, such as the attorney general and other officials charged with overseeing public charities, should be provided with additional access to Federal tax information beyond that authorized under section 6103; and (3) review the Form 990 reporting requirements to ensure the Form's utility to IRS and the public and to reduce unnecessary reporting burdens.

Effective dates.--The filing and disclosure provisions governing tax-exempt organizations generally would take effect on January 1, 1996 (or, if later, 90 days after enactment). However, the provisions regarding the reporting on annual returns of excise tax penalties and excess benefit transactions would be effective for returns with respect to taxable years beginning on or after January 1, 1995. The requirement that the Treasury Department provide copies of annual returns and applications for recognition of tax-exempt status for electronic dissemination would apply to returns and applications filed on or after January 1, 1996; it would apply to returns and applications filed prior to January 1, 1996, only to the extent provided by the Secretary of the Treasury. The Treasury Department studies would be required to be transmitted to Congress by January 1, 1997.

27. Repeal exemption for withholding on gambling winnings from bingo and keno where proceeds exceed $5,000

Present Law

In general, proceeds from a wagering transaction are subject to withholding at a rate of 28 percent if the proceeds exceed $5,000 and are at least 300 times as large as the amount wagered. The proceeds from a wagering transaction are determined by subtracting the amount wagered from the amount received. Any non-monetary proceeds that are received are taken into account at fair market value.

In the case of sweepstakes, wagering pools, or lotteries, proceeds from a wager are subject to withholding at a rate of 28 percent if the proceeds exceed $5,000, regardless of the odds of the wager.

No withholding tax is imposed on winnings from bingo or keno.

Description of Proposal

The proposal would impose withholding on proceeds from bingo or keno wagering transactions at a rate of 28 percent if such proceeds exceed $5,000, regardless of the odds of the wager.

Effective Date

The proposal would be effective on January 1, 1996.