[JOINT COMMITTEE PRINT]

SUMMARY OF H.R. 3838 (TAX REFORM ACT OF 1986) AS REPORTED BY THE SENATE COMMITTEE ON FINANCE

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTON

This pamphlet [1] provides a summary of the principal provisions of H.R. 3838 (Tax Reform Act of 1986) as amended and reported by the Senate Committee on Finance on May 29, 1986 (S. Rept. 99-313).[2]

The first part of the pamphlet is a brief overview of the bill. The second part is a title-by-title summary of the principal provisions of the bill, including effective dates. The third part presents estimated budget effects of the reported bill for fiscal years 1986-1991, by title of the bill and by effect on individual, corporate, excise, employment, and estate and gift tax receipts (and outlays.).

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Summary of H.R, 3838 (Tax Reform Act of 1986) as Reported by the Senate Committee on Finance* (JCS-12-86), June 5, 1986.

[2] References to the committee bill are to the Finance Committee amendment in the nature of a substitute to H.R. 3838 as passed by the House of Representatives.

I. OVERVIEW

The committee bill represents a major restructuring of the Federal income tax system. The bill provides significant reductions in tax rates and broadens the tax base through the elimination of a variety of tax benefits and preferences. The following is an overview of the principal provisions of the committee bill, along with some of the reasons for changes as indicated in the committee report on the bill (S. Rep. 99-313).

Individual Tax Provisions

The bill provides just two individual income tax rates—15 percent and 27 percent—to replace more than a dozen tax rates in each of the present-law rate schedules, which rise to 50 percent. The committee bill substantially increases the standard deduction (the present-law zero bracket amount) and nearly doubles the personal exemption to $2,000. Together with the expanded earned income credit, these provisions will relieve approximately six million low-income individuals from tax liability and will ensure that no families below the poverty level will have Federal income tax liability.

Tax liabilities of individuals are reduced by an average of 6.4 percent in 1988 under the bill. The table below shows the percentage changes in 1988 tax liabilities between present law and the committee bill by income classes.

PERCENTAGE CHANGES IN INCOME TAX LIABILITY IN COMMITTEE BILL, BY INCOME CLASS, 1988

[In thousands of 1986 dollars]

Income class	Percentage change in income tax liability
Less than $10	−63.0
$10 to $20	−20.1
$20 to $30	−8.1
$30 to $40	−5.0
$40 to $50	−6.6
$50 to $75	−3.9
$75 to $100	−3.3
$100 to $200	−3.8
$200 and above	−4.7
Total	−6.4

NOTE.—These figures do not take account of certain provisions affecting individuals. Thus, the total tax reductions may differ from what is indicated in this table.

The elderly and blind receive additional tax relief under the bill. A special $600 standard deduction amount is provided for these taxpayers in addition to the increased standard deduction and personal exemption provided for all taxpayers. These changes are intended to compensate for the elimination of the additional personal exemption for the elderly and blind available under present law. The present-law credit for elderly individuals and for individuals who are permanently and totally disabled is retained.

The committee bill retains the most widely utilized itemized deductions, including deductions for home mortgage interest, State and local income taxes, real estate and personal property taxes, charitable contributions, casualty and theft losses, and medical expenses (above an increased floor).

The committee bill disallows the itemized deductions for State and local sales taxes and consumer interest deductions for other than a mortgage on a first or second home. The committee stated that these deductions encourage consumption at the expense of savings and involve unnecessary complexity.

The significant increases in the standard deduction and restrictions on certain personal deductions will simplify tax filing for many individuals who will elect not to itemize their deductions. It is estimated that the number of itemizers will decline by one-third under the bill.

The requirements for deducting business meals are tightened and 80 percent of business meals and entertainment expenses are deductible under the bill. Deductions for attending investment seminars and for educational travel costs are eliminated. The committee bill also repeals the net capital gain deduction for individuals. Given the significant tax rate reductions on ordinary income, the committee concluded that it is no longeer necessary to provide a lower rate for capital gains.

The committee has adopted a number of measures designed to ensure that high-income taxpayers cannot reduce their tax liability to disproportionately low levels. One significant new provision directly restricts the use of tax shelter losses to offset unrelated income. Further, a strengthened minimum tax prevents the elimination of substantial income tax liability through the excessive use of preferences. As a result of these and other provisions and the elimination of preferences used primarily by higher income individuals, the sharp reduction in the top tax rate from 50 percent to 27 percent can be achieved while maintaining the distribution of the tax burden.

The committee bill makes numerous changes to increase employee eligibility for pension benefits. The bill expands the rules requiring coverage of a broad group of employees under an employer-maintained retirement plan, reduces from 10 years to five years the maximum time an employee must work for a given employer before becoming vested, and eliminates the ability of employers to offset completely the pension benefits of low-paid workers by the amount of their social security benefits. The committee bill also reduces the limitations on contributions to qualified cash or deferred

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arrangements (sec. 410(k) plans), and provides tighter nondiscrimination tests to ensure that such plans do not disproportionately benefit highly compensated employees.

The bill eliminates the deduction for contributions to an individual retirement account (IRA) for individuals who participate in other tax-favored retirement arrangements. The committee considered the present tax treatment of IRAs to be overly geneorus for such individuals. The bill permits these individuals, however, to make nondeductible contributions to an IRA and to defer taxes on the earnings of these contributions. To ensure universal availability of tax-favored retirement arrangements, the bill retains the present-law IRA deduction for individuals unable to participate in other pension plans.

Corporate and Other Business Tax Provisions

The committee bill provides a significant reduction in the top corporate tax rate from 46 percent to 33 percent. The investment tax credit is repealed, but the present-law Accelerated Cost Recovery System generally is enhanced to provide a more accelerated rate of depreciation for most equipment. The depreciation period of certain assets, such as real property and long-lived equipment, is lengthened to reflect more closely their actual useful life. The committee determined that these changes will help provide a more efficient capital cost recovery system.

The committee bill provides a broadened alternative minimum tax for corporations to prevent profitable corporations from significantly reducing their tax liability. A unique feature of this alternative minimum tax is the inclusion of a corporation's book income in the tax base used for this computation. The committee noted that it found it unjustifiable for some corporations to report large earnings and pay significant dividends to shareholders while paying little or no Federal income tax.

The committee bill makes several accounting changes to provide more accurate matching between the recognition of income and deductions for expenditures related to this income. Use of the installment method is restricted and certain costs of inventory and self-constructed assets are capitalized under the bill. Similarly, the committee bill alters the taxation of property and casualty insurance companies to account better for differences between the time a loss is deducted and the time claims are paid.

The taxation of foreign income also is modified to restrict opportunities to use passive financial transactions to reduce tax liability on U.S. income.

The committee bill generally preserves present law for natural resources, and retains a number of business incentives. The research and development tax credit, which expired at the end of 1985, is extended for four additional years at a 25-percent rate. Certain expired business energy tax credits also are temporarily extended by the bill, although at reduced rates.

The bill provides a new tax credit for low-income rental housing to consolidate the existing subsidies under present law. The credit is targeted to individuals with lower incomes than provisions under present law, and permissible rents are limited. The committee bill also preserves rehabilitaton tax credits for historic and pre-1936 structures at a reduced rate.

The committee bill modifies the activities of private persons for which tax-exempt financing is permitted by deleting certain activities and liberalizing the rules for other activities that the committee believed assist in the delivery of government services through private partnerships with governments. The bill also limits the ability of tax-exempt bond issuers to earn arbitrage profits.

Tax Compliance

The committee bill provides for significant increases in Internal Revenue Service funding for agents, audits, and the modernization of compliance systems. These budget increases are made possible by the establishment of a Tax Administration Trust Fund, funded through penalties for noncompliance and interest on underpayments of tax.

Overall Revenue Effect

Under the committee bill, individual tax liabilities are estimated to decrease by approximately $100 billion between fiscal years 1986 and 1991, while the aggregate corporate tax liability is estimated to increase by a similar amount. The net budget effect is a minus $952 million over the six-year period. (See Part III, "Budget Effects of the Bill," for a title-by-title budget effect of the bill as reported.)

II. SUMMARY OF THE BILL

Title I. Individual Income Tax Provisions

A. Basic Rate Structure

1. Tax rate schedules

New schedules.—The bill provides new two-bracket tax rate schedules for individuals, with rates of 15 and 27 percent. This replaces the present-law structure of up to 15 brackets, with a top rate of 50 percent.

The 27-percent rate begins at taxable income levels of $29,300 for married individuals filing jointly and surviving spouses, $23,500 for heads of household, $17,600 for single individuals, and $14,650 for married individuals filing separately. (Taxable income equals adjusted gross income less personal exemptions and less the standard deduction or itemized deductions.) Beginning in 1988, the taxable income amounts at which the 27-percent rate starts (the "breakpoints") will be adjusted for inflation.

Blended rates for 1987.—For 1987 returns, the bill directs the Treasury Department to prepare blended tax rate schedules; these schedules will incorporate half of the present-law rate structure (as adjusted for inflation) and half of the new rate structure. The income tax withholding tables published by the IRS will be changed effective January 1, 1987, to reflect the 1987 blended rate schedules.

Rate adjustment.—The benefit of the 15-percent bracket is phased out for taxpayers above certain income levels through a rate adjustment requiring additional tax liability. The rate adjustment occurs between $75,000 and $145,320 of adjusted gross income (AGI) for married individuals filing jointly; between $55,000 and $111,400 of AGI for heads of household; between $45,000 and $87,240 of AGI for single individuals; and between $37,500 and $72,660 for married individuals filing separately. (These amounts are adjusted for inflation, beginning in 1988.) If lesser in amount, the rate adjustment instead applies to the taxpayer's taxable income in excess of the breakpoint between the 15-percent and 27-percent brackets. There is no rate adjustment if the taxpayer's taxable income does not exceed the maximum dollar amount in the 15-percent bracket (e.g., taxable income of $29,300 for married individuals filing jointly).

The maximum rate adjustment cannot exceed 12 percent of the maximum amount of taxable income within the 15-percent bracket applicable to the taxpayer. Thus, if the maximum rate adjustment applies, in effect the 27-percent rate applies to all of the taxpayer's taxable income, rather than the amount of taxable income above the breakpoint.

2. Standard deduction

Increased amounts.—Under the bill, the standard deduction replaces the zero bracket amount (ZBA). Effective in 1988, the standard deduction amounts are $5,000 for married individuals filing jointly and for surviving spouses; $4,400 for heads of households; $3,000 for single individuals; and $2,500 for married individuals filing separately. Beginning in 1989, these amounts will be adjusted for inflation.

Additional amount for the elderly.—An additional standard deduction amount of $600 is allowed for an elderly or blind individual ($1,200 for an individual who is both elderly and blind). For these taxpayers only, the new standard deduction amounts (listed in the preceding paragraph) and the additional $600 standard deduction amount are effective on January 1, 1987. Beginning in 1989, the $600 additional standard deduction amount will be adjusted for inflation.

1987 amounts.—For all individual taxpayers other than elderly or blind individuals, the standard deduction amounts for 1987 are $3,800 for married individuals filing jointly and surviving spouses; $2,570 for heads of households and single individuals; and $1,900 for married individuals filing separately.

3. Personal exemption

Exemption amount.—The bill increases the personal exemption for each individual, individual's spouse, and each dependent to $1,900 for 1987 and to $2,000 for 1988. Beginning in 1989, the $2,000 personal exemption amount will be adjusted for inflation.

The personal exemption amounts are reduced starting at the AGI level at which the benefit of 15-percent rate is totally phased out (see "rate adjustment," above), and ending at $40,000 above that amount. For example, in the case of married individuals filing jointly, in 1987 the $1,900 personal exemptions for each individual and each dependent are reduced beginning at AGI of $145,320, and are completely phased out at AGI of $185,320 or higher.

Relief for elderly.—The additional exemption in present law for the elderly and for blind individuals is repealed starting in 1987. As stated above, the bill provides an additional standard deduction amount of $600 for an elderly individual and for a blind individual, starting in 1987. In addition, the increased standard deduction amounts generally applicable in 1988 (e.g., $5,000 for married individuals filing jointly) apply for elderly or blind individuals starting in 1987. The present-law tax credit for the elderly and certain disabled individuals is retained.

Rules for dependents.—The bill provides that the personal exemption is not allowed to an individual who is eligible to be claimed as a dependent on another taxpayer's return (for example, where a child is eligible to be claimed as a dependent on his or her parents' return). This rule is intended to preclude the doubling of tax benefits allowed under present law, where the personal exemption for a child can be claimed by the parents on their return and also by the child on his or her return. Also, the dependent may use the standard deduction only to offset earned income; this rule is similar to the present-law rule applicable to the ZBA.

The bill also provides that if a child or other dependent who is not allowed a personal exemption under this provision has gross income of less than $100 in a year, the individual is not subject to tax on that amount and is not required to file a Federal income tax return for that year.

4. Inflation adjustments

Inflation adjustments ("indexing") to the rate brackets, standard deduction (and the $600 additional standard deduction), and personal exemption will be made as described above. These adjustments will be rounded down to the nearest multiple of $50.

5. Repeal of two-earner deduction

The deduction for two-earner married individuals is repealed, beginning in 1987. Adjustments made in the standard deduction for married individuals filing jointly and in the relationship of the rate schedules for unmarried individuals and married individuals filing joint returns are intended to compensate for the repeal of this provision.

6. Repeal of income averaging

In light of the significantly flatter rate structure under the bill, income averaging is repealed after 1986.

B. Tax Credits for Individuals

1. Increase in earned income credit

The bill increases the rate of the refundable earned income credit from 11 to 14 percent of the first $5,000 of earned income. (The earned income credit provides tax relief to low-income working individuals with children.) In addition, the bill delays the credit phase-out to higher income levels than under present law. These changes apply after 1986.

As a further liberalization of present law, the $5,000 maximum amount of earned income against which the credit applies and the income levels at which the phase-out of the credit begins ($6,500 in 1987 and $10,000 in 1988 and later years) will be adjusted for inflation occurring after 1984. These adjustments will not be subject to the $50 rounding-down rule otherwise applicable under the bill to inflation adjustments.

2. Repeal of political contributions credit

The bill repeals the tax credit allowed to individuals for one-half the amount of contributions to political candidates and certain political campaign organizations, up to a maximum of $50 ($100 on a joint return), effective after 1986.

C. Personal Deductions

The bill retains the itemized deductions for State and local taxes other than sales taxes; medical expenses (subject to an increased floor); interest on the taxpayer's principal residence and a second residence, plus investment interest expense up to the amount of the taxpayer's investment income; charitable contributions; casualty and theft losses; and four specified miscellaneous deductions, including the deduction for costs of adopting children with special needs. The changes to the present-law itemized deductions are summarized below and under Title XIV–G (phase-out of itemized deduction for interest other than interest described in the preceding sentence).

As under present law, no deduction (other than the standard deduction) is provided after 1986 for charitable contributions by non-itemizers.

1. Disallowance of itemized sales tax deduction

The itemized deduction for State and local sales taxes is repealed, effective after 1986. (If incurred in a business or investment activity, sales taxes are to be capitalized where appropriate, or deducted if allowed under general rules for deductions allocable to such activities.) The itemized deductions for State and local income taxes, real estate taxes, and personal property taxes are retained.

2. Modification to medical expense deduction

The floor under the medical expense deduction is increased from five to ten percent of the taxpayer's adjusted gross income, effective after 1986. It is clarified that certain expenses incurred to accommodate a personal residence to the needs of a handicapped individual are eligible for the medical expense deduction.

3. Housing allowances for ministers and military personnel

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

D. Exclusions From Income

1. Inclusion of unemployment compensation benefits

The bill repeals the present-law partial exclusion for unemployment compensation benefits, effective for amounts received after 1986.

2. Exclusion for prizes and awards

The exclusion under present law for certain prizes and awards for charitable, scientific, artistic, and similar achievements will apply only if the winner assigns the award to charity. (No change is made to the present-law exclusion for scholarships and fellowships.) The bill provides a limited exclusion for certain employee awards for length of service or safety achievement; all other awards by employers to employees are includible in income. These provisions apply after 1986.

E. Business Meals and Entertainment; Miscellaneous Expenses

1. Limitations on travel and entertainment deductions

Under the bill, 80 percent of business meal expenses and business entertainment expenses are deductible, subject to certain exceptions. Requirements for deducting business meal expenses are tightened.

No deductions are allowed for costs of attending investment conventions or seminars or for educational travel expenses. Deductions for entertainment ticket costs and luxury water travel are limited. For purposes of the present-law foreign convention rule, Bermuda can be treated as in the North American area under certain conditions.

These provisions are effective for taxable years beginning after 1986.

2. Repeal of miscellaneous itemized deductions

The bill repeals the miscellaneous deductions allowed under present law only as itemized deductions on Form 1040 Schedule A, Lines 20-23, *other than* deductions for (a) costs of adopting children with special needs, (b) wagering losses not in excess of wagering income, (c) the estate tax in the case of income in respect of a decedent, and (d) the adjustment deduction where a taxpayer restores certain amounts held under claim of right. Thus, itemized deductions will not be allowed, for example, for investment advisor fees and similar expenses allocable to interest and dividend income, certain unreimbursed employee expenses such as bar association and union dues, and fees for preparing individuals' tax returns. This provision is effective for taxable years beginning after 1986.

3. Treatment of certain employee business expenses

Deductions for certain unreimbursed employee business expenses (reported on Form 2106) that under present law may be taken above-the-line are limited in the bill to itemizers, and are made subject to a floor of one percent of the taxpayer's adjusted gross income, effective after 1986. This rule applies to employee travel and transportation expenses and business expenses of employees who are "outside" salespersons.

The bill retains the present-law above-the-line deductions for certain reimbursed employee expenses, moving expenses, and alimony payments. (See summary of Title XII below, concerning the IRA deduction and other retirement plan provisions of the bill.)

4. Changes in treatment of hobby losses

Under present law, an activity other than horse breeding, training, showing, or racing is presumed not to be a hobby if it is profitable in two out of five consecutive years. Under the bill, an activity (other than one involving horses) is presumed not to be a hobby if it is profitable in three out of five consecutive years. The provision is effective for taxable years beginning after 1986.

5. Deductions for business use of home

Under the bill, no deduction is allowed for costs associated with business use of one's home (except for items allowable without reference to such use, such as home mortgage interest) in the case of an employee who rents a portion of the home to the employer. Also, home office costs are deductible only to the extent of net income from the business activity (rather than certain gross income, as under present law); excess deductions can be carried forward. These provisions are effective for taxable years beginning after 1986.

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Title II. Accelerated Cost Recovery System and Investment Tax Credit

A. Depreciation

Accelerated Cost Recovery System.—The bill modifies the Accelerated Cost Recovery System (ACRS) for property placed in service after December 31, 1986, except for property covered by transition rules.

The bill provides more accelerated depreciation for the revised five-year and ten-year classes and reclassifies certain assets according to their present class life (or "ADR midpoint life"). The bill prescribes depreciation methods for each ACRS class (in lieu of providing statutory tables). Eligible personal property is assigned among a three-year class, a five-year class, a ten-year class, or a fifteen-year class. The bill applies the 150-percent declining balance method, switching to the straight-line method at a time to maximize the recovery allowance, to certain property in the three-year class and to the fifteen year class. The depreciation method for other property in the three-year class is the straight-line method. The depreciation method applicable to property included in the five- and ten-year classes is the double declining balance method, switching to the straight-line method at a time to maximize the depreciation allowance. The cost of real property is recovered using the straight-line method over 27 1/2 years for residential rental property and 31 1/2 years for nonresidential property.

Alternative Depreciation System.—A taxpayer may elect to recover the cost of property over the ACRS class life or, generally, the ADR midpoint life, using the straight-line method. Additionally, assets used abroad or by tax-exempt entities, and for the alternative minimum tax computation and certain other purposes, must be recovered using the straight-line method generally over the ADR midpoint life.

Expensing.—The amount of personal property that may be expensed is increased to $10,000 (from the present-law $5000). For every dollar of qualifying investment in excess of $200,000, the $10,000 limit is reduced by $1.

B. Regular Investment Tax Credit

The bill repeals the investment tax credit for property placed in service after December 31, 1985, except for property covered by transition rules.

C. Finance Leasing

Finance leasing is repealed for agreements entered into after December 31, 1986, except for property covered by transition rules.

Title III. Accounting Provisions

A. Limitations on the Use of the Cash Method of Accounting

The bill prohibits the use of the cash method of accounting by any taxpayer that is eligible (under the bill) to use the reserve method of computing deductions for bad debts. These taxpayers are banks, thrift institutions, banks for cooperatives, production credit associations, and certain finance companies. The provision is effective for taxable years beginning after December 31, 1986.

B. Utilities Using Accrual Accounting

The bill provides that taxpayers using the accrual method of accounting must recognize income attributable to the sale or furnishing of utility services to customers not later than the year in which such services are provided to customers. The provision is effective for taxable years beginning after December 31, 1986.

C. Installment Sales

Under the bill, use of the installment method is denied for sales pursuant to a revolving credit plan and for sales of certain publicly traded property. The bill also limits the use of the installment method based on the ratio of the taxpayer's debt to assets for all sales of property held for sale to customers, and for sales of business or rental property (other than certain farm property) if the selling price of such property exceeds $150,000. Personal use and certain farm property, and debt related to such property, are not taken into account in applying the limitation. Taxpayers selling certain "residential lots" and "timeshares" are permitted to elect to pay interest on deferral of tax liability attributable to the use of the installment method, rather than be subject to the limitations under the bill. An exception from the provisions of the bill is provided for certain sales by a manufacturer to a dealer where the term of the installment obligation is based on the time that the property is resold by the dealer.

The denial of use of the installment method for sales pursuant to revolving credit plans and for sales of certain publicly traded property is effective for sales after December 31, 1986. Taxpayers selling property on revolving credit plans are permitted to spread any adjustment arising from the change in accounting method over a period not exceeding five years. The limitation on the use of the installment method based on the ratio of the taxpayer's debt to assets is effective as of January 1, 1987, for sales on or after March 1, 1986.

D. Capitalization of Inventory, Construction, and Development Costs

1. Uniform capitalization rules

The bill provides that, in general, uniform rules for determining costs that must be capitalized apply to all persons who produce property or acquire property for resale. Thus, the rules apply to inventory, noninventory property held for sale to customers, and assets constructed for self-use. These comprehensive capitalization rules, which are based on the rules of present law applicable to extended period long-term contracts, generally apply to costs paid or incurred after December 31, 1986. In the case of inventories, the rules apply to the taxpayer's first taxable year beginning after December 31, 1986.

2. Interest

Interest is subject to a special rule requiring capitalization only if the property is real property, long-lived property produced for self-use, or property that requires more than two years (one year if the cost of the item is greater than $1 million) to produce. This rule applies to interest incurred after December 31, 1986.

3. Long-term contracts

In general, all long-term contracts are subject to the extended period long-term contract regulations of present law. In addition, general and administrative expenses identified under the contract or pursuant to Federal certification procedures as contract-related must be treated as contract costs. The general rules requiring capitalization of interest also apply to long-term contracts. This provision applies to contracts entered into after February 28, 1986.

E. Special Treatment of Certain Items

1. Reserves for bad debts

The bill generally repeals the reserve method of computing deductions for bad debts, other than for financial institutions and certain finance companies. The reserve method of computing deductions for losses on debt obligations guaranteed by a dealer also is repealed. Taxpayers that are not allowed to continue to use the reserve method are allowed a deduction for business bad debts when the debt becomes wholly or partially worthless. Wholly worthless business debts must be treated as worthless on a taxpayer's books in order to be allowed as a deduction for Federal income tax purposes, as is the case under present law for partially worthless debts. The balance of any reserve for bad debts or guarantees is taken into income ratably over a period of five years. The provision is effective for taxable years beginning after December 31, 1986.

2. Qualified discount coupons

The bill repeals the election to deduct the cost of redeeming qualified discount coupons that are received for redemption after the close of the taxable year. A deduction will be allowed only for the cost of redeeming coupons which have been received by the close of the taxable year. The provision is effective for taxable years beginning after December 31, 1986.

3. Depreciation recapture income on installment sales of farm irrigation equipment

The bill provides that depreciation recapture income resulting from an installment sale of farm irrigation equipment may be reported as gain is recognized under the installment method, rather than entirely in the year of sale. This provision is effective as if included in the Deficit Reduction Act of 1984.

F. Cancellation of Indebtedness for Solvent Taxpayers

The bill repeals the provision of present law that allows income from the discharge of qualified business indebtedness to be excluded from gross income. Income from the discharge of indebtedness will be required to be recognized currently unless the discharge occurs in a title 11 (bankruptcy) case or when the debtor is considered to be insolvent. The provision is effective for discharges of indebtedness occurring after December 31, 1986.

G. Taxable Year of Partnerships, S Corporations, and Personal Service Corporations

The bill requires that partnerships, S corporations, and personal service corporations use a taxable year that generally conforms to the taxable year of their owners. A partnership must use (in order of priority) the taxable year of the partners owning the majority of partnership profits and capital, the taxable year of all of its principal partners, or the calendar year. An S corporation or a personal service corporation must use the calendar year. An exception is made for any partnership, S corporation, or personal service corporation that establishes to the satisfaction of the Treasury Department a business purpose for having a different taxable year. The provision is effective for taxable years beginning after December 31, 1986.

Title IV. Capital Gains

A. Capital Gains for Individuals

The bill repeals the present law exclusion for long-term capital gains of individuals for taxable years beginning after December 31, 1986. The bill also provides that the tax rate on long-term capital gains will not increase even if the tax rates on ordinary income are increased. Also, the tax rate on long-term capital gains during calendar year 1987 will not exceed the capital gain rate for years after 1987.

B. Incentive Stock Options

The bill liberalizes the incentive stock option provisions by repealing the requirement that options be exercised in the order granted. Also, the application of the $100,000 limit on the amount of options which may be granted in any year is modified. These provisions apply to options granted after 1986.

C. Tax Straddles

Under the loss deferral rule in the straddle provisions, the bill denies the qualified covered call exception to a taxpayer who fails to hold an option for 30 days after the related stock is disposed of at a loss, where gain on termination or other disposition of the option is included in the subsequent year. Also, gain on contracts marked to market is treated as short-term capital gain. These provisions apply to positions established after December 31, 1986.

Title V. Compliance and Tax Administration

A. Penalties

1. Penalty for failure to file information returns or statements.—The bill consolidates the present-law penalty for failure to file an information return with the IRS and the present-law penalty for failure to supply a copy of the information return to the taxpayer. The bill also provides a new penalty for failure to include correct information on an information return. This applies to information returns the due date for which is after December 31, 1986.

2. Increase in penalty for failure to pay tax.—The bill increases the penalty for failure to pay taxes from one-half of one percent under present law to one percent after the IRS notifies the taxpayer that the IRS will levy upon the assets of the taxpayer. This applies to amounts assessed after December 31, 1986. The bill also requires the Treasury Department to report (by March 1, 1987) on the cost of collection charge system.

3. Negligence and fraud penalties.—The bill expands the scope of the negligence penalty by making it applicable to all taxes under the Code. The bill modifies the negligence penalty by increasing the rate to 10 percent but applying the penalty only to the amount of the underpayment attributable to negligence. The bill also provides that failure to report on a tax return any amount reported on an information return is considered negligence in the absence of clear and convincing evidence to the contrary. The bill modifies the fraud penalty by increasing the rate to 75 percent but applying the penalty only to the amount of the underpayment attributable to fraud. This is effective for returns the due date of which is after December 31, 1986.

4. Penalty for substantial understatement of tax liability.—The bill increases the penalty for substantial understatement of tax liability from 10 to 20 percent of the amount of the underpayment of tax attributable to the understatement. This is effective for returns the due date of which is after December 31, 1986.

B. Interest Provisions

1. Differential interest rate.—The bill provides that the Government pays interest to taxpayers at the Federal short-term rate plus 2 percentage points, and that taxpayers pay interest to the Government at the Federal short-term rate plus 3 percentage points. These rates are adjusted quarterly, and apply to interest for periods after December 31, 1986.

2. Interest on accumulated earnings tax.—The bill provides that interest is imposed on underpayments of the accumulated earnings tax from the due date of the tax return with respect to which that tax is imposed. This applies to returns the due date for which (determined without regard to extensions) is after December 31, 1986.

C. Information Reporting Provisions

1. Real estate transactions.—The bill provides that the real estate broker or other specified person must provide an information report on real estate transactions. This is effective beginning January 1, 1987.

2. Information reporting on persons receiving Federal contracts.—The bill requires Federal executive agencies to provide information reports on contracts that they enter. Reporting is required beginning January 1, 1987.

3. Royalties.—The bill modifies current information reporting requirements for royalties, effective January 1, 1987.

4. Modification of separate mailing requirement.—The bill modifies the separate mailing requirement for information reports on interest, dividends, patronage dividends, and royalties, effective for those returns required to be filed after December 31, 1986.

D. Tax Shelters

1. Tax shelter user fee.—The bill requires that taxpayers who claim cumulative net losses (plus three times the value of cumulative net credits) that exceed cumulative actual cash invested in a tax shelter pay a user fee of one percent of the losses claimed and three percent of the credits claimed with respect to that tax shelter. This is effective for returns filed after December 31, 1986.

2. Tax shelter registration.—The bill conforms the tax shelter ratio computation (used to determine whether a tax shelter must register with the IRS) more closely to the new tax rate schedule in the bill, effective July 1, 1987.

3. Tax shelter penalties.—The bill increases the penalties for failure to register a tax shelter, for failure to report a tax shelter identification number, and for failure to maintain lists of tax shelter investors, effective on the date of enactment.

4. Tax shelter interest.—The bill increases the rate of interest on underpayments of tax attributable to tax-motivated transactions from 120 percent to 200 percent of the generally applicable interest rate, effective for interest accruing after December 31, 1986.

E. Estimated Tax Payments by Individuals

The bill increases from 80 to 90 percent the proportion of the current year's tax liability that taxpayers must make as estimated tax payments in order to avoid the estimated tax penalty, effective for taxable years beginning after December 31, 1986.

F. Tax Litigation and Tax Court

1. Awards of attorney's fees in tax cases.—The bill extends permanently with several modifications the provisions of present law authorizing awards of attorney's fees in tax cases. These modifications relate to the burden of proof and the basis for such awards.

2. Tax Court provisions.—The bill permits the Tax Court to impose a practice fee, clarifies that the Tax Court has jurisdiction over the penalty for failure to pay tax, clarifies that the Tax Court may obtain the assistance of U.S. Marshals, clarifies the pay and travel rules pertaining to Special Trial Judges, and permits a judge to elect to practice law after retirement and receive retirement pay.

G. Tax Administration Trust Fund

The bill establishes a Tax Administration Trust Fund. A specified level of spending is available to the IRS for each of the next five fiscal years, which will provide for funding at the current level plus a sizeable increase each year. The increase in spending is specifically targeted to examination, collection and other increased compliance measures. The Trust Fund is effective for fiscal years 1987 through 1991; it then expires.

H. Tax Administration Provisions

1. Suspend statute of limitations during prolonged dispute over third-party records.—The bill provides that, if a dispute betweeen the IRS and a third-party recordkeeper is not resolved within six months, the statute of limitations is suspended until the issue is resolved.

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

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

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

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

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

7. Voluntary disclosure policy.—The bill provides that taxpayers who voluntarily disclose their previous tax law violations are to be guaranteed immunity from criminal penalties for those offenses. Treasury is given broad regulatory authority to implement this provision, including the authority to exclude specified categories of taxpayers from participating. This provision is effective upon the issuance of the Treasury regulations, which must be issued no later than January 1, 1987.

8. Disclosure of return information to certain large cities.—The bill authorizes the Treasury to exchange tax return information with any city with a population exceeding two million that imposes an income or wage tax, effective the date of enactment.

I. Modification of Withholding Schedules

The bill requires employees to file revised withholding certificates by January 1, 1988. The bill also instructs the Treasury Department to modify withholding schedules to better approximate actual tax liability under the amendments made by the bill.

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J. Report on Return-Free System

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

Title VI. Corporate and General Business Taxation

A. General Corporate Provisions

1. Corporate tax rates

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

Taxable income:	Tax rate (percent)
Not over $50,000	15
Over $50,000 but not over $75,000	25
Over $75,000	33

This structure reduces from five to three the number of corporate income tax brackets, and lowers from 46 to 33 the tax rate applicable to large corporations. The benefit of graduated rates is phased out for corporations with more than $320,000 of taxable income (compared to $1,405,000 under present law).

The 28-percent alternative tax rate for net capital gains of corporations is retained.

The graduated income tax rates are effective for taxable years beginning on or after July 1, 1987. The rate schedule for taxable years including July 1, 1987 will reflect blended rates.

2. Dividends received deduction

The 85 percent dividends received deduction under present law is reduced to 80 percent for dividends received after December 31, 1986.

3. Dividend exclusion for individuals

The $100 dividend exclusion for individuals ($200 for a joint return) is repealed, effective for taxable years beginning after December 31, 1986.

4. Nondeductibility of stock redemption payments

The bill provides expressly that no amount paid or incurred by a corporation in connection with a redemption of its stock is deductible or amortizable. This would preclude, for example, deduction of so-called "greenmail" payments made to stockholders to avert a hostile takeover. The provision is effective for amounts paid or incurred after February 28, 1986.

5. Special limitations on net operating loss (NOL) and other carryforwards

The bill alters the special limitations on the use of net operating loss (NOL) and other carryforwards. After a change in ownership of more than 50 percent of value of stock in a loss corporation, however effected, the taxable income available for offset by pre-acquisition NOLs is limited to the Federal mid-term rate in effect on the ownership change date, times the value of the loss corporation's equity. The bill also expands the scope of the special limitations to include built-in losses (other than depreciation) and takes into account built-in gains. The bill includes a number of rules designed to ensure the limitations accomplish their intended objectives and makes other changes to present law, of a more technical nature, including rules relating to the measurement of beneficial ownership. The bill applies similar rules to carryforwards other than NOLs, such as net capital losses, and excess foreign tax credits, as well as passive activity losses and credits and minimum tax credits under the bill.

In general, the bill applies to changes in ownership that occur after December 31, 1986 (unless pursuant to plans of tax-free reorganization adopted before January 1, 1987).

6. Extraordinary dividends

The bill requires the basis of stock held by a corporation to be reduced by the untaxed portion of extraordinary dividends, regardless of the holding period of the stock. For purposes of determining whether a dividend is extraordinary, a taxpayer may measure the dividend by reference to the market value of the stock rather than its basis, provided market value is established to the satisfaction of the IRS. The provision applies to dividends declared after March 18, 1986.

7. Allocation of purchase price in certain asset sales

The bill conforms the basis allocation rules in asset acquisitions to the rules for stock acquisitions where basis is stepped up (section 338 rules) so that both buyer and seller would use the so-called "residual" method of allocating nondepreciable goodwill and going concern value. The Treasury Department is authorized to require information reporting with respect to purchase price allocations. The provision applies to transactions after May 6, 1986, unless pursuant to a binding contract in effect on that date.

B. Rapid Amortization Provisions

1. Trademark and tradename expenditures

The bill repeals five-year amortization for trademarks and tradenames, for expenditures paid or incurred after December 31, 1986. Transitional rules are provided for certain binding contracts.

2. Bus operating authorities

Owners of certain bus operating authorities are allowed an ordinary deduction ratably over five years for loss in value of such authorities, effective for taxable years ending after November 18, 1982.

C. Other Provisions

1. Limitation on business tax credits

The bill reduces the 85-percent limitation on the amount of income tax liability that can be offset by business tax credits to 75 percent, for taxable years beginning after December 31, 1986.

2. Regulated investment companies

Regulated investment companies ("RICs") are taxed under the bill on a calendar-year basis for taxable years beginning after December 31, 1986. Also, RICs are required to pay a five-percent nondeductible excise tax on dividends for which the RIC elects to receive a deduction in the taxable year prior to distribution.

3. Payroll tax deposits

The bill increases from $3,000 to $5,000 the amount of undeposited payroll taxes an employer may aggregate before the current one-eighth-monthly deposit rule becomes effective. This provision applies to months beginning after December 31, 1986.

Title VII. Agriculture, Energy, and Natural Resources

A. Provisions Relating to Agriculture

1. Special expensing and amortization provisions affecting agriculture

The bill provides that soil and water conservation expenditures are deductible only if they relate to improvements that are consistent with a conservation plan adopted by the the U.S. Department of Agriculture or (in the absence of a Federally approved plan) a comparable State agency. In no event, however, may expenditures relating to the draining or filling of wetlands or the installation or operation of a center pivot irrigation system be deducted under this provision.

The bill repeals the special provision allowing a deduction for land clearing expenditures.

These provisions apply to expenditures incurred after December 31, 1986.

2. Dispositions of converted wetlands and highly erodible croplands

The bill provides that gain from the disposition of highly erodible land that is converted to agricultural use (other than livestock grazing) is not eligible for capital gain treatment, and that any loss on such disposition is not treated as ordinary loss, effective for dispositions of land converted after March 1, 1986.

3. Prepayments of farming expenses

The bill provides that to the extent a farmer's prepaid farming expenses exceed 50 percent of total farm expenses, amounts paid for feed, seed, fertilizer, and other similar farm supplies may be deducted only as such supplies are actually consumed. This provision applies to amounts with respect to which a deduction would be allowable under present law after March 1, 1986.

4. Special rule for expenses incurred in replanting groves, orchards, or vineyards destroyed in natural disasters

The bill provides that a deduction for planting and maintenance costs incurred following loss or damage to a grove, orchard, or vineyard as a result of freezing temperatures, disease, drought, pests, or casualty, may be deducted by persons other than the farmer who owned the grove, etc., at the time of the damage, provided: (1) the taxpayer who owned the property at such time retains an equity interest of more than 50 percent in the property, and (2) the person claiming the deduction owns part of the remaining equity interest and materially participates in the planting or maintenance of the property. This provision is effective for costs paid or incurred after the date of enactment.

5. *Treatment of discharge of indebtedness income for certain farmers*

The bill provides that discharge of indebtedness income arising from an agreement between a solvent individual debtor engaged in the trade or business of farming and an unrelated person to discharge certain farming indebtedness will be treated as income realized by an insolvent individual (and hence eligible for exclusion), provided the debtor has a debt-to-equity ratio of at least 70 percent. Qualified indebtedness includes debt incurred to finance production of agricultural products and debt secured by farm land or equipment. The provision applies to discharge of indebtedness income realized after the date of enactment of the bill.

6. *Agricultural wages under FUTA*

The bill increases the quarterly payroll threshold at which agricultural wages are covered under the Federal Unemployment Tax Act from $20,000 to $40,000, effective for wages paid after September 30, 1986.

B. Energy-Related Tax Credits and Other Incentives

1. *Business energy tax credits*

The energy tax credit for solar property is extended through 1988 at a 15-percent rate in 1986 and at 12 percent in 1987 and 1988. For geothermal energy systems, the credit is extended for three years at 15 percent in 1986 and 10 percent in 1987 and 1988. (It is clarified that dual purpose property which serves both qualified geothermal energy property and nonqualified energy property is eligible for the geothermal energy credit, if at least 50 percent of the energy used comes from qualified geothermal energy property.) The 15-percent credit for ocean thermal energy is extended, unchanged, through 1988.

For both wind and biomass properties, the energy tax credit is extended for two years, at 15 percent in 1986 and 10 percent in 1987.

The expiration date of the 10-percent energy tax credit that was allowable for modifications to chlor-alkali electrolyte cells is changed from December 31, 1982, to December 31, 1983.

2. *Alcohol fuels credit and related excise tax exemptions; import duty*

Alcohol fuels.—The 9-cents-per-gallon exemption from the gasoline and motor fuels excise taxes for neat alcohol and methanol fuels is reduced to 6 cents per gallon, effective on and after January 1, 1987. The 60-cents-per-gallon nonrefundable income tax credit for blending alcohol with gasoline is repealed after December 31, 1986. The 6-cents-per-gallon excise tax exemption for gasohol is unchanged from present law.

Import duty.—Ethyl alcohol for use as a fuel may be imported duty-free into the United States from a Caribbean Basin Initiative (CBI) country, if it is produced in a CBI country from source material which is the product of a CBI country or the United States.

C. Foreign Intangible Drilling Costs (IDCs) and Mining-Related Costs

The bill retains present-law tax provisions applicable to the domestic production of oil, gas and hard minerals.

Foreign intangible drilling and development costs (IDCs) and mining exploration and development costs are recovered under the bill (1) using 10-year, straight-line amortization, or (2) at the taxpayer's election, as part of the basis for cost depletion. (These costs generally qualify for expensing under present law, under the same provisions that apply to equivalent domestic costs.)

This provision generally is effective for costs paid or incurred after December 31, 1986.

D. Estate and Gift Tax Deductions for Certain Conservation Easement Donations

Contributions of certain interests in real property to charitable organizations, to the United States, or to a State or local government are allowed for Federal estate and gift tax purposes even if the contributions do not meet the requirement for deductibility for Federal income tax purposes that the contributions be for conservation purposes. The provision is effective for transfers and contributions made after December 31, 1986.

Title VIII. Financial Institutions

A. Reserves for Bad Debts of Thrift Institutions

The bill reduces the maximum percentage of income that a thrift institution (a mutual savings bank, domestic building and loan association, or a cooperative bank) may exclude from income as an addition to a reserve for bad debts from 40 to 25 percent. The provision is effective for taxable years beginning after December 31, 1986.

B. Special Rules for Net Operating Losses of Thrift Institutions

The bill provides that net operating losses incurred by a thrift institution in taxable years beginning after 1981 and before 1986 may be carried back to the prior ten years and forward to the succeeding eight years. The provision is effective on the date of the enactment of the bill.

C. Treatment of Losses on Deposits in Insolvent Financial Institutions

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

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Title IX. Foreign Tax Provisions

A. Foreign Tax Credit

1. Foreign tax credit limitation.—The overall foreign tax credit limitation of present law is retained. The separate limitation for interest income is replaced with a separate limitation for passive income. Passive income includes certain categories of income that are subject to current taxation if earned by a controlled foreign corporation. These rules are effective for taxable years beginning after 1986.

Foreign gross withholding taxes on interest paid to financial institutions (and related parties, in some cases) that are at least five percent of the gross amount are subject to a separate foreign tax credit limitation. This provision is generally effective for taxes paid in taxable years beginning after 1986, but certain transitional relief is provided.

2. Subsidies.—The bill clarifies that foreign taxes that are rebated directly or indirectly are not creditable. This provision applies to taxable years beginning after 1986.

3. Effect of losses on foreign tax credit.—Foreign source losses reduce all types of foreign source income before reducing U.S. source income. U.S. losses reduce categories of foreign income pro rata. This provision applies to losses incurred in taxable years beginning after 1986.

4. Deemed-paid credit.—(a) The deemed paid credit for a U.S. corporation's share of foreign taxes paid by a foreign corporation is determined with respect to the foreign corporation's multi-year pool of accumulated earnings and profits; and (b) earnings and profits generally are computed in the same manner for actual distributions as they are now for Subpart F inclusions. These rules are generally effective for earnings and profits accumulated in taxable years beginning after 1986.

5. Carrybacks.—Foreign tax credits that are currently unusable only because of the bill's rate reductions cannot be carried back for use in higher-rate taxable years.

B. Source Rules

1. Income derived from purchase and sale of inventory-type property.—Present law is retained, except effectively connected income earned by a foreign person is U.S. source (except for foreign tax credit limitation purposes).

2. Income from intangible property.—With respect to royalty income, the bill retains the place-of-use source rule of present law. With respect to sales income, unless the amount received is contingent on the use of the intangibles, the source is generally in the country of residence of the seller. However, for U.S. persons, sales involving a foreign office will yield foreign source income (if the income is subject to more than a de minimis amount of foreign tax). In addition, effectively connected income earned by a foreign person is U.S. source (except for foreign tax credit limitation purposes).

3. Income derived from sale of other personal property.—Under the bill, recapture income derived from sales of personal property used by the seller in a business is sourced where deductions with respect to such property previously offset income. Income in excess of those deductions is sourced according to where title passes. Income derived from sales of other personal property, including passive investment property, is generally sourced in the country of residence of the seller. However, for U.S. persons, sales involving a foreign office will yield foreign source income (if the income is subject to more than a de minimis amount of foreign tax). Certain sales of corporate stock are sourced in the country where the corporation whose stock is sold did most of its business. In addition, effectively connected income earned by a foreign person is U.S. source (except for foreign tax credit limitation purposes).

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

The reciprocal tax exemption for foreign persons' shipping and aircraft income is available only if a foreign person's country of residence gives U.S. persons an equivalent foreign tax exemption. In addition, a four-percent gross basis tax is generally imposed on U.S. source transportation income of foreign persons resident in countries that impose a gross basis tax on U.S. carriers.

5. Other offshore income and income earned in space.—The bill generally sources other offshore income and income earned in space in the recipient's country of residence. Certain communications income is sourced half in the place of transmission, half in the place of reception.

6. Dividend and interest income.—In general, interest and dividend income paid by a U.S. corporation that earns more than 80 percent of its income from foreign sources (an "80/20" company) is foreign source to the extent that the company's income is derived from foreign sources. A similar rule applies to interest paid by an "80/20" individual. The bill also restructures certain interest income exceptions.

7. Allocation of interest and other expenses.—Generally, corporate members of affiliated groups must allocate all expenses between U.S. and foreign income on an affiliated group basis. With respect to interest expense, the allocation is based on the borrowing and assets of an expanded affiliated group, which includes foreign members. Unguaranteed debt of a lower-tier U.S. member may be treated as supporting only that member's assets. If the unguaranteed debt rule comes into play, other members' debt is allocated to foreign income to the extent necessary to reach the result that would have obtained absent the unguaranteed debt rule, if possible. The asset method of allocating interest expense is modified and the optional gross income method is eliminated. Tax-exempt income and assets are not taken into account for purposes of allocating expenses. The new interest allocation rules will be phased in over four years in certain cases. Other transitional relief is provided.

Effective date.—The rules governing the source of income are generally effective for taxable years beginning after 1986, although the bill provides certain transitional relief. Certain rules applicable to foreign taxpayers apply to transactions occurring after March 18, 1986.

C. Taxation of U.S. Shareholders of Foreign Corporations

1. Subpart F income generally.—Net gains from sales of passive assets and net gains from transactions in commodities, foreign currency, and certain other property generally are taxed currently if earned by controlled foreign corporations.

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

3. De minimis tax haven income rule.—Present law is amended to reduce the 10 percent threshold for foreign base company income to 5 percent of gross income.

4. Possessions-chartered corporations.—The exception in the Subpart F rules for possessions-chartered corporations is repealed subject to a transition rule.

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

6. Application of accumulated earnings tax (AET) and personal holding company (PHC) tax to foreign corporations.—Present law is amended to allow foreign corporations a net capital gain deduction for purposes of calculating the AET or PHC tax only if the gains are taxed by the United States at the corporate level. This provision applies to transactions occurring after March 1, 1986.

Effective date.—Except as indicated above, the bill's rules applicable to income earned through foreign corporations are generally effective for taxable years beginning after 1986.

D. Special Tax Provisions for U.S. Persons

1. Possession tax credit.—For section 936 companies, the passive income limitation is reduced from 35 to 25 percent, and the required cost sharing payment is increased to 110 percent of the present-law cost sharing payment. The bill also requires an increase in the cost sharing payment (20 percent above present law) for purposes of the 50/50 profit split method. Under the bill, income from loans for active business assets and development projects in qualified Caribbean Basin Initiative countries is eligible for U.S. tax exemption. Compliance rules are provided. In addition, the requirement that funds be received in a possession to qualify for the section 936 credit does not apply to active business income from an unrelated party. Finally, section 936 treatment is extended to the U.S. Virgin Islands.

2. Taxation of U.S. employees of Panama Canal Commission.—The bill clarifies that the Panama Canal Treaty and its implementing agreements do not exempt U.S. taxpayers from U.S. tax. The bill provides that Commission and Defense Department employees are entitled to certain tax-free allowances like those available for State Department employees. These provision apply for taxable years beginning after 1986.

3. Private sector earnings of Americans aboard.—The bill reduces the maximum annual exclusion for foreign earned income of Americans working abroad, from the present $80,000 to $70,000. It denies this exclusion to Americans in foreign countries to which travel is prohibited by law. These provisions are effective for taxable years beginning after 1986.

E. Treatment of Foreign Taxpayers

1. Branch profits tax.—The branch profits tax proposed by the President as a substitute for the present dividend withholding tax is generally adopted. The bill generally retains present law (but with a reduction of present law's 50 percent income threshold to 10 percent) when a treaty allows present law to apply but would not allow a branch profits tax to apply. Interest payments of foreign corporations are subject to tax if 10 percent of their income (rather than 50 percent as under present law) has a U.S. connection. The bill provides anti-treaty shopping rules. These rules are effective for taxable years beginning after 1986.

2. Repeal of FIRPTA.—The bill repeals the Foreign Investors in Real Property Tax Act (FIRPTA), which now taxes foreign investors on their dispositions of U.S. real property interests. The repeal applies to dispositions after 1986.

3. Retain character of effectively connected income.—The bill treats income or gain as effectively connected with a U.S. trade or business if it is attributable to a different taxable year and would have been so treated if it had been taken into account in the other year. Removal of an asset from U.S. tax jurisdiction by a foreign person is a taxable event. These rules apply to taxable years beginning after 1986.

4. Tax-free exchanges by expatriates.—The tax-avoidance expatriate rules under present law are applied to gains on the sale of property the basis of which was determined by reference to U.S. property. This rule applies to sales or exchanges of property received in exchanges after March 1, 1986.

5. Study of excise tax on insurance premiums paid to foreign insurers.—The bill mandates a Treasury study on the effect of treaty waivers of the excise tax on casualty reinsurance premiums on the U.S. reinsurance industry.

F. Foreign Currency Exchange Gain or Loss

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

These rules are effective for taxable years beginning after 1986.

G. Tax Treatment of Possessions

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

2. Guam, the Commonweath of the Northern Mariana Islands (CNMI), and American Samoa.—After 1986, full authority will be granted to Guam and the CNMI to determine their own income tax laws (as American Samoa currently does). To avoid U.S. withholding tax, 65 percent of a possession corporation's income must be effectively connected with a trade or business in a possession or in the United States. Anti-abuse rules are provided.

Effective date.—The bill's rules coordinating United States and possessions taxation generally apply to taxable years beginning after 1986, or as soon as the applicable possession agrees to cooperate with the United States in tax matters.

H. Other Provisions

1. Transfer prices for imports.—Importers cannot claim a transfer price for income tax purposes that is higher than would be consistent with the value they claim for customs purposes. This provision applies to transactions entered into after March 18, 1986.

2. Income of foreign governments.—The bill provides that the tax exemption for foreign governments applies only to investment income. It provides that payments from a controlled entity that engages in U.S. trade or business are not investment income, so they are taxable. The foreign government exception will not apply to controlled entities that engage in any commercial activities anywhere in the world. This provision applies to taxable years beginning after 1986.

3. Dual resident companies.—Losses of a U.S. corporation that offset a foreign corporation's foreign tax on income that the United States does not subject to tax cannot offset any income of any other corporation for U.S. tax purposes. This provision applies to taxable years beginning after 1986.

4. Earnings stripping: interest paid to related tax-exempt parties.—The bill denies the deduction for net interest paid or accrued to related tax-exempt parties (other than ESOPs) to the extent such interest exceeds 50 percent of taxable income before the net interest deduction. This provision is effective for taxable years beginning after 1986.

5. Withholding on foreign investors in U.S. partnerships.—The bill requires that domestic partnerships withhold on certain distributions to foreign partners. This provision is effective for taxable years beginning after 1986.

6. Compliance provisions applicable to U.S. persons resident abroad.—The bill requires that passport and green card applicants complete an IRS information return. It also requires withholding on pension payments to persons with foreign addresses. These provisions apply to taxable years beginning after 1986.

7. Dividends received deduction.—The deduction for dividends received from foreign corporations is modified to extend to dividends from corporations earning either any amount of U.S.-connected income or dividends from U.S. subsidiaries. The deduction is limited to 10-percent U.S. corporate shareholders, and is to be calculated on a net basis.

Title X. Insurance Products and Companies

A. Insurance Policyholders

1. Interest on installment payments of life insurance proceeds

The bill repeals the provision of present law under which the income on the proceeds of life insurance that are paid to a surviving spouse in periodic payments are includible in gross income only to the extent that the amount of income paid during any taxable year exceeds $1,000. The provision is effective for amounts received with respect to deaths occurring after December 31, 1986.

2. Treatment of structured settlement agreements

The bill repeals the special treatment of structured settlement agreements and replaces those rules with a new deduction election for a taxpayer assuming a liability to make damage payments to an injured party. The provision is effective for assignments entered into in taxable years beginning after December 31, 1986.

B. Life Insurance Companies

Under the bill, the special life insurance company deduction equal to 20 percent of tentative life insurance company taxable income (LICTI) is repealed, generally effective for taxable years beginning after December 31, 1986.

C. Property and Casualty Insurance Companies

1. Inclusion in income of 20 percent of unearned premium reserve

Under the bill, 20 percent of the annual increase in unearned premiums is included in property and casualty insurance company income. Also, 20 percent of the unearned premium reserve outstanding at the end of the most recent taxable year beginning before January 1, 1987 is included ratably over a seven and one-half year period commencing with the first taxable year beginning after December 31, 1986.

In the case of insurance against default in the payment of principal or interest on securities with a maturity of five years or more, the percentage of unearned premiums included in income is 10 percent, rather than 20 percent. If a property and casualty insurance company ceases to be subject to tax as such an insurance company, the remaining portion (if any) of the amount to be ratably included over seven and one-half years is includible for the taxable year preceding the taxable year in which the company ceases to be taxed as a property and casualty insurance company.

2. Loss reserve deductions

The deduction for unpaid losses (i.e., reported losses that have not been paid, estimates of losses incurred but not reported and resisted claims, and unpaid loss adjustment expenses) is limited to the amount of discounted unpaid losses. This provision applies to property and casualty lines of business reported on Schedules O and P of the annual statement approved by the National Association of Insurance Commissioners, to accident and health reserves (other than life insurance reserves subject to discounting under life insurance company tax rules), international and reinsurance lines of business, and to loss reserves of title insurance companies (regardless of whether denominated as unearned premium reserves under applicable State law). This treatment applies to loss reserves of both property and casualty insurance companies and life insurance companies to the extent such loss reserves are not subject to life insurance company reserve rules.

The amount of the discounted unpaid losses as of the end of any taxable year attributable to any accident year is determined by using (1) the gross amount to be subjected to discounting (i.e., the undiscounted loss reserves), (2) the pattern of payment of claims, including the duration in years over which the claims will be paid, and (3) the rate of interest to be assumed in calculating the discounted reserve. The interest rate to be applied is five percent for all accident years beginning before or in 1987, and 75 percent of a five-year rolling average applicable Federal midterm rate for later periods. The five-year rolling average is computed by taking into account the Federal midterm rate for calendar months beginning after December 31, 1986. The loss payment patterns are to be promulgated by the Secretary of the Treasury for 1987 and every fifth year thereafter, taking account of aggregate industry experience for each line of business.

A company may elect to use its own loss payment pattern experience. Special rules are provided for long-tail lines and for international and reinsurance lines of business. The provision is effective for taxable years beginning after 1986, with a fresh start provision and special treatment for reserve strengthening after March 1, 1986.

3. Repeal of protection against loss account

Effective for taxable years beginning after December 31, 1986, the deduction for contributions to the protection against loss (PAL) account for mutual property and casualty companies is repealed. Balances in the account are includible in income no less rapidly than ratably over the first five years beginning after December 31, 1986, or, if more rapidly, as such amounts would have been included over the five years had the PAL account provision not been repealed.

4. Revision of special treatment for small companies

Under the bill, property and casualty companies (whether stock or mutual) with net written premiums or direct written premiums (whichever is greater) that do not exceed $350,000 for the taxable year are exempt from tax. Property and casualty companies (whether stock or mutual) with net written premiums or direct written premiums (whichever is greater) that exceed $350,000, but do not exceed $1,200,000, may elect to be taxed only on taxable investment income. In the case of a controlled group, these amounts are determined on a group basis. The provisions are effective for taxable years beginning after December 31, 1986.

Title XI. Minimum Tax Provisions

A. Individual Minimum Tax

The present-law individual alternative minimum tax is retained with the following modifications. The exemption amount is phased out at a rate of 25 cents on the dollar for alternative minimum taxable income in excess of $150,000 ($112,500 for single taxpayers and $75,000 for married taxpayers filing separately). Accelerated depreciation on all property placed in service after 1986 (other than property granted a transitional exception for regular tax depreciation and investment tax credit purposes) is a preference to the extent different from alternative depreciation. Use of the completed contract method of accounting and of the installment method by dealers are preferences. Certain passive farm losses are denied, and the rule limiting passive losses for regular tax purposes applies under the minimum tax without a phase-in.

Certain timing preferences (such as depreciation) are measured for post-1986 property on an aggregated basis, instead of item-by-item without netting. A credit is allowed against the regular tax for prior years' minimum tax liability attributable to timing preferences. The foreign tax credit is not permitted to offset more than 90 percent of tentative minimum tax liability. The provision applies to taxable years beginning after December 31, 1986.

B. Corporate Minimum Tax

An alternative minimum tax, similar to the individual minimum tax, replaces the present-law add-on tax. The rate is 20 percent, and there is a $40,000 exemption amount (phased out at the rate of 25 cents on the dollar for alternative minimum taxable income in excess of $150,000). The items of tax preference include the corporate preferences under present law, accelerated depreciation (to the extent different from alternative depreciation) for all property (other than transitional property) placed in service after 1986, intangible drilling costs (with the same offset for net oil and gas income applying under present law for individuals), use of the completed contract method of accounting and of the installment method for dealers, capital construction funds for shipping companies, and one-half of the excess of pre-tax book income of the taxpayer (including members of a group filing a consolidated tax return for the year), over other alternative minimum taxable income.

Rules similar to those under the individual alternative minimum tax apply to incentive credits, the foreign tax credit, net operating losses, and the credit for minimum tax liability attributable to timing preferences. The provision applies to taxable years beginning after December 31, 1986.

Title XII. Pensions and Deferred Compensation; Employee Benefits; ESOPs

A. Treatment of Tax-Favored Savings

1. Individual retirement arrangements (IRAs)

Under the bill, no deductible IRA contribution can be made for any taxable year if an individual is an active participant in an employer-maintained retirement plan for any part of the plan year ending with or within the individual's taxable year. For purposes of this rule, an employer-maintained retirement plan means (1) a qualified pension, profit-sharing, or stock bonus plan, (2) a qualified annuity plan (sec. 403(a)), (3) a simplified employee pension (sec. 408(k)), (4) a plan established for its employees by the United States, by a State or political subdivision, or by any agency or instrumentality of the United States or a State or political subdivision, or (5) a plan described in section 501(c)(18). In addition, an individual is not permitted to make deductible IRA contributions if amounts are contributed, on an elective or nonelective basis, on the individual's behalf by an employer for a tax-sheltered annuity (sec. 403(b)).

The bill provides that individuals who are active participants (and who, therefore, are not eligible to make deductible IRA contributions for a taxable year) may make designated nondeductible IRA contributions. The limit on designated nondeductible contributions for a taxable year is the same as the limit on deductible IRA contributions (i.e., the lesser of 100 percent of compensation (earned income in the case of a self-employed individual) or $2,000 ($2,250 in the case of an additional contribution to a spousal IRA). Earnings on nondeductible IRA contributions are not subject to tax until they are withdrawn.

Under the bill, the rules relating to spousal IRA contributions is amended to eliminate the requirement that the spouse have no compensation for the year in order to be eligible for the spousal IRA contribution.

Notwithstanding the general provisions of the bill limiting deductions for interest under certain circumstances, the bill provides that no deduction is allowed for interest on indebtedness incurred or continued to make an IRA contribution. Under the bill, the interest deduction is denied whether or not a deduction is allowed for the IRA contribution.

The provisions are effective for taxable years beginning (or loans made) after December 31, 1986.

2. Qualified cash or deferred arrangements (sec. 401(k) plans)

Under the bill, effective for taxable years beginning after December 31, 1986, the maximum amount that an employee can elect to defer for any taxable year under all cash or deferred arrangements in which the employee participates is limited to $7,000. The $7,000 cap is adjusted for inflation by reference to percentage increases in the social security wage base at the same time and in the same manner as the dollar limits on annual benefits under defined benefit pension plans (sec. 415(d)).

The $7,000 cap (as indexed) on elective deferrals is increased by up to $2,500 in the case of certain investments in employer securities. The amount of the increase in the annual cap for an individual equals the lesser of (1) $2,500 or (2) the amount of elective deferrals for the year invested in employer securities and held by an ESOP (described in sec. 4975(e)(7) or meeting the requirements of sec. 409(e)).

Effective generally for taxable years beginning after December 31, 1988, the bill modifies the special nondiscrimination test applicable to qualified cash or deferred arrangements by (1) clarifying the rules for aggregating elective contributions with certain nonelective contributions for purposes of the special nondiscrimination test; (2) redefining the group of highly compensated employees to conform to the new uniform definition of highly compensated employees applicable generally to qualified plans and employee benefit programs; (3) establishing a mechanism for the return of contributions that violate the special nondiscrimination test; and (4) imposing an excise tax on contributions that are not returned (or forfeited) within a specified period of time.

The bill modifies certain present-law restrictions and imposes several additional restrictions on qualified cash or deferred arrangements. First, the bill provides that distributions may be made to a participant in a qualified cash or deferred arrangement on account of the sale of a subsidiary or termination of the plan of which the arrangement is a part.

The bill limits hardship withdrawals under a qualified cash or deferred arrangement to the amount of an employee's elective deferrals. In addition, the bill provides that a qualified cash or deferred arrangement cannot require, as a condition of participation in the arrangement, that an employee complete a period of service with the employer (or employers) maintaining the plan in excess of one year of service.

Under the bill, an employer generally may not condition, either directly or indirectly, contributions and benefits (other than matching contributions) upon an employee's elective deferrals.

The bill provides that qualified cash or deferred arrangements are not available to employees of State or local governments.

3. Employer matching contributions and employee contributions

Under the bill, a special nondiscrimination test is applied to employer matching contributions and employee contributions under all qualified defined contribution plans and employee contributions under a defined benefit plan (to the extent allocated to a separate account on behalf of the employee). This nondiscrimination test applies in lieu of the usual nondiscrimination rules applicable to the amount of contributions under qualified plans and is similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements.

The provisions are effective for plan years beginning after December 31, 1988.

4. Unfunded deferred compensation plans of State and local governments

The bill (1) requires that amounts deferred on a before-tax basis by an employee under a simplified employee plan (SEP) or a qualified cash or deferred arrangement (sec. 401(k)) that is grandfathered under the bill be taken into account in determining whether the employee's deferrals under an eligible deferred compensation plan exceed the limits on deferrals under the eligible plan; (2) modifies the distribution requirements applicable to eligible deferred compensation plans; (3) permits rollovers between eligible deferred compensation plans; and (4) modifies the rule that an employee is taxable on deferrals under an eligible plan when such amounts are made available. An exception is provided for qualified State judicial plans.

The provisions are effective for taxable years beginning after December 31, 1988.

5. Deferred annuity contracts

Under the bill, if any annuity contract is held by a person who is not a natural person (e.g., a corporation or a trust is not a natural person), then the contract is not treated as an annuity contract for Federal income tax purposes and the income on the contract for any taxable year is treated as ordinary income received or accrued by the owner of the contract during the taxable year.

In addition, the bill modifies the circumstances under which the additional income tax on early withdrawals from deferred annuity contracts will be imposed to conform generally to the circumstances under which the early withdrawal tax is imposed under qualified plans.

The provisions are effective for years beginning after December 31, 1986.

6. Simplified employee pensions (SEPs)

The bill revises the qualification requirements relating to SEPs to permit employees to elect to have SEP contributions made on their behalf or to receive the contributions in cash.

Elective deferrals under a SEP are to be treated like elective deferrals under a qualified cash or deferred arrangement and, thus, are subject to the $7,000 (indexed) cap on elective deferrals.

Consistent with the rules applicable to elective deferrals under a qualified cash or deferred arrangement or tax-sheltered annuity under present law, elective deferrals under a SEP are not excludable from the definition of wages for employment tax purposes.

The bill provides that the election to have amounts contributed to a SEP or received in cash is available only if at least 50 percent of the employees of the employer elect to have amounts contributed to the SEP and is available only in a taxable year in which the employer maintaining the SEP has 25 or fewer employees as of the beginning of the year.

In addition, elective deferrals under SEPs are subject to special nondiscrimination rules similar to the special nondiscrimination rules applicable to qualified cash or deferred arrangements.

In addition, the bill makes miscellaneous changes to the SEP requirements to decrease the administrative burden of maintaining a SEP.

The provisions are effective for years beginning after December 31, 1986.

7. Salary reduction permitted under section 501(c)(18) plans

Under the bill, employees who participate in a section 501(c)(18) pension plan are permitted to elect to make deductible contributions up to the lesser of $7,000 or 25 percent of the compensation of the employee includible in income for the taxable year subject to nondiscrimination rules similar to the rules applicable to qualified cash or deferred arrangements.

The provision is effective for years beginning after December 31, 1986.

B. Nondiscrimination Requirements

1. Minimum coverage requirements

Under present law, a qualified plan is required to cover employees in general rather than merely the employees of an employer who are officers, shareholders, or highly compensated. A plan generally satisfies the present-law coverage rule if (1) it benefits a significant percentage of the employer's workforce (percentage test), or (2) it benefits a classification of employees determined by the Secretary of the Treasury not to discriminate in favor of employees who are officers, shareholders, or highly compensated (classification test).

The bill (1) increases, to 80 percent of all employees, the level of coverage necessary to satisfy the "percentage test;" (2) replaces the "classification test" of present law with a "reasonable classification test" and provides the Treasury with guidance as to the manner in which the test is to be interpreted; (3) establishes an alternative method for satisfying the reasonable classification test ("alternative reasonable classification test"); (4) clarifies the circumstances under which an employee will be treated as benefiting under a plan for purposes of the coverage rules; (5) permits, for purposes of satisfying the reasonable classification test, the exclusion from consideration of employees who have not satisfied certain minimum age and service requirements; (6) establishes a uniform objective definition of those employees in whose favor discriminatory coverage is prohibited; (7) permits satisfaction of certain of the coverage rules on a controlled group or line of business basis; (8) establishes a definition of a line of business or separate operating unit with a special safe-harbor rule; and (9) contains a special transition rule for certain dispositions or acquisitions of a business.

The provision generally is effective for plan years beginning after December 31, 1988. A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

2. Minimum participation rule

Under the bill, a plan is not a qualified plan unless it benefits no fewer than the lesser of (a) 50 employees or (b) 40 percent or more of all employees of the employer. The requirement may not be satisfied by aggregating comparable plans.

The provisions are generally effective for plan years beginning after December 31, 1988. A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

3. Vesting standards

The bill provides that a plan (other than a top-heavy plan subject to separate vesting requirements) is not a qualified plan of an employer unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules.

A plan satisfies the first schedule if a participant has a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the participant's completion of five years of service. A plan satisfies the second alternative schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after three years of service, 40 percent at the end of four years of service, 60 percent at the end of five years of service, 80 percent at the end of six years of service, and 100 percent at the end of seven years of service.

A special rule is provided in the case of a multiemployer plan to require 100-percent vesting after 10 years of service.

The provisions are generally applicable for plan years beginning after December 31, 1988, with respect to participants who perform at least one hour of service in a plan year to which the new provisions apply. A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

4. Integration of pension plans

The bill provides that a plan is not to be considered discriminatory merely because the contributions and benefits of employees under the plan favor highly compensated employees (sec. 414(q)) if the plan meets the new requirements (i.e., the disparity limits) of the bill relating to the integration of contributions or benefits under qualified plans.

Under the bill, a defined contribution plan meets the disparity limits for integrated plans only if the contribution percentage under the plan for compensation over the integration level does not exceed the lesser of (1) 200 percent of the contribution percentage for compensation up to the integration level or (2) the sum of the contribution percentage for compensation up to the integration level and the rate of the tax imposed on employers under the Federal Insurance Contributions Act (5.7 percent for 1986) as of the beginning of the plan year.

A defined benefit pension plan meets the disparity limits for integrated excess plans if (1) the benefit percentage for compensation above the integration level does not exceed 200 percent of the benefit percentage for compensation up to the integration level, and (2) any optional form of benefit, preretirement benefit, actuarial factor, or other benefit or feature provided by the plan with respect to remuneration in excess of the integration level specified by the plan for the year is provided with respect to remuneration that is not in excess of that level.

A defined benefit pension plan meets the requirements for integrated offset plans if it provides that a participant's accrued benefit derived from employer contributions (sec. 411(c)(1)) may not be reduced by reason of the offset by more than 50 percent of the benefit that would have accrued without regard to the reduction.

The provisions are effective for plan years beginning after December 31, 1988. A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

5. Benefits treated as accruing ratably for purposes of determining top-heavy status

Under the bill, a uniform accrual rule is used in testing whether a qualified plan is top-heavy (or super top-heavy) (sec. 416(g)(4)(F)). The provision applies for plan years beginning after December 31, 1986.

6. Modification of rules for benefit forfeitures

The bill creates uniform rules for forfeitures under any defined contribution plan, effective for plan years beginning after December 31, 1985.

7. Uniform definition of highly compensated employees

The bill provides a new uniform definition of the group of employees in whose favor discrimination is prohibited ("highly compensated employees") that generally applies for purposes of the nondiscrimination rules for qualified plans and statutory employee benefit plans.

An employee is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer (as defined in sec. 416(i)); (2) earned more than $100,000 in annual compensation from the employer; (3) earned more than $50,000 in annual compensation from the employer and was a member of the top-paid group of employees i.e., the top 20 percent of employees by pay during the same year; or (4) was an officer of the employer (as defined in sec. 416(i)). The $50,000 and $100,000 thresholds are indexed by reference to the method, as of May 1, 1986, of percentage increases in the social security taxable wage base (i.e., at the same time and in the same manner as the adjustments to the dollar limits on benefits under defined benefit pension plans).

C. Treatment of Distributions

1. Uniform minimum distribution rules

The bill extends the required benefit commencement date for 5-percent owners to all participants in a plan who are highly compensated employees. In addition, the bill establishes a new sanction in the form of an excise tax, as an alternative to plan disqualification, for failure to satisfy the minimum distribution rules.

The provisions generally apply to years beginning after December 31, 1986. An exception is provided for certain individuals who made grandfathered designations under section 242 of TEFRA.

2. Taxation of distributions

The bill generally (1) phases out capital gains treatment over six years (except for certain grandfathered individuals); (2) eliminates 10-year forward averaging (except for certain grandfathered individuals who may elect 10-year averaging at present-law tax rates) and permits five-year forward averaging under limited circumstances; (3) modifies the present-law basis recovery rules for amounts distributed prior to a participant's annuity starting date; (4) eliminates on a phased-in basis (beginning in 1988) the special 3-year basis recovery rule of present law; (5) modifies the general basis recovery rules for amounts paid as an annuity; and (6) provides basis recovery rules for distributions from an IRA to which nondeductible contributions have been made.

The provisions are generally effective for distributions made after December 31, 1986. The repeal of the special three-year basis recovery rule generally is effective with respect to any individual whose annuity starting date is after January 1, 1988. If the employee's annuity starting date is after January 1, 1988, but on or before January 1, 1989, and the amount to be distributed during the first three years under the annuity is greater than the employee's total basis, then 50 percent of such basis may be recovered before any amounts are taxable. After the first 50 percent of the participant's basis has been recovered, the remaining 50 percent is to be recovered under the general pro-rata basis recovery rule for post-annuity starting date distributions.

3. Uniform taxation of early distributions from qualified retirement plans

The bill (1) generally extends the additional income tax on premature distributions from an IRA (or for 5-percent owners under a qualified plan) to early distributions by any participant from any qualified retirement plan; (2) increases the additional income tax on premature distributions from 10 to 15 percent for all early distributions other than distributions of income and employer matching contributions attributable to after-tax employee contributions and income attributable to nondeductible IRA contributions; (3) exempts certain distributions from the tax; and (4) requires that an employer offer an employee who separates from service and who elects to receive a lump-sum distribution the option of a direct transfer of the benefit to an IRA.

The provisions generally are effective for distributions in taxable years beginning after December 31, 1986.

4. Treatment of loans

The bill modifies the rules relating to the tax treatment of loans under qualified plans by (1) eliminating the ability of plan participants to maintain permanent loan balances and (2) limiting the availability of the extended repayment period for loans for principal residences.

The provision applies to loans made after December 31, 1986.

D. Limits on Tax Deferral under Qualified Plans

1. Adjustments to limitations on contributions and benefits under qualified plans

The bill makes several changes to the overall limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and SEPs of private and public employers.

The normal retirement age for purposes of the limit on benefits under a defined benefit pension plan is conformed to the social security retirement age. If the retirement benefit under a defined benefit plan begins before the social security retirement age (presently, age 65), then the $90,000 limitation on annual benefits generally is reduced so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at the social security retirement age. Under transition rules provided by the bill, benefits already accrued by a plan participant under an existing plan are not affected by the reductions for actuarial equivalence.

Although cost-of-living adjustments will be made to the defined benefit plan limit beginning in 1988, no cost-of-living adjustments to the defined contribution plan limit will be made until the $30,000 defined contribution plan limit is equal to 25 percent of the defined benefit dollar limit.

Under the bill, the class of employers whose employees are entitled to the special catch-up elections for tax sheltered annuities is expanded to include employers that are health and welfare service agencies.

The bill provides special rules for commercial airline pilots, participants in a qualified police or firefighters' pension plan, and for certain correctional officers.

The bill provides a limit on the amount of compensation that may be taken into account under any plan. The $200,000 limit presently applicable to top-heavy plans and SEPs is applied to all qualified plans, whether or not top-heavy (sec. 401(a)(17)). The limit on includible compensation will be increased at the same time and in the same manner as the dollar limits on benefits under a defined benefit plan.

The provisions generally are effective for years beginning after December 31, 1986. Special rules are provided in the case of plans maintained pursuant to collective bargaining agreements.

2. Adjustments to deduction (sec. 404) limitations

The bill makes several changes to the limits on employer deductions for contributions to qualified plans. The bill (1) repeals the limit carryforward applicable to profit-sharing and stock bonus plans and (2) extends the 25-percent of compensation combined plan deduction limit to any combination of a defined benefit pension plan and a money purchase pension plan, profit-sharing, or stock bonus plan.

The provisions are effective for years beginning after December 31, 1986.

3. Excise tax on reversion of qualified plan assets to employer

The bill imposes a 10-percent nondeductible excise tax on a reversion from a qualified plan. The tax is imposed on the person who received the reversion. The bill provides an exception to the excise tax on reversions in the case of transfers of assets from a defined benefit pension plan upon plan termination to an employee stock ownership plan (ESOP).

The provision applies to reversions received on account of plan terminations occurring after December 31, 1985.

E. Miscellaneous Pension and Deferred Compensation Provisions

1. Discretionary contribution plans

Under the bill, effective for plan years beginning after December 31, 1986, an employer's contribution to a profit-sharing plan is not limited to the employer's current or accumulated profits. This provision applies without regard to whether the employer is tax-exempt.

2. Requirement that collective bargaining agreements be bona fide

Under the bill, it is clarified that no agreement will be treated as a collective bargaining agreement unless it is a bona fide agreement between bona fide employee representatives and one or more employers.

3. Treatment of certain fishing boat crews as self-employed individuals

Under the bill, members of fishing boat crews (described in sec. 3121(b)(20)) are treated as self-employed individuals for purposes of the rules relating to qualified pension, profit-sharing, or stock bonus plans.

The provision is effective for taxable years beginning after December 31, 1986.

4. Cashout of certain accrued benefits

The bill amends the rules to relating to cash outs of accrued benefits to require that, for purposes of determining the present value of a participant's accrued benefit, a plan would be required to compute the first $3,500 of the present value of a benefit by using an interest rate no greater than the interest rate (deferred or immediate, whichever is appropriate) that would be used by the PBGC (as of the date of distribution) upon the plan's termination. The remaining portion of the present value of the benefit would be determined by using an interest rate no greater than 120 percent of the PBGC interest rate.

The provision is applicable for distributions after December 31, 1984. However, it does not apply to distributions that were made after December 31, 1984, and before the date of enactment, if such distributions were made in accordance with the requirements of regulations issued under the Retirement Equity Act of 1984.

5. Time required for plan amendments, issuance of regulations, and development of section 401(k) model plan

Under the bill, a delayed effective date is provided for plan amendments to comply with the provisions of the bill relating to qualified plans.

Further, the bill provides that the Treasury Department is to issue final regulations by February 1, 1988, for (1) the rules relating to the integration of benefits under qualified plans, (2) the coverage requirements applicable to qualified plans, (3) the amendments applicable to qualified cash or deferred arrangements (sec. 401(k) plans), and (4) the new nondiscrimination rules for employer matching and employee contributions (sec. 401(m)).

The bill provides that the Treasury Department is to publish, no later than May 1, 1987, a model plan document for qualified plans that include qualified cash or deferred arrangements.

F. Employee Benefit Provisions

1. Nondiscrimination rules for certain statutory employee benefit plans

The bill establishes comprehensive nondiscrimination rules for certain statutory employee benefit plans. Under the bill, a highly compensated employee who is a participant in any discriminatory statutory employee benefit plan is taxed on the value of such employee's employer-provided benefit under the plan.

The bill (1) revises the nondiscrimination rules applicable to group-term life insurance plans and self-insured accident or health plans; (2) extends those rules to insured accident or health plans; (3) establishes a new nondiscrimination test applicable (at the election of the employer) to any type of statutory employee benefit plan, in lieu of the present-law nondiscrimination rules; (4) establishes a concentration test applicable to both group-term life plans and accident or health plans, and an additional concentration test applicable only to group-term life plans; (5) establishes a uniform definition of highly compensated employee; (6) modifies the list of employees who may be excluded from consideration in applying the coverage rules; and (7) permits satisfaction of the coverage rules on a controlled group or line of business basis.

The provisions generally are effective for years beginning after December 31, 1986. A delayed effective date is provided for church plans.

2. Deductibility of health insurance costs of self-employed individuals

The bill provides a deduction for 50 percent of the amounts paid for health insurance for a taxable year on behalf of a self-employed individual and the individual's spouse and dependents. No deduction is allowable to the extent the deduction exceeds the self-employed individual's net earnings from self employment (sec. 1402(a)) for the taxable year. In addition, no deduction is allowable for any taxable year for which the self-employed individual is eligible to participate (on a subsidized basis) in a health plan of an employer of the self-employed individual or such individual's spouse.

The provision is effective for taxable years beginning after December 31, 1986.

3. *Exclusions for educational assistance programs and qualified group legal services made permanent*

The bill retroactively makes permanent the exclusions from gross income for educational assistance and group legal services and the tax exemption for qualified group legal services organizations.

In addition, the bill increases the cap on annual excludable educational assistance benefits to $5,250 from $5,000. This cap is indexed, under the bill, by reference to the method, as of May 1, 1986, for determining percentage increases in the social security taxable wage base.

The provisions generally are effective (1) in the case of educational assistance benefits, for taxable years beginning after December 31, 1985, and (2) in the case of group legal services benefits and the tax exemption for qualified group legal services organizations, for taxable years ending after December 31, 1985. A special rule is provided for group legal services benefits provided under a cafeteria plan.

4. *Tax treatment of qualified campus lodging*

The bill provides that, for Federal tax purposes, the fair market value of use (on an annualized basis) of qualified campus lodging furnished by, or on behalf of, a school, college, or university is to be treated as not greater than five percent of the appraised value for the lodging, but only if, under Treasury regulations, an independent appraisal of the fair market value is obtained by a qualified appraiser.

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

5. *Health benefits for retirees*

The bill provides that, for purposes of calculating an employer's deduction for contributions to a welfare benefit fund, projected increases in medical costs may be taken into account in the funding for post-retirement medical benefits. The amount of such projected increases to be used is determined under an index specified by the Secretary of the Treasury.

The provision is effective for taxable years beginning after December 31, 1986.

6. *Accrued vacation pay*

Under the bill, the special rule allowing a deduction for additions to a reserve account for vacation pay (sec. 463) is limited to the vacation pay that is paid during the current taxable year or within 8-1/2 months after the close of the taxable year of the employer with respect to which the vacation pay was earned by the employees.

The provision is effective for taxable years beginning after December 31, 1986.

G. Employee Stock Ownership Plans (ESOPs)

1. *Repeal of employee stock ownership credit*

The bill repeals the special payroll-based ESOP tax credit for compensation paid or accrued after December 31, 1986.

2. Certain additional tax benefits relating to ESOPs

The bill permits an exclusion from the gross estate of 50 percent of the qualified proceeds from a qualified sale of employer securities. Under the bill, a qualified sale means any sale of employer securities (within the meaning of sec. 409(l)) by the executor of an estate to (1) an ESOP, or (2) an eligible worker-owned cooperative (as defined in sec. 1042(c)(2)).

Under the bill, the deduction for dividends paid on ESOP stock is expanded to apply to dividends that are used to repay ESOP loans.

The bill modifies the 50-percent exclusion for interest paid on securities acquisition loans (sec. 133) in two respects. First, the bill provides that the exclusion is also available with respect to a loan to a corporation to the extent that, within 30 days, employer securities are transferred to the plan in an amount equal to the proceeds of the loan and such contributions are allocable to participants' accounts within one year after the date of the loan. Second, under the bill, a lender eligible for the interest exclusion is amended to include a regulated investment company (as defined in sec. 851).

The provision is effective for years beginning after December 31, 1986.

3. Changes in qualification requirements relating to ESOPs

Under the bill, additional requirements are provided for any ESOP. These additional qualification requirements (1) permit distributions upon termination of an ESOP, (2) modify the distribution and put option requirements, (3) modify the special limits on allocations of contributions to an ESOP to conform the definition of highly compensated employee to the new definition provided for qualified plans generally, and (4) require stock bonus plans to satisfy the put option requirements applicable to ESOPs.

The provision permitting distributions upon plan termination generally is effective for termination distributions made after December 31, 1984. The distribution and payment requirements are effective with respect to distributions attributable to stock acquired after the date of enactment. The extension of the put option requirement to stock bonus plans is effective for distributions attributable to stock acquired after the date of enactment. The modified definition of highly compensated employees is effective for years beginning after December 31, 1986.

Title XIII. Research and Development

A. Incremental Research Tax Credit; University Basic Research Credit

Incremental credit.—The bill extends the 25-percent incremental research tax credit for four additional years, i.e., for qualified research expenditures paid or incurred through December 31, 1989. Also, the bill provides a modified definition of qualified research for purposes of the extended credit, effective for taxable years beginning after 1985.

University credit.—The university basic research credit is modified. Under the bill, a 20-percent tax credit applies to the excess of (1) 100 percent of corporate cash expenditures for university basic research over (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period, as adjusted for inflation. This provision is effective for taxable years beginning after 1985.

Credit use limitation.—The general limitation on use of business credits applies to the research credit, effective for taxable years beginning after 1985.

B. Allocation of Research and Experimental Expenditures

Under the bill, for taxable years beginning generally after August 1, 1986, and on or before August 1, 1987, the application of the research expense allocation rule in Treasury Regulation section 1.861-8 is modified to provide generally that 75 percent of U.S.-incurred research expense may be allocated to domestic income, with the remainder apportioned on the basis of sales or gross income.

C. Treatment of Computer Software Royalties for Certain Tax Purposes

An exception from the definition of personal holding company income and foreign personal holding company income is provided for computer software royalties received by certain corporations that are actively engaged in the business of developing computer software, effective for past and future years.

Title XIV. Tax Shelters; Real Estate; Interest Expense

A. Limitations on Losses and Credits from Passive Activities

Deductions from passive activities, to the extent that they exceed income from all such activities (exclusive of portfolio income) generally may not be deducted against other income of the taxpayer. Similarly, credits from passive activities generally are limited to the tax allocable to the passive activities. Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the next taxable year. When the taxpayer disposes of his entire interest in an activity, any real loss that has been incurred is allowed in full.

Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate (e.g., a limited partnership interest in an activity), and rental activities. In the case of rental real estate activities in which an individual actively participates, up to $25,000 of losses (and credits, in a deduction-equivalent sense) from all such activities may be taken in each year against non-passive income of the taxpayer. This amount is phased out ratably at between $100,000 and $150,000 of adjusted gross income (determined without regard to passive losses). Low-income housing credits may be taken (in a deduction-equivalent sense) under the $25,000 allowance against non-passive income without regard to whether the individual actively participates.

The provision generally applies to individuals, estates, trusts, and personal service corporations (as defined for purposes of the provision). Certain closely held corporations are subject to a more limited rule under which passive losses and credits may not be applied to shelter portfolio income. The provision is effective for taxable years beginning after December 31, 1986, but is phased in over 5 years. During the transitional period, the amount of excess losses and credits that are disallowed is 35 percent in 1987, 60 percent in 1988, 80 percent in 1989, and 90 percent in 1990.

B. Extension of At-Risk Rules to Real Estate Activities

The at-risk rules are extended to the activity of holding real property, with an exception for qualified nonrecourse financing which is secured by real property used in the activity. Under this rule, real estate joint ventures may obtain financing from an otherwise qualified lender who has an equity interest in the venture, but seller financing is not treated as qualified nonrecourse financing. The provision is effective for losses attributable to property acquired after December 31, 1986.

C. Tax Credit for Rehabilitation Expenditures

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

The modifications to the rehabilitation credit are generally applicable to property placed in service after December 31, 1986.

D. Low-Income Housing Tax Credit

The bill provides a new tax credit that may be claimed by owners of residential rental projects providing low-income housing. The credit is claimed annually for a period of 10 years. The annualized credit amounts have a present value of 60 percent or 30 percent of the basis attributable to qualifying low-income units, depending on the income of the tenant qualifying the unit for the credit. Initially, the annual credit rate is eight percent for units occupied by individuals with incomes of 50 percent or less of area median income (as adjusted for family size) and four percent for a limited number of units occupied by individuals with incomes of between 50 percent and 70 percent of area median income.

Newly constructed properties, as well as existing properties which are transferred and substantially rehabilitated, are eligible for the credit.

Residential rental projects are eligible for the credit only if a minimum of 20 percent of the housing units in the project are occupied by individuals with incomes of 50 percent or less of area median income, adjusted for family size, and the rent charged to tenants in units with respect to which the credit is allowable does not exceed a specified amount. Projects are not eligible for the credit if they receive tax-exempt bond financing or other Federal subsidies. Such subsidies include grants, low-interest loans, and rental assistance payments. Eligible projects must continuously comply with these requirements for a 15-year period. The penalty for noncompliance is recapture of prior credits.

The credit is effective for property placed in service after December 31, 1986.

E. Real Estate Investment Trusts

The bill modifies several aspects of the requirements for qualification as, and the taxation of, real estate investment trusts ("REITs"). Under the bill, relief is granted from certain shareholder and income and asset requirements for the first year that an entity otherwise qualifies as a REIT. In addition, relief is granted from certain income and asset requirements for the first year after a REIT receives new equity capital. REITs also are permitted to hold assets in wholly owned subsidiaries under the bill.

The bill modifies the definition of rents from real property to permit REITs to perform those services that would not result in the receipt of "unrelated business income" if performed by certain tax-exempt entities, without using an independent contractor. The bill also includes in the definition of rents from real property and the definition of interest, rent or interest that is based on the net income of the tenant or debtor, but only if such net income is based substantially on amounts that would be treated as rents from real property if received directly by the REIT.

The bill provides certain relief from the distribution requirement where a REIT has certain types of income that are not accompanied by the receipt of cash. The REIT is required to pay tax on amounts not distributed, however. In addition, the safe harbor under which sales by a REIT may not be treated as prohibited transactions is expanded, the computation of the amount of capital gains dividends that a REIT may pay is modified, and one of the penalties relating to the distribution of deficiency dividends is eliminated.

The provisions of the bill are effective for taxable years beginning after December 31, 1986.

F. Mortgage-Backed Securities

The bill provides a new vehicle, referred to as a "real estate mortgage investment company" or "REMIC" for the issuance of multiple class mortgage-backed securities. The REMIC may be in the form of a corporation, partnership or trust. The assets that the REMIC is permitted to hold generally are limited to mortgages secured by real property.

If an entity qualifies as a REMIC, it is permitted to deduct amounts representing interest with respect to "regular interests" whether or not such interests otherwise would be treated as indebtedness of the REMIC for Federal income tax purposes. The REMIC also is allowed a deduction for certain amounts paid to the "residual interests." The amount of this deduction generally is limited to an amount that approximates the economic income of the residual interests. Thus, to the extent of these deductions allowed, the REMIC is in effect a conduit entity.

Gain is recognized on the transfer of mortgages to a REMIC under the bill. The bill also clarifies the application of the original issue discount and market discount rules for certain mortgage-backed securities. In addition, in order to assure only one set of Federal income tax consequences arise from the issuance of multiple class mortgage-backed securities, the bill treats certain other entities that otherwise may be used to issue mortgage-backed securities as corporations.

The provisions of the bill are effective for taxable years beginning after December 31, 1986.

G. Interest Deduction Limitation

No deduction is allowed for consumer interest (such as interest on car loans or credit card balances for personal expenditures), or for investment interest expense in excess of net investment income. The definitions of investment interest and investment income are modified to treat limited business interests as held for investment.

Interest on the principal residence and a second residence of the taxpayer remain fully deductible.

The effect of this provision is phased in, so that 35 percent of such interest would be disallowed in 1987, 60 percent in 1988, 80 percent in 1989, and 90 percent in 1990; 100 percent disallowance commences in 1991.

Title XV. Tax-Exempt Bonds

A. Tax-Exempt Bond Provisions

1. Bonds to finance general government operations

The bill retains the tax-exemption for interest on State and local government bonds used to finance traditional governmental operations. These bonds may continue to be issued without regard to the volume limits and certain other limitations applicable to bonds for nongovernmental persons.

2. Tax-exemption for interest on certain other bonds

As under present law, interest on bonds to provide conduit financing for nongovernmental persons is taxable unless a specific exception is provided in the Code. The bill provides the following exceptions permitting the issuance of tax-exempt bonds for such financing:

Industrial development bonds.—Under present law, industrial development bonds (IDBs) are defined as bonds (a) more than 25 percent of the proceeds of which are used in a trade or business carried on by a nongovernmental person (other than a tax-exempt section 501(c)(3) organization), and (b) which are repaid from, or secured by, money or property used in a trade or business. Interest on IDBs is tax-exempt only if they are issued for certain specified activities or are small-issue IDBs.

The bill clarifies that the "security interest" test for defining IDBs is satisfied by indirect, as well as direct, payments by private users of bond-financed facilities. The bill further directs the Treasury Department to liberalize its ruling guidelines, under which certain private management contracts are not treated as a private trade or business use.

Interest on IDBs is tax-exempt under the bill if the bonds are used in the following exempt activities: projects for multifamily residential rental property (subject to revised targeting rules); airports (not including hotels); docks and wharves; sewage and solid waste disposal facilities; facilities for the furnishing of water; facilities for the local furnishing of electric energy or gas; local district heating and cooling facilities; and hazardous waste treatment facilities. An additional tax-exemption is provided for interest on certain tax-increment financing bonds issued in connection with redevelopment activities (qualified redevelopment bonds).

The bill retains the tax-exemption for interest on small-issue IDBs, subject to present-law sunset dates (i.e., December 31, 1986, for other than manufacturing facilities, and December 31, 1988, for manufacturing facilities). Bonds for first-time farmers are treated as bonds for manufacturing facilities for this purpose. The first-time farmer rules are liberalized with respect to previously insolvent farmers and the acquisition of used equipment. To ensure appropriate targeting of IDB financing for farming activities, the bill applies a $250,000 lifetime limit on IDB financing of depreciable farm property for any principal user.

Mortgage revenue bonds.—The tax exemption for interest on qualified mortgage bonds and qualified veterans' mortgage bonds is retained under the bill (subject to the December 31, 1987 sunset date for qualified mortgage bonds). The option to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs) is also retained, with a 25-percent trade-in rate.

Limited equity cooperatives are permitted to elect to satisfy the targeting rules applicable to IDBs for multifamily rental housing, rather than the qualified mortgage bond rules. If they do so elect, the tenant-stockholders are denied a deduction for interest and real estate taxes under section 216 and the bonds are counted toward the qualified mortgage bond volume limit.

Qualified 501(c)(3) bonds.—The bill retains the tax-exemption for interest on bonds to finance activities of tax-exempt section 501(c)(3) organizations, provided the activities are directly related to the exempt purpose of the organization.

Student loan bonds.—Tax-exempt student loan bonds may be issued under the bill in connection with (a) the GSL and PLUS programs of the Federal Government (as under present law) and (b) qualifying State supplemental loan programs.

Related use requirement.—The bill requires that private trade or business use of governmental bonds, equal to or exceeding five percent of bond proceeds, must be related to governmental facilities also financed with the bonds. The private (consumer) loan bond restriction of present law is also retained by the bill.

3. State volume limitations

The bill retains the three separate volume limitations that apply under present law to (1) most IDBs and all student loan bonds, (2) qualified mortgage bonds, and (3) qualified veterans' mortgage bonds (in States permitted to issue such bonds). The scheduled reduction in the IDB and student loan volume limit after 1986, from $150 to $100 per capita, is retained.

As under present law, no volume limitation applies to qualified 501(c)(3) bonds or IDBs for multifamily rental housing. IDBs for governmentally owned airports, docks and wharves, and sewage, solid waste disposal, and water facilities are also exempt from volume limits.

4. Arbitrage restrictions

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

The bill makes several modifications to the arbitrage rules applicable to tax-exempt bonds, including the following:

(1) Rebate requirements, similar to the present law IDB rules, are applied to all tax-exempt bonds. (Mortgage revenue bonds are subject to the present law qualified mortgage bond rules.) Exceptions are provided for bonds to finance operations of certain small governmental units with general taxing powers, and for arbitrage earned during certain temporary periods on student loan bonds which are issued in connection with the Federal GSL and PLUS programs.

(2) A special penalty, rather than loss of tax exemption, is applied for failure to rebate arbitrage on governmental and qualified 501(c)(3) bonds. This rule does not apply if the failure results from willful disregard of the rebate requirement.

(3) The limit on investment in nonpurpose obligations, presently applied to most IDBs and qualified mortgage bonds, is extended to all tax-exempt bonds.

(4) Yield on all tax-exempt bonds is determined using the original issue discount rules of the Code (i.e., the *State of Washington* case is overruled).

(5) Tax-exemption is denied for pension arbitrage bonds.

(6) The Treasury Department is directed to modify its SLGS program to allow more flexible investment of bond proceeds.

5. Restriction on advance refundings

Advance refundings are limited to governmental and qualified 501(c)(3) bonds and are subject to various new restrictions, including a prohibition of devices used to obtain material financial advantages (other than lower interest rates).

6. Changes in use of bond-financed facilities

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

7. Cost recovery for bond-financed property

Under the bill, tax-exempt bond-financed property is depreciated using the straight-line method. In general, such property is depreciated over the ADR midpoint life of the property (40 years for real property). Multifamily residential rental property is depreciated over a 27½-year period, while solid waste disposal and hazardous waste treatment facilities are depreciated over eight years.

8. Information reporting for all bonds

Information reporting requirements are extended to issuers of all tax-exempt bonds.

Effective dates

The tax-exempt bond provisions of the bill generally apply to bonds issued after the date of enactment. Special effective dates are provided for certain provisions. Transitional exceptions are also provided for various provisions of the bill.

B. General Stock Ownership Corporations (GSOCs)

The bill eliminates the Code provisions relating to General Stock Ownership Corporations (GSOCs) as deadwood, effective January 1, 1984.

Title XVI. Unearned Income of Minor Children; Income Taxation of Trusts and Estates; Estate and Gift Taxes

A. Unearned Income of Minor Children

Under the bill, the unearned income of a child under 14 is taxed to the child at the top marginal rate of the parents to the extent attributable to property received from the parents. Unearned income that is derived from assets received from other sources (or by reason of a parent's death) and that is placed in a qualified segregated account is taxed at the child's marginal rate, as is earned income of the child. The provision is generally effective for taxable years beginning after December 31, 1986.

B. Income Taxation of Trusts and Estates

1. Tax rate schedule

The rate schedule applicable to the retained income of trusts and estates is compressed as compared with the rates applicable to individuals. The first $5,000 of taxable income of trusts and estates is taxed at 15 percent, with any excess taxed at 27 percent. The benefit of the 15-percent rate is phased out between $13,000 and $25,000 of taxable income. The compressed rate schedule applies to estates only beginning after their second taxable year.

The new rate schedules apply for the taxable years of both new and existing trusts and estates beginning after December 31, 1986.

2. Grantor trust rules

The income of a trust generally is taxed to its grantor if the trust corpus will revert to the grantor or the grantor's spouse. An exception is provided where the trust may revert only after the death of the income beneficiary of the trust who is a lineal descendant of the grantor. The provision applies to transfers in trust made after March 1, 1986, with an exception for certain trusts created pursuant to a binding property settlement entered into before March 1, 1986.

3. Taxable years of trusts

The bill requires that existing and newly created trusts adopt a taxable year ending on October 31, November 30, or December 31. This applies for taxable years beginning after December 31, 1986.

4. Trusts and estates to make estimated payments of income tax

The bill provides that new and existing trusts and estates pay estimated tax in the same manner as individuals. Also, the bill repeals the rules that permit estates to pay tax over four equal installments. This is effective for taxable years beginning after December 31, 1986.

C. Estate and Gift Tax Provisions

1. Current use valuation recapture period

The period during which heirs of individuals dying before 1982 leaving property for which estate tax special use valuation was elected must continue to own and use such property without incurring a special recapture tax is reduced from 15 years to 10 years. The provision is effective on enactment of the bill.

2. Filing information for estate tax current use valuation elections

Where an executor of a decedent's estate has elected special use valuation on a timely filed estate tax return by providing substantially all the information elicited by the return form, the executor will have an additional 90 days, after being notified by the IRS, to supply any missing information. The provision is effective on enactment of the bill.

3. Certain gift tax disclaimers

Certain disclaimers executed before February 22, 1982, with respect to property interests created before November 15, 1958, are treated as qualified disclaimers for gift tax purposes. The provision is effective on enactment of the bill.

Title XVII. Miscellaneous Tax Provisions

A. Extension of Expiring Provisions

1. Extension and modification of the targeted jobs tax credit

The bill extends the targeted jobs credit for three additional years, i.e., for first-year wages paid to individuals who begin work for the employer before 1989. Under the bill, wages paid in the second year of a targeted individual's employment are not eligible for the credit, and the credit is not available if the employee works less than a specified minimum period. These modifications to the credit apply with respect to individuals who begin work for the employer after 1985; the period for satisfying the certification requirement for the credit is extended for individuals hired after 1985 and within 25 days after enactment of the bill.

2. Expensing of costs for removal of architectural barriers to the handicapped and elderly

The bill reinstates on a permanent basis, effective for expenses incurred in taxable years beginning after 1985, the provision that allows the expensing of up to $35,000 of costs incurred in the removal of architectural and transportation barriers to the handicapped and elderly.

3. Reinstatement of rules for spouses of Vietnam MIA's

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

B. Exempt Organization Provisions

1. Exemption from unrelated business income tax for rental of mailing lists

The bill provides an exemption from the unrelated business income tax, in the case of tax-exempt organizations eligible to receive tax-deductible charitable contributions, for income from exchanges or rentals of donor or member lists with or to other such tax-exempt organizations, effective for transactions occurring after the date of enactment.

2. Tax-exempt status for certain title-holding companies

The bill adds a new category of section 501(c) tax-exempt organizations consisting of title-holding companies that have up to 35 related or unrelated tax-exempt organizations as shareholders or beneficiaries, if certain conditions are met. This provision is effective for taxable years beginning after 1986.

3. Divestiture exemption for certain grandfathered excess business holdings of foundations

The bill allows private foundations to retain "grandfathered" business holdings acquired prior to May 27, 1969, if certain conditions are met.

C. Cooperative Housing Corporations

Under the bill, the tax treatment of individuals owning stock in cooperative housing corporations is extended to corporations, trusts, and other entities that are stockholders. Also, the bill disallows maintenance and lease deductions by tenant-stockholders in situations where the amount paid by such stockholders is properly chargeable to the capital account of the cooperative. These provisions are effective for taxable years beginning after 1986.

Title XVIII. Technical Corrections

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

III. BUDGET EFFECT OF THE BILL

The following table presents estimated budget effects of the committee bill for fiscal years 1986–1991. The table gives amounts by title of the bill and by effect on individual, corporate, excise, employment, and estate and gift tax receipts (and outlays).

Over the six-year period, 1986–1991, the committee tax reform bill is estimated to be close to neutral, with a negative net budget effect of $952 million (or by less than 0.1 percent of total estimated tax revenues) over the six-year period.

Summary of Estimated Budget Effects of H.R. 3838, as Reported by the Committee on Finance, Fiscal Years 1986–1991

[Millions of dollars]

Title of Bill	1986	1987	1988	1989	1990	1991	1986–91
I. Individual Income Tax Provisions							
Individual		–12,242	–64,041	–65,653	–56,627	–58,069	–256,632
Corporate		652	1,109	1,263	1,474	1,628	6,126
Total		11,590	–62,932	–64,390	–55,153	–56,441	–250,506
II. Accelerated Cost Recovery System and Investment Tax Credit							
Individual	856	4,315	3,212	4,268	5,913	8,024	26,588
Corporate	7,398	18,377	17,017	22,464	28,724	36,767	130,747
Total	8,254	22,692	20,229	26,732	34,637	44,797	157,335
III. Accounting Provisions							
Individual		300	806	897	894	822	3,719
Corporate		7,238	11,188	10,918	10,489	10,126	49,959
Total		7,538	11,989	11,815	11,383	10,948	53,673
IV. Capital Gains							
Individual		(1)	(1)	(1)	(1)	(1)	(1)
V. Compliance and Tax Administration							
Individual		3,003	3,645	2,925	3,025	3,389	15,997

Corporate		817	1,989	2,750	3,069	3,335	11,960
Excise		4	4	4	4	4	20
Estate and Gift		4	4	4	4	4	20
Total		3,828	5,642	5,683	6,112	6,732	27,997
VI. Corporate and General Business Taxation							
Individual		−673	1,709	639	980	850	3,505
Corporate	−15	−7,616	−22,204	−30,025	−32,052	−33,355	−125,267
Employment		−561	−223	−35	78	−37	−778
Excise		(4)	68	75	82	90	315
Total	−15	−8,850	−20,650	−29,346	−30,912	−32,452	−122,225
VII. Agriculture, Energy, and Natural Resources							
Individual		10	34	14	13	16	87
Corporate	−152	−216	−71	26	38	27	−348
Employment		−15	−21	−24	−27	−29	−116
Excise	(2)	(2)	(2)	(2)	(2)	(2)	(3)
Customs		(4)	(4)	(4)	(4)	(4)	(3)
Total	−152	−221	−58	16	24	14	−377
VIII. Financial Institutions							
Individual		−3	−1	−1	−1	−1	−7
Corporate		55	28	......	16	49	148
Total		52	27	−1	15	48	141
IX. Foreign Tax Provisions							
Individual		24	34	45	56	61	220
Corporate		431	759	841	957	1,068	4,056
Total		455	793	886	1,013	1,129	4,276

Summary of Estimated Budget Effects of H.R. 3838, as Reported by the Committee on Finance, Fiscal Years 1986–1991—Continued

[Millions of dollars]

Title of Bill	1986	1987	1988	1989	1990	1991	1986-91
X. Insurance Products and Companies							
Individual		(4)	(4)	(4)	(4)	(4)	(3)
Corporate		1,059	1,968	2,052	2,144	2,163	9,386
Total		1,059	1,968	2,052	2,144	2,163	9,386
XI. Minimum Tax Provisions							
Individual		426	2,002	1,645	1,225	1,211	6,539
Corporate		3,877	6,947	7,207	7,318	7,979	33,328
Total		4,303	8,949	8,852	8,573	9,190	39,867
XII. Pensions and Deferred Compensation; Employee Benefits; ESOPs							
Individual		1,908	6,222	7,620	9,382	10,534	35,666
Corporate		1,101	955	269	117	40	2,482
Excise		−10	−10	30	30	30	70
Employment		−130	−112	−144	−166	−177	−729
Total		2,869	7,055	7,775	9,363	10,427	37,489

XIII. Research and Development							
Individual	−32	−91	−104	−118	−92	−23	−460
Corporate	−616	−1,733	−1,772	−1,735	−1,238	−654	−7,748
Total	−648	−1,824	−1,876	−1,853	−1,330	−677	−8,208
XIV. Tax Shelters; Real Estate; Interest Expense							
Individual		2,108	10,224	13,738	17,356	18,823	62,249
Corporate		−605	−2,276	−3,000	−3,552	−3,521	−12,954
Total		1,503	7,948	10,738	13,804	15,302	49,295
XV. Tax-Exempt Bonds							
Individual		−23	−127	−317	−475	−557	−1,499
Corporate		−2	−13	−29	−47	−65	−156
Total		−25	−143	−353	−533	−637	−1,691
XVI. Unearned Income of Minor Children; Income Taxation of Trusts and Estates; Estate and Gift Taxes							
Individual		1,727	841	602	645	694	4,509
Estate and Gift		−105	−26	(3)	(3)	(3)	−131
Total		1,622	815	602	645	694	4,378
XVII. Miscellaneous Tax Provisions							
Individual	−9	−48	−68	−29	−19	−28	−201
Corporate	−35	−163	−303	−252	−180	−152	−1,085
Total	−44	−211	−371	−281	−199	−180	−1,286

Summary of Estimated Budget Effects of H.R. 3838, as Reported by the Committee on Finance, Fiscal Years 1986-1991—Continued

[Millions of dollars]

Title of Bill	1986	1987	1988	1989	1990	1991	1986-91
XVIII. Technical Corrections							
Individual		−180	−24	−25	−27	−31	−287
Corporate		−206	−99	34	34	28	−209
Total		−386	−123	9	7	−3	−496
Totals:							
Individual	**815**	**561**	**−35,636**	**−33,750**	**−17,712**	**−14,295**	**−100,007**
Corporate	**5,580**	**23,066**	**15,214**	**12,776**	**17,300**	**25,448**	**100,384**
Excise		**−6**	**−62**	**109**	**116**	**124**	**405**
Employment		**−706**	**−356**	**−203**	**−115**	**−243**	**−1,623**
Estate and Gift		**−101**	**−225**	**4**	**4**	**4**	**111**
Customs		**([4])**	**([4])**	**([4])**	**([4])**	**([4])**	**([3])**
Grand Total	**7,395**	**22,814**	**−20,738**	**−21,064**	**−407**	**11,048**	**−952**

[1] The effects of changes relating to capital gains are included with rate changes in Title I.
[2] Loss of less than $5 million.
[3] Amounts have not been assigned to footnotes for summation purposes. Therefore, totals do not include estimates represented by footnotes.
[4] Gain of less than $5 million.