DESCRIPTION OF REVENUE PROVISIONS IN CHAIRMAN'S AMENDMENT IN THE NATURE OF A SUBSTITUTE TO H.R. 434, THE "AFRICAN GROWTH AND OPPORTUNITY ACT"

Scheduled for Markup

by the

HOUSE COMMITTEE ON WAYS AND MEANS

on June 10, 1999

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

June 9, 1999
JCX-25-99

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the modifications to the provisions of H.R. 434, the "African Growth and Opportunity Act," as ordered favorably reported by the Subcommittee on Trade of the House Committee on Ways and Means on February 3, 1999. These provisions are contained in the Chairman's amendment in the nature of a substitute to the bill, to be considered by the House Committee on Ways and Means on June 10, 1999.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Revenue Provisions in Chairman's Amendment in the Nature of a Substitute to H.R. 434, the "African Growth and Opportunity Act"* (JCX-25-99), June 9, 1999.

DESCRIPTION OF REVENUE PROVISIONS

The provisions contained in H.R. 434, the "African Growth and Opportunity Act," as ordered favorably reported by the Subcommittee on Trade on February 3, 1999, would be adopted. In addition, the following revenue offset provisions would be included in the bill.

A. Limit Use of Non-Accrual Experience Method of Accounting to Amounts to be Received for the Performance of Qualified Personal Services

Present Law

An accrual method taxpayer generally must recognize income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. An accrual method taxpayer may deduct the amount of any receivable that was previously included in income that becomes worthless during the year.

Accrual method taxpayers are not required to include in income amounts to be received for the performance of services which, on the basis of experience, will not be collected (the "non-accrual experience method"). The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

A cash method taxpayer is not required to include an amount in income until it is received. A taxpayer may not use the cash method if purchase, production, or sale of merchandise is a material income producing factor. Such taxpayers generally are required to keep inventories and use an accrual method of accounting. In addition, corporations (and partnerships with corporate partners) generally may not use the cash method of accounting if their average annual gross receipts exceed $5 million. An exception to this $5 million rule is provided for qualified personal service corporations, which are corporations (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting and (2) substantially all of whose stock is owned by current or former employees performing such services, their estates or heirs. Qualified personal service corporations are allowed to use the cash method without regard to whether their average annual gross receipts exceed $5 million.

Description of Proposal

The proposal would limit the use of the non-accrual experience method to amounts that are to be received for the performance of qualified personal services. Amounts to be received for the performance of all other services would be subject to the general rule regarding inclusion in income. Qualified personal services are personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. As under present law, the availability of the non-accrual experience method would be conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount.

Effective Date

The proposal would be effective for taxable years ending after the date of enactment. Any change in the taxpayer's method of accounting necessitated as a result of the proposal would be treated as a voluntary change initiated by the taxpayer with the consent of the Secretary of the Treasury. Any required section 481(a) adjustment would be taken into account over a period not to exceed four years under principles consistent with those in Rev. Proc. 98-60.[2]

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[2] 1998-51 I.R.B. 16.

B. Denial of Charitable Contribution Deduction for Transfers Associated With Charitable Split-Dollar Insurance Arrangements

Present Law

Under present law, in computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct charitable contributions paid during the taxable year. The amount of the deduction allowable for a taxable year with respect to any charitable contribution depends on the type of property contributed, the type of organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)). A charitable contribution is defined to mean a contribution or gift to or for the use of a charitable organization or certain other entities (sec. 170(c)). The term "contribution or gift" is not defined by statute, but generally is interpreted to mean a voluntary transfer of money or other property without receipt of adequate consideration and with denotive intent. If a taxpayer receives or expects to receive a quid pro quo in exchange for a transfer to charity, the taxpayer may be able to deduct the excess of the amount transferred over the fair market value of any benefit received in return, provided the excess payment is made with the intention of making a gift.[3]

In general, no charitable contribution deduction is allowed for a transfer to charity of less than the taxpayer's entire interest (i.e., a partial interest) in any property (sec. 170(f)(3)). In addition, no deduction is allowed for any contribution of $250 or more unless the taxpayer obtains a contemporaneous written acknowledgment from the donee organization that includes a description and good faith estimate of the value of any goods or services provided by the donee organization to the taxpayer in consideration, whole or part, for the taxpayer's contribution (sec. 170(f)(8)).

Description of Proposal

Deduction denial

The proposal[4] would restate present law to provide that no charitable contribution deduction is allowed for purposes of Federal tax, for a transfer to or for the use of an organization described in section 170(c) of the Internal Revenue Code, if in connection with the transfer (1) the organization directly or indirectly pays, or has previously paid, any premium on any "personal benefit contract" with respect to the transferor, or (2) there is an understanding or expectation that any person will directly or indirectly pay any premium on any "personal benefit contract" with respect to the transferor. It would be intended that an organization be considered as indirectly paying premiums if, for example, another person pays premiums on its behalf.

A personal benefit contract with respect to the transferor would be any life insurance,

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[3] United States v. American Bar Endowment, 477 U.S. 105 (1986). Treas. Reg. sec. 1.170A-1(h).

[4] The proposal is similar to H.R. 630, introduced on February 9, 1999, by Mr. Archer and Mr. Rangel (106th Cong., 1st Sess.).

annuity, or endowment contract, if any direct or indirect beneficiary under the contract is the transferor, any member of the transferor's family, or any other person (other than a sec. 170(c) organization) designated by the transferor. For example, such a beneficiary would include a trust having a direct or indirect beneficiary who is the transferor or any member of the transferor's family, and would include an entity that is controlled by the transferor or any member of the transferor's family. It would be intended that a beneficiary under the contract include any beneficiary under any side agreement relating to the contract. If a transferor contributes a life insurance contract to a section 170(c) organization and designates one or more section 170(c) organizations as the sole beneficiaries under the contract, generally, it would not be intended that the deduction denial rule under the proposal apply. If, however, there is an outstanding loan under the contract upon the transfer of the contract, then the transferor would be considered as a beneficiary. The fact that a contract also has other direct or indirect beneficiaries (persons who are not the transferor or a family member, or designated by the transferor) would not prevent it from being a personal benefit contract. The proposal would not be intended to affect situations in which an organization pays premiums under a legitimate fringe benefit plan for employees.

It would be intended that a person be considered as an indirect beneficiary under a contract if, for example, the person receives or will receive any economic benefit as a result of amounts paid under or with respect to the contract. For this purpose, as described below, an indirect beneficiary would not be intended to include a person that benefits exclusively under a bona fide charitable gift annuity (within the meaning of sec. 501(m)).

In the case of a charitable gift annuity, if the charitable organization purchases an annuity contract issued by an insurance company to fund its obligation to pay the charitable gift annuity, a person receiving payments under the charitable gift annuity would not be treated as an indirect beneficiary, provided certain requirements are met. The requirements would be that: (1) the charitable organization possess all of the incidents of ownership (within the meaning of Treas. Reg. sec. 20.2042-1(c)) under the annuity contract purchased by the charitable organization; (2) the charitable organization be entitled to all the payments under the contract; and (3) the timing and amount of payments under the contract be substantially the same as the timing and amount of payments to each person under the organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

In the case of a charitable gift annuity obligation that is issued under the laws of a State that requires, in order for the charitable gift annuity to be exempt from insurance regulation by that State, that each beneficiary under the charitable gift annuity be named as a beneficiary under an annuity contract issued by an insurance company authorized to transact business in that State, then the foregoing requirements (1) and (2) would be treated as if they are met, provided that certain additional requirements are met. The additional requirements would be that the State law requirement was in effect on February 8, 1999, each beneficiary under the charitable gift annuity is a bona fide resident of the State at the time the charitable gift annuity was issued, the only persons entitled to payments under the annuity contract issued by the insurance company are persons entitled to payments under the charitable gift annuity when it was issued, and (as required by clause (iii) of subparagraph (D) of the proposal) the timing and amount of payments under the annuity contract to each person are substantially the same as the timing and amount of payments to the person under the charitable organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

In the case of a charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)) that holds a life insurance, endowment or annuity contract issued by an insurance company, a person would not be treated as an indirect beneficiary under the contract held by the trust, solely by reason of being a recipient of an annuity or unitrust amount paid by the trust, provided that the trust possesses all of the incidents of ownership under the contract and is entitled to all the payments under such contract. No inference would be intended as to the applicability of other provisions of the Code with respect to the acquisition by the trust of a life insurance, endowment or annuity contract, or the appropriateness of such an investment by a charitable remainder trust.

Nothing in the proposal would be intended to suggest that a life insurance, endowment, or annuity contract would be a personal benefit contract, solely because an individual who is a recipient of an annuity or unitrust amount paid by a charitable remainder annuity trust or charitable remainder unitrust uses such a payment to purchase a life insurance, endowment or annuity contract, and a beneficiary under the contract is the recipient, a member of his or her family, or another person he or she designates.

Excise tax

The proposal would impose on any organization described in section 170(c) of the Code an excise tax, equal to the amount of the premiums paid by the organization on any life insurance, annuity, or endowment contract, if the premiums are paid in connection with a transfer for which a deduction is not allowable under the deduction denial rule of the proposal (without regard to when the transfer to the charitable organization was made). The excise tax would not apply if all of the direct and indirect beneficiaries under the contract (including any related side agreement) are organizations described in section 170(c). Under the proposal, payments would be treated as made by the organization, if they are made by any other person pursuant to an understanding or expectation of payment. The excise tax is to be applied taking into account rules ordinarily applicable to excise taxes in chapter 41 or 42 of the Code (e.g., statute of limitation rules).

Reporting

The proposal would require that the charitable organization annually report the amount of premiums that is paid during the year and that is subject to the excise tax imposed under the proposal, and the name and taxpayer identification number of each beneficiary under the life insurance, annuity or endowment contract to which the premiums relate, as well as other information required by the Secretary of the Treasury. For this purpose, it would be intended that a beneficiary include any beneficiary under any side agreement to which the section 170(c) organization is a party (or of which it is otherwise aware). Penalties applicable to returns required under Code section 6033 would apply to returns under this reporting requirement. Returns required under this proposal would have to be furnished at such time and in such manner as the Treasury Secretary shall by forms or regulations require.

Regulations

The proposal would provide for the promulgation by the Treasury Secretary of regulations necessary or appropriate to carry out the purposes of the proposal, including regulations to prevent the avoidance of the purposes of the proposal. For example, it would be intended that regulations prevent avoidance of the purposes of the proposal by inappropriate or improper reliance on the limited exceptions provided for certain beneficiaries under bona fide charitable gift annuities and for certain noncharitable recipients of an annuity or unitrust amount paid by a charitable remainder trust.

Effective Date

The deduction denial proposal would apply to transfers after February 8, 1999 (as provided in H.R. 630). The excise tax proposal would apply to premiums paid after the date of enactment. The reporting proposal would apply to premiums paid after February 8, 1999 (determined as if the excise tax imposed under the proposal applied to premiums paid after that date).

No inference would be intended that a charitable contribution deduction is allowed under present law with respect to a charitable split-dollar insurance arrangement. The proposal would not change the rules with respect to fraud or criminal or civil penalties under present law; thus, actions constituting fraud or that are subject to penalties under present law would still constitute fraud or be subject to the penalties after enactment of the proposal.