[JOINT COMMITTEE PRINT]

DESCRIPTION OF THE TECHNICAL CORRECTIONS ACT OF 1985 (H.R. 1800 AND S. 814)

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet [1] describes provisions of the Technical Corrections Act of 1985 (H.R. 1800, introduced by House Ways and Means Committee Chairman Rostenkowski and Congressman Duncan, and S. 814, introduced by Senate Finance Committee Chairman Packwood and Senator Long). The bills (introduced on March 28, 1985) contain revisions to the Deficit Reduction Act of 1984 (Public Law 98-369) and certain other recently enacted legislation.

The amendments made by the Technical Corrections Act of 1985 are intended to clarify and conform various provisions adopted by the original legislation. The bills generally are based on a review by the staffs of the Joint Committee on Taxation, the Committee on Ways and Means, and the Committee on Finance, taking into account comments submitted to the Congress that concerned changes that would be technical in nature. The bills were developed with the assistance of the Treasury Department, the Social Security Administration, and the Health Care Financing Administration.

Part I of the pamphlet is the description of the provisions of the bills relating to the Tax Reform Act of 1984 and other recently enacted tax legislation. Part II of the pamphlet is a description of the provisions of the bills relating to other provisions of the Deficit Reduction Act of 1984. Amendments in the bills for which no descriptions are provided are clerical in nature.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of the Technical Corrections Act of 1985 (H.R. 1800 and S. 814)*, (JCS-7-85), Apr. 14, 1985.

I. DESCRIPTION OF TITLE I OF THE BILL

A. Technical Corrections to Tax Freeze and Tax Reform Provisions

1. Tax Freeze Items

a. Telephone excise tax (sec. 101(a) of the bill and sec. 4251 of the Code)

Present Law

The Tax Reform Act of 1984[1] ("the Act") extended the three-percent telephone excise tax through December 31, 1987. Due to a clerical error in enrolling the Act, the year 1985 was inadvertently deleted.

Explanation of Provision

The bill restores the year 1985 to the table of years for which the three-percent telephone excise tax applies.

b. Requirement of electronic funds transfer for alcohol and tobacco excise taxes (sec. 101(b) of the bill and secs. 5061 and 5703 of the Code)

Present Law

The Act requires persons who were liable for $5 million or more in any alcohol or tobacco excise tax during the preceding calendar year to pay that tax by electronic funds transfer during the succeeding calendar year.

Explanation of Provision

The bill clarifies that all corporations that are members of a controlled group of corporations are treated as one person for purposes of the electronic funds transfer requirement. The term controlled group of corporations has the same meaning as under Code section 1563, except a 50-percent, rather than an 80-percent, common ownership test is applied. It is understood that the Treasury Department administratively will apply this 50-percent common ownership requirement only with respect to taxes due after March 28, 1985.

Additionally, Treasury Department authority to apply these principles to a group of persons under common control where some members of the group are not corporations is clarified.

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[1]Division A of the Deficit Reduction Act of 1984 (Public Law 98-369).

2. Tax-Exempt Entity Leasing

a. Treatment of use in unrelated trade or business (sec. 102(a)(1) of the bill and sec. 168(j)(3)(D) of the Code)

Present Law

In the case of 18-year real property, the Act defines "tax-exempt use property" as the portion of property that is leased to tax-exempt entities under disqualified leases. This definition applies only if the portion of the property leased in a disqualified lease is more than 35 percent of the property. The Act also provides that the term "tax-exempt use property" does not include any portion of a property that is used predominantly in a tax-exempt entity's unrelated trade or business.

Explanation of Provision

The bill clarifies that the portion of a property that is used in a tax-exempt entity's unrelated trade or business is not treated as used pursuant to a disqualified lease. For example, assume that a tax-exempt entity leases 100 percent of a building for a term of 21 years. Eighty percent of the building is used in the tax-exempt entity's unrelated trade or business, and 20 percent is used in its exempt function. No portion of the building constitutes tax-exempt use property because the portion used in a disqualified lease (20 percent) is less than 35 percent of the property.

b. Treatment of certain previously tax-exempt organizations (sec. 102(a)(2) of the bill and sec. 168(j)(4)(E) of the Code)

Present Law

Under the Act, the term "tax-exempt entity" includes any organization (other than certain farmers' cooperatives) that was exempt from U.S. income tax at any time during the five-year period ending on the date the property involved is leased to such organization (or any successor organization engaged in substantially similar activities).

Explanation of Provision

The bill clarifies that the rule for former tax-exempt organizations is not limited to property that is leased to such organizations; the rule applies with respect to any property other than property owned by a former tax-exempt entity or a successor organization. Under the bill, the five-year period ends on the date the property involved is "first used" by a former tax-exempt entity. Property is treated as first used by an organization (a) when the property is first placed in service under a lease to such organization, or (b) in the case of property leased to or owned by a partnership (or other pass-through entity) of which the organization is a member, the later of the day on which the property is first used by the partnership (or other pass-through entity) or the day on which the organization is first a member of such partnership (or other pass-through entity).

c. Repeal of overlapping regulatory authority (sec. 102(a)(3) of the bill and sec. 168(j)(5)(C)(iv) of the Code)

Present Law

The Act authorized the Treasury to determine whether any high-technology telephone station equipment or medical equipment is subject to rapid obsolescence. The Act also provides that the Treasury is to prescribe any other regulations that may be necessary or appropriate to carry out the purposes of section 168(j) (sec. 168(j)(10)).

Explanation of Provision

The bill repeals the overlapping regulatory authority relating to high-technology equipment.

d. Partnership rules (sec. 102(a)(4) of the bill and secs. 168(j)(8)-(9) and 48(a)(5) of the Code)

Present Law

The Act provides that sections 168(j)(8) (relating to property leased to a partnership) and 168(j)(9) (relating to property owned by a partnership) apply for purposes of paragraphs (4) and (5) of section 48(a) (relating to the nontaxable use restriction on investment credits).

Explanation of Provision

The bill clarifies the manner in which the partnership rules in section 168(j) apply for purposes of the investment credit provisions. Any portion of a property that is treated as tax-exempt use property by application of paragraph (8) or (9) of section 168(j) is excluded from the definition of section 38 property under paragraphs (4) and (5) of section 48.

e. Treatment of certain aircraft leased to foreign persons (sec. 102(a)(5) of the bill and secs. 47(a) and 48(a) of the Code)

Present Law

Section 47(a)(7) provides an exception to the investment credit recapture rules for certain leases of aircraft for use predominantly outside the United States. This exception applies if, *inter alia*, an aircraft that qualified for the credit in the taxable year in which it was placed in service would otherwise cease to qualify as section 38 property because it is used predominantly outside the United States.

Under the Act, generally, property that is leased for a term of less than six months qualifies as section 38 property, even if the lease is to a foreign person or entity. In the case of aircraft that is leased to a foreign person before January 1, 1990, and is used under a lease that qualifies for treatment under section 47(a)(7), investment credits are not recaptured if the term of such lease does not exceed three years.

Explanation of Provision

The bill clarifies that the short-term lease exception for aircraft is intended to permit the operation of section 47(a)(7), where property would otherwise cease to qualify as section 38 property because it is leased to a foreign person for use predominantly outside the United States, and not to provide an exception to the definition of section 38 property. The application of this provision is illustrated by the following example. Assume an aircraft is placed in service by a U.S. air carrier on January 1, 1986, and is used for the entire taxable year solely in the United States. On January 1, 1987, the aircraft is leased to a foreign person for use predominantly outside the United States, under a "qualifying lease" (within the meaning of section 47(a)(7)). The term of the lease is two years. Because of the application of new section 47(a)(9), as well as section 47(a)(7), no investment credit is recaptured. If such aircraft is disposed of or otherwise ceases to be section 38 property, investment credit recapture will be determined by disregarding the term of the lease to the foreign person. In the example above, at the end of the two-year lease term, although the U.S. air carrier has actually owned the aircraft for three years, the taxpayer is considered to have used the plane for only one year for purposes of the recapture rules.

f. Treatment of partnerships having section 593 organizations as members (sec. 102(a)(6) of the bill and sec. 46(e)(4) of the Code)

Present Law

Under the Act, the lessor of property to a section 593 organization (or "thrift institution") is entitled to no greater a credit with respect to such property than the thrift institution would have been entitled to had it owned the property. The Act also provides rules designed to prevent taxpayers from circumventing the rules with respect to leased property by use of certain arrangements, other than service contracts but including partnerships, under which a thrift institution obtains the use of property.

Explanation of Provision

The bill clarifies present law by expressly providing that a thrift institution cannot avoid the restriction on property leased to a section 593 organization by use of a partnership.

g. Treatment of certain property held by partnerships (sec. 102(a)(7) of the bill and sec. 168(j)(9) of the Code)

Present Law

If a tax-exempt entity's share of partnership items would be treated as income or loss from an unrelated trade or business under section 511, then the partnership's property will not be treated as tax-exempt use property.

Explanation of Provision

The bill clarifies that the determination of whether a tax-exempt partner's share of partnership items is treated as derived from an unrelated trade or business is to be made without regard to the debt-financed income rules of section 514.

h. Treatment of service contracts (sec. 102(a)(8)(C) of the bill and sec. 7701(e) of the Code)

Present Law

Section 7701(e) provides rules for use in determining whether an arrangement structured as a service contract is more properly treated as a lease.

Explanation of Provision

It is intended that the fact that a contract or arrangement is not treated as a lease under this provision is to be disregarded in determining whether the service recipient is a user for purposes of section 103.

Section 7701(e)(4) is also amended by adding a cross reference to the definition of "related entity" in section 168(j).

i. Effective date provisions (sec. 102(a)(9) of the bill)

(1). Section 31(g)(3)(B) of the Act is amended to clarify that transitional relief is provided only from the application of section 168(j)(9) (as added by the Act).

(2). Section 31(g)(4) of the Act is amended to clarify that certain credit unions qualify for transitional relief.

(3). Section 31(g)(15)(D) of the Act is amended to clarify that the transitional rule for certain aircraft applies to aircraft placed in service after May 23, 1983.

(4). Section 31(g)(20)(B)(ii) of the Act, which provides that improvements to property that qualify for transitional relief also qualify for relief unless the improvement is a substantial improvement, is amended to clarify that the rule applies to personal property, as well as real property. This amendment will not apply to personal property if there was a binding written contract to acquire, construct, or rehabilitate the property (or if construction, reconstruction, or rehabilitation of the property began) on or before March 28, 1985.

3. Bonds and Other Debt Instruments

a. Treatment of amounts received on disposition of short-term obligations (sec. 103(a)(1) and (2) of the bill and sec. 1271 of the Code)

Present Law

Section 1271 expressly provides that any gain realized on disposition of governmental short-term obligations is treated as ordinary income, to the extent of the ratable share of accrued acquisition discount. Long-standing judicial authority and Treasury regulations provide a basis for characterizing accrued original issue discount (OID) as ordinary income on disposition of nongovernmental obligations.

Explanation of Provision

The bill clarifies the treatment of amounts received on disposition of nongovernmental obligations. Under a general rule, any gain realized on disposition of a short-term nongovernmental obligation is treated as ordinary income to the extent of the ratable share of accrued OID. Taxpayers may elect to accrue OID with respect to a short-term nongovernmental obligation under an economic accrual formula, pursuant to which the daily portion of the discount is computed on the basis of the taxpayer's yield to maturity based on the issue price of the obligation, compounded daily. A similar election is provided for the computation of acquisition discount with respect to short-term governmental obligations. An election to account for discount under an economic accrual formula cannot be revoked without the consent of the Secretary.

b. Treatment of deduction of OID on short-term obligations (sec. 103(a)(4) of the bill and sec. 163(e) of the Code)

Present Law

In general, interest on a debt instrument with a maturity of one year or less which is payable at the maturity of the instrument is not deductible by a cash-method issuer until paid. *See* Treas. Reg. sec. 1.1232-3(b)(1)(iii) (providing that such interest is not included in the "stated redemption price at maturity" for purposes of section 1232, the predecessor of section 1273).

Explanation of Provision

The bill clarifies present law by expressly providing in section 163(e) that an issuer of a short-term debt instrument may deduct original issue discount and any other interest only in the year of payment. A similar provision was included in the Conference Report to the Act. That provision was deleted in House Concurrent Resolution 328 (June 29, 1984) because it was deemed to be a mere restatement of preexisting law.

It is understood that some taxpayers have interpreted the deletion of this provision from the Concurrent Resolution as evidencing an intent to modify the prior-law proscription against deduction of interest on an accrual basis by cash-method issuers of short-term obligations. The purpose of this amendment is to clarify that no such result was intended.

c. Treatment of certain transfers of market discount bonds (sec. 103(a)(5) of the bill and sec. 1276(d) of the Code)

Present Law

Under the Act, an obligation issued in an exchange subject to section 351 (which provides nonrecognition treatment where appreciated property is transferred to an 80-percent owned corporation in exchange for stock or securities of the corporation) falls within the definition of the term "market discount bond," without regard to whether the property transferred is a market discount bond (see the discussion of present law in part I.A.3.d., below). Thus, taxpayers are prevented from circumventing the rule that characterizes accrued market discount as interest by swapping a market discount bond for a new bond in a section 351 exchange. A different result may obtain, however, where a taxpayer swaps a market discount bond for stock in a section 351 exchange.

Explanation of Provision

The bill clarifies that taxpayers are prevented from circumventing the market discount provisions by transferring a bond with accrued market discount in a section 351 exchange. Under the bill, accrued market discount is taxed to the transferor of a market discount bond in a section 351 exchange, regardless of whether the transferor receives stock or securities in the exchange. The corporate transferee of the market discount bond will take the bond with a basis that reflects any gain recognized to the transferor (sec. 362(a)). If the stated redemption price of the bond exceeds the transferee's basis immediately after acquisition, then the bond will constitute a market discount bond in the hands of the transferee.

d. Treatment of bonds acquired at original issue for purposes of market discount rules (sec. 103(a)(6) of the bill and sec. 1278(a) of the Code)

Present Law

Because market discount is defined as any excess of stated redemption price over basis (excluding OID), it is arguable that market discount is created on issuance of obligations in certain nonrecognition (or nontaxable) exchanges. An example is provided by the application of the statutory definition to a bond issued in a section 351 exchange. Under section 358, the basis of a bond received in a section 351 exchange is determined by reference to the basis of the property transferred in exchange for the bond (in the hands of the transferor). Thus, the stated redemption price of the bond will exceed its basis to the extent of the appreciation in the transferred property. Assuming no OID, this excess could be viewed as market discount.

The Act provides that the rule that characterizes accrued market discount as interest on disposition of a bond is inapplicable to bonds issued on or before July 18, 1984. If a pre-enactment bond is exchanged for a newly issued bond in a tax-free transaction, however, the new bond is subject to the interest characterization rule, even if the holder of the bond essentially maintains the original investment.

Explanation of Provision

The bill clarifies that, except as provided by statute or by regulation, no market discount is created on the original issuance of a bond.

Under the bill, two statutory exceptions are provided. The first exception relates to bonds that are part of an issue that is publicly offered. Because the Act provides that the issue price of publicly offered bonds (other than bonds issued for property) is the price at which a substantial amount of the bonds are sold, the OID provisions are inapplicable to a portion of the OID with respect to bonds acquired on original issue by large investors at "wholesale" prices (at deeper discounts than those available to "retail" customers). Under the bill, market discount is created on original issuance of a bond if the holder has a cost basis determined under section 1012, and such basis is less than the issue price of the bond. The difference between the holder's issue price and basis is treated as market discount.

The second statutory exception applies to a bond that is issued in exchange for a market discount bond pursuant to a plan of reorganization. This exception is intended to prevent the holder of a market discount bond from eliminating the taint of unaccrued market discount by swapping the bond for a new bond (*e.g.*, in a recapitalization). Solely for purposes of the interest characterization rule, this exception is inapplicable to a bond issued in exchange for a pre-enactment market discount bond where term and interest rate of the new bond is identical to that of the old bond.

If the adjusted basis of a bond is determined by reference to the adjusted basis of the bond in the hands of a person who acquired the bond at original issue, the bond will be treated as acquired by the taxpayer at its original issue.

e. Treatment of certain stripped bonds or stripped coupons (sec. 103(a)(7) of the bill and sec. 1281(b) of the Code)

Present Law

The Act requires the current inclusion in income of OID or acquisition discount with respect to short-term obligations held by certain taxpayers. This provision was intended to limit the scope of the rules that permit deferral to the ordinary investor.

Explanation of Provision

The bill requires the current inclusion in income of OID with respect to stripped bonds and stripped coupons held by the taxpayer who stripped the bond or coupon (or any other person whose basis is determined by reference to the basis in the hands of the stripper). The allowance of a one-year deferral for OID with respect to stripped bonds or stripped coupons held by the stripper presents opportunities for tax avoidance. Taxpayers who engage in coupon stripping do not come within the intendment of the rules that allow a one-year deferral based on the complexity of accrual accounting.

f. Accrual of interest on certain short-term obligations (sec. 103(a)(8) of the bill and sec. 1281(a) of the Code)

Present Law

Under section 1281 of the Code, certain taxpayers are required to include in income as interest for a taxable year that portion of the acquisition discount or OID on a short-term obligation that is allocable to the portion of the taxable year during which the taxpayer held the obligation. Acquisition discount is defined as the excess of the stated redemption price at maturity over the taxpayer's basis in the obligation. Similarly, OID is defined as the excess of the stated redemption price at maturity over the issue price of the obligation. The taxpayers affected are those for whom the cash method of accounting for interest income from short-term obligations is considered inappropriate.

Explanation of Provision

The bill clarifies that taxpayers subject to the rule for mandatory accrual are required to include in income for a taxable year all amounts of interest allocable to that year with respect to short-term obligations, irrespective of whether the interest is stated or is in the form of acquisition discount or OID, and irrespective of when any stated interest is paid. For example, a calendar-year taxpayer designated in section 1281(b) holds an obligation from the time it is issued on October 1, 1985 until its maturity on October 1, 1986. Under the bill, the taxpayer is required to include in income for 1985 the equivalent of three months interest on the obligation, regardless of whether the interest income is in the form of acquisition discount, OID, stated interest, or any combination thereof.

g. Treatment of debt instruments issued for property where there is public trading (sec. 103(a)(10) of the bill and sec. 1273(b) of the Code)

Present Law

Under section 1273(b) of the Code, where an issue of debt instruments is publicly offered for cash, the issue price of each instrument is the initial offering price to the public (excluding bond houses and brokers) at which a substantial amount of such debt instruments is sold. Where an issue of debt instruments is sold for cash other than by public offering, the issue price for each instrument is the price paid by the first buyer.

If a debt instrument is issued for property and either the debt instrument is traded on an established securities market or the property for which it is issued is stock or securities which are traded on an established securities market, the issue price of the instrument is the fair market value of the property.

Explanation of Provision

If stock or securities which are traded on an established securities market are exchanged for debt instruments all of which are part of the same issue, but the value of the stock or securities fluctuated to any extent during the period in which the debt instruments were issued for such property, the debt instruments may have different issue prices. In order to avoid the administrative problems of having different issue prices, the bill provides a rule for determining the issue price in these situations which is analogous to the rule applicable where debt is issued for cash or is itself traded. Accordingly, under the provision, where an issue of debt instruments is issued solely for property, and either the debt instruments or the property is traded on an established securities market, the issue price for all of the debt instruments which are part of such issue will be the fair market of the property as of the time that a substantial amount of the debt instruments is issued. In addition, the provision permits the Secretary to designate in regulations other types of publicly traded property which for purposes of the issue price provisions will be treated like publicly traded stock or securities.

4. Imputed Interest

a. Treatment of transfers of land between related parties (sec. 103(a)(9) of the bill and sec. 483(f) of the Code)

Present Law

Section 483 provides that the stated interest rate on a debt instrument issued for nontraded property must at least equal 110 percent of the applicable Federal rate, as determined under section 1274(d) (but see sec. 44(b)(4) of the Act, as added by sec. 2 of Public Law 98-612, providing for a lower rate in certain cases). If inadequate interest is stated, interest is imputed at a higher rate.

Under section 483(f), the maximum rate at which interest may be imputed on land sales between members of the same family is 7 percent, compounded semiannually. This maximum rate is available only to the extent that the aggregate sales between that parties do not exceed $500,000 during the calendar year.

Prior to the Act, section 483 required that the test rate be at least 1 percentage point below the imputation rate. Section 483 as amended by the Act is silent as to the maximum test rate in related party sales.

Explanation of Provision

The bill clarifies that the maximum testing rate in qualified sales between family members under section 483(f) is 6 percent, compounded semiannually.

b. Clarification of transitional rule (sec. 103(b)(1) of the bill and sec. 44 of the Act)

Present Law

Section 44(b) of the Act (relating to effective dates), as amended by section 2 of Public Law 98-612, provides special test and imputation rates under sections 1274 and 483 for certain transactions occurring before July 1, 1985.

Explanation of Provision

The bill clarifies that the effective date for new section 1274 and section 483 as amended by the Act— transactions after December 31, 1984—is not accelerated by section 2 of Public Law 98-612.

c. Clarification of interest accrual with respect to transactions involving adequate stated interest (sec. 103(b)(2) of the bill and sec. 44(b)(3) of the Act)

Present Law

Section 44(b)(3)(A)(i)(I) of the Act provides that, after March 1, 1984, and before January 1, 1985 (the date on which new section 483 becomes effective), the unstated interest allocable to a taxable year must be computed on an economic accrual basis. Section 44(b)(3)(A)(i)(II) proscribes the accrual of interest on a noneconomic basis with respect to debt instruments issued in a sale or exchange after June 8, 1984, and before January 1, 1985, where there is adequate stated interest for purposes of section 483. The Act contains an exception for transactions pursuant to binding contracts in effect on March 1, 1984.

Explanation of Provision

The bill clarifies that, in the case of debt instruments issued for property in transactions occurring after December 31, 1984, whether involving adequate stated interest or inadequate stated interest, interest may not be computed using any method other than economic accrual, as described in Rev. Rul. 83-84, 1983-1 C.B. 9.

The bill also changes the binding contract date applicable to transactions involving adequate stated interest. The exception to the statutory requirement of economic accrual is made applicable to transactions occurring pursuant to a written contract that was binding on June 8, 1984 and at all times thereafter until the transaction was closed. No inference is intended regarding the proper treatment (under other provisions of the Code, or under general tax law priciples) of noneconomic accruals of interest with respect to obligations issued before the effective date of the Act.

5. Corporate Provisions

a. Debt-financed portfolio stock (sec. 104(a) of the bill and sec. 246A of the Code)

Present Law

The Act added a provision generally limiting the dividends received deduction for dividends received by a corporate shareholder with respect to debt-financed portfolio stock.

Explanation of Provision

The bill clarifies the rules for applying the provision in cases in which dividends are received from certain foreign corporations engaged in business in the United States. For example, assume that 70 percent of a domestic corporation's purchase price for portfolio stock of a foreign corporation described in section 245(a) is debt financed. Assume further that 60 percent of that foreign corporation's gross income is effectively connected with the conduct of a trade or business in the United States. In the absence of section 246A, the domestic corporation generally would be entitled to deduct 51 percent (85 percent times 60 percent) of any dividend received from the foreign corporation. Under section 246A and the bill, the domestic corporation generally is entitled to deduct only 15.3 percent ((30 percent times 85 percent) times 60 percent) of any such dividend.

b. Holding period rules for dividend received deduction (sec. 104(b)(1) of the bill and sec. 246(c) of the Code)

Present Law

Under present law, as amended by the Act, a corporation must hold stock for 45 days (90 days in the case of certain preference dividends) in order to obtain a dividend received deduction with respect to any dividend on that stock. Days more than 45 days after the ex-dividend date and days on which the corporation's risk of loss is diminished are not taken into account. Under these rules, it can thus be determined on the 45th day after the ex-dividend date whether or not the holding period requirement will be met. However, present law disallows the deduction only when the stock is disposed of by the corporation. Thus, present law appears to retroactively deny the dividends received deduction when the corporation disposes of the stock. This may require filing amended returns in some cases and in other cases the period of limitations may expire.

Explanation of Provision

In order to eliminate the administrative problems caused by the disposition requirement, the bill disallows the dividend received deduction where the holding period requirement is not met, without regard to whether the stock has been disposed of.

c. Application of related party rule to section 265(2) of the Code (sec. 104(b)(2) of the bill and sec. 53(e) of the Act).

Present Law

Section 265(2) of the Code disallows the deduction of interest incurred or continued to purchase or carry tax-exempt obligations. This rule applies both to individual and corporate taxpayers.

The Act (Code sec. 7701(f)) provides that the Treasury Department is to prescribe such regulations as may be necessary or appropriate to prevent the avoidance of Federal tax provisions which deal with (i) the linking of borrowing to investment, or (ii) diminishing risks, through the use of related persons, pass-through entities, or other intermediaries. This provision was specifically intended to apply to (but not to be limited to) the disallowance rule provided by sections 265(2).

Under the Act, the provision regarding related persons, pass-through entities, and other intermediaries was effective on the date of enactment (July 18, 1984).

Explanation of Provision

Under the bill, the provision regarding related parties, pass-through entities, and other intermediaries generally remains effective as of July 18, 1984 (i.e., the date of enactment). However, the bill clarifies that this provision, insofar as it relates to section

265(2) of the Code only, is effective for (i) term loans made after July 18, 1984, and (ii) demand loans outstanding after July 18, 1984 (other than any loan outstanding on July 18, 1984, and repaid before September 18, 1984). "Demand loans" mean any loan which is payable in full at any time on the demand of the lender. For purposes of this effective date rule, any loan renegotiated, extended, or revised after July 18, 1984, is treated as a loan made after such date.

d. Exempt-interest dividends from regulated investment companies (sec. 104(c) of the bill and sec. 852 of the Code)

Present Law

Prior to the Act, a taxpayer could convert short-term capital gain into long-term capital gain by buying stock of a regulated investment company (or real estate investment trust) immediately before the ex-dividend date of a long-term capital gain distribution, receiving that distribution, waiting 32 days, and then selling the stock. The Act made conversion of this type more difficult. However, a problem similar to the long-term capital gain distribution problem that existed before the Act remains with respect to exempt-interest dividends received from a regulated investment company. Under present law, a taxpayer can buy stock of a regulated investment company immediately before the ex-dividend date of an exempt-interest dividend, receive that dividend, wait 32 days, and then sell the stock. Any loss on the sale generally is recognized.

Explanation of Provision

Under the bill, if a taxpayer holds stock of a regulated investment company for 6 months or less, any loss on the sale or exchange of that stock is disallowed to the extent the taxpayer received exempt-interest dividends with respect to that stock. Conforming amendments are made, and an exception is provided for dispositions pursuant to a periodic liquidation plan.

The provision applies to stock with respect to which the taxpayer's holding period begins after March 28, 1985.

e. Definition of affiliated group (sec. 104(d)(1) and (6) of the bill and sec. 1504 of the Code)

Present Law

The Act substantially revised the definition of "affiliated group". To apply the new rules, a determination must be made as to the ownership of "stock" of a corporation. Under the Act and section 1504(a)(4), "stock" does not include stock which, among other things, has redemption and liquidation rights which do not exceed the paid-in capital or par value represented by such stock (except for a reasonable redemption premium in excess of such paid-in capital or par values).

Members of an affiliated group of corporations may file (or be required to file) consolidated returns. To be a member of an affiliated group for this purpose, a corporation has to be an "includible corporation". Under section 1504, certain corporations do not qualify as includible corporations. Thus, for example, a former DISC is not an includible corporation. Nor is a subsidiary of a former DISC. Under prior law, the accumulated DISC income of a former DISC was included in the gross income of its shareholders, as a dividend, over a period of up to 10 years. If the former DISC and its parent could file a consolidated return, the former DISC's accumulated DISC would go untaxed — the parent would eliminate the "dividend" under Treas. regs. sec. 1.1502-14.

The Act substantially revised the rules relating to DISCs and former DISCs. Under the new rules, there is less reason to keep a former DISC and its parent from filing consolidated returns. Furthermore, if a former DISC is not treated as an includible corporation, its parent may be able to selectively deconsolidate subsidiaries.

Explanation of Provision

Section 1504(a)(4) is amended to exclude stock which has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium). In general, the issue price of stock is its fair market value upon issuance. The amendment makes irrelevant the accounting treatment given the issuance of the stock.

Under the bill, any DISC or, to the extent provided in regulations, any other corporation having accumulated DISC income is treated as a corporation which is not an includible corporation.

f. Effective date of affiliated group provision (sec. 104(d)(2) and (3) of the bill and sec. 60 of the Act)

Present Law

The Act substantially revised the definition of "affiliated group". The provision was generally effective for taxable years beginning after December 31, 1984. However, section 60(b)(2) of the Act provided a grandfather rule with respect to any corporation which on June 22, 1984, was a member of an affiliated group filing a consolidated return for such corporation's taxable year which includes June 22, 1984—for purposes of determining whether such corporation continues to be a member of such group for taxable years beginning before January 1, 1988, the provision does not apply. Under section 60(b)(3) of the Act, the grandfather rule described in the preceding sentence does not apply once a "sell-down" with respect to the corporation involved has occurred.

Explanation of Provision

The bill makes two technical changes with respect to the effective date rules.

First, the grandfather rule ceases to apply as of the first day after June 22, 1984, on which the corporation involved would not qualify as a member of the group under prior law. Thus, for example, a corporation which ceased to be a member of a group on July 31, 1985, under prior law but which on July 31, 1985 (and thereafter), qualifies as a member of the group under the Act's substantive rule is treated as continuing to be a member of the group.

Second, the bill amends section 60(b)(3) of the Act to clarify the "sell-down" exception to the grandfather rule. Thus, the exception does not apply, and the grandfather rule continues to apply, if the percentage interest (by fair market value) in the stock of the corporation involved held by other members of the group (determined without regard to section 60(b)(3) of the Act) does not decline as a result of the sale, exchange, or redemption of such corporation's stock.

g. Complete liquidations of subsidiaries (sec. 104(d)(4) and (5) of the bill and secs. 332 and 337 of the Code)

Present Law

Prior to the Act, the rules applicable in determining whether a corporation qualified as a corporation which could be liquidated under section 332 were substantially similar to the general rules applicable in determining whether that corporation was a member of an affiliated group under section 1504. The Act substantially amended the general rules of section 1504 but not those of section 332. As a result, there is now discontinuity between the two sections. Thus, a corporation might be liquidated tax free under section 332 even though it and its "parent" are not members of the same affiliated group under new section 1504. The converse is also true. This discontinuity may produce unacceptable tax consequences.

For example, assume that beginning on January 1, 1985, P Corporation's ownership of S Corporation satisfies new section 1504 but not present-law section 332 and that, under new section 1504, P and S file consolidated returns for the 1985 calendar year. Assume further that (i) S adopts a plan of complete liquidation in 1985, then sells all its assets, and then liquidates within 12 months from the date the plan is adopted, and (ii) P does not liquidate. Because S's liquidation does not qualify under section 332, S may be able to avail itself of section 337 (sec 337(c)(2)). That result is appropriate so long as P is taxed on S's liquidation, as would in general be the result given the inapplicability of section 332. However, since P and S file a consolidated return, S's liquidation would not be taxable to P under Treas. regs. sec. 1.1502-14(b) (assuming S distributes no cash to P in the liquidation). Therefore, S could dispose of all its assets and liquidate, with neither P nor S incurring any current tax liability.

As a further example, assume that (i) J Corporation's ownership of K Corporation stock satisfies present-law section 332 but not new section 1504, and (ii) the two corporations are not filing a consolidated return under section 60(b)(2) of the Act for their 1985 calendar year. Assume further that K adopts a plan of complete liquidation, on January 1, 1985, then sells all its assets, and then liquidates within 12 months. Under section 332, the liquidation would not be taxable to J. Furthermore, it would appear that, since J and K are not in a new section 1504(a)(2) relationship, K may be able to avail itself of section 337 (sec. 337(c)(3)). Again, K could dispose of its assets and liquidate, with neither J nor K incurring any tax liability. (On the other hand, if J and K were filing consolidated returns under section 60(b)(2) of the Act, K could not avail itself of section 337 unless J timely liquidated. J would be a "distributee corporation" under section 337(c)(3)(B) since new section 1504 would not yet apply.)

Explanation of Provision

The bill amends section 332. Section 332 will not apply unless, among other things, the corporation receiving the liquidating distribution was, on the date of the adoption of the plan of liquidation and continued to be at all times until receipt of the liquidating distributions, the owner of stock in the liquidating corporation meeting the requirements of new section 1504(a)(2). (In applying section 1504(a)(2) for this purpose, the objective is to harmonize section 332 and section 1504(a)(2). Thus, it is generally intended that other parts of new section 1504(a), e.g., section 1504(a)(4), are applicable. However, section (a)(5)(E) is not applicable. It is not concerned with section 1504(a)(2) but rather with the effect of transfers within a group of a member's stock.) The new rule also applies even if one (or both) of the corporations involved is not an includible corporation under section 1504(b)). Under this rule, S in the first example above could be liquidated under section 332. However, S could avail itself of section 337 only if P complied with section 337(e)(3)(A)(i). In the second example above, J would be taxed because section 332 would not apply and because J and K, by definition, could not be filing a consolidated return.

Under the bill, the term "distributee corporation" under section 337(c)(3) is also amended. The amendment defines the term to mean any corporation which receives a distribution in a complete liquidation of the selling corporation to which section 332 applies. It also includes each other corporation "up the line" which receives a distribution in complete liquidation of another distributee corporation to which section 332 applies. Thus, assume, for example, that (i) M owns 100 percent of the stock of N, (ii) N owns 100 percent of the stock of O, and (iii) the 3 corporations are filing a consolidated return under new section 1504 for the calendar year 1985. If M transfers 30 percent of the stock of N to O, under regulations, the 3 corporations would continue to be eligible (or be required) to file a consolidated return (sec. 1504(a)(5)(E)). If N adopted a plan of complete liquidation, sold all its assets, and then liquidated within 12 months, under Treas. regs. sec. 1.1502-34, both M and O generally would be entitled to tax-free treatment under section 332. Under the bill, N could not avail itself of section 337 unless, among other things, both M and O complied with section 337(c)(3)(A)(i).

The amendment to section 337(c)(3)(B) applies with respect to plans of complete liquidation pursuant to which any distribution is made in a taxable year beginning after December 31, 1984. Thus, in the example above involving J and K, K could not avail itself of section 337 unless J timely liquidated because J would be a "distributee corporation" under the amendment.

Except as indicated below, the amendment to section 332 is generally applicable with respect to distributions pursuant to plans of liquidation adopted after March 28, 1985. Except as indicated below, the amendment is also applicable with respect to distributions pursuant to a plan of complete liquidation adopted on or before that date, but only if (i) any distribution is made in a taxable year beginning after December 31, 1984, and (ii) the liquidating corporation and any corporation which receives a distribution in complete liquidation of such corporation are members of an affiliated group of corporations which is filing a consolidated return for the taxable year which includes the distribution. However, the amendment to section 332 does not apply with respect to distributions pursuant to any plan of complete liquidation if the liquidating corporation is a member of an affiliated group of corporations under section 60(b)(2) or (5) (relating to Native Corporations established under the Alaska Native Claims Settlement Act) of the Act for each taxable year in which it makes a distribution.

The application of the effective date rules is illustrated by the following examples.

Example (1).—Assume that Q Corporation's ownership of the stock of R Corporation satisfies section 332 of present law and section 1504 of prior law but not section 332 as it is amended by the bill. (Under these facts, Q and R could not be filing a consolidated return unless grandfathered under the Act's amendment of section 1504). Assume further that R adopts a plan of complete liquidation on October 1, 1984, then sells its assets, and, then, before October 1, 1985, completely liquidates. Regardless of whether Q and R are filing consolidated returns under section 60(b)(2) of the Act for the calendar year 1985, and regardless of whether the liquidation is completed before January 1, 1985, the amendment to section 332 would not apply. As a result, R's liquidation could qualify under section 332. (However, R could avail itself of section 337 only if Q timely liquidated.)

Example (2).—Assume that S Corporation's ownership of the stock of T Corporation would satisfy new section 332 but not section 332 of present law or section 1504 of prior law. Assume further that on October 1, 1984, T adopts a plan of complete liquidation and then, making no sales or exchanges of assets in the interim, completes its liquidation on October 5, 1984. The amendment to section 332 would not apply. As a result, section 332 could not apply.

Example (3).—The facts are the same as in Example (2) except that (i) T adopts its plan on January 10, 1985, and completes its liquidation on January 15, 1985, and (ii) S and T file a consolidated return for the calendar year 1985 under new section 1504. The amendment to section 332 would be applicable. As a result, section 332 could be applicable.

Example (4).—The facts are the same as in Example (2) except that T sells assets between October 1, 1984, and October 5, 1984. New section 332 would not be applicable. As a result, section 332 could not apply, and T could avail itself of section 337.

Example (5).—The facts are the same as in Example (3) except that T sells assets between January 10, 1985, and January 15, 1985. The amendment to section 332 would apply. As a result, section 332 could apply. If it did, T could not avail itself of section 337 unless, among other things, S timely liquidated. (If S and T were not filing a consolidated return under new section 1504 for the calendar year 1985, the amendment to section 332 would not apply. As a result, T's liquidation would not be a section 332 liquidation, and T could avail itself of section 337.)

Example (6).—Assume that Corporation U's ownership of the stock of Corporation V satisfies section 332 of present law but not section 332 as it would be amended and that U and V are filing a consolidated return for the calendar year 1985, under section 60(b)(2) of the Act. On December 10, 1985, V adopts a plan of complete liquidation, then sells all its assets, and then liquidates on December 15, 1985. The amendment to section 332 would not apply. As a result, section 332 could apply. If it did, V could avail itself of section 337 only if, among other things, U timely liquidated.

h. Earnings and profits (sec. 104(e) of the bill and sec. 312 of the Code)

Present Law

The Act substantially revised the definition of a corporation's "earnings and profits".

One change was to increase a distributing corporation's earnings and profits by the amount of any gain which would be recognized if section 311(d)(2) did not apply to an ordinary, non-liquidating distribution by the corporation of appreciated property. However, the Act added no separate provision for reducing earnings and profits for all or any portion of that amount.

The Act also amended the rules regarding the effect on earnings and profits of a corporation's redemption of its own stock (sec. 312(n)(8) of current law). However, the Act did not contain a specific effective date for that amendment.

Explanation of Provision

The bill repeals section 312(n)(4) and section 312(a)(3) and amends section 312(b). Under 312(b), as amended, the distribution by a corporation of property the fair market value of which exceeds its adjusted basis increases the earnings and profits of the distributing corporation by the amount of such excess. The distribution also decreases the distributing corporation's earnings and profits by the lesser of (1) the fair market value of the distributed property, and (2) its earnings and profits (as increased under the rule described in the preceding sentence). The decrease is to be treated as occurring immediately after the distribution. Thus, assume that a corporation has no accumulated earnings and profits and no other current earnings and profits. Assume further that in 1985 it distributes property with a zero basis and a $1,000 value to an individual shareholder in a transaction described in section 311(d)(2). The distribution increases the distributing corporation's earnings and profits to $1,000, so the shareholder generally would have dividend income of $1,000. The distributing corporation's earnings and profits are then reduced to zero. (This change is not intended to affect the determination of earnings and profits for purposes of section 333.)

The bill provides that section 312(n)(8) of current law applies to redemption distributions after July 18, 1984.

i. Corporate tax preferences (sec. 104(f) of the bill and sec. 291 of the Code)

Present Law

The Act generally increased the corporate tax preference cutback (sec. 291) from 15 to 20 percent.

Explanation of Provision

The bill makes several clerical amendments, including a clarification that the prior law DISC provision did not apply to subchapter S corporations.

6. Partnership and Trust Provisions

a. Retroactive allocations (sec. 105(a) of the bill and sec. 706(d) of the Code)

Present Law

The Act provides that specified cash basis items are allocated to the persons who were partners during the period in which the items were economically attributable. Items (or portions of items) which are attributable to periods before the beginning of the taxable year are assigned to the first day of the taxable year. The items are allocated to the persons who were partners during the period to which each item is attributable, in accordance with their varying interests in the partnership during that period. If the persons to whom all or part of such items is allocable are not partners in the partnership on the first day of the partnership taxable year in which the item is properly taken into account, their portion of such items must be capitalized by the partnership and allocated to the basis of partnership assets.

Explanation of Provision

The bill clarifies that the rule described in present law applies to all cases in which the rule is necessary to allocate cash basis items to the period to which the items are attributable, even though no change in partnership interests occurs during the current taxable year.

b. Disguised sale transactions (sec. 105(b) of the bill and sec. 707(a)(2)(B) of the Code)

Present Law

The Act provides that, under Treasury regulations, if (1) a partner transfers money or other property (directly or indirectly) to a partnership, (2) there is a related direct or indirect transfer of money or other property by the partnership to that partner (or another partner), and (3) when viewed together, the transfers described above are properly characterized as a sale of property, the transaction is to be treated (as appropriate) as a transaction between the partnership and a non-partner or as a transaction between two or more partners acting in non-partnership capacities.

This "disguised sale" rule is intended to prevent the parties from characterizing a sale or exchange of property as a contribution to the partnership followed by a distribution from the partnership, and thereby to defer or avoid tax on the transaction.

Explanation of Provision

The bill specifies that "disguised sale" treatment is to apply to cases in which the transfers to and from the partnership (as described above), when viewed together, are properly characterized as an exchange of property, as well as to cases in which such transfers are properly characterized as a sale.

c. Distributions treated as exchanges for purpose of partnership provisions (sec. 105(c) of the bill and sec. 761(e) of the Code)

Present Law

The Act provides that any distribution not otherwise treated as an exchange is to be treated as an exchange for purposes of specified partnership provisions of the Code. The provisions to which this rule applies are section 708 of the Code (relating to continuation of a partnership); section 743 (relating to the optional adjustment to the basis of partnership property); and any other partnership provision (subchapter K of the Code) specified in Treasury regulations.

Explanation of Provision

The bill limits the application of the sale or exchange treatment rule to distributions of partnership interests.

d. Like-kind exchanges (section 105(d) of the bill and section 1031(a) of the Code)

Present Law

Under the Code (section 1031), generally no gain or loss is recognized if property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged solely for property of a like-kind that is also to be held for productive use in a trade or business or for investment.

The Act provides that, for purposes of the like-kind exchange provision, property which was not identified as the property to be received by the taxpayer on the date the taxpayer relinquishes property, or before the day which is 45 days after that date, does not qualify as like-kind property.

Explanation of Provision

The bill specifies that like-kind property includes property identified as the property to be received by the taxpayer on or before (rather than only before) the date which is 45 days after the date on which the taxpayer relinquishes property.

e. Multiple trusts (sec. 106(a) of the bill and sec. 643 of the Code)

Present Law

The Act provides that under Treasury regulation, two or more trusts will be treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose for the existence of the trusts in the avoidance of Federal income tax. This provision is effective for taxable years beginning after March 1, 1984.

Explanation of Provision

The bill provides that this provision is not applicable to any trust which was irrevocable on March 1, 1984, except to the extent corpus is transferred to the trust after that date.

7. Accounting Provisions

a. Tax shelters (sec. 107(a)(1) and (2) of the bill and sec. 461(i)(2) of the Code)

Present Law

Generally, a cash basis tax shelter is not allowed a deduction with respect to an amount any earlier than the time at which economic performance occurs. An exception is provided under which prepaid expenses are deductible when paid if economic performance occurs within 90 days after the close of the taxable year. For purposes of this exception, in the case of oil and gas activities, economic performance is deemed to occur with respect to intangible drilling expenses when the well is "spudded." It is unclear whether the exception applies if economic performance occurs before the close of the taxable year, because this is not "within" 90 days after the close of the taxable year. For example, it is unclear whether the exception applies if a well is spudded in the last month of the taxable year.

In the case of the trade or business of farming, the farming syndicate rules of section 464 apply to any tax shelter described in section 6661(b) (i.e., the principal purpose of which is the avoidance or evasion of Federal income tax). For purposes of applying section 464 to these tax shelters, it is unclear whether the exceptions under section 464(c)(2) relating to holdings attributable to active management apply.

Explanation of Provision

The bill clarifies that the 90-day exception applies if economic performance occurs before the close of the 90th day after the close of the taxable year. Thus, for example, if a well is spudded in the last month of the taxable year, the requirement that economic performance occur before the close of the 90th day after the close of the taxable year is satisfied.

The bill also clarifies that any tax shelter described in section 6661(b) will generally be treated as a farming syndicate for purposes of section 464. However, any person meeting the requirements of section 464(c)(20 will not be subject to the provisions of section 464 with respect to that person's interest in a tax shelter.

b. Mine reclamation and similar costs (sec. 107(a)(3) of the bill and sec. 468 of the Code)

Present Law

The Act provided electing taxpayers with a uniform method for deducting, prior to economic performance, certain reclamation costs which are mandated by Federal, State, or local law. Deductions accrued under this method must be accounted for in a book reserve and are subject to recapture to the extent that reclamation costs are less than accumulated reserves.

Explanation of Provision

The bill clarifies that a reserve balance must be increased by the amount of deductions accrued in each year that are allocable to the reserve. The bill also clarifies that this provision is effective for taxable years ending after the date of enactment of the Tax Reform Act of 1984 (July 18, 1984).

c. Nuclear power plant decommissioning expenses (sec. 107(a)(4) of the bill and sec. 468A of the Code)

Present Law

The Act permitted electing taxpayers to accrue a deduction for contributions made to a qualified nuclear decommissioning fund (a "fund"), subject to certain limitations.

Explanation of Provision

The bill clarifies that a taxpayer shall be deemed to have made a payment to a fund at the end of a taxable year provided that payment is made within 2-1/2 months after the close of that taxable year. Under a transitional rule, the Secretary of the Treasury is provided regulation authority to relax this 2-1/2 month rule for payments allocable to a taxable year beginning before January 1, 1985, and to provide that no interest will be allowed with respect to periods before payment is made. The bill clarifies that the tax treatment of fund income provided in sec. 468A is in lieu of any other Federal income tax, that a fund's tax liability is not deductible from its gross income, and that for purposes of subtitle F ("Procedure and Administration") a fund shall be treated as a corporation and taxes imposed on the fund shall be treated similarly to corporate income taxes. The bill clarifies that a fund may invest only in those assets in which the Code permits a Black Lung Trust Fund to invest. The bill also clarifies that this provision is effective for taxable years ending after the date of enactment of the Tax Reform Act of 1984 (July 18, 1984).

d. Treatment of deferred payments for services (sec. 107(b) of the bill and sec. 467(g) of the Code)

Present Law

Under section 467(g) of the Code, the Secretary of the Treasury is to prescribe regulations under which deferred payments for services will be subject to rules similar those those applicable to deferred rents.

Explanation of Provision

The bill clarifies that the regulations to be issued under section 467 relating to deferred payments for services will not apply to amounts to which section 404 or 404A applies, or to amounts subject to any other provision specified in regulations.

8. Tax Straddle Provisions

a. Treatment of Subchapter S corporations (sec. 108(a) of the bill)

Present Law

The Act extended the mark-to-market and sixty percent long-term, forty percent short-term capital gain and loss treatment applicable to commodities dealers to dealers in exchange-traded options, provided elections to adopt this treatment for positions carried forward from earlier taxable years into the taxable year including the date of enactment and to pay any increase in tax liability resulting from this election over 5 years, and permitted qualified incorporated commodities dealers and options dealers to elect S corporation status without regard to the requirement of present law that the election be made by the 15th day of the third month of the taxable year for which it is effective.

Explanation of Provision

The bill makes clarifying amendments to ensure that S corporation taxable year limitations do not affect the elections relating to adoption of mark to market treatment for positions carried forward from earlier years, and to properly coordinate those elections with the S corporation election with respect to taxable years commencing before January 1, 1984 in the manner provided by regulations.[2]

b. Treatment of amounts received for loaning securities (sec. 108(b) of the bill and sec. 263(g) of the Code)

Present Law

The present law requirement that interest and other carrying costs incurred to carry personal property constituting part of a straddle must be capitalized, as amended by the Act, limits the requirement to the excess of these costs over interest, discount income and dividend income with respect to the property that is subject to tax during the taxable year. A lender of securities to be

[2] See Treas. Reg. sec. 18.1362-1., 49 Fed. Reg. 38920 (October 1, 1984).

used in a short sale may receive compensation from the borrower to replace interest, dividends, and other compensating amounts with respect to the loaned property and may also incur interest and other carrying costs with respect to the property that are subject to the capitalization requirement.

Explanation of Provision

The bill provides for the inclusion of compensating payments to a lender of securities used in a short sale in those taxable amounts that reduce interest and other costs required to be capitalized under section 263(g) of the Code.

9. Depreciation Provisions

a. Mid-month convention for real property (sec. 109(a)(2) of the bill and secs. 57, 168, and 312 of the Code)

Present Law

The Act provided a mid-month convention for the depreciation of 18-year real property (which does not include low-income housing). Under that convention, property placed in service (or disposed of) by a taxpayer at any time during a month is treated as having been placed in service (or disposed of) by the taxpayer in the middle of that month.

Explanation of Provision

The bill clarifies that the mid-month convention is to be applied whenever a depreciation computation with respect to 18-year real property is required under section 168, section 57(a)(12) (relating to accelerated cost recovery deductions as items of tax preference), or section 312(k) (relating to the effect of depreciation on earnings and profits). Thus, for example, if a taxpayer elects under section 168(b)(3) to depreciate 18-year real property on a straight-line basis over 18, 35, or 45 years, the mid-month convention applies in computing the deductions. Similarly, the mid-month conventions applies in determining what cost recovery deductions "would have been allowable" under section 57(a)(12). Numerous conforming changes are also made.

b. Bond-financed 18-year real property (sec. 109(a)(4) of the bill and sec. 168(f)(12) of the Code)

Present Law

Prior to the Act, section 168(f)(12) placed restrictions on cost recovery allowances with respect to 15-year real property financed by the proceeds of an industrial development bond. Those rules did not apply if the property was placed in service in connection with a project for residential rental property financed by the proceeds of obligations described in section 103(b)(4)(A). The Act generally provided that the cost of real property qualifying as recovery property could not be recovered over a period of less than 18 years.

Explanation of Provision

The bill clarifies that, in general, the cost of 18-year real property (which does not include low-income housing) financed by the proceeds of an industrial development bond cannot be recovered more rapidly than on a straight-line basis over 18 years, using a mid-month convention. This rule does not apply if the property is either (i) low-income housing (sec. 168(c)(2)(F)), or (ii) property which is placed in service in connection with a project for residential rental property financed with the proceeds of obligations described in section 103(b)(4)(A) but which is not low-income housing under section 168(e)(2)(F). Costs of the former can be recovered on an accelerated basis under ACRS over 15 years, using a first-of-the month convention, and costs of the latter can be recovered on an accelerated basis under ACRS over 18 years, using a mid-month convention.

c. Treatment of certain transferees of recovery property (sec. 109(b) of the bill and sec. 168(f)(10) of the Code)

Present Law

A transferee of recovery property generally may elect a recovery period or method for the property different from the period or method elected by the transferor. However, restrictions are imposed by section 168(f)(10) to prevent the use of certain kinds of asset transfers as a means to change the recovery period or method for the property involved. For transfers subject to those restrictions, the transferee must "step into the shoes" of the transferor with respect to so much of the transferee's basis in the property as is not in excess of the property's adjusted basis in the hands of the transferor. Under this rule, the transferee's cost recovery deductions with respect to that basis are the same as those that would have been allowed the transferor had no transfer occurred. The transferee can elect to depreciate any excess basis pursuant to any recovery period or method available under the general rules.

Asset transfers subject to the rule of the preceding paragraph include sale-leasebacks (sec. 168(f)(10)(B)(iii)), transfers between related persons (sec. 168(f)(10(B)(ii)), and tax-free asset (carryover basis) transfers described in section 332, 351, 361, 371(a), 374(a), 721, or 731 (sec. 168(f)(10)(B)(i)).

Explanation of Provision

In cases described in sections 168(f)(10)(B)(ii) and (iii) of present law, the "step into the shoes" rule is often too generous to the transferee. The rule has the general effect of permitting such a transferee higher cost recovery deductions than would have been allowed to a transferee in a case not covered by either section. Furthermore, the Act, in amending the rules regarding the depreciation of real property (other than low-income housing) qualifying as recovery property, did not clearly provide how section 168(f)(10) would apply.

The bill amends section 168(f)(10) with respect to recovery property placed in service by the transferor. In a case described in section 168(f)(10)(B)(ii) or (iii) (but not (i)) of present law, the transferee does not "step into the shoes" of the transferor. Instead, the transferee starts depreciating the property as would any other new owner of it. However, to the extent of the adjusted basis of the property in the hands of the transferor, the transferee is treated as having made any election made by the transferor with respect to the property under section 168(b)(3) or section 168(f)(2)(C). Thus, for example, if the transferor had elected to depreciate 5-year property on a straight-line basis over 5 years, a transferee under section 168(f)(10)(B)(ii) or (iii) would be treated as having made the same election to the extent basis did not increase. Furthermore, the transferee would begin depreciating that basis in the year of the transfer over a new 5-year period. For purposes of this rule, if the transferor was depreciating 15-year real property on a straight-line basis, the transferee would be treated as having elected 18-year straight line depreciation. If the transferee's basis exceeded the transferor's adjusted basis, the transferee can depreciate the excess under the general rules.

With one exception, the bill does not amend section 168(f)(10)(B)(i). Thus, for example, in a section 351 transaction, the transferee steps into the transferor's shoes to the extent basis does not increase. However, the bill amends section 168(f)(10)(B)(i) to provide that it does not apply in the case of the termination of a partnership under section 708(b)(1)(B) (relating to the sale or exchange of 50 percent or more of the total interest in a partnership's capital and profits within a 12-month period).

The amendments apply to property placed in service by the transferee after March 28, 1985.

d. Films, videotapes, and sound recordings (sec. 109(c) of the bill and sec. 167 of the Code)

Present Law

Under the Act, films and videotapes cannot qualify as recovery property (sec. 168(e)(5)). Similarly, sound recordings do not qualify as recovery property unless an election is made under section 48(r)(1) (relating to treating a sound recording as 3-year property). Thus, their costs cannot be recovered under ACRS. If a film or videotape, or a sound recording, not qualifying as recovery property qualifies as tangible property, however, its costs may be recoverable under depreciation methods prescribed by section 167 (e.g., a declining balance method).

Explanation of Provision

Under the bill, films and videotapes, and sound recordings, are treated as intangible property for purposes of section 167. Thus, accelerated depreciation methods available under section 167(c) only with respect to tangible property are not available. However, the income forecast method or similar methods of depreciation are available. However, the income forecast method or similar methods of depreciation are available.

The provision applies to films, videotapes, and sound recordings placed in service by the taxpayer after March 28, 1985. However, no inference is intended that films or videotapes, or sound recordings, placed in service by a taxpayer before that date qualify as tangible property for purposes of section 167.

e. Investment tax credit (sec. 109(d) of the bill and sec. 48 of the Code)

Present Law

The Act amended the 3-month rule of section 48(b) (relating to whether property qualifies as new section 38 property). Under the Act, rules relating to the qualification of certain property reconstructed by the taxpayer as new section 38 property were inadvertently deleted.

Explanation of Provision

The bill reinstates the provision that section 38 property the reconstruction of which is completed by the taxpayer qualifies as new section 38 property. The bill also provides that the 3-month rule is not applicable to section 38 property the reconstruction of which is completed by the taxpayer. Thus, property reconstructed by a taxpayer and then sold and leased back by the taxpayer within 3 months of the date actually placed in service is to be treated as placed in service on the date actually placed in service.

The bill also clarifies the applicability of the 3-month rule in the case of certain sale-leasebacks. Thus, assume that taxpayer A places eligible property in service by leasing it to taxpayer B. Assume further that, within 3 months of the date A placed the property in service, A sells the property to taxpayer C and taxpayer C leases the property back to A, subject to the lease to B. Assuming C's lease to A qualifies as a lease under applicable Code principles, the property will constitute new section 38 property in C's hands.

10. Foreign Provisions

a. Maintaining the source of U.S. source income (sec. 110(a) of the bill and sec. 904(g) of the Code)

Present Law

Prior to the Act, a U.S. taxpayer could convert U.S. source income to foreign source income by routing the income through a foreign corporation: Interest and dividend payments from (and income inclusions with respect to) an intermediate foreign corporation generally were foreign source income to the U.S. taxpayer. As foreign source income, the income could be free of U.S. tax under the foreign tax credit.

The Act added to the foreign tax credit rules new source rules that prevent U.S. taxpayers from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only.

Interest and dividends paid by a domestic corporation that earns less than 20 percent of its gross income from U.S. sources over a three-year period (an "80/20 company") are foreign source, like interest and dividends paid by a typical foreign corporation (Code secs. 861(a)(1)(B) and 861(a)(2)(A)). Therefore, a U.S. taxpayer can convert U.S. source income to foreign source income by routing it through an 80/20 company, as long as the company's U.S. source gross income remains below the 20-percent threshold.

The Act provides a transitional rule for certain interest received by "applicable CFCs." The Act defines an "applicable CFC" as any controlled foreign corporation in existence on March 31, 1984, the principal purpose of which on that date consisted of issuing CFC obligations or holding short-term obligations and lending the proceeds to affiliates.

Explanation of Provision

Under the bill, an 80/20 company will be treated as a U.S.-owned foreign corporation and thus will be subject to the rules maintaining the source of U.S. source income. The bill thereby prevents U.S. taxpayers from using 80/20 companies to convert U.S. source income to foreign income.

This provision generally will apply on the date of the bill's introduction. In the case of any taxable year of an 80/20 company ending after the bill's date of introduction, only income received or accrued by the 80/20 company during that portion of the taxable year after the date of introduction generally is to be taken into account for purposes of the new source rules. However, *all* income received or accrued by the 80/20 company during that taxable year is to be taken into account in determining whether the 10 percent earnings and profits threshold for dividends and interest is exceeded.

The bill also clarifies the applicable CFC definition. Under the bill, an applicable CFC is any controlled foreign corporation in existence on March 31, 1984, the principal purpose of which on that date consisted of (1) issuing CFC obligations or short-term borrowing from nonaffiliated persons and (2) lending the proceeds to affiliates.

A discussion of another amendment to section 121 of the Act appears below, the discussion of section 110(d) of the bill (Repeal of 30-percent withholding tax on portfolio interest paid to foreign persons).

b. Maintaining the character of interest income (sec. 110(b) of the bill and sec. 904(d)(3) of the Code)

Present Law

In general

The Act provided that when a U.S. taxpayer includes in income foreign personal holding company or subpart F income with respect to (or an interest or dividend payment from) a designated payor corporation that has earned substantial "separate limitation interest" (generally passive interest income), that inclusion will generally constitute interest that is subject to the separate foreign tax credit limitation for interest income.

The purpose of this look-through rule is to prevent U.S. taxpayers from using foreign corporations to inflate the overall foreign tax credit limitation. Prior to the Act, U.S. taxpayers could arguably circumvent the separate foreign tax credit limitation for interest income by having low-taxed interest income paid to a foreign corporation rather than directly to them. Subpart F and foreign personal holding company inclusions with respect to the foreign corporation, and dividends and interest received from the foreign corporation, were treated as noninterest income of the U.S. taxpayers that was subject to the overall foreign tax credit limitation. As a result of an easily manipulable financial transaction, the conversion of interest income to noninterest income was possible.

Definition of designated payor corporation

The Act generally defines a designated payor corporation as any regulated investment company, 50-percent (or more) U.S.-owned foreign corporation, or foreign corporation with a ten-percent U.S. shareholder. A domestic corporation that pays foreign source dividends can be a designated payor corporation only if it is a regulated investment company.

A domestic company's dividends (and interest payments) are foreign source if it is an "80/20" company, that is, if it earns less than 20 percent of its gross income from U.S. sources for a three-year period (Code secs. 861(a)(1)(B) and 861(a)(2)(A)).

Code section 269 denies tax benefits to taxpayers who acquire control of corporations to avoid or evade tax. The extent to which section 269 applies to defeat schemes to avoid the Act's look-through rules by using U.S. or foreign corporations is not clear.

Ten-percent exception

The Act contains a de minimis rule that prevents characterization of inclusions and payments as interest subject to the separate foreign tax credit limitation for interest income unless ten percent or more of the earnings and profits of the designated payor corporation is attributable to separate limitation interest. This de minimis rule applies even in the case of income inclusions that arise under the anti-avoidance rules that apply to foreign personal holding companies and controlled foreign corporations.

Related party interest

The Act provided that when a designated payor corporation receives interest from another member of the same affiliated group, the interest shall not be treated as separate limitation interest unless the interest is attributable (directly or indirectly) to separate limitation interest of the other member.

Explanation of Provisions

Definition of designated payor corporation

The bill amends the definition of designated payor corporation in two respects.

First, the bill makes clear that any corporation formed or availed of for purposes of avoiding the look-through rule will be treated as a designated payor corporation subject to the rule. U.S. taxpayers will not be permitted, in violation of the purpose of the look-through rule, to convert interest income to noninterest income by earning the income through a corporation the ownership of which is structured to place the corporation technically outside the present law definition of designated payor corporation. For example, a foreign corporation that earns sufficient earnings and profits attributable to separate limitation interest to be subject to the look-through rule, but is majority-owned by foreign persons and has no ten-percent U.S. shareholders, will be treated as a designated payor corporation (regardless of the original purpose for its formation) if U.S. shareholders utilize the corporation to remove interest income from the separate foreign credit limitation for interest income. The Secretary may promulgate regulations setting forth appropriate rules for determining whether a corporation has been formed or availed of for purposes of avoiding the look-through rule.

The bill also expands the definition of designated payor corporation to include any 80/20 company. By subjecting 80/20 companies to the look-through rule, the bill prevents U.S. taxpayers from using 80/20 companies to circumvent the separate foreign tax credit limitation for interest income.

The amendments to the designated payor corporation definition generally take effect on the date of the bill's introduction. In the case of any taxable year of a corporation treated as a designated payor corporation by virtue of these amendments ending after the bill's date of introduction, only income received or accrued by the corporation during that portion of the taxable year after the date of introduction generally is to be taken into account for purposes of the look-through rule. However, *all* income received or accrued by the corporation during that taxable year is to be taken into account in determining whether the ten-percent earnings and profits threshold for dividends and interest is exceeded. A corporation formed before the date of the bill's introduction, but availed of after that date to avoid the look-through rule, will be subject to the rule.

Ten-percent exception

The bill removes the Act's de minimis rule that prevents maintenance of the character of interest income in the case of foreign personal holding company inclusions and Subpart F inclusions.

Related party interest

The bill makes it clear that when a designated payor corporation receives interest from another member of the same affiliated group, the interest shall be treated as separate limitation interest if (and only if) the interest is attributable (directly or indirectly) to separate limitation interest of the other member.

c. Related person factoring income (sec. 110(c) of the bill and secs. 864 and 956 of the Code)

Present Law

Investment in U.S. property

Under present and prior law, the Code treats an investment in United States property by a controlled foreign corporation as an effective repatriation of the amount invested and thus as a dividend. The Act provided that "United States property" includes any trade or service receivable acquired from a related U.S. person if the obligor under the receivable is a U.S. person. This provision overrode exceptions (listed in Code sec. 956(b)(2)) to the investment in U.S. property rules. Among those exceptions is an exclusion from U.S. property of an amount of assets equal to post-1962 earnings and profits previously excluded from subpart F income on the ground that the United States had already subjected those amounts to tax directly as effectively connected income (sec. 956(b)(2)(H)).

Current inclusion of factoring income

The Act provided that if any person acquires a trade or service receivable from a related person, the acquirer's income from the receivable is treated as interest on a loan to the obligor under the receivable. In general, this income is currently taxable to the owners of the acquirer of the receivable under the foreign personal holding company rules or the controlled foreign corporation rules (subpart F). The income is currently taxable even when the related person that acquires the receivable acquires it from an entity that is organized under the laws of the same foreign country as the acquirer and that has a substantial part of its assets used in its trade or business located in that same country.

Explanation of Provisions

Investment in U.S. property

The bill provides that the exclusion from U.S. property of an amount of assets equal to the controlled foreign corporation's post-1962 earnings and profits excluded from subpart F income as taxable effectively connected income will apply in the case of the acquisition of a trade or service receivable that otherwise constitutes U.S. property.

Current inclusion of factoring income

The bill generally exempts factoring income from current inclusion when the related person that acquires the factored receivable acquires it from an entity that is organized under the laws of the same foreign country as the acquirer and that has a substantial part of its assets used in its trade or business located in that same country. Factoring income is still subject to the current inclusion rule, however, if the person transferring the receivable would have derived any foreign base company income (determined without regard to the 10-percent exception) or income that is effectively connected with a U.S. trade or business had it collected the receivable.

For example, assume that a controlled foreign corporation manufactures a product in the foreign country of its incorporation and sells the product to an unrelated customer in exchange for the customer's receivable. None of the manufacturer's income from this sale is effectively connected with a U.S. trade or business, and none of it would be currently taxable to its U.S. shareholders. The manufacturer sells the receivable to a related controlled foreign corporation that is organized under the laws of the same foreign country. Under the bill, the income of the acquirer from that receivable is not subject to current U.S. taxation.

By contrast, assume that another controlled foreign corporation purchases goods from its U.S. parent and resells those goods to a customer (in exchange for the customer's receivable) for use outside the country of incorporation of the controlled foreign corporation. This income would be currently taxable to the U.S. shareholders of the controlled foreign corporation as foreign base company sales income under the subpart F rules (sec. 954(d)). The controlled foreign corporation sells the receivable to a related controlled foreign corporation that is organized under the laws of the same foreign country as the seller. Under the bill, the income of the acquirer from the receivable remains subject to current taxation at the level of its U.S. shareholders.

The bill's treatment of factoring income also extends to income from analogous loans by a controlled foreign corporation to finance transactions with related parties.

d. Repeal of 30-percent withholding tax on portfolio interest paid to foreign persons (secs. 110(a) and 110(d) of the bill and secs. 871, 881, 1441, and 1442 of the Code)

Present Law

In general

The United States generally imposes a flat 30-percent withholding tax on the gross amount of U.S. source investment income payments to foreign persons. The Act repealed the 30-percent tax with respect to portfolio interest paid on certain indebtedness by U.S. borrowers to nonresident alien individuals and foreign corporations. This exemption from the 30-percent tax is effective for interest paid on qualifying obligations issued after July 18, 1984, the date of enactment of the Act.

Registered obligations—non-U.S. person statement

The Act repealed the 30-percent tax with respect to interest paid on obligations issued in registered form for which the U.S. payor (or U.S. person whose duty it would otherwise be to withhold tax) receives a statement that the beneficial owner of the obligation is not a U.S. person.

Interest received by controlled foreign corporations

Interest received by a controlled foreign corporation ("CFC") from a person other than a related person may be exempt from the 30-percent tax under the Act. To prevent U.S. persons from indirectly taking advantage of the exemption, however, the Act provides that portfolio interest received by a CFC is includible in the gross income of the CFC's U.S. shareholders under subpart F without regard to any of the exceptions otherwise provided under the subpart F rules.

It appears that some interest paid by foreign corporations, which would not have been subject to the 30-percent tax *prior* to the Act, nonetheless may fall within the technical definition of portfolio interest. Where such interest is paid to a CFC, treatment of the interest as portfolio interest subjects it to current taxation under subpart F without regard to any of the subpart F exceptions.

Amnesty

The Act provided that, if certain requirements are met, interest paid to an applicable CFC on a U.S. affiliate obligation issued before June 22, 1984 (the date of conference action) will be treated for all Code purposes as paid to a resident of the country in which the applicable CFC is incorporated. This rule gives "amnesty" from the imposition of the 30-percent tax to interest paid by a U.S. affiliate on certain obligations issued before the effective date of the statutory exemption by a U.S.-owned finance subsidiary located in the Netherlands Antilles. While an exemption from the tax for such interest typically has been claimed pursuant to Article VIII of the tax treaty between the United States and the Netherlands (as extended to the Netherlands Antilles), that exemption has been challenged on audit in some cases by field agents of the IRS.

Subsequent to the enactment of the Act, the IRS issued two revenue rulings holding that interest paid by U.S. subsidiaries of a Swiss and a U.S. parent, respectively, to a Netherlands Antilles subsidiary of that parent on certain obligations was not exempt from the 30-percent tax under Article VIII of the U.S.-Netherlands treaty (Rev. Rul. 84-152, 1984-42 I.R.B. 8; Rev. Rul. 84-153, 1984-42 I.R.B. 9). Absent eligibility under the amnesty provision, under these rulings, certain interest paid on pre-repeal obligations issued by U.S.- and foreign-owned Antilles finance subsidiaries will be ineligible for an Article VIII treaty exemption from the 30-percent tax.

For purposes of the amnesty provision, an applicable CFC is any U.S.-controlled foreign corporation in existence on the date of the interest payment, the principal purpose of which on that date consisted of issuing CFC obligations or otherwise borrowing money and lending the proceeds to affiliates. Interest paid on an obligation issued by a foreign corporation controlled by foreign persons does not qualify for amnesty treatment. A U.S. affiliate obligation is any obligation of a U.S. person related (within the meaning of Code section 482) to an applicable CFC holding the obligation. Interest paid on an obligation of a foreign person does not qualify for amnesty treatment.

Explanation of Provisions

Registered obligations—non-U.S. person statement

The bill clarifies that the beneficial owner of a registered obligation, the interest on which is otherwise eligible for the repeal, may claim a refund of any tax withheld where the required non-U.S. person statement is provided *after* one or more interest payments are made rather than before. Claims for such refunds are subject to the general statute of limitations rules for refund claims (sec. 6511).

Interest received by controlled foreign corporations

The bill amends the definition of portfolio interest to exclude interest that would not have been subject to the 30-percent tax prior to the Act (without regard to the operation of treaties). Thus, under the bill, interest received by CFCs will be denied the benefit of any otherwise applicable subpart F exceptions only if the interest would have been subject to the 30-percent tax in the absence of the repeal provision.

Amnesty

The bill liberalizes the amnesty provision in two respects.

First, the bill provides that certain U.S. source interest paid to an applicable CFC by an affiliated foreign corporation on an obligation of that corporation issued before June 22, 1984 will be eligible for amnesty from imposition of the 30-percent tax to the same extent that interest so paid by a affiliated U.S. corporation would be eligible. This treatment applies if at least 50 percent of the foreign corporation's gross income for the three-year periods ending on or before March 31, 1984, and with the close of its taxable year preceding the payment of the interest in question, was effectively connected with a U.S. trade or business.

Second, the bill extends the amnesty provision to cover interest that would be eligible for amnesty treatment under the present rules but for the fact that the recipient finance affiliate is controlled by foreign persons (i.e., does not meet the greater-than-50-percent U.S. ownership requirement of Code sec. 957(a)) and, for that reason, is not an applicable CFC. The income tax deduction of the U.S. payor of interest covered by this extension is to be appropriately reduced, however, to reflect the spread between the interest rate paid by the U.S. payor to the foreign-owned finance affiliate and the interest rate paid by the finance affiliate to unrelated lenders of the borrowed funds. In the case where related persons have lent money to the CFC, the interest deduction also is to be appropriately reduced to prevent the shifting of income from the U.S. payor to related persons. This may occur, for example, when a related person holds obligations of the finance affiliate that has lent the proceeds of those obligations to the U.S. payor.

These interest deduction reductions will ensure that the net value of the interest deduction to the affiliated group does not exceed the sum of the actual interest cost to the affiliated group of money borrowed from unrelated persons and the interest expense attributable to the equity funds of the foreign-owned finance affiliate. Direct reductions in the U.S. payor's interest deduction are needed to achieve this result in the case of borrowings through a foreign-owned finance affiliate because the spread income of the foreign-owned finance affiliate to which the U.S. payor pays interest and the interest income of any related foreign-owned persons that also participate in the lending generally are not subject to U.S. tax; the interest income of a *U.S.-owned* finance affiliate and any related U.S.-owned recipients of interest from the finance affiliate generally is subject to U.S. tax. The inclusion of this interest income in U.S. taxable income offsets, in effect, part of the U.S. payor's deduction for interest paid to the U.S.-owned finance affiliate.

e. Original issue discount—foreign investors

Deduction for Original Issue Discount (sec. 110(e)(1) of the bill and sec. 163 of the Code)

Present Law

The Act delayed until actual payment the deduction for interest accrued, but not paid, to related foreign lenders with respect to an original issue discount (OID) obligation.

Explanation of Provision

The bill provides that the delay in the timing of deductions for interest accrued but not paid to related foreign lenders with respect to an OID obligation does not apply to the extent that the OID income is effectively connected with the lender's conduct of a U.S. trade or business, unless the OID income is exempt from U.S. taxation or is subject to a reduced rate of tax pursuant to a treaty obligation of the United States.

Taxation of Original Issue Discount (sec. 110(e)(2) of the bill and secs. 871 and 881 of the Code)

Present Law

Under the Act, a foreign investor that receives a taxable interest payment on an OID obligation is taxable on an amount equal to the OID accrued on the obligation since the last payment of interest thereon. On the sale, exchange, or retirement of an OID obligation, the foreign investor is taxable on the amount of any gain not in excess of the OID accruing while the foreign investor held the obligation (to the extent not previously taxed).

Explanation of Provision

The bill provides that when a foreign investor receives a payment (whether constituting interest or principal) on an OID obligation, the amount taxable is equal to the OID accrued on the obligation that has not before been subject to tax, whether or not the OID accrued since the last payment of interest. On the sale, exchange, or retirement of an OID obligation, the foreign investor is taxable on the amount of the OID accruing while the foreign investor held the obligation (to the extent not previously taxed), whether or not that amount exceeds the foreign investor's gain on the sale, exchange, or retirement.

f. Withholding on dispositions by foreigners of U.S. real property interests (sec. 110(f) of the bill and secs. 897, 1445, 6039C, and 6652(g) of the Code)

Present Law

In general

Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), a foreign investor that disposes of a U.S. real property interest generally is required to pay tax on any gain on the disposition. FIRPTA provided for enforcement of this tax through a system of information reporting designed to identify foreign owners of U.S. real property interests.

The 1984 Act generally repealed the information reporting requirements of FIRPTA and established a withholding system to enforce the FIRPTA tax.[3] The Act imposes a withholding duty on a transferee of a U.S. real property interest from a foreign person unless the transferee receives a sworn affidavit stating that the transferor is not foreign ("non-foreign affidavit"), or one of four other withholding exemptions (some of which are discussed in more detail below) applies. The amount withheld generally is the lesser of ten percent of the amount realized (purchase price), or the maximum tax liability on disposition (after proof of basis). Special rules are provided (some of which are discussed further below) for withholding by partnerships, trustees, executors, distributing foreign corporations, and domestic U.S. real property holding corporations.

Corporations making section 897(i) election

The Act does not treat foreign corporations electing under Code section 897(i) to be considered domestic corporations for purposes of FIRPTA's substantive and reporting provisions as domestic corporations for withholding purposes. This was intended to simplify the non-foreign affidavit procedure. If the section 897(i) election were applicable for withholding purposes, then electing foreign corporations could provide non-foreign affidavits. Congress was concerned that there would be uncertainty on the part of U.S. buyers regarding the validity of non-foreign affidavits received from foreign corporations.

Since enactment of the Act, the Internal Revenue Service has developed a procedure that would provide U.S. buyers with reasonable assurance that a non-foreign affidavit received from a foreign corporation is valid (as a result of a valid section 897(i) election) (Temp. Reg. secs. 1.1445-2T(b)(2)(ii), 1.1445-5T(b)(3)(ii)(C), and 1.1445-7T(a)).

Withholding exemptions for transfers of stock in domestic corporations

Withholding is not required on the disposition of an interest (other than an interest solely as a creditor) in a nonpublicly traded domestic corporation if the corporation furnishes a sworn affidavit to the transferee stating that the corporation is not and has not been a U.S. real property holding corporation ("U.S. RPHC") during the base period specified in Code section 897(c)(1)(A)(ii)—the shorter of the period after FIRPTA's general effective date (June 18, 1980) during which the transferor held the interest and the five-year period ending on the date of disposition of the interest ("non-U.S. RPHC affidavit"). The receipt of a non-U.S. RPHC affidavit will not relieve the transferee of withholding responsibility if the transferee has actual knowledge that the affidavit is false or the

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[3] The Act does authorize the Secretary of the Treasury to require information reporting by foreign investors not engaged in a U.S. business that hold direct investments in U.S. real property of $50,000 or more.

transferee receives a notice from his or her agent or an agent of the transferor that the affidavit is false.

In addition, no withholding is required on a disposition of shares of a class of corporate stock that is regularly traded on an established securities market.

Notice-giving and withholding responsibilities of agents

A transferor's agent or transferee's agent with actual knowledge that a non-foreign or non-U.S. RPHC affidavit is false must give the transferee notice to that effect at such time and in such manner as the Secretary shall require by regulations. In the case of a foreign corporate transferor, an agent of the transferor is deemed to have actual knowledge that any non-foreign affidavit furnished by the transferor is false. Congress believed that any agent deriving compensation from a foreign corporate principal in a real estate transaction would or should know that his or her principal was in fact foreign and that any non-foreign affidavit furnished by the foreign corporation was, therefore, false. In a case involving the transfer by a foreign corporation of stock in a domestic corporation that furnishes a false *non-U.S. RPHC* affidavit, it was not Congress' intention that an agent of the foreign corporate transferor be charged with actual knowledge of the non-U.S. RPHC affidavit's falsity, absent actual possession of such knowledge.

A transferor's agent or transferee's agent that does not give the required notice is liable for withholding as if he or she were the transferee, up to the amount of compensation the agent receives in connection with the transaction.

Dispositions of U.S. real property interests by domestic partnerships, trusts, and estates

The Act requires withholding at a ten-percent rate by a domestic partnership, a trustee of a domestic trust, or an executor of a domestic estate with respect to amounts in the custody of the partnership, trust, or estate that are attributable to the disposition of a U.S. real property interest and includible in either the distributive share of a foreign partner of the partnership, the income of a foreign beneficiary of the trust or estate, or the income of the grantor or other substantial owner of the trust (under the grantor trust rules of the Code).

Distributions by domestic U.S. RPHCs

The Act generally requires withholding by a domestic corporation that is (or, at any time during the five-year or shorter base period specified in Code section 897(c)(1)(A)(ii), was) a U.S. RPHC when the corporation distributes property to a foreign shareholder in a corporate liquidation or in redemption of its stock. In general, the amount of tax required to be withheld is ten percent of the gross amount of the distribution received by the foreign shareholder.

Withholding is not required under this rule when the stock liquidated or redeemed qualifies for the withholding exemption for stock transferred on an established securities market. Stock qualifying for that exemption may not be a U.S. real property interest and, hence, its surrender may not be a taxable disposition under the FIRPTA rules.

In addition, a qualifying statement granting exemption from withholding under this rule may be requested from the Internal Revenue Service in connection with a liquidating distribution by a domestic corporation of a non-U.S. real property interest when Code section 337 nonrecognition treatment was not elected for related corporate-level dispositions of U.S. real property interests (made during the base period specified in Code section 897(c)(1)(A)(ii)) by the domestic corporation. If the section 337 election was not made, the related corporate-level dispositions would have been subject to tax; a foreign shareholder's interest in the liquidating corporation may not be a U.S. real property interest (under the Code section 897(c)(1)(B) rule excluding from the definition of a U.S. real property interest an interest in a corporation that is not currently holding U.S. real property interests and that was fully taxed on previous corporate-level dispositions of such interests during the section 897(c)(1)(a)(ii) base period). Thus, the foreign shareholder's surrender of his interest in the corporation may not be a taxable disposition under the FIRPTA rules.

Taxable distributions by partnerships, trustees, and executors

The Act requires withholding by a domestic or foreign partnership, the trustee of a domestic or foreign trust, or the executor of a domestic or foreign estate when the partnership, trustee, or executor makes a distribution of a U.S. real property interest to a foreign person that is a taxable distribution under the FIRPTA rules taxing certain partnership, trust, and estate distributions notwithstanding general Code rules. In general, the amount of tax required to be withheld is ten percent of the fair market value of the distributed U.S. real property interest at the time of the distribution.

As drafted, this rule technically would apply only to U.S. real property distributions made taxable by regulations promulgated pursuant to Code section 897(g). The statute makes no reference to another Code provision added by FIRPTA—section 897(e)(2)(B)—under which certain partnership, trust, and estate distributions not covered by section 897(g) could be treated as taxable sales by regulation.

Return-filing and remittance of tax

To prevent double taxation, the Economic Recovery Tax Act of 1981 directs a person subject to tax under the FIRPTA rules to pay the tax to and file the necessary returns with the United States in the case of real property interests located in the United States, and to pay the tax to and file the necessary returns with the Virgin Islands in the case of real property interests located in the Virgin Islands. A sale of an interest, other than solely as a creditor, in a U.S. RPHC is subject to tax in the United States, while the tax on a sale of an interest in a Virgin Islands real property holding corporation is payable to the Virgin Islands.

Information returns—penalty provision

The FIRPTA information reporting rules include a provision imposing penalties on persons that fail to file required FIRPTA information returns and statements (Code sec. 6652(g)). As indicated above, the 1984 Act limited the circumstances under which the Secretary could require information reporting. The Act did not, however, make necessary conforming changes in the penalty provision.

Explanation of Provisions

Corporations making section 897(i) election

Under the bill, a foreign corporation electing under section 897(i) to be treated as a domestic corporation for purposes of FIRPTA's substantive and reporting provisions will be treated as a domestic corporation for purposes of the FIRPTA withholding provisions too.

The bill also provides that the section 897(i) election will be the exclusive remedy for any person claiming discriminatory treatment under a treaty obligation of the United States with respect to the FIRPTA withholding provisions.

Withholding exemptions for transfers of stock in domestic corporations

The bill conforms the non-U.S. RPHC withholding exemption more closely to the underlying substantive tax rule by substituting for it a new "non-U.S. real property interest" exemption to reflect Code section 897(c)(1)(B). Under the bill, withholding is not required on the disposition of an interest (other than an interest solely as a creditor) in a nonpublicly traded domestic corporation if the corporation furnishes an affidavit to the transferee stating, under penalty of perjury, either that the corporation is not and has not been a U.S. RPHC during the base period specified in Code section 897(c)(1)(A)(ii), or that, as of the date of the disposition, interests in the corporation are not U.S. real property interests by reason of section 897(c)(1)(B). Under section 897(c)(1)(B), interests in a corporation are not U.S. real property interests if the corporation is not holding any U.S. real property interests at the time of the disposition of the corporate interests and if the corporation disposed of all U.S. real property interests it held during the section 897(c)(1)(A)(ii) base period in transactions in which the full amount of gain (if any) was recognized.

The present law rules governing notice-giving by agents and withholding by agents and transferees in the case of a false non-U.S. RPHC affidavit will control (with the clarification discussed below) in the case of a false non-U.S. real property interest affidavit.

Notice-giving and withholding responsibilities of agents

The bill clarifies that an agent of a foreign corporate transferor of a domestic corporation's stock will not be charged with actual knowledge of the falsity of a false non-U.S. real property interest affidavit (the bill's substitute for the Act's non-U.S. RPHC affidavit) furnished by the domestic corporation, absent actual possession of such knowledge. Thus, no notice-giving or withholding duty will be imposed on such a transferor's agent unless he or she actually knows that the non-U.S. real property interest affidavit is false. An agent of a foreign corporate transferor will be charged with knowledge of the falsity only of a false *non-foreign affidavit* furnished by his or her principal.

It should be noted that, under the bill, unlike the Act, a non-foreign affidavit furnished by a foreign corporation may be valid. This will be the case where the foreign corporation has elected to be treated as a domestic corporation under Code section 897(i) and the corporation provides the transferee with proof of the section 897(i) election in the manner specified in regulations.

Dispositions of U.S. real property interests by domestic partnerships, trusts, and estates

The bill modifies the special withholding rule for dispositions of U.S. real property interests by domestic partnerships, trusts, and estates. Under the bill, a domestic partnership, a trustee of a domestic trust, or an executor of a domestic estate is to withhold a tax equal to 28 percent of the gain realized on the disposition by the entity of a U.S. real property interest, to the extent that gain is currently taken into account with respect to a foreign partner or foreign beneficiary of the partnership, trust, or estate or, in the case of a trust, is allocable to a portion of the trust treated as owned by a foreign person under the grantor trust rules of the Code.

Consistent with the Act's general withholding rule, withholding liability under this special rule, as amended by the bill, is not limited to the amount received on the disposition that is in the custody of the partnership, trustee, or executor. A partnership, trustee, or executor that does not have sufficient sales proceeds to satisfy its withholding liability (for example, because it mortgaged the disposed-of property on or after acquiring it, or agreed to accept payment for the disposed-of property on an installment basis) may request a qualifying statement from the Internal Revenue Service authorizing it to withhold a lesser amount.

Computing the tax to be withheld as a percentage of gain should, however, result (in many cases) in the collection of an amount of tax that more closely approximates the final tax liability of foreign partners, beneficiaries, and substantial owners than would the amount of tax collected were the tax computed as a percentage of the full amount realized. Withholding on the basis of gain is feasible under this special withholding rule because the withholding agent—a partnership, trustee, or executor—unlike the buyer (who may not know the seller's basis) in the usual withholding situation, knows what the foreign taxpayer's gain from the disposition will be: the partnership, trustee, or executor computes the amount of that gain. The 28-percent withholding rate reflects the maximum 28-percent capital gains rate for corporations—the highest rate at which a foreign partner, beneficiary, or substantial owner could be taxed on its share of the gain from the disposition of a U.S. real property interest by a partnership, trust, or estate.

This modification will be effective for dispositions of U.S. real property interests that occur after the day 30 days after the bill's date of enactment.

Distributions by domestic U.S. RPHCs

The bill eliminates withholding on certain liquidations and redemptions that are not taxed under the substantive FIRPTA rules. It provides that the special rule requiring withholding by domestic U.S. RPHCs (and former domestic U.S. RPHCs) upon the distribution of property in a corporate liquidation or redemption will not apply when interests in the corporation are not U.S. real property interests by reason of Code section 897(c)(1)(B) on the date of the distribution.

As indicated above, section 897(c)(1)(B) excludes from the definition of a U.S. real property interest an interest in a corporation that (1) is not holding U.S. real property interests at the time the corporate interest is disposed of and (2) disposed of all U.S. real property interests it held during the section 897(c)(1)(A)(ii) base period in transactions in which the full amount of gain (if any) was recognized. If section 897(c)(1)(B) applies to a corporation's stock, a stock interest surrendered in connection with a liquidation or redemption by the corporation is not a U.S. real property interest. Therefore, the surrender of that stock interest is not a taxable disposition under the FIRPTA rules, and withholding on the surrender is inappropriate.

Taxable distributions by partnerships, trustees, and executors

The bill clarifies that a distribution to a foreign person of a U.S. real property interest by a domestic or foreign partnership, trustee, or executor is subject to withholding if such distribution is taxable under regulations promulgated pursuant to any of the substantive FIRPTA rules, not Code section 897(g) only.

Return-filing and remittance of tax

The bill clarifies that persons required to withhold tax under the FIRPTA withholding rules, like persons having substantive FIRPTA tax liability, are to pay the tax to and file the necessary returns with the United States in the case of real property interests located in the United States, and are to pay the tax to and file the necessary returns with the Virgin Islands in the case of real property interests located in the Virgin Islands.

Information returns—penalty provision

The bill amends the provision (Code sec. 6652(g)) imposing penalties on persons that fail to file required FIRPTA information returns to conform it with the revised information reporting rules of the Act.

g. Foreign personal holding companies

U.S. shareholders in a foreign personal holding company are subject to current U.S. tax on their pro rata share of the company's undistributed foreign personal holding company income. The foreign personal holding company rules were enacted (in 1937) to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks."

Same Country Dividend and Interest Exception (sec. 110(h)(1) of the Act and sec. 552 of the Code)

Present Law

The Act provides that dividends and interest received by a foreign corporation from a person (1) related to the recipient, (2) organized in the same country as the recipient corporation, and (3) having a substantial part of its assets used in its trade or business located in that some country generally do not count in determining whether the foreign corporation is a foreign personal holding company. The Act does not define related person for this purpose.

Explanation of Provision

For the purpose of the Act's rule excluding same country dividends and interest from the foreign personal holding company calculation, the bill adopts the related party definition of the controlled foreign corporation rules (sec. 958). The bill provides that a person is a related person with respect to a foreign personal holding company if the person is (1) an individual, partnership, trust, or estate which controls the foreign personal holding company, (2) a corporation which controls, or is controlled by, the foreign personal holding company, or (3) a corporation which is controlled by the same person or persons which control the foreign personal holding company. For this purpose, control means the ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote. The bill incorporates certain rules for determining ownership of stock for this purpose.

Interposed Foreign Entities (sec. 110(h)(2) of the Act and sec. 551(f) of the Code)

Present Law

The Act added a tracing rule to the foreign personal holding company rules that was intended to make clear that U.S. taxpayers cannot interpose foreign entities (other than other foreign personal holding companies) between themselves and a foreign personal holding company to avoid the foreign personal holding company rules. Under the tracing rule, stock of a foreign personal holding company that is owned by a foreign entity other than another foreign personal holding company is to be considered (for income inclusion purposes) as being owned proportionately by the foreign entity's partners, beneficiaries, or stockholders.

Explanation of Provision

The bill clarifies that the tracing rule applies to all foreign trusts and estates interposed between U.S. taxpayers and foreign personal holding companies.

h. Treatment of certain indirect transfers (sec. 110(i) of the bill and sec. 1248(i) of the Code)

Present Law

Code section 1248 requires gain realized by certain U.S. persons on the disposition of stock in a foreign corporation to be treated as ordinary income to the extent of allocable earnings and profits of the foreign corporation. Under the Act, if shareholders of a U.S. corporation exchange stock in the corporation for newly issued stock (or treasury stock) of a foreign corporation ten percent or more of the voting stock of which is owned by the U.S. corporation, the transaction is recast for purposes of applying section 1248. Because the Act provides that the U.S. corporation is treated as having distributed the stock in the foreign corporation "in redemption" of the shareholder's stock, every indirect transfer could be viewed as a nonliquidating distribution.

Explanation of Provision

The bill clarifies that an indirect transfer is recast as a distribution in redemption or liquidation, whichever is appropriate. For example, assume that a U.S. corporation ("P") is the sole shareholder of a U.S. holding company ("Holdco"). Holdco owns 100 percent of the stock of a corporation that was organized under the laws of a foreign country ("S"). Holdco merges downstream into S; in the merger P exchanges Holdco stock for stock of S. Under section 1248(i), the transaction is treated as if Holdco distributed the S stock in a liquidating distribution to P. This result occurs because Holdco goes out of existence and the transaction has the economic effect of a liquidation. Under section 1248(f)(2), however, no amount is includible in P's gross income because the liquidation is subject to section 332 (and therefore P is treated as holding the S stock for the period the stock was held by Holdco and P satisfies the prescribed stock ownership requirements with respect to S).

i. Stapled stock

Collection of Tax (sec. 110(j)(1) of the bill and sec. 269B(b) of the Code)

Present Law

The Act treats a foreign corporation whose stock is is stapled to that of a U.S. corporation as a U.S. corporation. That corporation is thus taxable on its worldwide income. It is not clear, in some cases, how the United States would collect the tax due under this rule. The Act requires the Secretary of the Treasury to prescribe such regulations as may be necessary to prevent tax avoidance or evasion through the use of stapled entities.

Explanation of Provision

The bill specifies that the regulations that the Secretary is to prescribe pertaining to stapled entities may include regulations providing that any tax imposed on a foreign corporation that the Act treats as a U.S. corporation may, if that corporation does not pay them, be collected from the U.S. corporation to which it is stapled or from the shareholders of the foreign corporation. For example, assume that all the interests in a foreign corporation are stapled to interests in a U.S. corporation. In that case, regulations may provide that the U.S. corporation is liable for any tax that the foreign corporation does not pay. Alternatively, it could be appropriate to collect the tax from the shareholders of the foreign corporation.

Foreign-Owned Corporations (sec. 110(j)(2) of the bill and sec. 269B(b) of the Code)

Present Law

Under the stapled entity rules of the Act, a foreign corporation whose stock is is stapled to that of a U.S. corporation is treated as a U.S. corporation, whoever owns the two corporations. However, the purpose of the stapled entity rules was, in general, to prevent avoidance of tax rules that apply to U.S.-controlled foreign corporations.

Explanation of Provision

The bill limits the stapled entity rules treating a foreign corporation as domestic. These rules will not apply if it is established to the satisfaction of the Secretary of the Treasury that both the stapled foreign corporation and the U.S. corporation to which it is stapled are foreign owned. A corporation is foreign owned for this purpose if less than half of its stock, by vote or value, belongs directly or indirectly to U.S. persons.

j. Insurance of related parties by a controlled foreign corporation (sec. 110(k) of the bill and sec. 954(e) of the Code)

Present Law

U.S. shareholders of controlled foreign corporations are currently taxable on the foreign base company services income of those corporations. Foreign base company services income is income derived in connection with certain services that satisfy a two-pronged test: (1) they are performed for or on behalf of any person related to the controlled foreign corporation and (2) they are performed outside the country under the laws of which the controlled foreign corporation is organized. For the purpose of the first prong of this test, a related person is generally one with more than 50 percent common ownership. The Act amended the second prong of the test in the case of insurance services: if the primary insured is a related person (defined more broadly in this case to include a 10-percent U.S. shareholder and persons related to that shareholder), any services performed with respect to any policy of insurance or reinsurance will be treated as having been performed in the country in which the risk of loss against which that related person is insured is located. The Act did not amend the definition of related person with respect to the first prong of the test.

Explanation of Provision

The bill makes it clear that there is a single definition of related person for the purpose of determining the amount of foreign base company services income that arises from insurance. In applying the rule that treats income from services performed with respect to insurance or reinsurance for or on behalf of related persons as foreign base company services income (the first prong of the base company services income test), the primary insured will be treated as a related person if it is related within the broad related party rule used specifically for insurance services under the Act—the rule that reaches 10-percent U.S. shareholders and persons related to them.

k. Definition of resident alien (sec. 110(l) of the bill and sec. 7701(b)(4)(E) of the Code)

Present Law

Resident aliens, like U.S. citizens, are subject to U.S. tax on their worldwide income at the regular graduated rates. The Act provided standards for determining whether a foreign individual is a resident alien for income tax purposes.

Under these standards, an individual who spends substantial time in the United States in any year or over a three-year period is generally a U.S. resident (the "substantial presence test"). Days spent in the United States as an "exempt individual," a term that includes certain teachers, trainees, and students temporarily present in the United States under subparagraphs (F) and (J) of section 101(15) of the Immigration and Nationality Act, do not count as days of U.S. presence under the substantial presence test. However, a teacher or trainee cannot be an exempt individual in a particular calendar year if the teacher or trainee was exempt as a teacher, trainee, or student for any part of two of the six preceding calendar years. Thus, foreign teachers and trainees may work as such in the United States during no more than two calendar years in any seven calendar-year period without exposing themselves to possible resident alien treatment under the substantial presence test.

In 1961, to relieve foreign students, teachers, and scholars of U.S. tax liability that had the effect of reducing the value of their stipends while they were in the United States, Congress provided that compensation paid by a foreign employer to a *nonresident* alien individual for the period the individual is temporarily present in the United States as a non-immigrant (under subparagraph (F) or (J) of section 101(15) of the Immigration and Nationality Act) is not subject to U.S. tax (Code sec. 872(b)(3), added by the Mutual Educational and Cultural Exchange Act of 1961). Because foreign teachers and trainees who work as such in the United States during more than two calendar years may become resident aliens under the substantial presence test, some foreign teachers and trainees admitted to the United States under exchange visitor programs during three or four calendar years whose foreign income would otherwise be exempt from U.S. tax under Code section 872(b)(3) will be subject to

U.S. tax on such income received or accrued during their third and fourth calendar years in the United States.

Explanation of Provision

The bill increases the exemption period for teachers and trainees, all of whose compensation would otherwise be exempt from tax under the Mutual Educational and Cultural Exchange Act, to a maximum of four calendar years. Under the bill, days spent working in the United States as a teacher or trainee during four calendar years in any seven calendar year period do not count as days of U.S. presence for purposes of the substantial presence test if all of the individual's compensation is described in Code section 872(b)(3).

11. Compliance Provisions (sec. 111 of the bill and secs. 6050H, 6050K, and 7502 of the Code)

Present Law

The Act contained compliance provisions requiring that:

(1) Recipients of mortgage interest report to the payor and the Internal Revenue Service the amount of mortgage interest paid;

(2) Information reporting to the Internal Revenue Service and the taxpayers involved be completed on exchanges of certain partnership interests; and

(3) All deposits of $20,000 or more of any tax required to be deposited under the provisions of section 6302(c) of the Code that are made by any taxpayer required to deposit any tax under that section more than once a month must be made by the due date of the deposit, regardless of the method of delivery.

Explanation of Provision

The bill makes the following changes to these compliance provisions:

(1) The bill provides that a cooperative housing corporation must report to both its tenant-stockholder and the Internal Revenue Service on the tenant-stockholder's proportionate share of interest paid to the cooperative housing corporation. The bill also corrects a citation to the Code in the effective date of this provision.

(2) The bill corrects an internal reference in the provision relating to reporting on exchanges of certain partnership interests.

(3) The bill clarifies that the new deposit rules apply to any taxpayer required, under the provisions of section 6302(c), to deposit any tax under that provision more than once a month.

12. Miscellaneous Reform Provisons

a. Tax benefit rule (sec. 112(a) of the bill and sec. 111 of the Code)

Present Law

The Act amended the rules of prior law to more clearly reflect economic reality in applying the statutory tax benefit exclusion. To accomplish this, the Act repealed the prior law "recovery exclusion" concept and provided that an amount is excludible from income only to the extent it did not reduce income subject to tax.

Explanation of Provision

The bill provides that an amount is excludible from income only to the extent that it does not reduce a taxpayer's income tax under chapter 1 of the Code. Thus, where a deduction reduces taxable income but does not reduce tax (because, for example, the taxpayer is subject to the alternative minimum tax), recovery of the amount giving rise to the deduction may be excludible from income under section 111. This amendment is not intended to change the result in the example set forth in the committee reports accompanying the Act.

b. Low interest loans (sec. 112(b) of the bill and sec. 7872 of the Code)

Present Law

Section 7872 generally provides that certain loans bearing a below-market rate of interest are treated as loans bearing a market rate of interest accompanied by a payment or payments from the lender to the borrower which are characterized in accordance with the substance of the particular transaction, e.g., gift, compensation, dividend, etc.

For purposes of determining the appropriate market rate of interest as well as the timing of the deemed transfers, section 7872 distinguishes between demand loans and term loans. As presently provided by section 7872, a demand loan is defined as a loan which is due on demand. A term loan is defined as a loan which is not a demand loan. For income tax purposes, in the case of a below-market term loan that is not a gift loan, section 7872 treats the excess of the amount loaned over the present value of all payments due under the loan as having been transferred from the lender to the borrower at the time the loan is made. In the case of a below-market demand loan as well as all gift loans, the deemed transfer occurs at the end of each taxable year and the amount of the deemed transfer is the foregone interest that year.

In applying the prescribed market rate, section 7872 requires semi-annual compounding for non-gift term loans, but does not require semi-annual compounding for gift loans and demand loans.

Section 7872 also provides that withholding by an employer is not required where a deemed payment arising from a below-market *demand* loan is in the nature of compensation. However, there is no similar exception from withholding where a deemed compensation payment arises from a below-market *term* loan.

Under section 4941 of the Code, certain so-called acts of self-dealing between a private foundation and a "disqualified person" are subject to penalty excise taxes on the amount involved. Generally, a loan between the foundation and a disqualified person is an act of self-dealing. However, an exception is provided for interest-free loans to the private foundation, provided that the proceeds of the loan are used exclusively for certain designated charitable purposes.

Explanation of Provision

The definitions of term loan and demand loan in section 7872 appear to treat loans with an indefinite maturity as term loans. However, it often is impractical to treat a loan with an indefinite maturity as a term loan, since section 7872 requires the computation of the present value of the payments due under such a loan. Accordingly, the bill grants the Treasury Department authority to treat loans with indefinite maturities as demand loans rather than term loans.

The various time value of money provisions of the Code, (including provisions relating to the treatment of below-market term loans), generally require the use of semi-annual compounding in calculating interest. In order to treat all loans consistently, the bill provides that semi-annual compounding will also be required in calculating interest with respect to gift loans and demand loans under section 7872.

The Conference Report to the Act indicated that payments of compensation, deemed to have been made by section 7872, would be subject to the information reporting requirements but not the withholding requirements of the Code. H. R. Rep. No. 98-861, 98th Cong., 2d Sess. 1017 (1984). The failure to except from the withholding requirements deemed payments of compensation arising from below-market term loans was inadvertent, and the bill corrects this omission.

Finally, the bill clarifies that Congress did not intend in enacting section 7872 to affect the definition of acts of self-dealing with private foundations.

c. Transactions with related foreign persons (sec. 112(c) of the bill and sec. 267 of the Code)

Present law

The Act generally imposes a matching principle by placing taxpayers on the cash method of accounting with respect to the deduction of amounts owed to a related cash-basis taxpayer. In other words, the deduction by the payor is generally allowed no earlier than when the related payee recognizes the corresponding income. The application of this rule is unclear when the related payee is a related foreign person that does not, for many Code purposes, include in gross income foreign source income that is not effectively connected with a U.S. trade or business.

Explanation of Provision

The bill directs the Secretary of the Treasury to issue regulations applying the matching principle generally applicable to related party transactions in cases in which the person to whom the payment is to be made is not a United States person. For example, assume that a foreign corporation, not engaged in a U.S. trade or business, performs services outside the United States for use by its wholly owned U.S. subsidiary in the United States. That income is foreign source income that is not effectively connected with a U.S. trade or business. It is not subject to U.S. tax (or, generally, includible in the foreign parent's gross income). Under the bill, regulations could require the U.S. subsidiary to use the cash method of accounting with respect to the deduction of amounts owed to its foreign parent for these services. In the case of amounts accrued to a controlled foreign corporation by a related person, regulations might appropriately require the payor's accounting method to conform to the method that the controlled foreign corporation uses for U.S. tax purposes.

Regulations will not be necessary when amount paid to a related foreign person is effectively connected with a U.S. trade or business (unless a treaty reduces the tax). In that case, present law already imposes matching. However, regulations may be necessary when a foreign corporation uses a method of accounting for some U.S. tax purposes (*e.g.*, because some of its income is effectively connected), but when the method does not apply to the amount that the U.S. person seeks to accrue.

d. Federal Home Loan Mortgage Corporation ("Freddie Mac") (sec. 112(d) of the bill and sec. 246 of the Code)

Present Law

General background

The Act repealed the prior law exemption from Federal income tax of Freddie Mac, effective January 1, 1985. Various transition rules were included to ensure that, to the extent possible, Freddie Mac was subject to tax only on its post-1984 income.

The 12 regional Federal Home Loan Banks, which hold the common stock of Freddie Mac, are themselves exempt from tax; however, the member institutions of the Home Loan Banks are subject to tax.

In a transaction completed in early 1985, Freddie Mac issued a new class of preferred stock in itself to the regional Federal Home Loan Banks, which then transferred the stock to their member institutions. Distributions with respect to this preferred stock will thus be paid directly to the member institutions. The common stock of Freddie Mac continues to be owned by the Federal Home Loan Banks.

Dividends received deduction

The Act allows shareholders of the Federal Home Loan Banks a dividends received deduction for that portion of dividends received from a Federal Home Loan Bank which is allocable to dividends paid to the Federal Home Loan Bank by Freddie Mac out of Freddie Mac earnings and profits for periods after December 31, 1984. Special "stacking" rules are included in order that a deduction may be received only with respect to dividends which are properly allocable to post-1984 earnings and profits of Freddie Mac. No dividends received deduction is allowed to member institutions for dividends received from Federal Home Loan Banks which are allocable to Freddie Mac earnings and profits which Freddie Mac accumulated before January 1, 1985 (i.e., prior to the date of taxability).

In addition to these rules, the Act states that, for all income tax purposes, Freddie Mac is to be treated as having no accumulated earnings and profits as of January 1, 1985. This provision was intended to ensure that the deduction for dividends received by member institutions from the Federal Home Loan Banks would apply only to the extent the dividends are allocable to post-1984 earnings and profits of Freddie Mac (i.e., to Freddie Mac income which has already been subject to tax).

Explanation of Provisions

Dividends received deduction

The bill makes several adjustments in the dividends received deduction for dividends allocable to post-1984 Freddie Mac income.

First, the bill adds an explicit statutory rule stating that no dividends received deduction is to be allowed with respect to dividends paid by Freddie Mac out of earnings and profits accumulated before January 1, 1985 (i.e., the date of taxability). This rule is in addition to the present law rule which denies a dividends received deduction for dividends paid by a Home Loan Bank which are ultimately allocable to pre-1985 Freddie Mac income. Thus, under the bill, dividends received deductions would be limited to amounts allocable to post-1984 (i.e., taxable) Freddie Mac income, both in the case of income distributed via the Federal Home Loan Banks and in the case of any dividends which may be paid directly to Freddie Mac corporate shareholders who are themselves subject to tax (e.g., member institutions which hold Freddie Mac preferred stock). This rule allows a dividends received deduction where necessary to avoid a double corporate-level tax on Freddie Mac income. In conjunction with this amendment, the present law rule under which Freddie Mac is treated as having no accumulated profits as of January 1, 1985, is repealed.

Second, in the case of income distributed via a Federal Home Loan Bank, the bill clarifies that no dividends paid by Freddie Mac may serve as the basis for more than one deduction for dividends received from a Federal Home Loan Bank. This clarification applies both to dividends paid by a Federal Home Loan Bank in different years, or when two or more dividends are paid during the same year.

Third, in the case of dividends paid directly by Freddie Mac to taxable corporate shareholders, the bill permits a deduction for dividends received in 1985, as well as later years. This result would otherwise be prevented by a Code provision which denies dividends received deductions for one year after the corporation paying the dividend ceases to be tax-exempt (sec. 246(a)(1)).

Tax treatment of preferred stock distribution

The bill provides that, for all purposes under the Code, the distribution of preferred stock by Freddie Mac to the Federal Home Loan Banks in late 1984, and the distribution of such stock by the Federal Home Loan Banks to their member institutions in January, 1985, are to be treated as if they were distributions of money in an amount equal to the fair market value of the stock on the date of the distribution by the Federal Home Loan Banks, followed by the payment of such money by the member institutions to Freddie Mac in return for its stock. Thus, under the special rule, the Federal Home Loan Banks will be treated as receiving cash dividends to the extent that the money deemed received from Freddie Mac is attributable to earnings and profits of Freddie Mac, and the earnings and profits of the Federal Home Loan Banks will be increased by an equivalent amount. The member institutions, in turn, will be treated as receiving cash dividends from the Federal Home Loan Banks, to the extent that the money deemed received from the Federal Home Loan Banks is attributable to earnings and profits of the Federal Home Loan Banks (taking into account the earnings and profits resulting from the distribution from Freddie Mac). Because these dividends are allocable to pre-1985 earnings and profits of Freddie Mac, the member institutions will not be entitled to a dividends received deduction with respect to these amounts.

Under the special rule above, the earnings and profits of Freddie Mac will be reduced by the amount deemed distributed to the Federal Home Loan Banks. If Freddie Mac later makes distributions to the member institutions out of its pre-1985 income, these distributions will be treated as dividends (and will not qualify for a dividends received deduction) to the extent (if any) that pre-1985 earnings and profits of Freddie Mac exceeded the amount deemed distributed at the time of the preferred stock distribution.

e. Personal use property (sec. 112(e) of the bill and sec. 280F of the Code)

Present Law

The Act provided limitations on the maximum amount of investment tax credit and depreciation that a taxpayer may claim with respect to a passenger automobile. The Act also provided that if use in a trade or business of listed property does not exceed 50 percent, no investment tax credit is available, and depreciation must be determined on the straight line method over the earnings and profits life of the property. Listed property is any passenger automobile or other means of transportation, any entertainment, recreation, or amusement property, any computer, or any other property specified in regulations. However, any computer used exclusively at a regular business establishment is not considered to be listed property. Employee use of listed property must be for the convenience of the employer and a condition of employment for the employee to be able to claim a deduction or credit for the use of listed property.

Explanation of Provision

The bill clarifies the definition of passenger automobile by providing that the weight of the automobile shall not include the weight of the passengers or the weight of any cargo. A similar clarification is made for purposes of the gas guzzler tax (sec. 4064 of the Code).

The bill also clarifies that computers eligible for the exception from the definition of listed property must be owned or leased by the person operating the business establishment, in addition to being used exclusively at a regular business establishment. See H. Rep. No. 98-861 (June 23, 1984), p. 1026 (Conference Report).

The bill also clarifies that the requirements that, in order to take a deduction or credit, employee use of listed property be for the convenience of the employer and required as a condition of employment also apply to the amount of any deduction allowable to the emloyee for rentals or other payments under a lease of listed property.

B. Technical Corrections to Life Insurance Provisions

1. Certain amounts not less than surrender value of contract (sec. 121(a) of the bill and sec. 807(c) of the Code)

Present Law

Present law provides that net increases or decreases in certain items like reserves should be taken into account in computing life insurance company taxable income (LICTI). For purposes of computing increases or decreases in life insurance reserves, the amount of the reserve for any contract is the greater of the net surrender value of such contract or a Federally prescribed reserve; the Federally prescribed reserve requires a company to use a particular method, the prevailing State assumed interest rate, and the prevailing commissioner's standard mortality or morbidity table.

Another item for which increases or decreases are taken into account in computing LICTI is amounts (discounted at the appropriate rate of interest) necessary to satisfy the obligations under insurance and annuity contracts, but only if such obligations do not involve at the time with respect to which the computation is made life, accident, or health contingencies. For these purposes, the appropriate rate of interest for any obligation is the higher of the prevailing State assumed interest rate as of the time such obligation first did not involve life, accident, or health contingencies or the rate of interest assumed by the company (as of such time) in determining the guaranteed benefit. Present law does not provide that, in computing increases or decreases in amounts discounted at the appropriate rate of interest, the taxpayer can take into account the net surrender value of the contract if such value is higher than the amount discounted at the appropriate rate.

Explanation of Provision

The bill provides that, in computing the increases or decreases of amounts discounted at interest under insurance and annuity contracts, the amount taken into account will in no case be less than the net surrender value of such contract. This correction recognizes that amounts under these contracts discounted at the prevailing State assumed interest rate may in fact yield a reserve item which is less than the net surrender value guaranteed by the contract. The correction will allow the taxpayer to recognize increases and decreases in at least their current liability as represented by its guaranteed net surrender value of a contract, as is the case in computing such increases or decreases with respect to life insurance reserves.

With respect to determining what method should be used in computing the Federally prescribed reserves for life insurance contracts, the 1984 Act adopted the provision as it was passed by the

Senate. In explaining this, the Statement of Managers for the Conference Report expanded the explanation previously made in the Senate report with respect to how annuity reserves should be revalued as of January 1, 1984. In general, the Federally prescribed reserve methods refer to those recommended by the NAIC for the particular type of contract. Thus, in computing any life insurance reserve (including an annuity reserve), a company must take into account any factors specifically recommended by the NAIC. If specific factors are not recommended by the NAIC prescribed reserve method, the prevailing State interpretation of such method should be considered for purposes of determining what factors can be taken into account in applying the computation method for tax purposes. Because there were divergent State views on how CARVM (the reserve method prescribed for annuity contracts) should be interpreted, and there was a possibility that the NAIC would act to resolve State differences by the end of 1984, the Statement of Managers indicated that if the NAIC acted in 1984, their recommendations would be given retroactive effect.

The NAIC did not act to resolve the State differences on how CARVM should be applied. Accordingly, annuity reserves should have been revalued as of January 1, 1984, in accordance with the prevailing State interpretation of CARVM. It is understood that, through 1983, the prevailing State interpretation of CARVM was that annuity reserves could be reduced by the amount of any surrender charges (whether or not such charges were contingent). Thus, it was assumed that, failing action by the NAIC in 1984, annuity reserves would be revalued and computed for tax purposes by taking into account any surrender charges.

2. Clarification of definition of excess interest (sec. 121(b) of the bill and sec. 808(d)(1) of Code)

Present Law

Under present law, excess interest is defined as any amount in the nature of interest paid or credited to a policyholder in his capacity as such, and determined at a rate in excess of the prevailing State assumed interest rate for such contract.

Explanation of Provision

The bill changes the language of the statute so that excess interest refers to any amount in the nature of interest in excess of the prevailing State assumed rate for such contract. This change is intended to clarify that the term excess interest refers only to the excess amount and not to the entire amount in the nature of interest (including the amount determined at the prevailing State assumed interest rate).

3. Coordination of 1984 fresh start adjustment with certain accelerations of policyholder dividends deductions (sec. 121(c) of the bill and sec. 808 of the Code)

Present Law

As under prior law, present law allows a deduction for dividends or similar distributions to policyholders. Present law departs from prior law, however, in that the amount of the deduction for any taxable year is the amount of policyholder dividends paid or accrued during the taxable year rather than the amount of policyholder dividends paid during the taxable year for the increases (or less the decreases) in the reserves for policyholder dividends that are payable during the year following the taxable year. Under a transitional rule, this change from a reserve to an accrual method was not treated as a change in a method of accounting. Thus, no income or loss was recognized with respect to amounts in existing policyholder dividend reserves, and taxpayers were given a "fresh start" in computing their policyholder dividends deduction.

Explanation of Provision

This "fresh start" was granted with respect to the accounting change for policyholder dividends on the assumption that insurance companies would continue to follow their general business practice in declaring policy dividends at the end of the calendar year to be payable on policy anniversaries during the following calendar year only in the event the policy remained outstanding on such anniversary. It was understood that, given the general business practices, the present-law change in policyholder dividends accounting had the effect of delaying the deduction for policyholder dividends to the taxable year in which they are paid.

It appears that by guaranteeing policy dividends on termination (which may not change necessarily the payment date of policy dividends) or by changing the payment date by making policy dividends available upon declaration, a company can accelerate the deduction for approximately one half the policyholder dividends that would have been deducted in the following taxable year if there had been no change in the company's business practices in declaring policy dividends. As a practical matter, the amount of the acceleration of the policyholder dividend deduction might be viewed as restoring a company, in part, to the position it enjoyed under prior law with respect to the timing of the policyholder dividends deduction. The "fresh start" for the change in policyholder dividends accounting was intended to mitigate the detriment caused taxpayers by a statutory change in such accounting; to the extent the detriment caused by the statutory change is mitigated in fact by a company's own changed business practices, the "fresh start" was not intended to give a company additional tax benefits.

For these reasons, the bill adopts a provision that would reduce a company's policyholder dividends deduction by the amount by which the company's policyholder dividends deduction was accelerated because of a change in business practices. This reduction for an accelerated policyholder dividends deduction would be made before any reduction for the ownership differential provision for mutual life insurance companies and would not exceed on a cumulative basis the amount of the 1984 fresh-start adjustment for policyholder dividends that was enjoyed by the company. Also, the determination of the amount of the accelerated policyholder dividends deduction and the amount of the 1984 fresh-start adjustment will be made with respect to each line of business.

The term "accelerated policyholder dividends deduction" means the amount that would be determined for the taxable year as policyholder dividends paid or accrued, but which would have been determined for a later taxable year under the business practices of the company as in effect at the close of the preceding taxable year. Thus, types of changes in business practices which would result in an accelerated policyholder dividends deduction include guaranteeing of policy dividends on termination for a particular product line or changing the actual payment date of policy dividends (for example, by making such dividends available upon declaration). On the other hand, changes in plans of insurance being sold or the development of new products will not result in an accelerated policyholder dividends deduction. For example, the introduction and sale of a universal life insurance product that credits excess interest to the cash surrender value on a monthly basis and that may depart from prior business practices of selling traditional participating life insurance policies that pay policy dividends at the policy anniversary date is not the type of change in business practice covered by this provision. Likewise, the exchange of an old contract for a new product by a current policyholder would not be a change in business practices by the company covered by this provision.

The bill specifically provides that this provision does not apply to a mere change in the amount of policyholder dividends. Thus, if a company changed its dividends scale, for example, by increasing the amount of the policyholder dividend over the previous year or by changing the formula for determining amounts of policy dividends to include items not previously considered in determining the amount of policyholder dividends (e.g., capital gains), this provision would not apply to such change in business practices.

The cumulative amount of reduction of a company's policyholder dividends deduction with respect to a particular line of business because of this provision is limited to the 1984 fresh-start adjustment for policyholder dividends with respect to such business. Specifically, the 1984 fresh-start adjustment for policyholder dividends means the amounts held as of December 31, 1983, by the company as reserves for policyholder dividends that were deductible in 1983, less dividends that accrued before January 1, 1984. Also, the adjustment amount will be properly reduced to reflect the amounts of previously nondeductible policyholder dividends as determined under prior-law section 809(f).

3. Clarification of equity base (sec. 121(d) of the bill and sec. 809(b) of the Code)

Present Law

Although the general rules and definitions relating to policyholder dividends apply to stock and mutual life insurance companies alike, for mutual companies the amount of the deduction for policyholder dividends is reduced by an amount referred to in present law as the "differential earnings amount." This reduction reflects the Congress's recognition that, to some extent, policyholder dividends paid by mutual companies are distributions of the companies' earnings to the policyholders as owners. The differential earnings amount is computed by multiplying a company's average equity base for the taxable year by a differential earnings rate.

The term equity base means an amount equal to the statutory surplus and capital of a company plus any nonadmitted financial assets, the excess of statutory reserves over tax reserves, the amount of any mandatory securities valuation reserve, the amount of any deficiency reserve or any voluntary reserve, and 50 percent of the amount of any provision for policyholder dividends (or other similar liability) payable in the following taxable year.

Explanation of Provision

As a clarification, the bill specifically provides that no item shall be taken into account more than once in determining the equity base. This clarification is made to ensure that items which are specifically included in the equity base are not counted a second time because they may be indirectly included under another item which is included in the equity base. For example, deficiency reserves, which are specifically listed in the statute as included in the equity base, could also be included indirectly as part of the excess of statutory policy reserves over tax reserves, which is also specifically included in the equity base.

4. Definition of 50 largest stock companies (sec. 121(e) of the bill and sec. 809(d)(4) of the Code)

Present Law

Under present law, the differential earnings amount which reduces a mutual company's policyholder dividends deduction is determined by multiplying the company's average equity base for the taxable year by the differential earnings rate for the taxable year. The differential earnings rate is the excess of an imputed earnings rate over the average mutual earnings rate. The imputed earnings rate is set in the Code and subsequently adjusted to provide comparable treatment for stock and mutual companies.

Specifically, for taxable years beginning after 1984, the imputed earnings rate will be an amount which bears the same ratio to 16.5 percent as the current stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock life insurance companies for the 3 years preceding the taxable year) bears to the base period stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock companies for 1981, 1982, and 1983). The 50 largest stock companies are to be determined by the Secretary of the Treasury on the basis of gross assets; for these purposes, assets of a company among the 50 largest will be aggregated with assets of any affiliated life companies. However, in order to eliminate distortions in the computation of the average earnings rate of the 50 largest stock companies which is then used to index the imputed earnings rate, the Secretary has the authority to omit from such computation companies with aberrational rates caused by disproportionately small equity bases (for example, when a company is close to being or is insolvent).

Explanation of Provision

Rather than require stock life insurance companies to compute their average equity base in order to determine whether the company might be eliminated because such equity base is disproportionately small, the bill provides that the Secretary can omit companies from the computations involving the 50 largest stock companies based on the surplus and capital of such company. Specifically, the Secretary may by regulations exclude from the group of the 50 largest stock life insurance companies any stock life insurance company if (1) the surplus and capital of such company is not great enough for such company to be one of the 50 largest stock life insurance companies if the determination were made on the basis of the surplus and capital, and (2) by reason of the small equity base of such company, it has an earnings rate which would seriously distort the stock earnings rate used to index the imputed earnings rate. The surplus and capital referred to in this provision is the statutory surplus and capital which is used as the base for determining the equity base under section 809(b)(2)(A).

5. Clarification of statement gain or loss from operations (sec. 121(f) of the bill and sec. 809(g)(1) of the Code)

Present Law

Under present law, the earnings rate for any life insurance company is the percentage, determined by the Secretary of the Treasury, which a company's statement gain or loss from operations is of its average equity base. The statutory language under present law states that the term "statement gain or loss from operations" means the net gain or loss from operations required to be set forth in the annual statement (a) determined with regard to policyholder dividends (as defined in section 808) but without regard to Federal income taxes, (b) determined on the basis of tax reserves rather than statutory reserves, and (c) properly adjusted for realized capital gains or losses and other relevant items.

Explanation of Provision

The bill revises the statutory language of the definition of statement gain or loss from operations to make it clear that the term refers to net gain or loss from operations set forth in the annual statement, determined without regard to Federal income taxes and with further adjustment for certain tax items. Specifically, the bill clarifies that the "statement gain or loss from operations" must be adjusted by substituting for the amount shown on the annual statement for policyholder dividends the amount of the deductions for policyholder dividends under section 808, unreduced by any differential earnings amount (i.e., without regard to section 808(c)(2)). The use of the tax amount for the policyholder dividends deduction *unreduced* by any differential earnings amount is necessary to eliminate a circularity in computation of the differential earnings amount and to ensure that subsequent adjustments in the differential earnings amount have the revenue impact intended by the ownership differential provision.

6. Most recent differential earnings rate may be used for purposes of estimated tax payments (sec. 121(g) of the bill and sec. 809(c) of the Code)

Under present law, the differential earnings amount which reduces a mutual company's policyholder dividends deduction is determined by multiplying a company's average equity base for the taxable year by the differential earnings rate for the taxable year. The differential earnings rate is the excess of an imputed earnings rate over the average mutual earnings rate. The imputed earnings rate is set in the Code and subsequently adjusted to provide comparable treatment for stock and mutual companies.

Specifically, for taxable years beginning after 1984, the imputed earnings rate will be an amount which bears the same ratio to 16.5 percent as the current stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock life insurance companies for the three years preceding the taxable year) bears to the base period stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock companies for 1981, 1982, and 1983). The differential earnings rate for the taxable year will be published by the Secretary of the Treasury after all the relevant data and computations have been made.

Explanation of Provision

The bill amends the definition of the differential earnings rate to be used for a taxable year for purposes of estimated tax payments. Specifically, the bill provides that if, with respect to any installment of estimated tax, the most recent published differential earnings rate is less than the differential earnings rate applicable to the taxable year for which the installment is paid, for purposes of applying additions to tax for underpayments of estimated tax with respect to such installment, the amount of tax shall be determined by using the most recent published differential earnings rate. The "most recent published differential earnings rate" means the most recent differential earnings rate published by the Secretary of the Treasury, determined as of 30 days before the date prescribed for payment of the installment of estimated tax. In providing this relief from additions to tax for underpayments of estimated tax under these limited circumstances, the bill recognizes that, as a practical matter, Treasury will be unable to collect the data from the previous taxable year and compute the new differential earnings rate for the current taxable year in time for the taxpayer to use that differential earnings rate to make its initial estimated tax payments. A 30-day grace period for using the most recent published differential earnings rate was provided to relieve companies from waiting until the last possible day before filing their estimated tax returns.

7. Amendments related to proration formulas (sec. 121(h) of the bill and sec. 812 of the Code)

Present Law

Present law retains a prior law concept that items of investment yield should be allocated between policyholders and the company. Because reserve income increases may be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. The policyholders' share of any item is 100 percent of the item reduced by the company's share of the item. The company's share is defined as the percentage obtained by dividing the company's share of net investment income by total net investment income. Net investment income is defined as 90 percent of gross investment income. Gross investment income is generally all income from investments, including tax-exempt interest, and not including 100-percent dividends except to the extent such dividends are paid directly or indirectly out of tax-exempt income.[4] The net investment income definition as 90 percent of gross investment income was believed to reflect generally the historical level of industry investment expenses.

The company's share of net investment income is the excess of net investment income over the sum of: (1) required interest for reserves; (2) the deductible portion of any excess interest; (3) the deductible portion of any amount in the nature of interest (whether or not a policyholder dividend) credited to a policyholder or customer fund under a pension plan contract for employees not yet retired or to a deferred annuity contract before the annuity starting date; and (4) a fraction (referred to as the "minifraction") of the deductible portion of policyholder dividends (not including the deductible portion of any amounts previously included under (1), (2), or (3), or any premium or mortality charge adjustments associated with a contract for which excess interest was credited during the taxable year).

The amount of the required interest for reserves is determined at the prevailing State assumed rate. Whether a payment constitutes excess interest is determined by the contract terms. The deductible portion of any policyholder dividend is that portion remaining after a pro-rata reduction of all policyholder dividends by the differential earnings amount under section 809 (if applicable). Finally, the fraction of the deductible portion of policyholder dividends to be included is determined by applying the minifraction. The numerator of the minifraction is gross investment income (including tax-exempt income), less required interest, excess interest and the amounts credited to pension plan contracts and deferred annuities (items (1), (2) and (3) described above). The denominator of the minifraction is gross income (including tax-exempt income), less net increases in reserve items.

[4] 100-percent dividends are those which would be eligible for the 100-percent dividends-received deduction, assuming the recipient is not a foreign corporation.

Explanation of Provision

The bill amends the definition of the company's share of net investment income to clarify that, in arriving at such amount, net investment income should be reduced by all interest paid to a depositor or any customer for the services provided by the life insurance company, whether it is interest guaranteed on the contract (like required interest) or excess interest. For example, net investment income should be reduced by all interest paid on deposit administration contracts which provide no permanent purchase rate guarantees; although the purchaser of such a contract may not technically be a "policyholder," the purchaser may be viewed as a depositor or a customer for the services provided by the life insurance company.

Also, the bill amends the definition of required interest to include not only interest for reserves determined at the prevailing State assumed interest rate, but, where such rate is not used, another appropriate rate.

The bill eliminates a circularity problem existing under the language of present law in determining the minifraction to be used for purposes of computing the gross investment income's proportionate share of policyholder dividends. Specifically, the bill redefines the denominator of the minifraction to be life insurance gross income reduced by the excess (if any) of the closing balance for the reserve items described in section 807(c) over the opening balance for such items for the taxable year. It further generally states that, for purposes of computing the denominator, life insurance gross income shall be determined by including tax-exempt interest and computing any decreases in reserves without any reduction of the closing balance of the reserve items by the company's share of tax-exempt interest.

In addition, the bill refines the definition of net investment income to take into account the fact that investment expenses with respect to assets held in segregated asset accounts have historically been significantly smaller than those with respect to general account assets. Accordingly, in the case of gross investment income attributable to assets held in segregated asset accounts underlying variable contracts, the bill defines net investment income to mean 95 percent of gross investment income.

Finally, for purposes of computing net increases or decreases in reserves and for purposes of the proration formula, the bill provides that the terms "gross investment income" and "tax-exempt interest" shall not include any interest received with respect to a securities acquisition loan (an ESOP loan) as defined in section 133(b) of the Code. Also, for purposes of determining the gross investment income's proportionate share of policyholder dividends, "life insurance gross income" shall not include ESOP loan interest. This amendment more fully implements the intention of Congress when it adopted section 133(b), that is, to encourage financial institutions to make loans to ESOPs.

8. Treatment of foreign life insurance companies (sec. 121(i) of the bill and sec. 813(a) of the Code)

Present Law

In general, under present law, foreign corporations are subject to U.S. tax only on certain U.S.-source income and on income that is effectively connected with a trade or business conducted in the United States. A foreign corporation carrying on an insurance business within the United States, which would qualify as a life insurance company if it were a U.S. corporation, is taxable like a U.S. life insurance company on its income effectively connected with its conduct of any U.S. trade or business. The determination of whether a foreign corporation would qualify as a life insurance company considers only the income of the corporation that is effectively connected with the conduct of its business carried on in the United States.

A special rule alters the U.S. tax on foreign life insurance companies doing business in the United States if they hold a relatively small surplus attributable to the U.S. business in the United States. If a foreign life insurance company's surplus held in the United States is less than a specified minimum amount, then the company must increase its income by the product of (1) the excess of the required minimum surplus over actual surplus, and (2) its current investment yield.

Explanation of Provision

The bill clarifies how a foreign life insurance company doing business in the United States should compute its life insurance company taxable income if additional income has been imputed because actual surplus held in the United States is less than the required minimum surplus. Specifically, any amount of income imputed by section 813 shall be added to life insurance gross income (before computing the amount of the special life insurance company deduction and the small life insurance company deduction), and such increase in income shall be treated as gross investment income.

9. Treatment of certain distributions to shareholders from pre-1984 policyholders surplus account (sec. 121(j) of the bill and sec. 815 of the Code)

Present Law

In general, present law eliminated any further deferral of tax through additions to a policyholders surplus account with regard to income for 1984 and later years. Although companies are not able to enlarge their policyholders surplus account after 1983, they will not be taxed on previously deferred amounts unless such amounts are treated as distributed to shareholders or subtracted from the policyholders surplus account under rules that are comparable to those provided under the 1959 Act, but that reflect the basic changes in the tax structure under the 1984 Act.

Present law provides that any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company will be subject to tax at the corporate rate in the taxable year of distribution. For these purposes, the term distribution includes actual or constructive distributions. See *Union Bankers Insurance Company* v. *Commissioner*, 64 T.C. 807 (1975). When there are distributions from the policyholders surplus account, the amount of the distribution (whether actual or deemed, or by the indirect use of amounts in the policyholders surplus account for the benefit of shareholders) is taxed in addition to LICTI and not as part of the LICTI computation. Thus, distributions from the policyholders surplus account cannot be offset by life insurance company losses and are not subject to the special and small life insurance company deductions.

Explanation of Provision

The citation in the legislative history of the 1984 Act to *Union Bankers Insurance Company* indicated the type of fact situations in which liability for a phase III tax could arise (i.e., tax on distributions from a policyholders surplus account). The present law emphasis on taxing both direct and indirect distributions from the policyholders surplus account was intended to be construed more broadly than under the 1959 Act, causing certain uses of policyholders surplus account funds to be treated as a distribution therefrom, whether or not there was a distribution specifically under general corporate tax provisions.

The bill includes a statutory clarification as to what would be an indirect distribution from the policyholders surplus account. Specifically, the bill provides that a direct or indirect distribution does not include a bona fide loan with arm's-length terms and conditions. More generally, an indirect distribution will be treated as occurring whenever policyholders surplus account funds are used to benefit the shareholders indirectly. For example, this may occur by using such funds to purchase stock of a parent or an affiliated company or by using such funds to make loans within an affiliated group for less than adequate consideration. Whether or not a loan is made with arms-length terms and conditions may be determined by reference to section 482 and the regulations thereunder.

The bill also reinstates a prior law provision (section 819(b)) which provides instructions for distributions from policyholder surplus accounts of foreign life insurance companies doing business in the United States.

10. Treatment of deficiency reserves (sec. 121(k) of the bill and sec. 816 of the Code)

Present Law

Because of a general change in State law, as well as new rules for computing tax reserves, a prior law provision that specifically excluded deficiency reserves from the definition of life insurance reserves and total reserves was eliminated. Instead, the present law rules for computing tax reserves prohibit a company from taking into account any State requirements for "deficiency reserves" caused by a premium undercharge for purposes of computing the company's increases or decreases in life insurance reserves.

Explanation of Provision

The bill reinstates the prior-law exclusion of deficiency reserves from the definition of life insurance reserves and total reserves for purposes of section 816, which defines a life insurance company, and section 813(a)(4)(B), which defines surplus held in the United States for foreign life insurance companies doing business in the United States. This correction is made to clarify that the prior omission was not intended to have a substantive effect on the qualification of a company as a life insurance company or on the computation of surplus held in the United States for foreign life insurance companies. Likewise, this change does not affect the fact that deficiency reserves are included in statutory reserves for purposes of comparing the tax reserve to statutory reserves in determining the amount of any increase or decrease in life insurance reserves.

11. Treatment of certain nondiversified contracts (sec. 121(l) of the bill and sec. 817(h) of the Code)

Present Law

Present law provides special rules for variable life insurance or annuity contracts, or contracts with reserves based on segregated asset accounts (generally, all referred to as variable contracts). In addition to the rules for separate accounting with respect to variable contracts, present law grants the Secretary of the Treasury regulatory authority to prescribe diversification standards for investments of segregated asset accounts underlying variable contracts. Likewise, present law includes specific statutory diversification guidance for segregated accounts that are at least as diversified as regulated investment companies (if no more than 55 percent of assets are held in cash items), for variable life insurance contracts based on investments in Treasury securities, and for segregated accounts using investment funds that are not available to the public. If a segregated asset account underlying a variable contract does not meet the prescribed diversification standards, the contract will not be treated as an annuity or as life insurance for tax purposes.

Explanation of Provision

The bill clarifies the exception for variable life insurance contracts based on investments in Treasury securities. Generally, to the extent that any segregated asset account with respect to a variable life insurance contract is invested in securities issued by the United States Treasury, the investments made by such account will be treated as adequately diversified.

In addition, the bill provides that if all the beneficial interests in a regulated investment company or any trust are held by one or more (a) insurance companies (or affiliated companies) in their general account or in segregated asset accounts, or (b) fund managers (or affiliated companies) in connection with the creation or management of the regulated investment company or trust, the diversification requirements shall be applied by taking into account the assets held by such regulated investment company or trust. This revision of the present law "look through" rule generalizes and broadens the statutory language to allow for the use of seed money, or for the ownership of fund shares by an insurance company or fund manager for administrative convenience, in operating an underlying investment fund.

12. Treatment of certain deferred compensation plans (sec. 121(m) of the bill and sec. 818(a)(6)(A) of the Code)

Present Law

Diversification requirements prescribed by Treasury for segregated asset accounts underlying variable contracts do not apply with respect to pension plan contracts. Pension plan contracts refer generally to contracts used for qualified pension plans, individual retirement accounts, or governmental plans which provide retirement benefits.

Explanation of Provision

The bill clarifies the coverage of the term pension plan contract by specifically providing that a governmental plan covered by such term includes a governmental plan within the meaning of section 414(d) or an eligible State deferred compensation plan within the meaning of section 457(b).

13. Dividends within affiliated group (sec. 121(n) of the bill and sec. 818(e) of the Code)

Present Law

In addition to the general rules applicable to affiliated groups filing consolidated returns, present law provides a specific rule that if an election to file a consolidated return is in effect with respect to an affiliated group for the taxable year, all items of the members of such group which are not life insurance companies shall not be taken into account in determining the amount of the tentative LICTI of members of such group which are life insurance companies.

Present law, as adopted under the 1984 Act, omitted a prior-law provision (prior law sec. 818(f)(1)) that provided a special rule for a life insurance company filing or required to file a consolidated return. Generally, this provision required that a company compute its policyholder's share of investment yield as if such company were not filing a consolidated return.

Explanation of Provision

The bill reinstates the prior-law provision of section 818(f)(1) with minor modifications to reflect changes in the general tax structure recently adopted under subchapter L. Specifically, the bill provides that, in the case of a life insurance company filing or required to file a consolidated return with respect to any affiliated group for any taxable year, any determination under part 1 of subchapter L with respect to any dividend paid by one member of such group to another member of such group shall be made as if such group was not filing a consolidated return. This reinstatement of the prior-law provision is necessary to maintain the integrity of the proration rule for tax-exempt interest and the intercorporate dividend deduction between policyholders and the company.

14. Clarification denial of fresh-start provisions and of application of 10-year spread (sec. 122(a) and (d) of the bill and sec. 216(b)(3)(A) and (C) of the Act)

Present Law

Under the Act, life insurance companies were required to revalue their reserves as of the beginning of the first taxable year beginning after December 31, 1983, according to newly prescribed reserve computation rules. Generally, any change in method of accounting or any change in the method of computing reserves which was required by the provisions in the Act was not to be treated as a change in method of accounting or in the method of computing reserves and thus not to give rise to income or loss. This gave life insurance companies a "fresh start" with respect to computing their life insurance reserves.

However, the fresh-start provision did not apply to any reserve transferred pursuant to a reinsurance agreement entered into, or a modification of a reinsurance agreement made after, September 27, 1983 (the date the fresh start provision was announced) and before January 1, 1984 (the effective date of the new provisions). Likewise, the fresh start benefits did not apply to any reserve strengthening reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984. For these purposes, the phrase "any reserve strengthening" included the computation of reserves on contracts issued in 1983 at an interest rate that was lower than the rate normally assumed in computing reserves for similar contracts.

Further, the Act provided that in the case of any item to which the fresh start had been denied, such item should be taken into account for the first taxable year beginning after December 31, 1983 (in lieu of over the 10-year period otherwise provided under present law), unless the item was required to have been taken into account over a period of 10 taxable years under prior law.

Explanation of Provision

The bill conforms the closing date for the period for which proscribed reinsurance transactions will result in a denial of the "fresh start" to that date given for revaluation of reserves. Specifically, it provides that for purposes of the denial of fresh start provision (sec. 216(b)(3)(A) of the 1984 Act), if a reinsurer's taxable year is not a calendar year, "the first day of the first taxable year beginning after 1983" shall be substituted for "January 1, 1984." This is intended to prevent abuse of the fresh-start provisions by use of reinsurance transactions after 1983 where the reinsurer's taxable year may be a fiscal year rather than the calendar year.

Also, the bill clarifies that, with respect to reserves for which the fresh start is denied, the present-law rule for spreading a change in basis of computing reserves over a 10-year period will be applied to the extent that the reserve change would have been required to be taken into account over a 10-year period under prior law. Even with this clarification, with respect to reserves for which the fresh start has been denied, that portion of the reserve change attributable to the repeal of an election under 818(c) is taken into account in the first taxable year beginning after December 31, 1983, and is not spread over a 10-year period.

15. Treatment of certain elections under sec. 818(c) (sec. 122(b) of the bill and sec. 216(b)(4)(B) of the Act)

Present Law

The Act provided that, except in a limited situation, any election after September 27, 1983, under prior-law section 818(c) to revalue preliminary term reserves to net level reserves shall not take effect. An election under prior-law section 818(c) was allowed to take effect after September 27, 1983, if more than 95 percent of the reserves computed in accordance with such election were attributable to risks under life insurance contracts issued by the taxpayer under a plan of insurance first filed after March 1, 1982, and before September 28, 1983.

The legislative history describing the denial of fresh start provisions described reserve strengthening as also including generally an election under prior-law section 818(c) which was made after September 27, 1983.

Explanation of Provision

The bill clarifies that a valid prior-law section 818(c) election made under the exception described above shall not be treated as reserve strengthening for purposes of denying a fresh start and requiring that the amount be taken into income in the first taxable year beginning after December 31, 1983. This allows a taxpayer that qualifies for the limited exception for making a prior-law section 818(c) election after September 27, 1983, to have the full benefit of that election.

16. Election not to have reserves recomputed (sec. 122(c) of the bill and sec. 216(c) of the Act)

Present Law

Under the Act, certain qualified life insurance companies can elect not to recompute reserves for existing contracts as of January 1, 1984, but to use their statutory reserves for all such contracts. In so using statutory reserves for tax purposes, a company elects to forgo the "fresh start" with respect to the difference between statutory reserves and the Federally prescribed reserves; there is still a "fresh start" with respect to the difference between statutory reserves and prior law tax reserves attributable to a prior law 818(c) election.

Also, as a transitional rule, any company that makes the above described election and that has tentative LICTI for its first taxable year after 1984 of $3 million or less may further elect to have the reserve for any contract issued on or after 1983 and before January 1, 1989, be equal to the statutory reserve for the contract computed for tax purposes with an adjustment similar to the geometric

Menge formula under TEFRA (sec. 805(c)(1) of prior law as in effect for 1982 and 1983).

These elections must be made at the time and in the manner prescribed by Treasury and, once made, are irrevocable.

Explanation of Provision

The provision in the bill makes it clear that in determining whether a company is eligible to make the election for contracts issued on or after 1983 and before January 1, 1989, a company must compute its tentative LICTI taking into account reserves as though the election was in effect. The bill also clarifies that the so-called geometric Menge adjustment should be applied to opening and closing statutory reserves, for purposes of computing net increases or decreases in life insurance reserves.

17. Special rule for companies using net level reserve method for noncancellable accident and health insurance contracts (sec. 123 of the bill and sec. 217(n) of the Act)

Present Law

The present-law provision in the Act states that a company shall be treated as meeting the requirements of the Federally prescribed reserve method with respect to any noncancellable accident and health insurance contract for any taxable year if such company (1) uses the net level reserve method to compute its tax reserves on such contracts for such taxable year, (2) was using the net level reserve method to compute its statutory reserves on such contracts as of December 31, 1982, and (3) has continuously used such method for computing such reserves on such contracts after December 31, 1982, and through such taxable year.

In explaining this special rule, the Statement of Managers for the Conference Report for the 1984 Act stated that a company can use the net level reserve method for tax purposes for noncancellable accident and health contracts sold under a particular plan of insurance, if the company computed all its reserves for such contracts on that method for statutory purposes as of December 31, 1982, (as evidenced by its 1982 annual statement, as originally filed) and continues to do so for all such reserves on both new and existing business.[5] If the company was not using a net level reserve method as of the prescribed date, with respect to contracts sold under a particular plan of insurance, the company must use the generally prescribed reserve method (2-year full preliminary term method) for all contracts under the plan. Likewise, the generally prescribed method must be used for noncancellable accident and health insurance contracts sold under any new plans of insurance. The explanation in the Statement of Managers limited the application of the rule to noncancellable accident and health contracts sold under currently marketed plans of insurance, but not under new plans of insurance. The practical consequences of this limiting language is that no company, even one meeting the otherwise strict

[5] The Statement of Managers erroneously refers to 1983 in describing this part of the provision.

qualification requirements, will elect to use the special rule because the detriment of foregoing the fresh start (because noncancellable accident and health reserves are not revalued) will not be offset by any favorable future reserve treatment for new product developments.

Explanation of Provision

The special rule described above was intended to be narrow in its application by requiring a complete and continuous commitment by the company to the use of the more conservative net level reserve method for its directly written noncancellable accident and health contracts as a reflection of the company's conservative business practices before a company could recognize such practices for tax purposes. Specifically, it was intended to address the factual situation of a company that has been predominantly a writer of noncancellable accident and health insurance and that had followed, and continues to follow, the business practice of computing all its reserves for directly written noncancellable accident and health contracts on a net level basis for State purposes. It was intended to allow such company to use this more conservative reserve basis for tax purposes.

Because the rule under present law is impractically narrow, and would not result in any taxpayer making the election, the bill expands the coverage of the rule to allow the net level reserve method for tax purposes on any directly written noncancellable accident and health insurance contract, whether under existing or new plans of insurance. For purposes of applying this special rule and qualifying therefor, only reserves on directly written contracts will be taken into account because, as a reinsurer, a company would generally adopt the reserve method used by the ceding company. This limited expansion will allow the special rule to have its intended practical effect.

Although the Statement of Managers describes present law as requiring that all reserves for noncancellable accident and health insurance contracts be computed on a net level basis for statutory purposes as of December 31, 1982, the bill adopts a *de minimis* margin for error for purposes of administrative convenience. Accordingly, in order to qualify for the application of this rule, a company must have been using the net level reserve method to compute at least 99 percent of its statutory reserves for directly written noncancellable accident and health insurance contracts as of December 31, 1982, and for the 1982 calendar year must have received more than half its premium income from directly written noncancellable accident and health insurance. After December 31, 1983, the company will be treated as using the prescribed reserve method for a taxable year if through such taxable year, the company has continuously used the net level method for computing at least 99 percent of its tax and statutory reserves on its directly written noncancellable accident and health contracts. This requires a complete and continuous use of the net level method for tax and statutory purposes for all but one percent of directly written noncancellable accident and health contracts; for contracts for which the company does not use the net level method, the company should use the method used for statutory purposes, for purposes of computing tax reserves.

18. Underpayments of estimated tax (sec. 124 of the bill and sec. 218 of the Act)

Present Law

Under present law, no addition to tax shall be made under the provision relating to failure by a corporation to pay estimated tax with respect to any underpayment of an installment required to be paid before the date of enactment of this Act to the extent that such underpayment was created or increased by any provision of the insurance tax subtitle and such underpayment is paid in full on or before the last date prescribed for payment of the first installment of estimated tax required to be paid after the date of the enactment of the Act. The title of section 218 of the Act was "Underpayments of Estimated Tax for 1984."

Explanation of Provision

The bill repeals section 218 of the Act in favor of the application of the broader general relief granted by section 175 of this bill. Section 175 of the bill provides generally that no addition to tax shall be made for underpayments of estimated tax by corporations for any period before March 16, 1985 (by individuals, for any period before April 16, 1985), to the extent that such underpayment was created or increased by a provision of the 1984 Act.

19. Definition of life insurance contract; computational rules (sec. 125(a) of the bill and sec. 7702(e)(1) of the Code)

Present Law

Under present law, a life insurance contract is defined as any contract, which is a life insurance contract under the applicable State or foreign law, but only if the contract meets either of two alternative tests; (1) a cash value accumulation test, or (2) a test consisting of a guideline premium limitation requirement and a cash value corridor requirement. Under the cash value accumulation test, the cash surrender value of the contract, by the terms of the contract, may not at any time exceed the net single premium which would have to be paid at such time in order to fund the future benefits under the contract assuming the contract matures no earlier than age 95 for the insured. Under the guideline premium limitation/cash value corridor test, a contract will continue to be treated as life insurance so long as it does not violate its guideline premium limitation or the cash value corridor. A life insurance contract meets the guideline premium limitation if the sum of the premiums paid under the contract does not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums to such date. Under both tests, present law prescribes minimum interest assumptions and mortality assumptions that must be taken into account in computing the limitations.

In addition, present law provides three general rules or assumptions to be applied in computing the limitations set forth in the definitional tests. These computational rules restrict the actual provisions and benefits that can be offered in a life insurance contract only to the extent that they restrict the allowable cash surrender value (under the cash value accumulation tests) or the allowable funding pattern (under the guideline premium limitation). First, in computing the net single premium (under the cash value accumulation test) or the guideline premium limitation for any contract, the death benefit is deemed not to increase at any time during the life of the contract (qualified additional benefits are treated the same way). Second, the maturity date, including the date on which any endowment benefit is payable, shall be no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100. Third, the amount of any endowment benefit (or sum of endowment benefits, including any cash surrender value on the maturity date described in the second computational rule) shall be deemed not to exceed the least amount payable as a death benefit at any time under the contract.

Explanation of Provision

The bill clarifies the second computational rule by specifically stating that the maturity date shall be *deemed to be* no earlier than age 95 and no later than age 100. This conforms the language of the second computational rule to that of the first and third.

The bill also adds an additional computational rule which provides that for purposes of applying the second computational rule and for purposes of determining the cash surrender value on the maturity date under the third computational rule, the death benefits shall be deemed to be provided until the maturity date described in the second computational rule. This rule combined with the second computational rule will generally prevent contracts endowing at face value before age 95 from qualifying as life insurance. However, it will allow an endowment benefit at ages before 95 for amounts less than face value.

20. Treatment of contracts issued during 1984 which meet new requirements (sec. 125(b) of the bill and sec. 221(d)(1) of the Act)

Present Law

Under the Act, the new definition of life insurance generally applies to contracts issued after December 31, 1984, except in the case of certain increasing death benefit contracts issued after June 30, 1984. Also, the TEFRA provisions for flexible premium contracts (that is, prior-law section 101(f) applicable previously to 1982 and 1983) were extended through 1984.

Explanation of Provision

The bill clarifies the definition of life insurance transition rules so that any contract issued during 1984 which meets the definitional requirements of present-law section 7702 will be treated as meeting the requirements of prior-law section 101(f), which was extended through 1984.

21. Treatment of certain contracts issued before October 1, 1984 (sec. 125(c) of the bill and sec. 221(d)(2)(C) of the Act)

Present Law

Under the Act, there was a transition rule for certain increasing death benefit policies which made the new definitional provisions of section 7702 applicable only for a contract issued after September 30, 1984, if the contract would meet the new definition by substituting 3 percent for 4 percent as the minimum interest rate in the cash value accumulation test (assuming that the rate or rates guaranteed on issuance of a contract can be determined without regard to any mortality charges), and if the cash surrender value of the contract did not at any time exceed the net single premium which would have to be paid at such time to fund future benefits at the then current level of benefits (with the same 3 percent for 4 percent substitution).

Explanation of Provision

The bill clarifies the above described transition rule so that in applying the cash value accumulation test by substituting 3 percent for 4 percent as the minimum interest rate, the taxpayer should not only assume that rate or rates guaranteed on issuance of the contract can be determined without regard to any mortality charges, but should also assume that rate or rates should be determined without regard to any initial interest rate guaranteed in excess of the stated minimum rate.

22. Amendments related to annuity contracts (sec. 126 of the bill and sec. 72(s) of the Code)

Present Law

Under present law, cash withdrawals prior to the annuity starting date are includible in gross income to the extent that the cash value of a contract (determined immediately before the amount was received and without regard to any surrender charge) exceeds the investment in the contract. A penalty tax of 5 percent is imposed on the amount of any such distribution that is includible in income, to the extent that the amount is allocable to an investment made on or after August 14, 1982. The penalty is not imposed if the distribution is made after the contractholder attains age 59-1/2, when the contractholder becomes disabled, upon the death of the contractholder, or as payment under an annuity for life or at least 5 years.

An annuity contract must provide specific rules for distribution in the event of the contractholder's (owner's) death in order to be treated as an annuity contract for income tax purposes. These distribution rules generally conform to those applicable to qualified pension plans and IRAs. To be treated as an annuity contract, the contract must provide that, if the contractholder dies on or after the annuity starting date and before the entire interest in the contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distribution in effect. If the contractholder dies before the annuity starting date, the entire interest generally must be distributed within 5 years after the date of death of the contractholder, or must be annuitized for some period (including the life of a designated beneficiary) within one year after the date of death. For these purposes, the "beneficiary" is the person who becomes the new owner of the annuity contract and controls the use of the cash value of the contract.

If there is a spousal beneficiary, the contract (including deferral on income tax) may be continued in the name of the spouse as the contractholder upon the contractholder's death. Thus, a spousal beneficiary steps into the shoes of the decedent contractholder.

To the extent that the terms used refer to individuals (e.g., death, spouse, or age), the provisions apply only to individual contractholders or owners of annuity contracts.

Explanation of Provision

The bill makes it clear that the requirement that the annuity contract include required distribution provisions in order to be treated as an annuity need not be met by contracts which are used as part of a qualified pension plan or for an IRA by adopting a specific statutory exemption for these purposes. This provision is added because annuity contracts provided under a qualified pension plan or an IRA must satisfy the required distribution rules applicable to such plans.

In addition, the bill includes special rules to clarify the application of the required distribution rules where the contractholder is not an individual. Specifically, if the contractholder is not an individual, the primary annuitant shall be treated as the holder of the contract. For these purposes, the term "primary annuitant" means the individual, the events in the life of whom are of primary importance in affecting the timing or amount of the pay-out under the contract. For example, the primary annuitant would be that person referred to in the contract as the measuring life for the annuity starting date or for annuity benefits payable under the contract. Likewise, the bill also clarifies the application of the penalty exception for distributions at death so that the penalty does not apply to any distribution made on or after the death of the contractholder or, where the contractholder is not an individual, the death of the primary annuitant.

The bill also adds a provision which states that if an individual who holds an annuity contract transfers it by gift or, in the case of a holder which is not an individual, if there is any change in the primary annuitant, then such transfer or change shall be treated as the death of the holder. This correction is made in order to implement fully the forced distribution rules adopted under the 1984 Act, which were intended to terminate deferral allowed in annuity contracts when such contracts were no longer required as a retirement vehicle for the contractholder who was enjoying the tax deferral on the income accumulating in the contract. Without the correction covering gratuitous transfers of annuity contracts, the required distribution rules adopted in the 1984 Act could be avoided easily because they would allow taxpayers to continue tax deferral beyond the life of an individual taxpayer. As with the required distribution rules, there is an exception to the rule for transfers of annuity contracts by gift where the transfer is made to a spouse. Specifically, a distribution of the entire interest in the contract will not be required with respect to any transfer to which section 1041(a) (relating to transfers of property between spouses or incident to divorce) applies.

Finally, the bill addresses the problem of how joint contractholders should be treated when one holder dies and clarifies that the forced distribution requirements adopted in the 1984 Act apply upon the death of any holder to such contract.

In order to allow annuity writers time to make changes conforming to the clarifications contained in this bill, these provisions shall apply to contracts issued after the date which is 6 months after the date of enactment of the technical corrections bill.

23. Amendments related to group term insurance (sec. 127 of the bill and secs. 79 and 83(e) of the Code)

Present Law

Under present law, the cost of group-term life insurance purchased by an employer for an employee for a taxable year is included in the employee's gross income to the extent that the cost is greater than the sum of the cost for $50,000 of life insurance plus any contribution made by an employee to the cost of the insurance. The $50,000 cap on the group-term life insurance exclusion is applicable to active employees and to employees who have terminated their employment because of retirement; it does not apply to employees who have terminated employment because of disability. Generally, the cost of an employee's share of group-term life insurance is determined on the basis of uniform premiums, computed with respect to 5-year age brackets.

If a group-term life insurance plan maintained by an employer discriminates in favor of any key employee, the exclusion for the cost of the first $50,000 of this insurance is further limited. In the case of a discriminatory plan, the full cost of the group-term life insurance for any key employee is included in the gross income of the employee at actual cost. For these purposes, the term employee includes all former employees.

Explanation of Provision

The bill provides that, in the case of a discriminatory plan, the cost of group-term life insurance on the life of any key employee shall be the greater of the actual cost of the insurance or the cost determined based on the uniform premium table. The present-law requirement that key employees recognize the actual cost of their coverage within discriminatory plans was intended to discourage further the use of discriminatory group-term life insurance plans. This requirement would only tend to have this effect if the actual cost exceeds that specified in the uniform premium table. The technical correction adopted in the bill was intended to give full effect to the prior Congressional intent to not create situations which encourage discrimination (i.e., when the actual cost may be less than that specified in the uniform premium table). Likewise, the bill revises the definition of key employee to include any retired employee if such employee, when he retired, was a key employee. For purposes of applying the nondiscrimination requirements of the group-term life insurance provisions, the bill also clarifies that, to the extent provided in regulations, coverage and benefit tests may be applied separately to active and former employees.

In addition, the bill makes a clerical correction to section 83(e)(5), which coordinates that section with section 79. Section 83(e)(5) presently excepts *the cost of* group-term life insurance to which section 79 applies from the application of section 83 (governing the taxation of property transferred in connection with performance of services). The bill provides that section 83 shall not apply to group-term life insurance covered by section 79. Thus, when an employee retires, the present value of any future group-term life insurance coverage which may become nonforfeitable upon retirement will not be taxed immediately to the employee upon retirement. Rather, if the coverage constitutes group-term life insurance within the meaning of section 79 (e.g., the employee does not receive a permanent guarantee of life insurance coverage from the insurance company), the cost of the coverage will be taxable annually to the retired employee under section 79.

Finally, the bill clarifies the effective date of the present-law provisions which were adopted in the 1984 Act by providing that the extension of the $50,000 cap to retired employees and the extension of the nondiscrimination provisions to former employees do not apply to any group-term life insurance plan of the employer in existence on January 1, 1984, but only with respect to an individual who attained age 55 on or before January 1, 1984, and was employed by such employer (or a predecessor employer) at any time during 1983. The 1984 Act amendments also shall not apply to any employee who retired from employment on or before January 1, 1984, and who, when he retired, was covered by a group-term life insurance plan of the employer (or a predecessor plan).

The provision relating to the determination of costs with respect to key employees in a discriminatory plan is effective for taxable years ending after the date of enactment of the bill.

24. Amendment related to certain exchanges of insurance policies (sec. 128 of the bill and sec. 1035(b) of the Code)

Present Law

Under present law, no gain or loss is recognized on the exchange of (1) a contract of life insurance for another contract of life insurance or for an endowment or an annuity contract; (2) a contract of endowment insurance for another contract of endowment with the same or earlier payment date, or for an annuity contract; or (3) an annuity contract for an annuity contract. For purposes of this exchange rule, an endowment contract and a life insurance contract is defined to include contracts issued by any insurance company taxable under subchapter L of the Code. This change in law was intended to recognize that the focus of the exchange rule should be on the character and benefits of the contract rather than the particular tax status of the company issuing the contract.

Explanation of Provision

The bill amends the definition of an endowment contract and a life insurance contract by merely requiring that the contracts be issued by any insurance company, whether or not such company is a taxable entity under the Code.

25. Waiver of interest on certain underpayments of tax (sec. 129 of the bill)

Present Law

Interest on an underpayment of tax generally is payable from the due date of the return (determined without regard to extensions).

Explanation of Provision

The bill provides that no interest shall be payable for any period before July 18, 1984, on any underpayment of tax imposed by the Internal Revenue Code, to the extent such underpayment was created or increased by any provision of subtitle A of title II of the Tax Reform Act of 1984.

C. Technical Corrections to Private Foundation Provisions

1. Reduction in section 4940 excise tax where charitable payout meets certain distribution requirements (sec. 132 of the bill and sec. 4940 of the Code)

Present Law

Under section 303 of the Act, the rate of the excise tax imposed on the net investment income of a private foundation (Code sec. 4940) is reduced for a taxable year from two percent to one percent if the amount of qualifying distributions made by the foundation during that taxable year equals or exceeds the sum of (a) an amount equal to the foundation's assets for such taxable year multiplied by the average percentage payout for the base period, plus (b) one percent of the foundation's net investment income for such taxable year. However, the reduction is not available for a year if the foundation's average percentage payout for the base period is less than five percent, or 3-1/3 percent in the case of a private operating foundation (Code sec. 4940(e)(2)(B)). The reduction in the section 4940 tax rate is effective for taxable years beginning after 1984.

Explanation of Provision

The bill modifies the rule disqualifying certain foundations from the section 4940 rate reduction, to provide that the rate reduction is not available if the foundation was liable for tax under section 4942 with respect to any year in the base period.

This modification effectuates the intended rule that a foundation which failed in any base period year to make the minimum required expenditures for charitable purposes should not be eligible to obtain the benefit of tax reduction merely by increasing its qualifying distributions (in an amount at least equal to one percent of net investment income) up to the minimum section 4942 level. As a result of the modification made by the bill, a nonoperating foundation will not be disqualified from the rate reduction in two situations where the foundation does not incur liability for section 4942 taxes even though the amount of its qualifying distributions (sec. 4942(g)) does not equal at least five percent of its assets. The first situation results from the fact that under section 4942(d), the distributable amount equals the minimum investment return (five percent of assets) reduced by the sum of any taxes imposed on the foundation for the taxable year under section 4940 and the unrelated business income tax. The second situation results from the fact that under section 4942(i), the distributable amount is further reduced by the amount of any excess distributions carryovers from a prior year. However, since neither the amount of such taxes nor the amount of such carryover distributions is included in the definition of qualifying distributions in section 4942(g), a foundation whose distributable amount is reduced by such taxes or carryover excess distributions does not incur section 4942 tax liability if the amount of its qualifying distributions, while less than the minimum investment return, equals or exceeds the distributable amount as thus computed. At the same time, the technical amendment made by the bill precludes any reduction in the section 4940 tax if, with respect to any base period year, the foundation is liable for tax under section 4942 for failure to satisfy the minimum distribution requirements.

2. Exemption for certain games of chance (sec. 133 of the bill and sec. 513 of the Code)

Present Law

Section 311 of the Act provides that, for purposes of Code section 513, the term unrelated trade or business does not include any trade or business that consists of conducting a game of chance if (1) the game of chance is conducted by a nonprofit organization, (2) the conducting of the game by such organization does not violate any State or local law, and (3) as of October 5, 1983, there was a State law in effect that permitted the conducting of the game of chance only by a nonprofit organization (i.e., the conducting of the game of chance by other than nonprofit organizations would violate the State law). This provision applies to games of chance conducted after June 30, 1981.

Explanation of Provision

The bill clarifies that the only State law to which the provision is intended to apply is a North Dakota law originally enacted on April 22, 1977.

D. Technical Corrections to Tax Simplification Provisions (secs. 141-148 of the bill)

Present Law

The Act contained a title which added a number of provisions intended to simplify and improve the laws. These included provisions related to the individual estimated tax, domestic relations, at-risk, administrative provisions, distilled spirits, the Tax Court, income tax credits and deadwood.

Explanation of Provision

The bill makes numerous nonsubstantive clerical and conforming amendments to these provisions.

The bill also restores two provisions of prior law which were inadvertently changed by the Act. First, certain non-resident aliens will continue to be required to make estimated tax payments in three, rather than four, installments. One-half of the estimated tax will be due with the first payment. Second, the principles of prior law relating to the carryover of credits (including the foreign tax credit) by taxpayers subject to the alternative minimum tax are restored. The conforming amendment relating to the foreign tax credit will apply to taxable years beginning after December 31, 1982 (the effective date of the changes to the minimum tax made by TEFRA).

E. Technical Corrections to Employee Benefit Provisions

1. Funded Welfare Benefit Plans (sec. 151 of the bill and secs. 419, 419A, 505, 512, and 4976 of the Code)

Under the Act, the amount of the deduction otherwise allowable to an employer for a contribution to a welfare benefit fund for any taxable year is not to exceed the qualified cost of the fund for the year. The Act defines the qualified cost of a welfare benefit fund for a year as the sum of (1) the qualified direct cost of the fund for the year and (2) the addition (within limits) to reserves under the fund for the year (the qualified asset account), reduced by the after-tax income of the fund. The deduction limits do not apply to a 10-or-more employer plan.

a. Definition of fund

Present Law

The Act defines a fund as any tax-exempt social club, voluntary employees' beneficiary association (VEBA), supplemental unemployment compensation benefit trust (SUB), or group legal services organization; any trust, corporation, or other organization not exempt from income tax; and, to the extent provided by Treasury regulations, any account held for an employer by any person. A fund includes a retired life reserve account maintained by an insurance company on behalf of an employer. Further, if an employer contributes amounts to an insurance company for benefits and under that arrangement the employer is entitled to a rebate if the amount paid exceeds benefit claims and is liable if the benefit claims exceed the amount paid, then such contributions are considered to have been made to a welfare benefit fund.

Explanation of Provision

Under the bill, the term "fund" generally does not include amounts held by an insurance company pursuant to an insurance contract if (1) there is no guarantee of a renewal of the contract, and (2) other than current insurance protection, the only payments to which the employer or employees are entitled (on a nonguaranteed basis) are refunds or policy dividends that are experience rated and are determined based upon factors other than the amount of welfare benefits paid to (or on behalf of) the employees of the employer or their beneficiaries. Thus, under the bill, amounts that are held by an insurance company for an employer generally are not to be treated as a fund to the extent the amounts are subject to a significant current economic risk of loss that is determined, in part, by factors other than the amount of welfare benefits paid to (or on behalf of) the employees of the employer.

Such an arrangement is to be treated as a fund, however, unless the amount of any such refund or dividend paid (including amounts used to reduce future premiums of the employer) with respect to a policy year is treated by the employer as paid or accrued in the taxable year in which the policy year ends. Thus, the employer is to include in gross income for a taxable year the amount of any refund or policy dividend paid or accrued in the policy year ending in the taxable year. If the actual amount of the refund or dividend is not known by the due date of the employer's tax return for the year, Treasury regulations could permit the use of a reasonable estimate of the amount of such refund or dividend.

Solely for purposes of these provisions, the amounts paid from a premium stabilization reserve to purchase current insurance coverage or as a payment to an employer on termination of a contract are to be treated as experience-rated refunds or policy dividends. Thus, the amounts paid from the premium stabilization reserve are to be treated by the employer as paid or accrued in the taxable year in which the policy year ends.

Thus, to the extent that the general rule for exclusion of amounts held by an insurance company is satisfied, amounts held by an insurance company for a reasonable premium stabilization reserve for an employer may not be treated as a fund. Thus, the premium stabilization reserve, if limited to a reasonable amount, such as 20 percent of premiums for the year, is not to be treated as a fund to the extent the amounts are subject to a significant current economic risk of loss.

Whether amounts are subject to a significant current risk of loss depends upon the facts and circumstances. For example, if an employer does not have a guaranteed right under the insurance contract to policy dividends based on the employer's experience but the insurance company has, in practice, consistently paid such dividends based solely on the employer's experience, it is anticipated that Treasury regulations would provide that the amounts do constitute a fund because they are not subject to a significant current economic risk of loss.

b. Coordination of post-retirement medical benefits with limits on qualified plans

Present Law

Under the provisions of the Act relating to the coordination of net contributions for post-retirement medical benefits provided by a welfare benefit fund with the overall limits on contributions and benefits under qualified pension plans and certain other funded plans deferring compensation (secs. 415(c) and (e)), any amount allocated to a separate account for a key employee is treated as an annual addition to a defined contribution plan. Under the overall limits, the annual addition with respect to an employee under all defined contribution plans of an employer for a year is not to exceed the lesser of $30,000 or 25 percent of compensation. A lower limit may apply if the employer also maintains a defined benefit plan for the employee. The 25-percent limit prevents reserve additions for post-retirement medical benefits after the retirement of an employee.

Explanation of Provision

The bill provides that the amount treated as an annual addition under the rules for coordinating the post-retirement medical benefits with the overall limits on qualified plans is not subject to the 25-percent-of-compensation limit usually applicable to annual additions. For example, assume the compensation of an employee is $100,000 for a year and $5,000 is treated as an annual addition under the limits for the employee under the rules for post-retirement medical benefits under a qualified plan. Assume further that the annual addition for the year under a qualified defined contribution plan, without regard to the post-retirement medical benefit, is $25,000 (a contribution equal to the maximum percentage of compensation limit). Under the bill, the annual addition for post-retirement medical benefits does not cause the annual addition to exceed the 25-percent limit on annual additions even though the annual addition would exceed that limit if the amount added for post-retirement medical benefits were taken into account. The annual addition of $30,000 would, however, be subject to the separate dollar limit for the year and, if the employer also maintains a defined benefit plan for the employee, the full annual addition of $30,000 would be taken into account in determining whether the combined plan limits are satisfied (sec. 415(e)).

The effect of this rule is to permit the funding of post-retirement medical benefits on behalf of a key employee during periods when the employee has no compensation from the employer (e.g., after retirement).

c. Separate accounting required for certain amounts

Present Law

In order to provide an overall limit with respect to pre-retirement deductions for certain post-retirement benefits of key employees, the Act requires separate accounting for contributions to provide post-retirement medical or post-retirement life insurance benefits to an individual who is, or ever has been (after the effective date of the Act), a key employee.

Explanation of Provision

The bill clarifies the requirement for separate accounting with respect to post-retirement medical benefits and post-retirement life insurance benefits. Under the bill, the requirement does not apply until the first taxable year for which a reserve is computed using the special provisions applicable to these benefits. Under the bill, the separate account requirement applies for that first year and for all subsequent taxable years.

d. Reserves for discriminatory post-retirement benefits disregarded

Present Law

Under the Act, no reserve is to be taken into account in computing the account limit with respect to a post-retirement medical benefit or a post-retirement life insurance benefit under a plan that does not meet the nondiscrimination standards provided by the Act (sec. 505(b)(1)). The nondiscrimination standards of the Act do not apply to benefits under certain collectively bargained plans.

Explanation of Provision

The bill provides that no reserve generally may be taken into account in determining the account limit for a welfare benefit fund for post-retirement medical benefits or life insurance benefits (including death benefits) unless the plan meets the nondiscrimination requirements with respect to those benefits (sec. 505(b)), whether or not those nondiscrimination requirements apply in determining the tax-exempt status of the fund. The bar against taking post-retirement medical benefits and life insurance benefits into account in determining the account limit does not apply, under the bill, in the case of a plan maintained pursuant to a collective bargaining agreement between one or more employee representatives and one or more employers if the Secretary of the Treasury finds that the agreement is a collective bargaining agreement and that post-retirement medical benefits or post-retirement life insurance benefits (as the case may be) were the subject of good faith bargaining between the employee representatives and the employer or employers.

e. Account limit for life insurance benefits

Present Law

In the case of a life insurance or death benefit, the Act provides that the account limit is not to include a reserve to the extent the reserve takes into account an amount of insurance that exceeds the amount that may be provided to an employee tax-free under an employer's group-term life insurance program (sec. 79). In the case of a self-insured death benefit, the account limit is not to include a reserve to the extent that a benefit would be includible in gross income if the limit on excludible death benefits were $50,000.

Explanation of Provision

The bill clarifies that life insurance benefits are not to be taken into account in determining the account limit under a welfare benefit fund to the extent that the aggregate amount of such benefits to be provided with respect to an employee exceeds $50,000. Accordingly, under the bill, the $50,000 limit applies with respect to the aggregate of self-insured and insured life insurance benefits under all funds maintained by the employer. The bill does not change the rules of the Act under which certain life insurance benefits in excess of $50,000 may be taken into account in determining the account limit for certain individuals under plans in existence on January 1, 1984 (Act sec. 223(d)(2)).

f. Actuarial certification

Present Law

The Act provides that the account limit for a qualified asset account (reserve) for a taxable year is generally the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for benefits with respect to which the account is maintained and the administrative costs incurred with respect to those claims. Claims incurred but unpaid include claims incurred but unreported as well as claims reported but unpaid. The time at which claims are incurred is the time at which the employee becomes entitled to the benefits, i.e., the time at which the fund becomes liable for the claims. Under the Act, insurance premiums, whenever payable, are not regarded as claims incurred but unpaid.

Unless there is an actuarial certification with respect to benefits other than (1) post-retirement medical benefits or post-retirement life insurance benefits or (2) supplemental unemployment compensation (SUB) or severance pay benefits, the account limit for a welfare benefit fund is not to exceed certain safe-harbor limits.

Explanation of Provision

The bill provides that the requirement for an actuarial certification also applies to post-retirement medical benefits and post-retirement life insurance benefits, unless a safe harbor computation is used.

g. Aggregation of funds

Present Law

In addition to the limits provided by the Act with respect to post-retirement medical benefits provided under a welfare benefit fund, the Act provided dollar limits applicable to the amount of life insurance benefits and supplemental unemployment compensation benefits or severance pay benefits for which a reserve may be accumulated for any participant. The Act does not specify that these limits apply to the aggregate of reserves under all funds of an employer rather than on a fund-by-fund basis. Also, in the case of life insurance benefits, the Act does not specify that the limit on reserves is to be applied to the aggregate of insured and self-insured benefits.

Explanation of Provision

The bill provides that, in computing the dollar limits applicable to the amount of reserves for disability benefits, post-retirement medical benefits, and post-retirement life insurance benefits for which reserves may be accumulated for any participant, all welfare benefit funds of an employer are to be treated as a single fund. For example, under the bill, if an employer maintains 2 or more welfare benefit funds to provide life insurance benefits for a participant, then the $50,000 limit is to be applied with respect to that participant to the aggregate of the group of funds rather than to each separate fund.

h. Transition rules

Present Law

The account limit for any of the first 4 taxable years to which the rules for welfare benefit funds apply is increased, under the Act, by the applicable percentage of any existing excess reserve. In particular, the Act provides that, for the first year, the limit is to be the sum of (1) the limit determined without regard to the transitional rule, and (2) 80 percent of the existing excess reserve amount. For the second, third, and fourth succeeding years, 60, 40, and 20 percent, respectively is substituted for 80 percent. The Act does not clearly provide that the existing excess reserve for any year is to be the excess of (1) the amount of assets set aside to provide disability, medical, SUB, severance pay, or life insurance benefits under a plan and fund to provide a benefit in existence on July 18, 1984, as of the close of the first taxable year ending after that date, over (2) the account limit determined, for the year the computation is being made, without regard to the transitional rule.

Explanation of Provision

The bill provides that, under the transition rules for existing excess reserves, the amount of existing excess reserves for any year is the excess (if any) of (1) the amount of assets set aside at the close of the first taxable year ending after July 18, 1984, to provide disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits, over (2) the account limit determined under the Act (without regard to the transition rules) for the taxable year for which the excess is being computed. The bill further provides that the transition rule allowing an increase in the account limit because of existing excess reserves applies only to a welfare benefit fund which, on July 18, 1984, had assets set aside to provide the enumerated benefits.

For example, in the case of an employer that maintains a funded plan which had assets set aside to provide disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits on July 18, 1984, and to which the deduction limits first apply for the taxable year beginning January 1, 1986, the increase in the account limit for taxable year 1986 attributable to existing excess reserves is 80 percent of the excess, if any, of the amount of assets set aside on December 31, 1984 (the first taxable year ending after July 18, 1984), over the account limit determined under the general rules for 1986. For 1987, however, the increase attributable to existing excess reserves is 60 percent of the excess, if any, of the amount of assets set aside on December 31, 1984, over the account limit determined for 1987.

i. Tax on unrelated business income

Present Law

Under the Act, the tax on unrelated business taxable income of a social club, VEBA, SUB, or group legal service organization applies to an amount equal to the lesser of the income of the fund or the amount by which the assets in the fund exceed a specific limit on amounts set aside for exempt purposes. The limit on the amount that may be set aside for a year is generally not to increase the total amount that is set aside to an amount in excess of the account limit for the taxable year determined under the deduction limits provided by the Act.

The limitation on the amount that may be set aside for purposes of the unrelated business income tax does not apply to income attributable to certain existing reserves for post-retirement medical or post-retirement life insurance benefits. Under the Act, this exclusion applies only to income attributable to the amount of assets set aside, as of the close of the last plan year ending before July 18, 1984, for purposes of providing such benefits.

In addition, the Act provides for the inclusion of a similar amount (deemed unrelated income) in the gross income of an employer who maintains a welfare benefit fund that is not exempt from income tax. It is anticipated that Treasury regulations will provide that deemed unrelated income will be treated in a manner that will not subject the same income to tax more than once.

Explanation of Provision

The bill makes it clear that the tax on unrelated business income applies in the case of a 10-or-more employer plan. Under the bill, the account limit is to be determined as if the rules limiting deductions for employer contributions applied.

In addition, the bill clarifies that the transition rule for pre-existing reserves for post-retirement medical and life insurance benefits applies to assets set aside on July 18, 1984, rather than to assets set aside as of the end of the plan year ending before July 18, 1984.

The bill deletes the provision of the Code barring a set aside for assets used in the provision of permissible benefits (facilities). Treasury regulations are to provide that the value of a facility used to provide permissible benefits is disregarded in determining whether fund assets exceed the account limit for a qualified asset account.

In addition, the bill provides that if any amount is included in the gross income of an employer for a taxable year as deemed unrelated income with respect to a welfare benefit fund, then the amount of the income tax imposed on the deemed unrelated income is to be treated as a contribution paid by the employer to the fund on the last day of the taxable year and, thus, is deductible, subject to the limits on deductions for fund contributions. The tax attributable to the deemed unrelated income is to be treated as if it were imposed on the fund for purposes of determining the after-tax income of the fund.

j. Tax on disqualified benefits provided under funded welfare benefit plans

Present Law

Under the Act, if a welfare benefit fund provides a disqualified benefit during a taxable year, then an excise tax is imposed for that year on each employer who maintains the fund. The tax is equal to 100 percent of the disqualified benefit.

Under the Act, a disqualified benefit is (1) any medical benefit or life insurance benefit provided with respect to a key employee other than from a separate account required under the rules limiting employer deductions with respect to welfare benefit funds, (2) any post-retirement medical or life insurance benefit unless the plan meets the requirements of the nondiscrimination rules of the Act for benefits under a welfare benefit fund, or (3) any portion of a welfare benefit fund reverting to the benefit of the employer. Under the Act, a portion of a welfare benefit fund is not considered to revert to the benefit of an employer merely because it is applied, in accordance with the plan, to provide welfare benefits to employees or their beneficiaries. Also, amounts returned to employees that represent the employees' contributions to the fund are not treated as amounts reverting to the benefit of the employer and, therefore, are not subject to the tax on disqualified benefits.

Explanation of Provision

With respect to benefits required to be paid from a separate account, the bill defines the term "disqualified benefit" to mean any post-retirement medical benefit or post-retirement life insurance benefit provided with respect to a key employee if a separate account is required to be established for the employee and the payment is not from such an account. Accordingly, pre-retirement benefits would not be considered to be disqualified benefits under the bill merely because they are paid to a key employee from a source other than a separate account.

In addition, under the bill, a post-retirement medical benefit or post-retirement life insurance benefit provided by a fund with respect to an individual in whose favor discrimination is prohibited by the Code is a disqualified benefit unless the plan meets the nondiscrimination requirements of the Act with respect to the benefit (sec. 505(b)), whether or not the nondiscrimination requirements apply in determining the tax-exempt status of the fund from which the benefit is provided. Under the bill, therefore, if a plan is not exempt from the discrimination rules under the rules for collectively bargained plans, a discriminatory benefit is a disqualified benefit subject to the excise tax even though no discrimination test applies for purposes of determining the exempt status of the fund from which the benefit is provided. A benefit is not subject to the nondiscrimination requirements if it is provided under a plan maintained pursuant to a collective bargaining agreement between one or more employee representatives and one or more employers if the Secretary of the Treasury finds that the agreement is a collective bargaining agreement and that post-retirement medical benefits or post-retirement life insurance benefits (as the case may be) were the subject of good faith bargaining between the employee representatives and the employer or employers.

Further, under the bill, a payment that reverts to the benefit of an employer is not a disqualified benefit to the extent it is attributable to an employer contribution with respect to which no deduction is allowable in the current or any preceding taxable year or to an employee contribution. A reduction is to be made to the amount treated as a carryover (sec. 419(d)) to the extent that any nondeducted contribution reverts to the benefit of an employer. Any amounts reverting to the benefit of an employer are treated as coming first out of nondeducted contributions for purposes of this rule.

Also, the bill provides that a benefit that would otherwise be a disqualified benefit because it does not meet the separate-account rule or because it is discriminatory is not a disqualified benefit if it is a post-retirement benefit that is charged against an existing reserve for post-retirement medical or post-retirement life insurance benefits as provided under the transition rules of the Act (sec. 512(a)(3)) applicable to the unrelated business income tax.

k. Effective dates

Present Law

The Act provides that the new limits on deductions under welfare benefit funds generally apply to contributions paid or accrued after December 31, 1985, in taxable years ending after that date. Special effective dates are provided for contributions with respect to facilities and for certain collectively bargained plans. The effective dates for the provisions relating to the tax on unrelated business income and the excise tax on disqualified benefits were unclear under the Act.

Explanation of Provision

The bill provides that the rules of the Act relating to the tax on disqualified benefits generally apply to benefits provided after December 31, 1985. Under the bill, however, the tax on disqualified benefits does not apply to benefits charged against an existing reserve for post-retirement medical benefits or post-retirement life insurance benefits (as defined under the transition rules (sec. 512(a)(3))) applicable to the unrelated business income tax.

The bill clarifies that the amendments made by the Act with respect to the tax on unrelated business income are effective for taxable years ending after December 31, 1985, and are to be treated as a change in the rate of income tax imposed for purposes of Code section 15.

2. Qualified Pension, Profit-Sharing, and Stock Bonus Plans

If a pension, profit-sharing, or stock bonus plan qualifies under the tax law ("qualified plan"), then (1) a trust under the plan generally is exempt from income tax, (2) employers generally are allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, (3) benefits distributed as a lump-sum distribution may be accorded special long-term capital gain treatment or 10-year income averaging treatment, and (4) certain distributions may be rolled over, tax-free, to an individual retirement account or annuity (IRA) or to another qualified plan.

Under a tax-sheltered annuity program, amounts paid by an educational institution or by an eligible tax-exempt organization to purchase an annuity contract for an employee are excluded from the employee's income, subject to certain limits (sec. 403(b)). Excludable contributions to custodial accounts investing in stock of a regulated investment company (e.g., a mutual fund) are also permitted. Amounts distributed or made available under tax-sheltered annuity contracts generally are includible in gross income. However, certain distributions may be rolled over, tax-free, to another such annuity contract or to an IRA.

a. Distribution rules for qualified plans (secs. 152(a) and (b) of the bill and secs. 72, 401, 402, 403, and 408 of the Code)

Present Law

Distributions prior to age 59-1/2

Under the Act, the 10-percent additional income tax on distributions prior to age 59-1/2 applies to a distribution only to the extent that the distribution is attributable to contributions made or benefits accruing in years in which the participant was a 5-percent owner (as defined in sec. 416(i)).

Before-death distribution rules

The Act provides that a trust is not a qualified trust unless the plan of which it is a part provides that the entire interest of the employee will be distributed no later than the required beginning date. Alternatively, the requirements of the Act may be satisfied if the entire interest is to be distributed (in accordance with Treasury regulations), beginning no later than the required beginning date, over (1) the life of the employee, (2) the lives of the employee and a designated beneficiary, (3) a period (which may be a term certain) not extending beyond the life expectancy of the employee, or (4) a period (which may be a term certain) not extending beyond the life expectancy of the employee and a designated beneficiary.

Under the Act, the required beginning date is generally April 1 of the calendar year following the calendar year in which (1) the employee attains age 70-1/2 or (2) the employee retires, whichever is later. If an employee is a 5-percent owner (sec. 416(i)) with respect to the plan year ending in the calendar year in which the employee attains age 70-1/2, then the required beginning date is generally April 1 of the calendar year following the calendar year in which the employee attains age 70-1/2, even though the employee has not retired. The Act does not, however, require the distribution of employer securities subject to an 84-month holding period (sec. 409(d)) to a 5-percent owner before the expiration of the 84-month period.

Benefits provided under a qualified plan must be for the primary benefit of an employee, rather than the employee's beneficiaries. Accordingly, any death benefits provided for a participant's beneficiaries must be incidental.[6] Under this incidental death benefit rule, a qualified plan generally is required to provide for a form of distribution under which the present value of the retirement benefits payments projected to be made to the participant, while living, is more than 50 percent of the present value of the total payments projected to be made to the participant and the participant's beneficiaries. The incidental death benefit rule is designed to limit the use of qualified plans for nonretirement purposes (e.g., to provide for deferral of income tax or to provide for tax-favored transfers of wealth).

The before-death distribution rules under present law for IRAs are similar to the before-death distribution rules provided for qualified plans and are applied separately to each IRA owned by an individual.

After-death distribution rules

The Act provides rules that apply in the case of an employee's death before the employee's entire interest has been distributed. The Act provides that, if distributions have commenced to the employee before death, then the remaining portion of the employee's interest is to be distributed at least as rapidly as under the method of distribution in effect prior to death. If distributions have not commenced before the participant's death, the Act provides permissible periods over which the remaining interest may be paid to a designated beneficiary. Under the Act, the beneficiary could elect to accelerate payments of the remaining interest.

Under the Act, similar rules are provided for after-death distributions from or under an IRA. In addition, the rules applicable to after-death distributions under an annuity contract apply to a custodial account that is treated as a tax-sheltered annuity contract (sec. 403(b)(7)). Other tax-sheltered annuity contracts are subject to the after-death distribution rules applicable to annuity contracts under the Act (sec. 72(s)).

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[6] See, e.g., Rev. Rul. 72-241, 1972-1 C.B. 108.

Qualifying rollover distributions

Under the Act, distributions of less than the balance to the credit of an employee under a qualified plan or a tax-sheltered annuity contract may be rolled over, tax-free, by the employee (or the surviving spouse of the employee) to an IRA. A rollover of a partial distribution is permitted only if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, determined immediately before the distribution, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects tax-free rollover treatment at the time and in the manner prescribed by the Secretary of the Treasury.

Explanation of Provisions

Distributions prior to age 59-1/2

Under the bill, the 10-percent additional income tax on distributions prior to age 59-1/2 is applied to amounts received from or under a qualified plan by a 5-percent owner who is not disabled (within the meaning of section 72(m)(7)). However, the bill provides that the tax does not apply to amounts attributable to contributions paid before January 1, 1985. In applying this rule, any distribution to a 5-percent owner is deemed to come first out of contributions paid before January 1, 1985.

The bill removes the requirement of present law that each plan distribution must be examined to determine whether it is attributable to contributions on behalf of a 5-percent owner. Instead, the bill provides that the status of an individual at the time of a plan distribution is the relevant factor for imposition of the tax.

The bill defines a 5-percent owner as any individual who at any time during the 5 plan years preceding the plan year in which the distribution is made was a 5-percent owner (within the meaning of sec. 416(i)(1)(B)).

Before-death and after-death distribution rules

The bill clarifies the required beginning date for distributions from or under qualified plans, tax-sheltered annuities, and IRAs. Thus, under the bill, in the case of a 5-percent owner, distributions must commence no later than April 1 of the calendar year following the year in which the 5-percent owner attains age 70-1/2. An individual is considered to be a 5-percent owner for a calendar year if the individual was a 5-percent owner (within the meaning of section 416(i)(1)(B)) at any time during the 5 plan years ending in the calendar year in which the individual attains age 70-1/2.

The bill clarifies that distributions from IRAs are to commence no later than April 1 of the calendar year following the year in which the owner of the IRA attains age 70-1/2, without regard to whether the owner has retired. In addition, the bill provides that distributions from IRAs are subject to the incidental death benefit rules applicable to qualified plans.

Under the bill, the before-death and after-death distribution rules applicable to qualified plans also apply to distributions under tax-sheltered annuity contracts (including custodial accounts held by regulated investment companies and to retirement income accounts provided by churches, etc.). The rules applicable to tax-sheltered annuities include the incidental death benefit rules applicable to qualified plans. Under the bill, if a tax-sheltered annuity fails to satisfy the distribution requirements (in form or in operation), then the amounts held in the contract are to be includible in the employee's gross income (sec. 403(c)).

The bill repeals the exception to the required distribution rules applicable to amounts held by an ESOP, which are subject to the 84-month rule. Instead, the bill provides an exception to the 84-month rule for amounts required to be distributed under the required distribution rules for qualified plans.

Finally, the bill provides that amounts required to be distributed under the required distribution rules are not eligible for rollover to another qualified plan, a tax-sheltered annuity, or an IRA. This rule ensures that individuals will not be able to take year-end distributions, which are rolled over after the beginning of the next year but within 60 days and, thereby, circumvent the required distribution rules. The rollover restriction would apply only to the amounts required to be distributed. Thus, individuals would not be prevented from rolling over those distributions that exceed the minimum required distribution. For this purpose, the first amounts distributed to an individual during a taxable year are treated as amounts required to be distributed. Thus, a 60-day period during which rollovers may be made could not commence before an amount is distributed that is not a minimum required distribution.

Qualifying rollover distributions

Under the bill, a total distribution that does not satisfy the requirements for a qualified total distribution is treated as a distribution eligible for rollover under the partial distribution rollover rules. Thus, for example, a total distribution that is not a lump-sum distribution (e.g., because the distribution is not made on account of a separation from service) would be eligible for rollover under the partial distribution rollover rules.

The bill clarifies that accumulated deductible employee contributions (within the meaning of section 72(o)(5)) are not taken into account for purposes of calculating the balance to the credit of an employee under the partial distribution rollover rules. In addition, the bill clarifies that a self-employed individual is generally treated as an employee for purposes of the rules governing the tax treatment of distributions, including the rules relating to rollover distributions.

The bill provides that the rules relating to rollovers in the case of a surviving spouse of an employee who received distributions after the employee's death apply to permit rollovers to an IRA but not to another qualified plan. Also, the bill clarifies that partial distributions are to be rolled over within 60 days of the distribution to be eligible for rollover under the partial distribution rollover rules.

Finally, the bill provides that a pension plan is not treated as failing to be a qualified plan merely because it makes distributions to employees on account of plan termination prior to the time the employees otherwise would be eligible for distributions.

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b. Treatment of distributions if substantially all contributions are employee contributions (sec. 152(c) of the bill and sec. 72 of the Code)

Present Law

Under the Act, if substantially all of the contributions under a qualified plan are employee contributions, then distributions under the plan will be considered to be income until all income has been distributed. In addition, if an employee received (directly or indirectly) any amount as a loan under the plan, the Act treats the amount of the loan as an amount distributed from the plan.

The Act defines a plan in which substantially all of the contributions are employee contributions as a plan with respect to which 85 percent of the total contributions during a representative period (such as 5 years) as determined under Treasury regulations are employee contributions (whether or not mandatory).

Explanation of Provision

Under the bill, a plan is defined as one in which substantially all of the contributions are employee contributions if 85 percent or more of the total contributions during a representative period are employee contributions. Also, the bill provides that the 5-percent additional income tax on premature distributions from annuity contracts does not apply to distributions from a plan substantially all of the contributions of which are derived from employee contributions.

The bill clarifies that deductible employee contributions are not taken into account as employee contributions for purposes of testing whether 85 percent or more of total contributions to a plan during a representative period are employee contributions.

c. Provisions relating to top-heavy plans (sec. 152(d) of the bill and sec. 416 of the Code)

Present Law

Additional qualification standards are provided with respect to a qualified plan that is top-heavy. These rules are designed to provide safeguards for rank-and-file employees and to curb abuse of the special tax incentives available under qualified plans. These rules (1) limit the amount of a participant's compensation that may be taken into account; (2) require accelerated vesting; (3) provide minimum nonintegrated benefits or contributions for plan participants who are not key employees; and (4) reduce the overall limit on contributions and benefits for certain key employees.

A qualified plan is top heavy if, as of the determination date, more than 60 percent of the value of benefits accrued under the plan is allocable to key employees. Under the Act, the cumulative accrued benefits of any individual who has not received any compensation from any employer maintaining a plan during a period of 5 plan years ending on the determination date may be disregarded for purposes of determining whether the plan is top heavy.

Present law provides that the additional standards for top-heavy plans do not apply to a governmental plan (as defined in sec. 414(d)).

Explanation of Provision

Under the bill, the definition of a key employee would be amended to exclude any individual who is an officer or employee of an entity described in section 414(d) (relating to governmental plans). The effect of this provision is to clarify that certain separate accounting and nondiscrimination provisions of the Code (e.g., secs. 79, 415(l), and 419A) do not apply to employees of a State or local government or certain other governmental entities. The bill does not repeal the provision that exempts governmental plans from the top-heavy plan requirements.

The bill provides that the rule disregarding benefits of an employee after 5 plan years applies to employees who have not performed services for the employer maintaining the plan at any time during the 5-year period ending on the determination date. This provision is added to relieve the administrative difficulties associated with determining whether or not amounts an individual might receive after separation from service are in the nature of compensation.

d. Provisions relating to estate and gift taxes with respect to qualified plan benefits (sec. 152(e) of the bill and secs. 2039 and 2517 of the Code)

Present Law

Under present law, if the spouse of an employee on whose behalf contributions or payments are made to a qualified plan or a tax-sheltered annuity predeceases the spouse, the decedent spouse's estate does not include any community property interest in the employee spouse's interest in the employer-derived benefits under the qualified plan. A similar rule applies for purposes of the effect of certain transfers under the gift tax provisions.

In addition, present law provides that the exercise or nonexercise by an employee of an election or option under which an annuity will become payable to a beneficiary under a qualified plan, a tax-sheltered annuity, an IRA, or certain military pensions is not considered a transfer for purposes of application of the gift tax provisions.

Explanation of Provision

Under the bill, the special community property rules applicable to qualified plans for purposes of the estate and gift tax provisions are repealed. However, the bill would clarify that, if a transfer is made to an employee spouse by a nonemployee spouse in a community property state, the amount transferred is eligible for the unlimited marital deduction (secs. 2056 and 2523).

The bill also repeals the general exemption from the gift tax provisions of transfers pursuant to the exercise or nonexercise by an employee of an election or option under a qualified plan, etc.

Effective Date

The bill applies to gifts made or decedents dying after the date of enactment.

e. Affiliated service groups and employee leasing arrangements (sec. 152(f) of the bill and sec. 414 of the Code)

Present Law

Under the Act, the Secretary of the Treasury is granted regulatory authority to develop rules as may be necessary to prevent the avoidance of any employee benefit requirement to which the employee leasing provisions apply through the use of employee leasing or other arrangements (sec. 414(o)).

Explanation of Provision

Under the bill, the special regulatory authority provided to the Secretary of the Treasury with respect to abuses through the use of affiliated service groups (sec. 414(m)(7)) is repealed in favor of the broader general authority provided under the Act (sec. 414(o)). In addition, the bill clarifies that the other definitions relating to affiliated service groups (sec. 414(m)(6)) continue to apply.

f. Discrimination standards applicable to cash or deferred arrangements (sec. 152(g) of the bill and sec. 401(k) of the Code)

Present Law

Under the Act, all elective deferrals made by a participant under all cash-or-deferred arrangements of an employer are to be aggregated for purposes of calculating that participant's actual deferral percentage. In addition, the Act provides that a cash-or-deferred arrangement is a qualified cash-or-deferred arrangement only if it meets the special tests provided by the Code relating to actual deferral percentages. If a cash-or-deferred arrangement fails to meet the special tests, an elective deferral made under the arrangement is treated as an employee contribution under the plan which, under the usual rules, could be wholly or partly nondeductible.

Explanation of Provision

Under the bill, if an employee participates in more than one cash-or-deferred arrangement of an employer, all such cash-or-deferred arrangements are treated as one arrangement for purposes of determining the deferral percentage with respect to the employee. Thus, an employee's actual deferral percentage taken into account for purposes of applying the special deferral percentage tests under any plan of the employer is the sum of the elective deferrals for that employee under each plan of the employer which provides a cash-or-deferred arrangement divided by the participant's compensation from the employer.

In addition, the bill clarifies that a plan which includes an otherwise qualified cash-or-deferred arrangement that satisfies the special tests provided by section 401(k)(3) of the Code will be treated as satisfying the general nondiscrimination test of section 401(a)(4) with respect to the elective deferrals.

g. Treatment of certain medical, etc., benefits under section 415 (sec. 152(h) of the bill and sec. 415 of the Code)

Present Law

Under the Act, any defined benefit pension plan that provides medical benefits to retired employees is required to create and maintain an individual medical benefit account for any participant who is a 5-percent owner (within the meaning of sec. 416(i)(1)(B)) and to treat contributions allocated to such accounts as annual additions for purposes of the overall limits on contributions and benefits.

Under the overall limits, the annual addition with respect to an employee under all defined contribution plans of an employer for a year is not to exceed the lesser of $30,000 or 25 percent of compensation. A lower limit may apply if the employer also maintains a defined benefit plan for the employee.

Explanation of Provision

The bill clarifies that the special rules for post-retirement medical benefits applies to any pension or annuity plan under which such benefits are provided.

In addition, the bill changes the definition of employees for whom separate accounting is required to conform to the definition provided with respect to the separate accounting for post-retirement medical and life insurance benefits under a welfare benefit fund. Thus, separate accounting would be required with respect to any employee who is a key employee (within the meaning of section 416(i)).

Finally, the bill provides that the amount treated as an annual addition under the rules for coordinating the post-retirement medical benefits with the overall limits on qualified plans is not subject to the 25-percent-of-compensation limit usually applicable to annual additions. For example, assume the compensation of an employee is $100,000 for a year and $5,000 is treated as an annual addition under the limits for the employee under the rules for post-retirement medical benefits under a qualified plan. Assume further that the annual addition for the year under a qualified defined contribution plan, without regard to the post-retirement medical benefit is $25,000 (a contribution equal to the maximum percentage of compensation limit). Under the bill, the annual addition for post-retirement medical benefits does not cause the annual addition to exceed the 25-percent limit on annual additions, even though the annual addition would exceed that limit if the amount added for post-retirement medical benefits were taken into account. The annual addition of $30,000 would, however, be subject to the separate dollar limit for the year and, if the employer also maintains a defined benefit plan for the employee, the full annual addition of $30,000 would be taken into account in determining whether the combined plan limits are satisfied (sec. 415(e)).

3. Fringe Benefit Provisions (sec. 153 of the bill, sec. 531 of the Tax Reform Act of 1984, and secs. 132, 125, and 4977 of the Code)

a. Definition of dependent children

Present Law

Section 531 of the Act provided exclusions from gross income for no-additional-cost services and certain other fringe benefits. These exclusions generally apply to benefits provided by an employer for use by an employee, the employee's spouse, or the employee's dependent child. The 1984 Act defines the latter term to mean any child of the employee (1) who is a dependent of the employee, or (2) both of whose parents are deceased (Code sec. 132(f)(2)(B)).

Explanation of Provision

The bill defines dependent child to mean any child of the employee (1) who is a dependent of the employee, or (2) both of whose parents are deceased and who has not attained age 25.

b. Clarification of cross-reference

Present Law

Code section 132(f) provides that for purposes of paragraphs (1) and (2) of subsection (a), any use by the spouse or a dependent child of the employee is treated as use by the employee. The cross-references are to both the no-additional-cost service exclusion (sec. 132(a)(1)), which applies to a service provided by an employer to an employee for use by such employee if certain conditions are met, and also the qualified employee discount exclusion (sec. 132(a)(2)), which applies in certain circumstances where the price at which property or services are provided to the employee by the employer is less than the price to nonemployee customers.

Explanation of Provision

To clarify the mechanics of the cross-reference in Code section 132(f), the bill adds the words "for use by such employee" in section 132(a)(2). Accordingly, the qualified employee discount exclusion applies in certain circumstances where the price at which property or services are provided to the employee by the employer for use by such employee (or the spouse or dependent children of the employee) is less than the price to nonemployee customers.

c. Cross-reference in definition of customer

Present Law

Under Code section 132(i), the term customers does not include nonemployee customers except for purposes of section 132(c)(2)(B), relating to the determination of gross profit percentage as a limitation on the exclusion for qualified employee discounts.

Explanation of Provision

The bill provides that this exception to the definition of customers also applies for purposes of section 132(c)(2)(A), defining the term gross profit percentage.

d. Excise tax on certain fringe benefits

Present Law

Under the Act, the line of business limitation otherwise applicable to the section 132 exclusions for no-additional-cost services and qualified employee discounts is relaxed under an elective grandfather rule set forth in section 4977. The requirements for that provision necessitate determining the employees in certain lines of business of the employer.

Explanation of Provision

The bill provides that section 4977 is to apply only with respect to employment within the United States, except as otherwise provided in Treasury regulations.

e. Applicability of section 132(a)(1) exclusion to certain pre-divestiture retired telephone employees

Present Law

Section 531 of the 1984 Act excludes from income and wages the fair market value of a no-additional-cost service provided by an employer to an employee for use of the employee (Code sec. 132(a)(1)). This exclusion applies if (1) the employer incurs no substantial cost (including foregone revenue) in providing the service; (2) the service is provided by the employer (including certain businesses under common control) or another business with whom the employer has a written reciprocal agreement, and is of the same type ordinarily sold to the public in the line of business in which the employee works; (3) the service is provided to a current or retired employee, or a spouse or dependent child of either, or a widow(er) or dependent children of a deceased employee; and (4) for certain highly compensated employees, nondiscrimination requirements are met. Subject to certain transitional rules, the exclusion takes effect January 1, 1985.

Generally, situations in which an employer incurs no additional cost in providing services to employees are those in which the employees receive, at no substantial additional cost to the employer, the benefit of excess capacity that otherwise would have remained unused because nonemployee customers would not have purchased it—e.g., where telephone companies provide telephone service to employees within existing capacity. Local telephone service and long-distance telephone service are considered the same line of business.

Explanation of Provision

The provision effectuates an intended transitional rule under which the fair market value of free telephone service provided to employees of the Bell System who had retired prior to divestiture of the system on January 1, 1984, is excluded from income and wages of such pre-divestiture retirement employees. The exclusion pursuant to the provision does not apply to the furnishing of any equipment or to the furnishing of any type of service that was not furnished to such retirees as of January 1, 1984.

The provision applies in the case of an employee who, prior to January 1, 1984, separated from service (by reason of retirement or disability) of an entity subject to the modified final judgment (as defined in Act sec. 559(c)(4)). The provision does not apply to any employee who separated from such service on or after January 1, 1984. No inference is intended from adoption of this transitional rule as to the interpretation of the no-additional-cost service exclusion in any other circumstances.

Under the provision, all entities subject to the modified final judgment are treated as a single employer in the same line of business for purposes of determining whether telephone service provided to the employee is a no-additional-cost service. Also, payment by an entity subject to the modified final judgment of all or part of the cost of local telephone service provided to the employee by a person other than an entity subject to the modified final judgment (including rebate of the amount paid by the employee for the service and payment to the person providing the service) is treated as telephone service provided to the employee by such single employer for purposes of determining whether the telephone service is a no-additional-cost service.

For purposes of this provision, the term employee has the meaning given to such term in Code section 132(f). Except as otherwise provided in this provision, the general requirements for the Code section 132(a)(1) exclusion apply; e.g., the exclusion applies to officers, owners, or highly compensated employees only if the no-additional-cost service is available to employees on a nondiscriminatory basis.

f. Cafeteria plans

Present Law

Present law defines a cafeteria plan as a plan under which employees may choose (1) taxable benefits consisting of cash or certain other taxable benefits, or (2) certain fringe benefits that are specifically excluded from gross income by the Code (statutory fringe benefits).

Under the Act, the only taxable benefits which may be offered in a cafeteria plan consist of certain life insurance coverage that is not excludable from gross income, certain vacation pay, or cash.

The life insurance coverage that may be offered is the coverage that is included in gross income to the extent the coverage exceeds $50,000 or to the extent it is provided on the life of a spouse or dependent of an employee. Vacation days may be provided under a cafeteria plan only if the plan precludes any participant from using (or receiving cash for) vacation days remaining unused as of the end of the plan year.

A cafeteria plan may offer any fringe benefit (other than scholarships or fellowships, vanpooling, educational assistance, or miscellaneous fringe benefits) that is excludable from gross income under a specific section of the Code.

Under the Act, both general and special transition relief is provided with respect to the Treasury regulations on cafeteria plans, for cafeteria plans and "flexible spending arrangements" in existence on February 10, 1984.

Explanation of Provision

Under the bill, the definition of permissible cafeteria plan benefits is clarified. The effect of the provision, which changes the reference in section 125 from nontaxable benefits to qualified benefits is to (1) eliminate any possible implication that a taxable benefit provided through a cafeteria plan is nontaxable, and (2) clarify that certain taxable benefits, as permitted under Treasury regulations, can be provided in a cafeteria plan.

The bill makes two changes to the transition relief provided to certain cafeteria plans under section 531(b) of the Tax Reform Act of 1984. The first change provides that a cafeteria plan, in existence on February 10, 1984, maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers will be granted relief under the transition rules until the expiration of the last collective bargaining agreement relating to the cafeteria plan. When a collective bargaining agreement terminates is determined without regard to any extension of the agreement agreed to after July 18, 1984. Also, if a cafeteria plan is amended to conform with either the requirements of the Act or the requirements of any cafeteria plan regulations, the amendment is not treated as a termination of the agreement.

Second, the bill provides that a cafeteria plan which suspended a type or amount of benefit after February 10, 1984, and subsequently reactivated the benefit is eligible for transition relief under either the general or special transition relief provision.

4. Employee Stock Ownership Plan Provisions (ESOPs)

a. Sales of stock to employee stock ownership plans or certain cooperatives (sec. 154(a) of the bill and secs. 1042 and 4978 of the Code)

Present Law

In general

A taxpayer may elect to defer recognition of gain on the sale of certain qualified securities to an employee stock ownership plan (ESOP) or to an eligible worker-owned cooperative to the extent that the taxpayer reinvests the proceeds in qualified replacement property within a replacement period. To be eligible for nonrecognition treatment, (1) the qualified securities must be sold to an employee organization; (2) the employee organization must own, immediately after the sale, at least 30 percent of the total value of the employer securities then outstanding; (3) the employee organization must preclude allocation of assets attributable to qualified securities to certain individuals; and (4) the taxpayer must provide certain information to the Secretary of the Treasury.

Qualified securities; qualified replacement property

For purposes of this provision, the Act defines qualified securities as employer securities that (1) are issued by a domestic operating corporation that has no readily tradable securities outstanding, (2) have been held by the seller for more than one year, and (3) have not been received by the seller as a distribution from a qualified plan or as a transfer pursuant to an option or similar right to acquire stock granted to an employee by an employer (other than stock acquired for full consideration).

Qualified replacement property (which includes both debt and equity instruments, as defined in sec. 165(g)(2)) consists of securities issued by another domestic corporation that does not, for the corporation's taxable year in which such securities are acquired by the taxpayer seeking nonrecognition treatment, have passive investment income (within the meaning of sec. 1362(d)(3)(D)) exceeding 25 percent of such corporation's gross receipts for that taxable year.

Disposition of qualified replacement property

In general, the Act provides that the basis of the taxpayer in qualified replacement property is reduced by an amount not greater than the amount of gain realized on the sale of qualified securities to the employee organization which was not recognized pursuant to the election provided by this provision. The gain is to be recognized upon disposition of the qualified replacement property. However, the Act did not clarify the impact of any other rules that otherwise might permit nonrecognition treatment upon a direct or indirect disposition of the qualified replacement property.

Explanation of Provisions

Qualified securities; qualified replacement property

The bill makes several clarifying changes to the definition of qualified securities and qualified replacement property.

With respect to qualified securities, the bill makes it clear that stock of a corporation with no readily tradable stock outstanding may be eligible for nonrecognition treatment whether or not the corporation or any member of the controlled group has outstanding any readily tradable debt securities. The bill also clarifies that the nonrecognition provision applies only if the gain on the sale would otherwise have been long-term capital gain. For example, the sale of securities that had been held for less than six months and the sale of securities which otherwise would be treated as ordinary income (e.g., by reason of the collapsible corporation provisions) will be ineligible for nonrecognition treatment under this provision.

With respect to qualified replacement property, the bill makes it clear that any debt or stock instrument that is a security within the meaning of section 165(g)(2) (other than securities issued by a government or political subdivision thereof) may be treated as replacement property if it meets the standards of the Code. Qualified replacement property is limited under the bill to securities issued by a domestic operating corporation other than the corporation that issued the securities involved in the nonrecognition transaction. The bill generally defines a domestic operating corporation as a corporation substantially all the assets of which were, at the time the securities were purchased, used in the active conduct of a trade or business. However, if (1) the corporation issuing the qualified replacement property owns stock representing control of one or more other corporations, or (2) one or more other corporations own stock representing control of the corporation issuing the qualified replacement property, then all such corporations will be treated as one corporation for purposes of determining whether the corporation is a domestic operating corporation. For purposes of this provision, control means control within the meaning of section 304(c).

The bill also clarifies the Act requirement that qualified replacement property be issued by a domestic operating corporation that does not have passive investment income exceeding 25 percent of gross receipts. Under the bill, the determination is made for the last taxable year of the corporation preceding the year in which the qualified replacement property is acquired.

Thirty-percent test

Under the bill, the employee organization must own, immediately after the sale, at least 30 percent of the total value of all stock (other than preferred stock described in section 1504(a)(4)) of the corporation that issued the qualified securities.

Exclusive benefit

The bill makes several clarifying changes to the rule requiring the employee organization to be maintained for the exclusive benefit of employees. First, the bill makes it clear that no portion of the assets attributable to qualified securities with respect to which a nonrecognition election is made may be allocated to (1) the taxpayer seeking nonrecognition treatment, (2) any person who is related to that taxpayer after application of attribution rules (sec. 267(b)), or (3) any other person who owns (after application of attribution rules (sec. 318(a)) more than 25 percent of the value of (A) any class of stock of the corporation that issued such qualified securities, or (B) the total value of the stock of certain related corporations.

In addition, the bill makes it clear that this restriction applies to prohibit any direct or indirect accrual of benefits or an allocation of assets attributable to the qualified securities involved in the nonrecognition transaction. Where an employer otherwise elects to aggregate two or more plans for purposes of the coverage or discrimination rules, the plans will be treated as a single plan for purposes of applying this provision.

Thus, for example, an ESOP in which the taxpayer seeking nonrecognition treatment participates could not allocate any assets attributable to the securities involved in the nonrecognition transaction to his account. Nor could the employer make an allocation of other assets to the taxpayer under the ESOP or any plan with which the ESOP was aggregated without making additional allocations to other participants sufficient separately to satisfy the coverage and nondiscrimination requirements (secs. 410 and 401(a)).

Of course, a participant's right to previously accrued benefits, including the right to increased vesting in such benefits, is not affected by this rule. Nor is the allocation of earnings to account balances to be treated as an allocation prohibited under this rule.

Eligible taxpayers

Generally, effective for sales after March 28, 1985, the bill limits the class of taxpayers eligible to elect nonrecognition treatment under this provision by making the election unavailable to any subchapter C corporation. However, a subchapter C corporation may elect nonrecognition treatment with respect to certain sales made no later than July 1, 1985, provided the sales otherwise satisfy the requirements of this provision and are made pursuant to a binding contract in effect on March 28, 1985, and at all times thereafter.

Disposition of qualified replacement property

The bill also clarifies the coordination of the provision's requirement that gain be recognized upon disposition of any qualified replacement property with other rules providing nonrecognition treatment. Effective for dispositions made after the date of enactment, the bill overrides all other provisions permitting nonrecognition and requires that gain realized upon the disposition of qualified replacement property be recognized at that time. For this purpose, it is not intended that death be treated as a disposition. The amount of gain required to be recognized under this rule is limited to the amount not recognized pursuant to the election provided by this provision by reason of the acquisition of such replacement property. Any gain in excess of that amount continues to be eligible for any otherwise applicable nonrecognition treatment.

To ensure that this rule is not avoided through the use of controlled corporations, the bill provides special rules for corporations controlled by the taxpayer seeking nonrecognition property. If the taxpayer owns stock representing control (within the meaning of section 304(c)) of the corporation issuing the qualified replacement property, the taxpayer shall be treated as having disposed of such qualified replacement property when the corporation disposes of a substantial portion of its assets other than in the ordinary course of its trade or business.

b. Deduction for dividends paid on ESOP stock (sec. 154(b) of the bill and sec. 404(k) of the Code)

Present Law

An employer is entitled to deduct the amount of any dividends paid in cash during the employer's taxable year with respect to stock of the employer that is held by an ESOP (including a tax credit ESOP), but only to the extent such dividends are actually paid out currently to participants or beneficiaries.

The Act permits the employer to claim a deduction for the employer's taxable year when paid to the extent that the dividends (1) are, in accordance with the plan provisions, paid in cash directly to the participants, or (2) are paid to the plan and subsequently distributed to the participants in cash no later than 90 days after the close of the plan year in which paid.

For income tax purposes, dividends distributed under an ESOP, whether paid directly to participants pursuant to plan provisions or paid to the plan and redistributed to participants, generally are treated as plan distributions. Accordingly, such dividends do not qualify for the partial exclusion from income otherwise permitted under Code section 116. However, the Act does not clarify whether the treatment of such dividend distributions permits the recipient to reduce the amount includible in income by recovering, tax-free, any net employee contributions under the plan.

Explanation of Provision

The bill makes it clear that dividends paid on any employer stock held by the ESOP and actually allocated to a participant's account may be deducted under this provision, including those dividends paid on employer stock that is not considered to be qualified employer securities within the meaning of section 409(l). No deduction is permitted, however, with respect to employer stock held in a suspense account under an ESOP. The bill also makes it clear that current distributions of dividends paid on employer stock allocated to a participant's account under an ESOP will not be considered disqualifying distributions.

In addition, effective for dividends paid after the date of the bill's enactment, the bill makes it clear that employer deductions for dividends paid on employer stock held by an ESOP are to be permitted only in the year in which employees have a corresponding income inclusion. Thus, where the employer pays such dividends directly to participants in accordance with plan provisions, a deduction would be permitted in the year paid. However, where the employer pays such dividends to the ESOP for redistribution to participants no later than 90 days after the close of the plan year, a deduction would be permitted in the employer's taxable year in which the dividend is distributed from the ESOP to the participants.

Moreover, also effective for dividends paid after the date of enactment, the bill makes it clear that, although the dividends for which the Act allows a deduction are generally to be treated as distributions under the plan, they are to be fully taxable. Thus, these distributions are not to be treated as distributions of net employee contributions.

c. Partial exclusion of interest earned on ESOP loans (sec. 154(c) of the bill and sec. 133 of the Code)

Present Law

A bank (within the meaning of sec. 581), an insurance company, or a corporation actively engaged in the business of lending money may exclude from gross income 50 percent of the interest received with respect to a securities acquisition loan.

A securities acquisition loan means any loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities (within the meaning of sec. 409(l)) for the plan.

Explanation of Provision

The bill clarifies the interaction of the partial interest exclusion with other provisions affecting tax-exempt income. First, the bill makes it clear that for purposes of section 291(e), relating to certain tax preference items, (1) interest on an obligation eligible for the partial exclusion of section 133 will not be treated as exempt from tax, and (2) in determining the interest allocable to indebtedness on tax-exempt obligations, obligations eligible for the partial exclusion will not be taken into account in calculating the taxpayer's average adjusted basis for all assets.

In addition, the bill clarifies the coordination of the partial exclusion with the installment payment provisions (sec. 483) and the original issue discount rules (secs. 1271 through 1275). The bill makes it clear that, in testing the adequacy of the stated interest rate for purposes of applying the below-market interest rate rules, the applicable Federal rate will be adjusted as appropriate to reflect the partial interest exclusion.

d. Payment of estate tax liability by ESOP (sec. 154(d) of the bill and sec. 2210 of the Code)

Present Law

If qualified employer securities are (1) acquired from a decedent by an ESOP or an eligible worker-owned cooperative, (2) pass from a decedent to an ESOP or worker-owned cooperative, or (3) are transferred by the decedent's executor to an ESOP or worker-owned cooperative, then the executor of the decedent's estate generally is relieved of the estate tax liability to the extent the ESOP or cooperative is required to pay the liability.

No executor is relieved of estate tax liability under this provision with respect to securities transferred to an ESOP unless the employer whose employees participate in the ESOP guarantees, by surety bond or other means as required by the Secretary of the Treasury, the payment of any estate tax or interest.

To the extent that (1) the decedent's estate is otherwise eligible to make deferred payments of estate taxes pursuant to section 6166 with respect to the decedent's interest in qualified employer securities, and (2) the executor elects to make payments pursuant to that section, the plan administrator of the ESOP or an authorized officer of the worker-owned cooperative also may elect to pay any estate taxes attributable to the qualified employer securities transferred to the ESOP or cooperative in installments pursuant to that section. The Act provides that the usual rules (sec. 6166) apply to determine ongoing eligibility for deferral. Thus, for example, disposition of the qualifying securities held by the estate and employee organization may trigger acceleration of any remaining unpaid tax.

Explanation of Provision

The bill makes several changes to clarify the applicability of these provisions and the coordination with the provisions governing the installment payment of estate taxes under section 6166. First, the bill makes it clear that only executors of those estates eligible to make deferred payments of estate taxes may be relieved of estate tax liability under this provision. In addition, under the bill, the transfer of employer securities to an ESOP or to an eligible worker-owned cooperative will not be treated as a disposition or withdrawal which triggers acceleration of the remaining unpaid tax.

The bill makes it clear that, after the transfer, the ongoing eligibility of the estate and the ESOP or cooperative to make installment payments applicable to their respective interests is to be tested separately. Thus, with respect to the estate's remaining interest (if any), cumulative dispositions and withdrawals of amounts up to 50 percent of the estate's remaining interest would be permitted without requiring acceleration of the remaining unpaid tax. Similarly, with respect to an ESOP or cooperative, cumulative dispositions and withdrawals of up to 50 percent of the interest transferred to such organization would be permitted without requiring acceleration. In addition, under the bill, a distribution made by an ESOP to participants on account of death, retirement after attainment of age 59-1/2, disability, or any separation from service resulting in a one-year break in service will not be treated as a disposition requiring acceleration of any unpaid tax and will not be taken into account in determining whether any subsequent disposition triggers acceleration.

The bill also makes it clear that no executor will be relieved of estate tax liability with respect to employer securities transferred to an eligible worker-owned cooperative unless the cooperative guarantees the payment of any estate tax or interest by surety bond or other means as required by the Secretary of the Treasury.

e. Tax on certain dispositions by employee stock ownership plans and certain cooperatives (sec. 154(e) of the bill and sec. 4978 of the Code)

Present Law

Under the Act, if an ESOP or worker-owned cooperative disposes of any qualified securities during the 3-year period after the ESOP or cooperative acquires the securities, a 10-percent excise tax generally applies to the amount realized on the disposition if the disposition reduces the amount of employer securities held by the ESOP or worker-owned cooperative below a prescribed level. The Act provides an exception to the general rule for certain distributions to employees by reason of death, retirement after age 59½, disability, or separation from service resulting in a 1-year break in service.

Explanation of Provision

Under the bill, an exception to the rule imposing a 10-percent excise tax on certain dispositions is provided in the case of any exchange of qualified securities pursuant to a liquidation of the corporation issuing the securities into an eligible worker-owned cooperative. This exception applies only if (1) the exchange meets the rules relating to a complete liquidation of a subsidiary (sec. 332) and (2) the cooperative owns 100 percent of the corporation.

5. Incentive Stock Option Provision (sec. 155 of the bill and secs. 57 and 422A of the Code)

Present Law

The Act clarifies that the fair market value of stock, for purposes of applying the incentive stock options provisions, is determined without regard to lapse restrictions.

The Act applies, for purposes of the minimum tax, to options exercised after March 20, 1984. Transitional relief was provided for certain options exercised on or before December 31, 1984.

Explanation of Provision

The bill clarifies that, under the transitional rule, the amendment to the minimum tax provision relating to incentive stock options (sec. 57(a)(10)) will not apply to options exercised before January 1, 1985, if the option was granted pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before May 15, 1984.

F. Technical Corrections to the Tax-Exempt Bond Provisions

1. Mortgage subsidy bonds and mortgage credit certificate provisions (secs. 161-163 of the bill and secs. 25 and 103A of the Code)

Present Law

Mortgage subsidy bonds

The Act extends the tax-exemption for qualified mortgage bonds for four years, for bonds issued after December 31, 1983, and before January 1, 1988. These bonds generally are subject to the same restrictions as applied before January 1, 1984.

The Act restricts the issuance of qualified veterans' mortgage bonds by (1) limiting the veterans eligible for loans financed with these bonds, and (2) imposing State volume limitations based on pre-1984 issuance of the bonds. The Act further directs the Federal Financing Bank to make cash flow loans to the Oregon Department of Veterans' Affairs to offset lower than anticipated prepayments on loans funded with specified veterans' mortgage bonds.

Mortgage credit certificates

As an alternative to qualified mortgage bonds, the Act permits States to elect to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs generally are subject to the same eligibility restrictions as qualified mortgage bonds.

Explanation of Provisions

Mortgage subsidy bonds

The bill clarifies that, in certain cases, the Treasury Department may grant extensions of time for publishing annual policy statements that issuers of qualified mortgage bonds are required to make. These statements must explain measures taken by the issuers to comply with the Congressional objective of providing housing for lower-income persons.

The bill further clarifies that veterans eligible for loans financed by qualified veterans' mortgage bonds must apply for the financing before the later of (1) 30 years after leaving active service, or (2) January 31, 1985 (rather than January 1, 1985).

The bill provides that the Oregon Department of Veterans' Affairs may advance refund up to $300 million of qualified veterans' mortgage bonds. (Advance refundings of mortgage subsidy bonds generally are prohibited.) The advance refunding is in lieu of authority included in the Act permitting that State agency to receive cash flow loans not exceeding $300 million at any time from the Federal Financing Bank.

Mortgage credit certificates

Issuers of qualified mortgage bonds must satisfy information reporting requirements, must certify that the bonds meet the requirements of the Code, and must publish annual policy statements demonstrating that their programs satisfy Congress' objective in authorizing issuance of tax-exempt bonds for this purpose. The bill clarifies that these requirements also apply with respect to MCCs.

The bill clarifies that good faith errors in MCC program administration may be corrected without invalidating all MCCs issued under the program. The bill further clarifies the method for determining the amount of an unused MCC that may be carried forward for up to three years by a taxpayer.

Miscellaneous

The bill also corrects other minor clerical and technical errors.

2. Private activity bond provisions (secs. 164-170 of the bill and sec. 103 of the Code)

Present Law

Volume limitations

Private activity bonds generally are subject to statewide volume limitations. The limitations apply to most industrial development bonds (IDBs) and to student loan bonds issued within the State. Certain bonds issued to finance governmentally owned airports, docks, wharves, convention or trade show facilities, and mass commuting facilities are not subject to these volume limitations.

The Act provides a statutory formula for allocating each State's volume limitation among issuers within the State. This Federal formula may be overridden by State statute, or by gubernatorial proclamation on an interim basis.

Application of certain Internal Revenue Code requirements to bonds exempt from tax pursuant to other provisions of law

The Act requires bonds issued pursuant to provisions of law other than the Internal Revenue Code to satisfy numerous Code requirements. Examples of these requirements are the restrictions on IDBs, the Code arbitrage rules, the prohibition on Federal guarantees of tax-exempt bonds, the State volume limitations, and the Code public approval and information reporting requirements.

Consumer loan bonds

The Act provides that interest on bonds generally is not tax-exempt if five percent or more of the proceeds is reasonably expected to be used, directly or indirectly, to make loans to nonexempt persons. Exceptions are provided for IDBs, qualified student loan bonds, and mortgage subsidy bonds.

Effective dates

Section 631 of the Act provides effective dates for the various tax-exempt bond provisions for which (1) no separately stated effective dates are included as part of the Act section containing a substantive rule, or (2) no effective dates are provided by means of dates included within substantive rules identifying the bonds to which the rules apply. Transitional exceptions are provided with respect to many of the provisions for which the effective dates are provided in Act section 631.

Explanation of Provisions

Volume limitations

Facilities located outside a State.—The bill clarifies that each State's annual private activity bond volume limitation generally may be used only to finance facilities located within that State. Under this clarification, a State may allocate a portion of its volume limitation to financing for facilities located outside its boundaries only in the case of certain specified facilities, and only to the extent of the State's share of the use of those facilities.

Facilities located outside a State and to which a State may allocate a portion of its volume limitation include (1) otherwise eligible sewage and solid waste disposal facilities or facilities for the local furnishing of electric energy or gas (sec. 103(b)(4)(E)); (2) otherwise eligible facilities for furnishing of water (sec. 103(b)(4)(G)); and (3) qualified hydroelectric generating facilities (sec. 103(b)(4)(H)). This clarification does not affect the rule in Code section 103(o)(3) that student loan bonds must be issued to finance loans to (1) residents of the State issuing the bonds regardless of the location of the school the residents attend, and (2) students attending schools within the issuing jurisdiction, regardless of the State of their legal residence, since no facilities are financed with student loan bonds.

In the case of sewage and solid waste disposal facilities, the determination of a State's use of a facility is based on the percentage of the facility's total treatment provided to the State (and its residents). In the case of facilities for the local furnishing of electric energy and gas, facilities for the furnishing of water, and qualified hydroelectric generating facilities, the determination of use is based upon the share of the output of the facility received by the State (and its residents).

These clarifications are effective for bonds issued after the date of the bill's enactment.

Certain facilities financed outside a State's volume limitation.—The bill clarifies that the determination of whether facilities forming a part of an airport, dock, wharf, mass commuting facility, or trade or convention center may be financed outside a State's volume limitation is to be made on a property-by-property basis rather than by reference to the entire airport or other excepted facility. Under the bill, *all* property to be financed pursuant to this exception must be owned by or on behalf of a governmental unit. Therefore, property financed with the so-called "minor portion" of bond proceeds that otherwise could be used for a purpose other than the governmental purpose for which the bonds are issued also must be governmentally owned.

Authority to allocate a State's volume limitation directly to issuing authorities other than governmental units.—The bill clarifies that a State may allocate its private activity bond volume limitation directly to issuing authorities within the State that are not governmental units as well as to such governmental units. This clarification applies to allocations pursuant to gubernatorial proclamations and also to allocations pursuant to State statutes.

Reporting requirement for allocations of volume limitations.—The bill clarifies the authority of the Treasury Department to require reports on allocations of State volume limitations as part of the presently required information reporting (Code sec. 103(*l*)).

Application of certain Internal Revenue Code requirements to bonds exempt from tax pursuant to other provisions of law

The bill clarifies that bonds issued pursuant to provisions of law other than the Code must be issued in registered form. Additionally, the bill clarifies that the private ("consumer") loan bond provisions of the Code apply to these bonds. These clarifications are effective for bonds issued after March 28, 1985.

Consumer loan bonds

The bill clarifies the scope of the Act's consumer loan bond restriction. The bill retitles consumer loan bonds "private loan bonds" to reflect the fact that all bonds issued to finance loans to nonexempt persons are subject to this restriction unless a specific exception is provided (e.g., IDBs, mortgage subsidy bonds, and qualified student loan bonds).

This restriction applies whether bonds are used to finance loans for businesses or to finance personal loans. For example, an issue may be an issue of private loan bonds if 5 percent or more, but less than 25 percent, of the proceeds are used to provide financing that would be considered IDB-financing, but for the fact that, under Treasury Department regulations, bonds are not treated as IDBs if less than 25 percent of the proceeds is used for a purpose described in section 103(b). Similarly, an obligation that would be an IDB except for the fact that the security interest test of section 103(b)(2)(B) is not satisfied is a private loan bond.

Effective dates

The bill clarifies the private activity bond provisions to which the effective dates provided in Act section 631(c) apply. These provisions are (1) the prohibition on Federal guarantees (Act sec. 622); (2) the aggregate limit for small issue bonds (Act sec. 623); (3) the restrictions on financing land, existing facilities, and certain specified facilities (Act sec. 627); (4) the rules relating to aggregation of certain related facilities, the definition of substantial user, and mixed use residential rental property (Act secs. 628(c), (d), and (e)); (5) the option for student loan bond authorities to issue taxable bonds (Act sec. 625(c)); (6) the public approval requirements for certain airports (Act sec. 628(f)); and (7) the authorization of tax-exempt financing for acquisition of a bankrupt railroad (Act sec. 629(b)).

The bill clarifies that the transitional exceptions contained in Act section 631(c)(3) apply only in the case of certain of the provisions enumerated in section 631(c)(1).

The bill further clarifies that the exception for obligations to finance facilities the construction, reconstruction, or rehabilitation of which was begun before October 19, 1983, applies only if the construction, reconstruction, or rehabilitation was completed on or after that date. Similarly, the exception for obligations issued to finance facilities with respect to which a binding contract to incur significant expenditures for construction, reconstruction, rehabilitation, or acquisition was entered before October 19, 1983, applies only if some of the expenditures are incurred on or after that date.

The two clarifications to these transitional exceptions requiring activity (e.g. construction) for expenditures after October 18, 1983, apply to obligations issued after March 28, 1985; however, no inference is intended that the same rules do not apply to obligations issued on or before that date.

Finally, the bill clarifies that the prohibition on tax-exempt financing for health clubs applies generally only to obligations issued after April 12, 1984.

Miscellaneous

The bill also corrects other minor clerical and technical errors.

G. Technical Corrections to Miscellaneous Tax Provisions

1. Miscellaneous pension provisions (sec. 171 of the bill and secs. 62, 219, 402, 404, and 408 of the Code)

Present Law

Rollovers

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) amended the premature distribution rules to impose a ten-percent additional income tax penalty on certain premature distributions made to key employees (rather than owner-employees). TEFRA failed to make a conforming amendment to the rollover rules that were designed to preclude evasion of the rule by rolling assets over into another qualified plan. The Act further amended those rules effective for years beginning after December 31, 1984, to impose the penalty on all 5-percent owners, rather than key employees. Although the Act also conformed the rollover rules to the TEFRA change (from owner-employee to key employee), it did not conform the rollover rules to the subsequent change affecting 5-percent owners.

Overall limits

Generally, effective for years ending after July 1, 1982, TEFRA reduced the overall limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, or SEPs. TEFRA also provided rules to calculate the dollar limits applicable to alternate forms of benefits, benefits commencing prior to age 62, and benefits commencing after age 65. In calculating employer contributions required to fund benefit amounts not in excess of those limits (and deductions for those contributions), TEFRA provided that anticipated cost-of-living increases could not be taken into account.

Deduction limits for self-employed individuals

Generally, effective for years beginning after December 31, 1983, TEFRA revised the definition of earned income so that the amount of earned income corresponds to the amount of compensation of a common-law employee. Under TEFRA, in applying the rules relating to deductions and limitations under qualified plans, the earned income of a self-employed individual was computed after taking into account contributions by the employer to a qualified plan to the extent a deduction was allowed for the contributions. The Act attempted to make it clear that the TEFRA definition of earned income did not apply for purposes of determining whether contributions made on behalf of a self-employed individual were ordinary and necessary.

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Explanation of Provisions

Rollovers

The bill coordinates the rules relating to qualifying rollover distributions with those applicable to premature distribution penalties. Thus, under the bill, distributions made after July 18, 1984, but before the enactment of this bill, may not be rolled over to a qualified plan if any part of the distribution is a benefit attributable to contributions made on behalf of an employee while a key employee in a top-heavy plan. Distributions made after enactment of this bill to or on behalf of an individual who is a 5-percent owner at the time of distribution may not be rolled over to a qualified plan.

Overall limits

The bill makes it clear that the rule precluding anticipated cost-of-living adjustments to the overall benefit limits applies to limit benefits payable as a single life annuity commencing at age 62, as well as benefits paid in alternate forms, those commencing prior to age 62, and those commencing after age 65.

Excess contributions

The bill makes it clear that the Act's repeal of the rule relating to the return of excess contributions made on behalf of a self-employed individual applies with respect to contributions made in taxable years beginning after December 31, 1983.

IRAs, SEPs

The bill conforms the limits on certain distributions of excess IRA contributions and the limits on employer contributions on behalf of certain officers, shareholders, or owner employees to simplified employee pensions (SEPs) to conform with the dollar limit on annual additions to a qualified defined contribution plan.

Deduction limits for self-employed individuals

The bill makes it clear that the Act's amendment to the definition of earned income was not intended to change the TEFRA definition of earned income for purposes of the 15 -or 25-percent limits on deductions (sec. 404). Rather, the change permitting earned income of a self-employed individual to be determined without regard to the deductions allowable for contributions to a qualified plan is to apply solely for purposes of determining the extent to which contributions made to a qualified plan are ordinary and necessary for purposes of the deduction rules (sec. 404(a)(8)(C)).

The bill also clarifies that the deduction available to a self-employed individual for contributions to a qualified plan is not necessarily limited to the cost of actual benefits provided for, or allocations to, the individual. Rather, subject to the usual rules (sec. 404), a self-employed individual is permitted to deduct his allocable share of contributions to a qualified plan. Thus, for example, any partner's share of total contributions to qualified plans is to be determined on the basis of partnership interests or, if the partnership agreement so provides, pursuant to the partnership special allocation provisions (sec. 704).

2. Effective date of provision relating to interest on tentative carrybacks and refund adjustments (sec. 171(b) of the bill, sec. 6611(f) of the Code, and sec. 714(n)(2) of the Act)

Present Law

The Act provided that, for purposes of computing interest on refunds arising from net operating loss carrybacks where a tentative adjustment claim is filed, the refund is treated as filed on the date that the tentative adjustment claim is filed. Prior to this amendment, some taxpayers filed an amended return claiming a refund based on a carryback, waited until the expiration of the 45-day period within which, if a refund is made, no interest is paid, and then filed for a tentative adjustment, which provides for rapid payment. These taxpayers consequently defeated the intent of the interest rules relating to tentative adjustments by obtaining interest on the tentative adjustment relating back to the due date of the return for the year of the loss. The provision of the Act that prevented this misapplication of the intended rules relating to the payment of interest was added to the Act in conference and was effective as if it were included in the Tax Equity and Fiscal Responsibility Act of 1982.

Explanation of Provision

The bill provides that the provision of the Act (sec. 714(n)(2)) relating to interest on tentative carrybacks and refund adjustments is effective only with respect to applications filed after July 18, 1984.

3. Foreign Sales Corporations

a. Treatment of income that a FSC earns without using administrative pricing rules (sec. 172(a)(1) of the bill and secs. 927 and 1248 of the Code)

Present Law

In general, the Act exempts a fraction of the foreign trade income of a Foreign Sales Corporation (FSC) from tax. The fraction is 15/23 if the FSC uses an administrative pricing rule to determine its income (16/23 if the FSC shareholder is not a corporation). The Act generally denies foreign tax credits for taxes imposed on foreign trade income, but allows a 100-percent dividends received deduction for dividends distributed out of earnings and profits of a FSC that are attributable to that income.

Different rules apply, however, when a FSC does not use the Act's administrative pricing rules. Then, a fraction (generally 30 or 32 percent) of the FSC's foreign trade income is exempt from U.S. tax, and the balance (70 or 68 percent) is so-called "section 923(a)(2) non-exempt income." In general, this section 923(a)(2) non-exempt income is subject to one of three sets of pre-existing rules governing income of foreign corporations generally. It may be taxable currently to the FSC as income effectively connected with a U.S. trade or business. It may be taxable to the FSC's U.S. shareholders under the anti-avoidance rules of subpart F. It may be exempt from current taxation, and taxable only on repatriation to U.S. shareholders.

The Act makes this section 923(a)(2) non-exempt income ineligible for some treatment that it applies to other foreign trade income. For instance, foreign taxes on this income may be creditable, but distributions out of earnings and profits attributable to this income are not eligible for the 100-percent dividends received deduction.

Explanation of Provision

The bill conforms the treatment of effectively connected foreign trade income that a FSC earns *without* administrative pricing rules (effectively connected "section 923(a)(2) non-exempt income") to that of other foreign trade income. Taxes on that income are not creditable, but the bill allows a 100-percent dividends received deduction for dividends distributed out of earnings and profits of a FSC that are attributable to that income. That is, this income will be subject to full U.S. tax at the FSC level, but not again at the shareholder level.

b. Treatment of foreign trade income under section 1248 (sec. 172(a)(2) of the bill and sec. 1248(d)(6) of the Code)

Present Law

Section 1248 treats gain realized by certain U.S. persons on the disposition of stock in a foreign corporation as ordinary income to the extent of allocable earnings and profits. The Act excluded all FSC earnings and profits attributable to foreign trade income from ordinary income treatment under section 1248, whether or not those earnings would have been eligible for the 100 percent dividends received deduction had the FSC distributed them.

Explanation of Provision

The bill refines the Act's restriction of section 1248 ordinary income treatment on disposition of FSC shares. It provides that FSC earnings and profits that would be taxable on a distribution are subject to ordinary income treatment under section 1248.

c. Clarification of corporate preference cutbacks (sec. 172(b) of the bill and secs. 291, 923, and 995 of the Code)

Present Law

Present law provides for a reduction in certain corporate tax preferences. The Act, in extending this reduction of corporate preferences, sought to reduce the exempt portion of the foreign trade income of a FSC by 5/85 if the shareholder of the FSC is a corporation. The statute indicates that the cutback applies "with respect to" the corporate shareholder of the FSC. Congress intended that the cutback apply at the FSC level, which would reduce the portion of the FSC's foreign trade income that is exempt from tax at that level.

Present law provides a similar reduction in benefits in the case of deferred DISC income. A shareholder of a DISC is treated as having received a distribution taxable as a dividend equal to 1/17 of the excess of the taxable income of the DISC over certain other deemed distributions. The reduction in benefits applies whether or not the shareholder of the DISC is a corporation. Congress intended to limit this cutback to cases where the shareholder of the DISC is a corporation.

Congress intended that the amount of deemed DISC distribution attributable to international boycott activities be computed by multiplying 16/17 of the excess taxable income by the international boycott factor. Present law erroneously indicates that the deemed distribution is computed by multiplying 1/17 of the excess taxable income by the international boycott factor.

Explanation of Provision

The bill clarifies that the FSC preference cutback applies with respect to the FSC, rather than the corporate shareholder of the FSC. The exempt portion of foreign trade income is reduced from 32 to 30 percent in cases in which income is determined without regard to the administrative pricing rules, and from 16/23 to 15/23 in cases in which income is determined under the administrative pricing rules. The bill also provides that the portion of foreign trade income that is exempt will be adjusted, under regulations, to take into account any shareholders that are not C corporations for whom there is no preference cutback.

The bill also clarifies that the deemed distribution of 1/17 of the excess taxable income of the DISC applies only in the case of a shareholder which is a C corporation. Neither the FSC nor the DISC corporate preference cutback applies when an S corporation is the shareholder.

In addition, the bill corrects the method for computing the amount of the deemed distribution attributable to international boycott activities. This amount is computed by multiplying 16/17 of the excess taxable income by the international boycott factor.

d. Treatment of foreign trade income under subpart F (sec. 172(c) of the bill and secs. 951 and 952 of the Code)

Present Law

The Act contains a sentence designed to prevent shareholder level taxation under Subpart F's anti-avoidance rules of income already taxed at the FSC level. That sentence appears in a Code provision designed to prevent shareholder level taxation of foreign trade income, whether or not taxed at the FSC level.

Explanation of Provision

The bill makes it clear that there is to be no shareholder level taxation under Subpart F's anti-avoidance rules of income already taxed at the FSC level.

e. Dividends received deduction for certain distributions from a FSC (sec. 172(d)(1) of the bill and sec. 245 of the Code)

Present Law

Present and prior law allow an 85-percent dividends received deduction for dividends received from a foreign corporation if half or more of the foreign corporation's gross income (over a three-year period) is effectively connected with the conduct of a U.S. trade or business. This 85-percent deduction applies, on a pro rata basis, to the extent that the foreign corporation's gross income is effectively connected income.

The Act treats all interest, dividends, royalties, and other investment income received or accrued by a FSC as income effectively connected with a trade or business conducted through a permanent establishment in the United States. If enough of a FSC's income is effectively connected, the FSC will meet the 50-percent of gross income test that will qualify its U.S. corporate shareholders for the 85-percent dividends received deduction for dividends attributable to this passive income. If the FSC does not meet the 50-percent of gross income test, however, then none of its dividends attributable to passive income will be eligible for the 85-percent dividends received deduction. Whether the FSC meets the 50-percent of gross income test depends on a number of factors (for instance, whether a substantial portion of its activity yields income that the Act treats as effectively connected income because it is not subject to the Act's administrative pricing rules).

Explanation of Provision

In general, the bill provides an 85-percent dividends received deduction for any dividend received by a U.S. corporation from a FSC that is distributed out of earnings and profits attributable to "qualified interest and carrying charges." Qualified interest and carrying charges mean interest or carrying charges derived from a transaction that results in foreign trade income. Passive income that is not directly related to foreign trade income is not eligible for this treatment.

f. Separate foreign tax credit limitation for FSC income (sec. 172(d)(2) of the bill and sec. 904 of the Code)

Present Law

Distributions from a FSC or former FSC out of earnings and profits attributable to foreign trade income are subject to a separate foreign tax credit limitation.

Explanation of Provision

Under the bill, distributions from a FSC or former FSC out of earnings and profits attributable to foreign trade income or qualifying interest and carrying charges are subject to a separate foreign tax credit limitation. The purpose of this provision is to prevent this income from absorbing foreign tax credits from other income, and to prevent other income from absorbing foreign tax credits (if any are allowable) on this income.

g. Coordination of foreign tax credit for foreign corporations and deemed paid credit (sec. 172(d)(3) of the bill and secs. 902 and 906 of the Code)

Present Law

A foreign corporation may credit foreign taxes imposed on income that is effectively connected with the conduct of a trade or business in the United States (sec. 906). If that foreign corporation is a controlled foreign corporation, its U.S. shareholders may be eligible for a deemed paid foreign tax credit when the corporation pays them a dividend (sec. 902). This deemed paid credit allows them to credit again the taxes that the foreign corporation paid. If enough of the foreign corporation's income is effectively connected, its U.S. shareholders may be eligible for a dividends received deduction for the dividends the foreign corporation pays them.

The Act makes all investment income of a FSC effectively connected income. It generally makes the taxable portion of foreign trade income of a FSC effectively connected income.

Explanation of Provision

The bill provides that taxes paid or accrued with respect to, and accumulated profits attributable to, income of a foreign corporation that is effectively connected with the conduct of a trade or business within the United States shall not be taken into account for purposes of the deemed paid credit. This provision is designed to prevent a double tax benefit.

h. Exchange of information requirements (sec. 172(e) of the bill and sec. 927(e)(3) of the Code)

Present Law

A corporation (other than a corporation formed in an eligible U.S. possession) cannot qualify as a FSC unless there was in effect, at the time of creation or organization of the FSC, with the foreign country under whose laws it was created or organized, either (1) an agreement allowing tax benefits under the Caribbean Basin Initiative, or (2) an income tax treaty with respect to which the Secretary of the Treasury certifies that the exchange of information program with respect to the country carries out the purposes of paragraph 927(e)(3) of the Code. The purposes of that paragraph are not specified in the statute.

A FSC (other than a small FSC) must maintain its principal bank account outside the United States at all times during the taxable year.

Explanation of Provision

The bill provides that a corporation cannot continue to qualify as a FSC if its country, having once qualified as a host country for FSCs, ceases to qualify. Notwithstanding a Treasury determination that a country ceases to qualify, under Treasury regulations, corporations established in that country continue to be eligible for FSC benefits for the six months following the determination.

The bill also makes it clear that an income tax treaty will allow a country to qualify as a host country for FSCs only if the Secretary certifies that its exchange of information program is satisfactory in practice for purposes of the Internal Revenue Code. That is, the program must provide adequate information to the United States about U.S. taxes generally.

In addition, the bill makes it clear that, for a corporation to qualify as a FSC, the exchange of information program of the country of its incorporation must cover that particular corporation. The bill makes it clear, for example, that a corporation incorporated in a treaty partner country but not subject to the exchange of information program of the treaty because it is not resident in the treaty partner does not qualify for FSC status.

The bill also makes it clear that a country may qualify as a host country for FSCs by entering into an exchange of information agreement of the type that allows tax benefits under the Caribbean Basin Initiative, whether or not that country is or is not eligible to be a beneficiary of the Caribbean Basin Initiative. The other benefits of the Caribbean Basin Initiative will not be available to countries that are not beneficiary countries under that legislation.

The bill makes it clear that a FSC (other than a small FSC) must maintain its principal bank account in a possession of the United States or in a country that qualifies as a host country for FSCs at all times during the taxable year.

i. Coordination with possessions taxation (sec. 172(f) of the bill and sec. 927(e)(5) of the Code)

Present Law

Under present law, a possession of the United States may not impose a tax on any foreign trade income of a FSC that is derived before January 1, 1987. Foreign trade income is generally the gross income of a FSC attributable to the sale or lease of export property outside the United States. Thus, foreign trade income may be derived from the sale or lease of export property (or performance of services) within a U.S. possession by a FSC located in the possession.

Explanation of Provision

The bill provides that a U.S. possession is not prohibited from imposing a tax on any income attributable to the sale of property or the performance of services for use, consumption or disposition within the possession. Thus, for example, the Virgin Islands is not prohibited from imposing a tax on the income derived from the sale of goods by a U.S. company, through its FSC located in the Virgin Islands, to customers in the Virgin Islands.

The bill clarifies that no provision of law may be construed as prohibiting a U.S. possession from exempting from tax any foreign trade income or passive income (e.g., interest, dividends or carrying charges) of a FSC. The bill also clarifies that no provision of law may be construed as requiring any income tax imposed by the United States on a FSC to be covered over (or otherwise transferred) to any U.S. possession.

j. Interest on DISC-related deferred tax liability (sec. 172(g) of the bill and sec. 995(f) of the Code)

Present Law

A DISC may defer income attributable to $10 million or less of qualified export receipts. However, an interest charge is imposed on the shareholders of the DISC. The amount of the interest is based on the tax otherwise due on the deferred income, computed as if the income were distributed.

Explanation of Provision

The bill clarifies that an interest charge is to be imposed on the deferred income of a former DISC in the same manner that it is imposed on a DISC.

k. Exemption of accumulated DISC income (sec. 172(h) of the bill and sec. 805(b)(2) of the Act)

Present Law

Accumulated DISC income which is derived before January 1, 1985 is generally exempt from tax. This result is achieved by treating actual distributions made after December 31, 1984 by a DISC (or former DISC which was a DISC on December 31, 1984) as previously taxed income with respect to which there had previously been a deemed distribution. It is unclear under present law whether a distribution in liquidation is an "actual distribution" for purposes of this provision. It is also unclear how such a distribution would be treated for purposes of computing the earnings and profits of any corporate shareholder of the DISC.

Explanation of Provision

The bill clarifies that for purposes of exempting from tax accumulated DISC income, the term actual distribution includes a distribution in liquidation. The bill further clarifies that the earnings and profits of any corporation receiving a distribution, that is not included in gross income because it is treated as previously taxed income under this provision, will be increased by the amount of the distribution.

l. Effective date of tax year conformity requirement (sec. 172(i) of the bill and sec. 805(a)(4) of the Act)

Present Law

In general, the taxable year of any DISC must be the taxable year of its owner. If the DISC has more than one shareholder, the taxable year of shareholders with a plurality of voting power controls. This rule applies to any DISC established after March 21, 1984.

Explanation of Provision

The bill provides that the rule requiring conformity of tax years applies to taxable years beginning after December 31, 1984. The bill makes it clear that this rule will apply to interest-charge DISCs, whether or not newly formed.

4. Excise tax refund for diesel fuel used in school buses (sec. 173 of the bill and sec. 6427(b) of the Code)

Present Law

The Act allows a complete refund of the 15-cents-a-gallon excise tax paid on diesel fuel which is used by private contractors to provide scheduled local bus service to the general public over regular routes, because the service substitutes for publicly provided service that would use tax-exempt fuel. However, the Act failed to provide a complete refund when private contractors supply school bus service, the diesel fuel for which would be tax-exempt if the service were supplied by a State or local government or nonprofit school. The effective excise tax rate on this fuel is 3 cents a gallon (tax of 15 cents a gallon, less refund of 12 cents a gallon), the effective rate that generally applies to diesel fuel used in privately operated buses.

Explanation of Provision

The bill allows a full 15-cents-a-gallon refund of excise tax on diesel fuel used in a school bus while engaged in the transportation of students and school employees.

5. Certain helicopter uses exempt from aviation excise taxes (sec. 174(c) of the bill and secs. 4041 and 4261 of the Code)

Present Law

The Act expands the exemptions from the aviation excise taxes previously provided with respect to helicopters engaged in qualified timber and hard mineral resource activities to include helicopters engaged in qualified oil and gas activities.

Explanation of Provision

The bill clarifies that the exemptions for oil and gas activities are coterminous with those previously provided for hard mineral resource activities. Therefore, helicopters engaged in the exploration for, or the development or removal of, oil and gas will be exempt from the aviation excise taxes, provided the helicopters do not use Federally aided airports or Federal airway facilities.

6. Military housing rollover (sec. 174(f) of the bill and sec. 1034(h)(2) of the Code)

Present Law

The Act provides an extended nonrecognition period for rollover of gain on sale of a personal residence in the case of military personnel stationed outside the United States, or required to reside in government quarters at certain remote base sites within the United States. In such a case, the nonrecognition rollover period otherwise allowable under Code section 1034(h)(1) is not to expire until the last day on which the person is stationed outside the United States or is required to reside in government quarters at a remote base site within the United States, except that this extended nonrecognition period cannot exceed eight years after the date of the sale of the old residence. This provision applies to sales of old residences occurring after July 18, 1984.

Explanation of Provision

The extended nonrecognition period under Code section 1034(h)(2) is not to expire before the day which is one year after the last day on which the taxpayer is stationed outside the United States or is required to reside in government quarters at a remote base site within the United States, except that this extended nonrecognition period cannot exceed eight years after the date of the sale of the old residence. This modification conforms the provision to the Senate amendment, which was adopted by the conference committee on the 1984 Act.

7. Effective date for disallowance of deduction for costs of demolishing structures (sec. 174(g) of the bill and sec. 280B of the Code)

Present Law

Costs and other losses incurred in connection with the demolition of buildings must be added to the basis of the land on which the demolished buildings were located in all cases, rather than claimed as a current deduction. Before enactment of the Act, this rule applied only to certified historic structures. The expanded provision is effective for taxable years beginning after December 31, 1983.

Explanation of Provision

The bill clarifies that the expanded prohibition on current deduction of costs and other losses incurred in connection with demolition applies only to demolitions commencing after July 18, 1984, in the case of buildings other than certified historic structures.

8. Waiver of estimated tax penalties (sec. 175(a) of the bill)

Present Law

Under present law, if the withholding of income taxes from wages does not cover an individual's total income tax liability, the individual, in general, is required to file estimated tax returns and make estimated tax payments. Also, corporations are normally required to make quarterly estimated tax payments. An underpayment of an estimated tax installment will, unless certain exceptions are applicable, result in the imposition of an addition to tax which is currently computed at a rate of 13 percent per annum on the amount of underpayment for the period of underpayment (secs. 6654 and 6655, with the rate as determined under sec. 6621).

The Act, enacted on July 18, 1984, made several changes which increased tax liabilities from the beginning of 1984.

Explanation of Provision

The bill allows individual taxpayers until April 15, 1985, and corporations until March 15, 1985 (the final filing dates for calendar year returns) to pay their full 1984 income tax liabilities without incurring any additions to tax on account of underpayments of estimated tax to the extent that the underpayments are attributable to changes in the law made by the Tax Reform Act of 1984.

In order to minimize any administrative problems to the Internal Revenue Service, it will be expected that taxpayers notify the IRS if they are entitled to the benefits of this provision. The IRS will not be required to notify taxpayers of possible relief under this provision.

9. Orphan drug credit (sec. 175(b) of the bill and sec. 28 of the Code)

Present Law

A 50-percent tax credit is available for qualified clinical testing expenses that are necessary to obtain the approval of the Food and Drug Administration for the commercial sale of a drug for a rare disease. The term "clinical testing" is defined, in part, by reference to the date on which an application with respect to a drug is approved under section 505(b) of the Federal Food, Drug, and Cosmetic Act. The term "rare disease or condition" is defined as any disease or condition that occurs so infrequently in the United States that the taxpayer has no reasonable expectation of recovering the cost of developing and marketing a drug for such disease from sales in the United States.

Explanation of Provision

The bill clarifies that, in the case of a drug that is a biological product, "clinical testing" is defined, in part, by reference to the date on which a license for such drug is issued under section 351 of the Public Health Services Act. The bill also redefines the term "rare disease or condition" as any disease that (a) affects less than 200,000 persons in the United States, or (b) affects more than 200,000 persons in the United States but for which there is no reasonable expectation that the cost of developing and making available a drug for such disease in the United States will be recovered from sales of such drug in the United States. This will conform the provisions of the tax credit with the provisions of the Federal Food, Drug, and Cosmetic Act.

The amendments apply to amounts paid or incurred after December 31, 1982.

10. Credit for producing fuel from nonconventional source (sec. 175(c) of the bill and sec. 29 of the Code)

Present Law

Present law provides a credit for certain fuels produced by a taxpayer and sold to an unrelated party.

Explanation of Provision

The bill provides that the credit may be allowed where the sale to an unrelated person is made by a corporation which files a consolidated return with the corporation producing the fuel. The provision applies as if included in section 231 of the Crude Oil Windfall Profit Tax Act of 1980.

11. Report of refunds by Joint Committee to Congress (sec. 175(e) of the bill and sec. 6405(b) of the Code)

Present Law

The Code (sec. 6405(b)) requires the Joint Committee on Taxation to make an annual report to Congress setting forth the proposed tax refunds and credits submitted by the Internal Revenue Service to the Joint Committee for its review, including the names of the taxpayers and amounts involved. It is unclear whether this requirement was overridden by the tax return disclosure limitations (sec. 6103) enacted in 1976. Because of this apparent conflict, these reports have not been submitted in recent years and the Joint Committee believes it appropriate to delete the requirement to submit this report.

Explanation of Provision

The bill repeals the requirement that the Joint Committee on Taxation submit an annual report to Congress on proposed tax refunds and credits.

H. Effective Dates

Except as otherwise described, the amendments made by Title I of the Technical Corrections Act of 1985 will take effect as if included in the original legislation to which each amendment relates.

II. DESCRIPTION OF TITLE II OF THE BILL

A. Technical Corrections to Social Security Act Programs

1. Special Social Security Treatment for Church Employees (sec. 201 of the bill, sec. 2603 of the Act, secs. 1402 and 3121 of the Code and sec. 211 of the Social Security Act.)

a. Application to members of certain religious faiths

Present Law

The Act allows a church or qualifying church-controlled organization to make a one-time election to exclude from the definition of employment, for purposes of FICA taxes, services performed in the employ of the church or organization. If an election is made to exclude services for FICA purposes, the employee is treated similarly to a self-employed person with respect to those services. Thus, the employee is liable for self-employment ("SECA") taxes on remuneration for such services. The amount of remuneration on which an employee of an electing organization is liable for SECA tax is generally the same as the amount which would have been subject to FICA tax in the absence of an election.

Under section 1402(g) of the Code, an exemption from SECA taxes is provided for self-employed members of a religious sect (e.g., the Amish) who are adherents of established tenets or teachings of that sect, by reason of which such individuals are conscientiously opposed to public or private death, retirement, or medical insurance (including social security). This exemption is not available to employees. This exemption is granted only upon application by the individual, which must include evidence of the sect's tenets or teachings and of the individual's adherence to them. To obtain an exemption, the individual must waive all social security benefits.

Explanation of Provision

The bill makes clear that the exception from SECA taxes for members of certain religious faiths (sec. 1402(g)) is not available for services with respect to which SECA tax is due as a result of an election under the Act. Thus, if a member of a religious faith covered by the sec. 1402(g) exception is an employee of a church or church-controlled organization, and that church or organization elects to treat the employee as self-employed for FICA tax purposes, the employee cannot also claim a section 1402(g) exception from SECA taxes with respect to those services. This provision prevents the combination of an election under the Act, and a section 1402(g) exception, from resulting in an avoidance of any employment taxes on the services performed for the electing organization. This is consistent with the general principle that the tax for services covered by an election should be determined (to the extent possible) as it would be under FICA, for which the section 1402(g) exception would be unavailable. The provision does not affect the individual's ability to claim a section 1402(g) exception with respect to other services not covered by an election under the Act.

b. Computation of income subject to SECA tax

Present Law

Under the Act, the remuneration on which the employee of an electing church or organization is liable for SECA tax generally is the same as the amount which would have been subject to FICA tax if that individual had continued to be treated as an employee. Thus, trade or business expenses are not subtracted in computing self-employment income (reimbursed business expenses are not included in self-employment income, however), and the $400 threshold generally applicable to self-employment income does not apply. Similarly, a $100 threshold (per employer) for a taxable year applies in determining whether remuneration for services covered by an election is subject to SECA tax. However, after 1989 these employees will be eligible for a deduction, in computing SECA taxes, for the product of net earnings from self-employment and one-half of the SECA rate.

Explanation of Provision

The bill provides several changes to insure that church employee income will be determined, as far as possible, using FICA principles, and that the taxation of other self-employment income will not be affected by an election. Specifically, the bill specifies that the SECA tax base for services covered by an election is to be computed in a separate "basket" from the tax base for other self-employment income. Thus, church employee income is not reduced by any deduction, while other income and deductions are not affected by items attributable to church employee income.[7] (This rule does not apply to the deduction for the product of all net self-employment earnings and one-half the SECA tax rate, beginning after 1989). Additionally, the $100 threshold for taxing church employee income, and the $400 threshold applicable to other self-employment income, are separately applied under the bill (i.e., church employee income does not count toward the general $400 threshold).

This provision is effective only for remuneration paid or derived in taxable years beginning on or after January 1, 1985.

c. Voluntary revocation of election

Present Law

Under the Act, a church or organization must make an election to treat services performed for the church or organization as subject to SECA (rather than FICA) taxes before its first quarterly employment tax return is due, or if later, 90 days after July 18, 1984.

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[7] The "optional" method of computing self-employment income would apply only to non-church employee income.

Once made, that election may not be revoked by the church or organization. However, an election is to be permanently revoked by the Treasury Department if the electing church or organization fails to provide required information regarding its employees for a period of two years or more and, upon request by the Treasury Department, fails to furnish previously unfurnished information for the period covered by the election. (This information is required in order to monitor compliance with the provisions of the Act.) This rule could allow an electing church or organization effectively to revoke its election by failing to provide the required information.

Explanation of Provision

The bill allows a church or organization to revoke an election under regulations to be prescribed by the Treasury Department. The Treasury Department would continue to be permitted to revoke an election for failure to provide required information, as under present law. A church or organization which revokes an election (or for which the election is revoked) could not make another election, because the time for making such an election would have lapsed.

2. Amendments to the Medicare Program

a. Corrections relating to enrollment and premium penalty under the working aged provision (sec. 202 of the bill and secs. 1839(b) and 1837(i) of the Social Security Act)

Present Law

Under current law, employers are required to offer to employees age 65 through 69, and employees with spouses age 65 through 69, the same health benefit plan they offer to their other employees. Where the employee or spouse choose the employer plan, medicare becomes the secondary payor.

Aged employees or aged spouses may wish to delay their enrollment in medicare because the coverage may be duplicative of the employer plan. However, persons who enroll in part A or part B late are subject to a penalty. The monthly premium is increased by 10 percent for each 12 months that an individual delays enrollment in medicare beyond his or her initial enrollment period at age 65. In addition, after the initial enrollment period, a person may enroll in medicare only during the annual enrollment period in January, February, and March.

The Deficit Reduction Act (P.L. 98-369) created a special enrollment period and waived the enrollment penalty for the working aged (and aged spouses) under certain circumstances. DEFRA provided a special enrollment period for persons who did not elect medicare because of coverage at the time under an employer plan and who lose such employer coverage or turn age 70. However, there is an anomaly in the law in that individuals who did not enroll during an initial enrollment period (even though the reason for nonenrollment may have been coverage under the employer plan) have only one special enrollment period, while persons who enrolled in the initial enrollment period, but later terminated coverage when covered under an employer plan, may have more than one special enrollment period.

DEFRA also forgives the premium penalty in certain cases. The provision currently forgives the penalty for those months in which an individual is enrolled in an employer group health plan related to the current employment of the individual (or the individual's spouse), is under 70 years of age, and is entitled to medicare part A (that is, meets the eligibility requirements and has filed an application for part A).

Explanation of Provision

The provision corrects the anomaly in the special enrollment provision which permits only one special enrollment period for an individual who was covered under an employer plan during his initial enrollment period and therefore did not enroll during such period. The bill gives such an individual unlimited special enrollment periods so long as the person was enrolled in medicare during any periods during which he or she was not covered by an employer group health plan.

The bill also forgives the premium penalty for months in which an individual is enrolled in an employer group health plan related to the current employment of the individual (or the individual's spouse) and is 65 years of age or over. This drops the requirement that a person be entitled to part A by virtue of having met the eligibility requirements and having filed for part A benefits. It is recognized that this may provide forgiveness for certain workers 65 years of age and over (or aged spouses of workers) whose employer coverage is secondary to medicare.

b. Miscellaneous corrections (sec. 202 of the bill)

The bill makes certain corrections in spelling, language and indentation in title XVIII of the Social Security Act.

B. Technical Corrections to Unemployment Compensation Programs and Public Assistance Programs

1. Limitation on the Federal Unemployment Tax Act (FUTA) Credit in States Meeting the Solvency Requirements of Section 1202 of the Social Security Act (sec. 211(2) of the bill and sec. 3302(f) of the Code)

Present Law

Under present law, States can borrow funds from the Federal Unemployment Account if they have insufficient funds in their own unemployment accounts to pay unemployment benefits. Depending on the month in which such a loan is advanced, a State has between 22 and 34 months to repay the loan. If the loan is not repaid in time, the FUTA tax credit for employers in the State is reduced by .3% for each year the loan is in arrears.

The Social Security Act Amendments of 1983 provided for a partial limitation on the FUTA credit reduction in States that take legislative steps to improve the solvency of their unemployment insurance systems. If States meet the solvency test, the FUTA credit reduction is limited to .1% a year for each year a State has a loan in arrears. This limitation on the FUTA credit reduction is in effect for calendar years 1983, 1984 and 1985.

Explanation of Provision

The provision clarifies that the limitation on the FUTA credit reduction in States meeting the solvency test of Section 1202 of the Social Security Act expires at the end of calendar year 1985.

2. Reference to Agricultural Crew Leaders in the Federal Unemployment Tax Act (FUTA) (sec. 211(3) of the bill and sec. 3306 of the Code)

Present Law

Section 3306(0)(A)(i) of the Internal Revenue Code provides that for purposes of the Federal Unemployment Tax Act an individual who is a member of a crew furnished by a crew leader to perform agricultural labor for any other person shall be treated as an employee of such crew leader if such crew leader holds a valid certificate of registration under the Farm Labor Contractor Act of 1963. This act has been repealed and replaced with the Migrant and Seasonal Agricultural Workers Protection Act of 1983.

Explanation of Provision

The provision strikes the reference in section 3306 of the Internal Revenue Code of 1954 to the Farm Labor Contractor Act of

1963 and replaces it with a reference to the Migrant and Seasonal Agricultural Workers Protection Act of 1983.

3. Federal Incentive Payments in Cases of Interstate Collections (sec. 203(b)(4) of the bill and sec. 458(d) of the Social Security Act)

Present Law

P.L. 98-378 made a number of amendments to the child support enforcement program. Several of these amendments were designed to encourage States to enforce the more complicated interstate child support obligations which arise when the custodial parent and child(ren) live in one State and the noncustodial parent lives in another State.

Section 458(d) of the Social Security Act as established by P.L. 98-378 provides that in interstate cases "support which is collected by one State on behalf of individuals residing in another State shall be treated as having been collected in full by each such State." As a result, in interstate collection efforts, both States are to be credited with the collection for the purposes of calculating the incentive payment.

Explanation of Provision

The provision clarifies the intent of Congress that the incentive be credited to both the State initiating the collection and the State making the collection. It describes the initiating State as the State requesting the collection, rather than the State of residence of the individuals on whose behalf the collection is made. The change is necessary because the State of residence is not always the same as the State initiating the collection request.

C. Technical Corrections to Trade and Tariff Programs

1. Amendments to the Tariff Schedules (sec. 221 of the bill, various provisions of the Tariff Schedules of the United States (TSUS), and Title I of the Trade and Tariff Act of 1984)

a. Telecommunications product classification corrections (sec. 221(1) of the bill, various provisions of the TSUS, and sec. 124 of the Trade and Tariff Act of 1984)

Present Law

The provisions of part 5 of schedule 6 of the Tariff Schedules applicable to telecommunications products were revised, without changes in rates of duty, under section 124 of the Trade and Tariff Act of 1984, in order to better reflect the state of current technology in such products in the TSUS.

Explanation of Provisions

Section 221(1) of the bill makes conforming changes to several headnotes in the Tariff Schedules which refer to the TSUS items in part 5 of schedule 6 which were changed by section 124 of the Trade and Tariff Act of 1984. It would also add the appropriate column 2 rate of duty for new item 685.34 which was inadvertently omitted from the Act.

b. Miscellaneous corrections (sec. 221 (2) and (3) of the bill, various provisions of the TSUS, and secs. 111, 112, 123, 146, and 182 of the Trade and Tariff Act of 1984)

Section 221 (2) and (3) of the bill make corrections in the article descriptions of TSUS items 906.38, 907.38 912.13 and in headnote 1 of part 4D of schedule 1 and headnote 1 of part 4C of schedule 3, as amended by sections 111, 112, 123, 146, and 182 of the Trade and Tariff Act of 1984, in order to correct spelling, utilize proper chemical nomenclature, correct TSUS references and eliminate duplication.

2. Technical Corrections to Countervailing and Antidumping Duty Provisions (sec. 222 of the bill, Title VII of the Tariff Act of 1930 and sec. 626(b) of the Trade and Tariff Act of 1984)

a. Definition of "interested party" (sec. 222(a)(2) of the bill and secs. 702(b)(1), and 732(b)(1) of the Tariff Act of 1930)

Present Law

Section 612(a)(3) of the Trade and Tariff Act of 1984 amended section 711(9) of the Tariff Act of 1930 to include industry-labor coalitions within the definition of "interested party" for purposes of countervailing duty or antidumping investigations, and section 612(b)(2) made conforming amendments in sections 704(g)(2) and (h)(1) and 734 (g)(2) and (h)(1).

Explanation of Provision

Section 222(a)(2) of the bill makes similar conforming changes in sections 702(b)(1) and 732(b)(1) of the Tariff Act of 1930 to ensure that industry-labor coalitions will be considered proper petitioners under the countervailing duty and antidumping laws.

b. Imports under suspension agreements (sec. 222(a)(4) of the bill and sec. 704 of the Tariff Act of 1930)

Present Law

Section 704(b) of the Tariff Act of 1930 authorizes the suspension of countervailing duty investigations if the foreign government or exporters accounting for substantially all imports of the merchandise agree to eliminate or offset the subsidy or to cease exports of the subsidized merchandise within 6 months after the suspension.

Explanation of Provision

Section 222(a)(4) of the bill restores section 704(d)(2) of the Tariff Act of 1930, which was inadvertently deleted when House provisions deleting the 6-month grace period were not agreed to in House-Senate conference on the Trade and Tariff Act of 1984. Section 704(d)(2) requires that a suspension agreement provide a means of ensuring that exports shall not surge during the 6-month period for phase-in of measures to eliminate or offset subsidies.

The provision also corrects a typographical error in section 704(i)(1)(D) of the Tariff Act of 1930.

c. Waiver of deposit of estimated antidumping duties (sec. 222(a)(7) of the bill and sec. 736(c)(1) of the Tariff Act of 1930)

Present Law

Section 736(c)(1) of the Tariff Act of 1930 authorizes the administering authority for 90 days after publication of an antidumping order to continue to permit entry of merchandise subject to the order under bond in lieu of the deposit of estimated duties for individual importers if it has reason to believe these importers have taken steps to eliminate or substantially reduce dumping margins. This provision covers all merchandise entered as of the date of the first affirmative antidumping determination, i.e., whether or not sold to an unrelated purchaser which is necessary to compute price.

Explanation of Provision

Section 222(a)(7) of the bill amends section 736(c)(1) of the Tariff Act of 1930 to change its scope to cover only entries entered and resold to unrelated purchasers during the period between the first affirmative antidumping determination and the International

Trade Commission's final affirmative determination. This amendment was inadvertently omitted from the Trade and Tariff Act of 1984 as enrolled.

d. Revocation of orders (sec. 222(a)(8) of the bill, sec. 751(b)(1) of the Tariff Act of 1930, and sec. 611(a)(2)(B)(iii) of the Trade and Tariff Act of 1984)

Present Law

Section 751(b)(1) of the Tariff Act of 1930 as amended by section 611(a)(2)(B)(iii) of the Trade and Tariff Act of 1984 clarifies that the party seeking revocation of an antidumping order has the burden of persuasion as to whether there are changed circumstances sufficient to warrant revocation.

Explanation of Frovision

Section 222(a)(8) of the bill amends section 751(b)(1) of the Tariff Act of 1930 to apply the same standard to revocations of countervailing duty orders as applies to antidumping orders. The amendment corrects an inadvertent omission from the Trade and Tariff Act of 1984 since there is no reason to distinguish between the two types of revocations.

e. Definition of upstream subsidies (sec. 222(a) (10) of the bill, sec. 771A(a) of the Tariff Act of 1930, and sec. 613 of the Trade and Tariff Act of 1984)

Present Law

Section 771A(a) of the Tariff Act of 1930 as added by section 613 of the Trade and Tariff Act of 1984 defines "upstream subsidies" in part in terms of the types of practices described under section 771(5)(B) (i), (ii), or (iii) of the Tariff Act as domestic subsidies.

Explanation of Provision

Section 222(a)(10) of the bill amends section 771A(a) of the Tariff Act of 1930 to correct the unintended omission of section 771(5)(B)(iv) from the list of domestic subsidy practices which may constitute an upstream subsidy.

f. Release of confidential information (sec. 222(a)(13) of the bill, sec. 777 of the Tariff Act of 1930, and sec. 619 of the Trade and Tariff Act of 1984)

Present Law

Section 777 of the Tariff Act of 1930 contains various provisions relating to the release of confidential information. As amended by section 619 of the Trade and Tariff Act of 1984, section 777(b)(1)(B)(i) provides that the administering authority may release such information under an administrative protective order if it is accompanied by a statement of permission.

Explanation of Provision

Section 222(a)(13) of the bill amends section 777 of the Tariff Act of 1930 to substitute the term "proprietary" for "confidential" throughout the section, a change that was omitted inadvertently from the Trade and Tariff Act of 1984 as enrolled. The provision also amends subsection (b)(1)(B)(i) to correct the inadvertent omission of the International Trade Commission as being permitted to release information, as well as the administering authority, consistent with the rest of the section.

g. Effective dates (sec. 222(b) of the bill and sec. 626(b) of the Trade and Tariff Act of 1984)

Present Law

Section 626(b) of the Trade and Tariff Act of 1984 made the amendments in sections 602, 609, 611, 612, and 620 of that Act to Title VII of the Tariff Act of 1930 applicable with respect to investigations initiated on or after date of enactment and the amendments made by section 623 were made applicable to civil actions pending or filed on or after date of enactment.

Explanation of Provision

Paragraph (1) of section 222(b) of the bill amends paragraph (1) of section 626(b) of the Trade and Tariff Act of 1984 so that the amendments in section 602, 609, 611, 612, and 620 of the Act will apply to reviews of outstanding antidumping and countervailing duty orders, as well as to new investigations. These orders would involve merchandise entered, or withdrawn from warehouse, for consumption many years after date of enactment. This amendment is consistent with the Congressional intent of these amendments to reduce the cost and increase the efficiency of proceedings.

Paragraph (2) of section 222(b) of the bill authorizes the administering authority to delay implementation of any of the amendments to Title VII with respect to investigations in progress on the date of enactment of the Trade and Tariff Act of 1984 if it determines that immediate implementation would prevent compliance with an applicable statutory deadline. New questionnaires would have to be issued to seek information required by certain amendments that may not be obtainable on cases in progress within the statutory deadlines.

Paragraph (2) of section 222(b) of the bill also clarifies that the amendment made by section 621 of the Trade and Tariff Act of 1984 to section 778 of the Tariff Act of 1930 concerning the rate of interest payable on overpayments and underpayments of antidumping and countervailing duties is applicable to merchandise unliquidated as of five days after date of enactment, i.e., on or after November 4, 1984, consistent with U.S. Customs Service practice.

h. Miscellaneous corrections (sec. 222(a) (1), (3), (5), (6), (9), (11), and (12) of the bill)

Section 222(a) (1), (3), (5), (6), (9), (11), and (12) of the bill correct errors in various provisions of Title VII of the Tariff Act of 1930 concerning subsection designations, cross-references, and printing, grammatical, and typographical errors and provides for the addition of a section heading.

3. Amendments to the Trade Act of 1974 (sec. 223 of the bill, various sections of the Trade Act of 1974)

a. Miscellaneous corrections (sec. 223 (1), (2), (3), and (4) of the bill)

Section 223 (1), (2), (3), and (4) of the bill makes certain corrections of numbers, subsection designations, cross-references to the United States Code and syntax in amendments to various sections of the Trade Act of 1974 made by the Trade and Tariff Act of 1984.

b. Waiver authority under Generalized System of Preferences (GSP) (sec. 223(5) of the bill, sec. 504(c)(3)(D)(ii) of the Trade Act of 1974, and sec. 505 of the Trade and Tariff Act of 1984)

Present Law

Section 504(c)(3)(D)(ii) of the Trade Act of 1974 as added by section 505 of the Trade and Tariff Act of 1974 limits the President's authority to waive more restrictive GSP competitive need limits with respect to products from advanced beneficiary developing countries to no more than 15 percent of the total value of GSP duty-free imports during the preceding calendar year.

Explanation of Provision

Section 223(5) of the bill clarifies that the 15-percent limit on the President's waiver authority under section 504(c)(3)(D)(ii) of the Trade Act of 1974 as amended applies to the aggregate value of all waivers granted in a given year with respect to GSP imports from advanced beneficiary countries as a whole, not to each country individually.

4. Amendments to the Tariff Act of 1930 (sec. 224 of the bill, secs. 304(c) and 313(j) of the Tariff Act of 1930, and secs. 202 and 207 of the Trade and Tariff Act of 1984)

a. Marking of pipes and tubes (sec. 224(1) of the bill, sec. 304(c) of the Tariff Act of 1930, and sec. 207 of the Trade and Tariff Act of 1984)

Present Law

Section 207 of the Trade and Tariff Act of 1984 adds a new subsection (c) to section 304 of the Tariff Act of 1930 providing that no exceptions may be made to the marking requirements of section 304 for certain pipes and pipe fittings and requires such products to be marked with the country of origin by means of die stamping, cast-in-mold lettering, etching, or engraving.

Explanation of Provision

Section 224(1) of the bill provides a limited exception to the above marking requirement for articles which, due to their nature, may not be marked by one of the four prescribed methods because it is technically or commercially infeasable to do so. Such articles may be marked by an equally permanent method of marking, such as paint stenciling, or in the case of small diameter pipe and tube, by tagging the containers or bundles. Those articles which Customs has determined are capable of being marked by die stamping, cast-in-mold lettering, etching or engraving without adversely affecting their structural integrity or significantly reducing their commercial utility would continue to be marked in this manner. Further, the tagging of containers or bundles may only be used for small diameter pipes and tubes for which individual marking would be impractical or inconspicuous.

b. Drawback—incidental operations (sec. 224(2) of the bill, sec. 313(j) of the Tariff Act of 1930, and sec. 202 of the Trade and Tariff Act of 1984)

Present Law

Section 202 of the Trade and Tariff Act of 1984 amends section 313(j) of the Tariff Act of 1930 to allow for the substitution of domestic fungible merchandise for imported merchandise under prescribed circumstances and still receive the benefits of drawback when such products are exported. However, incidental operations which may be performed on imported merchandise under section 313(j)(4) without depriving them of drawback privileges may not be performed on such substituted domestic merchandise.

Explanation of Provision

Section 224(2) of the bill redesignates paragraphs (3) and (4) of section 313 as (2) and (3), respectively, and amends paragraph (3) as redesignated so that incidental operations may be performed on both domestic and imported merchandise so that the intent of the original provision (i.e., allowing fungible domestic and imported merchandise to be mixed together and still be entitled to drawback) is accomplished.

c. Interested parties (sec. 224 (4) and (5) of the bill and secs. 514(a) and 516(a)(2) of the Tariff Act of 1930)

Present Law

Section 771(9) of the Tariff Act of 1930, as amended by section 612(a) of the Trade and Tariff Act of 1984, defines the term "interested party" for purposes of countervailing duty or antidumping proceedings to include industry-labor coalitions. The term is also used in the provisions for judicial review of such proceedings under Title V of the Tariff Act of 1930.

Explanation of Provision

Section 224(4) and (5) of the bill amend sections 514(a) and 516(a)(2) of the Tariff Act of 1930 to conform the definition of the term "interested party" to the inclusion of industry-labor coalitions under section 771(9) of the Tariff Act of 1930.

d. Miscellaneous corrections (sec. 224(3) and (6) of the bill and secs. 339(c)(2)(A) and 516A(a)(3) of the Tariff Act of 1930)

Present Law

Section 224(3) of the bill corrects a cross-reference to a title in section 339(c)(2)(A) of the Tariff Act of 1930, as added by section 221 of the Trade and Tariff Act of 1984. Section 224(6) of the bill corrects an erroneous paragraph reference in section 516A(a)(3) of the Tariff Act as amended by section 623(a)(4) of the Trade and Tariff Act of 1984.

5. Amendments to the Trade and Tariff Act of 1984 (sec. 225 of the bill, secs. 126, 174(b), 212, 234(a), 304(d)(2)(A), 307(b)(3), and 504 of the Trade and Tariff Act of 1984)

a. Chipper knife steel (sec. 225(1) of the bill and sec. 126 of the Trade and Tariff Act of 1984)

Present Law

Section 126 of the Trade and Tariff Act of 1984 amends the Tariff Schedules of the United States (TSUS) to reduce the duty on imports of chipper knife steel in two stages on April 1, 1985, and April 1, 1986.

Explanation of Provision

Section 225(1) of the bill amends section 126 to eliminate a duplication and correct the rate of duty that will apply at the first stage of the duty reduction.

b. Watch glasses (sec. 225(2) of the bill and sec. 174(b) of the Trade and Tariff Act of 1984)

Present Law

Section 174 of the Trade and Tariff Act of 1984 reduced the level of duty on watch glasses other than round to the same level as the duty applicable to round watch glasses. However, the Act does not provide for the third-year staged reduction on January 1, 1987, for watch glasses other than round.

Explanation of Provision

Section 225(2) of the bill amends section 174(b) of the Trade and Tariff Act of 1984 to provide for the third-year reduction to 4.9 percent ad valorem for such watch glasses.

c. Miscellaneous corrections (sec. 225(3), (4), (5), (6), (7), and (8) of the bill)

Section 225(3), (4), (5), (6), (7), and (8) of the bill correct paragraph designations and number and statutory references in various sections of the Trade and Tariff Act of 1984.

6. Amendments to the Caribbean Basin Economic Recovery Act (sec. 226 of the bill, sec. 213 of the Caribbean Basin Economic Recovery Act, and sec. 235 of the Trade and Tariff Act of 1984)

Present Law

Section 235 of the Trade and Tariff Act of 1984 amended section 213(a) of the Caribbean Basin Economic Recovery Act (CBI) to allow products of a beneficiary country to be processed in a bonded warehouse in Puerto Rico after being imported directly from such country and be eligible for duty-free treatment under the CBI upon withdrawal from warehouse if they meet the rule-of-origin requirements set out in paragraph (1)(B) of section 213(a).

Explanation of Provision

Section 226 of the bill corrects a reference to a wrong Tariff Schedules item in section 213(f)(5)(B) of the Caribbean Basin Economic Recovery Act and clarifies that products entering Puerto Rico directly from *any* CBI beneficiary country, not merely the country of manufacture, should qualify for entry under bond.

7. Conforming Amendments Regarding Customs Brokers (sec. 227 of the bill, Title 28 of the United States Code, and sec. 212(b) of the Trade and Tariff Act of 1984)

Section 227 of the bill makes corrections to conforming amendments made by section 212(b) of the Trade and Tariff Act of 1984 in Title 28 of the U.S. Code to cross-references in the Tariff Act of 1930 relating to customs brokers and deletes an incorrect reference in section 1581(g)(1) of Title 28.

8. Special Effective Date Provisions for Certain Articles Given Duty-Free Treatment Under the Trade and Tariff Act of 1984 (sec. 228 of the bill and secs. 112, 115, 118, 167, and 179 of the Trade and Tariff Act of 1984)

Present Law

Sections 112, 115, 118, 167, and 179 of the Trade and Tariff Act of 1984 were made effective 15 days after enactment because the provisions providing for retroactive application of such provisions were inadvertently omitted from the Act.

Explanation of Provision

Section 228 of the bill provides for the retroactive application of sections 112, 115, 118, 167, and 179 of the Trade and Tariff Act of 1984.

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