[JOINT COMMITTEE PRINT]

DESCRIPTION OF MISCELLANEOUS REVENUE PROPOSALS

SCHEDULED FOR HEARINGS

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON SEPTEMBER 8, 21, AND 23, 1993

AND THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON SEPTEMBER 9, 1993

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled public hearings on various miscellaneous revenue proposals on September 8, 21, and 23, 1993. The full Committee on Ways and Means held a public hearing on the financing of health benefits for retired coal miners on September 9, 1993.

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and the proposals, based on proposals submitted to Chairman Rostenkowski by Members of the Committee on Ways and Means.

Part I of the pamphlet describes additional revenue-reducing proposals;[2] Part II describes the revenue-raising proposals included for the hearings; and Part III describes revenue-related proposals concerning the financing of health benefits for retired coal miners (September 9 hearing).

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Miscellaneous Revenue Proposals* (JCS-12-93), September 16, 1993.

[2] See also prior staff pamphlet: Joint Committee on Taxation, *Description of Miscellaneous Tax Proposals* (JCS-8-93), June 16, 1993.

DESCRIPTION OF PROPOSALS

I. MISCELLANEOUS REVENUE REDUCING PROPOSALS

A. Alternative Minimum Tax

1. Use of the 200-percent declining balance depreciation method for automobiles for alternative minimum tax purposes

Present Law

A taxpayer is subject to an alternative minimum tax (AMT) to the extent that the taxpayer's tentative minimum tax exceeds the taxpayer's regular income tax liability. A taxpayer's tentative minimum tax is calculated by applying the AMT rate to the excess of the taxpayer's alternative minimum taxable income over an exemption amount. Alternative minimum taxable income (AMTI) is the taxpayer's taxable income increased by certain tax preferences and modified by certain adjustments to negate the deferral of income resulting from the regular tax treatment of those items.

One of the adjustments that is made to taxable income to arrive at AMTI relates to depreciation. For AMT purposes, depreciation on most personal property placed in service after 1993 is calculated using the 150-percent declining balance method (switching to straight line in the year necessary to maximize the deduction) over the property's class life.[3] The class lives of property generally are longer than the recovery periods allowed for regular tax purposes.

For automobiles, the recovery period for regular tax purposes and the class life for AMT purposes are both five years. For regular tax purposes, automobiles are depreciated using the 200-percent declining balance method over 5 years. For alternative minimum tax purposes, automobiles are depreciated using the 150-percent declining balance method over 5 years.

Description of Proposal

For both AMT and regular tax purposes, taxpayers would compute depreciation for automobiles by using the 200-percent declining balance method over a period of 5 years.

Effective Date

The proposal would be effective for property placed in service after December 31, 1993.

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[3] For property placed in service by a corporation after 1986 and before 1994, AMT depreciation is computed twice—once using the 150-percent declining balance method over the property's class life, and again (for the "ACE adjustment") using the straight-line method over the class life. The Omnibus Budget Reconciliation Act of 1993 repealed the ACE adjustment for property placed in service after 1993.

B. Financial Institutions

1. Deductibility of bad debt losses of nonbank lending institutions

Present Law

Bad debt deductions of taxpayers that are not banks

Taxpayers are permitted a deduction for any debt that is acquired or incurred in the taxpayer's trade or business that becomes wholly or partially worthless (the "specific charge-off method").[4] In determining whether a debt is worthless in whole or in part, all pertinent evidence, including the value of any collateral and the financial condition of the debtor, are to be taken into account.[5]

Bad debt deductions of banks

All banks are allowed a deduction for bad debts under the specific charge-off method. In addition, a commercial bank whose average adjusted bases of all assets does not exceed $500 million (i.e., a "small bank") also is allowed a deduction for a reasonable addition to a reserve for bad debts.[6] The reasonable addition to the reserve is an amount computed on the basis of a moving six-year average of the loans that became worthless in those years (the "experience method").

Under Treasury Regulations, in the case of a bank or other corporation which is subject to supervision by Federal authorities or by State authorities maintaining substantially equivalent standards, debts that are charged off are conclusively presumed to have become worthless. In order to sustain this presumption, the bank must have (1) received a specific order from its regulatory authority to charge off the debt or written confirmation of the charge-off in the next audit, or (2) elected a "tax-book" conformity method of accounting for bad debts and received an express determination letter from the appropriate Federal banking agency affirming that the bank's loan loss classification standards were consistent with regulatory standards.[7]

Description of Proposal

In the case of a nonbank lending institution the stock of which is publicly traded that has a high volume of low balance, homogeneous loans, a loan of that type would be presumed worthless no later than the time it would be determined worthless under the regulatory criteria applicable to regulated depository institutions, such as banks and thrift institutions, so long as the loan has been written off for financial accounting purposes.

Effective Date

The proposal would be effective losses on loans occurring in taxable years beginning after the date of enactment of the provision.

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[4] Code sec. 166.
[5] Treas. Reg. sec. 1.166-2(a).
[6] Code sec. 585.
[7] Treas. Reg. secs. 1.166-2(d) and 1.166-2T(a).

C. Insurance

1. Extension of tax and loss bond treatment applicable to mortgage and lease guarantee insurance and insurers of State and local obligations

Present Law

A property and casualty insurance company generally is subject to tax on its taxable income, meaning its gross income less allowable deductions. A special deduction for additions to State-required reserves for adverse economic cycles is allowed with respect to certain types of insurance business, provided the company purchases "tax and loss bonds" in the amount of the tax benefit attributable to the special deduction, and restores to income the amount of the special deduction at the close of 10 years (or 20 years for certain insurance) (sec. 832(e)).

The special deduction is allowed with respect to mortgage guaranty insurance, lease guaranty insurance, and insurance on obligations the interest on which is excludable from gross income under Code section 103 (tax-exempt obligations). The amount of the deduction is generally the sum of (1) the amount required by State law or regulation to be set aside in a reserve for losses resulting from adverse economic cycles, including losses from declining revenues related to tax-exempt obligations, and (2) the amount so set aside for the preceding eight taxable years to the extent not already deducted. The amount treated as set aside in a reserve under (1) above may not exceed 50 percent of the company's premiums earned during the taxable year. The amount of the special deduction may not exceed taxable income (computed without regard to the special deduction or to any net operating loss carryback). The special deduction is not allowed, however, unless the company purchases "tax and loss" Federal Government bonds in the amount of the tax benefit of the deduction. These bonds are noninterest bearing, nontransferable and redeemable when the amount deducted under the provision is restored to income. The amount of the special deduction for any taxable year is restored to income no later than the tenth following year (or, in the case of insurance of tax-exempt obligations, the twentieth following year).

Description of Proposal

The proposal would extend the special deduction and requirements of section 832(e) (including the requirement to purchase tax and loss bonds) to any financial guaranty insurance regardless of whether the insured obligations are obligations the interest on which is excludable from gross income under Code section 103. Thus, the proposal would apply to the extent the financial guaranty insurer is required under State law or regulation to set aside amounts in a reserve for losses resulting from adverse economic cycles, including losses from declining revenues related to the insured obligations.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1993, with transition rules similar to those that applied upon original enactment of section 832(e).

2. Treatment of policy acquisition expenses with respect to certain accident and health insurance contracts

Present Law

Present law provides that specified policy acquisition expenses of an insurance company are required to be capitalized and amortized ratably generally over a 120-month period (sec. 848). A special rule provides that an insurance company's first $5,000,000 of specified policy acquisition costs may be amortized ratably over 60 months rather than 120 months; the $5,000,000 amount is phased out ratably for insurance companies with specified policy acquisition expenses exceeding $10,000,000 and is reduced to zero when such expenses exceed $15,000,000. In the case of a controlled group (defined to include non-insurance and insurance members, including certain foreign insurance members), all insurance company members are treated as one company.

Specified policy acquisition expenses are determined as a percentage of net premiums for each of three categories of specified insurance contracts. Specified insurance contracts means any life insurance, annuity, or noncancellable accident and health insurance contract or combination thereof (excluding pension plan contracts, flight insurance or similar contracts, and certain foreign contracts). For annuity contracts, the percentage is 1.75; for group life insurance contracts, the percentage is 2.05; and for other specified insurance contracts, the percentage is 7.7. Specified policy acquisition expenses may not exceed the company's general deductions for the taxable year.

The provision grants the Treasury Secretary authority to provide that a type of insurance contract is treated as a separate category for purposes of the provision (and to prescribe a percentage applicable to such category), if the Secretary determines that the deferral of acquisition expenses for such type of contract that would otherwise result under the provision is substantially greater than the deferral of acquisition expenses that would have resulted if actual acquisition expenses (including indirect expenses) and the actual useful life for such type of contract had been used. If this authority is exercised with respect to any type of contract, the Secretary is required to adjust the percentage that would otherwise have applied under the provision to the category which includes such type of contract so that the exercise of such authority does not result in a decrease in the amount of revenue received for any fiscal year.

Description of Proposal

The proposal would provide that certain employer-sponsored noncancellable accident and health insurance group contracts would be treated as group life insurance contracts. Thus, the percentage of net premiums that would be treated as specified policy

acquisition expenses would be changed from 7.7 percent to 2.05 percent for such contracts.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1993.

D. Employee Benefits

1. Tax-credit employee stock ownership plans

Present Law

An employee stock ownership plan (ESOP) is a qualified stock bonus plan or a combination of a stock bonus and a money purchase pension plan which is designed to invest primarily in securities of the employer. An ESOP is subject to the same rules generally applicable to tax-qualified retirement plans. In addition, some special rules and tax benefits apply to ESOPs that do not apply to other tax-qualified retirement plans. Within limits, an employer is entitled to a deduction for contributions made to a tax-qualified retirement plan, including an ESOP.

Under prior law, an employer could obtain a tax credit in lieu of a deduction for certain contributions to an ESOP. Initially, the credit was based upon qualified investment by the employer, and was later changed to a payroll-based credit by the Economic Recovery Act of 1981.

Under the payroll-based credit, for taxable years beginning after December 31, 1982, an employer was entitled to a credit for contributions to a tax-credit ESOP up to one-half of one percent of the aggregate compensation of all employees participating in the plan. The amount of the credit was scheduled to increase to 0.75 percent of compensation for years beginning in 1985, 1986, and 1987. The scheduled increase in the amount of the credit was repealed by the Deficit Reduction Act of 1984, and the credit was repealed entirely by the Tax Reform Act of 1986, with respect to compensation paid or accrued after December 31, 1986. The amount of the employer's tax liability that could be offset by the payroll-based tax credit was limited to the first $25,000 of tax liability, plus 90 percent of the excess over $25,000.

In order to qualify as a tax-credit ESOP, the ESOP was required to meet certain requirements. For example, a tax-credit ESOP was required to provide that each participant had a nonforfeitable right to amounts allocated to his or her account. In addition, no more than $100,000 of a participant's compensation could be taken into account under the plan. Employer securities allocated to participant accounts could not be distributed within 84 months after the month in which the securities were allocated. The 84-month rule did not apply in the case of death, disability, separation, termination of the plan, or certain corporate transactions. Other requirements also applied.

Description of Proposals

(1) Reinstate the 0.75 percent payroll-based tax credit for contributions to a tax-credit ESOP.

(2) Same as (1), except provide that no more than $60,000 of a participant's compensation could be taken into account.

(3) Same as (1), except that the credit would be limited to the compensation of nonhighly compensated employees. Only nonhighly compensated employees would be entitled to an allocation under the tax-credit ESOP.

(4) Same as (1), but provide that amounts in the tax-credit ESOP must be distributed to the participant within 4 years of contribution by the employer. The present-law rules regarding taxation of distributions would apply.

(5) Limit the amount of the credit to 0.5 percent of compensation.

Effective Date

The proposals would be effective for taxable years beginning after December 31, 1993.

2. Permit ESOPs to prohibit rollover of in-service distributions

Present Law

Under present law, a distribution of benefits from a qualified pension plan generally is includible in income in the year in which it is paid or distributed except to the extent that the amount distributed represents the employee's investment in the contract (i.e., basis). An additional 10-percent tax may apply if the distribution is made before the employee is age 59 1/2. If the distribution is an eligible rollover distribution, it can be rolled over tax free to an individual retirement arrangement (IRA) or another qualified pension plan or annuity. An eligible rollover distribution is all or any portion of a taxable distribution from a qualified pension plan that is not (1) one of a series of substantially equal periodic payments made (a) over the life (or life expectancy) of the employee or the joint lives (or life expectancies) of the employee and the employee's beneficiary, or (b) for a specified period of 10 years or more, and (2) a minimum required distribution (sec. 401(a)(9)). A plan is required to give the employee the option of directly rolling over an eligible rollover distribution. These distribution rules apply to all qualified pension plans, including employee stock ownership plans (ESOPs), and to all contributions to (and earnings under) such plans, including employer contributions, employee contributions, and elective deferrals.

Under both the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA), as amended, amendments to qualified pension plans which reduce or eliminate certain protected benefits are prohibited. Protected benefits include a participant's accrued benefit as of the later of the amendment's adoption date or effective date. Protected benefits also include early retirement benefits, retirement-type subsidies, and optional forms of benefit. An optional form of benefit is a distribution form with respect to a participant's benefit under the plan. A distribution of

benefits while a participant is still employed by an employer (in-service distribution) is an optional form of benefit that cannot be eliminated with respect to existing account balances.

Under present law, ESOPs are required to permit participants who have attained age 55 and 10 years of plan participation to diversify the portion of their account balance which is invested in employer securities. Under these diversification rules, the ESOP must offer the participant an opportunity to either transfer his or her investment in employer securities to other investment funds or must distribute the employer securities.

Description of Proposal

The proposal would permit an ESOP to provide that in-service distributions of employer securities attributable to employer contributions other than elective deferrals are not eligible rollover distributions. The proposal would not apply to distributions of employer securities under the diversification rules of present law. The proposal would provide that ESOPs which restrict the availability of rollover treatment in this way do not violate the rules prohibiting the reduction or elimination of protected benefits.

Effective Date

The proposal would be effective for in-service distributions of employer securities made after December 31, 1993.

3. Rollover of military separation pay (H.R. 2617)

Present Law

Sections 1174 and 1174a of title 10 of the United States Code provide for payment to military officers and enlisted personnel upon involuntary separation from the armed services.

Any part of the taxable portion of a distribution from a qualified pension or annuity plan or a tax-sheltered annuity (other than a minimum required distribution) can be rolled over tax free to an individual retirement arrangements (IRA) or another qualified plan or annuity, unless the distribution is one of a series of substantially equal periodic payments made (1) over the life or life expectancy of the individual (or the joint lives or life expectancies of the individual and his or her beneficiary), or (2) over a specified period of 10 years or more.

Distribution from other types of plans (e.g., nonqualified deferred compensation plans) or other types of payments (e.g., severance payments) are not eligible for such tax-free rollover treatment.

Description of Proposal

The Military Separation Retirement Benefits Act of 1993 (H.R. 2617) would provide that military separation pay, as defined in section 1174 or 1174a of title 10 of the United States Code, may be rolled over tax free to an IRA within 60 days of receipt.

Effective Date

The bill would be effective for pay received after December 5, 1991. In the case of a payment received after December 5, 1991, and before the date of enactment, the rollover could be made within one year after the date of enactment.

E. Individual Income Tax

1. Increase eligible income level for performing artist employee exemption from the limitation on deduction for unreimbursed business expenses

Present Law

In general, a taxpayer may deduct all ordinary and necessary expenses paid or incurred during the taxable year (1) in carrying on any trade or business and (2) in the case of an individual, for the production of income. Such deductible expenses may include expenses of providing services as an employee.

In general, business expenses other than unreimbursed employee business expenses may be deducted in computing adjusted gross income (AGI) and are not subject to the 2-percent of AGI floor on miscellaneous itemized deductions. Expenses for the production of income other than rental or royalty income (e.g., unreimbursed employee business expenses) are generally deductible as an itemized deduction from AGI (if the activity does not constitute a trade or business) and are subject to the 2-percent floor on miscellaneous itemized deductions.

A qualified performing artist may take a deduction in computing AGI for expenses paid or incurred in connection with performance of services in the performing arts (even if such expenses are unreimbursed). To qualify as a performing artist, a taxpayer must (1) perform services in the performing arts for at least two employers[8] during the taxable year, (2) have an aggregate amount of business deductions in connection with the performance of such services in excess of 10 percent of the taxpayer's income from such services, and (3) have an AGI (determined prior to application of this provision) of no more than $16,000.

If the taxpayer is married and does not live apart from his or her spouse at all times during the taxable year, then the taxpayer must file a joint return in order to take the deduction in computing AGI as a qualified performing artist. If both spouses are performing artists, the tests in (1) and (2), above, are applied separately to each spouse. The AGI threshold is applied to the couple's combined AGI in determining whether the spouses are qualified performing artists.

Description of Proposal

The proposal would increase from $16,000 to $36,000 the AGI threshold for determining eligibility for the deduction in computing AGI for expenses of a qualified performing artist.

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[8] An employer from whom the performing artist received less than $200 for services during the taxable year is not treated as an employer for purposes of meeting the two-employer test.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1993.

2. Treatment of certain military disability severance payments (H.R. 2971)

Present Law

An individual who receives payments for personal injuries or sickness resulting from active service in the armed forces can exclude such amounts from gross income if (1) the individual was entitled to receive such payments on or before September 24, 1975, (2) on September 24, 1975, the individual was a member of the armed services or under a binding written commitment to enter the armed services, (3) the payments were received as a result of a combat-related injury, or (4) the individual would be entitled to receive disability compensation from the Veteran's Administration. The amount excludable under this provision cannot be less than the maximum amount of disability compensation the individual would be entitled to receive from the Veteran's Administration.

Description of Proposal

The bill (H.R. 2971) would permit individuals who included military disability severance payments in income to seek a refund even though the statute of limitations has passed. Under the bill, if an individual included in gross income a lump-sum severance payment which was received on account of personal injuries or sickness resulting from active service in the armed forces and such payment is excludable from gross income, the individual may make a claim for refund within one year after the date of enactment of the proposal.

Effective Date

The bill would be effective on the date of enactment.

F. Tax-Exempt Bonds

1. Certain airport, dock and wharf facilities

Present Law

Interest on State and local government bonds generally is exempt from the regular Federal income tax. However, interest on private activity bonds is taxable, unless the private activity that the bonds are issued to finance is specifically identified in the Code. Private activity bonds are bonds for which more than a specified minimum amount of the proceeds is used in a trade or business of an entity other than a State or local government or is used to make loans to nongovernmental entities. Most tax-exempt private activity bonds are subject to annual, per capita State volume limitations.

Tax-exempt private activity bonds may be issued to finance certain governmentally owned airport, dock and wharf facilities. Unlike most other tax-exempt private activity bonds, however, these

bonds are not subject to the annual State private activity bond volume limitations. Airport, dock and wharf facilities financed with these bonds are limited to airports, docks, wharves, and related warehouses and infrastructure.

Description of Proposal

The proposal would expand the property eligible for tax-exempt bond financing as an airport, dock or wharf facility in two respects. First, the definition of port facility would be expanded to include all transportation facilities (including railroad track and other facilities) used for transport of cargo or passengers, at least 80 percent of which is destined for (or departing from) a qualified airport, dock or wharf facility.

Second, the requirement that all tax-exempt bond financed airport, dock, or wharf facilities be governmentally owned would be waived.

The proposal would not alter the present-law rule exempting private activity bonds for airport, dock and wharf facilities from the State private activity bond volume limitations.

Effective Date

The proposal would be effective for bonds issued after December 31, 1993.

G. Tax-Exempt Entities

1. Permit a qualified scholarship funding corporation to transfer assets and debts to a for-profit corporation without causing tax-exempt bond interest to be taxable

Present Law

Qualified scholarship funding corporations

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

Qualified student loan bonds

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

Qualified student loan bonds are obligations that are part of an issue all, or a major portion, of the proceeds of which are used, directly or indirectly, to finance loans to students who meet certain requirements. Such loans must be made under a program of general application to which the Higher Education Act of 1965 applies

and with respect to which special allowance payments (SAP) under the Higher Education Act of 1965 are authorized. In addition, the program must restrict the maximum amount of loans that may be outstanding to any student and the maximum rate of interest payable on any loan, and the loans must be guaranteed by the Federal government. Finally, the financing of loans under the program must not be limited by Federal law to the proceeds of tax-exempt bonds.

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

Arbitrage restrictions and rebate requirement

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

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

Private foundation excess business holding restrictions

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

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

Description of Proposal

The proposal would provide that a nonprofit student loan funding corporation may elect to cease status as a qualified scholarship funding corporation. If the corporation meets the requirements outlined below, such an election will not cause any bond outstanding as of the date of the issuer's election and any bond issued to refund such a bond to fail to be a qualified student loan bond. Accordingly,

the interest on such bonds would remain tax-exempt to the bondholders.

First, the issuer must transfer all of the student loan notes to another, taxable, corporation in exchange for all of the stock of such corporation within a reasonable period of time after the election is made. Such transfer must be structured so as to ensure that the value of all charitable assets transferred to the taxable corporation (i.e., the assets of the issuer) is preserved for charitable purposes. The transferee corporation must assume or otherwise provide for the payment of all the qualified scholarship funding bond indebtedness of the issuer within a reasonable period after the election. In addition, to the extent permitted by law, the transferee corporation must assume all of the responsibilities and succeed to all of the rights of the issuer under the issuer's agreements with the Secretary of Education with respect to student loans. Further, the issuer must have the right to require the transferee corporation to redeem stock held by the issuer not later than ten years after the date of the election.

After the transfer, the issuer must operate as an exempt educational organization under section 501(c)(3) and be exempt from tax under section 501(a). As such, the issuer would not be authorized to issue any new bonds. While refunding of existing bonds may occur, because a qualified scholarship funding corporation would no longer exist, any bonds issued to refund such bonds must be issued by a governmental entity.

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

Once made, an election may be revoked only with the consent of the Secretary of Treasury.

Effective Date

The proposal would be effective on the date of enactment.

2. Provide favorable tax treatment for preservation of civic assets by community trusts

Present Law

Rules generally applicable to charitable organizations

To qualify as a charitable tax-exempt organization described in section 501(c)(3), an organization must be organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. No part of the net earnings of the organization may inure to the benefit of any private shareholder or individual. In addition, no substantial part of the activities of a 501(c)(3) organization may consist of carrying on propaganda, or otherwise attempting to influence legislation, and such organization may not

participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office.

Although tax-exempt organizations are not subject to Federal income tax on income related to their exempt purposes, they are subject to tax on certain unrelated business income under section 501(b). Section 512 defines unrelated business taxable income as gross income derived by an organization from any unrelated trade or business that it regularly carries on, less permissible deductions which are directly connected with such trade or business.

Under section 170, contributions to a qualified charitable organization are deductible for Federal income tax purposes, subject to certain limitations. Similarly, sections 2055 and 2522 provide that charitable contributions are deductible in determining Federal estate and gift tax liability.

Special rules for community trusts

Community trusts are particular types of organizations described in Code section 501(c)(3) that also meet the requirements of section 1.170A-9(e)(11) of the Treasury Regulations. Community trusts have often been established to attract large contributions of a capital or endowment nature for the benefit of a particular community or area.[9] As publicly supported charities, community trusts are not subject to the special rules applicable to private foundations, such as the prohibition against self-dealing and a tax on net investment income, and contributions to such organizations are subject to the general 50-percent of contribution base deduction limitation rather than the 30-percent limitation applicable to contributions to private foundations.

Treasury Regulations provide that a community trust must be "publicly supported," operate under a common name, a common governing instrument, and a common governing body.[10] In addition, transfers of assets to community trusts may not be directly subjected by the transferor to any material condition or restriction with respect to the transferred assets. Treasury regulations provide that the existence of a material restriction or condition is determined based on the facts and circumstances of a transfer, and set forth certain significant factors to be considered in making such a determination.[11]

In general, an organization will be treated as "publicly supported" if (a) it normally receives at least one-third of its total amount of support (including exempt function income) from governmental sources and the general public, or (b) it normally receives a substantial part (at least 10 percent) of its total amount of support (excluding exempt function income) from governmental sources and the general public.[12] In determining whether an organization satisfies one of the above public-support tests, contributions from any single member of the general public generally are taken into account only to the extent such contributions do not exceed two

[9] Treas. Reg. sec. 1.170A-9(e)(10).
[10] Treas. Reg. secs. 1.170A-9(e)(10) and (11).
[11] Treas. Reg. sec. 1.507-2(a)(8). In general, under section 507(b)(1)(A), a private foundation may terminate its status as such if it distributes all of its net assets to one or more organizations described in section 170(b)(1)(A), subject to certain restrictions.
[12] Treas. Reg. secs. 1.170A-9(e)(2) and (3).

percent of the organization's total support for the period.[13] However, substantial contributions or bequests from a member of the general public that are attracted by reason of the publicly supported nature of the organization, are unusual or unexpected with respect to the amount thereof, and which would, by reason of their size, adversely affect the status of the recipient organization as being publicly supported, may be disregarded for purposes of applying the 2-percent limitation.[14]

Description of Proposal

The proposal would provide that activities of a community trust in fostering the retention of a civic asset would be considered to be activities described in section 501(c)(3). Contributions of a civic asset (including the stock of a corporation that owns the civic assets) or any portion thereof, to a community trust would be deductible only for Federal estate and gift tax purposes, and not for Federal income tax purposes. Contributions of money or property (other than a civic asset) to a community trust to assist the trust in activities fostering the retention of a civic asset would be deductible for Federal income tax and Federal estate and gift tax purposes.

The term "civic asset" would be defined to mean a facility, enterprise, or activity which (1) has a long-standing association and identification with the community, (2) provides recreational, entertainment or cultural services to the community, and (3) enhances the economic well-being of the community. Examples of civic assets would be cultural activities, entertainment activities, recreational facilities, sporting activities, and ethnic festivals. A period of at least 20 years generally would be considered a long-standing association with a community.

Activities to foster the preservation of a civic asset would include (but not be limited to) investments in a civic asset, but would not include purchases of a civic asset from a third party.

A contribution of a civic asset to a community trust would be considered an "unusual grant" for purposes of determining whether the trust is a publicly supported organization. Where a private foundation or other donor conditions the contribution to a community trust on the use of the contribution for the purpose of fostering the preservation of a civic asset, or restricts the control of the community trust over the civic asset, including the ability to sell the civic asset or to obtain financial information regarding its operation, such condition or restriction would not constitute a material restriction or condition or affect or change the character or value of the contribution.

The proposal would not apply in cases in which any person (or related person) who makes a contribution of a civic asset to a community trust, or who makes a contribution of cash or other property to a community trust to help foster the preservation of such asset, controls the asset after such contribution. Under the proposal, net income derived from the operation of a civic asset by a

[13] Treas. Reg. sec. 1.170A-9(e)(6).
[14] Treas. Reg. sec. 1.170A-9(e)(6)(ii).

community trust would be subject to income taxation as unrelated business taxable income.

Effective Date

The proposal would be effective with respect to activities of community trusts, and transfers to community trusts, after the date of enactment. Such transfers generally would include transfers of civic assets made after the effective date pursuant to testamentary instruments of decedents dying prior to the effective date if such instruments required such civic assets to be transferred to a charitable beneficiary.

H. Employment Taxes

1. Eliminate statutory employee rule for bakery distributors

Present Law

Under present law, the determination of whether an individual is an employee for employment tax purposes is made under a common-law test. Under this test, an employer-employee relationship exists if the person contracting for the services has the right to control not only the result of the services, but also the means by which that result is accomplished. Whether the requisite control exists is determined based on the facts and circumstances. The Internal Revenue Service uses a 20-factor test for this purpose.

However, a statutory rule provides that an individual who performs ongoing services as an agent-driver or commission-driver engaged in distributing bakery products is treated as an employee for employment tax purposes, unless the bakery distributor has a substantial investment in facilities used in connection with the performance of such services (other than in facilities for transportation).[15] This provision also applies to distributors of meat, vegetable, fruit, and beverage (other than milk) products, as well as to distributors of laundry and dry cleaning services.

Description of Proposal

The proposal would repeal the present-law rule deeming bakery distributors to be employees for employment tax purposes. Therefore, whether such individuals are employees for employment tax purposes would be determined under the common-law test.

Effective Date

The proposal would be effective on the date of enactment.

2. Treat State universities and agency accounts as related corporations for FICA tax purposes

Present Law

Under the Federal Insurance Contributions Act (FICA), a tax is imposed on employees and employers up to a maximum amount of

[15] This provision does not apply for Federal income tax purposes. Thus, whether such a person is an employee for Federal income tax purposes is determined under the common-law test.

employee wages. The tax is comprised of two parts: old-age, survivor and disability insurance (OASDI) and hospital insurance (HI). For wages paid in 1993 to covered employees, the OASDI tax rate is 6.2 percent on both the employer and the employee on the first $57,600 of wages and the HI tax rate is 1.45 percent on both the employer and the employee on the first $135,000 of wages. The Omnibus Budget Reconciliation Act of 1993 repealed the dollar limit on wages subject to HI taxes for wages received after December 31, 1993.

In any calendar year, the cap on wages subject to FICA applies separately to the wages received from each employer of the employee unless a statutory exception applies. Section 3121(s) of the Internal Revenue Code provides a statutory exception to the separate application of the FICA wage caps if related corporations concurrently employ the same individual and compensate that individual through a common paymaster. Related corporations can treat an employee as if he or she has only one employer for FICA tax purposes. Thus, FICA taxes are paid on the total wages received by the employee from all related corporations up to the applicable wage cap.

Corporations are considered related for these purposes for an entire calendar quarter if, at any time during a calendar quarter, (1) they are members of a "controlled group of corporations" as defined in section 1563 of the Internal Revenue Code (or would be members under section 1563 if section 1563(a)(4) and section 1563(b) did not apply and if the phrase "more than 50 percent" were substituted for the phrase "at least 80 percent" wherever it appears in section 1563(a)); (2) 50 percent or more of one corporation's officers are also officers of the other corporation; (3) 30 percent or more of one corporation's employees are also employees of the other corporation; or (4) in the case of a corporation that does not issue stock, 50 percent or more of the directors of one corporation are also directors of the other corporation. In addition, section 125 of the Social Security Amendments of 1983 provides that a State university which employs health professionals as faculty members at a medical school and a tax-exempt faculty practice plan described in section 501(c)(3) of the Internal Revenue Code that concurrently employs 30 percent or more of the faculty members of the medical school are deemed related corporations under section 3121(s) of the Internal Revenue Code.

Description of Proposal

Certain health professionals employed as faculty members of State universities receive their wages from both the State university and an agency account of the State university. Under the proposal, a State university and its agency account would be deemed related corporations under Code section 3121(s).

Effective Date

The proposal would be effective for wages received after December 31, 1993.

3. Exempt certain religious schools from Federal unemployment tax

Present Law

Section 3304(a)(6)(A) of the Federal Unemployment Tax Act (FUTA) requires States to cover certain nonprofit organizations under their unemployment compensation laws. Exceptions from this required coverage are provided for services performed in the employ of: (1) a church or convention or association of churches; or (2) an organization that is operated primarily for religious purposes and that is operated, supervised, controlled, or principally supported by a church or convention or association of churches.

Description of Proposal

The proposal would provide an exception from mandatory participation under FUTA for service performed in the employ of an elementary or secondary school which meets certain requirements. To qualify for such exemption, the elementary or secondary school must be (1) operated primarily for religious purposes; (2) described in section 501(c)(3); and (3) exempt from tax under section 501(a).

Effective Date

The proposal would apply to services performed after December 31, 1993.

I. Other Provisions

1. Enhanced deduction for charitable contributions of scientific equipment for design research

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization.[16] However, in the case of a charitable contribution of inventory or other ordinary-income property, short-term capital gain property, or certain gifts to private foundations, the amount of the deduction is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, a taxpayer's deduction is limited to the adjusted basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose (sec. 170(e)(1)(B)(i)).

Special rules in the Code provide augmented deductions for certain corporate contributions of inventory property for the care of the ill, the needy, or infants (sec. 170(e)(3)) and certain corporate contributions of scientific equipment constructed by the taxpayer, provided the original use of such donated equipment is by the donee for research or research training in the United States in

[16] The amount of the deduction allowable for a taxable year with respect to a charitable contribution may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)). Corporations are entitled to claim a deduction for charitable contributions, generally limited to 10 percent of their taxable income (computed without regard to the contribution) for the taxable year.

physical or biological sciences (sec. 170(e)(4)). Under these special rules, the amount of the augmented deduction available to a corporation making a qualified contribution is equal to its basis in the donated property plus one-half of the amount ordinary income that would have been realized if the property had been sold (the sum not to exceed twice the basis).

Description of Proposal

The proposal would expand the eligible uses of donated scientific equipment under section 170(e)(4) to include design research. Thus, an augmented deduction would be available for corporate contributions of scientific equipment constructed by the donor and used by the donee for research or research training in the United States for design research. For example, an augmented deduction would be available to a corporation that donates computers constructed by the corporation to a tax-exempt educational arts institution for use in design research or training.

Effective Date

The proposal would be effective for contributions made after December 31, 1993.

2. Require Treasury to issue certificates evidencing obligations of the United States held by the Social Security Trust Funds (H.R. 931)

Present Law

In general, section 201(d) of the Social Security Act requires the Secretary of the Treasury to invest annual surpluses of the Social Security Trust Funds in interest bearing obligations of the United States government. Under current Treasury practice, these holdings are recorded as entries on a ledger. No certificates are issued to the Trust Funds evidencing these obligations.

Description of Proposal

The bill (H.R. 931) would require the Secretary of the Treasury, within 60 days of the date of enactment, to issue to the Social Security Trust Funds under the old-age, survivors, and disability insurance programs, certificates evidencing obligations of the United States held by such Trust Funds.

Effective Date

The bill would be effective upon enactment.

3. Limit applicability of generation skipping transfer tax

Present Law

Under Code sections 2601 through 2663, a generation skipping transfer tax (GST tax) is generally imposed on transfers, either directly or through a trust or similar arrangement, to a skip person (i.e., a beneficiary in more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips,

taxable terminations and taxable distributions. For this purpose, a direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person (sec. 2612(c)(1)). A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person (sec. 2612(a)). A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or a direct skip)(sec. 2612(b)).

A direct skip transfer to a transferor's grandchild is not subject to GST tax if the child of the transferor who was the grandchild's parent is deceased at the time of the transfer (sec. 2612(c)(2)). This "predeceased parent exception" to the GST tax is not applicable to (1) transfers to collateral heirs, e.g., grandnieces or grandnephews, or (2) taxable terminations or taxable distributions.

Description of Proposal

The proposal would apply the predeceased parent exception to transfers to collateral heirs, and to taxable terminations and taxable distributions. Thus, for example, a transfer by a transferor to his or her grandniece will not be subject to GST tax if the transferor's nephew or niece who was the grandniece's parent is deceased at the time of the generation skipping transfer. Similarly, the proposal would permit an exclusion from generation skipping tax where the grantor established a trust which is to pay an annuity to charity for a term of years (which would have the effect of reducing Federal estate or gift taxes on the establishment of the trust) with the remainder to a grandnephew or grandniece whose parents are deceased at the time the trust was created.

Effective Date

The proposal would be effective for generation skipping transfers made after date of enactment.

II. MISCELLANEOUS REVENUE-RAISING PROPOSALS

A. Alternative Minimum Tax

1. Increase the alternative minimum tax class life for assets used in the production of tobacco products

Present Law

A taxpayer is subject to an alternative minimum tax (AMT) to the extent that the taxpayer's tentative minimum tax exceeds the taxpayer's regular income tax liability. A taxpayer's tentative minimum tax is calculated by applying the AMT rate to the excess of the taxpayer's alternative minimum taxable income over an exemption amount. Alternative minimum taxable income (AMTI) is the taxpayer's taxable income increased by certain tax preferences and modified by certain adjustments to negate the deferral of income resulting from the regular tax treatment of those items.

One of the adjustments that is made to taxable income to arrive at AMTI relates to depreciation. For AMT purposes, depreciation on most personal property placed in service after 1993 is calculated using the 150-percent declining balance method (switching to straight line in the year necessary to maximize the deduction) over the property's class life.[17] The class lives of property generally are longer than the recovery periods allowed for regular tax purposes.

Assets used in the production of cigarettes, cigars, smoking and chewing tobacco, snuff, and other tobacco products are depreciated using the 200-percent declining balance method over 7 years for regular tax purposes and the 150-percent declining balance method over 15 years for AMT purposes.

Description of Proposal

The proposal would increase the AMT class life for assets used in the production of cigarettes, cigars, smoking and chewing tobacco, snuff, and other tobacco products from 15 years to 30 years. Alternatively, the proposal would increase the regular tax recovery periods from 7 years to 15 years and/or require that such assets be depreciated using the straight-line method for AMT or regular tax purposes.

Effective Date

The proposal would be effective for property placed in service after December 31, 1993.

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[17] For property placed in service by a corporation after 1986 and before 1994, AMT depreciation is computed twice—once using the 150-percent declining balance method over the property's class life, and again (for the "ACE adjustment") using the straight-line method over the class life. The Omnibus Budget Reconciliation Act of 1993 repealed the ACE adjustment for property placed in service after 1993.

2. Increase the alternative minimum tax class life for coal mining equipment

Present Law

Assets used in coal mining are depreciated using the 200-percent declining balance method over 7 years for regular tax purposes. For AMT purposes, such assets are depreciated using the 150-percent declining balance method over 10 years.

Description of Proposal

The proposal would increase the AMT class life for assets used in coal mining from 10 years to a period of between 11 and 13 years.

Effective Date

The proposal would be effective for property placed in service after December 31, 1993.

3. Increase the alternative minimum tax amortization period for mining exploration and development costs incurred with respect to coal mining

Present Law

For regular tax purposes, individual taxpayers may deduct mining exploration and development costs as a current expense. Corporations, however, may deduct only 70 percent of mining exploration and development costs as a current expense. The other 30 percent of such costs must be capitalized and amortized ratably over a 60-month period. Alternatively, any taxpayer may elect to capitalize all mining exploration and development costs and amortize them ratably over a 10-year period.

For AMT purposes, all mining exploration and development costs of individual and corporate taxpayers must be capitalized and amortized ratably over a 10-year period.

Description of Proposal

The proposal would increase the AMT amortization period for mining exploration and development costs incurred with respect to coal mining from 10 years to 20 years.

Effective Date

The proposal would be effective for costs incurred after December 31, 1993.

B. Accounting

1. Modify definition of applicable high yield discount obligations

Present Law

A taxpayer generally may deduct the amount of interest paid or accrued within the taxable year on indebtedness issued by the tax-

payer. Original issue discount (OID) is the excess of the stated redemption price at maturity over the issue price of a debt instrument. The issuer of a debt instrument with OID generally accrues and deducts, as interest, the discount over the life of the obligation, even though the amount of the interest may not be paid until the maturity of the instrument.

Special rules apply to applicable high yield discount obligations. A certain portion of the yield on an applicable high yield discount obligation is treated as a dividend and is not deductible and another portion is not deductible until paid. An applicable high yield discount obligation is one that: (1) has a maturity date more than five years from the date of issue; (2) has a yield to maturity at least equal to the applicable Federal rate plus 5 percentage points; and (3) has significant OID. An instrument has significant OID if, for any accrual period ending after the date five years after the date of issue, the aggregate amount of interest to be taken into account as income under the instrument exceeds the sum of the aggregate amount of interest to be paid plus the product of the issue price of the instrument and its yield to maturity.

Description of Proposal

Under the proposal, an applicable high yield discount obligation would be one that: (1) has a maturity date more than four years (rather than five years) from the date of issuance; (2) has a yield to maturity at least equal to the applicable Federal rate plus 5 percentage points; and (3) has significant OID. An instrument would have significant OID if, for any accrual period ending after the date four years (rather than five years) after the date of issue, the aggregate amount of interest to be taken into account as income under the instrument exceeds the sum of the aggregate amount of interest to be paid plus the product of the issue price of the instrument and its yield to maturity.

Effective Date

The proposal would be effective for obligations issued after the date of enactment.

2. Modify treatment of organizational expenditures

Present Law

Organizational expenditures of a corporation must be capitalized and, at the election of the corporation, may be amortized ratably over a period not less than 60 months. Such amortization deductions are not allowed for purposes of the adjusted current earnings adjustment of the corporate alternative minimum tax. "Organizational expenditures" means any expenditure that is incidental to the creation of the corporation, is chargeable to capital account, and is of a character which, if expended incidental to the creation of a corporation having a limited life, would be amortizable over such life.

Description of Proposal

The proposal would lengthen the period over which organizational expenditures may be amortized from 60 months to 14 (or some other period of) years.

Effective Date

The proposal would be effective for organizational expenditures incurred after the date of enactment.

3. Modify treatment of advertising expenditures

Present Law

A deduction is allowed for all ordinary and necessary business expenses that are paid or incurred during a taxable year in carrying on a trade or business. The cost of acquiring an asset having a useful life that extends substantially beyond the taxable year must be capitalized and recovered over time. Selling expenses, including expenses relating to advertising and promoting a product, generally are treated as ordinary and necessary business expenses and, thus, are fully deductible in the year paid or incurred.

Description of Proposal

The proposal would require a taxpayer to capitalize and amortize over a specified period of time a portion of its advertising costs. A de minimis rule could exempt small firms (i.e., those with gross receipts under a certain threshold) or those firms that have a de minimis amount of advertising costs.

Effective Date

The proposal would be effective for costs incurred after the date of enactment.

C. Financial Institutions

1. Require financial institutions to include in gross income certain prepaid interest when received

Present Law

Treatment by lender

Original issue discount (OID) is the excess of the stated redemption price at maturity over the issue price of a debt instrument. The holder of the debt instrument generally accrues and includes in gross income the amount of the OID over the term of the loan on a yield-to-maturity basis.

The gross income of an accrual basis taxpayer generally includes prepayments for services to be rendered by the taxpayer.[18] Similarly, a savings and loan association was required to include in gross income prepaid interest ("points") it received from a borrower. In this case, the points were paid from the separate funds of the

[18] *Schlude v. Comm.*, 372 U.S. 128 (1962). Cf. National IRS Notice 89-21, 1989-1 C.B. 651, where lump-sum payments received under a notional principal contract are to be taken into account over the life of the contract.

borrower and were not treated as OID on the loan.[19] Thus, if the taxpayer lends the points to the borrower as part of the overall lending transaction, it is possible that the taxpayer may take the position that the points are to be treated as OID (as thus includible in gross income over the term of the loan) rather than prepaid income (and thus includible in gross income when received.[20])

Treatment by borrower

A cash basis taxpayer generally may deduct, when paid, points paid with respect to any indebtedness incurred in connection with the purchase or improvement of, and secured by, the principal residence of the taxpayer.

Description of Proposal

The proposal would require a thrift institution to include in gross income points received with respect to single family mortgages when received. Alternatively, the proposal could be applied to all mortgage originators.

Effective Date

The proposal would apply to points received after the date of enactment.

2. Require thrift institutions to take net operating loss carryovers into account for purposes of calculating bad debt reserves under the percentage of income method

Present Law

Thrift institutions may, in general, take a deduction for bad debts equal to 8 percent of their taxable income in a particular year.

Treasury regulations provide that taxable income must be reduced by net operating loss (NOL) carrybacks for purposes of calculating the bad debt reserve deduction of thrift institutions (Treas. reg. sec. 1.593-6A(b)(5)). The U.S. Tax Court held that the regulations on this point were invalid.[21]

Description of Proposal

The proposal would codify that portion of the Treasury Regulations that provides that taxable income be reduced by NOL carrybacks for purposes of calculating the bad debt reserve deduction of thrift institutions under the percentage of taxable income method.

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[19] *Bell Federal Savings and Loan Association v. Comm.*, 62 T.C.M. 376 (1991).

[20] See Prop. Treas. Reg. sec. 1.1273-2(f)(2) that provides that the payment of points in a lending transaction reduces the issue price of the debt instrument evidencing the loan and thus may create OID.

[21] See *Pacific First Federal Savings Bank v. Comm.*, 94 T.C. 101, (1990); *Peoples Federal Savings and Loan Association of Sidney v. Comm.*, 59 T.C.M. 85 (1990); *Leader Federal Savings and Loan Association v. Comm.*, 62 T.C.M. 201 (1991); *Georgia Federal Bank, F.S.B. v. Comm.*, 98 T.C. 105 (1992); *Bell Federal Savings and Loan Association v. Comm.*, 62 T.C.M. 367 (1991); and *First Federal Savings Bank of Washington v. Comm.*, 766 F. Supp. 897 (E. D. Wa. 1991). However, the U.S. Court of Appeals for the Ninth and Sixth Circuits overruled such holdings. *Pacific First Federal Savings Bank v. Comm.*, 961 F.2d 800 (9th Cir.), cert. denied, 113 S.Ct. 209 (1992); and *Peoples Federal Savings and Loan Association of Sidney v. Comm.*, 948 F.2d 289 (6th Cir. 1991).

Effective Date

The proposal would be effective for losses incurred in taxable years ending after the date of enactment. No inference would be intended as to the validity of the Treasury Regulation with respect to losses incurred prior to the effective date of the proposal.

D. Cost Recovery

1. Require water utility property to be recovered over 25 years (H.R. 846)

Present Law

The amount of the depreciation deduction allowed with respect to any tangible property is determined under the Accelerated Cost Recovery System ("ACRS"), as modified by the Tax Reform Act of 1986. Under ACRS, property is assigned a recovery period that generally is based on the class life of the property under the asset depreciation range ("ADR") system in effect before 1981. Under ACRS, recovery periods range from 3 to 50 years. The depreciation method generally applicable to property with a recovery period of 15 or 20 years is the 150-percent declining balance method (switching to the straight-line method in the year that maximizes the depreciation deduction). The straight-line method applies to property with a recovery period over 20 years.

Property used by a water utility in the gathering, treatment, and commercial distribution of water has a recovery period of 20 years and a class life of 50 years.[22]

Description of Proposal

H.R. 846 would provide that water utility property would have a recovery period of 25 years and would be depreciated under the straight-line method. For this purpose, "water utility property" would mean property which is an integral part of the gathering, treatment, or commercial distribution of water and which, without regard to the bill, would have had a recovery period of 20 years. The bill would not change the class life for water utility property.[23]

Effective Date

The bill would be effective for property placed in service after the date of enactment, other than property placed in service pursuant to a binding contract in effect on such date and at all times thereafter before the property is placed in service.

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[22] Rev. Proc. 87-56, 1987-2 C.B. 674.

[23] H.R. 846 also would restore certain provisions that were repealed by the Tax Reform Act of 1986 relating to the treatment of contributions in aid of construction for regulated utilities that provide water or sewage disposal services. For a description of this provision of the bill, see Joint Committee on Taxation, *Description of Miscellaneous Tax Proposals* (JCS-8-93), June 16, 1993, p. 2.

2. Extend the recovery period applicable to assets used in printing and publishing

Present Law

The amount of the depreciation deduction allowed with respect to any tangible property is determined under the Accelerated Cost Recovery System ("ACRS"), as modified by the Tax Reform Act of 1986. Under ACRS, property is assigned a recovery period that generally is based on the class life of the property under the asset depreciation range ("ADR") system in effect before 1981. Under ACRS, recovery periods range from 3 to 50 years. The depreciation method generally applicable to property with a recovery period of less than 15 years is the 200-percent declining balance method (switching to the straight-line method in the year that maximizes the depreciation deduction).

Recovery periods of 7 years and class lives of 11 years are provided for assets used in: (1) printing by one or more processes, such as letter-press, lithography, gravure, or screen; (2) the performance of services for the printing trade, such as bookbinding, typesetting, engraving, photo-engraving, and electrotyping; and (3) the publication of newspapers, books, and periodicals.[24]

Description of Proposal

The proposal would extend the recovery periods applicable to assets used in printing and publishing to 10 years. The proposal would not change the class lives for such property.

Effective Date

The proposal would be effective for property placed in service after the date of enactment.

E. Pass-Through Entities

1. Income tax treatment of estates that own interests in S corporations or partnerships

Present Law

S Corporations

Under section 1366(a), each S corporation shareholder generally must report his or her pro rata share of the S corporation's items of income, gain, loss, deduction and credit for the shareholder's taxable year in which (or with which) the S corporation's taxable year ends. If, however, a shareholder of an S corporation dies before the end of the taxable year of the S corporation, the deceased shareholder must take into account his or her pro rata share of the corporation's items of income, gain, loss, deduction or credit in the shareholder's final taxable year, notwithstanding the fact that the shareholder's final taxable year terminated prior to the end of the S corporation taxable year. No similar provision applies under present law for including an estate's pro rata share of the S cor-

[24] Rev. Proc. 87-56, 1987-2 C.B. 674.

poration's items in the estate's final taxable year where the estate terminates before the end of the taxable year of the S corporation.

Partnerships

The taxable year of a partnership closes with respect to a partner who "sells or exchanges" his or her entire partnership interest, or whose entire partnership interest is liquidated (sec. 706(c)(2)). The taxable year of a partnership, however, generally does not close upon the transfer by an estate of its entire partnership interest to one or more beneficiaries.[25] Thus, the estate's share of items of income, gain, loss, deduction and credit for the partnership year in which the estate is terminated is taxed to the estate's successor in interest, rather than to the estate.[26]

Description of Proposal

The proposal would require an estate to include its pro rata share of an S corporation's items of income, gain, loss, deduction, or credit for its final taxable year, if the estate terminates before the end of the S corporation's taxable year.

The proposal would also provide that the transfer of a partnership interest from an estate is treated as a sale or exchange, for purposes of determining whether the partnership taxable year closes with respect to such estate.

For purposes of both of these rules, an estate would include a bankruptcy estate.

Effective Date

The proposal would be effective for estates terminating, and transfers of partnership interests from estates, after December 31, 1993.

2. Repeal taxable income limitation on recognition of built-in gains of S corporations

Present Law

A subchapter C corporation is subject to corporate-level tax on its income; a subchapter S corporation generally is not. However, if a C corporation elects to convert to S corporation status, corporate-level tax is imposed on the net built-in gains recognized by the S corporation in any taxable year beginning in the recognition period. The recognition period generally is the 10-year period following the conversion from C corporation to S corporation status. The net

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[25] Treas. Reg. sec. 1.706-1(c)(3)(vi), example (3). Other types of transfers (e.g., gifts, transfers to an estate (or other successor) upon death, and transfers to a trust) generally do not cause the partnership year to close with respect to the transferor (See, e.g., Treas. Reg. secs. 1.706-1(c)(3), (5).) The IRS, however, has ruled that the distribution of a partnership interest upon the termination of a trust causes the partnership year to close with respect to the trust (Rev. Rul. 72-352, 1972-2 C.B. 395). Also, the Secretary of the Treasury has been granted regulatory authority to treat any distribution of a partnership interest as an "exchange" for purposes of any provision of subchapter K, including section 706 (sec. 761(e)).

[26] Section 651 of H.R. 13, the Tax Simplification Act of 1993 (introduced by House Ways and Means Committee Chairman Rostenkowski on January 5, 1993), provides that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation, or otherwise. The provision is not intended to change the present-law treatment of a transfer of a partnership interest between a debtor and the debtor's bankruptcy estate.

built-in gains of an S corporation generally are the gains (net of any built-in losses) recognized by the S corporation through the disposition of assets that were held by the corporation when it was a C corporation.

The amount of gain taken into account for purposes of imposing the corporate-level tax is limited to the amount of net unrealized built-in gain of the corporation as of the date of conversion. In addition, the amount of net recognized built-in gain taken into account for the year is limited to the amount of the S corporation's taxable income for the year (the "taxable income limitation"). In the case of an S corporation electing such status on or after March 31, 1988, if any amount of gain is not taken into account because of the taxable income limitation, such amount is carried forward as recognized built-in gain to the next taxable year.

Description of Proposal

The proposal would repeal the taxable income limitation applicable to the corporate-level taxation of net recognized built-in gains of S corporations.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment.

F. Individual Income Tax

1. Restrict deductions relating to travel expenses paid or incurred in connection with holding or managing real property

Present Law

In general, a taxpayer may deduct all ordinary and necessary expenses paid or incurred during the taxable year (1) in carrying on any trade or business and (2) in the case of an individual, for the production of income. Such deductible expenses may include reasonable travel expenses paid or incurred while away from home, such as transportation costs and the cost of meals and lodging.

If a taxpayer travels to a destination and while at that destination engages in both business and personal activities, the taxpayer may deduct travel expenses to and from the destination only if the trip is related primarily to the taxpayer's trade or business. If the trip is primarily personal in nature, expenses incurred while at the destination that are properly allocable to the taxpayer's trade or business are deductible even though the traveling expenses to and from the destination are not deductible (Treas. Reg. sec. 1.162-2(b)(1)).

Description of Proposal

The proposal would deny a deduction for travel expenses paid or incurred with respect to holding or managing real property unless the taxpayer's principal trade or business is holding or managing real property.

Effective Date

The proposal would be effective for amounts paid or incurred after December 31, 1993.

2. Change the determination of the standard mileage rate for deductible automobile expenses

Present Law

In general, automobile expenses are deductible if the automobile is used (1) in carrying on any trade or business or (2) in the case of an individual, for the production of income. Unreimbursed employee automobile expenses are deductible subject to the 2-percent floor on miscellaneous itemized deductions.

To compute the amount of deductible automobile expenses, taxpayers generally have a choice of two methods. Under the actual cost method, the deductible expenses equal the actual expenses multiplied by the ratio of business miles driven to total miles driven. Under the standard mileage method, the deductible expenses equal the number of business miles driven multiplied by the standard mileage rate. For 1993, the standard mileage rate is 28 cents per mile. The standard mileage rate is determined annually by the IRS.

Description of Proposal

For the purpose of deductions for business use of an automobile, the computation of the standard mileage rate would be altered. While the methodology of the IRS calculation would not be altered, a rounding convention would be implemented. Initially, the standard mileage rate for 1994 would be frozen at the 1993 level of 28 cents. In succeeding years, the IRS would calculate the standard mileage rate and then round it down to the nearest whole cent. The rounded rate would be used by taxpayers in computing their deductions under the standard mileage method.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1993.

3. Limit the deduction for business transportation expenses with regard to travel beginning at the taxpayer's home

Present Law

In general, a taxpayer may deduct all ordinary and necessary expenses paid or incurred during the taxable year (1) in carrying on any trade or business and (2) in the case of an individual, for the production of income. Such deductible expenses may include reasonable travel expenses paid or incurred while away from home, such as transportation costs and the cost of meals and lodging. Deductible expenses may also include daily transportation expenses paid or incurred in traveling between two specific business locations. Taxpayers may generally not deduct personal, living, or family expenses, including commuting expenses.

Description of Proposal

The proposal would restrict the present-law deduction for transportation expenses paid or incurred in carrying on a trade or business by permitting the deduction only to the extent that the distance traveled exceeds 10 miles. For example, if a taxpayer travels 15 miles away from home on a business trip, only one-third (= (15-10)/15) of the otherwise allowable transportation expenses would be deductible. The proposal would apply to all forms of transportation.

Effective Date

The proposal would be effective for expenses paid or incurred after December 31, 1993.

4. Require taxpayers to include rental value of residence in income without regard to period of rental

Present Law

Gross income generally includes all income from whatever source derived, including rents. Section 280A provides rules for determining deductibility of expenses attributable to rental property. Section 280A(g) provides a *de minimis* exception to these rules where a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year. In this case, the income from such rental is not included in gross income and no expenses arising from such rental use are allowed as a deduction.

Description of Proposal

The proposal would repeal the 15-day rule of section 280A(g). Consequently, the taxpayer would be required to include in gross income the rental income received with respect to the rental of the residence without regard to the period of rental. The rules of section 280A would be applied to determine deductibility of the expenses attributable to the rental of such property.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1993.

5. Reduce limit on deduction for wagering losses

Present Law

In general, individuals may deduct losses from wagering transactions, but only to the extent of gains from wagering transactions in the same taxable year. Unless an individual is in the trade or business of gambling, he or she must itemize deductions in order to claim a deduction for wagering losses.[27] The itemized deductions for wagering losses are not subject to the 2-percent floor on miscellaneous itemized deductions.

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[27] Rev. Rul. 54-339, 1954-2 CB 89.

Description of Proposal

The proposal would reduce the limit on the deductible portion of wagering losses under section 165(d) to 80 percent of the gains from wagering transactions in that taxable year.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1993.

6. Deny business deduction for air travel expenditures in excess of coach fare

Present Law

In general, a taxpayer may deduct all ordinary and necessary expenses paid or incurred during the taxable year (1) in carrying on any trade or business and (2) in the case of an individual, for the production of income. Such deductible expenses may include reasonable travel expenses paid or incurred while away from home, such as transportation costs and the cost of meals and lodging.

Description of Proposal

The proposal would deny taxpayers a deduction for the amount paid for air transportation that exceeds "normal tourist class fare". Normal tourist class fare is defined as the lowest fare charged on a regularly scheduled flight without regard to discounts available to special groups or persons or under certain special conditions.

Effective Date

The proposal would be effective for amounts paid or incurred after the date of enactment for transportation beginning after such date.

7. Increase threshold for deduction of casualty losses from $100 to $500

Present Law

Under Present Law, individuals who itemize deductions may deduct losses of property not connected with a trade or business or a transaction entered into for profit if the loss arises from theft or from fire, storm, shipwreck, or other casualty. Only the amount of the loss in excess of $100 per casualty loss can be deducted. In addition, the casualty losses of a taxpayer for a taxable year (determined after application of the $100 threshold to each loss) may be deducted only to the extent that the sum of such losses (net of casualty gains) exceeds 10 percent of the taxpayer's adjusted gross income (AGI).

Description of Proposal

The $100 threshold for deducting casualty losses would be increased to $500. The $500 threshold would be indexed for inflation (with rounding to the nearest $10) for taxable years beginning after 1994. As under Present Law, the amount of casualty losses above

the threshold would be allowed as a deduction only to the extent that their sum (net of casualty gains) exceeds 10 percent of the individual's AGI.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1993.

G. Natural Resources

1. Impose excise tax on extraction of hard rock minerals

Present Law

Under Present Law, no federal tax is imposed solely on the extraction of minerals from the ground. Federal income tax is imposed based on taxable income arising from the taxpayer's operations, including mineral extraction operations. Severance (excise) taxes on mineral extraction are imposed by various State and local taxing authorities.

Description of Proposal

The proposal would impose a Federal excise tax on the extraction of any hard rock mineral from deposits located in the United States. The tax would be levied on the producer of the mineral (i.e., the holder of the economic interest with respect to the mineral).

The amount of the tax would be 12 percent of the removal price of the hard rock mineral. Under the proposal, the term "removal price" generally would mean the amount for which the mineral is sold. In the case of sales between related persons, the removal price would not be less than the constructive sales price used in computing gross income from the property for purposes of determining percentage depletion. If a hard rock mineral is removed from the premises before it is sold, the removal price would be the constructive sales price used in computing gross income from the property for purposes of determining percentage depletion. If the processing of any hard rock mineral begins before the mineral is removed from the premises, the mineral is treated as removed from the premises on the day such processing commences.

For purposes of the proposal, the term "hard-rock mineral" means any mineral which is of a type the mining of which on Federal lands is subject to the Mining Law of 1872 (30 U.S.C. 22 et.seq.). Hardrock minerals include (but are not limited to) gold, silver, and copper. They do not include oil, gas, oil shale, iron ore, so-called fertilizer minerals (such as phosphates), and common varieties of sand, stone, gravel, pumice, and cinders.

Effective Date

The proposal would be effective for hard rock minerals extracted after date of enactment.

2. Increase the tariff on imported crude oil and refined petroleum products

Present Law

The United States subjects imported crude oil and refined petroleum products to tariffs based upon the type of product imported. For example, the tariff on light crude oil, distillate and residual fuel oil (testing under 25 degrees API) is 5.25 cents per barrel; the tariff on heavy crude oil, distillate and residual fuel oil (testing 25 degrees API or more) is 10.5 cents per barrel; the tariff on motor fuels (including gasoline) is 52.5 cents per barrel; and the tariff on kerosene and naphthas is 10.5 cents per barrel.

Description of Proposal

The proposal would increase the tariff on all types of imported crude oil by 15 cents per barrel and increase the tariff on refined petroleum products by 1 cent per gallon (i.e., 42 cents per barrel).

Effective Date

The proposal would be effective for crude oil and refined petroleum products imported into the United States after December 31, 1993.

H. Foreign Tax Provisions

1. Source of income from certain sales of inventory property

Present Law

The foreign tax credit may eliminate the U.S. tax on foreign source income. That credit cannot reduce U.S. tax on U.S. source income. To calculate the foreign tax credit, every item of gross income is either assigned a domestic or foreign source or is divided into domestic and foreign source portions.

Title passage source rule

In general, gross income derived from the sale of personal property by U.S. residents is U.S. source (sec. 865). Income attributable to the marketing of inventory property by U.S. residents, however, has its source at the place of sale, generally being the place where the seller's right, title, and interest in the property passes to the purchaser (the "title passage" rule). This title passage rule applies both to all income from the purchase and resale of inventory and to the marketing portion of income from the production of inventory property in the United States and marketing of that property abroad. Moreover, this rule applies regardless of whether the sale is to an unrelated purchaser or to a related person (for example, a foreign corporate subsidiary) that resells the property to an unrelated purchaser.

Production/marketing split

Income derived from the manufacture of products in the United States and their sale elsewhere is treated as having a divided source, which may be viewed as a division of the income between

production and marketing activities. Under Treasury regulations, 50 percent of such income generally is apportioned on the basis of the location of assets held or used to produce income from the sale (in this case, typically the United States), and 50 percent of the income is sourced on the basis of the place of sale (determined under the title passage rule).[28] Under certain circumstances, the division of the income between production and marketing activities must be made on the basis of an independent factory or production price, rather than on a 50-50 basis, where a taxpayer sells part of its output to wholly independent distributors or other selling concerns in such a way as to establish fairly the independent factory or production price unaffected by considerations of tax liability (Treas. Reg. sec. 1.863-3(b)(2), *Example (1)*; Notice 89-10, 1989-1 C.B. 631).

Example 1.—As an illustration, assume that a U.S. corporation manufactures in the United States a product that can be sold to an unrelated foreign buyer at a price that generates $100 of gross income. Assume that the U.S. corporation makes such a sale. (Such a "direct" sale could result from marketing by a branch of the corporation located in the foreign country. Or it could result from marketing by a broker or other unrelated intermediary or agent operating abroad, or simply from marketing activities performed wholly within the United States.) The corporation arranges its affairs so that under Treasury regulations, the product is treated as sold in a foreign country. No independent factory or production price is applicable.

Under these assumptions, the corporation generally would be permitted under current regulations to treat approximately $50 of the gross income from the sale as foreign source gross income, and the remainder as U.S. source gross income. Assume that the corporation's deductions allocable to this foreign source gross income are much less than $50 and that no foreign income tax is imposed on the corporation's income from the sale. Using excess foreign tax credits generated by its other foreign income, the corporation may be entitled to exemption from U.S. tax on up to $50 of the taxable income from this sale.

Example 2.—Assume the above facts except that there is an applicable independent factory or production price that applies to the product pursuant to Notice 89-10. Assume that this price is $75. Under this assumption, the U.S. corporation would be entitled to exemption from U.S. tax on up to, at most, $25 of the taxable income from this sale.

Example 3.—Now assume that instead of selling directly to the foreign purchaser, the U.S. corporation has a foreign corporate sales subsidiary. The U.S. corporation sells the product to the sales subsidiary, and the subsidiary sells the product to the purchaser for $100. Assume that the arm's length price of the product between the parent and subsidiary is $75. If no independent factory or production price is applicable, then $37.50 of the parent's gross income from the sale is U.S. source income. The other $37.50 of the

[28] Treas. Reg. secs. 1.863-3(b)(1) and 1.863-3T(b)(2), *Example (2)*. Under this example, the one-half of the taxpayer's gross income not sourced according to the place of sale is apportioned between U.S. and foreign sources on the basis of the fraction of the taxpayer's property in the United States and the fraction of its property in the foreign country held or used to produce income from the sale.

parent's gross income is foreign source income and may be exempt from tax by the use of excess foreign tax credits from other income. The remaining $25 of income from the sale belongs to the foreign subsidiary. Depending on the circumstances, this income may bear no current U.S. tax, or may be subject to current U.S. tax under subpart F as an amount of foreign source income of the parent deemed distributed from the subsidiary. In either case, the $25 may be eligible for permanent exemption from U.S. tax due to foreign tax credits. Thus, a total of up to $62.50 of income from the manufacture and sale of the product is eligible for potential U.S. tax exemption.

Example 4.—If in the above example there was also an applicable independent factory price of $75, then all of the parent's income from its sale to the subsidiary would be U.S. source, and (as in the case of the direct sale of the product using an independent factory price of $75) only $25 of income from the manufacture and sale of the product to an unrelated party would be eligible for partial or total U.S. tax exemption through foreign tax credits.

Sales through a Foreign Sales Corporation

As an alternative, in part, to the use of foreign tax credits to reduce or eliminate U.S. tax on income from export sales, U.S. tax on such income may be reduced by selling to a foreign sales corporation (FSC) that sells to unrelated buyers, or having a FSC act as commission agent with respect to export sales. In this case, a portion of the income from exports will be free of U.S. tax as "exempt foreign trade income" of the FSC. Another portion will be subject to tax at the FSC level with no foreign tax credit. The remaining portion is subject to tax in the hands of the manufacturer or other supplier, with sourcing and foreign tax credit rules as described above. However, the amount of the export income that may be foreign source in the hands of a supplier related to the FSC is limited to the amount that would have been foreign source had the sale been made to or by a domestic international sales corporation (DISC) (sec. 927(e)(1)). Under current rules, the IRS does not consider an independent factory or production price to be established, and hence requires use of the 50-50 divided sourcing rule, in the case of a manufacturer or producer that uses a FSC to sell inventory (Notice 89-11, 1989-1 C.B. 632; Treas. Reg. sec. 1.861-8(g), *Example (23)*).

Example 5.—Assume a U.S. corporate manufacturer exports through a wholly owned FSC and uses the combined taxable income method to determine the income of the FSC. Assume combined taxable income from exports is $100. Generally, $15 of the combined taxable income is exempt from U.S. tax, and $8 is taxable to the FSC with no foreign tax credit. The remaining $77 is potentially taxable in the hands of the U.S. corporation. Of this amount, approximately $25 may be foreign source and the rest (approximately $52) would be domestic source income. (The $25 figure is arrived at by applying the 50-50 divided source rule to the amount (approximately $50) that would have been income of the manufacturer were the sale made to or by a DISC, using the DISC combined taxable income pricing rule of section 994(a)(2).) As this example demonstrates, up to approximately 40 percent of the in-

come from exports may be exempted from U.S. tax through a combination of the FSC-level exemption and the use of foreign tax credits at the related supplier level.

Description of Proposal

In general

The proposal would make two changes to the method by which income from the sale of inventory property is sourced.[29] First, where the income is derived partly within and without the United States, the amount apportioned to production activities under the production/marketing split would be no less than the amount that would be so allocated by applying the production/marketing split to the relevant combined income of the taxpayer and any related person. Second, the proposal generally would treat as domestic source income any gross income of a U.S. resident from the direct or indirect sale of inventory property to another U.S. resident for use, consumption, or disposition in the United States.

Apportionment of income between production and marketing

Under the proposal, if a taxpayer produces property and sells it to a related person (within the meaning of section 482), the portion of the taxpayer's income that is allocated and apportioned to production activities would be sourced according to the place where the production activities occur. Moreover, that portion must equal at least so much of its income as does not exceed the amount that would be so apportioned under the 50-50 divided source rule if the apportionment were based on the relevant combined income of the taxpayer and any related person. If greater, the amount of the taxpayer's income that is allocated and apportioned to production activities is the amount so allocated and apportioned on a separate company basis.

For example, assume that a U.S. company manufactures a product in the United States and sells the product to its own controlled foreign corporation which markets the product to unrelated persons. Under the proposal, a portion of the U.S. company's income possibly may be sourced on the basis of the place of sale. However, a portion of the U.S. company's income must be treated as U.S. source income on the basis of its production activities in the United States. Moreover, if that portion is determined by applying a fraction to gross income from production and marketing, then that fraction must be applied to the combined income of the two entities from production and marketing, as well as to the U.S. taxpayer's income. The portion of the income of the U.S. company from that sale apportioned to production activities is determined on the basis of the computation (combined or separate) that yields the greater apportionment of income to production activities. In determining the source of the income apportioned to production activities, it is intended that foreign assets or other attributes of the U.S. taxpayer or the controlled foreign corporation would not be taken into account unless they are used for production activities by the U.S. taxpayer.

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[29] This proposal is based on H.R. 5270 (102nd Cong., Sec. 203).

Sales to U.S. persons for U.S. use

The proposal would expand the general residence-based sourcing rule for sourcing sales of personal property. Under the proposal, generally the place of sale abroad generally would remain determinative of the source of income when inventory property sold abroad is also used, consumed, or disposed of abroad. However, where inventory property sold abroad is sold by a U.S. resident directly or indirectly to another U.S. resident, the property sold is used, consumed, or disposed of in the United States, and the sale is not attributable to an office or other fixed place of business maintained by the first U.S. resident outside the United States, the gross income of the first U.S. resident (or any related person) from the sale would be sourced domestically.

For example, under the proposal, a U.S. resident wholesaler would derive U.S. source income from the sale of inventory goods to a retailer for resale in the United States, without regard to where the title to the goods passes from the wholesaler to the retailer.[30] In addition, if such a sale is routed by the wholesaler through its controlled foreign corporation, then the subpart F income of the wholesaler from the sale by the controlled foreign corporation would also be U.S. source income. The same source rule would apply under the proposal if the wholesaler routes it through any other related person (e.g., a domestic sister corporation of the wholesaler, or a controlled foreign corporation the voting stock of which is owned by such a domestic sister corporation). In that case, the related person's income would be treated as U.S. source as well.

Effective Date

The proposal would be effective for sales after December 31, 1993.

2. Increase tax on gross transportation income of foreign persons

Present Law

In general, the United States taxes the worldwide income of U.S. persons whether the income is derived from sources within or outside the United States. On the other hand, nonresident alien individuals and foreign corporations generally are taxed by the United States only on income effectively connected with a U.S. trade or business (which is taxed on a net-income basis) and on their other U.S. source income (which is taxed on a gross-income basis).

The Code sets forth special rules, applicable both to U.S. and foreign persons, for sourcing transportation income (sec. 863(c)). All transportation income attributable to transportation which begins *and* ends in the United States is considered U.S. source income under these rules. In the case of income that is attributable to transportation which begins in, and ends outside, the United States, or alternatively begins outside, and ends in, the United States, 50 percent is U.S. source, and 50 percent is foreign source.

[30] *Cf. Liggett Group, Inc. v. Commissioner*, 58 T.C.M. (CCH) 1167 (1990).

Transportation income is any income derived from, or in connection with, (1) the use (or hiring or leasing for use) of a vessel or aircraft, or (2) the performance of services directly related to the use of a vessel or aircraft. For this purpose, the term "vessel or aircraft" includes any container used in connection with a vessel or aircraft.

The United States imposes a 4-percent tax on the gross U.S. source transportation income of foreign persons. If a foreign person is engaged in a trade or business in the United States and has transportation income that is effectively connected with that trade or business, the foreign person must, in lieu of paying the gross-basis tax, file a U.S. tax return and pay tax on its net effectively connected income. For a foreign person's transportation income (other than leasing income) to be effectively connected with the conduct of a U.S. trade or business, (1) the foreign person must provide regularly scheduled transportation into, out of, or within the United States; (2) substantially all of the person's U.S. source gross transportation income must be attributable to the regularly scheduled transportation; and (3) the foreign person must maintain a fixed place of business in the United States through which it conducts its U.S. transportation business.

For purposes of the gross-basis tax, U.S. source gross transportation income generally does not include gross income derived by a corporation organized in a foreign country from the international operation of ships or aircraft if such foreign country grants an equivalent tax exemption to transportation income earned by corporations organized in the United States. It also does not include any income taxable in a possession of the United States under the provisions of the Internal Revenue Code as made applicable in such possession.

Description of Proposal

The proposal would increase the rate of tax on the gross transportation income of foreign persons from 4 percent to 8 percent.

Effective Date

The proposal would be effective after December 31, 1993.

3. Impose withholding tax on certain interest paid to foreign persons

Present Law

A 30-percent gross-basis withholding tax generally is imposed on certain types of U.S. source income, including interest income, received by foreign persons if the income is not effectively connected with a U.S. trade or business. However, interest income is exempt from U.S. tax if it (1) qualifies for a general exemption, added to the Code in 1984, that applies to "portfolio interest," (2) is paid on a bank deposit, (3) constitutes short-term original issue discount, or (4) qualifies for exemption under a U.S. tax treaty.

Portfolio interest generally is defined as any U.S. source interest, not effectively connected with the conduct of a U.S. business, (1) on an obligation that satisfies certain registration requirements or

specified exceptions thereto, and (2) that is not received by a direct or indirect 10-percent shareholder of the issuer of the obligation. Portfolio interest generally excludes interest received by a corporation that is a bank, on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of the bank's trade or business.

The estate of a nonresident decedent who was not a U.S. citizen is subject to the U.S. estate tax. That tax is imposed on the portion of the decedent's gross estate which at the time of death is situated in the United States. The Code provides that debt obligations, any interest on which would qualify for the portfolio interest exemption from U.S. income tax as described above if received by the decedent at the time of death, generally are not considered property situated within the United States, and thus are not subject to the estate tax.

Description of Proposal

The proposal would repeal the income tax exemption for portfolio interest and would repeal the estate tax exemption for obligations that generate portfolio interest.

Effective Date

The proposal would apply to interest received after the date of enactment of the proposal with respect to obligations issued after such date.

4. Change the foreign tax credit to a deduction

Present Law

The United States imposes income tax on the worldwide income of U.S. persons. U.S. taxpayers generally *deduct* foreign and U.S. State and local taxes in arriving at the taxable income to which the appropriate Federal tax rate is applied. However, the Code permits taxpayers with foreign source income to forego the deduction, and instead take a tax *credit,* with respect to *income* taxes and certain income-related taxes paid to *foreign* governments: the credit applies to income taxes, war profits taxes, and excess profits taxes paid to foreign governments, and to taxes paid to the government of a foreign country in lieu of income, war profits, and excess profits taxes generally imposed by that government.[31] The credits generally are limited under formulas that take into account the U.S. income tax that would be imposed on foreign source taxable income in the absence of credits or deductions for the taxes. Foreign taxes other than these income-related taxes generally are not creditable under the Code.

The United States also is obligated under tax treaties to allow U.S. taxpayers credits for certain of the taxes imposed by treaty partners.

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[31] For purposes of this discussion, the terms "foreign country," "foreign government," "foreign source income," and "foreign taxes" are used to refer to territories, governments, income, and taxes outside those of the 50 States and the District of Columbia. For example, they refer to the so-called "possessions" of the United States.

Description of Proposal

The proposal would eliminate Federal income tax credits for foreign taxes (including taxes imposed by U.S. possessions). Foreign taxes would continue to be deductible. The denial of credits would be effective regardless of a treaty provision to the contrary.

Effective Date

The proposal would be effective for taxes paid or accrued in taxable years beginning after date of enactment. Taxes paid by foreign corporations in pre-effective-date years would not be creditable by U.S. persons who would (under the principles of current law which would be repealed under the proposal) be deemed to have paid those taxes upon receipt of dividends or other income inclusions in post-effective-date years.

5. Increase excise tax on certain insurance premiums paid to certain foreign persons

Present Law

Under Present Law, an excise tax generally is imposed on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer to or for or in the name of a domestic corporation or partnership or a U.S. resident individual with respect to risks wholly or partly within the United States, or to or for or in the name of any foreign person engaged in business within the United States with respect to risks within the United States (sec. 4371). The tax does not apply, however, to any amount effectively connected with the conduct of a trade or business within the United States (unless such amount is exempt from the net-basis U.S. tax under a treaty) (sec. 4373(1)).

The tax is imposed at the following rates: (1) 4 percent of the premium paid on a casualty insurance policy or indemnity bond; (2) 1 percent of the premium paid on a policy of life, sickness, or accident insurance, or an annuity contract on the life or hazards to the person of a U.S. citizen or resident; and (3) 1 percent of the premium paid on a policy of reinsurance covering any of the contracts taxable under (1) or (2).

The tax is waived in U.S. tax treaties with the United Kingdom, France, Germany, Spain, Italy, Cyprus, India, and certain other countries. These treaty waivers generally include an anti-conduit rule denying the benefit of the exemption to premiums covering risks that are reinsured with a foreign person not entitled to a similar treaty exemption. Notably, however, the U.K. treaty includes no anti-conduit rule. However, Present Law imposes a tax on any insurance of a U.S. risk directly with a foreign insurer (not subject to U.S. income tax), and an additional tax on any reinsurance of the U.S. risk from that foreign insurer to another foreign insurer. A policy of reinsurance issued by a foreign insurer covering U.S. risks is subject to the tax imposed on reinsurance policies regardless of whether the direct insurer is domestic or foreign.[32]

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[32] See Rev. Rul. 58-612, 1958-2 C.B. 850; see also *American Bankers Insurance Co. of Florida v. United States*, 388 F.2d 304 (5th Cir. 1968).

The Code itself (sec. 4373) provides exemptions from the tax in the case of (1) any amount effectively connected with the conduct of a trade or business within the United States (unless such amount is exempt from the net-basis U.S. tax under a treaty), or (2) any indemnity bond required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the United States, or to secure a duplicate for, or the payment of, any bond, note, certificate of indebtedness, war-saving certificate, warrant, or check issued by the United States.

Section 4374 provides that the excise tax imposed by section 4371 shall be paid, on the basis of a return, by any person who makes, signs, issues, or sells any of the documents and instruments subject to the taxes, or for whose use or benefit the same are made, signed, issued, or sold. Thus, the liability for the tax falls jointly on all the parties to the insurance or reinsurance transaction.

Under regulations, the tax must be remitted by the resident person who actually pays the premium to a foreign insurer, reinsurer, or nonresident agent, solicitor or broker (Treas. Reg. sec. 46.4374-1(a)). The Treasury has stated that where a treaty permits an exemption from tax to the extent that the foreign insurer or reinsurer does not reinsure the risks covered by the policy with a person that would not be entitled to an exemption from the tax on such policy, the person otherwise required to remit the tax may consider the policy exempt only if, prior to filing the return for the taxable period, such person has knowledge that there was in effect for such taxable period a certain type of closing agreement between the insurer or reinsurer and the IRS (Rev. Proc. 92-39, 1992-1 C.B. 860, and Rev. Proc. 84-82, 1984-2 C.B. 779). Under the required closing agreement, the foreign insurer or reinsurer makes a secured promise to pay to the IRS any excise tax liability arising due to reinsurance of the risk with a non-treaty-protected reinsurer.

Description of Proposal

The proposal would revise the excise tax imposed on insurance premiums paid to foreign insurance companies by raising to 4 percent the excise tax on certain premiums paid to foreign persons for reinsurance covering casualty insurance and indemnity bonds. The proposal would subject premiums to the increased excise tax unless (1) the premiums are paid to a foreign insurer or reinsurer that is a resident of a foreign country, (2) the insurance income (including investment income) relating to the policy of reinsurance is subject to tax by a foreign country or countries at an effective rate that is substantial in relation to the tax imposed under the Code on similar premiums received by U.S. reinsurers, and (3) the insured risk is not reinsured (whether directly or through a series of transactions or business relationships or practices having the same effect) by a resident of another foreign country who is not subject to a substantial tax (as defined in condition (2)) on the income. In cases where all three conditions are satisfied, the excise tax would be imposed at the present-law rate of 1 percent.

The proposal would authorize such collection and enforcement mechanisms (e.g., closing agreements) as the Treasury may specify in order to ensure that any excise tax due on any reinsurance of the U.S. risk is collected. Parties to covered reinsurance trans-

actions would be required to comply with such specified mechanisms in order to remain eligible for the present-law rate of 1 percent.

Effective Date

The proposal would apply to premiums paid after the date of enactment, but only to the extent that they are allocable to insurance or reinsurance coverage for periods after December 31, 1993.

6. Tax certain foreign corporate dividends and deemed income inclusions as unrelated business taxable income

Present Law

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

Exceptions to this rule exist, however, in the case of certain dividends that are either business income of the recipient or distributions of business earnings on which the payor of the dividends was exempt from tax. For example, if a tax-exempt organization engages in commercial-type insurance activities, such activities are considered to be an unrelated trade or business and tax is computed on income from the activity (including income from investment assets that might otherwise generate tax-exempt income under the unrelated business taxable income rules) under subchapter L (sec. 501(m)(2)). As another example, a Domestic International Sales Corporation (DISC) is a domestic corporation exempt from U.S. income taxation by reason of section 991. Any dividend paid or deemed paid by a DISC to an organization that is exempt from tax under section 501(a) is treated as unrelated business taxable income (sec. 995(g)).

Although the Code is generally designed to impose only a single corporate-level tax on corporate earnings, a dividend paid by a foreign corporation to a U.S. corporation eligible for an indirect foreign tax credit on the dividend may have been subject to foreign tax at a rate lower than the full U.S. (34-percent) rate, and may therefore be subject to additional U.S. tax in the hands of the corporate shareholder. For example, if a gross dividend of $100 carries a total foreign tax credit of $17 (representing either direct or indirect foreign taxes, or both), the dividend represents a distribution of earnings that were subject to foreign tax at less than the full U.S. rate. If the recipient is a taxable U.S. person that is eligible for the indirect foreign tax credit, $17 of net U.S. tax is imposed on the recipient, representing the amount by which one full level of U.S. corporate tax exceeds the foreign taxes that were actually imposed. However, no similar U.S. tax is imposed on that amount if the recipient is generally exempt from U.S. tax under section 501(a).

The treatment of subpart F inclusions as unrelated business taxable income under Present Law is unclear. While temporary Treasury regulations specifically provide that subpart F income attributable to tax-exempt bond interest will retain that character in the

hands of a U.S. shareholder, a similar rule has not been provided for treatment as unrelated business taxable income.

Description of Proposal

The proposal would treat as unrelated business taxable income certain distributions made by a foreign corporation to a tax-exempt entity that is otherwise generally subject to taxation on income from an unrelated business, and that owns sufficient stock in the foreign corporation to be eligible for an indirect foreign tax credit with respect to the dividend. Similarly, the proposal would treat as unrelated business taxable income certain amounts that would be included in the income of a tax-exempt entity (if the tax-exempt entity were subject to tax) as a deemed distribution from a controlled foreign corporation.

Under the proposal, distributions of earnings by a foreign corporation would be treated as unrelated business taxable income in the same proportion that the earnings and profits of the foreign corporation would be treated as unrelated business taxable income if received directly by the recipient tax-exempt entity. Income inclusions under subpart F would be treated as unrelated business taxable income to the extent that the subpart F income of the controlled foreign corporation would be treated as unrelated business taxable income if received directly by the tax-exempt entity.

Effective Date

The proposal would be effective for distributions of earnings and profits that are generated in taxable years of foreign corporations beginning after December 31, 1993, and for inclusions of income under subpart F in respect of taxable years of foreign corporations beginning after December 31, 1993.

I. Excise Tax Provisions

1. Increase excise tax on State-authorized wagers

Present Law

An excise tax is imposed on the amount of certain wagers. The rate of tax is 0.25 percent for any wager authorized under the law of the State in which accepted and 2 percent for any other wager (sec. 4401).

Wagers subject to the excise tax are those placed in a for-profit lottery or those with respect to a sports event or contest that are placed (1) with a person engaged in the business of accepting wagers or (2) in a for-profit wagering pool. The term "lottery" does not include games in which usually wagers are placed, winners are determined, and prizes are distributed in the presence of all persons placing wagers or games conducted by organizations exempt from tax under Code sections 501 or 521 if no part of the net proceeds of the games inures to the benefit of any private shareholder or individual.

No excise tax is imposed on wagers placed in a wagering pool conducted by a parimutuel wagering enterprise licensed under State law, in a coin-operated device, or in a State-conducted lottery

(but only if the wager is placed with the State agency conducting the lottery).

Description of Proposal

The proposal would increase the rate of the excise tax on State-authorized wagers from 0.25 percent to 1 percent.

Effective Date

The proposal would be effective for wagers placed after the date of enactment.

2. Impose 5-percent excise tax on purchases from foreign corporations failing to provide IRS with timely information

Present Law

Under sections 6038A (a) and (b) of the Internal Revenue Code, any corporation (U.S. or foreign) that conducts a trade or business in the United States and that is 25-percent owned by a foreign person ("reporting corporation") must furnish the IRS with such information as the Secretary may prescribe regarding transactions with certain foreign persons treated as related to the reporting corporation. Under current regulations, the IRS requires the annual filing of an information return reporting all related-party transactions.

Failure to furnish the IRS with the relevant information is sanctioned by a monetary penalty of $10,000, and additional penalties are imposed if the failure continues more than 90 days after the IRS notifies the taxpayer of the failure (sec. 6038A(d)). The additional penalties are $10,000 for each 30-day period (or part thereof) during which the failure continues after the 90th day after IRS notification.

Description of Proposal

The proposal would impose a 5-percent excise tax on any purchase by a U.S. corporation of tangible personal property from a foreign person that is a foreign related party within the scope of section 6038A. The U.S. purchaser would be exempt from the tax if it files with its return a consent executed by the foreign person to provide the information specified in section 6038A(b) in the time and manner requested by the Secretary.

Effective Date

The proposal would be effective for taxable years with returns due 90 days or later after the date of enactment.

3. Increase excise tax on prohibited transactions under section 4975 to 10 percent

Present Law

Under present law, a 5-percent initial tax ("first-tier tax") is imposed with respect to the amount involved in each prohibited transaction relating to a qualified pension plan (sec. 4975). The tax is

imposed on any disqualified person who participates in the prohibited transaction. If the prohibited transaction is not corrected within a specified period of time, an additional 100-percent tax is imposed on the amount involved with respect to the transaction.

In general, a prohibited transaction refers to certain statutorily proscribed activities between a qualified plan and a disqualified person. Such activities include: (1) the direct or indirect sale or exchange, or leasing, of any property between a plan and a disqualified person; (2) the lending of money or other extension of credit between a plan and a disqualified person; (3) the furnishing of goods, services, or facilities between a plan and a disqualified person; (4) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan; (5) an act by a disqualified person who is a fiduciary whereby he or she deals with the income or assets of a plan in his or her own interest or for his or her own account; or (6) the receipt of any consideration for his or her own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan. Certain statutory exemptions to the rules apply. In addition, the Secretary of Labor may grant conditional or unconditional exemptions in appropriate cases. A disqualified person includes plan fiduciaries and certain other persons with a close relationship to the plan, such as the employer sponsoring the plan, persons providing services to the plan, and persons related to such persons.

Description of Proposal

The proposal would increase the first-tier tax on prohibited transactions from 5 percent to 10 percent.

Effective Date

The proposal would be effective with respect to prohibited transactions taxes assessed after December 31, 1993.

4. Increase cigarette excise tax rate

Present Law

Present law imposes an excise tax of $12 per thousand (24 cents per pack of 20) on small cigarettes, which are defined as cigarettes weighing no more than 3 pounds per thousand. Large cigarettes are subject to a tax of $25.20 per thousand. Most cigarettes consumed in the United States are small cigarettes.

The cigarette excise tax is imposed on the manufacture or importation of cigarettes. For excise tax purposes, there is no domestic tobacco content requirement, or tax rate differential, for domestically produced cigarettes.

Description of Proposal

The present excise tax rate on small cigarettes would be increased by 0.6 cent per pack of 20 cigarettes (i.e., to 24.6 cents per pack). Proportionate increases would be provided in the tax rate on large cigarettes.

Effective Date

The proposal would be effective on January 1, 1994.

5. Extend 3-percent communications excise tax to cable television

Present Law

A 3-percent Federal excise tax is imposed on amounts paid for local and toll (long-distance) telephone service and teletypewriter exchange service. The tax is collected by the service providers from their customers.

Exemptions from the telephone excise tax are provided for international organizations, the American Red Cross, servicemen in combat zones, nonprofit hospitals and educational organizations, State and local governments, and certain communications services furnished to news services for use in collection or dissemination of news services (except local telephone service to news services). Other exemptions include amounts paid for installation charges, certain calls from coin-operated telephones, and private communications systems (e.g., certain dedicated lines leased to a single business user).

Description of Proposal

The proposal would extend the present-law 3-percent communications excise tax to amounts paid for cable television service.

Effective Date

The proposal would be effective for service provided after December 31, 1993.

6. Repeal exemption from telephone excise tax for certain news services

Present Law

A 3-percent Federal excise tax is imposed on amounts paid for local and toll (long distance) telephone service, and on teletypewriter exchange service. The tax is collected by service providers from their customers.

Exemptions from the telephone excise tax are provided for international organizations, the American Red Cross, servicemen in combat zones, nonprofit hospitals and educational organizations, State and local governments, and certain communications services furnished to news services for use in collection or dissemination of news services (except local telephone service to news services).[33] Other exemptions include amounts paid for installation charges, certain calls from coin-operated telephones, and private communications systems (e.g., certain dedicated lines leased to a single business user).

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[33] More specifically, the Code provides an exception for "services used in the collection of news for the public press, or a news ticker service furnishing a general news service similar to that of the public press, or radio broadcasting, or in the dissemination of news through the public press. . . ." (sec. 4253(b)).

Description of Proposal

The exemption for news services from the telephone excise tax would be repealed.

Effective Date

The proposal would be effective for services provided after December 31, 1993.

7. Impose excise tax on carbon dioxide sold by ethanol producers

Present Law

Under present law, income tax credits and excise tax exemptions are available for ethanol that is used as a fuel, or mixed with fuel in a mixture used as fuel. An additional income tax credit is allowed for ethanol that is produced by certain small ethanol producers. Carbon dioxide, which is a natural byproduct when ethanol is produced, is neither eligible for a credit nor subject to a tax.

Description of Proposal

The proposal would impose a tax of $15 per ton on sales of carbon dioxide by ethanol producers.

Effective Date

The proposal would be effective for sales on or after January 1, 1994.

8. Increase heavy truck excise tax rate

Present Law

A 12-percent excise tax is imposed on the first retail sale of trucks (including tractors and trailers) having a gross vehicle weight of more than 33,000 pounds. The tax is scheduled to expire after September 30, 1999.

Revenues from the heavy truck excise tax are deposited in the Highway Trust Fund.

Description of Proposal

The heavy truck excise tax rate would be increased by 0.1 percentage points, to 12.1 percent.

Effective Date

The proposal would be effective on January 1, 1994.

9. Add additional chemicals to the list of taxed chemicals under the excise tax on ozone-depleting chemicals

Present Law

An excise tax is imposed on certain ozone-depleting chemicals. The amount of tax generally is determined by multiplying the base tax amount applicable for the calendar year by an ozone-depleting

factor assigned to each chemical. Certain chemicals are subject to reduced rate of tax.

The base tax amount is $3.35 per pound in 1993, $4.35 per pound in 1994, and $5.35 per pound in 1995. For years after 1995, the base tax amount will increase by 45 cents per pound per year. Taxed chemicals include: CFC–11; CFC–12; CFC–113; CFC–114; CFC–115; CFC–13; CFC–111; CFC–112; CFC–211; CFC–212; CFC–213; CFC–214; CFC–215; CFC–216; CFC–217; Halon-1211; Halon-1301; Halon-2402; carbon tetrachloride; and methyl chloroform.

A reduced rate of tax is provided for chemicals used as propellants for metered dose inhalers. Reduced rates of tax are provided in 1993 for chemicals used in rigid foam insulation, chemicals used as medical sterilants, the halons, and methyl chloroform.

Description of Proposal

The proposal would add to the present-law list of taxed chemicals methyl bromide, the HCFCs (hydrochlorofluorocarbons or halogenated CFCs) identified in the Copenhagen amendments to the Montreal Protocol for phaseout by the year 2030, and HBFCs (hydrobromofluorocarbons) identified in the Copenhagen amendments to the Montreal Protocol for phaseout by the year 1996.

Effective Date

The proposal would be effective for chemicals sold or used after December 31, 1993. A floor stocks tax would be imposed on taxed chemicals held on the effective date.

J. Tax-Exempt Entities

1. Deny tax-exempt status to social clubs that discriminate on the basis of gender and strengthen rules prohibiting discrimination by social clubs

Present Law

Exempt status for social clubs

Clubs organized for pleasure, recreation, and other nonprofitable purposes generally are exempt from Federal income tax so long as substantially all of their activities are for such purposes and no part of their net earnings inures to the benefit of any private shareholder (sec. 501(c)(7)). However, such organizations are not exempt for any year that the charter, by-laws, or other governing instrument of the organization or any written policy statement of the organization contains a provision that provides for discrimination against any person on the basis of race, color, or religion (sec. 501(i)). This prohibition does not apply to discrimination on the basis of religion by an auxiliary of certain fraternal beneficiary societies that limit their memberships to members of a particular religion or by a club that in good faith limits its membership to members of a particular religion in order to further the teachings of that religion and not to exclude individuals of a particular race or color (sec. 501(i)).

Preferential tax treatment of tickets to charitable sports events

A deduction under section 162 for a ticket at an activity or facility that is of a type generally considered to constitute entertainment, amusement, or recreation is allowed only for 50 percent of the lesser of the ticket's purchase price or its face value (secs. 274(l)(1) and (n)). This limitation does not apply, however, to sports events that utilize volunteers for substantially all of the work in carrying out the event and are organized for the primary purpose of benefiting a tax-exempt charitable organization to which all of the net proceeds from the event are contributed (secs. 274(l)(1)(B) and (n)(2)(C)). Tickets purchased for such charitable sports events (and related services) are fully deductible—provided other rules of section 162 and substantiation requirements are met—even if the purchase price exceeds the face value of such tickets (sec. 274(l)(1)).

Description of Proposal

The proposal[34] would add discrimination based on gender to the types of prohibited discrimination that cause a social club to lose its tax-exempt status. In addition, the proposal would amend section 501(i) to provide that, even if the governing instruments or written policy statements of a social club do not expressly provide for discrimination on the basis of race, color, gender, or religion, the social club nonetheless will lose its tax-exempt status if, at any time during the taxable year or a prior taxable year, there has been a final determination by an appropriate government agency or court that the social club so discriminated against any person.[35]

The proposal also would deny the present-law preferential tax treatment (i.e., a trade or business deduction of 100 percent of the full purchase price) for tickets to certain charitable sports events (and for related services) if the event is held at a club or facility that discriminates based on race, color, gender, or religion (within the meaning of section 501(i)).[36]

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment.

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[34] The proposal originally was introduced as a separate bill, H.R. 188 (102nd Cong.), by Mr. Rangel on January 3, 1991.

[35] Under the proposal, a final determination of prohibited discrimination will not be taken into account if it is established to the satisfaction of the Secretary of the Treasury that the organization no longer engages in discrimination of the type involved in such determination.

[36] Under the proposal, the preferential tax treatment for tickets to certain charitable sports events would be denied if the event were held at a taxable club that could be denied tax-exempt status by reason of section 501(i). The proposal would not alter the present-law limited exception that allows tax-exempt status for organizations that discriminate on the basis of religion in case of (a) certain fraternal beneficiary societies that limit their membership to members of a particular religion, or (b) clubs that in good faith limit their membership to members of a particular religion in order to further the teachings or principles of that religion and not to exclude individuals of a particular race or color.

2. Tax investment income of all political organizations at highest corporate rate

Present Law

Political organizations generally are exempt from Federal income tax on amounts received as contributions, membership dues, or proceeds from political fundraising events (sec. 527). For this purpose, a "political organization" means a party, committee, association, fund, or other organization (whether or not incorporated), organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures (or both) in an attempt to influence the selection, nomination, election, or appointment of any individual to any Federal, State, or local public office or an office in a political organization.

Despite their general tax-exempt status, most political organizations are subject to tax on their investment income at the highest marginal corporate tax rate. However, under a special rule contained in section 527(h), the investment income of principal campaign committees of *congressional* candidates is subject to tax at graduated corporate rates.[37] This special rule does not apply to campaign committees of candidates for State or local office, the investment income of which is subject to Federal income tax at the highest marginal corporate tax rate.

Description of Proposal

The proposal would repeal the special rule contained in section 527(h) that taxes at graduated corporate tax rates the investment income of principal campaign committees of congressional candidates. Thus, the investment income of *all* political organizations would be subject to tax at the highest marginal corporate tax rate.

Effective Date

The proposal would apply to taxable years beginning after the date of enactment.

3. Impose 30-percent excise tax on lobbying expenditures of tax-exempt organizations

Present Law

Non-charitable tax-exempt organizations

Most tax-exempt organizations other than charitable organizations (e.g., social welfare organizations and trade associations) may engage in unlimited lobbying efforts, provided the lobbying furthers the organization's tax-exempt purpose, without jeopardizing their tax-exempt status. Nonetheless, under provisions contained in the Omnibus Budget Reconciliation Act of 1993 (described below), the portion of dues (or other similar payments) made to a tax-exempt organization other than a charity that is attributable to lobbying may not be deducted by the payor as a trade or business expense,

[37] This special rule for principal campaign committees of congressional candidates was enacted in 1981.

unless the organization elects to itself pay a 35-percent proxy tax on its lobbying expenditures (Sec. 6033(e)(2)).

Limitations on public charities

A charitable organization otherwise described in section 501(c)(3) is not entitled to tax-exempt status under that section if a substantial part of its activities is "carrying on propaganda, or otherwise attempting, to influence legislation." There is no statutory definition under section 501(c)(3) of "propaganda, or otherwise attempting, to influence legislation," but Treasury regulations provide that an organization will be regarded as "attempting to influence legislation" if it (1) contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation; or (2) advocates the adoption or rejection of legislation (meaning action by Congress or another legislative body) (Treas. Reg. sec. 1.501(c)(3)–1(c)(3)). Conducting nonpartisan research is not considered lobbying for purposes of the section 501(c)(3) restriction, nor is seeking to protect the organization's own existence (the so-called "self-defense" exception) or responding to a governmental request for testimony.[38]

An organization will not fail to meet the requirements of section 501(c)(3) merely because it advocates, as an insubstantial part of its activities, the adoption or rejection of legislation. *Id.* Similarly, a public charity making the 501(h) election may incur lobbying expenditures in an amount determined in accordance with a numeric formula set forth in section 501(h) without jeopardizing its tax-exempt status. Section 501(h) defines "lobbying expenditures" as "expenditures for the purpose of influencing legislation (as defined in section 4911(d))." Section 4911(d) defines the term "influencing legislation" as—

> (A) any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment thereof, and
>
> (B) any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of the legislation.

However, section 4911(d)(2) specifically excludes from the definition of "influencing legislation" the following activities:

> (A) making available the results of nonpartisan analysis, study, or research;
>
> (B) providing of technical advice or assistance (where such advice would otherwise constitute the influencing of legislation) to a governmental body or to a committee or other subdivision thereof in {response to a written request by such body or subdivision, as the case may be;
>
> (C) appearances before, or communications to, any legislative body with respect to a possible decision of such body which might affect the existence of the organization, its

[38] See Rev. Rul. 64–195, 1964–2 C.B. 138; Rev. Rul. 70–79, 1970–1 C.B. 127; Rev. Rul. 70–449, 1970–2 C.B. 111; *Slee v. Comm'r*, 42 F.2d 184 (2d Cir. 1930).

powers and duties, tax-exempt status, or the deduction of contributions to the organization;

(D) communications between the organization and its bona fide members with respect to legislation or proposed legislation of direct interest to the organization and such members, other than communications . . . [which directly encourage members to contact a legislative body in an attempt to influence legislation, or which directly encourage members to urge persons other than members to attempt to affect the opinions of the general public or to contact a legislative body in an attempt to influence legislation]; and

(E) any communication with a government official or employee, other than

(i) a communication with a member or employee of a legislative body (where such communication would otherwise constitute the influencing of legislation), or

(ii) a communication the principal purpose of which is to influence legislation.

The limitations on lobbying activities of public charities apply to attempts to influence the actions of Congress, as well as State and local legislative bodies (Treas. Reg. sec. 1.501(c)(3)-1(c)(3)), but the limitations do not apply to attempts to influence the actions of Federal, State, or local executive, judicial, or administrative bodies (Treas. Reg. sec. 56.4911-2(d)(3)). Moreover, Treasury regulations provide that "administrative bodies" include school boards, housing authorities, sewer and water districts, zoning boards, and other similar Federal, State, or local special-purpose bodies, whether elective or appointive (Treas. Reg. sec. 56-4911-2(d)(4)).

Limitations on private foundations

Private foundations (as distinguished from public charities) generally are subject to penalty excise taxes under section 4945 if they engage in any direct or grass roots lobbying, even if not substantial. For purposes of section 4945, lobbying is defined in a manner similar to the definition under section 4911(d). Specifically, the section 4945 penalty excise taxes do not apply to nonpartisan analysis, the provision of technical advice to a governmental body in response to a written request, or lobbying before a legislative body with respect to a possible decision of such body which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation (sec. 4945(e)).

Disallowance of lobbying expenses as a trade or business expense

The Omnibus Budget Reconciliation Act of 1993 ("1993 Act") amended section 162(e) to provide that (except for up to $2,000 of in-house expenses) taxpayers may not deduct as a business expense amounts incurred in an attempt to influence Federal or State (but not local) legislation through communication with members or employees of legislative bodies or other government officials who may participate in the formulation of legislation. The Act also disallows a deduction for costs of contacting certain high-ranking Federal executive branch officials in an attempt to influence their official ac-

tions or positions.[39] In contrast to the rules governing lobbying by charities, exceptions are not provided for nonpartisan analysis, providing technical advice in response to a written request from a governmental body, or "self-defense" lobbying.

The 1993 Act also contains a flow-through rule to disallow a business deduction for a portion of membership dues paid to a trade organization or other non-charitable organization that engages in lobbying, unless the organization elects to pay a 35-percent proxy tax on its lobbying expenditures. However, flow-through information disclosure by a noncharitable organization to its members is not required, if the organization establishes to the satisfaction of the Secretary that substantially all of the dues (or similar payments) paid by persons to the organization are not deductible (without regard to the lobbying disallowance rule). The Act's flow-through information disclosure requirement does not apply to charities, but an anti-abuse rule provides that a charitable deduction is denied under section 170 if (1) a charity conducts lobbying on matters of direct financial interest to the donor's trade or business, and (2) a principal purpose of the contribution was to avoid Federal income tax by securing a deduction for lobbying activities that would be disallowed if the donor conducted such activities directly.

Description of Proposal

The proposal would impose a 30-percent excise tax on the lobbying expenditures (defined under sec. 162(e)) incurred by tax-exempt organizations. Thus, in the case of a tax-exempt charity that conducts "lobbying" as defined in section 162(e) (that is, no exception is provided for non-partisan analysis, technical advice provided in response to a written request from a governmental body, or so-called "self-defense" lobbying), the charity would be subject to a 30-percent excise tax on its lobbying expenditures, even if such expenditures do not constitute lobbying expenditures for purposes of determining whether the charity is entitled to tax-exempt status under section 501(c)(3).

The proposal would not apply to lobbying expenditures to the extent that a tax-exempt organization (e.g., a trade association) pays a proxy tax on its lobbying expenditures under the 1993 Act or penalty excise taxes are imposed on a private foundation with respect to such lobbying expenditures under present-law section 4945.

Effective Date

The proposal would apply to lobbying activities conducted after December 31, 1993.

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[39] "Covered executive branch officials" under the 1993 Act include the following Federal officials: (1) the President; (2) the Vice President; (3) an individual serving in a position of level I of the Executive Schedule, 5 U.S.C. sec. 5312, (e.g., a Cabinet member) or any other individual designated by the President as having Cabinet-level status; (4) any immediate deputy of an individual listed in (3) above; (5) the two most senior-level officers of each agency within the Executive Office of the President; and (6) any other officer or employee of the White House Office of the Executive Office of the President.

4. Extend limitations on lobbying activities of charitable organizations to attempts to influence actions of administrative agencies

Present Law

Limitations on public charities

A charitable organization otherwise described in section 501(c)(3) is not entitled to tax-exempt status under that section if a substantial part of its activities is "carrying on propaganda, or otherwise attempting, to influence legislation." There is no statutory definition under section 501(c)(3) of "propaganda, or otherwise attempting, to influence legislation," but Treasury regulations provide that an organization will be regarded as "attempting to influence legislation" if it (1) contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation; or (2) advocates the adoption or rejection of legislation (meaning action by Congress or another legislative body) (Treas. Reg. sec. 1.501(c)(3)-1(c)(3)). Conducting nonpartisan research is not considered lobbying for purposes of the section 501(c)(3) restriction, nor is seeking to protect the organization's own existence (the so-called "self-defense" exception) or responding to a governmental request for testimony.[40]

An organization will not fail to meet the requirements of section 501(c)(3) merely because it advocates, as an insubstantial part of its activities, the adoption or rejection of legislation. *Id.* Similarly, a public charity making the 501(h) election may incur lobbying expenditures in an amount determined in accordance with a numeric formula set forth in section 501(h) without jeopardizing its tax-exempt status. Section 501(h) defines "lobbying expenditures" as "expenditures for the purpose of influencing legislation (as defined in section 4911(d))." Section 4911(d) defines the term "influencing legislation" as—

> (A) any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment thereof, and
>
> (B) any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of the legislation.

However, section 4911(d)(2) specifically excludes from the definition of "influencing legislation" the following activities:

> (A) making available the results of nonpartisan analysis, study, or research;
>
> (B) providing of technical advice or assistance (where such advice would otherwise constitute the influencing of legislation) to a governmental body or to a committee or other subdivision thereof in response to a written request by such body or subdivision, as the case may be;

[40] See Rev. Rul. 64-195, 1964-2 C.B. 138; Rev. Rul. 70-79, 1970-1 C.B. 127; Rev. Rul. 70-449, 1970-2 C.B. 111; *Slee v. Comm'r*, 42 F.2d 184 (2d Cir. 1930).

(C) appearances before, or communications to, any legislative body with respect to a possible decision of such body which might affect the existence of the organization, its powers and duties, tax-exempt status, or the deduction of contributions to the organization;

(D) communications between the organization and its bona fide members with respect to legislation or proposed legislation of direct interest to the organization and such members, other than communications . . . [which directly encourage members to contact a legislative body in an attempt to influence legislation, or which directly encourage members to urge persons other than members to attempt to affect the opinions of the general public or to contact a legislative body in an attempt to influence legislation]; and

(E) any communication with a government official or employee, other than

(i) a communication with a member or employee of a legislative body (where such communication would otherwise constitute the influencing of legislation), or

(ii) a communication the principal purpose of which is to influence legislation.

The present-law limitations on lobbying activities of tax-exempt charities apply to attempts to influence the actions of Congress, as well as State and local legislative bodies (Treas. Reg. sec. 1.501(c)(3)-1(c)(3)), but the limitations do not apply to attempts to influence the actions of Federal, State, or local executive, judicial, or administrative bodies (Treas. Reg. sec. 56.4911-2(d)(3)). Moreover, Treasury regulations provide that "administrative bodies" include school boards, housing authorities, sewer and water districts, zoning boards, and other similar Federal, State, or local special-purpose bodies, whether elective or appointive (Treas. Reg. sec. 56-4911-2(d)(4)).

Limitations on private foundations

Private foundations (as distinguished from public charities) generally are subject to penalty excise taxes under section 4945 if they engage in any direct or grass roots lobbying, even if not substantial. For purposes of section 4945, lobbying is defined in a manner similar to the definition under section 4911(d). Specifically, the section 4945 penalty excise taxes do not apply to nonpartisan analysis, the provision of technical advice to a governmental body in response to a written request, or lobbying before a legislative body with respect to a possible decision of such body which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation (sec. 4945(e)).

Disallowance of lobbying expenses as a trade or business expense

The Omnibus Budget Reconciliation Act of 1993 ("1993 Act") provides that (except for up to $2,000 of in-house expenses) taxpayers may not deduct as a business expense amounts incurred in an attempt to influence Federal or State (but not local) legislation through communication with members or employees of legislative

bodies or other government officials who may participate in the formulation of legislation. The 1993 Act also disallows a deduction for costs of contacting certain high-ranking Federal executive branch officials in an attempt to influence their official actions or positions.[41] In contrast to the rules governing lobbying by charities, exceptions to the general disallowance rule are not provided for nonpartisan analysis, technical advice provided in response to a written request from a governmental body, or "self-defense" lobbying.

The 1993 Act also contains a flow-through rule to disallow a business deduction for a portion of membership dues paid to a trade organization or other non-charitable organization that engages in lobbying, unless the organization elects to pay a 35-percent proxy tax on its lobbying expenditures (Sec. 6033(e)(2)). The flow-through rule does not apply to charities, but an anti-abuse rule provides that a charitable deduction is denied under section 170 if (1) a charity conducts lobbying on matters of direct of direct financial interest to the donor's trade or business, and (2) a principal purpose of the contribution was to avoid Federal income tax by securing a deduction for lobbying activities that would be disallowed if the donor conducted such activities directly. However, the section 162(e) disallowance and flow-through rules and the section 170 anti-abuse rule contained in the 1993 Act do not apply to attempts to influence actions of Federal agencies, provided that there is no direct communication with a covered high-ranking Federal official, nor do these rules apply to attempts to influence State or local executive branch or agency actions.

Description of Proposal

The proposal would extend the present-law limitations on lobbying activities of tax-exempt charities to attempts made by charities to influence the actions of Federal, State, or local administrative agencies (other than local land-use agencies, such as zoning boards). Thus, if a charity's aggregate lobbying activities for a taxable year with respect to legislation and administrative agency actions are substantial (or, if the section 501(h) election is made, the charity normally makes lobbying expenditures in excess of the lobbying ceiling amount under that section), the charity would be denied tax-exempt status under section 501(c)(3).

As under present-law, exceptions would be provided for (1) nonpartisan analysis, (2) technical advice provided in response to a written request from a governmental body, and (3) lobbying with respect to agency decisions that might affect the existence, powers or duties, tax-exempt status, or the deduction of contributions to a charity.

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[41] "Covered executive branch officials" under the 1993 Act include the following Federal officials: (1) the President; (2) the Vice President; (3) an individual serving in a position of level I of the Executive Schedule, 5 U.S.C. sec. 5312, (e.g., a Cabinet member) or any other individual designated by the President as having Cabinet-level status; (4) any immediate deputy of an individual listed in (3) above; (5) the two most senior-level officers of each agency within the Executive Office of the President; and (6) any other officer or employee of the White House Office of the Executive Office of the President.

Effective Date

The proposal would apply to lobbying activities conducted after December 31, 1993.

5. Extend private inurement rule to section 501(c)(4) organizations

Present Law

A tax-exempt charitable organization described in section 501(c)(3) must be organized and operated exclusively for a charitable, religious, educational, scientific, or other exempt purpose specified in that section, and no part of the organization's net earnings may inure to the benefit of any private shareholder or individual.[42]

A tax-exempt social welfare organization described in section 501(c)(4) must be organized on a non-profit basis and must be operated exclusively for the promotion of social welfare.[43] In contrast to section 501(c)(3), however, there is no specific rule in section 501(c)(4) that prohibits the net earnings of a social welfare organization from inuring to the benefit of a shareholder or individual.

Description of Proposal

Section 501(c)(4) would be amended to provide tax-exempt status to civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, provided that no part of the net earnings of such an organization inures to the benefit of any private shareholder or individual. In addition, section 501(c)(4) would be amended to provide tax-exempt status to local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, provided that the association is operated exclusively for charitable, educational, or recreational purposes, and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Effective Date

The proposal would be effective on the date of enactment.

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[42] The private inurement restriction prohibits inurement of an organization's assets to "persons having a personal and private interest in the activities of the organization." Treas. Reg. sec. 1.501(a)-1(c). Even where no prohibited private inurement exists, however, more than incidental private benefits may be conferred upon disinterested persons such that the organization is not operated exclusively for an exempt purpose. (See *American Campaign Academy v. Comm'r*, 92 T.C. 1053 (1989)).

[43] Section 501(c)(4) also provides tax-exempt status to local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

K. Compliance

1. Information reporting on State and local real property taxes and refunds

Present Law

Individual taxpayers who itemize deductions may deduct State and local income, real property, and personal property taxes. No deduction is allowed for taxes assessed against local benefits that tend to increase the value of the assessed property. Any refund, credit, or offset of State or local taxes that was deducted (with a resulting tax benefit) in a previous year is includible in the taxpayer's gross income in the year the refund is received. Present law does not require State and local governments to provide information reports to the Internal Revenue Service (IRS) and the taxpayer on payments of State and local real property taxes or on refunds, credits, or offsets of such taxes.

Description of Proposal

The proposal would require State and local governments to file information returns with the IRS regarding real property taxes. These information reports would set forth (1) the amount of real property taxes paid by a taxpayer, (2) any cash payment, credit, or offset for real property taxes received by the taxpayer, and (3) the name, address, and taxpayer identification number of the taxpayer. The same information also would be provided to the taxpayer. Nondeductible user fees would not be included in the amounts of real property taxes paid.

The information reports would be required to be filed in accordance with the timetable generally applicable to other information returns. Consequently, the State and local governments would provide the information return to the taxpayer by the last day of January of the year following the year in which the payments, credits, or offsets are made; the State and local governments would have one additional month (until the end of February) to supply the information return to the IRS.

Effective Date

The proposal would be effective for payments made after December 31, 1994. Thus, State and local governments would first provide information returns to individual taxpayers by the end of January 1996, and to the IRS by the end of February 1996, on taxes that were paid in 1995.

2. Modify estimated tax requirements for individuals

Present Law

An individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to: (1) 100 percent of the tax shown on the return of the individual for the preceding year (the "100 percent of last year's liability safe harbor")

or (2) 90 percent of the tax shown on the return for the current year. Income tax withholding from wages is considered to be a payment of estimated taxes. However, for taxable years beginning after 1993, the 100 percent of last year's liability safe harbor is modified to be a 110 percent of last year's liability safe harbor for any individual with an AGI of more than $150,000 as shown on the return for the preceding taxable year.[44]

Description of Proposal

For any individual with an AGI of more than $150,000 as shown on the return for the preceding taxable year, the proposal would modify the present-law 110 percent of last year's liability safe harbor to be a 115 percent of last year's liability safe harbor.

Effective Date

The proposal would be effective for estimated tax payments applicable to taxable years beginning after December 31, 1993.

3. Change substantiation requirements for business meal and entertainment expenses

Present Law

In general, a taxpayer may deduct all ordinary and necessary expenses paid or incurred during the taxable year (1) in carrying on any trade or business and (2) in the case of an individual, for the production of income. Taxpayers generally may not deduct personal, living, or family expenses.

Meal and entertainment expenses incurred for business or investment reasons are deductible only if certain legal and substantiation requirements are met. The amount of the deduction generally is limited to 80 percent of the expense that meets these requirements. For taxable years beginning after December 31, 1993, the applicable limitation percentage is 50 percent. No deduction is allowed, however, for meal or beverage expenses that are lavish or extravagant under the circumstances.

No deduction is allowed with respect to business meal and entertainment expenses (as well as other specified items) unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement (1) the amount of the expense, (2) the time and place of the expense, (3) the business purpose of the expense, and (4) the business relationship between the taxpayer and the persons entertained. Under Treasury regulations, documentary evidence is required for expenditures of $25 or more (Treas. Reg. sec. 1.274-5T(c)(2)(iii)(B)).

Description of Proposal

The proposal would deny a taxpayer a deduction for any business meal or entertainment expenditure (or, in the alternative, for any such expenditure that is $10 or more) unless the taxpayer could

[44] The 110 percent of last year's liability safe harbor was added by sec. 13214 of the Omnibus Budget Reconciliation Act of 1993. The Act also repealed a special rule that denied the use of an estimated tax safe harbor calculated on the basis of the prior year's tax liability for certain individuals.

substantiate the expenditure with a receipt prepared at the time of the expenditure (or within a reasonable period thereafter) by the provider of the goods or services constituting the expenditure.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1993.

4. Deny deduction for interest payable on corporate tax underpayments

Present Law

In general, a corporation is allowed an income tax deduction for all interest paid or accrued, including interest paid to the Internal Revenue Service on tax obligations.

An individual is not allowed to deduct personal interest. For this purpose, personal interest includes interest on underpayments of the individual's income taxes, even if all or a portion of the individual's income is attributable to a trade or business.

Interest is charged by the Internal Revenue Service on any underpayment of tax. The underpayment rate generally is the sum of the short-term Federal rate plus three percentage points. In addition, an interest rate equal to the sum of the short-term Federal rate plus five percentage points is applicable for purposes of determining interest attributable to underpayments of more than $100,000 of a C corporation for periods beginning after the 30th day following the date the corporation is notified by the Internal Revenue Service of an underpayment.

Description of Proposal

The proposal would deny a deduction to a corporation for interest attributable to the underpayment of tax.

Effective Date

The proposal would be effective for interest attributable to periods beginning after the date of enactment (or a specified time after the date of enactment), regardless of the taxable period to which the underlying underpayment of tax may relate.

5. Increase the rate of interest payable on corporate tax underpayments

Present Law

Interest is charged by the Internal Revenue Service on any underpayment of tax. The underpayment rate generally is the sum of the short-term Federal rate plus 3 percentage points. In addition, an interest rate equal to the sum of the short-term Federal rate plus 5 percentage points is applicable for purposes of determining interest attributable to underpayments of more than $100,000 of a C corporation for periods beginning after the 30th day following the date the corporation is notified by the Internal Revenue Service of an underpayment.

Description of Proposal

The proposal would increase the underpayment rate.

Effective Date

The proposal would be effective for interest attributable to periods beginning after the date of enactment (or a specified time after the date of enactment), regardless of the taxable period to which the underlying underpayment of tax may relate.

6. Increase rate of interest for underpayments of estimated tax for certain Alaska Native Corporations and individuals

Present Law

Corporate and individual taxpayers are subject to an addition to tax for any underpayment of estimated tax. The addition to tax is computed by applying the underpayment interest rate (100 percent of the Federal short-term rate plus 3 percentage points) to the amount of the underpayment for the period of the underpayment.

Description of Proposal

Under the proposal, the rate of addition to tax for underpayments of estimated tax would be increased by 10 percent for certain Alaska Native Corporations established under the Alaska Native Claims Settlement Act (43 U.S.C. Secs. 1601 *et seq.*) and certain Alaska Native individuals (generally, those individuals entitled to receive Alaska Native Corporation stock). Thus, in such cases the rate would be 110 percent of the sum of the Federal short-term rate plus 3 percentage points.

Effective Date

The proposal would be effective for underpayments of estimated taxes due on or after the date of enactment.

7. Information returns relating to the discharge of indebtedness by all companies in the trade or business of originating or acquiring loans

Present Law

Discharge of indebtedness

Under Code section 61(a)(12), a taxpayer's gross income includes income from the discharge of indebtedness. The determination of when a discharge of indebtedness occurs under section 61(a)(12) is a question of fact. (See, e.g., *Carl T. Miller Trust v. Commissioner*, 76 T.C. 191 (1981).) In general, a debtor has discharge of indebtedness income where a debt is repurchased or otherwise deemed satisfied for less than its outstanding balance. For example, discharge of indebtedness income may be triggered by a debt modification under Code section 1001 or where a court adjudicates favorably a defense for the borrower. Discharge of indebtedness income is generally not deemed to result merely because the lender (1) has not actively pursued its claim against the debtor, provided a legal

claim still exists, (2) claims a deduction for financial or regulatory reporting purposes, or (3) claims a partial or full bad debt deduction for tax purposes. However, the existence of several factors such as these may, when considered collectively, indicate that a discharge of indebtedness has occurred.

Information reporting

As amended by the Omnibus Budget Reconciliation Act of 1993, the Internal Revenue Code generally requires "applicable financial entities" to file information returns with the Internal Revenue Service (IRS) regarding any discharge of indebtedness (within the meaning of sec. 61(a)(12)) of $600 or more (sec. 6050P).[45] An information return must set forth the name, address and taxpayer identification number of the person whose debt was discharged, the amount of debt discharged, and the date on which the debt was discharged.[46] The information return must be filed in the manner and at the time specified by the IRS. The same information also must be provided to the person whose debt is discharged by January 31 of the year following the discharge.

Such information returns are required regardless of whether the debtor is subject to tax on the discharged debt. For example, reporting entities need not determine whether the debtor qualifies for an exclusion under section 108.

"Applicable financial entities" include: (1) the Federal Deposit Insurance Corporation, the Resolution Trust Company, the National Credit Union Administration, any other Federal executive agency (as defined in section 6050M), and any successor or subunit of any of them; (2) any financial institution (as described in secs. 581 or 591(a)); (3) any credit union; and (4) any subsidiary of an entity described in (2) or (3) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a Federal or State agency regulating such entities.

The penalties for failure to file correct information reports with the IRS and to furnish statements to taxpayers are similar to those imposed with respect to a failure to provide other information returns. For example, the penalty for failure to furnish statements to taxpayers is generally $50 per failure, subject to a maximum of $100,000 for any calendar year.[47] These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

Description of Proposal

The proposal would broaden the type of entities that are required to file information reports with respect to discharges of indebtedness by amending the definition of "applicable financial entities" to include any company that is in the trade or business of originating or acquiring loans.

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[45] Non-governmental entities are only required to report under this provision with respect to discharges of indebtedness after December 31, 1993.

[46] The date of discharge is required to facilitate the use of such information returns with respect to fiscal year taxpayers.

[47] In the case of intentional disregard of the filing requirements, the penalty is not less than $100 per failure and the $100,000 annual limitation does not apply.

Effective Date

The proposal would be applicable to discharges of indebtedness after December 31, 1993.

8. Increase withholding rate on supplemental wage payments

Present Law

Under Treasury regulations, withholding on supplemental wage payments (such as bonuses, commissions, and overtime pay) that are not paid concurrently with wages (or that are paid concurrently with wages, but are separately stated) for a payroll period may be done at a rate of 20 percent (at the employer's election) (Treas. Reg. sec. 31.3402(g)-1).[48]

For payments made after December 31, 1993, the rate for withholding on supplemental wage payments is 28 percent.[49]

Description of Proposal

The proposal would increase the applicable withholding rate on supplemental wage payments to 36 percent.

Effective Date

The proposal would be effective for payments made after December 31, 1993.

9. Increase withholding rate on gambling winnings

Present Law

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

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

No withholding tax is imposed on winnings from a slot machine, bingo, or keno.

Description of Proposal

The proposal would increase the applicable withholding rate on gambling winnings to 36 percent.

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[48] If an employer chooses not to use the 20-percent method, withholding may be computed by aggregating the supplemental payments with regular wages paid within the same calendar year for the last preceding payroll period or the current payroll period. The employer would then use withholding tables to determine the total tax on this aggregate amount. The amount to be withheld for the supplemental wages is the total tax less any amount already withheld for regular wages included in the aggregate amount.

[49] The increase in the withholding rate to 28 percent was made in the Omnibus Budget Reconciliation Act of 1993.

Effective Date

The proposal would be effective for payments made after December 31, 1993.

10. Increase backup withholding rate

Present Law

Under Code section 3406, a payor is required to withhold on certain "reportable payments", such as interest and dividends, at a rate of 31 percent[50] if: (1) the payee fails to furnish his or her taxpayer identification number (TIN) to the payor; (2) the Internal Revenue Service notifies the payor that the payee's TIN is incorrect; (3) a notified payee underreporting of reportable payments has occurred (as described in section 3406(c)); or (4) a payee certification failure with respect to reportable payments has occurred (as described in section 3406(d)).

Description of Proposal

The proposal would increase the withholding rate on interest, dividends and all other "reportable payments" under section 3406 from 31 percent to 36 percent.

Effective Date

The proposal would be effective for amounts paid after December 31, 1993.

11. Reporting requirements for purchasers of fish

Present Law

Under present law, service as a crew member on a fishing vessel is generally excluded from the definition of employment for purposes of income tax withholding on wages and for purposes of the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) taxes if the operating crew of the boat normally consists of fewer than 10 individuals, the individual receives a share of the catch based on the total catch, and the individual does not receive cash remuneration other than proceeds from the sale of the individual's share of the catch. Crew members to which the exemption applies are subject to self-employment taxes. The operator of a boat on which one or more exempt crew members serve is required to report information about such individuals and the catch.

Description of Proposals

(1) The proposal would require persons who purchase more than $600 of fish or other forms of aquatic animal life from any seller in a calendar year for the purpose of resale to file information returns with the Secretary regarding such purchases. The return would be required to contain such information as the Secretary may prescribe.

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[50] For amounts paid prior to January 1, 1993, the withholding rate is 20 percent. The backup withholding rate was increased to 31 percent in the Energy Policy Act of 1992.

(2) Same as (1), except that the reporting threshold would be $1,000 rather than $600.

Effective Date

The proposals would be effective for years beginning after December 31, 1993.

12. Extend IRS offset authority for undercover operations

Present Law

The Anti-Drug Abuse Act of 1988 exempted Internal Revenue Service (IRS) undercover operations from the otherwise applicable statutory restrictions controlling the use of Government funds (which generally provide that all receipts be deposited in the general fund of the Treasury and all expenses be paid out of appropriated funds). In general, the exemption permits the IRS to "churn" the income earned by an undercover operation to pay additional expenses incurred in the undercover operation (sec. 7608(c)). The IRS is required to conduct a detailed financial audit of large undercover operations in which the IRS is churning funds and to provide an annual audit report to the Congress on all such large undercover operations. The exemption originally expired after December 31, 1989, and was extended by the Comprehensive Crime Control Act of 1990 through December 31, 1991.

Description of Proposal

The proposal would extend the IRS's offset authority under section 7608(c) until September 1, 1996. The proposal would amend the IRS annual reporting requirement under section 7608(c)(4)(B) to require the provision of the following data: (1) the date the operation was initiated, (2) the date offsetting was approved, (3) the total current expenditures and the amount and use of proceeds of the operation, (4) a detailed description of the undercover operation projected to generate proceeds, including the potential violation being investigated, whether the operation is being conducted under grand jury auspices, and the conclusion date of covert operations, and (5) the results of the operation to date, including the results of criminal proceedings.

Effective Date

The proposal would be effective as of January 1, 1992.

13. Extend cash transactions disclosure rule permanently

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service (IRS) to another agency unless the other agency estab-

lishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Under section 6050I, any person who receives more than $10,000 in cash in one transaction (or two or more related transactions) in the course of a trade or business generally must file an information return (Form 8300) with the IRS specifying the name, address, and taxpayer identification number of the person from whom the cash was received and the amount of cash received.

The Anti-Drug Abuse Act of 1988 provided a special rule permitting the IRS to disclose these information returns to other Federal agencies for the purpose of administering Federal criminal statutes. The special rule originally was to expire after November 18, 1990, and was extended by the Comprehensive Crime Control Act of 1990 to November 18, 1992.

Description of Proposal

The proposal would permanently extend the special rule for disclosing Form 8300 information. Moreover, the proposal would permit disclosures not only to Federal agencies but also to State, local and foreign agencies and for civil, criminal and regulatory purposes (i.e., generally in the same manner as CTRs filed by financial institutions under the Bank Secrecy Act.) Disclosure, however, would not be permitted to any such agency for purposes of tax administration. The proposal also (1) would extend the dissemination policies and guidelines under section 6103 to people having access to Form 8300 information, and (2) would apply section 6103 sanctions to persons having access to Form 8300 information that disclose this information without proper authorization.

Effective Date

The proposal would be effective on November 18, 1992.

L. Miscellaneous

1. Repeal safe harbor provisions for construction industry employers

Present Law

In general, the determination of whether an employer-employee or independent contractor relationship exists for Federal tax purposes is made under a common-law test. Under this test, an employer-employee relationship generally exists if the person contracting for the services has the right to control not only the result of the services, but also the means by which that result is accomplished. Whether the requisite control exists is determined based on the facts and circumstances. The Internal Revenue Service (IRS) uses a 20-factor test for this purpose.

In the late 1960s, the IRS increased enforcement of the employment tax laws and controversies developed between the IRS and taxpayers as to whether businesses had correctly classified certain workers as independent contractors rather than as employees. In response to this problem, Congress enacted section 530 of the Revenue Act of 1978 ("section 530"), which generally permits an em-

ployer to treat an individual as not being an employee for employment tax purposes[51] regardless of the individual's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment and if certain additional requirements are satisfied. Under section 530, a reasonable basis is considered to exist for this purpose if the taxpayer reasonably relied on certain factors, such as a longstanding industry practice or the past failure of the IRS to raise such an employment tax issue on audit.

Section 1706 of the Tax Reform Act of 1986 ("section 1706") provides that section 530 does not apply to certain technical sevice workers such as engineers, drafters, computer programmers and other similarly skilled workers who are part of a three-party employment transaction. Under section 1706, technical service workers are classified, for income and employment tax purposes, as employees or as independent contractors, under the common-law test without regard to section 530.

Description of Proposal

The proposal would provide that section 530 of the Revenue Act of 1978 does not apply in the case of an individual who provides services for a construction industry employer.

Effective Date

The proposal would apply to remuneration paid and services rendered after December 31, 1993.

2. Deny deductions for certain oil spill and hazardous waste cleanup expenses

Present Law

Ordinary and necessary expenses generally are deductible (sec. 162(a)). Fines or similar penalties are not deductible (sec. 162(f)).

Under the Oil Pollution Act of 1990 ("OPA") and the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA"), a company has unlimited liability for an oil or hazardous waste spill that resulted from gross negligence, willful misconduct, or certain violations of law.

Expenses related to cleaning up oil and hazardous waste spills generally are considered to be ordinary and necessary.

Description of Proposal

The proposal would deny deductions for all cleanup costs associated with an oil or hazardous substance spill caused by a company found to have unlimited liability under OPA or CERCLA.

Effective Date

The proposal would be effective for expenses incurred after the date of enactment.

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[51] Section 530 does not apply for income tax purposes.

3. Modify standard for nonrecognition of gain on exchanges of like-kind property

Present Law

An exchange of property, like a sale, generally is a taxable transaction. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" that is to be held for productive use in a trade or business or for investment (sec. 1031). Unimproved real estate that is exchanged for improved real estate generally qualifies as a "like-kind" exchange.

The like-kind standard contrasts with the standard under section 1033 providing for nonrecognition of gain upon certain involuntary conversions of property (e.g., through destruction, theft, seizure, or condemnation). Other than upon a condemnation of real estate (to which the like-kind standard applies), section 1033 permits nonrecognition of gain to involuntary conversions only if the taxpayer acquires replacement property that is "similar or related in service or use" to the converted property. This standard is significantly narrower than the like-kind standard. For example, unimproved and improved real estate generally are not considered similar or related in service or use.

Description of Proposal

The proposal would conform the standard for nonrecognition under section 1031 to the standard under section 1033 that applies for purposes of nonrecognition on involuntary conversions. Thus, in order to qualify for nonrecognition under section 1031, the property that is received generally would need to be "similar or related in service or use" to the property that is transferred. The "similar or related in service or use" standard, however, would not replace the like-kind standard in the case of a condemnation of real estate (sec. 1033(g)).

Effective Date

The proposal would be effective on the date of enactment.

4. Disallow stock options as qualifying expense under research tax credit

Present Law

The research and experimentation tax credit ("research tax credit") provides a credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceed its base amount for that year. The credit is scheduled to expire after June 30, 1995.

The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 pe-

riod bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up" firms) are assigned a fixed-base percentage of .03.[52]

In computing the credit, a taxpayer's base amount may not be less than 50 percent of its current-year qualified research expenditures.

Qualified research expenditures eligible for the credit consist of: (1) "in-house" expenses of the taxpayer for research wages and supplies used in research; (2) certain time-sharing costs for computer use in research; and (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf. The credit is not available for expenditures attributable to research that is conducted outside the United States. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

For purposes of the research credit, the term "wages" has the same meaning as for wage withholding purposes under section 3401(a), which generally includes amounts received by an employee upon exercise of a stock option (sec. 41(b)(2)(D)).[53] Consequently, wages received upon exercise of a stock option may be counted as part of the employer's qualified research expenditures during the year that the option is exercised (and, thus may be eligible for credit dollars), even though there may be no incremental increase in research activities conducted by the employer during that year.[54]

The 20-percent research tax credit also applies to the *excess* of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for basic research conducted by universities (and certain scientific research organizations) *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.

Deductions for expenditures allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.[55]

Description of Proposal

The proposal would exclude stock options as qualified expenditures for purposes of the research credit (unless the option is included in gross income by the employee at the time of the grant).

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[52] The Omnibus Budget Reconciliation Act of 1993 (P.L. 103–66) contains a special rule providing that, in the event that the research credit is extended beyond June 30, 1995, a start-up firm will be required to recompute its fixed-base percentage based on its actual research experience after 1993.

[53] If a nonstatutory option (i.e., one not meeting the requirements of secs. 421-424) does not have a readily ascertainable fair market value at the time of the grant, income is realized at the time of exercise or disposition of the option (Treas. Reg. sec. 1.83-7(a)). When such an option is exercised, the excess of the fair market value of the stock over the option price constitutes wages subject to withholding (see Rev. Rul. 67-257, 1967-2 C.B. 359; Rev. Rul. 78-185, 1978-1 C.B. 304).

[54] See *Apple Computer, Inc. v. Comm'r*, 98 T.C. #18 (March 3, 1992); *acq.* ——— C.B. ———.

[55] Taxpayers may alternatively elect to claim a reduced research credit amount in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

Effective Date

The proposal would be effective for options exercised after the date of enactment.

5. Provide anti-abuse rules with respect to the special rules applicable to FCC-certified sales of broadcast properties

Present Law and Background

Section 1071 of the Internal Revenue Code allows a seller to defer recognizing gain on the sale or exchange of property if the transaction is certified by the Federal Communications Commission ("FCC") to be necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the FCC with respect to the ownership and control of broadcasting stations. A seller receiving a certificate from the FCC can defer recognizing gain on its sale by making either one or a combination of two elections on its tax return.

First, the seller may elect to treat the sale or exchange as an "involuntary conversion" under section 1033. If this election is made, the taxpayer will generally defer recognizing gain on the sale to the extent that it reinvests the sale proceeds in qualifying replacement property within two years from the end of the tax year in which the sale occurs. Second, if the seller chooses not to elect an "involuntary conversion" or would otherwise recognize gain (because it reinvested only a portion of its cash proceeds in qualifying replacement property), section 1071 allows the seller to elect to apply the gain to reduce the basis of depreciable property that is either held by the seller immediately after the sale or acquired by the seller in the taxable year of the sale.

In 1978, the FCC announced a policy of promoting minority ownership of broadcast facilities by offering a tax certificate to those who voluntarily sell such facilities (either in the form of assets or stock) to minority individuals or minority-controlled entities.[56] The FCC's policy was based on the view that minority ownership of broadcast stations would provide a significant means of fostering the inclusion of minority views in programming.

Some news reports suggest that tax certificates are being issued for sales of broadcast property to minority individuals and to minority-controlled entities that are not significantly fostering minority ownership of broadcast stations.[57] In some instances, minority buyers are reported to have resold the broadcast property (or their interest in the property) shortly after the original sale. In other instances, minority investors purport to control the buyer (often a limited partnership or other syndication), but effectively do not.

Description of Proposal

The proposal would modify section 1071 by adding anti-abuse rules to ensure that tax incentives are available only for sales that actually foster minority ownership of broadcast stations.

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[56] *Minority Ownership of Broadcasting Facilities*, F.C.C. 78-322, 68 F.C.C. 2d 979 (1978).

[57] "FCC Minority Programs Spurs Deals—and Questions", *Washington Post*, June 3, 1993; "How the Rich Get Richer", *Forbes*, May 15, 1989; "Minority Broadcasters' Tax Break Hit," *Washington Post*, July 12, 1987.

Effective Date

The proposal would be effective for sales occurring on or after the date of enactment.

6. Capitalization and amortization of certain environmental remediation costs

Present Law

Code section 162 allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Treasury Regulations provide that the cost of incidental repairs which neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense.

Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury Regulations define "capital expenditures" as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use. Amounts paid for repairs and maintenance do not constitute capital expenditures.[58]

The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case. An early formulation of the distinction between repairs and capital improvements is set forth in *Illinois Merchants Trust Co.*, 4 B.T.A. 103, 106 (1925), acq. V-2 C.B. 2:

> A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, not does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings.

Treasury Regulations provide that capital expenditures include the costs of acquiring or substantially improving buildings, machinery, equipment, furniture, fixtures and similar property having a useful life substantially beyond the current year.[59] In *INDOPCO, Inc. v. Commissioner*, 112 S. Ct. 1039 (1992), the Supreme Court required the capitalization of legal fees incurred by a taxpayer in connection with a friendly takeover by one of its customers on the grounds that the merger would produce significant economic benefits to the taxpayer extending beyond the current year; capitalization of the costs thus would match the expenditures with the income produced. Similarly, the amount paid for the construction of a filtration plant, with a life extending beyond the year of comple-

[58] Treas. Reg. sec. 1.263(a)-1(b).
[59] Treas. Reg. sec. 1.263(a)-2(a).

tion, and as a permanent addition to the taxpayer's mill property, was a capital expenditure rather than an ordinary and necessary current business expense. *Woolrich Woolen Mills v. United States*, 289 F.2d 444 (3d Cir. 1961).

Although Treasury regulations provide that expenditures that materially increase the value of property must be capitalized, they do not set forth a method of determining how and when value has been increased. In *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962), nonacq., 1964-2 C.B. 8, the U.S. Tax Court held that increased value was determined by comparing the value of an asset after the expenditure with its value before the condition necessitating the expenditure. The Tax Court stated that "an expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair."

In two recent Technical Advice Memoranda (TAM), the Internal Revenue Service (IRS) declined to apply the *Plainfield Union* valuation analysis, indicating that the analysis represents just one of several alternative methods of determining increases in the value of an asset. In TAM 9240004 (June 29, 1992), the IRS required certain asbestos removal costs to be capitalized rather than expensed. In that instance, the taxpayer owned equipment that was manufactured with insulation containing asbestos; the taxpayer replaced the asbestos insulation with less thermally efficient, non-asbestos insulation. The IRS concluded that the expenditures resulted in a material increase in the value of the equipment because the asbestos removal eliminated human health risks, reduced the risk of liability to employees resulting from the contamination, and made the property more marketable. Distinguishing *Plainfield Union*, the IRS stated that: (1) the *Plainfield Union* test is relevant only in situations where repairs are necessary because the property has progressively deteriorated; (2) it was impossible to value the asset prior to the existence of the asbestos because the asbestos was in the property when manufactured; and (3) the objective measurement of increased value set forth in *Plainfield Union* is not compatible with the subjective factors (such as safer working conditions and improved marketability) that are the source of the increase in the value of the property containing asbestos. In addition, the IRS noted that the asset increased in value as a result of being brought into compliance with local regulations and requirements, and that the removal of the asbestos reduces the possibility of equipment interruptions due to safety violations and enhanced certain operating efficiencies.[60]

The IRS also recently issued TAM 9315004 (December 17, 1992) requiring a taxpayer to capitalize certain costs associated with the remediation of soil contaminated with polychlorinated biphenyls (PCBs). The costs at issue included costs for the following: (1) soil contamination assessments to determine the level of PCB contami-

[60] The IRS also noted that removal of asbestos effectuates a permanent improvement and thus, represents a significant change to the property that is not remedial. Citing *INDOPCO*, the IRS stated that removal costs create long-term future benefits that accrue beyond the year they were incurred. Finally, the IRS stated that the future benefits are not merely incidental, but relate to the very reason for incurring the expense—increased health and safety.

nation; (2) groundwater contamination assessment; (3) soil remediation, including excavation and backfilling work; (4) legal fees; (5) oversight of the cleanup operations; (6) environmental audits and preparation of a compliance manual; and (7) research and development for chemical remediation processes to facilitate the remediation of PCBs. The IRS concluded that the costs of positive soil contamination assessments, soil remediation and oversight costs should be capitalized as an addition to the taxpayer's existing facilities, because they increased the value of the property and constituted a general plan of rehabilitation. In contrast, the IRS held that negative assessment costs and legal fees were deductible, and expressed no opinion on the costs of environmental audits and research and development. Again distinguishing this case from *Plainfield Union*, the IRS stated that (1) the decision in *Plainfield Union* was based on the entire factual context and not solely on the valuation measurement analysis;[61] (2) unlike the case at issue, the repair in *Plainfield Union* involved only a minor part of the taxpayer's operation and was not part of any general plan; and (3) if the *Plainfield Union* test were the only relevant factor, then any replacement of a capital asset would be deductible. The IRS further noted that the expenditures at issue were for extensive replacements of significant sections of land and costs associated with this work. The IRS took the position that, as a result of this replacement, the taxpayer's property will be more valuable in its business after it is cleaned of PCB residues than property that is in need of remediation.[62]

Description of Proposal

The proposal would clarify the treatment of environmental remediation costs by specifying costs which must be capitalized. Alternatively, the proposal would require that all environmental remediation costs be capitalized and amortized over a uniform period.

Effective Date

The proposal would be effective upon enactment.

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[61] As evidence that *Plainfield Union* test is just one of many factors to be considered, the IRS cited *Wolfsen v. Commissioner*, 72 T.C. 1 (1979), which states that "a cleaned...or reworked [asset] is of more value than one in need of repair."

[62] The IRS also cited the "general plan of rehabilitation" doctrine, pursuant to which a deductible repair may be classified as a capital expenditure if it is part of an overall plan of rehabilitation. *Wehrli v. United States*, 400 F.2d 686 (10th Cir. 1968). The IRS noted that the PCB cleanup program is a long-term systematic plan that involves systematic testing, assessing, remediating, removing and replacing extensive amount of lands.

III. PROPOSALS RELATING TO THE HEALTH BENEFITS OF RETIRED COAL MINERS

Present Law

In general

The Coal Industry Retiree Health Benefit Act of 1992 ("the Coal Act")[63] creates two plans to provide health and death benefits to certain coal industry retirees and their beneficiaries. The United Mine Workers of America (UMWA) Combined Benefit Fund (the Combined Fund) covers miners and their beneficiaries who were already eligible for and receiving benefits from the 1950 UMWA Benefit Plan or the 1974 UMWA Benefit Plan as of July 20, 1992.[64] The 1992 UMWA Benefit Plan ("the 1992 Plan") covers miners (and their beneficiaries) who, but for the Coal Act, would have met the age and service requirements for eligibility under the 1950 or 1974 UMWA Benefit Plan as of February 1, 1993, who become eligible for benefits by retiring between July 21, 1992, and September 30, 1994, and whose last signatory employer does not provide the health benefits promised under a 1978 or later collective bargaining agreement with the UMWA. The Combined Fund and the 1992 UMWA Benefit Plan are tax exempt.

Assignment of beneficiaries

By October 1, 1993, the Secretary of Health and Human Services is to assign each eligible beneficiary to a signatory operator (or a related person) which remains in business (whether or not in the coal industry). A signatory operator is a person who is or was a signatory to a coal wage agreement with the UMWA.[65] Eligible beneficiaries are to be assigned to signatory operators in the following order:

> First, to the signatory operator which was a signatory to the 1978 coal wage agreement or any subsequent coal wage agreement and was the most recent signatory opera-

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[63] The Coal Industry Retiree Health Benefit Act of 1992 (the Coal Act) was enacted as part of the Energy Policy Act of 1992 (P.L. 102-486). For a more detailed discussion of the Coal Act, see Committee on Ways and Means, U.S. House of Representatives, *Financing UMWA Coal Miner "Orphan Retiree" Health Benefits* (WMCP:103-19), September 3, 1993.

[64] Participation in the 1950 UMWA Benefit Plan is substantially limited to individuals who retired from the coal industry before 1976 (and their beneficiaries). Participation in the 1974 UMWA Benefit Plan is substantially limited to individuals who retired from the coal industry on or after January 1, 1976 (and their beneficiaries). Pursuant to the Coal Act, these two plans were merged into the Combined Fund.

[65] A coal wage agreement is defined as the National Bituminous Coal Wage Agreement (which is a collective bargaining agreement between the United Mine Workers of America (UMWA) and the Bituminous Coal Operators' Association Inc. (BCOA)), or any other agreement entered into between an employer in the coal industry and the UMWA that required or requires (a) the provision of health benefits to retirees based on years of service credited under a plan established by the UMWA and the BCOA and described in section 404(c) of the Internal Revenue Code (the "Code") or a continuation of such plan and/or (b) contributions to the 1950 or 1974 UMWA Benefit Plan or any predecessor thereof.

tor to employ the coal industry retiree in the coal industry for at least 2 years;

Second (if no assignment is made under the above), to the signatory operator which was a signatory to the 1978 coal wage agreement or any subsequent coal wage agreement, and was the most recent signatory operator to employ the coal industry retiree in the coal industry; and

Third (if no assignment is made under the above), to the signatory operator which employed the coal industry retiree in the coal industry for a longer period of time than any other signatory operator prior to the effective date of the 1978 coal wage agreement.

An operator to which beneficiaries are assigned is referred to as an assigned operator.

An assigned operator may request from the Secretary of Health and Human Services detailed information as to the work history of a beneficiary assigned to it and the basis for the assignment within 30 days after receiving notice of the assignment. Within 30 days after the receipt of such additional information, the assigned operator may request a review of the assignment by the Secretary of Health and Human Services. The Secretary is required to conduct a review if the Secretary finds that the operator provided evidence constituting a prima facie case of error. If, upon review, the Secretary finds there was an error, then premiums of the assigned operator will be reduced accordingly.

Any decisions by the Secretary of Health and Human Services as to whether to review an assignment or whether there has been an error are final. However, the operator may bring a separate civil action against another person for responsibility for assigned premiums, notwithstanding any prior decision by the Secretary.

Financing of the Combined Fund

Benefits under the Combined Fund are financed through a combination of premiums and transfers from other funds. Each assigned operator is required to pay an annual premium consisting of three components:

(1) a health benefit premium for each eligible beneficiary assigned to the operator;
(2) a death benefit premium; and
(3) an unassigned beneficiaries premium.

The health benefit premium is to be calculated each year by the Secretary of Health and Human Services based on the actual per capita net expenses of the 1950 and 1974 UMWA Benefit Plans in fiscal year 1992, indexed by the increase in the medical component of the consumer price index. The premium can be increased to offset any decreases in Medicare benefits.

The death benefit premium for a plan year for an assigned operator is equal to the operator's applicable percentage of the amount, actuarially determined, which the Combined Fund will be required to pay during the year for death benefits. The applicable percentage is the percentage that the beneficiaries assigned to the operator are of the total number of assigned beneficiaries.

The aggregate unassigned beneficiaries premium for a plan year is equal to the product of the per beneficiary premium for the year multiplied by the number of eligible beneficiaries who are not assigned to any operator. Each assigned operator is liable for the operator's applicable percentage of this aggregate premium. The applicable percentage is the percentage that the beneficiaries assigned to the operator are of the total number of assigned beneficiaries.

Transfers of assets from the 1950 UMWA Pension Fund are to be made in order to reduce the premiums. A total of $210 million is to be transferred in 3 installments of $70 million each. The first transfer was on February 1, 1993, and is to be used to proportionately reduce the total premium for each assigned operator. The second and third transfers are to occur on October 1, 1993, and October 1, 1994, respectively, and are to be used to proportionately reduce the unassigned beneficiary premium and the death benefit premium.

For subsequent years, beginning October 1, 1995, up to $70 million per year can be transferred from the interest credited to the Abandoned Mine Reclamation Fund[66] into the Combined Fund. Such transfers may be used only to reduce the unassigned beneficiaries premium. The interest earned by the Abandoned Mine Reclamation Fund each year beginning with fiscal year 1996 can be supplemented by drawing upon interest credited during prior fiscal years 1993-1996.

A penalty of $100 per beneficiary per day is imposed on an assigned operator (or related person) who fails to pay any of the required premiums. No penalty is imposed if it is established to the satisfaction of the Secretary of the Treasury that none of the persons responsible for the failure knew or should have known that the failure existed. In addition, no penalty is imposed if the failure was due to reasonable cause and not to willful neglect and the failure is corrected within 30 days after the persons responsible knew or should have known that the failure existed. The Secretary of the Treasury is authorized to waive all or part of the penalty if imposition of the penalty would be excessive relative to the failure involved.

Transition rules

A number of transition rules apply. During the first plan year of the Combined Fund, February 1, 1993, through September 30, 1993 (a short plan year), beneficiaries will not yet be assigned to operators. The premium for the first year will be calculated later and charged in conjunction with the premium established for the plan year beginning October 1, 1993. To cover expenses during the first plan year, 1988 agreement operators[67] are required to contrib-

[66] The Abandoned Mine Reclamation Fund fees are levied at the lesser of (a) 35 cents per ton for surface-mined coal and 15 cents per ton for underground-mined coal, or (b) 10 percent of the value of the coal at the mine. For lignite the rate is the lesser of 10 cents per ton, or 2 percent of the value of the coal at the mine.

[67] The term "1988 agreement operator" means an operator who was a signator to the 1988 National Bituminous Coal Wage Agreement, an employer in the coal industry which was a signatory to an agreement containing pension and health care contributions and benefit provisions which are the same as those contained in the 1988 National Bituminous Coal Wage Agreement, or an employer from which contributions were actually received after 1987 and before July 20,

Continued

ute to the Combined Fund amounts necessary to pay benefits and administrative costs for this first plan year (reduced by amounts transferred from the 1950 UMWA Pension Plan on February 1, 1993). The 1988 signatories will receive a credit against the first year contributions for these interim payments. No credit is provided for payments in excess of premium obligations.

In addition, the 1988 signatories are responsible for paying down the combined net deficits held by the merged 1950 and 1974 Benefit Plans as of February 1, 1993.

If an operator fails to meet these transition obligations, then any contribution by the operator to the Combined Fund (or any pre-1954 UMWA Funds) is nondeductible.

Financing the 1992 Plan

Responsibility for financing benefits under the 1992 Benefit Plan rests primarily with last signatory operators [68] who are 1988 agreement operators. The contribution requirements are to be established in the Plan and are to be applied uniformly to each 1988 last signatory operator on the basis of the number of eligible and potentially eligible beneficiaries attributable to each operator. The contribution requirements are to include a monthly per beneficiary premium for each person receiving benefits under the Plan and attributable to the operator. In addition, 1988 last signatory operators must prefund and provide security for the future cost of providing benefits. The amount of the prefunding premium or how it is to be determined is not specified by statute.

Last signatory operators who were not signatories to the 1988 coal wage agreement are responsible for the monthly per beneficiary premium for persons receiving benefits and attributable to that operator.

Persons related to a last signatory operator responsible for premiums are jointly and severally liable for the premiums.

Description of Proposals

1. Elimination of "reachback" liability

Under the proposal, persons responsible for contributing to the Combined Fund would be limited to persons who are 1988 Agreement operators or Alternate Agreement operators (and related persons). A 1988 Agreement operator would be an operator which was a signatory to the 1988 wage agreement between the UMWA and the BCOA or a person engaged in operating or processing coal from a bituminous coal mine and who was a signatory to an agreement (excluding the National Coal Mine Construction Agreement) during the term of the 1988 Agreement containing pension and health care contribution and benefit provisions which are the same as those contained in the 1988 Agreement. An Alternate Agreement would be defined as a collective bargaining agreement (excluding the National Coal Mine Construction Agreement and the 1988 Agreement) which was negotiated between an employer and the UMWA and

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1992, by the 1950 UMWA Benefit Plan or the 1974 UMWA Benefit Plan in connection with employment in the coal industry during the period covered by the 1988 National Bituminous Coal Wage Agreement.

[68] A last signatory operator is a signatory operator which was the most recent employer of a coal industry retiree.

which, as of the date of enactment of the Coal Act (1) was in effect, (2) covered the active operation of, or processing of coal from, a bituminous coal mine, (3) contained health care contribution and benefit provisions different than those contained in the 1988 Agreement, and (4) required the provision of health care benefits to UMWA bituminous coal industry retirees.

Effective date.—The proposal would be effective as if included in the Coal Act.

2. Reductions in premiums for payment of withdrawal liability

The 1988 wage agreement between the UMWA and the BCOA required signatory companies which ceased operations between February 1, 1988, and February 1, 1993, to pay withdrawal liability pursuant to a formula to help finance future retiree health benefit costs. The proposal would modify the Coal Act to take into account withdrawal liability payments. In particular, claims for withdrawal liability which have not yet been assessed or collected would be extinguished. Companies that paid withdrawal liability could elect to receive a refund of the amount paid or direct that the amount be transferred to the 1992 Benefit Plan. Any company electing a refund would remain responsible for maintaining its own individual employer plan. Any company electing a transfer would terminate its individual employer plan and the beneficiaries would become beneficiaries of the 1992 Benefit Plan. When the premiums attributable to the particular company's beneficiaries exceeded the amount transferred, the company would be assessed per beneficiary premiums by the 1992 Benefit Plan.

Effective date.—The proposal would be effective as if included in the Coal Act.

3. Transition rules

The proposal would provide that 1988 agreement operators who are required to make contributions during the first plan year or contributions to reduce the deficit of the 1950 and 1974 Benefit Plans and who are not assessed a premium are entitled to a refund at a rate comparable to the reductions in 1988 agreement operator's annual premiums.

Effective date.—The proposal would be effective as if included in the Coal Act.

4. Exemption for small coal producers

Under the proposal, no premium would be required to be paid to the Combined Fund in the case of a signatory operator, related person, or assigned operator if the gross income of such person for the five taxable years ending before July 20, 1992, did not exceed an average of $20 million per year and whose taxable income for such 5-year period did not exceed an average of $2 million per year. An exemption for 80 percent of the otherwise required premium would be provided to a signatory operator, related person, or assigned operator if the gross income of such person for the five taxable years ending before July 20, 1992, did not exceed $150 million per year on average and such person's taxable income as a percentage of its gross income for such 5-year period did not exceed an average of

0.5 percent per year. For purposes of the proposal, the gross income and taxable income of the following persons would be taken into account: (1) each member of the controlled group of corporations (as defined in Code sec. 52) which includes the signatory operator, related person, or assigned operator; (2) any trade or business which is under common control with the signatory operator, related person, or assigned operator; and (3) any person who is identified as having a partnership interest (other than as a limited partner) or joint venture with such person in a business within the coal industry, but only if such business employed eligible beneficiaries. The proposal would not apply to 1988 agreement operators or related persons to such operators.

Effective date.—The proposal would be effective as if enacted as part of the Coal Act.

5. Tax credit for metallurgical coal (H.R. 1443)

The bill (H.R. 1443) would provide a metallurgical coal mining tax credit equal to the lesser of: (1) the applicable percentage of the aggregate amount of premiums paid or accrued by the taxpayer during the taxable year pursuant to chapter 99 of the Code (relating to coal industry health benefits), or (2) 7.5 percent of the aggregate gross revenue from the sale of qualified metallurgical coal sold by the taxpayer during the year to an unrelated person. No credit would be allowed to the taxpayer unless at least 20 percent of the total tons of qualified coal sold by the taxpayer during each of the four preceding years was qualified metallurgical coal (taking into account only coal produced from an economic interest held by the taxpayer).

For this purpose, "applicable percentage" would mean the percentage of the aggregate tons of qualified coal sold by the taxpayer during the taxable year to unrelated persons which consists of qualified metallurgical coal. In no event may the applicable percentage exceed 75 percent. The term "qualified metallurgical coal" would mean any bituminous coal which is used in the production of iron and steel and is processed by, or produced from an economic interest held by, a signatory operator. The term "qualified coal" would mean any bituminous coal which is produced or processed by a signatory operator from an economic interest held by a signatory operator. The term "bituminous coal" would mean coal so classified according to the publication of the American Society for Testing and Materials under the title "Standard Classification of Coals by Rank" (ASTM D 338-91A) as in effect on the date of enactment of chapter 99. The term "unrelated person" would have the same meaning as when used in Code section 29. The term "signatory operator" would have the meaning given such term by Code section 9701(c)(1) and would include all members of the affiliated group of which such signatory operator is a member that are also signatory operators. The term "economic interest" would mean an interest with respect to which an allowance for depletion is allowed. The term "ton" would mean 2,000 pounds.

The metallurgical coal mining credit would become part of the general business credit and would be allowed to offset 90 percent of the taxpayer's tentative minimum tax for the year.

Effective date.—The bill would be effective on January 1, 1993.

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ERRATA FOR JCS-12-93

On Page 62 **(Item 6. Increase rate of interest for underpayments of estimated tax for certain Alaska Native Corporations and individuals)**, the paragraph under **Description of Proposal** should read as follows:

Under the proposal, the rate of addition to tax for underpayments of estimated tax would be increased for certain Alaska Native Corporations established under the Alaska Native Claims Settlement Act (43 U.S.C. secs. 1601 et seq.) and certain Alaska Native individuals (generally, those individuals entitled to receive Alaska Native Corporation stock). In such cases, the rate would be 110 percent (rather than 100 percent) of the Federal short-term rate, plus 3 percentage points.