[JOINT COMMITTEE PRINT]

DESCRIPTION OF MISCELLANEOUS TAX PROPOSALS

SCHEDULED FOR HEARINGS

BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON JULY 11–13, 1995

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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ERRATA (REVISED) FOR JCS-19-95

Description of Miscellaneous Tax Provisions

1. On page 161, the Legislative Background section for item 14 (relating to shareholders of a "10/50" corporation) should read as follows: The proposal was included in H.R. 5270 (102nd Cong.).

2. On page 65, the second sentence under subsection b. of the Description of Proposals section (relating to effective date of FICA tip credit) should read as follows: Under the proposal, the FICA tip credit would be available with respect to taxes paid after December 31, 1993, regardless of when the services with respect to which the tips were received were performed.

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INTRODUCTION

The House Committee on Ways and Means has scheduled public hearings on various miscellaneous tax proposals on July 11–13, 1995. This pamphlet was prepared by the staff of the Joint Committee on Taxation.

The first part of this pamphlet [1] provides a description of present law and the miscellaneous proposals scheduled for the hearings. The second part of this pamphlet describes possible modifications to tax simplification provisions contained in H.R. 3419 (103d Congress).[2] This pamphlet does not describe proposals relating to extension of certain expiring tax provisions on which hearings were held by the Ways and Means Subcommittee on Oversight on May 9–10, 1995.[3] This pamphlet also does not describe provisions relating to the tax simplification provisions of H.R. 3419 that previously passed the House, except to the extent that consideration is being given to modification of these provisions.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Miscellaneous Tax Proposals* (JCS–19–95), July 10, 1995.

[2] The provisions relating to tax simplification were included in H.R. 3419 (103rd Cong.,), as passed by the House (H. Rept. 103–353, 103rd Cong., 1st Sess., Nov. 10, 1993).

[3] See Joint Committee on Taxation, *Description and Analysis of Certain Tax Provisions Expiring in 1994 and 1995* (JCS–8–95), May 8, 1995.

I. MISCELLANEOUS PROPOSALS

A. Accounting

1. Expensing of certain costs associated with natural disasters

Present Law

No deduction is allowed for costs incurred for permanent improvements or betterments made to increase the value of any property. Rather, such costs must be capitalized into the basis of the underlying property (sec. 263).

The direct, and an allocable portion of the indirect, costs incurred by a taxpayer in the production of real or tangible personal property must be capitalized into the basis of the property (the "uniform capitalization rules" of sec. 263A). The uniform capitalization rules apply to property produced in a farming business unless (1) the property is an animal or a plant with a preproductive period of two years or less or (2) in the case of certain plants, the taxpayer elects to have the rules not apply. If the taxpayer so elects, the taxpayer loses the benefits of accelerated depreciation for property used in its farm business. In addition, the uniform capitalization rules do not apply to any costs of a taxpayer in replanting plants bearing an edible crop for human consumption if plants of the same type of crop were lost or damaged (while in the hands of a taxpayer) by reason of freezing temperatures, disease, drought, pests, or casualty (whether or not replanted on the same parcel of land or any other parcel of land of the same acreage in the United States).

Description of Proposal

The bill (H.R. 4144, 103rd Cong.) would provide that if plants bearing an edible crop for human consumption were lost or damaged (while in the hands of the taxpayer) by reason of freezing temperatures, disease, drought, pests, or casualty, sections 263A and 263 would not apply to (1) any preproductive or removal costs and (2) 80 percent of the taxpayer's special replanting costs, that are incurred for replanting plants bearing the same type of crop (whether or not replanted on the same parcel of land or any other parcel of land of the same acreage in the United States). For this purpose, "preproductive costs" means costs that are incurred during the preproductive period and are not treated as special replanting costs and include cultivation, maintenance, and development costs as well as administrative costs and interest. Special replanting costs includes direct costs incurred for plants and supporting structures, irrigation and drainage systems destroyed during removal of the lost or damaged plants, and land preparation and fumigation costs.

In addition, no loss would be allowed under section 165 with respect to any loss for which the costs of replanting would be deducted under this exception.

Effective Date

The bill would be effective as if included in the Tax Reform Act of 1986.

Legislative Background

The uniform capitalization rules, including the exception for certain re-planted plants, were added by the Tax Reform Act of 1986 (1986 Act). Prior to its repeal by the 1986 Act, section 278(c) of the Internal Revenue Code of 1954 contained a similar rule that provided that otherwise capitalizable costs attributable to a grove, orchard, or vineyard that was replanted after having been lost or damaged by reason of freezing temperatures, disease, pests, drought, or casualty were deductible when paid or incurred.

H.R. 4144 (103rd Cong.) was introduced by Mr. Matsui on March 24, 1994.

2. Allow installment method of reporting income from sale of certain residential real property

Present Law

Under Code sec. 453(l)(1)(B), income from any disposition of real property that is held by the taxpayer for sale to customers in the ordinary course of business is not eligible for treatment under the installment method.

Description of Proposal

The "First–Time Homebuyers Assistance Act" (H.R. 1076) would allow dealers in real property to use the installment method to recognize income from sales of single-family residential real property if the following conditions are met:

(1) The acquisition cost of the property (as defined under the mortgage revenue bond rules in Code sec. 143) is no more than 75 percent (95 percent in the case of a "targeted area" under Code sec. 143(j)) of the median purchase price of newly constructed single-family homes in the statistical area,

(2) the face amount of any obligation held by the dealer arising out of the sale is no more than 20 percent of the acquisition cost,

(3) the purchaser of the property is financially qualified to assume 100 percent of the obligations arising from the disposition,

(4) the property is to be used as the purchaser's principal residence, and

(5) the purchaser had no present ownership interest in such a principal residence during the three-year period ending on the date the property is acquired.

Effective Date

The bill would be effective for sales after the date of enactment.

Legislative Background

The H.R. 1076 was introduced by Mr. Goodling on February 28, 1995.

3. Eliminate "look-back method" for nonresidential construction contracts

Present Law

Taxpayers engaged in the production of property under a long-term contract generally must compute income from the contract under the percentage of completion method. Under the percentage of completion method, a taxpayer must include in gross income for any taxable year an amount that is based on the product of (1) the gross contract price and (2) the percentage of the contract completed as of the end of the year. The percentage of the contract completed as of the end of the year is determined by comparing costs incurred with respect to the contract as of the end of the year with the estimated total contract costs.

Because the percentage of completion method relies upon estimated, rather than actual, contract price and costs to determine gross income for any taxable year, a "look-back method" is applied in the year a contract is completed in order to compensate the taxpayer (or the Internal Revenue Service) for the acceleration (or deferral) of taxes paid over the contract term. The first step of the look-back method is to reapply the percentage of completion method using actual contract price and costs rather than estimated contract price and costs. The second step generally requires the taxpayer to recompute its tax liability for each year of the contract using gross income as reallocated under the look-back method. If there is any difference between the recomputed tax liability and the tax liability as previously determined for a year, such difference is treated as a hypothetical underpayment or overpayment of tax to which the taxpayer applies a rate of interest equal to the overpayment rate, compounded daily. The taxpayer receives (or pays) interest if the net amount of interest applicable to hypothetical overpayments exceeds (or is less than) the amount of interest applicable to hypothetical underpayments.

The look-back method must be reapplied for any item of income or cost that is properly taken into account after the completion of the contract.

The look-back method does not apply to any contract that is completed within two taxable years of the contract commencement date and if the gross contract price does not exceed the lesser of (1) $1 million or (2) 1 percent of the average gross receipts of the taxpayer for the preceding three taxable years. In addition, a simplified look-back method is available to certain pass-through entities and, pursuant to Treasury regulations, to certain other taxpayers. Under the simplified look-back method, the hypothetical underpayment or overpayment of tax for a contract year generally is determined by applying the highest rate of tax applicable to such taxpayer to the change in gross income as recomputed under the look-back method.

Description of Proposal

The proposal would eliminate the look-back method with respect to nonresidential construction contracts. The proposal would not apply to defense contracts.

Effective Date

The proposal would apply to contracts completed in taxable years ending after the date of enactment.

4. Treatment of contributions in aid of construction for water utilities

Present and Prior Law

The gross income of a corporation does not include contributions to its capital. A tax-free contribution to the capital of a taxpayer does not include any contribution in aid of construction or any other contribution as a customer or potential customer.

Prior to the enactment of the Tax Reform Act of 1986, a regulated public utility that provided electric energy, gas, water, or sewage disposal services was allowed to treat any amount of money or property received from any person as not includible in its gross income so long as such amount: (1) was a contribution in aid of construction and (2) was not included in the taxpayer's rate base for rate-making purposes. A contribution in aid of construction did not include a connection fee. The basis of any property acquired with a contribution in aid of construction was zero.

If the contribution was in property other than electric energy, gas, steam, water, or sewage disposal facilities, such contribution was not includible in the utility's gross income so long as: (1) an amount at least equal to the amount of the contribution was expended for the acquisition or construction of tangible property, which was the purpose motivating the contribution, and which was used predominantly in the trade or business of furnishing utility services; (2) the expenditure occurred before the end of the second taxable year after the year that the contribution was received; and (3) certain records were kept with respect to the contribution and the expenditure. In addition, the statute of limitations for the assessment of deficiencies was extended in the case of certain contributions of property other than electric energy, gas, steam, water, or sewage disposal facilities.

These rules were repealed by the Tax Reform Act of 1986. Thus, after the 1986 Act, the receipt by a utility of a contribution in aid of construction is includible in the gross income of the utility and the basis of property received or constructed pursuant to the contribution is not reduced.

Description of Proposal

The bill (H.R. 957) would restore the contributions in aid of construction provisions that were repealed by the Tax Reform Act of 1986 for regulated public utilities that provide water or sewage disposal services.

Effective Date

The bill would be effective for amounts received after the date of enactment.

Legislative Background

Prior to the enactment of the Tax Reform Act of 1986, a regulated public utility was allowed to exclude from gross income amounts received as a contribution in aid of construction. This rule were repealed by the Tax Reform Act of 1986. A provision similar to H.R. 957 was included in H.R. 11 (102nd Cong.) which passed the House of Representatives and the Senate in 1992 and was vetoed by President Bush.

H.R. 957 was introduced by Mrs. Johnson of Connecticut, Mr. Matsui, Mr. Neal of Massachusetts, Mr. Jacobs, and Mr. Jefferson on February 15, 1995.

5. Allow trading partnerships and corporations to use a mark-to-market method of accounting for securities

Present Law

Under section 475, (1) any security that is inventory in the hand of a dealer must be included in inventory at its fair market value and (2) any security that is that is not inventory in the hand of a dealer and that is held at year end shall be treated as sold for its fair market value (i.e., subject to a "mark-to-market" method of accounting). For this purpose, "security" means any stock in a corporation; any partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; any note, bond, debenture, or other evidence of indebtedness; any interest rate, currency or equity notional principal contract; any evidence of an interest in, or a derivative financial instrument of, any security described above; and any position identified as a hedge of any of the above (other than a section 1256(a) contract). Section 475 generally does not apply to any security identified as held for investment (or a hedge of such security). For this purpose, a "dealer in securities" is any person who (1) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (2) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. Any gain or loss taken into account under section 475 generally is treated as ordinary gain or loss.

Description of Proposal

The proposal would allow certain partnerships and corporations to elect mark-to-market accounting with respect to qualified assets. Qualified assets would be defined as all actively traded personal property (as defined in sec. 1092) and any interest in a partnership or trust where 90 percent or more of the assets of the partnership or trust consist of actively traded personal property. In order to be entitled to make the election, at least 90 percent of the value of the assets of the electing partnership and corporation must consist of qualifying assets.

Effective Date

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

6. Allow partnerships and S corporations to elect taxable years other than required taxable years by paying estimated taxes on behalf of their owners

Present Law

The taxable income of a partnership or an S corporation (a "flow-thru entity") generally is reported by the partnership's partners or the corporation's shareholders (the "owners") in the taxable year within which the taxable year of the flow-thru entity ends. As a result, if a flow-thru entity uses a taxable year that is the same as the taxable year of its owners, the owners will report income earned by the entity in the year that it is earned. If a flow-thru entity uses a taxable year that is different than the taxable year of its owners, the owners will defer reporting a portion of the income earned by the entity until the year following the year the income was earned.[4] Thus, in order to avoid this deferral, under present law, a flow-thru entity generally must use a taxable year that corresponds to the taxable years of its owners (i.e., generally, the calendar year in the case of an entity owned by individuals).

However, under certain circumstances, deferral through use of a fiscal year is permitted (sec. 444). A flow-thru entity may use a fiscal year that it used prior to 1987 or a fiscal year that provides up to a 3-month deferral so long as it makes a payment equal to the income attributable to the deferral period times the highest individual tax rate plus 1 percentage point (currently, 40.6 percent). Such payments remain on deposit and may be refunded if the income of the entity for the deferral period diminishes or the entity abandons its fiscal year (sec. 7519). Under Treasury regulations, the payment described above is not required for a fiscal year for which the entity establishes a business purpose to the satisfaction of the IRS (Treas. Reg. sec. 1.444–1T(a)(3)(i)).

The due date for the tax return of a partnership is the 15th day of the fourth month following the taxpayer's yearend. The due date for the tax return of an S corporation is the 15th day of the third month following the taxpayer's yearend. Thus, to the extent flow-thru entities are required to use the calendar year and do no elect fiscal years, the unextended due dates of the tax returns of flow-thru entities and individuals all fall between March 15th and April 15th of the year.

Description of Proposal

Estimated tax payments by flow-thru entities

The bill (H.R. 1661) would allow any flow-thru entity to use any fiscal year so long as the entity makes quarterly estimated tax pay-

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[4] For example, assume that an individual using a calendar year wholly owns the stock of an S corporation using a fiscal year ending January 31. If for its fiscal year beginning February 1, 1994, and ending January 31, 1995, the corporation earned $1,000 a month, the individual would report the $12,000 of aggregate corporate income in his calendar year ending December 31, 1995, even though $11,000 had been earned by the corporation during 1994.

ments at an "applicable rate" that are credited to the owners' accounts for the year in which fiscal year ends. Quarterly installments would be due on the 15th day of the 3rd, 5th, 8th, and 12th months of the taxable year. An election to make quarterly estimated tax payments must be made on or before the 15th day of the 3rd month of the first taxable year of 12 months under the election. Such election generally would remain in effect until (1) it is revoked by owners of more than half of the equity interests of the entity, (2) there is a termination of the partnership or the subchapter S election of the corporation, or (3) the entity becomes part of a tiered structure of entities with different fiscal years. An entity would not be allowed to re-elect the provisions of the bill until five years after the termination of an election without the consent of the Secretary of the Treasury. Estimated tax payments would not be required for a taxable year if the amount of aggregate payments otherwise due was $5,000 or less.

In determining its estimated tax payments, the flow-thru entity would use an applicable rate of 34 percent, unless the flow-thru entity is a "high income average entity," in which case the applicable rate would be 39.6 percent. A "high average income entity" would be one where the average applicable income of the 2-percent owners for the base year was at least $250,000, or in the case of a partnership, the applicable income for the base year was at least $10,000,000. For this purpose, a "2-percent owner" would be (1) in the case of a partnership, any person who owns (or would be considered as owning within the meaning of the attribution rules of sec. 318) on any day during the base year, more than 2 percent of the capital interest of the partnership, and (2) in the case of an S corporation, any shareholder who owns (or would be considered as owning within the meaning of the attribution rules of sec. 318) on any day of the taxable year, more than 2 percent of the outstanding stock of the corporation or more than 2 percent of the outstanding voting stock of the corporation. For this purpose, the "base year" would be the most recent prior taxable year containing 12 months.

In determining quarterly estimated tax payments, the entity may use (1) the 110-percent method, (2) the 100-percent method, or (3) the annualization method. Under the 110-percent method, the required quarterly installment is one-quarter of 110 percent of the product of the entity's applicable income for the base year and the applicable rate. For this purpose, the "base year" would be the most recent prior taxable year containing 12 months. The 110-percent method would be unavailable if the entity's current year applicable income exceeds its base year applicable income by more than $750,000, or if the entity elects to use the 100-percent method or the annualization method. Under the 100-percent method, the required quarterly installment is one-quarter of the product of the entity's applicable income for the current year and the applicable rate. The entity must select the 100-percent method on or before the due date of the first quarterly installment and use such method throughout the year. Under the annualization method, the required quarterly installment is one-quarter of the product of the entity's annualized applicable income and the applicable rate. The amount of the quarterly installment may be increased or decreased to the extent prior installments were overpaid or underpaid under the

annualization method. The entity may elect the annualization method for any quarter on or before the due date for such quarter and once selected, must be applied for the remainder of the taxable year.

For this purpose, "applicable income" would be determined by taking the entity's items into account under subchapter K or S, as the case may be, with the following adjustments: (1) charitable contributions and foreign taxes would be deducted; (2) various limitations determined on the partner or shareholder level would be disregarded; (3) guaranteed payments to partners would not be deductible; and (4) no deduction would be allowed for disproportionate deferral period applicable payments. For this purpose, "disproportionate deferral period applicable payments" means the excess (if any) of (1) the product of the deferral ratio and the aggregate applicable payments made to owners during the taxable year, over (2) the aggregate applicable payments made to owners during the deferral period. For this purpose, (1) "applicable payments" would mean amounts paid by the entity that are includible in the income of the owner (except for gains on the sale of property between the entity and the owner or dividends paid by an S corporation), (2) "deferral period" means the months in the period beginning with the entity's taxable year and ending on December 31, and (3) "deferral ratio" means the ratio of number of months in the deferral period to the number of months in the taxable year.

If, by reason of the election, the entity has a short taxable year (i.e., a taxable year of less than 12 months), the entity would be required to make an additional estimated tax payment on or before the due date of the election. Such additional tax payment would be determined and treated in a manner similar to the determination and treatment of other estimated tax payments under the bill. Any net operating loss arising in such short year would be spread ratably over three taxable years, beginning with the short year (unless the entity is a new entity).

Underpayments of estimated tax

If a flow-thru entity has an underpayment of estimated tax as provided by the bill, the entity would be subject to an addition to tax determined by applying the underpayment rate established under section 6621 to the amount of the underpayment over the period of the underpayment. The period of the underpayment would run from the due date of the installment until the earlier of the date the entity pays the underpayment or the first April 15 more than 3 months after the close of the entity's taxable year. In addition, if, on the first April 15 more than 3 months after the close of the entity's taxable year, the entity has an underpayment of estimated tax, and the aggregate deposits made by the entity are less than the aggregate amount of allocable shares of estimated tax shown on the entity's return for the year, such shortfall would be treated as a tax on the entity due on such April 15 (unless the owners had paid such shortfall). If the entity has an excess of deposits, such excess would be treated as an overpayment of tax by the entity.

Credit to owners for estimated tax

An owner's allocable share of estimated tax paid by a flow-thru entity would be allowed as a credit ("estimated tax credit") against the owner's tax liability for the first taxable year ending with or after the close of the entity's taxable year. An owner's allocable share of estimated tax paid by a flow-thru entity would be the determined by applying the ratio of the owner's applicable income for the year to the aggregate applicable income for all owners for the year to the aggregate estimate tax payments made by the entity during the taxable year. In the case of an entity that uses the annualization method, this determination would be made on an quarterly basis.

An owner generally would treat the estimated tax credit as being incurred ratably throughout the owner's taxable year. However, if the flow-thru entity uses the annualization method for any quarter, the estimated tax credit would be deemed to flow through to the owner in the same pattern as such payments were made by the flow-thru entity.

Other provisions

A new flow-thru entity would not be allowed to make an election under present-law section 444. An entity that currently has a section 444 election in effect may (1) retain the election or (2) revoke the election and receive a refund of its deposit or credit its deposit as payment of estimated tax under the bill.

For taxable years beginning after 1986, the bill would allow a waiver of penalties for failure to make deposits under present-law section 7519 for failures due to reasonable cause. In addition, the bill would allow interest to be paid to taxpayers with respect to late refunds of deposits to taxpayers after the date of enactment.

Effective Date

Except as provided above, the bill would be effective for taxable years beginning after December 31, 1995.

Legislative Background

The Tax Reform Act of 1986 restricted the use of fiscal years by flow-thru entities. The Revenue Act of 1987 instituted present-law sections 444 and 7519. H.R. 11, as passed by the House of Representatives and the Senate and vetoed by President Bush in 1992, would have expanded sections 444 and 7519 by providing that any flow-thru entity could use any fiscal year so long as it made a deposit equal to the highest rate plus 2 percentage points.

H.R. 1661 was introduced by Mr. Shaw on May 17, 1995.

7. Allow deduction for intrastate operating rights of motor carriers

Present Law

A taxpayer is allowed to write-off and deduct the adjusted basis of property used in trade or business when such property becomes worthless (sec. 165). A write-off is not allowed if the property merely loses value but does not become worthless. For example, in

CRST, Inc., 909 F2d. 1146, (8th Cir. 1990), a motor carrier was denied a worthlessness deduction for the basis of operating authorities that had become less valuable, but not worthless, due to deregulation.

Effective January 1, 1995, section 601 of the Federal Aviation Administration Authorization Act of 1994 preempts and prohibits States regulation of the price, route, or service of intrastate operations of motor carriers.

Description of Proposal

The proposal would allow a taxpayer who held, on January 1, 1995, an operating authority that was preempted by section 601 of the Federal Aviation Administration Authorization Act of 1994 to deduct the adjust basis of such authority.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1995.

Legislative Background

The Economic Recovery Tax Act of 1981 allowed taxpayers to amortize, over 60 months, the adjusted bases of operating rights affected by the Motor Carrier Act of 1980, which deregulated interstate trucking.

8. Allow taxpayers to estimate shrinkage for inventory accounting

Present Law

A taxpayer that sells goods in the active conduct of trade or business generally must use an inventory method of accounting in order to clearly reflect its income. Inventory may be accounted for under a variety of methods and by using a variety of conventions. However, these methods and conventions generally are based upon actual, rather than estimated, quantities or costs.

Description of Proposal

The proposal would allow taxpayers to estimate shrinkage for purposes of inventory accounting.

Effective Date

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

9. Provide exclusion for certain amounts received by a utility with respect to nuclear decommissioning costs

Present Law

Under present law, utilities are required to include in income amounts collected from customers, through cost of service, for nuclear decommissioning (sec. 88). Such inclusion is required even if the customer is a tax-exempt entity (such as a State or political

subdivision) or payments are made directly to a trust or a tax-exempt entity (Treas. Reg. sec. 1.88–1).

Utilities are allowed deductions to the extent amounts collected for nuclear decommissioning costs are deposited in certain qualified funds (sec. 468A).

Description of Proposal

The proposal would provide that, in the case of a taxpayer who sells nuclear energy pursuant to a contract or rate schedule that provides for payment of nuclear decommissioning costs at the time when decommissioning occurs rather than at the time when electricity is supplied, customer contributions to a separate trust (and earnings on such contributions) shall not be included in the taxpayer's income until paid from the trust, provided that the trust is funded and administered in a manner consistent with the decommissioning funding guidelines promulgated by the NRC for licenses and by FERC for public utilities and meets certain requirements set out in section 468A(e)(4) and (5).

The proposal would not disallow a portion of the amount deductible under section 468A.

Effective Date

The proposal would be effective for payments paid after the effective date of the proposal and all amounts on account for an affected customer in any qualified trusts established by the taxpayer transferred to a nuclear decommissioning trust.

Legislative Background

Present-law sections 88 and 468A were enacted as part of the Tax Reform Act of 1984.

10. Repeal Treasury ruling requirement for nuclear decommissioning funds

Present Law

Under the economic performance rules, a deduction for accrual basis taxpayers generally is deferred until there is economic performance for the item for which the deduction is claimed. Present law contains an exception to the economic performance rules under which a taxpayer responsible for nuclear power plant decommissioning may elect to deduct contributions made to a qualified nuclear decommissioning fund.[5] Taxpayer who do not elect this provision are subject to the general economic performance rules.

A qualified decommissioning fund is a segregated fund established by the taxpayer that is used exclusively for the payment of decommissioning costs, taxes on fund income, payment of management costs of the fund, and investment in certain types of invest-

[5] As originally enacted in 1984, the fund paid tax on its earnings at the top corporate rate and, as a result, there would be no present value tax benefit of making deductible contributions to the fund. Also, as originally enacted, the funds in the trust could be invested only in certain nonrisky investments. Subsequent amendments to the provision have reduced the rate of tax on the fund to 20 percent and removed the restrictions on the types of permitted investment that the fund can make.

ments. The fund is prohibited from dealing with the taxpayer that established the fund.

Contributions to the fund are deductible in the year made to the extent that these amounts were collected as part of the cost of service to ratepayers. Withdrawal of funds by the taxpayer to pay for decommissioning expenses are included in income at that time, but the taxpayer also is entitled to a deduction at that time for decommissioning expenses as economic performance for those costs occurs.

In order to prevent accumulations of funds over the remaining life of the plant in excess of those required to pay future decommissioning costs and to ensure that contributions to the funds are not deducted more rapidly than level funding, taxpayers are required to obtain a ruling from the IRS to establish the maximum contribution that may be made to the fund. The IRS is directed to review the ruling amount at least once during the plant's life, but may do so more frequently at the request of the taxpayer. The existing Treasury regulations provide that there is one required request per reactor, even if there are sites on which there are multiple reactors.

If the decommissioning fund fails to comply with the qualification requirements or when the decommissioning is substantially completed, the fund's qualification may be terminated in which case the amounts in the fund must be included in income of the taxpayer.

Description of Proposal

The proposal would delete the requirement of obtaining a ruling from the IRS in order to allow a deduction for contributions to a nuclear decommissioning fund. In addition, the proposal would repeal the provision that allows the IRS to disqualify a fund upon a showing that the fund's assets are not used for decommissioning or that there is self-dealing between the fund and the utility.

Effective Date

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

11. Treatment of certain compensation payable by certain personal service corporations using an accrual method of accounting

Present Law

Under the Tax Reform Act of 1986, a personal service corporation that uses an accrual method of accounting generally is not allowed a deduction for an amount payable to an employee-owner of the corporation prior to the time that the amount is includible in the gross income of the employee-owner. For this purpose, a personal service corporation is any corporation the principal activity of which is the performance of personal services if the services are substantially performed by employee-owners and more than 10 percent of the value of the outstanding stock of the corporation is owned by employee-owners. An employee-owner is any employee of the corporation who owns any of the outstanding stock of the cor-

poration (generally determined by applying the attribution rules of section 318).

Description of Proposal

A qualifying personal service corporation that uses an accrual method of accounting would be allowed a deduction for certain periodic compensation (generally, compensation other than vacation pay or bonuses) that is payable to an employee-owner of the corporation at the time that the compensation would otherwise have been deductible in the absence of the 1986 Act provision that postpones the deduction until the time that the compensation is includible in the gross income of the employee-owner. A "qualifying personal service corporation" would mean any personal service corporation (within the meaning of section 441(i)(2)) that uses an accrual method of accounting for its taxable year prior to the date of enactment.

Effective Date

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

Legislative Background

A provision similar to the proposal was included in H.R. 11 (102nd Cong.), which passed the House of Representatives and the Senate in 1992, and was vetoed by President Bush.

12. Treatment of livestock sold on account of weather-related conditions

Present Law

In general, cash-method taxpayers report income in the year it is actually or constructively received. However, present law contains two special rules applicable to livestock sold on account of drought conditions. Code section 451(e) provides that a cash-method taxpayer whose principal trade or business is farming who is forced to sell livestock due to drought conditions may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought conditions that resulted in the area being designated as eligible for Federal assistance. This exception is generally intended to put taxpayers who receive an unusually high amount of income in one year in the position they would have been in absent the drought.

In addition, the sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought conditions is treated as an involuntary conversion under section 1033(e). Consequently, gain from the sale of such livestock could be deferred by reinvesting the proceeds of the sale in similar property within a two-year period.

Description of Proposal

The bill (H.R. 1588) would amend Code section 451(e) to provide that a cash-method taxpayer whose principal trade or business is farming and who is forced to sell livestock due not only to drought (as under present law), but also to floods or other weather-related conditions, may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income would be available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for the drought, flood or other weather-related conditions that resulted in the area being designated as eligible for Federal assistance.

In addition, the bill would amend Code section 1033(e) to provide that the sale of livestock (other than poultry) that are held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought (as under present law), flood or other weather-related conditions is treated as an involuntary conversion.

Effective Date

The bill would apply to sales and exchanges after December 31, 1994.

Legislative Background

The bill H.R. 1588 was introduced by Mr. Johnson of South Dakota on May 9, 1995.

As passed by the House, H.R. 2735 (102nd Congress), the Miscellaneous Revenue Act of 1992, and section 7602 of H.R. 11 (102nd Congress), the Revenue Act of 1992, contained the same provision, effective for sales and exchanges after December 31, 1992.

13. Treatment of certain crop insurance proceeds and disaster assistance payments

Present Law

A taxpayer engaged in a farming business generally may use the cash receipts and disbursements method of accounting ("cash method") to report taxable income. A cash method taxpayer generally recognizes income in the taxable year in which cash is received, regardless of when the economic events that give rise to such income occur. Under a special rule (sec. 451(d)), in the case of insurance proceeds received as a result of destruction or damage to crops, a cash method taxpayer may elect to defer the income recognition of the proceeds until the taxable year following the year of the destruction or damage, if the taxpayer establishes that under his practice, income from such crops would have been reported in a following taxable year. For this purpose, certain payments received under the Agricultural Act of 1949, as amended, or title II of the Disaster Assistance Act of 1988, are treated as insurance proceeds received as a result of destruction or damage to crops.

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Description of Proposal

The bill H.R. 1408 would amend the special rule of section 451(d) to allow a cash method taxpayer to elect to *accelerate* (or defer) the recognition of certain disaster-related payments if the taxpayer establishes that, under the taxpayer's practice, income from the crops lost in the disaster would have been accelerated (or deferred). The bill also would expand the payments for which these elections are available to include disaster assistance received as a result of destruction or damage to crops caused by drought, flood, or other natural disaster, or the inability to plant crops because of such a disaster, under *any* Federal law (rather than only payments received under the Agricultural Act of 1949, as amended, or title II of the Disaster Assistance Act of 1988).

Thus, for example, the bill would allow a calendar-year, cash method taxpayer who has received disaster assistance payments in 1996 relating to the destruction of crops by a flood in 1995 to elect to treat such payments as received in 1995, so long as the taxpayer establishes that, under the taxpayer's practice, income from such crops would have been reported in 1995. Without the benefit of the bill, the income of such a taxpayer would be "bunched" in 1996, possibly resulting in the loss of itemized deductions in 1995, a higher marginal income tax rate in 1996, and the loss of several AGI-based deductions and exemptions in 1996.

Effective Date

The bill would be effective for payments received after December 31, 1992, as a result of destruction or damage occurring after such date.

Legislative Background

The bill H.R. 1408 was introduced by Mr. Minge on April 5, 1995, and is the same as H.R. 3757 (103rd Cong.). A companion bill (S. 1814 (103rd Cong.)) was introduced by Senator Daschle. S. 1814 was reported by the Senate Finance Committee in April 1994. Senator Daschle reintroduced his bill as S. 110 in the 104th Congress on January 4, 1995.

14. Allow certain contractors to use the cash method of accounting

Present Law

A taxpayer generally may use any method of accounting so long as the method clearly reflects income and is regularly used in keeping the taxpayer's books (sec. 446). A taxpayer for whom the production, purchase, or sale of merchandise is a material income-producing factor generally is required to keep inventories and to use an accrual method of accounting with respect to inventory items. In addition, a C corporation (or a partnership that has a C corporation partner) may not use the cash receipts and disbursements method of accounting unless the corporation (or partnership) meets a $5,000,000 gross receipts test for all prior years beginning after 1985 (sec. 448). An entity meets the $5,000,000 gross receipts test for any prior taxable year if the average annual gross receipts of

the entity for the three-taxable-year period ending with the prior taxable year does not exceed $5,000,000.

Description of Proposal

The proposal would provide that a qualified contractor that meets a $5,000,000 gross receipts test may use the cash receipts and disbursements method of accounting. A "qualified contractor" would be one that (1) performs services pursuant to a contract; (2) does not take title or have other indicia of ownership with respect to the subject matter of the contract; and (3) for whom the provision of services, rather than the sale of merchandise, is a material income-producing factor under the contract. For example, a taxpayer that contracts to redesign the interior of a building owned by another person generally may be treated as a qualified contractor under the proposal if the materials supplied by the taxpayer under the contract are relatively insignificant compared to the services provided under the contract.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1985.

B. Alternative Minimum Tax

1. Allow certain investment expenses to be deducted for alternative minimum tax purposes

Present Law

Individuals are subject to an alternative minimum tax imposed at rates of 26 and 28 percent on the taxpayer's alternative minimum taxable income. In computing alternative minimum taxable income, no deduction is allowed for miscellaneous itemized deductions. Investment expenses deductible under section 212 are generally treated as a miscellaneous itemized deduction and thus are not deductible in computing the minimum tax. Under the regular tax, miscellaneous itemized deductions (including investment expenses) are deductible only to the extent they exceed two percent of the individual's adjusted gross income.

Description of Proposal

Under the bill (H.R. 747), a certain amount of the distributive share of section 212 expenses of a partner in a partnership would be deductible by an individual for AMT purposes. The aggregate amount deductible for AMT purposes would be limited to the lesser of (1) the aggregate of the individual's adjusted investment income from partnerships or (2) the excess of the aggregate of the taxpayer's distributive shares of section 212 expenses over two percent of the taxpayer's adjusted gross income. For purposes of the bill, "adjusted investment income" would mean investment income (as defined by sec. 163(d)(4)(B) so as not to be reduced by sec. 212 expenses) reduced by investment interest (as defined by section 163(d)(3) so as not to be reduced by the limitation applicable to investment interest).

For example, assume that for 1996, the only items of taxable income of an individual are from an interest in a partnership. For the year, the partnership reports $30,000 of investment income, $10,000 of section 212 expenses, and $25,000 of investment interest to the individual. Under the bill, the individual would be allowed to deduct $5,000 of section 212 expenses for AMT purposes ($30,000 investment income less $25,000 investment interest).

As a further example, assume that for 1996, the individual described in the example above also receives a salary of $270,000. Under the bill, the individual would be allowed to deduct $4,000 of section 212 expenses for AMT purposes ($10,000 less 2 percent of adjusted gross income of $300,000 ($6,000)).

Effective Date

The bill would be effective for taxable years beginning after 1994.

Legislative Background

H.R. 747 was introduced by Messrs. Rangel, Houghton, Crane, Matsui, Shaw and Herger on January 30, 1995. A similar provision was included in H.R. 11 as passed by the House and the Senate in 1992, and vetoed by President Bush. Conference report language to section 13113 of the Omnibus Budget Reconciliation Act of 1993

urged the Department of Treasury to study this matter and issue a report to the Congress. In December 1994, the Department of the Treasury submitted "Report to the Congress on Section 212 Expenses and the Alternative Minimum Tax" to the House Committee on Ways and Means and the Senate Finance Committee.

2. Allow energy tax credits against the alternative minimum tax

Present Law

Subject to certain limitations, a taxpayer engaged in a trade or business may claim the general business credit with respect to qualified expenditures. The general business credit includes the rehabilitation credit, the energy credit and the reforestation credit. The energy credit is equal to 10 percent of the basis of energy property placed in service during the taxable year. Energy property generally is property that is equipment (1) that uses solar energy to generate electricity, to cool or heat a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit. The general business credit cannot offset the alternative minimum tax liability of taxpayer.

Description of Proposal

The proposal would allow the energy credit to offset the alternative minimum tax liability of taxpayer.

Effective Date

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

C. Business Expenses

1. Any period during which a Federal employee is certified by the Attorney General to be participating in a Federal criminal investigation not included in computation of one-year limitation with respect to deductibility of travel expenses while temporarily away from home

Present Law

Unreimbursed ordinary and necessary travel expenses paid or incurred by an individual in connection with temporary employment away from home (e.g., transportation costs and the cost of meals and lodging) are generally deductible, subject to the two-percent floor on miscellaneous itemized deductions. Travel expenses paid or incurred in connection with indefinite employment away from home, however, are not deductible. A taxpayer's employment away from home in a single location is indefinite rather than temporary if it lasts for one year or more; thus, no deduction is permitted for travel expenses paid or incurred in connection with such employment (sec. 162(a)). If a taxpayer's employment away from home in a single location lasts for less than one year, whether such employment is temporary or indefinite is determined on the basis of the facts and circumstances.

Description of Proposal

The one-year limitation with respect to deductibility of expenses while temporarily away from home would not include any period during which a Federal employee is certified by the Attorney General (or the Attorney General's designee) as travelling on behalf of the Federal Government in a temporary duty status to investigate or provide support services to the investigation of a Federal crime. Thus, expenses for these individuals during these periods would be fully deductible, regardless of the length of the period for which certification is given (provided that the other requirements for deductibility are satisfied).

Effective Date

The proposal would be effective for amounts paid or incurred with respect to taxable years beginning after December 31, 1994.

2. Deduction for regularly scheduled air transportation limited to normal tourist class fare

Present Law

Taxpayers may deduct ordinary and necessary business expenses, provided they are not lavish and extravagant (sec. 162). No statutory provision limits deductions for airfares for regularly scheduled flights to the normal tourist class fare.

Description of Proposal

The bill (H.R. 283) would limit deductions for airfares for regularly scheduled flights to the normal tourist class fare. This is defined to be the lowest fare charged for the transportation of a per-

son by air on a regularly scheduled flight determined without regard to any special fares available to certain groups or certain persons or under certain special conditions.

Effective Date

The bill would be effective for amounts paid or incurred after the date of enactment for transportation after that date.

Legislative Background

The bill (H.R. 283) was introduced by Mr. Jacobs on January 4, 1995.

3. Increase deductibility of business meal expenses for individuals subject to Federal hours of service limitations

Present Law

In general, 50 percent of meal and entertainment expenses incurred in connection with a trade or business that are ordinary and necessary (and not lavish or extravagant) are deductible (sec. 274). Food or beverage expenses are fully deductible provided that they are (1) required by Federal law to be provided to crew members of a commercial vessel, (2) provided to crew members of similar commercial vessels not operated on the oceans, or (3) provided on certain oil or gas platforms or drilling rigs.

Description of Proposal

The bill (H.R. 1003) would provide that 80 percent of meal expenses would be deductible with respect to food or beverages consumed by an individual during, or incident to, the period of duty subject to the hours of service limitations of the Department of Transportation. There are four general groupings of individuals subject to these limitations. The first is certain air transportation employees, such as pilots, crew, dispatchers, mechanics, and control tower operators, pursuant to Federal Aviation Administration regulations. The second is interstate truck and bus drivers, pursuant to Department of Transportation regulations. The third is certain railroad employees, such as engineers, conductors, train crews, dispatchers, and control operations personnel, pursuant to Federal Railroad Administration regulations. The fourth is certain merchant mariners, pursuant to Coast Guard regulations.

Employers of individuals subject to these limitations would have to maintain recordkeeping systems to enable them to differentiate expenses eligible for 80-percent deductibility (e.g. expenses of individuals during, or incident to, the period of duty subject to the hours of duty limitations) from expenses eligible for 50-percent deductibility (e.g. expenses of individuals not subject to these limitations, as well as expenses of individuals subject to these limitations but not incurred during, or incident to, the period of duty subject to these limitations).

Effective Date

The bill would be effective for taxable years beginning after December 31, 1994.

Legislative Background

The bill (H.R. 1003) was introduced by Mrs. Johnson of Connecticut, and Mr. Neal of Massachusetts and Mr. Jefferson on February 21, 1995.

D. Business Tax Credits

1. Credit for the rehabilitation of certain historic homes

Present Law

Present law provides a nonrefundable two-tier credit for qualified rehabilitation expenditures. The credit percentage is 20 percent for rehabilitations of certified historic structures and 10 percent for rehabilitations of buildings (other than historic structures) originally placed-in-service before 1936. The 10-percent credit is limited to nonresidential buildings but the 20-percent credit is available to both nonresidential buildings and rental residential buildings. Generally qualified rehabilitation expenditures are eligible for the credit if incurred in connection with a substantial rehabilitation that meets the exterior walls requirement and several other rules. The exterior walls requirement generally provides that: (1) at least 75 percent of the existing exterior walls (including at least 50 percent as exterior walls) as well as (2) at least 75 percent of the building's internal structural framework be retained. The taxpayer's basis in the building is reduced by the amount of the credit. All rehabilitation expenditures must be depreciated on a straight line basis to qualify for the credit. This credit is not available for residential buildings that are not rental buildings.

Description of Proposal

The proposal would allow a credit against Federal income tax equal to 20 percent of the qualified rehabilitation expenditures of homeowners who rehabilitate a principal residence. The credit also would be available to purchases of home who are the first to inhabit a rehabilitated historic structure as a principal residence if (1) the purchase occurs within five years of the rehabilitation, and (2) the seller was not entitled to a credit in connection with the rehabilitation. The credit amount would be limited to $50,000 per historic structure used as a principal residence. The credit is not available unless at least five percent of the total expenditures made during the rehabilitation are allocable to rehabilitating the exterior of the building.

In lieu of a tax credit, the taxpayer may elect to receive an historic Rehabilitation Mortgage Credit Certificate, which could be transferred to a lending institution for the purpose of securing a loan to acquire or rehabilitate an historic structure. The amount of the Historic Mortgage Credit Certificate would be the same as the amount of the tax credit. Finally, the credit would be nonrefundable with excess credit amounts carried forward to subsequent taxable years.

Effective Date

The proposal would apply to rehabilitations the physical work on which begins after the date of enactment.

2. Increase tax credit and modify other provisions with respect to electric vehicles

Present Law

Tax credit for electric vehicles

A taxpayer is allowed a credit of 10 percent of the cost of any qualified electric vehicle placed in service by the taxpayer during the year (sec. 30). A "qualified electric vehicle" means any motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current and is acquired by the taxpayer and not for resale. For this purpose, a "motor vehicle" is any vehicle manufactured primarily for use on public streets, roads, and highways (not including a vehicle operated exclusively on a rail or rails) and has at least four wheels. In general, vehicles used by tax-exempt entities do not qualify for the credit.

The maximum amount of credit allowed per vehicle is $4,000. The amount of the credit is phased-out for vehicles placed in service after 2001 and is completely phased-out by 2005. The credit is not allowed to offset the alternative minimum tax liability of the taxpayer.

Expensing for clean-fuel vehicles

Taxpayers are allowed to expense and deduct an amount equal to the cost of any qualified clean-fuel vehicle property or any qualified clean-fuel vehicle refueling property (sec. 179A). For this purpose, the term "qualified clean-fuel vehicle property" means new property acquired by the taxpayer and not for resale, which meets certain environmental standards, and which uses or is designed to use a clean-burning fuel in the operating of a motor vehicle. The term "qualified clean-fuel vehicle property" does not include any qualified electric vehicle (as described above as qualifying for the 10-percent credit).

The amount of the deduction is limited to (1) $50,000 in the case of a truck or van with a gross vehicle rating greater than 26,000 pounds or a bus with a passenger seating capacity of at least 20 adults; (2) $5,000 in the case of a truck or van with a gross vehicle rating greater than 10,000 pounds but not greater than 26,000 pounds; and (3) $2,000 in the case any other motor vehicle. The amount of the deduction is phased-out for vehicles placed in service after 2001 and is completely phased-out by 2005.

Depreciation limits for automobiles

Taxpayers generally are allowed to claim depreciation deductions for the cost of tangible property placed in service in the active conduct of trade or business. Business-use automobiles generally are depreciated over a 5-year recovery period using the 200-percent declining balance method (sec. 168(b)(1) and (e)(3)(B)(i)). However, with certain exceptions, the amount of depreciation deductions allowed with respect to a passenger automobile is limited to $2,560 in the first taxable year the property is placed in service; $4,100 in the second taxable year; $2,450 in the third taxable year; and $1,475 thereafter (sec. 280F). For automobiles placed in service

after 1988, these limitations have been and are indexed for inflation.

Luxury tax

Present law imposes a tax of 10 percent on the excess of price over $32,000 (indexed) on certain passenger vehicles (sec. 4001). The tax expires after December, 31 1999.

Description of Proposal

Tax credit for electric vehicles

Effective for taxable years beginning after 1995, the proposal would make the electric vehicle credit a flat $4,000 credit (rather than a 10-percent credit with a $4,000 cap) and would allow the credit to offset a taxpayer's alternative minimum tax liability. In addition, vehicles that are used by the United States, any State or political subdivision thereof, any U.S. possession, or any agency or instrumentality of the foregoing would qualify for the credit.

Expensing for clean-fuel vehicles

The proposal would provide that any truck or van with a gross vehicle rating greater than 10,000 pounds or a bus with a passenger seating capacity of at least 20 adults that also qualifies as a qualified electric vehicle would qualify for the expensing under section 179A rather than the tax credit.

Depreciation limits for automobiles

The depreciation limitations of section 280F would not apply to any qualified electric vehicle.

Luxury tax

The luxury tax of section 4001 would not apply to the value of (1) any qualified clean-fuel vehicle property to the extent of any basis that is attributable to an engine that uses a clean-burning fuel, to the storage of such fuel, or to the exhaust of gases of such fuel in a vehicle produced by an original equipment manufacturer, or (2) any component of a passenger vehicle to the extent such component enables such vehicle to qualify as a qualified electric vehicle.

Effective Date

Except as provided above, the proposal would be effective for property placed in service after the date of enactment.

3. Tax credit and tax-exempt financing for environmental remediation expenses

Present Law

Tax credits

Present law does not provide for special tax credits for investments in environmental remediation. Nonrefundable 10-percent income tax credits are allowed for investments in qualifying solar en-

ergy property and geothermal property (the "business energy tax credits").

The business energy credit is a component of the general business credit. The general business credit may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of: (1) 25 percent of net regular tax liability above $25,000; or (2) the tentative minimum tax. Any unused general business credit generally may be carried back to the three previous taxable years and carried forward to the subsequent 15 taxable years.

Tax-exempt bonds

State and local governments may issue tax-exempt bonds to finance governmental activities, but may issue tax-exempt private activity bonds only for specified purposes. Among the specified purposes are qualified exempt facilities including facilities for the furnishing of water, sewage facilities, solid waste disposal facilities, qualified hazardous waste disposal facilities, and environmental enhancements of hydro-electric generating facilities.

Description of Proposal

The proposal is generally the same as H.R. 2340, "The Environmental Remediation Tax Credit Act of 1993," as introduced in the 103rd Congress in 1993.

The proposal would provide a 25-percent credit for the costs incurred by the taxpayer for environmental remediation with respect to any qualified contaminated site which is owned by the taxpayer and which costs are incurred by the taxpayer pursuant to an environmental remediation plan for such site which was approved by the Administrator of the Environmental Protection Agency (EPA). In addition, the bill would create a new class of private activity bonds, "qualified contaminated site remediation bonds."

Tax credits

The proposal would direct the Secretary of Housing and Urban Development to designate four large cities and 20 medium-sized cities[6] for participation in the environmental remediation credit program. In addition, the Secretary of Agriculture would designate five States for participation in the environmental remediation credit program. To be eligible for designation, a city or State must submit an application to the appropriate Secretary including an environmental credit remediation program that provides procedures for assessment of contaminated sites located within the city or State, a credit allocation plan, and provision for non–Federal contributions to the environmental remediation. The credit allocation plan must select sites for remediation based upon: (1) the condition of the contaminated site and its likelihood for redevelopment in the absence of the environmental remediation credit program; (2) contaminated sites that have not been in productive use for at least one year prior to participation in the program; (3) likelihood of redevelopment of the site for industrial or commercial use; and (4)

[6] A large city is any city with a population of at least 1,000,000 and a medium-sized city is any city with a population of at least 250,000 but less than 1,000,000.

the likelihood that remediation and redevelopment are completed within a reasonable period of time.

The appropriate Secretary is to select eligible cities or States based upon: (1) the comparative degree of economic deterioration among cities (or States) of the same category, as measured by the city's manufacturing job loss between 1970 and 1990; (2) the strength and quality of the established local commitment to remediate contaminated sites; and (3) the percentage of the total Comprehensive Environmental Response, and Liability Information System sites which are located in such city or State. The first criterion is to carry twice the weight of the latter two in the selection procedure.

For each calendar year after 1994, the bill would establish an overall credit limitation of $75 million, to be allocated $25 million among the designated large cities, $25 million among the designated medium-sized cities, and $25 million among the designated States. Jurisdictions receiving a portion of the overall credit limitation for any calendar year may make allocations only during the calendar year or the calendar year subsequent to the receipt of such portion.

No credits could be claimed unless the Administrator of the EPA certifies the environmental remediation plan for such site has been completed. Upon such certification, taxpayers may claim credits allocated to them ratably over the five taxable years beginning with the taxable year in which the plan was certified as complete.[7]

Environmental remediation includes removal or remediation activity including soil and ground water remediation, restoration of natural, historic, or cultural resources, health assessments or studies, environmental audits, remediation of off-site contamination caused by activity on the site, and other costs reasonably required by reason of the environmental conditions on the site.[8]

The credit would be part of the general business credit. The basis of any qualified contaminated site shall be reduced by the amount of the any credit claimed with respect to the site.

Tax-exempt bonds

The proposal would create a new class of private-activity bonds, "qualified contaminated site remediation bonds." A qualified contaminated site remediation bond is any bond at least 95 percent of the proceeds of which are used to finance the acquisition of a qualified contaminated site[9] or the costs of environmental remediation. The bonds would be subject to the annual State private activity bond volume limitation. Only persons eligible to claim the environmental remediation credit could use the proceeds of qualified contaminated site remediation bonds.

Effective Date

The bill would be effective upon the date of enactment.

[7] Provision is made for situations where unforeseen circumstances increase the cost of completing the remediation plan in excess of 200 percent of the estimated completion cost.

[8] Such additional expenses would include demolition of existing contaminated structures, site security, and permit fees.

[9] Acquisition costs include the costs of acquiring land.

Legislative Background

A similar proposal was the subject of hearings before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on June 17, 22, and 24, 1993.

E. Capital Gains

1. 10-percent alternative tax on gains with respect to assets held 5 years or more

Present Law

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of capital assets, the net capital gain is taxed at the same rate as ordinary income, except that individuals are subject to a maximum marginal rate of 28 percent of the net capital gain. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

A 50-percent exclusion for gain is provided for gain from the sale of certain small business stock acquired at original issue and held for at least five years.

Description of Proposal

The proposal would permit individual taxpayers to elect to pay either present-law taxes on capital gains or, if the taxpayer has held the asset for at least five years, the taxpayer may elect to pay a tax equal to 10 percent of the sales proceeds.

Legislative Background

H.R. 1215 would provide individuals a deduction equal to 50 percent of net capital gain. H.R. 1215 also would provide an inflation adjustment to the adjusted basis of certain assets for purposes of determining gain upon a sale or other dispositions of such assets by a taxpayer other than a C corporation. Under H.R. 1215, capital gains realized on collectibles are not eligible for the 50-percent exclusion, but may elect to be taxed at the 28-percent maximum marginal rate of present law in liew of indexing the basis of such assets.

2. Onetime exclusion on the sale of a principal residence by an individual who has attained age 55

Present Law

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

Description of Proposal

a. Allow multiple exclusions where two otherwise eligible taxpayers marry

The first proposal allows an exclusion to an individual who otherwise qualifies but for a marriage to a spouse with existing election in effect. The exclusion would only be available if the individual held the property which is the subject of the exclusion for at least three years prior to marrying the spouse with the existing exclusion.

b. Allow multiple exclusions in certain cases

The second proposal would provide that an election by one individual with respect to a sale or exchange before the date of marriage (or a sale or exchange on or after the date of marriage for property owned before the date of marriage) would not prevent another election to exclude up to $125,000 of gain by the individual's spouse.

c. Allow multiple exclusions in the case of certain unemployed persons

The third proposal would waive the age 55 requirement for sale or exchanges when either the taxpayer or his spouse is unemployed. For these purposes, an individual would be treated as unemployed while he is receiving unemployment compensation or would be receiving unemployment compensation but for: (1) the termination of the period during which such compensation is payable, or (2) the exhaustion of such individual's rights to such compensation.

d. Treat certain disabled persons as satisfying the age 55 requirement

The fourth proposal would waive the age 55 rule if at the time of the sale or exchange, the taxpayer is disabled. For these purposes, an individual would be considered disabled if he or she has: (1) a disability meeting the requirements of sec. 216(1) of the Social Security Act, or (2) has a service connected disability rated as total by the Secretary of Veterans Affairs under Chapter 11 of Title 38 of the United States Code.

Effective Dates

The first, second, and fourth proposals would be effective for sale or exchanges on or after January 1, 1995.

The third proposal would be effective for sales or exchanges after the date of enactment in taxable years ending after such date.

3. Modifications to the capital gains exclusion for certain small business stock

Present Law

In general

Gain from the sale or exchange of stock held for more than one year generally is treated as long-term capital gain. Net capital gain (i.e., long-term capital gain less short-term capital loss) of noncorporate taxpayers is taxed at the same rates that apply to ordinary income, subject to a maximum rate of 28 percent.

A noncorporate taxpayer who holds qualified small business stock for more than 5 years may exclude 50 percent of any gain on the sale or exchange of the stock. The remaining gain is subject to a maximum rate of 28 percent. The amount of a taxpayer's gain eli-

gible for the 50 percent exclusion is limited to the greater of (1) 10 times the taxpayer's basis in the stock or (2) $10 million gain from stock in that corporation.

Qualified small business stock

In order for stock held by a taxpayer to qualify as small business stock, the following requirements must be met.

Eligible stock and redemptions

The stock must be acquired by the taxpayer at the original issuance (directly or through an underwriter) in exchange for money, other property (not including stock) or as compensation for services provided to the issuing corporation (other than services performed as an underwriter of the stock).

In order to prevent evasion of the requirement that the stock be newly issued, the exclusion does not apply if the issuing corporation (1) purchases any stock from the stockholder (or a related person) within 2 years of the issuance of the stock or (2) redeems more than 5 percent (by value) of its own stock within 1 year of the issuance.

Qualified corporation

As of the date of issuance, the issuing corporation must be a subchapter C corporation and its cash and aggregate adjusted basis other property cannot exceed $50 million.

Active business

During substantially all of the taxpayer's holding period for the stock, at least 80 percent (by value) of the corporation's gross assets (including intangible assets) must be used by the corporation in the active conduct of a qualified trade or business. If in connection with any future qualified trade or business, a corporation uses assets in certain start-up activities, research and experimental activities or in-house research activities, the corporation is treated as using such assets in the active conduct of a qualified trade or business.

Assets that are held to meet reasonable working capital needs of the corporation, or are held for investment and are reasonably expected to be used within 2 years to finance future research and experimentation, are treated as used in the active conduct of a trade or business. After the corporation has been in existence for 2 years, no more than 50 percent of the assets of the corporation may qualify as working capital.

A qualified trade or business is any trade or business other than one involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of the trade or business is the reputation or skill of 1 or more of its employees. The term also excludes any banking, insurance, leasing, financing, investing, or similar business, any farming business (including the business of raising or harvesting trees), any business involving the production or extraction of products of a character for

which percentage depletion is allowable, or any business of operating a hotel, motel, restaurant or similar business.

Minimum tax

One-half of any excluded gain is treated as a preference for purposes of the alternative minimum tax.

Description of Proposal

In general

The bill (H.R. 1918) would (1) extend the exclusion to corporate investors, (2) increase the exclusion from 50 to 75 percent, and (3) repeal the limitation on the amount of gain that could be excluded by a taxpayer. The exclusion would not apply to corporate investors that invested in stock of another member of its controlled group (using a 50% ownership test).

Qualified Small Business Stock

Eligible stock and redemptions

A redemption would be disregarded for purposes of the 5-percent redemption rule if the issuing corporation establishes that there was a business purposes for the redemption and one of the principal purposes of the purchase was not to avoid the limitations for qualified small business stock.

Qualified corporation

The gross asset limitation would be increased from $50 million to $100 million. The limitation also would be indexed for inflation.

Active business

Assets that are held for investment and are reasonably expected to be used within 5 (rather than 2) years to finance future research and experimentation would be treated as used in the active conduct of a trade or business. The 2-year limitation on the amount of working capital that can be treated as used in the active conduct of a trade or business would be repealed.

The bill would treat the business of operating a hotel, motel, restaurant, or similar business as a qualified trade or business.

Minimum tax

None of the excluded gain would be treated as a preference for purposes of the alternative minimum tax.

Effective Date

The bill generally would be effective for stock issued after December 31, 1994. A taxpayer may elect to apply the provisions of the bill for qualified stock issued after August 10, 1993. For these purposes, qualified stock is stock that is held by the taxpayer on December 31, 1994, and that was not qualified small business stock when issued but would be qualified small business stock under the modifications described above.

Legislative Background

The bill (H.R. 1918) was introduced by Mr. Matsui and Mr. English on June 22, 1995. The 50-percent exclusion for gain from the sale of stock in qualified small businesses was enacted by the Revenue Reconciliation Act of 1993. (Except for certain grandfathered stock, the exclusion would be repealed under H.R. 1215 (Contract with America Tax Relief Act of 1995) as passed by the House of Representatives on April 5, 1995).

4. Exempt tax-exempt bonds from treatment as market discount bonds

Present Law

Generally a market discount bond is a bond that is acquired for a price that is less than the principal amount of the bond. Market discount arises when the value of a debt obligation declines after issuance (typically, because of an increase in prevailing interest rates or a decline in credit-worthiness of the borrower).

Gain on the disposition of a market discount bond generally must be recognized as ordinary income to the extent of the market discount that has accrued. Prior to 1993, tax-exempt bonds were not treated as market discount bonds. Under prior law, gain attributable to accrued market discount on a tax-exempt bond was taxable as capital gain if the bond was held as a capital asset.

Description of Proposal

The bill (H.R. 843) would exempt tax-exempt bonds from treatment as market discount bonds. Gain attributable to accrued market discount generally would be taxable as capital gain.

Effective Date

The proposal would be effective for bonds purchased after April 30, 1993 (which was the effective date for the changes enacted in 1993).

Legislative Background

The bill (H.R. 843) was introduced by Mr. Cardin and Mr. Shaw on February 7, 1995. The market discount rules were expanded to cover tax-exempt bonds by the Revenue Reconciliation Act of 1993.

F. Charitable Deduction

1. Commemorative coins purchased from U.S. Mint

Present Law

A taxpayer who itemizes deductions is allowed to deduct amounts contributed in cash (and generally may deduct the fair market value of contributed property) to a qualified charitable organization or governmental entity (sec. 170). However, a payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the payor receives an economic benefit generally is not deductible under section 170, except to the extent that the taxpayer can demonstrate that the payment exceeds the fair market value of the benefit received from the charity or governmental entity.

Description of Proposal

Any amount paid to purchase a commemorative coin directly from the United States Mint would be considered a charitable contribution deductible under section 170 to the extent that the amount paid exceeds the face amount of such coin.

Effective Date

The proposal would be effective for amounts paid after December 31, 1995.

2. Charitable deduction for nonitemizers

Present Law

In computing taxable income, individuals who do not elect the standard deduction may claim itemized deductions, including a deduction (subject to certain limitations) for charitable contributions or gifts made to a qualified charitable organization during the taxable year (sec. 170).[10] Individuals who elect the standard deduction may not claim a deduction for charitable contributions made during the taxable year. 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).

Description of Proposal

Individuals who elect the standard deduction would be allowed to claim a deduction for charitable contributions (subject to the present-law rules that apply to contributions made by individuals who itemize deductions) to the extent that aggregate contributions made during the taxable year exceed $570 in the case of single taxpayers, heads of households, or married couples filing separately ($1,140 in the case of a married couple filing a joint return).

[10] In computing taxable income, a taxpayer who itemizes generally is allowed to deduct the fair market value of property contributed to a charity (subject to annual percentage limitations based on the individual's AGI, the type of property contributed, and the type of donee organization). 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 (sec. 170(e)).

Under the proposal, the deduction for charitable contributions would be a "below-the-line" deduction (meaning that the deduction would not be taken into account in computing an individual's AGI).

Effective Date

The proposal would be effective for contributions made after December 31, 1995.

Legislative Background

The proposal is similar to a provision in H.R. 1493, introduced by Messrs. Crane, Rangel, and Cox on April 7, 1995.

Prior to 1982 (as under present law), only itemizers were allowed a deduction for charitable contributions. This deduction was extended to nonitemizers during 1982–1986, subject to differing limitations during those years. The maximum charitable contribution deduction for nonitemizers was $25 in 1982 and 1983, and $75 for 1984. For 1985, 50 percent of the amount contributed was deductible (without a dollar cap) and, for 1986, 100 percent of the amount contributed was deductible (without a dollar cap).

3. Remove charitable deductions from overall limitation on itemized deductions

Present Law

Charitable contributions may be claimed as itemized deductions, subject to certain restrictions (sec. 170). In the case of an individual taxpayer, the total amount of otherwise allowable itemized deductions (other than medical expenses, casualty and theft losses, and investment interest) is reduced by three percent of the amount of the taxpayer's AGI in excess of $111,800 in 1994 (indexed for inflation). Under this present-law provision, otherwise allowable deductions are reduced by not more than 80 percent (sec. 68).

Description of Proposal

The proposal would remove charitable contributions from the overall limitation on itemized deductions provided for by present-law section 68. Thus, individuals who itemize deductions could claim as a deduction the full amount of their charitable contributions, regardless of the individual's AGI, subject to the limitations of present-law section 170.

Effective Date

The proposal would be effective for contributions made after December 31, 1995.

Legislative Background

The proposal is the same as a provision in H.R. 1493, introduced by Messrs. Crane, Rangel, and Cox on April 7, 1995.

The section 68 overall limitation on itemized deductions originally was enacted as part of the Omnibus Budget Reconciliation Act of 1990 ("OBRA 1990"), effective for taxable years beginning after 1990 and prior to 1996. Section 68 was permanently extended

as part of the Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993").

4. Repeal of charitable substantiation rule for contributions of $250 or more

Present Law

Taxpayers who itemize deductions are allowed to claim a deduction for contributions made to a qualifying charity, subject to certain limitations contained in section 170. However, a payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the payor receives an economic benefit is not deductible as a charitable contribution under section 170, except to the extent that the taxpayer can demonstrate that the payment exceeds the fair market value of the benefit received from the charity.

Section 170(f)(8) requires taxpayers who make a separate charitable contribution of $250 or more for which they claim a deduction under section 170 to obtain a written substantiation from the charity, rather than relying solely on a cancelled check. The written substantiation must indicate the amount of cash (and a description, but not value, of other property) contributed by the donor, whether the donee organization provided any goods or services in return, and a good faith estimate of the value of any goods or services provided by the donee organization.[11] The taxpayer must obtain the required substantiation prior to filing his or her return for the taxable year in which the contribution was made (or, if earlier, the due date, including extensions, for filing such return).[12]

Another provision of the Code (sec. 6115) imposes a disclosure requirement directly upon charities. Under section 6115, any charity that receives a *quid pro quo* contribution exceeding $75 (meaning a payment in excess of $75 made partly as a gift and partly as consideration for goods or services furnished by the charity) is required to inform the contributor in writing of the value of the goods or services furnished by the charity and that only the portion of the payment exceeding the value of the goods or services is deductible as a charitable contribution. Disclosure is not required where token goods or services are given to the donor that meet certain criteria for "insubstantial value," where there is no donative element involved in a transaction (such as a typical museum gift shop sale), or where only an intangible religious benefit is provided to the donor (see IRS Publication 1771, issued January 3, 1995). Penalties may be imposed on a charity that fails to satisfy this disclosure requirement, unless the failure is due to reasonable cause (sec. 6714).

[11] If goods or services provided by the donee organization consist solely of intangible religious benefits generally not sold in a commercial transaction, then the substantiation must contain a statement to that effect, but such intangible religious benefits need not be valued (sec. 170(f)(8)(B)).

[12] In Notice 95-15, the IRS provided transition relief for contributions of $250 or more made during 1994. With respect to such contributions, a taxpayer will be treated as having satisfied the requirements of section 170(f)(8) if (1) the taxpayer has obtained the required substantiation prior to October 16, 1995, or (2) the taxpayer has made a good faith effort to obtain the substantiation by that date (such as by sending the donee organization a letter requesting written substantiation that meets the requirements of section 170(f)(8)).

Description of Proposal

The proposal would repeal the section 170(f)(8) substantiation requirement for charitable contributions of $250 or more. The proposal would not affect the disclosure obligation imposed directly on charities by present-law section 6115 for *quid pro quo* contributions exceeding $75.

Effective Date

The proposal would be effective for contributions made after 1995.

Legislative Background

The section 170(f)(8) substantiation requirement for charitable contributions of $250 or more was enacted as part of the Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993"). The section 6115 disclosure obligation imposed on charities also was enacted as part of OBRA 1993.

5. Allocation of basis to sale portion of bargain sales of real estate interests to charities or governments

Present Law

Individuals who itemize deductions, and corporations, are allowed to deduct contributions to qualified charities and governmental entities, subject to certain limitations (sec. 170). If a taxpayer transfers property to a charity or governmental entity and, in return, receives cash (or other property with a value) less than the fair market value of the property so transferred, then such a so-called "bargain sale" is treated as a part-sale/part-gift transaction. In such a case, section 1011(b) provides that the taxpayer's basis in the property is allocated on a pro-rata basis between the sale portion and the gift portion of the transaction based on the ratio that the amount realized bears to the fair market value of the property transferred to the charity or governmental entity.

Description of Proposal

The bill (H.R. 523) would amend section 1011(b) to provide a special rule for cases involving bargain sales of real property (or an interest therein) to a publicly supported charity or governmental entity. Under the bill, the entire basis of the real property would be allocated to the sale portion of a bargain sale transaction. If the transaction involves the transfer to a charity or governmental entity of a restriction (granted in perpetuity) on the use which may be made of real property (e.g., a scenic easement), then the taxpayer's entire basis in the real property would be allocated to the restriction on the use which may be made of the property. The bill would apply to all bargain sales of real property (or interests therein) to publicly supported charities or governmental entities, regardless of how the property is to be used by the charity or governmental entity.

In addition, the bill would specifically provide that, if any restriction (granted in perpetuity) on the use which may be made of real

property is sold to a publicly supported charity or governmental entity, the fair market value of such restriction (for purposes of determining the extent to which the transaction involves a gift portion deductible under section 170) would be determined without regard to the amount paid by the charity or governmental entity, even if such amount is "determined in a competitive fashion."

Effective Date

The proposal would be effective for bargain sale transactions occurring after the date of enactment.

Legislative Background

The bill (H.R. 523) was introduced by Mr. Zimmer on January 14, 1995.

6. Enhanced deduction for corporate 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.[13] 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 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 contribu-

[13] 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.

tions 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, 1995.

Legislative Background

Section 170(e)(3) was enacted in 1976; and section 170(e)(4) was enacted in 1981.

G. Child Care Credit

1. Extend dependent care credit and dependent assistance programs to certain overnight camp expenses

Present Law

The Omnibus Budget Reconciliation Act (OBRA) of 1987 denied the dependent care credit and dependent assistance program exclusion to overnight camp expenses.

Description of Proposal

The proposal would provide that up to $46.15 a week in overnight camp expenses would be eligible for the dependent care credit. Also, the proposal would allow up to $96.15 a week of such overnight camp expenses paid for by the employer to be excluded under a dependent assistance program.

Effective Date

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

H. Compliance

1. Allow offset of State tax liability with overpayments of federal tax

Present Law

Federal tax refunds must be offset against three types of debt (Code sec. 6402). First, they must be offset against any liability for any internal revenue tax. Second, they must be offset against past-due child support payments. In the case of families receiving specified public assistance payments (primarily AFDC payments), these past-due support payments are assigned to the State that makes the public assistance payments. Third, Federal tax refunds must be offset for the amount of any past-due, legally enforceable debt to a Federal agency. Federal tax refunds may not be offset against past-due, legally enforceable State tax obligations.

If a refund is subject to offset both under the Federal agency provision and because of past-due child support, the offset for past-due child support that has been assigned to a State is to be implemented first, the offset for past-due debts owed to Federal agencies second, and the offset for past-due child support not assigned to a State (but owed to the family) last. No court of the United States has jurisdiction to hear any action brought to restrain or review a refund offset made because of either past-due child support or a nontax Federal debt.

Description of Proposal

The bill (H.R. 757) would require the Internal Revenue Service "IRS" to reduce the amount of an overpayment of Federal tax otherwise payable to a person by the amount of past-due, legally enforceable State tax obligations of such person and pay those amounts to the State. The bill would impose several procedural requirements on the States before the IRS could offset a refund. These procedural requirements are generally parallel to present-laws procedural requirements imposed on the Federal Government prior to offsetting a refund for nontax Federal debts. The bill would apply to all types of State taxes and to any local tax that is administered by the chief tax administration agency of the State.

If a refund were subject to offset under multiple provisions, this offset would occur after overpayments of a Federal tax liability are reduced by (1) the amount of any liability for any internal revenue tax on the part of the person who made the overpayments, (2) the amount of past-due child support, and (3) any past-due, legally enforceable debt owed to a Federal agency. However, this offset would occur before the overpayment is credited to any future liability for any Federal internal revenue tax of such person.

The bill would permit disclosure of the following otherwise confidential tax information to the States, relating to the refund offset for State tax obligations: whether or not a reduction has been made, the amount of the reduction, and identifying information regarding the person against whom a reduction was or was not made.

Effective Date

The bill would be effective for Federal tax refunds payable after December 31, 1995.

Legislative Background

The bill H.R. 757 was introduced by Mr. Jacobs, Mr. McCrery, and Mr. Moran on January 31, 1995.

2. Repeal of information reporting on real estate transactions

Present Law

Real estate transactions are required to be reported on a return to the IRS and on statements to the customers. In general, the primary responsibility for reporting is on the "real estate reporting person," that is, the person responsible for closing the transaction, including any title company or attorney who closes the transaction. If there is no person responsible for closing the transaction, the real estate reporting person is the first person who exists in the following order: the mortgage lender, the seller's broker, the buyer's broker, or such other person designated in regulations prescribed by the Secretary.

In the case of a real estate transaction involving a residence, the real estate reporting person is required to include on an information return and on the customer statements (1) the portion of any real property tax that is treated as a tax imposed on the purchaser and (2) whether or not the financing (if any) of the seller was federally subsidized indebtedness.

Description of Proposal

The proposal would eliminate the requirement for information reports and customer statements for real estate transactions.

Effective Date

The proposal would be effective for real estate transactions after December 31, 1995.

3. Extend IRS offset authority for undercover operations

Present Law

The Anti-Drug Abuse Act of 1988 exempted 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. 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 on December 31, 1989, and was extended by the Com-

prehensive Crime Control Act of 1990 to December 31, 1991. The IRS has not had the authority to churn funds from its undercover operations since 1991.

Description of Proposal

The proposal would reinstate the IRS's offset authority under section 7608(c) until December 31, 2000. The proposal also would impose certain additional annual reporting requirements on the IRS under section 7608(c)(4)(B).

Effective Date

The proposal would be effective on the date of enactment.

Legislative Background

A similar proposal was one of the subjects of a hearing on miscellaneous tax proposals held by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means in September 1993.

I. Corporate

1. Certain distributions by Alaska Native Corporations and treatment of certain settlement trusts

Present Law

Shareholders are generally taxed on dividends received from a corporation during the taxable year. In general, a corporate distribution to shareholders is treated as a dividend to the extent of the corporation's current or accumulated earnings and profits. A shareholder includes in gross income the amount of a dividend received and the corporation's earnings and profits are reduced by the amount of such distribution.

Distributions that are not out of a corporation's earnings and profits reduce a shareholder's basis in the distributing corporation's stock but are not included in the gross income of the shareholder, to the extent of such basis. Distributions in excess of earnings and profits and of basis are generally treated by a shareholder as capital gain.

Amendments in 1987 to the Alaska Native Claims Settlement Act of 1971 ("ANCSA") created certain settlement trusts, nonbusiness entities intended to promote th health, education and welfare of its beneficiaries and preserve the heritage and culture of Alaska Natives.

Description of Proposal

The proposal would treat an amount of distributions by an Alaska Native Corporation (ANC) to its Native shareholders or their descendants (as defined in section 3 of ANCSA[14]) as distributions that are not out of earnings and profits, in cases where such distributions would otherwise be treated as dividends. The amount of distributions granted this treatment would be limited to an amount equal to the lesser of (1) the amount of cash received by the ANC (or its wholly owned subsidiary) on or before July 9, 1992 from the sale by the ANC (or by such subsidiary) of any natural deposits or timber received by the ANC pursuant to ANCSA,[15] or (2) the aggregate bases (as determined pursuant to section 21(c) of ANCSA) of such natural deposits or timber sold or cash received on or before July 9, 1992; in each case adjusted as described below.

For purposes of these computations, basis and cash attributable to natural deposits or timber that were sold in a "special purpose sale" are excluded. Such a sale is one in which a loss was recognized and which was made under an agreement entered into either (1) after October 22, 1986 and on or before April 26, 1988, or (2)

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[14] 43 U.S.C. secs. 1601 et. seq.

[15] Cash received by the ANC or its wholly owned subsidiary from a sale of natural deposits or timber is within the scope of the provision only if such cash is received by the ANC or subsidiary on or before July 9, 1992 without any limitation or restriction. Amounts in escrow, for example, are not considered cash received on or before July 9, 1992 within the meaning of this provision.

Amounts received by an ANC or its wholly owned subsidiary will not be treated as cash received on or before July 9, 1992 if such amounts are directly or indirectly attributable to a sale by any entity in which the ANC or such subsidiary owns a proportionate interest but which is not a wholly owned subsidiary of a single ANC.

Sales of any land or property, other than natural deposits or timber received by the ANC pursuant to ANCSA, are not within the scope of the provision.

after April 26, 1988, if the loss incurred thereon was used in a contract referred to in section 5021(b) of the Technical and Miscellaneous Revenue Act of 1988. Also, any amount realized directly or indirectly for the use of losses or credits of the ANC (or a corporation all of whose stock is owned directly by such corporation) is excluded where such use would not have been allowable but for section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986 and repealed by section 5021 of the Technical and Miscellaneous Revenue Act of 1988).

The distribution of any amount that is treated under this provision as not out of earnings and profits shall reduce the basis of the shareholder's stock by such amount.

The proposal would also provide for taxation of Alaska Natives when payments from a settlement trust are actually made to them and not when the settlement trust is created.

Effective Date

The provision regarding distributions would apply to any distributions after the date of enactment of ANCSA. However, the provision does not include any special rules that would reopen any closed tax year or extend the statute of limitations for any taxpayer to permit claims for credit or refund. nevertheless, all distributions made by an ANC after the date of enactment of ANCSA (whether in a closed year or an open year and however reported for tax purposes) and which, but for this provision, would have been taxable as dividends for Federal income tax purposes, are counted toward the maximum amount of distributions treated under this provision as not out of earnings and profits.

Legislative Background

The proposal regarding distributions is the same as H.R. 5658 (102nd Cong.) and was included in H.R. 11(102nd Cong.) , as passed by the House and Senate in 1992 and vetoed by President Bush.

2. Extend carryforward for capital losses of corporations

Present Law

Corporations may carry back capital losses three years and forward five years.

Description of Proposal

The proposal would permit corporate capital losses to be carried forward 15 years.

Effective Date

The proposal would be effective for capital losses that would otherwise expire in taxable years ending after 1995.

Legislative Background

The Revenue Act of 1942 provided the 5-year carryforward of unused corporate capital losses. In 1969, the three-year carryback was added.

3. Repeal rule that accumulated earnings tax applies without regard to the number of shareholders

Present Law

An accumulated earnings tax is imposed on corporations that are formed or availed of for the purpose of avoiding the income tax with respect to shareholders by permitting earnings and profits of the corporation to accumulate instead of being distributed. Where applicable, the tax is imposed at the rate of 39.6 percent of the accumulated taxable income. The term "accumulated taxable income" (ATI) means regular taxable income, with certain adjustments, reduced by a deduction for dividends paid and an accumulated earnings credit.

The fact that a corporation is a mere holding or investment company is prima facie evidence that such corporation was formed or availed of for the purpose of avoiding the income tax with respect to shareholders. In the case of other corporations, an accumulation of earnings and profits beyond the reasonable needs of the business establishes a rebuttable presumption of a tax avoidance purpose.

In the Deficit Reduction Act of 1984, Congress specifically provided that the application of the provision is determined without regard to the number of shareholders of the corporation. Prior to that time, there was some controversy regarding the application of the accumulated earnings tax to widely held corporations. The Internal Revenue Service asserted that the tax could be imposed on widely-held corporations, even those not controlled by a few shareholders or groups of shareholders. The issue had not been resolved definitively by the courts. See, *Golconda Mining Corp. v. Commissioner*, 507 F.2d 594 (9th Cir. 1974). But see, *Trico Products Corp. v. Commissioner*, 137 F.2d 424 (2d Cir. 1943); *Trico Products Corp. v. McGowan*, 169 F.2d 343 (2d Cir. 1948); and Rev. Rul. 75–305, 1975–2 C.B. 228.

Description of Proposal

The proposal would repeal the rule that the application of the accumulated earnings tax is determined without regard to the number of shareholders of the corporation.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1994.

Legislative Background

This proposal is the same as H.R. 663 (103rd Cong.) except that H.R. 663 was proposed to be effective for taxable years beginning after December 31, 1992.

4. Modify rules for interest on large corporate underpayments

Present Law

Taxpayers are subject to an interest charge on underpayments of taxes. A corporation is subject to an interest charge computed with respect to a rate equal to the applicable Federal rate plus five percentage points if the corporation fails to pay a tax deficiency of $100,000 or more within 30 days of receiving the notice of the deficiency (sec. 6621(c)). Once this rate, known as the large corporate underpayment rate, applies with respect to a corporation's taxable year, it applies to all subsequent underpayments of tax with respect to that year.

Description of Proposal

The proposal would provide that the large corporate underpayment rate would not apply to an adjustment to a loss or credit carryover merely because the taxable year to which the loss or credit is carried to is subject to the large corporate underpayment rate.

For example, assume that the large corporate underpayment rate applies to the taxable year 1993 of a corporation. If the corporation subsequently incurs a net operating loss in 1996 that is carried back to 1993, the large corporate underpayment rate would not apply to an adjustment to the loss by the IRS merely because 1993 had been subject to the large corporate underpayment rate.

Effective Date

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

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J. Depreciation and Amortization

1. Normalization of consolidated tax adjustments with respect to non-regulated subsidiary of a regulated public utility

Present Law and Background

A regulated public utility is allowed to use the accelerated depreciation deductions of the modified Accelerated Cost Recovery System ("MACRS") of section 168 so long as such deductions are subject to a normalization method of accounting for rate making purposes. Utility rates generally are set by a public utility commission ("PUC") by allowing the utility to recover its operating costs (including Federal income taxes) as well as earn a rate of return on its invested capital, known as its "rate base." Under normalization, when setting utility rates a PUC must (1) essentially assume that MACRS is not available for public utility property in determining the utility's tax expense for cost-of-service purposes, but (2) may reduce the utility's rate base by the deferred tax liability generated by the use of MACRS. In this way, the deferral benefits of MACRS generally are spread over the life of the property.

A utility may join in the filing of a consolidated return with an affiliate that is not a utility. The non-regulated affiliate may generate losses or tax benefits that reduce the group's overall liability. When PUCs initially tried to reflect a portion of such losses (i.e., a "consolidated tax adjustment" or "CTA") in rate-making, the IRS ruled that these procedures violated the normalization requirements. See, e.g., Private Letter Rulings 8801040 and 890408. The validity of these rulings was questioned by PUCs.

In November 1990, the IRS issued proposed regulations that provided that CTAs could not be reflected in cost of service, but could be reflected in rate base. Utilities questioned the validity of the regulations and challenged them as constituting a "major rule." The IRS withdrew the regulations in April 1991 "pending Congressional guidance".

Description of Proposal

The proposal would provide that consolidated tax adjustments violate the normalization requirements of section 168.

Effective Date

The proposal would be effective for consolidated tax adjustments made after the date of enactment.

2. Establish 15-year recovery period for small retail motor fuel outlet stores

Present Law

Under present law, property used in the retail gasoline trade is depreciated under section 168 using a 15-year life and the 150-percent declining balance method. Nonresidential real property (such as a convenience store) is depreciated using a 39-year life and the straight-line method. It is unclear whether gas station convenience

stores ("c-stores") and truckstop structures installed at motor fuel retail outlets belong to the 15-year or 39-year class. According to an IRS Coordinated Issues Paper, the 15-year life is applicable only where (1) 50 percent or more of the gross revenues are generated by the c-store are derived from gasoline sales and (2) 50 percent or more of the floor space in the building is devoted to petroleum marketing sales. All structures of 1,400 square feet or less qualify for the 15-year designation.

Description of Proposal

The proposal would provide that 15-year property includes any building and depreciable land improvements, whether section 1245 or 1250 property, used in the marketing of petroleum products, such as a retail motor fuel outlet building where gasoline and food are sold, but not including any of these facilities related to petroleum and natural gas truck pipelines. The 15-year designation would not apply to any section 1250 property used only to an insubstantial extent in the retail marketing of petroleum or petroleum products.

Effective Date

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

3. Establish 3-year recovery period for semiconductor manufacturing equipment

Present Law

Equipment used in the manufacture of semiconductors is treated as 5-year property under section 168. Consequently, the depreciation deductions for semiconductor manufacturing equipment are determined by using a 5-year recovery period and the 200-percent declining balance method for regular tax purposes. A 5-year class life is also used for purposes of the alternative depreciation system and the alternative minimum tax.

Description of Proposal

The bill (H.R. 1061) would change the recovery period and class life of semiconductor manufacturing equipment from 5 to 3 years.

Effective Date

The bill would be effective on the date of enactment.

Legislative Background

H.R. 1061 was introduced by Mrs. Johnson of Connecticut, Mr. Matsui, Mr. Crane, Mrs. Kennelly, and Ms. Eshoo on February 27, 1995.

4. Establish a 3-year recovery period for property subject to certain rental purchase agreements

Present Law

Depreciation for property subject to a lease generally is calculated over the applicable recovery period for such property under section 168, regardless of the term of a lease.

Description of Proposal

The proposal would provide a 3-year recovery period for property subject to a qualified rental purchase agreement (i.e., generally, "rent-to-own" contracts). A "qualified rental purchase agreement" means a agreement that provides (1) for the rental of tangible personal property for an initial period of 4 months or less, (2) for the renewal of the agreement at the option of the renter for a period of 4 months or less, (3) that the renter is not obligated to renew the agreement and may terminate at the end of the rental period, and (4) that the renter may at its option acquire ownership of the property either (a) at a stated amount based on the agreement (if required by law) at the end of the rental term, or (b) at a specific price or formula if acquired during such term. Under present law, such property generally has a 5-year recovery period.

In addition, the proposal would provide a 4-year class life (i.e., the period used for alternative minimum tax and alternative depreciation system purposes).

Effective Date

The proposal would be effective for property placed in service after 1994.

5. Establish 10-year recovery period for commercial improvement property

Present Law

If an improvement to property constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168(b)(3), (c)(1), (d)(2), and (i)(6)).[16] A 40-year class life is use for alternative minimum tax purposes for nonresidential real property.

Description of Proposal

The proposal would provides a 10-year life for qualified commercial improvement property. "Qualified commercial improvement property" would be defined as any addition or improvement to an

[16] If the improvement is characterized as tangible personal property, ACRS depreciation is calculated using the shorter recovery periods and accelerated methods applicable to such property. The determination of whether certain improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a "structural component" of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, for example, *Metro National Corp.*, 52 TCM 1440 (1987); *King Radio Corp.*, 486 F.2d 1091 (10th Cir., 1973); *Mallinckrodt, Inc.*, 778 F.2d 402 (8th Cir., 1985) (with respect to various leasehold improvements).

interior portion of nonresidential real property that is placed in service more than three years after the building was placed in service. Qualified property would not include expenditures attributable to: (1) the enlargement of the building; (2) any property for which the rehabilitation credit is claimed; (3) any property that benefits multiple units of real property and that is not itself used to facilitate the sale of tangible or intangible property or services (such as an elevator, escalator, the common area of a mall, or a building lobby); or (4) any internal structural framework of the building. In addition, the proposal could be limited to an improvement to space that is primarily used for the sale of tangible or intangible goods and services to the public. The proposal would require the use of the straight-line method of depreciation for such property.

Effective Date

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

6. Establish 10-year recovery period for certain leasehold improvements

Present Law

Improvements made on leased property are depreciated under the modified Accelerated Cost Recovery System ("MACRS"), even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)).[17] This rule applies regardless of whether the lessor or lessee places the leasehold improvements in service.[18] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168(b)(3), (c)(1), (d)(2), and (i)(6)).[19] A 40-year class life is use for alternative minimum tax purposes.

Description of Proposal

The proposal (H.R. 1171) would provide a recovery period and class life of 10 years for certain property placed in service by a lessee or a lessor pursuant to a lease. Qualified property would be any improvement to an interior portion of nonresidential real property that: (1) is made pursuant to a lease; (2) is of a portion occupied

[17] Prior to the adoption of the Accelerated Cost Recovery System ("ACRS") by the Economic Recovery Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The denial of component depreciation also applies under MACRS, as provided by the Tax Reform Act of 1986.

[18] Former Code sections 168(f)(6) and 178 provided that in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. These provisions were repealed by the Tax Reform Act of 1986.

[19] If the improvement is characterized as tangible personal property, ACRS depreciation is calculated using the shorter recovery periods and accelerated methods applicable to such property. The determination of whether certain improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a "structural component" of a building (as defined by Treas. Reg. sec. 1.48–1(e)(1)). See, for example, *Metro National Corp.*, 52 TCM 1440 (1987); *King Radio Corp.*, 486 F.2d 1091 (10th Cir., 1973); *Mallinckrodt, Inc.*, 778 F.2d 402 (8th Cir., 1985) (with respect to various leasehold improvements).

exclusively by a lessee; and (3) is placed in service more than three years after the building was placed in service. Qualified property would not include expenditures attributable to: (1) the enlargement of the building; (2) any elevator or escalator; (3) any structural component benefitting a common area; or (4) any internal structural framework of the building. A commitment to enter into a lease would be treated as lease and a lease between related parties would not be treated as a lease.

Effective Date

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

Legislative Background

H.R. 1171 was introduced by Mr. Shaw, Mr. Crane, Mrs. Johnson of Connecticut, Mr. Thomas, Mr. Hancock, Mr. Neal of Massachusetts, Mr. English of Pennsylvania, Mr. Sam Johnson of Texas, and Mr. Herger on March 8, 1995.

7. Treatment of intermodal cargo containers

Present and Prior Law

Prior to the enactment of the Tax Reform Act of 1986, an investment tax credit was allowed for certain tangible personal property. The credit was not allowed for property that was used predominantly outside the United States. For purposes of the credit, any container of a United States person that was used in the transportation of property to and from the United States was not property that was used predominantly outside the United States. The investment tax credit generally was repealed by the Tax Reform Act of 1986.

In addition, under both present and prior law, accelerated depreciation is not allowed for any tangible property used predominantly outside the United States. For depreciation purposes, any container of a United States person that is used in the transportation of property to and from the United States is not property that is used predominantly outside the United States.

In Rev. Rul. 90–9, 1990–1 C.B. 46, the Internal Revenue Service (IRS) ruled that a taxpayer may not use accelerated depreciation with respect to intermodal cargo containers if the taxpayer cannot document that the containers were used substantially in the direct transportation of property to or from the United States during the taxable year. In Rev. Proc. 90–10, 1990–1 C.B. 467, the IRS provided an irrevocable election that allowed taxpayers to use certain specified percentages to determine the aggregate basis of intermodal cargo containers placed in service in 1974 and all subsequent years that would be deemed used in the direct transportation of property to or from the United States (and thus eligible for the investment tax credit and accelerated depreciation). The election was available regardless of whether or not the taxpayer maintained sufficient records to trace the usage of cargo containers. The IRS position was affirmed in *Norfolk Southern Corp. v. Comm.*, 104 T.C. N. 2, 1/11/95.

Description of Proposal

In general

The bill (H.R. 2024, 103rd Congress) would provide that a "qualified intermodal cargo container" shall be treated as property described in section 48(a)(2)(B)(v) (as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990) and thus eligible for the investment tax credit and accelerated depreciation.

Definitions

For this purpose, a "qualified intermodal cargo container" would mean any intermodal cargo container of a United States person that, after being placed in service, at all times during the taxable year either: (1) is subject to a qualifying lease; or (2) is being held for lease, moved for purposes of leasing or being available for lease, or maintained or repaired for subsequent lease, by the taxpayer, a lessee or agent of the taxpayer or any other person. The term "qualifying lease" would mean: (1) any lease to a container user that has one or more trade routes that contact the United States or (2) any short-term lease to a container user. A "container user" would mean: (1) a person that is in the business of using intermodal cargo containers to ship or transport cargo for other persons, or (2) with respect to an intermodal cargo container, a person that uses the container to ship or transport its own cargo. A container user would be deemed to have one or more trade routes that contact the United States if at any time during the taxable year such person: (1) owns, operates, or charters any vessel that receives or delivers any intermodal cargo container in the United States, or (2) uses any intermodal cargo container to ship cargo to or from the United States. The term "short-term lease" would mean: (1) any lease the stated term of which is not more than 50 percent of the class life (within the meaning of section 168(i)(1)) of the container and (2) any lease under a lease agreement under which the lessee is not required to use or hold the container for a specified term. The term "lease" would mean a lease or sublease.

Other rules

No inference could be drawn from this bill as to the application of section 48(a)(2)(B)(v) (as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990) or section 168(g)(4)(e) to containers that are not qualified intermodal cargo containers or to containers placed in service after December 31, 1989.

Any election made under Rev. Proc. 90–10 prior to the date of enactment of this bill may be revoked (without regard to the application of the statutes of limitations of sections 6511 and 6514) without the consent of the Secretary of the Treasury or his delegate. A revoked election would be treated as never having been made. Any revocation would be made within 180 days after the date of enactment by filing with the Secretary of the Treasury or his delegate (1) a statement describing the election being revoked and indicating that the election is being revoked and (2) an amended return consistent with such revocation.

Effective Date

The bill generally would apply to all intermodal cargo carriers placed in service before January 1, 1990. The rules regarding the revocation of the election under Rev. Proc. 90–10 would take effect on the date of enactment of the bill.

Legislative Background

H.R. 2024 (103rd Cong.) was introduced on May 6, 1993. A provision similar to H.R. 2024 was included in H.R. 11 (102nd Cong.), as passed by the House of Representatives and the Senate in 1992, and was vetoed by President Bush.

8. Exempt acquisition of software and software services businesses from 15-year intangibles amortization

Present Law

Most acquired intangible assets are amortized on a straight line basis over a period of 15 years under section 197. Computer software that is not acquired in connection with the acquisition of a trade or business is amortized over a 3-year period. Also, even if acquired in connection with the acquisition of a trade or business, certain computer software which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified is amortized over a 3-year period.

Description of Proposal

The proposal would provide a special amortization rule for intangible assets in the case of the acquisition of certain qualified software businesses and software services businesses.

In the case of an acquisition of a qualified computer software business, 50 percent of the intangibles value would be amortized over a 15-year period and 50 percent would be treated as computer software that is not a section 197 intangible and amortized over a 3-year period.

A qualified software business would be any entity that is engaged in the active conduct of the trade or business of developing, manufacturing, or producing computer software and that meets certain other tests. At least 50 percent of the ordinary gross income of the entity, if any, for the taxable year immediately preceding the acquisition must be income allocable to such trade or business. In addition, either (i) the sum of the deductions allowable under section 172, 174 and 195 for the taxable year immediately preceding the acquisition that are properly allocable to such trade or business must be at least 25 percent of the average ordinary gross income of such entity, or (ii) the average of such deductions for the 5-taxable year period (or shorter period of existence if the entity has not been in existence 5 years) ending with the taxable year immediately preceding the year of the acquisition must be at least 25 percent of the average ordinary gross income of the entity for such period.

If an entity has never generated ordinary gross income, these requirements would be treated as met if 75 percent of the total expenditures of such entity for the taxable year immediately preced-

ing the acquisition are directly or indirectly allocable to developing, manufacturing or producing computer software.

All entities treated as a single taxpayer under section 41(f)(1) are treated as a single entity and the term entity includes any predecessor of such entity.

Effective Date

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

K. EITC

1. Advance payment of the earned income tax credit through State agencies

Present Law

In general

Under present law, certain eligible low-income workers are entitled to claim a refundable earned income tax credit (EITC). The amount of the credit an eligible taxpayer may claim depends upon whether the taxpayer has one, more than one, or no qualifying children and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income threshold. The maximum amount of the credit is the product of the credit rate and the earned income threshold. For taxpayers with earned income (or adjusted gross income (AGI), if greater) in excess of the phaseout threshold, the credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the phaseout threshold. For taxpayers with earned income (or AGI, if greater) in excess of the phaseout limit, no credit is allowed.

As enacted in Public Law 104–7 (H.R. 831), for taxable years beginning after December 31, 1995, a taxpayer is not eligible for the EITC if the aggregate amount of "disqualified income" of the taxpayer for the taxable year exceeds $2,350. Disqualified income is the sum of:

(1) interest (taxable and tax-exempt),

(2) dividends, and

(3) net rent and royalty income (if greater than zero).

The parameters for the EITC depend upon the number of qualifying children the taxpayer claims. For 1995 the parameters are as follows:

	Two or more qualifying children—	One qualifying child—	No qualifying children—
Credit rate (percent)	36.00	34.00	7.65
Phaseout rate (percent)	20.22	15.98	7.65
Earned income threshold	$8,640	$6,160	$4,100
Maximum credit	3,110	2,094	314
Phaseout threshold	11,290	11,290	5,130
Phaseout limit	26,673	24,396	9,230

For 1996 and after, the credit rate will be 40 percent and the phaseout rate will be 21.06 percent for taxpayers with two or more qualifying children. For 1996 and after, the credit rate and the phaseout rate for taxpayers with one qualifying child or no qualifying children will be the same as those listed in the table above.

Advance payments of EITC

A worker with a qualifying child may elect to receive the EITC on an advance basis by furnishing a certificate of eligibility to his employer. For such a worker, the employer makes an advance payment of the credit at the time wages are paid. The amount of ad-

vance payment allowable in a taxable year is limited to 60 percent of the maximum credit available to a taxpayer with one qualifying child. The Internal Revenue Service (IRS) is required to provide notice to taxpayers with qualifying children who receive a refund on account of the EITC that the credit may be available on an advance payment basis.

Advance payments by an employer during any payroll period are not treated as a payment of compensation. Instead, they are treated as made out of amounts required to be withheld by the employer for wage withholding of income taxes, FICA employee taxes, and FICA employer taxes as if the employer had paid to the Treasury an amount equal to such advance payments on the day the wages were paid to the employees. If for any payroll period the aggregate amount of advance EITC payments made by an employer exceeds the sum described in the previous sentence, each advance payment is reduced by a percentage that equals the ratio of the excess to the aggregate amount of advance EITC payments by the employer.

Description of Proposal

In general

A worker participating in a State Advance Payment Program would be able to receive the EITC on an advance basis from a designated State agency instead of receiving it on an advance basis from his employer.

The State may elect to increase the amount of such advance payment allowable in a taxable year to between 60 and 75 percent of the maximum credit available to a taxpayer with the corresponding number of qualifying children. The advance payments could be made on the basis of the participant's payroll period, or a single Statewide schedule, or on any other reasonable basis prescribed by the State, but no less frequently than every calendar quarter.

Advance payments during any calendar quarter would not be treated as a payment of compensation and would not be included in the gross income of the recipient. Instead, they would be treated as made out of amounts required to be withheld by the State for wage withholding of income taxes, FICA taxes, and FICA employer taxes as if the State had paid to the Treasury an amount equal to such advance payments on the day the advance payments were made to participants. If for any calendar quarter the aggregate amount of advance EITC payments made by a State agency would exceed the sum described in the previous sentence, each advance payment would be reduced by a percentage that equals the ratio of the excess to the aggregate amount of advance EITC payments by the State agency.

State advance payment programs

The Secretary of the Treasury, in consultation with the Secretary of Health and Human Services, would designate State Advance Payment Programs for States submitting satisfactory plans. In order to be eligible for selection, a State would have to submit a proposal to the Treasury that would identify the State agency responsible for making the advanced payments; describe how the agency would make the advanced payments, including how they

would be coordinated with other benefits; describe how the State would get information on the amount of advance payments made to each participant; describe the process to select and notify participants for the demonstration program; and describe how the State would verify participants' eligibility for the EITC. The proposal would commit the State to providing to the IRS and the participant by each January 31 information returns showing the participant's name, taxpayer identification number (TIN), and amount of advance payments of EITC for the preceding calendar year. The proposal would commit the State to providing a written statement to the IRS each December 1 showing the name and TIN of each participant.

The Secretary of the Treasury could revoke a State program's status for failure to comply substantially with the proposal or to comply with the reporting requirements.

Authorization of appropriation

For purposes of providing technical assistance, writing reports, and providing grants to States in support of demonstration programs, there would be authorized to be appropriated in advance to the Secretary of the Treasury and the Secretary of Health and Human Services a total of $1,400,000 for fiscal years 1996 through 1999.

Effective Date

The programs would be effective for EITC advance payments made after December 31, 1995.

Legislative Background

A similar proposal was contained in section 741 of the Administration's 1994 welfare proposal, introduced by Mr. Gibbons as H.R. 4605 (103rd Congress).

L. Education

1. Exclusion for income earned on State prepaid tuition plans

Present Law

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162–5). Education expenses are not deductible if they relate to certain minimum educational requirements or to education that enables a taxpayer to begin working in a new trade or business.

In *Michigan v. United States*, No. 92–2295 (6th Cir. Nov. 8, 1994), the Sixth Circuit held that the Michigan Education Trust, an entity created by the State of Michigan to operate a prepaid tuition payment program, is an agency or instrumentality of the State, and, thus, the investment income of the Trust is not subject to Federal income tax at the Trust level.

Description of Proposal

The bill (H.R. 1328) would provide an exclusion from gross income for earnings on individual accounts in a qualified State prepaid tuition program if paid to (or on behalf of) a beneficiary to be used for post-secondary educational purposes. In effect, the proposal would operate in a manner similar to a "back-loaded" IRA that could be used for educational purposes.

"Qualified State prepaid tuition programs" could be established by any State, pursuant to which an individual could purchase tuition credits that would cover the undergraduate tuition of any designated beneficiary (even a nondependent) at any participating college or university. The tuition credits also could be used to pay for graduate-level tuition, and other educational expenses (such as room or board) paid to the school, provided that there is a "significant reduction in the value of such credits if used for such other purposes." The value of an individual account would equal the aggregate contributions to the account plus a pro rata share of the earnings of the State prepaid tuition program.

Taxpayers who participate in such State programs would be allowed to receive full refunds of the value of their individual accounts (although the earnings would not be tax-free) if the beneficiary dies or becomes disabled or receives a scholarship. If a beneficiary fails to be admitted to a participating school, the taxpayer could receive a refund up to 90 percent of the value of the designated account. Refunds would also be allowed for any other reason, provided that the refund does not exceed the lesser of (1) the aggregate amount paid to the individual account by the taxpayer, or (2) 90 percent of the value of the account. A taxpayer would designate a beneficiary (i.e., the prospective student) at the time that the individual account is established, but could substitute a dif-

ferent beneficiary at a later date (if so allowed by the State program).

Under the proposal, taxpayers could contribute only cash to a qualified State prepaid tuition program (and, thus, could not rollover appreciated property to such programs on a tax-free basis). For purposes of present-law section 2503(e), a contribution to a State prepaid tuition program would *not* be paid "as tuition" and also would be considered the gift of a future interest under section 2503(a). Consequently, all contributions to such programs would be counted against the unified estate and gift tax credit, which (under present law) effectively exempts a total of $600,000 in cumulative taxable transfers from the estate and gift tax.

Effective Date

H.R. 1328 would be effective for taxable years ending after September 30. 1993.

Legislative Background

The bill (H.R. 1328) was introduced by Mr. English on March 28, 1995.

2. Adopt education savings accounts

Present Law

Present law does not contain any special tax provisions relating to education savings accounts.

Description of Proposal

The proposal (H.R. 3449, 103rd Cong.) would permit individuals to deduct up to $1,500 per year for contributions to an education savings account for the benefit of an individual who has not attained age 19 and who is the child of the taxpayer or of the taxpayer's brother, sister, stepbrother or stepsister, an individual with respect to whom the taxpayer has been appointed guardian, or a descendant of a child of the taxpayer. The deduction would be taken in arriving at adjusted gross income (i.e., "above the line"). Amounts contributed to an education savings account would not be treated as a gift for gift tax purposes. The $1,500 limit would be indexed annually for inflation.

Earnings on assets held in an education savings accounts would be exempt from income tax. Education savings accounts would be subject to the tax on unrelated business taxable income ("UBTI"). Distributions from an education savings account would not be includible in gross income if used for qualified education expenses of the individual for whom the account was established. Education expenses would be defined as tuition and fees required for the enrollment or attendance of a student at an eligible educational institution, fees, books, supplies, and equipment required for courses of instruction at an eligible educational institution, and a reasonable allowance for meals and lodging while attending an eligible educational institution. An eligible educational institution would mean an institution of higher education as defined in section 1201(a) or 481(a) of the Higher Education Act of 1965 or a vocational school.

Distributions not used to pay education expenses would be includible in gross income and subject to an additional 10-percent tax. The additional 10-percent tax would not apply to distributions after the individual for whom the account was established dies or becomes disabled.

Any balance in an education savings account remaining after the individual for whom the account was established attains age 30 (or, if earlier, dies) would have to be distributed within 30 days to the individuals who contributed to the account[20] or, as directed by such individuals, to another education savings account established for the benefit of an eligible individual who has not attained age 30 or to an eligible educational institution. Any amounts transferred to another education savings account or paid to an eligible educational institution would not be includible in gross income.

Under the proposal, amounts could be withdrawn from an individual retirement arrangement ("IRA") and transferred tax free to an education savings account. Such amounts could be retransferred tax free from an education savings account to an IRA.

Education savings accounts would be subject to rules similar to IRAs. Thus, for example, an education savings account would have to be held by a bank or similar financial institution.[21] The trustee of an education savings account would be required to make such reports as the Secretary may require.

Effective Date

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

Legislative Background

H.R. 1215, the Tax Fairness and Deficit Reduction Act of 1995, as passed by the House, would create American Dream Savings accounts to which nondeductible contributions could be made. Distributions from the account after five years would not be includible in income. Distributions made within the 5-year period would be includible in income and subject to a 10-percent early withdrawal tax. However, the 10-percent additional tax would not apply to certain distributions, including distributions for education expenses.

3. Expand section 108(f) to provide that cancellation of private college student loans is not taxable income

Present Law

In the case of an individual, gross income subject to Federal income tax does not include amounts discharged from the cancellation or discharge of certain student loans, provided that the discharge was pursuant to a provision of the loan under which the indebtedness would be discharged if the individual worked for a cer-

[20] The amount to be distributed to such individuals would be determined in accordance with Treasury regulations.

[21] There would be some differences between the rules applicable to IRAs and those applicable to education savings accounts. For example, contributions to education savings accounts could be made in cash or readily tradable securities, and education savings accounts would be permitted to invest in life insurance contracts.

tain period of time in certain professions for any of a broad class of employers (sec. 108(f)).

Student loans eligible for the exclusion from gross income under section 108(f) include any loan to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on, but only if the loan was made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) an educational organization which originally received the funds from which the loan was made from the United States or a State, or (4) certain tax-exempt public benefit corporations whose employees have been deemed to be public employees under State law (sec. 108(f)(2)).

Section 108(f) does not apply to student loans made by an educational organization from funds that were not originally provided to the organization by the United States or a State government.

Description of Proposal

Section 108(f) would be expanded so that an individual's gross income does not include discharge-of-indebtedness income from the cancellation of a loan made by an educational organization (which maintains a regular faculty and body of students at the place where educational activities are regularly carried on) to assist the individual in attending the educational organization, provided that the loan was made pursuant to a program of the educational organization designed to encourage its students to serve in occupations or geographic areas with unmet needs, and provided that funds for the discharge are not directly (or indirectly) provided by the student's employer. In addition, an exclusion from gross income would be provided for discharges of loans made by any organization exempt from tax under section 501(a) to refinance student loans originally made by a governmental body or educational organization meeting the requirements of section 108(f).

As under present law, the section 108(f) exclusion would apply only if the discharge of indebtedness was pursuant to a provision of the loan under which all or part of the loan would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers.

Effective Date

The proposal would be effective for discharges of indebtedness after the date of enactment.

Legislative Background

The proposal was included in H.R. 11 (102nd Cong.), as passed by the House and the Senate and vetoed by President Bush.

M. Employment Taxes

1. Employment tax status of certain fishermen

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") if the operating crew of the boat normally consists of fewer than 10 individuals, the crew member receives a share of the catch based on the total catch, and the crew member 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.

In a recent decision, the United States Federal Court of Claims held that the determination of whether the operating crew is normally fewer than 10 could be made on the basis of four calendar quarters (rather than on the basis of each quarter).[22] The court also held that the exemption did not apply to an individual who receives cash for other services (e.g., cook or mate) in addition to receiving a share of the catch.

The operators of boats on which exempt crew members serve are required to report to the Secretary certain information, including the identity of each crew member performing exempt services, the percentage of the crew member's share of the catch, the type and weight of any share of the catch the crew member receives in kind, and the amount (if any) of the proceeds of the catch received by the crew member.

Description of Proposal

Under the proposal, the operating crew of a boat would be treated as normally made up of fewer than 10 individuals if the average size of the operating crew on trips made during the preceding 4 calendar quarters consisted of fewer than 10 individuals. In addition, the exemption would apply if the crew member receives cash remuneration which does not exceed $100 per trip, is contingent on a minimum catch, and is paid solely for additional duties (e.g., mate, engineer, or cook) for which additional cash remuneration is traditional. The reporting requirements applicable to boat operators would be modified to take into account the additional cash remuneration that may be paid under the proposal.

Effective Date

The proposal would be effective with respect to remuneration paid after June 30, 1993. In addition, the proposal would apply to remuneration paid after December 31, 1984, and before July 1, 1993, unless the payor treated such remuneration when paid as being subject to wage withholding and employment taxes.

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[22] Flamingo Fishing Corp. v. United States, 32 Fed. Cl. 377 (1994).

Legislative Background

The proposal was included in H.R. 11, as passed by the 102d Congress.

2. FICA exemption for certain seasonal children camp employees

Present Law

Under present law, wages are subject to taxation under the Federal Insurance Contributions Act ("FICA") unless specifically exempted. Wages paid to full-time students employed by seasonal children's camps are not specifically exempted.

Description of Proposal

Under the proposal, wages paid to a full-time student employed for less than 13 calendar weeks in a calendar year by a seasonal children's camp would be exempt from FICA taxation for that year.

Effective Date

The proposal would be effective after the date of enactment.

Legislative Background

This proposal was included in the conference report to H.R. 11.

3. FICA tip credit

Present Law

Under present law, all employee tip income is treated as employer-provided wages for purposes of the Federal Insurance Contributions Act ("FICA"). For purposes of the minimum wage provisions of the Fair Labor Standards Act ("FLSA"), reported tips are treated as employer-provided wages to the extent they do not exceed one-half of the minimum wage.

The Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993") provided a business tax credit for food or beverage establishments in an amount equal to the employer's FICA obligations attributable to reported tips with respect to the food or beverage establishment in excess of those treated as wages for purposes of satisfying the minimum wage provisions. Tips are taken into account for purposes of the credit only if they are received from customers in connection with the provision of food or beverages for consumption on the premises of an establishment with respect to which the tipping of employees serving food or beverages by customers is customary.

OBRA 1993 provides that the FICA tip credit is effective for taxes paid after December 31, 1993. Temporary Treasury regulations provide that the tax credit is effective for taxes paid by an employer after December 31, 1993, with respect to tips received for services performed after December 31, 1993.

Description of Proposals

a. Extend FICA tip credit to all employees who receive tips

The proposal would provide that the FICA tip credit is available with respect to tips received by all employees who receive tips from customers.

b. Effective date of FICA tip credit

The proposal would statutorily reverse the position in the Treasury regulations regarding the effective date of the FICA tip credit. Under the proposal, the FICA tip credit would be available with respect to tips paid after December 31, 1993, regardless of when the services with respect to which the tips were received were performed.

Effective Date

The provision relating to the effective date of the FICA tip credit would be effective as if included in OBRA 1993.

4. Repeal presumption that bakery distributors are employees for employment tax purposes

Present Law

For Federal tax purposes, there are two classifications of workers: a worker is either an employee of the service recipient or an independent contractor (i.e., self employed). Significant tax consequences result from the classification of a worker as an employee or independent contractor. These differences relate to withholding and employment tax requirements, as well as the ability to exclude certain types of compensation from income or take tax deductions for certain expenses. Some of these consequences favor employee status, while others favor independent contractor status. For example, an employee may exclude from gross income employer-provided benefits such as pension, health, and group-term life insurance benefits. On the other hand, an independent contractor can establish his or her own pension plan and deduct contributions to the plan. An independent contractor also has greater ability to deduct work-related expenses.

Under present law, the determination of whether a worker is an employee or an independent contractor is generally made under a 20-factor common-law facts and circumstances test that seeks to determine whether the service provider is subject to the control of the service recipient, not only as to the nature of the work performed, but the circumstances under which it is performed. Under a special safe harbor rule (sec. 530 of the Revenue Act of 1978), a service recipient may treat a worker as an independent contractor for employment tax purposes even though the worker is in fact an employee if the service recipient has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met.

For employment tax purposes, the Code specifically provides that agents or commission drivers engaged in the distribution of bakery products are treated as employees, unless the individual has a substantial investment in facilities used in connection with the per-

formance of such services (other than in facilities for transportation) (secs. 3121(d)(3)(A) and 3306(i)).[23] The bakery industry has generally taken the position that this provision does not apply to bakery distributors who have purchased their routes or territories on the grounds that such purchase constitutes a "substantial investment in facilities," and the Internal Revenue Service ("IRS") had issued private letter rulings consistent with this position.

In 1991, however, the IRS revoked these rulings and issued a general counsel memorandum concluding that a substantial investment in facilities does not include an investment in distribution rights, such as a territory.

Description of Proposal

The proposal would delete the reference to "bakery products" from Code section 3121(d)(3)(A) so that the employment status of bakery distributors (whether or not they have a substantial investment in facilities) would be determined under the 20-factor common-law test.

Effective Date

The proposal would be effective on the date of enactment.

5. FUTA exemption for certain religious schools

Present Law

The Federal Unemployment Tax Act ("FUTA") requires States to cover under their unemployment compensation laws certain nonprofit organizations designated under FUTA. Specifically, FUTA exempts service performed in the employ of: (1) a church or convention or association of churches, or (2) an organization which is operated primarily for religious purposes and which is operated, supervised, controlled, or principally supported by a church or convention or association of churches. Individuals who are in the employ of entities with a religious orientation which are not affiliated with a particular church, or convention, or association of churches are not exempt.

Description of Proposal

The proposal (H.R. 1492) would exempt from FUTA service performed in an elementary or secondary school which is operated primarily for religious purposes. This exemption would be available to such schools even though they are not operated, supervised, controlled, or principally supported by a church or convention or association of churches.

Effective Date

The proposal would be effective after the date of enactment.

[23] Employment status for income tax status is determined under the 20-factor common-law test.

Legislative Background

H.R. 1492 was introduced by Mr. Crane on April 7, 1995.

6. Application of common paymaster rules to certain agency accounts at State universities

Present Law

In general, Federal Insurance Contributions Act ("FICA") taxes are payable with respect to employee remuneration which does not exceed the contribution base specified in the law. If an employee works for more than one employer during the year, FICA taxes are payable for each employer up to the contribution base.

Section 3121(s) of the Internal Revenue Code provides an exception known as the "common paymaster" rule. If two or more related corporations concurrently employ the same individual and compensate that individual through a common paymaster which is one of the corporations, each corporation is considered to have paid the individual only the amounts actually disbursed by it to the individual and is not considered to have paid as remuneration amounts actually disbursed to the individual by the other corporation. Thus, the remuneration is subject to FICA taxation only up to the contribution base for the total remuneration.

Section 125 of the Social Security Amendments of 1983 provides that a State university that employs health care professionals as faculty members at a medical school and a tax-exempt faculty practice plan that employs faculty members of the medical school are deemed to be related corporations for purposes of the common paymaster rule, provided that 30 percent or more of the employees of the plan are concurrently employed by the medical school. Remuneration that is disbursed by the faculty practice plan to an individual employed by both the plan and the university which, when added to remuneration actually disbursed by the university, exceeds the contribution base, will be deemed to have been actually disbursed by the university as a common paymaster and not to have been disbursed by the faculty practice plan.

Description of Proposal

The proposal would establish a common paymaster rule in cases where a qualified institution provides remuneration pursuant to a single contract of employment to certain health care professionals as members of its faculty and an agency account at such qualified institution also provides remuneration to such health care professionals. For these purposes, a qualified institution would be defined as a State or State university that operates a health science center that includes a College of Medicine and one or more of the following: a College of Dentistry, a College of Public Health, a College of Nursing, a College of Veterinary Medicine, a College of Pharmacy or a College of Health Related Professions.

7. Repeal section 1706 of the 1986 Tax Reform Act

Present Law

For Federal tax purposes, there are two classifications of workers: a worker is either an employee of the service recipient or an independent contractor (i.e., self employed). Significant tax consequences result from the classification of a worker as an employee or independent contractor. These differences relate to withholding and employment tax requirements, as well as the ability to exclude certain types of compensation from income or take tax deductions for certain expenses. Some of these consequences favor employee status, while others favor independent contractor status. For example, an employee may exclude from gross income employer-provided benefits such as pension, health, and group-term life insurance benefits. On the other hand, an independent contractor can establish his or her own pension plan and deduct contributions to the plan. An independent contractor also has greater ability to deduct work-related expenses.

In general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a 20-factor common-law, facts and circumstances test. Under this test, an employer-employee relationship generally exists if the person contracting for services has the right to control not only the result of the services, but also the means by which that result is accomplished.

In 1978, the Congress enacted section 530 of the Revenue Act of 1978. That provision, which originally was intended to be a temporary measure pending further legislation, generally allowed a taxpayer to treat a worker as not being an employee for employment tax purposes—regardless of the individual's actual status under the common-law test—unless the taxpayer had no reasonable basis for such treatment. Under section 530, a reasonable basis was 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. The relief under section 530 was made available with respect to an individual only if certain additional requirements are satisfied. One of these requirements was that the taxpayer (or a predecessor) must not have treated any individual holding a substantially similar position as an employee for purposes of employment taxes for any period beginning after 1977. The Tax Equity and Fiscal Responsibility Act of 1982 extended section 530 indefinitely.

The Tax Reform Act of 1986 ("the 1986 Act") provided that section 530 of the Revenue Act of 1978 does not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work. By making section 530 inapplicable, the status of individuals in these technical services fields as employees or independent contractors is determined under the common-law test.

Description of Proposal

The proposal would repeal section 1706 of the 1986 Act. Thus, individuals in technical services fields would be eligible for treatment as independent contractors under section 530 of the Revenue Act of 1978 to the extent the requirements of section 530 are satisfied.

Effective Date

The proposal would be effective on the date of enactment. Section 530 of the Revenue Act of 1978 would not be violated merely because an individual in a technical services field was treated as an employee as a result of section 1706 of the 1986 Act.

N. Empowerment Zones

1. Expand number of community development corporations (from 20 to 40) eligible for tax credit and increase aggregate amount of contributions eligible for tax credit

Present Law

Taxpayers are entitled to claim a tax credit for certain contributions made to one of 20 non-profit community development corporations (CDCs) selected by the Secretary of HUD to provide assistance in economically distressed areas. If a taxpayer makes a qualified contribution (i.e., a cash payment to a CDC, which can be made in the form of an equity investment or 10-year loan, the principal of which is to be returned to the taxpayer no sooner than after 10 years), the credit may be claimed by the taxpayer for each taxable year during the 10-year period beginning with the taxable year during which the contribution was made. The credit that may be claimed for each year is equal to five percent of the amount of the contribution to the CDC. Thus, during the 10-year credit period, the taxpayer may claim aggregate credit amounts totalling 50 percent of his or her contribution. The aggregate amount of contributions that may be designated by any one CDC as eligible for the credit may not exceed $2 million. (Thus, a total amount of $40 million in contributions will be available for the credit with respect to all 20 selected CDCs—and the maximum credit amounts will total $20 million over the 10-year credit period.) The CDCs must use the contributions to provide employment and business opportunities to low-income residents who live in an area where the unemployment rate is not less than the national unemployment rate and the median family income does not exceed 80 percent of the median gross income of residents of the jurisdiction of the local government which includes such area.

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

Description of Proposal

The Secretary of HUD would be permitted to designate an additional 20 CDCs that would be eligible to receive contributions that qualify for the tax credit. In addition, with respect to the 40 designated CDCs (i.e., the original 20 designated CDCs and the additional 20 CDCs designated under the proposal), the aggregate amount of contributions that may be designated by any one CDC as eligible for the credit would be increased from $2 million to $4 million.

Effective Date

The proposal would be effective for contributions made after 1995.

Legislative Background

The tax credit for certain contributions to CDCs was enacted (as an off-Code provision) as part of the Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993").

2. Tax incentives for economic recovery in designated areas with employment loss in financial and real estate businesses

Present Law

Pursuant to the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), the Secretaries of the Department of Housing and Urban Development (HUD) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994. As required by law, six empowerment zones are located in urban areas and three empowerment zones are located in rural areas.[24] Of the enterprise communities, 65 are located in urban areas and 30 are located in rural areas (sec. 1391). Designated empowerment zones and enterprise communities were required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations (sec. 1392). The designated areas were selected from among over 500 areas nominated by State and local governments, which submitted proposed strategic plans to promote economic development in these areas.

The following tax incentives are available for certain businesses located in empowerment zones: (1) a 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the zone; (2) an additional $20,000 of section 179 expensing for certain zone business property (accordingly, certain businesses operating in empowerment zones are allowed up to $37,500 of expensing); and (3) expanded tax-exempt financing for certain zone facilities. In contrast, the 95 enterprise communities are eligible for the expanded tax-exempt financing benefits, but not the other tax incentives available in the nine empowerment zones. In addition to these tax incentives, OBRA 1993 provided that Federal grants would be made to designated empowerment zones and enterprise communities.

The tax incentives for empowerment zones and enterprise communities generally will be available during the period that the designation remains in effect, i.e., a 10-year period.

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[24] The six designated urban empowerment zones are located in New York City, Chicago, Atlanta, Detroit, Baltimore, and Philadelphia–Camden (N.J.).

The three designated rural empowerment zones are located in Kentucky Highlands (Clinton, Jackson, Wayne counties, Ky.), Mid–Delta Mississippi (Bolivar, Holmes, Humphreys, Leflore counties, Miss.), and Rio Grande Valley Texas (Cameron, Hidalgo, Starr, Willacy counties, Texas).

Description of Proposal

From among eligible areas nominated by State and local governments, the Secretary of HUD would be authorized to designate three "economic recovery areas." Such areas would be required to satisfy the present-law geographic and poverty criteria for urban empowerment zones (sec. 1392), except that the areas may include a portion of a central business district (as such term is used for purposes of the most recent Census of Retail Trade). To be eligible for designation under the proposal, at least 12 percent of the wages attributable to private, nonagricultural employment in the area during 1991 must have been in the financial institution (i.e., banks, insurance, and brokerage firms) and real estate sectors, and there must have been a 10 percent decline (or, if less, a loss of 5,000 full-time equivalent jobs) in employment in such sectors compared to 1991. This loss-of-employment requirement would not be satisfied if substantially all of the decline in employment is attributable to one employer.

Within the three nominated economic recovery areas, the following tax incentives would be available: (1) a 20-percent wage credit for the first $15,000 of wages paid to a resident of the area who works in the area, provided that the prior employment of such employee was by an employer in such area and such employee was involuntarily separated from service (other than for misconduct) or such employee retired; (2) unlimited section 179 expensing for depreciable business property and leasehold improvements, the original use of which in an economic recovery area commences with the taxpayer, if used in the active conduct of a business within the area; (3) the rehabilitation credit under present-law section 47 could be used to offset passive income if the credit is attributable to a certified historic structure located in an economic recovery area; (4) the amount of any deduction otherwise allowable under section 162 for security expenses would be increased by 100 percent of such amount; and (5) a maximum capital gains tax rate of 10 percent would apply to individuals (17 percent for investments made by corporations) for certain stock and partnership interests in a qualifying economic recovery area business (i.e., an active business located in the area if at least 35 percent of its employees are area residents) or tangible property used in a qualifying business, provided that such stock, partnership interests, or property is held by the taxpayer for more than five years.

The designation of areas as "economic recovery areas" generally would remain in effect for 10 years.

Effective Date

Designations of areas as "economic recovery areas" would be made within one year after date of enactment. The tax incentives available for business activities in such areas generally would be in effect for 10 years following the date of designation.

Legislative Background

The present-law empowerment zone and enterprise community tax incentives were enacted as part of OBRA 1993.

3. Allow 20-percent tax credit for commercial revitalization in empowerment zones and other specially designated areas

Present Law

Pursuant to the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), the Secretaries of the Department of Housing and Urban Development (HUD) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994. As required by law, six empowerment zones are located in urban areas and three empowerment zones are located in rural areas.[25] Of the enterprise communities, 65 are located in urban areas and 30 are located in rural areas (sec. 1391). Designated empowerment zones and enterprise communities were required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations (sec. 1392). The designated areas were selected from among over 500 areas nominated by State and local governments, which submitted proposed strategic plans to promote economic development in these areas.

The following tax incentives are available for certain businesses located in empowerment zones: (1) a 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the zone; (2) an additional $20,000 of section 179 expensing for certain zone business property (accordingly, certain businesses operating in empowerment zones are allowed up to $37,500 of expensing); and (3) expanded tax-exempt financing for certain zone facilities. In contrast, the 95 enterprise communities are eligible for the expanded tax-exempt financing benefits, but not the other tax incentives available in the nine empowerment zones. In addition to these tax incentives, OBRA 1993 provided that Federal grants would be made to designated empowerment zones and enterprise communities.

The tax incentives for empowerment zones and enterprise communities generally will be available during the period that the designation remains in effect, i.e., a 10-year period.

Description of Proposal

A 20-percent tax credit against Federal income taxes would be available for costs incurred for new construction (or major alterations or historic preservation) for business development purposes within a designated empowerment zone, enterprise community, or any other specially designated revitalization area established by a State or local government. Under the proposal, annual credits totalling $300 million would be distributed to States for allocation to projects at the local level in the same manner as Federal low-income housing tax credits are made available to States and then allocated to eligible projects. Eligible projects must be included in a

[25] The six designated urban empowerment zones are located in New York City, Chicago, Atlanta, Detroit, Baltimore, and Philadelphia–Camden (N.J.).

The three designated rural empowerment zones are located in Kentucky Highlands (Clinton, Jackson, Wayne counties, Ky.), Mid–Delta Mississippi (Bolivar, Holmes, Humphreys, Leflore counties, Miss.), and Rio Grande Valley Texas (Cameron, Hidalgo, Starr, Willacy counties, Texas).

locally developed strategy for coordinated revitalization of the zone or designated area.

The tax credit provided for under the proposal would be governed by the same present-law rules applicable to the low-income housing tax credit. Thus, the credit would be available to corporations, individuals, and other entities, and could be carried forward against future income, including passive income under certain circumstances. Non-profit entities (e.g., a community development corporation) would be permitted to sell credits to corporations to raise private capital. The credit would not be allowed to reduce alternative minimum tax liability.

Effective Date

The proposal would be effective for costs incurred after 1995.

Legislative Background

The present-law empowerment zone and enterprise community tax incentives were enacted as part of OBRA 1993.

O. Energy

1. Modifications to tax credit for producing fuel from a nonconventional source

Present Law

Certain fuels produced from "nonconventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation) per barrel or BTU oil barrel equivalent (Code sec. 29) (referred to as the "section 29 credit"). Qualified fuels must be produced within the United States. Qualified fuels include:

(1) oil produced from shale and tar sands;

(2) gas produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and

(3) liquid gaseous, or solid synthetic fuels produced from coal (including lignite).

The Treasury Department has defined "tar sands" as rock types that contain extremely viscous hydrocarbon which is not recoverable in its natural state by conventional oil production methods, including currently used enhanced oil recovery techniques.

In general, the credit is available only with respect to fuels produced from wells drilled or facilities placed in service after December 31, 1979, and before January 1, 1993. An exception extends the January 1, 1993, expiration date for facilities producing gas from biomass and synthetic fuel from coal ("coal gasification") if the facility producing the fuel is placed in service before January 1, 1997, pursuant to a binding written contract in effect before January 1, 1996. The Internal Revenue Service has issued a technical advice memorandum in which it held that the "facility" required to be placed in service before January 1, 1997, in the case of underground coal gasification facilities is the underground chamber, or module, in which the gas is released from coal.

The section 29 credit may be claimed for qualified fuels produced and sold before January 1, 2003 (in the case of nonconventional sources subject to the January 1, 1993, expiration date) or January 1, 2008 (in the case of biomass gas and synthetic fuel facilities eligible for the extension period).

The credit applies to qualified fuels that are sold by the taxpayer to unrelated persons during the taxable year. For this purpose, persons are considered related to one another if they would be treated as a single employer under regulations promulgated under Code section 52(b).

The nonconventional fuels credit may not be used to offset the alternative minimum tax. ("AMT"). Additionally, unused credits may not be carried back or carried forward, other than as a component of the minimum tax credit.

Description of Proposal

a. Allow credit against the AMT

The section 29 credit would be allowed to be claimed against the AMT.

b. Unrelated party sale requirement

The proposal would treat taxpayers as selling a qualified fuel produced from coal gasification to an unrelated party if the tax-

payers used the fuel at the site of production to generate electricity which was sold to an unrelated party.

Alternatively, the proposal would apply to fuel produced from coal gasification and biomass.

c. Underground coal gasification

The proposal would define the term facility in the case of fuel derived from underground coal gasification to include all modules drilled within a coal production area defined in an applicable mining permit filed before January 1, 1997, and recovered through a gathering system placed in service before that date.

d. Definition of tar sands

The proposal would define "tar sands" based on viscosity of the deposit rather than the recovery process used. The revised definition would be any consolidated or unconsolidated rock (other than coal, oil shale, or gilsonite) that either: (1) contains a hydrocarbonaceous material with gas free viscosity, at original reservoir temperature, greater than 10,000 contipoise, or (2) contains a hydrocarbonaceous material and is produced by mining or quarrying.

The proposal also extend the date on which wells could be drilled for production from tar sands to include wells drilled, and mines and quarries first opened, after January 4, 1995, and before January 1, 2000. The expiration date for fuels would be extended to include fuels sold before January 1, 2006.

Effective Date

Allow credit against AMT

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

Unrelated party sale requirement

The proposal would apply to fuel produced after December 31, 1995, at facilities originally placed in service after that date, and to existing facilities if, immediately before the date of enactment, a contract existed under which the fuel produced at the facility was sold by the producer to unrelated persons for the generation of electricity on the site of production.

Underground coal gasification and definition of tar sands

The proposals would be effective for fuel produced after the date of its enactment.

Legislative Background

The nonconventional fuels production credit was originally enacted in the Windfall Profit Tax Act of 1980, with a requirement that the property generally be placed in service before January 1, 1990.

In the Technical and Miscellaneous Revenue Act of 1988, the placed-in-service date was extended for one year, from January 1, 1990, to January 1, 1991. The Omnibus Budget Reconciliation Act of 1990 ("1990 Act") extended the placed-in-service date for two years to January 1, 1993. Additionally, the 1990 Act extended the credit sunset so that sales of qualifying fuels occurring before Janu-

ary 1, 2003, would be eligible for the credit. The 1990 Act also reinstated gas produced from certain tight formations as qualifying for the credit, and repealed the requirement that the price of such gas be regulated.

The expiration date for placing in service facilities producing gas from biomass and synthetic fuels from coal (and for receiving credits for fuels produced at such facilities) was further extended by the Energy Policy Act of 1992.

2. Determination of independent oil and gas producer status

Present Law

Persons who own economic interests in oil and gas producing properties may deduct an allowance for depletion in computing taxable income (Code sec. 611). Independent oil and gas producers and persons who own royalty interests in oil and gas producing properties are permitted to deduct the greater of costs or percentage depletion on production of up to 1,000 barrels per day of crude and oil and natural gas produced from domestic sources. The percentage depletion deduction for oil and gas is computed as a fixed percentage (generally, 15 percent) of the taxpayer's gross income from the oil or gas property, subject to net income and taxable income limitations.

Taxpayers are permitted the option to elect to deduct intangible drilling and development costs ("IDCs") in the case of domestically located oil and gas wells (sec. 263(c)). For taxpayers other than independent oil and has producers, however, 30 percent of the otherwise deductible amount of IDCs must be capitalized and recovered over a 60-month period.

As a part of the Energy Policy Act of 1992,[26] Congress provided exceptions from inclusion in alternative minimum taxable income for IDCs and percentage depletion related to oil and gas properties that otherwise would be considered items of tax preference. These exceptions apply to independent oil and gas producers, but not to integrated oil and gas companies.

A producer of oil or natural gas is considered an independent producer unless that person (or a related person) also is engaged in a significant amount of either retailing or refining activity. A taxpayer is not considered an independent producer if (a) the taxpayer directly, or through a related person, sells oil or natural gas (excluding bulk sales of such items to commercial or industrial users) or any product derived from oil or natural gas (excluding bulk sales of aviation fuels to the Department of Defense) through a retail outlet operated by the taxpayer (or a related person) and (b) the taxpayer has combined gross receipts from retail sales of oil, natural gas, or petroleum products for a taxable year of more than $5 million (sec. 613A (d)(2)).[27]

A taxpayer is treated as a refiner, and thus is excluded from independent producer status, if the taxpayer or a related person

[26] P.L. 102–486.

[27] Sales by the taxpayer to any person (1) obligated under an agreement or contract with the taxpayer to use a trademark, trade name, or service mark or name of the taxpayer in marketing the oil, natural gas, or product derived therefrom, or (2) given authority, pursuant to an agreement or contract with the taxpayer (or related person) to occupy any retail outlet owned, leased, or controlled by the taxpayer, are treated as retail sales made by the taxpayer for this purpose.

engages in the refining of crude oil and on any day during the taxable year the refinery runs of the taxpayer (and related persons) exceed 50,000 barrels.

For purposes of the retailer and refiner exceptions, a person is a related person with respect to the taxpayer if a significant ownership interest (i.e., 5 percent or more) in either the taxpayer or such person is held by the other, or if a third person has a significant ownership interest in both the taxpayer and such person.

Description of Proposal

a. Increase permitted retail sales

The proposal would permit gross receipts from retail sales of natural gas by a regulated public utility that is a related party to be disregarded in determining whether a taxpayer is a retailer. For example, assume a producer of oil and gas has retail sales of natural gas by a related regulated public utility during a taxable year of $10 million, but has no other retail sales of natural gas or of oil or petroleum products. Under the proposal in this case, the taxpayer would be treated as an independent oil and gas producer since the regulated public retail sales of natural gas would be disregarded and thus, its retail sales for the year would not exceed $5 million.[28] As such, the taxpayer would be eligible for the above-described benefits available only to independent oil and gas producers. For this purpose, the term "regulated public utility" would be as defined in section 7701(a)(33) of the Code, except that the company would be required to generate at least one-half of its gross income for the taxable year from sources described in subparagraphs (A), (B), and (C) of that section.

b. Increase permitted refining activity

The maximum refinery production that a taxpayer may have while qualifying as an independent producer would be increased from 50,000 barrels on any day during the taxable year to 75,000 barrels, determined based on average daily refinery runs during the year.

Effective Date

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

3. Tax credit for lubricating oil produced from re-refined oil

Present Law

Present law includes no income tax credit for taxpayers producing lubricating oil from previously used oil. Present law does, however, allow tax credits for (a) fuels produced from nonconventional sources (Code sec. 29); (b) oil produced using enhanced oil recovery techniques (sec. 43); and, (c) certain alcohol fuels produced from renewable sources (sec. 40).

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[28] This example assumes that the taxpayer (or a related person) does not otherwise engage in significant levels of crude oil refining.

Description of Proposal

The proposal would allow a tax credit for lubricating oil produced by re-refining used motor oil.

Effective Date

The proposal would apply to lubricating oil produced in taxable years beginning after December 31, 1995.

4. Allow geological and geophysical costs incurred in connection with oil and gas development to be expensed in the year incurred

Present Law

Geological and geophysical (G&G) costs are expenditures incurred for the purpose of obtaining and accumulating data that will serve as a basis for the acquisition and retention of properties by taxpayers exploring for oil and gas. G&G costs include the costs incurred for geologists, seismic surveys, gravity surveys, magnetic surveys, and the drilling of core holes.

There are no specific provisions in the Code for the treatment of G&G costs. In general, under the Code, no current deduction is allowed for any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate (sec. 263(a)). The regulations define capital amounts to include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer or (2) to adapt property to a new or different use.[29] Courts have ruled that G&G costs are capital in nature and are not deductible as ordinary and necessary business expenses.[30] Accordingly, the costs attributable to such exploration are allocable to the cost of the property acquired or retained.[31] The term "property" is used in this case in the sense of an interest in a property as defined in the Code (sec. 614) and related regulations, and includes an economic interest in a tract or parcel of land notwithstanding that a mineral deposit has not been established or proven at the time the costs are incurred. If a property ultimately becomes productive, G&G costs are amortizable through the allowance for cost depletion over the life of the property. If oil or gas is not found, G&G costs are deductible as a loss under section 165 for the taxable year in which that particular project area is abandoned as a potential source of mineral production.[32]

Description of Proposal

The proposal would allow taxpayers to expense all G&G costs incurred in connection with oil and gas development in the year incurred.

[29] Treas. Reg. sec. 1.263(a)–(1)(b).
[30] See, e.g., *Schermerhorn Oil Corporation*, 46 B.T.A. 151 (1942).
[31] By contrast, section 617 of the Code permits a taxpayer to deduct certain expenditures incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (but not oil and gas). These deductions are subject to recapture if the mine with respect to which the expenditures were incurred reaches the producing stage.
[32] Rev. Rul. 77–188, 1977–1 C.B. 76.

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Effective Date

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

5. Extend the renewable electricity production credit to electricity produced from certain fuel cell power plants

Present Law

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

The credit applies to electricity produced by a qualified closed-loop biomass facility placed in service after December 31, 1992, and before July 1, 1999, and to electricity produced by a qualified wind energy facility placed in service after December 31, 1993, and before July 1, 1999. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party.

The renewable electricity production credit is a component of the general business credit (sec. 38(b)(8)). This credit, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. An unused general business credit generally may be carried back three taxable years and carried forward 15 taxable years.

Description of Proposal

The proposal would extend the renewable electricity production credit to electricity produced from fuel cell power plants using gaseous fuel derived from biomass, and fuel cell power plants using natural gas as a fuel when at least 50 percent of the by-product heat from the fuel cell is used to offset the use of fossil fuels.

Effective Date

The proposal would be effective for electricity produced from a qualified facility after the date of enactment.

Legislative Background

The renewable electricity production credit was enacted as part of the Energy Policy Act of 1992.

P. Estate and Gift Tax

1. Exemption from estate tax for qualified historic property subject to permanent conservation easement

Present law

A Federal estate tax is imposed on the value of property passing at death. Generally, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

A deduction is allowed for estate and gift tax purposes for a contribution of a qualified real property interest to a charity (or other qualified organization) exclusively for conservation purposes (secs. 2055(f), 2522(d)). For this purpose, a qualified real property interest means the entire interest of the transferor in real property (other than certain mineral interests), a remainder interest in real property, or a perpetual restriction on the use of real property (sec. 170(h)). A "conservation purpose" is (1) preservation of land for outdoor recreation by, or the education of, the general public, (2) preservation of natural habitat, (3) preservation of open space for scenic enjoyment of the general public or pursuant to a governmental conservation policy, and (4) preservation of historically important land or certified historic structures. Also, a contribution will be treated as "exclusively for conservation purposes" only if the conservation purpose is protected in perpetuity.[33]

Description of Proposal

The proposal would allow an exemption from the estate tax for the value of any qualified historic property that would otherwise be included in a decedent's gross estate. To qualify under the bill, (1) the property must be an historically important land area or a certified historic structure (within the meaning of Code section 170(h)(4)(A)(iv)); (2) a qualified conservation contribution (within the meaning of section 170(h)) of a qualified real property interest (as generally defined in section 170(h)(2)(C)) must have been granted to a charity (or other qualified organization) exclusively for conservation purposes; and (3) each person having an interest in the property must have signed a written agreement with a State historic preservation agency (or similar State agency) providing that the historic property will be open to the public for a period of at least 20 years, and such agreement must be filed with the estate tax return.

The reduction in estate taxes resulting from the exclusion would be recaptured if, within the 20-year period, (1) any individual who signed the written agreement disposes of his or her interest in the property, unless the transferee agrees to be bound by the terms of the agreement, or (2) there is a violation of any provision of the agreement. The amount of recapture would be determined on a pro

[33] A member of the transferor's family would include: (1) his or her ancestors; (2) his or her spouse; (3) a lineal descendant of the decedent, the decedent's spouse or the decedent's parents; and (4) the spouse of any of the foregoing lineal descendants.

rata basis based on the number of months remaining in the 20-year period.

Effective Date

The proposal would be effective with respect to the estates of decedents dying after the date of enactment.

Legislative Background

H.R. 1945 was introduced by Mr. Bateman on June 28, 1995.

2. Exempt certain land subject to permanent conservation easement from estate tax

Present law

A Federal estate tax is imposed on the value of property passing at death. Generally, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

A deduction is allowed for estate and gift tax purposes for a contribution of a qualified real property interest to a charity (or other qualified organization) exclusively for conservation purposes (secs. 2055(f), 2522(d)). For this purpose, a qualified real property interest means the entire interest of the transferor in real property (other than certain mineral interests), a remainder interest in real property, or a perpetual restriction on the use of real property (sec. 170(h)). A "conservation purpose" is (1) preservation of land for outdoor recreation by, or the education of, the general public, (2) preservation of natural habitat, (3) preservation of open space for scenic enjoyment of the general public or pursuant to a governmental conservation policy, and (4) preservation of historically important land or certified historic structures. Also, a contribution will be treated as "exclusively for conservation purposes" only if the conservation purpose is protected in perpetuity.[34]

Description of Proposal

Introduced bill

Qualification for exclusion

The bill (H.R. 864) would provide that an executor may elect to exclude from the estate and gift tax the value of any land subject to a qualified conservation easement (less the amount of any indebtedness to which the land is subject). To qualify under the bill, the land (1) must be located within 50 miles of a metropolitan area (as defined by the Office of Management and Budget) or a National Park (in which case land within 50 miles of such National Park must also be under significant development pressure, as determined by the Treasury Department), (2) must have been owned by the transferor or a member of his or her family within three years

[34] A member of the transferor's family would include: (1) his or her ancestors; (2) his or her spouse; (3) a lineal descendant of the decedent, the decedent's spouse or the decedent's parents; and (4) the spouse of any of the foregoing lineal descendants.

of his or her death or the date of gift (as applicable), and (3) a qualified conservation contribution (within the meaning of section 170(h)) of a qualified real property interest (as generally defined in section 170(h)(2)(C)) has been granted by the transferor or a member of his or her family. The basis of such land acquired at death would be a carryover basis (i.e., the basis would not be stepped up to its fair market value at death). For purposes of the bill, preservation of a historically important land area or a certified historic structure would not qualify as a conservation purpose.

Retained development rights

The exclusion would not extend to the value of any development rights retained by the decedent or donor. The estate or gift tax on the retained development rights would only be imposed upon the disposition (other than by gift or devise), either in whole or in part, of the property. Such tax would be due (without interest) on April 15th of the calendar year following the year of disposition. For this purpose, retained development rights would be any rights retained to establish or use any structure (and the land immediately surrounding it) for sale, rent or any other commercial purpose, which is not subordinate to and directly supportive of (1) the conservation purpose identified in the easement, or (2) the activity of farming, forestry, ranching, horticulture, viticulture, or recreation, whether or not for profit, conducted on the land subject to the easement.

An executor would be required to compute the amount of the deferred estate tax on any retained development right and to include such amount on the estate tax return. The executor also would be required to file a notice regarding the deferred estate tax with the land records for the locality in which the land is located.

Alternative proposal

An alternative proposal would make the following modifications to the introduced bill. First, the estate or gift tax on transfers of retained development rights would be due as under present law, rather than deferred until disposition of such rights. Second, a retained development right would include the right to use or establish any structure for recreation purposes. Third, for estate tax purposes, any debt outstanding at the decedent's death that was used to purchase (or improve) land subject to a qualified conservation easement would reduce the value of the land excluded under the proposal.

Effective Date

The bill (as introduced) would apply generally to qualified conservation easements granted after December 31, 1994. The alternative proposal would apply to qualified conservation easements granted after December 31, 1995.

Legislative Background

H.R. 864 introduced by Mr. Houghton on February 8, 1995. A similar bill (H.R. 2031, 103rd Cong.) was one of the subjects of a hearing on miscellaneous tax proposals held by the Subcommittee on Select Revenue Measures of the House Ways and Means Committee in June 1993. This bill also is similar to S. 692, "The Family

Forestland Preservation Tax Act," introduced by Sen. Gregg on April 6, 1995.

3. Estate tax marital credit for certain employees of international organizations

Present Law

Property subject to tax

A Federal estate tax is imposed on the value of property passing at death. If a decedent was a U.S. citizen or resident, the estate tax is determined by reference to all of his or her property, wherever situated. In contrast, if the decedent was a nonresident alien, the estate tax is determined only by reference to the decedent's property situated in the United States.

Treasury regulations provide that a "resident" decedent is one who was domiciled in the United States at the time of his or her death and that residence without an intention to remain indefinitely does not establish domicile (Treas. Reg. sec. 20.0–1(b)). Thus, whether a decedent employed in the United States by an international organization is domiciled in the United States depends upon whether the decedent intended to remain in the United States indefinitely. (See Rev. Rul. 80–363, 1980–2 C.B. 250.)

Marital deduction

To determine the taxable estate of a decedent, a deduction is generally allowed for the value of any property that passes to a citizen spouse, but not for the value of property passing to a noncitizen spouse. Property passing to a noncitizen spouse, however, may qualify for the marital deduction if it passes (or is treated under sec. 2056(d)(2)(B) as passing) to a qualified domestic trust or the surviving spouse becomes a U.S. citizen before the estate tax return is filed (sec. 2056(d)).

Description of Proposal

The bill (H.R. 1401) would provide a credit against the tax on property passing to a noncitizen spouse if either the decedent or the spouse is employed full-time by an international organization and has a principal place of employment with such organization in the United States.[35] The credit would be available only if, at the date of the decedent's death, neither spouse is a U.S. citizen or lawful permanent resident of the United States (i.e., a green card holder), and the executor of the estate waives the right to use a qualified domestic trust under section 2056A. The intent of the bill would be to allow a limited marital deduction to estates subject to U.S. estate tax solely by reason of the decedent or surviving spouse's employment with an international organization.

The credit available under the provision would depend upon whether the decedent, on the date of death, is a U.S. resident for Federal estate tax purposes (i.e., is domiciled in the United States).

[35] The term "international organization" is defined under section 7701(a)(18) as a public international organization entitled to enjoy privileges, exemptions, and immunities as an international organization under the International Organizations Immunities Act (22 U.S.C. 288–288f).

In the case of the estate of a resident decedent, the applicable marital transfer credit effectively would equal an exemption of $600,000, in addition to the amount exempted by the unified credit. In the case of the estate of a nonresident decedent, the applicable marital transfer credit effectively would equal $600,000, reduced by the amount exempted by the unified credit.

Effective Date

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

Legislative Background

H.R. 1401 was introduced by Mr. Houghton on April 5, 1995. A similar bill (H.R. 770, 103rd Cong.) was one of the subjects of a hearing on miscellaneous tax proposals held by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means in June 1993. Also, H.R. 1401 is similar to the approach taken in the recent proposed protocol to the income tax treaty between the United States and Canada.

4. Relief from retroactive gift tax regulation on disclaimers

Present Law

A disclaimer is an irrevocable and unqualified refusal to accept an interest in property. If a disclaimer is qualified for Federal tax purposes, the Federal estate, gift, and generation-skipping transfer tax provisions apply with respect to the property interest disclaimed as if the interest had never been transferred to the person making the disclaimer. Thus, the transfer of property pursuant to the disclaimer will not be treated as a taxable gift.

Under present law (applicable to transfers occurring after December 31, 1976), a disclaimer is effective for Federal transfer tax purposes if it is an irrevocable and unqualified refusal to accept an interest in property and certain other requirements are satisfied (sec. 2518). One of these other requirements is that the disclaimer generally must be made in writing not later than nine months after the transfer creating the interest occurs.

Prior to the enactment of section 2518, however, no uniform Federal law existed regulating the manner or timing of disclaimers. Before the promulgation of regulations in 1958, the administrative practice of the Internal Revenue Service was to allow the Federal tax consequences of a disclaimer to depend upon its treatment under local law.

On November 14, 1958, Treasury regulations were issued stating that, in order for a disclaimer to be effective for Federal estate and gift tax purposes, the disclaimer had to be effective under local law and that it had to be made "within a reasonable time after knowledge of the existence of the transfer." It was not clear even after promulgation of this regulation, however, whether an individual wishing to disclaim a remainder interest was required to do so within a reasonable time after he or she obtained knowledge of the creation of the remainder interest or a reasonable time after the interest vested, or became possessory. *Compare Keinath v. Commissioner*, 58 T.C. 352 (1972) with *Keinath v. Commissioner*, 480 F.2d

57 (1973) (the Eighth Circuit overruled the Tax Court and upheld the taxpayer's position that a disclaimer of a future interest was timely when made within a reasonable time after termination of the prior interest).

This issue was finally resolved by the Supreme Court in *Jewett v. Commissioner*, 102 S. Ct. 1082 (1982), which held that the correct interpretation of the 1958 regulation required an individual wishing to disclaim an interest created prior to November 15, 1958 to disclaim the remainder interest within a reasonable time after the original transfer creating the remainder interest occurred. Thus, for example, where property was transferred in 1939 to X for life, with the remainder to Y, Y was required to disclaim his or her interest within a reasonable time of the original transfer, even though the original transfer occurred long before the 1958 regulation was issued and Y could not take possession until X's death.

Description of Proposal

Under the proposal, a disclaimer with respect to an interest created by a transfer prior to November 15, 1958 would not be treated as a transfer for estate and gift tax purposes and would be deemed to satisfy the requirements of Treasury regulation section 25.2511-1(c) (as in effect at the time the disclaimer was made) if the disclaimer was made (1) in writing before May 22, 1972,[36] and (2) no later than a reasonable time after the interest vested or became possessory.

Effective Date

The proposal would be effective for claims for refund made within one year of the date of enactment. The proposal would apply to such claims for refund regardless of any statute of limitations, any law regarding final court (or other) determinations, and any law barring multiple suits on one cause of action.

Legislative Background

A similar proposal was one of the subjects of a hearing on miscellaneous tax proposals held by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means in June 1993.

5. Extend the "predeceased parent exception" to collateral heirs and to taxable terminations and distributions

Present Law

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

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[36] This is the date of the U.S. Tax Court's decision in *Keinath v. Commissioner*, which upheld the IRS's position that the 1958 regulations required a disclaimer of a contingent interest to be made within a reasonable time after creation of the interest, rather than its vesting or becoming possessory.

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 bill (H.R. 1099) would extend the predeceased parent exception to transfers to collateral heirs, provided that the decedent has no living lineal descendants at the time of the transfer. Thus, for example, a transfer by a transferor to his or her grandniece will not be subject to GST tax if, at the time of the generation-skipping transfer, the decedent has no living lineal descendants and the transferor's nephew or niece who was the grandniece's parent is deceased.

In addition, the bill would extend the predeceased parent exclusion to taxable terminations and taxable distributions. For example, assume that a decedent made a transfer in trust to her spouse for life with the remainder to her grandchild. Under the bill, if the grandchild's parent is deceased at the time that the spouse's life estate terminates, no GST tax would be imposed.

Effective Date

The bill would be effective for generation skipping transfers occurring after December 31, 1994.

Legislative Background

H.R. 1099 was introduced by Mr. Houghton on March 1, 1995. A similar proposal was one of the subjects of a hearing on miscellaneous tax proposals held by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means in September 1993.

6. Increase special use valuation limit to $1.5 million

Present Law

A Federal estate tax is imposed on the value of property passing at death. Generally, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

Under section 2032A, an executor may elect to value certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current use value, rather than its highest and best use value. Under present law, the maximum reduction in the value of such real property resulting from an election under section 2032A is $750,000.

Description of Proposal

The bill (H.R. 520) would increase the maximum reduction in the value of qualified real property resulting from an election under section 2032A to $1,500,000.

Effective Date

The bill would apply to decedents dying after the date of enactment.

Legislative Background

H.R. 520 was introduced by Mr. Thomas on January 13, 1995. A similar bill (H.R. 1411, 103rd Cong.) was one of the subjects of a hearing on miscellaneous tax proposals held by the Subcommittee on Select Revenue Measures of the House Ways and Means Committee in June 1993.

H.R. 1215 ("Tax Fairness and Deficit Reduction Act of 1995"), as passed by the House on April 5, 1995, would index the $750,000 amount after 1998.

7. Estate tax credit for conservation property donated to Federal Government

Present Law

A Federal estate tax is imposed on the value of property passing at death. Generally, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

A deduction is allowed for estate and gift tax purposes for a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes (secs. 2055(f), 2522(d)). The United States is a qualified organization for this purpose. Credits against the estate tax are not provided for transfers for conservation purposes.

Under present law, a qualified real property interest means the entire interest of the transferor in real property (other than certain mineral interests), a remainder interest in real property, or a perpetual restriction on the use of real property (sec. 170(h)). A "conservation purpose" is (1) preservation of land for outdoor recreation by, or the education of, the general public, (2) preservation of natural habitat, (3) preservation of open space for scenic enjoyment of the general public or pursuant to a governmental conservation policy, and (4) preservation of historically important land or certified historic structures. Also, a contribution will be treated as "exclu-

sively for conservation purposes" only if the conservation purpose is protected in perpetuity.

The estate tax, like other taxes, generally must be paid in cash or a cash equivalent (i.e. check or money order).

Description of Proposal

The bill (H.R. 522) would allow a credit against the estate tax for the value of any real property interest (included in the decedent's estate) that is transferred to a Federal agency for use exclusively for conservation purposes without any payment or reimbursement by the agency. Under the bill, the credit would be nonrefundable, i.e., the credit could not exceed the decedent's estate tax liability (before taking into account the amount of the credit).

Effective Date

H.R. 522 would apply to transfers of real property interests made after the date of enactment.

Legislative Background

H.R. 522 was introduced by Mr. Zimmer on January 13, 1995. Section 2010 of the Tax Reform Act of 1976 (H.R. 10612, 94th Cong.) and section 1028 of the Deficit Reduction Act of 1984 (H.R. 4170, 98th Cong.) provided a similar credit with respect to the contribution of land to the United States by specific taxpayers.

8. Proposals to simplify and improve estate and gift tax

a. Equal treatment for individuals who utilize revocable trusts

Both estates and revocable intervivos trusts can function to wind up the affairs of a decedent and distribute assets to heirs. In the case of revocable intervivos trusts, the grantor transfers property into a trust which is revocable during his or her lifetime. Upon the grantor's death, the power to revoke ceases and the trustee then performs the winding up functions typically performed by the executor of an estate. While both estates and revocable trusts perform essentially the same function after the testator or grantor's death, there are a number of ways in which an estate and a revocable trust operate in different ways. First, there can only be one estate per decedent while there can be more than one revocable trust. Second, estates are in existence only for a reasonable period of administration; revocable trusts can perform the same winding up functions as an estate, but may continue in existence thereafter as testamentary trusts. While there presently are numerous differences between the income tax treatment of estates and revocable trusts, the proposal would conform the income tax treatment of estates and revocable trusts in the following 10 areas:

(1) Set-aside deduction (Code sec. 642(c))

Present Law

Estates are allowed a charitable deduction for amounts *permanently set aside* for charitable purposes while post death revocable

trusts are allowed a charitable deduction only for amounts *paid* to charities.

Description of Proposal

The proposal would extend the set-aside deduction to post death revocable trusts for a period comparable to what an estate would get for its administration.

(2) 65-day rule (Code sec. 663(b))

Present Law

In general, trusts and estates are treated as conduits for Federal income tax purposes; income that is distributed is taxed to beneficiaries to whom it is distributed; income that is retained by the trust or estate is initially taxed to the trust or estate. In the case of distributions of previously accumulated income by trusts (but not estates), there may be additional tax if the beneficiary's marginal rates were higher than those of the trust (i.e., the so-called "throwback" or "accumulation distribution" rules). Under the so-called "65-day rule", trusts are permitted to avoid throwback rule with respect to that year by electing to treat distributions paid within 65 days after the close of its taxable year as paid on the last day of its taxable year. No such rule applies to estates since estates are not subject to the throwback rules.

Description of Proposal

The proposal would extend application of the 65-day rule to estates.

(3) Separate share rule (Code sec. 663(c))

Present Law

Trusts with more than one beneficiary must[37] use the "separate share" rule in order to provide different tax treatment of distributions to different beneficiaries to reflect the income earned by different shares of the trust's corpus. Existing Treasury regulations (sec. 1.663(c)–3) provide that "[t]he application of the separate share rule . . . will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. . . . Separate share treatment will not be applied to a trust or portion of a trust subject to a power to distribute, apportion, or accumulate income or distribute corpus to or for the use of one or more beneficiaries within a group or class of beneficiaries, unless the payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made under the governing instrument so that substantially separate and independent shares exist."

[37] Application of the separate share rule is not elective; it is mandatory if there are separate shares in the trust.

Description of Proposal

The proposal is to extend the application of the separate share rule to estates.

Legislative Background

The Trust and Partnership Income Tax Revision Act of 1960 (H.R. 9662 which passed the House and the Finance Committee, but not the Senate in 1960) provided that the separate share would apply to estates. The committee reports stated the extension of the separate share rule to estates " . . . will eliminate many of the inequities under present law whereby beneficiaries receiving distributions from estates are sometimes subjected to taxation in excess of the share of estate income to which they are entitled. . . . Applicability of the separate share rule . . . to estates . . . and their beneficiaries will be required even though separate and independent accounts are not maintained, nor required to be maintained, for each share, and even though no physical segregation of assets is made or required. . . . " (pp. 11 and 54 of H. Rept. 1231, 86th Cong. 2d Sess.) "Since the [separate share] rule does not apply to estates, distributions to residuary legatees who are only entitled to receive corpus may be taxed as distributions of income." (p. 23 of Sen. Rept. 1616, 86th Cong. 2d Sess.). The examples provided by the Subchapter J consultants looked to the pre–1954 Code standard of tracing cash flows to "corpus" and "income" (presumably accounting income determined under applicable local law). The use of tracing rules was specifically rejected by the Congress in 1954 when it created the concept of "distributable net income".

(4) Passive loss rules (Code sec. 469(i)(4))

Present Law

In general, under section 469, deductions from passive investments are not allowed in excess of income from passive investments. Section 469 contains an exception under which up to $25,000 of deductions in excess of income are permitted where the activity is the rental of real estate in which the property's owner "actively participated." In the case of a death of the property's owner, the active participation requirement is waived in the case of estates (but not trusts) for 2 years after the owner's death.

Description of the Proposal

The proposal would extend the same 2 year waiver period to post death revocable trusts.

(5) Sales to related persons (Code secs. 267 and 1239)

Present Law

Section 267 disallows a loss on the sale of an asset to a related person. Section 1239 disallows capital gain treatment on the sale of depreciable property to a related person. For the purposes of section 267 and 1239, the following parties are related persons: (1) a trust and the trust's grantor, (2) two trusts with the same grantor, (3) a trust and a beneficiary of the trust, (4) a trust and a corpora-

tion of which more than 50 percent is owned by the trust or the trust's grantor. The rules applicable to trusts do not apply to estates.

Description of Proposal

The proposal would provide that the same exemptions applicable to estates would be made available to post death revocable trusts.

(6) Treatment as qualified shareholder for Subchapter S purposes (Code secs. 1361(c)(2) and (d)(3))

Present Law

S corporations are entitled to pass-thru status under which the income and loss of the corporation is not taxed to the corporation, but is passed through directly to its shareholders. One of the requirements for status as an S corporation is that it not more than 35 individual shareholders none of whom are nonresident aliens. Trusts are treated as one individual shareholder (instead of each of the trust's beneficiaries being treated as separate shareholders) where (1) the entire trust is a "grantor trust", (2) in the case of a grantor trust, for a period of 60 days after a grantor's death, (3) in the case of a grantor trust which is includible in the gross estate of the grantor, for a period of 2 years after the grantor's death. Certain trusts (know as "qualified subchapter S trust" or "QSST") which are not treated as grantor trust may elect to be treated as a grantor trust so long as the trust has only one "income beneficiary" who is a citizen or U.S. resident, to whom all corpus, if any, must be distributed, and to whom the trust must distribute all its assets upon the trust's termination.

Description of Proposal

The proposal would allow post death revocable trusts to be shareholders of S corporations for a two year period after the grantor's death. In addition, the proposal would clarify that distributions to a post death revocable trust by a Qualified Subchapter S Trust (QSST) would meet the requirement of a QSST (Code sec. 1361(d)(3)(B)) that the trust distribute its taxable income annually to the sole income beneficiary of the QSST.

(7) Taxable years (Code sec. 645)

Present Law

The taxability of distributions from a trust or estate is based on the amount of income received by the trust of estate in the trust or estate's taxable year "ending with or within" the taxable year of the beneficiary (typically a calendar year). Trusts are required to use a calendar year and, consequently, income of a trust that is distributed to its beneficiaries in the year earned is taxed to the beneficiary in the year earned. Estates, on the other hand, can use fiscal years. Consequently, in the case of estates, taxation of distributions to beneficiaries can be postponed up to 11 months depending upon the fiscal year selected.

Description of Proposal

The proposal would permit a post death revocable trust to elect a fiscal year during the period of administration.[38]

(8) Treatment of gifts from revocable intervivos trusts (Code secs. 2035(e) and 2038)

Present Law

Section 2035 includes in the gross estate the value of any property transferred within three years of the decedent's death on any property which would have been included in the decedent's gross estate under sections 2036 (relating to transfers with retained life estate), 2037 (relating to transfers taking effect at death), 2038 (relating to revocable trusts), or 2042 (relating to proceeds of life insurance). Under these rules, a gift made by a grantor of a revocable inter vivos trust within three years of his death are includible in his estate even though that transfer would not be includible in his estate if the grantor would have first revoked a portion of the trust and then made the gift directly by himself.

Description of Proposal

The proposal would treat transfers by the predeath revocable trust as if they had been made directly by the trust's grantor.

(9) Equal generation skipping tax treatment of estates and revocable trusts following death of settlor (Code sec. 2652(b)(1))

Present Law

The entire GST statute is drafted with the assumption that the property is held in a trust. Section 2652(b)(1) provides that '[t]he term "trust" includes any arrangement (other than an estate) which, although not a trust, has substantially the same effect as a trust.'

Description of Proposal

The proposal provides that trusts which are taxed as grantor trusts for income tax purposes (e.g., there are sufficient retained rights such that the income of the trust is taxed directly to the trust's grantor) and to which the decedent's estate distributes its residue is to be treated as an "estate" for a period lasting until the later the (i) 2 years after the grantor's death or (ii) six months after the final determination of any Federal estate tax on the grantor's estate.

[38] Use of a fiscal year for an intervivos trust that will continue after its administration functions will require the filing of an additional tax return for the short year and annualization of the short period income.

(10) Equal treatment of individuals and revocable trust with regard to amortization of reforestation expenditures (Code sec. 194)

Present Law

Section 194 permits the amortization of up to $10,000 of reforestation expenditures per year over a 84 month period. The amortization provision does not apply to trusts (Code sec. 194(b)(3)).

Description of Proposal

The proposal would extend the amortization of reforestation expenditures to revocable trusts during the lifetime of the trust's grantor.

b. Eligibility for ordinary loss deduction on loss on small business stock (Code sec. 1244)

Present Law

Section 1244 allow loss on investments in certain small corporations to be treated as ordinary loss that may be used to reduce all income, instead of a capital loss which can only offset capital gains plus $3,000. Present law section 1244(d)(4)) specifically makes estates or trusts ineligible for ordinary loss treatment.

Description of Proposal

The proposal would change the rule so that revocable trusts would be eligible for ordinary loss treatment on section 1244 stock during the grantor's lifetime.

Legislative Background

Section 1244 was added to the Code by section 202 of the Technical Corrections Act of 1958 (P.L. 58–866). The legislative history of that Act does not indicate why ordinary loss treatment was not extended to estates and trust. The Conference Report indicates that it merely accepts the House version of H.R. 13382. The legislative history of H.R. 13382, "The Small Business Tax Act of 1958", also does not indicate the purpose of the limitation. Nonetheless, section 1244 is limited to losses incurred by shareholders who acquired their stock directly from the corporation. Thus, section 1244 does not apply, for example, to stock acquired by gift or divorce. Presumably, trusts and estates were excluded from section 1244 because assets of a trust or estate typically are not acquired by purchase.

c. Repeal of income-shifting provisions (i.e., throwback rules (Code secs. 665–668), capital gains (Code sec. 644))

Present Law

Under present law, income which is accumulated in a trust is taxable to the trust instead of its beneficiaries. Trusts are subject to their own set of tax rates which historically has permitted trust income to be taxed at lower rates than the rates applicable to its beneficiaries. This benefit often was compounded through the creation of multiple trusts. The Internal Revenue Code has a series

of rules to limit the benefit that would otherwise occur from using the lower rates applicable to one or more trusts. Under the so-called "throwback" or "accumulation distribution" rules, the distribution of previously accumulated trust income will be subject to tax (in addition to any tax paid by the trust on that income) where the beneficiary's average top marginal rates in the previous 5 years is higher than those of the trust. Beneficiaries of estates are not subject to the throwback rules presumably because estates typically had a short duration and the creation of an estate was not tax motivated.

In 1984, Congress provided Treasury authority to issue regulations that would treat multiple trusts created with the principal purpose to avoid tax that have substantially the same grantor or grantors for substantially the same beneficiaries as one trust. Code sec. 643(f). The effective date of this provision was contribution to trusts after March 1, 1984.

Under section 644, capital gains of a trust arising from a sale or exchange by the trust of any property within two years of its contribution to the trust will be taxed at the grantor's rates.

In the Tax Reform Act of 1986, Congress provided a new rate schedule for estates and trusts under which the maximum tax benefit per estate or trust per year was slightly more than $600. Because of indexing of the rate brackets, that benefit has increased to $845 per year per trust or estate.

Description of Proposal

The proposal would repeal the throwback (or accumulation distribution) rules (Code secs. 665–7), including the special rule (Code sec. 644) taxing capital gains of a trust arising from a sale or exchange within two years of its contribution to the trust at the grantor's rates.

Legislative Background

This proposal is the basically same change that was passed as part of simplification in H.R. 11 (which was vetoed by President Bush). Under a special effective date rule of that legislation, the repeal did not apply to multiple trusts which were grandfathered from the multiple trust rule (Code sec. 643(f)). There have been several bills introduced in the 103d Congress providing for lower rates in the case of estates and trusts for minors and disabled beneficiaries or all estates and trusts.

d. Restore unified credit in case of split gifts

Present Law

A gift tax is imposed on transfers by gift during life and an estate tax is imposed on transfers at death. The gift and estate taxes are a unified transfer tax system in that one progressive tax is imposed on the cumulative transfers during the lifetime and at death. The amount of gift tax payable for any taxable period generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative lifetime taxable transfers made by the taxpayer and then subtracting any gift taxes payable for prior

taxable periods. This amount is reduced by any available unified credit (and other applicable credits) to determine the gift tax liability for the taxable period.

The amount of estate tax payable generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative post–1976 taxable transfers made by the taxpayer and then subtracting any transfer taxes payable for prior taxable periods. This amount is reduced by any remaining available unified credit (and other applicable credits) to determine the estate tax liability. The estate tax is imposed on all of the assets held by the decedent at his death and the value of property previously transferred by the decedent in which the decedent had retained powers or interests in the trust (e.g., sections 2036 (relating to transfers with retained life estate), 2037 (relating to transfers taking effect at death), 2038 (relating to revocable trusts), or 2042 (relating to proceeds of life insurance)).

Under section 2513, one spouse can elect to treat a gift made by the other spouse to a third person as made one-half by each spouse (i.e., "gift-splitting"). Under this rule, if the non-transferor spouse elects to gift split, and the transferor spouse dies within three years of the date of the transfer and the transferor spouse had retained sufficient interests such that the entire transferred interest is includible in the transferor's estate (e.g., the gift was of a remainder interest after a retained life estate), the benefit of any annual exclusion, lower gift tax brackets, and any unified credits used by the non-transferor spouse on the transfer as a result of the gift split will be lost. Under a special rule, the split gift of the nontransferor spouse is not taken into account in determining the estate tax of the nontransferor spouse (sec. 2001(e)).

Description of Proposal

The proposal would restore any unified credit applied to any split gift that is subsequently included in the estate of the donor spouse.

e. Provide for portability of unified credit and GST exemption

Present law

Every individual is allowed an exemption against cumulative lifetime transfers and transfers at death. The exemption is provided in the form of a credit, called the "unified credit". The unified credit is $192,800 which effectively exempts the first $600,000 of transfers from estate and gift tax. In addition, every individual is entitled to a lifetime exemption of $1 million from the generation skipping transfer tax. Present law also generally provides an unlimited deduction for estate and gift tax purposes for transfers to a spouse. Under section 2513, one spouse can elect to treat a gift made by the other spouse to a third person as made one-half by each spouse (i.e., "gift-splitting").

Description of Proposal

The proposal would allow a surviving spouse to inherit and use any unused unified credit and GST exemption amount of a decedent spouse.

f. Making use of unified credit optional

Present Law

A gift tax is imposed on transfers by gift during life and an estate tax is imposed on transfers at death. The gift and estate taxes are a unified transfer tax system in that one progressive tax is imposed on the cumulative transfers during the lifetime and at death. The amount of gift tax payable for any taxable period generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative lifetime taxable transfers made by the taxpayer and then subtracting any gift taxes payable for prior taxable periods. This amount is reduced by any available unified credit (and other applicable credits) to determine the gift tax liability for the taxable period. Use of any unused unified credit is mandatory.

In general, the period of limitations on assessment and collection of gift tax is 3 years after the gift tax return was filed or 6 years if there has been more than a 25 percent omission (Code secs. 6501(a-) and (e)(2)).

Description of Proposal

The proposal would make the use of the unified credit with respect to gift in any taxable year optional.

g. Modification of rules relating to marital deduction

Background of marital deduction

Prior to the 1948, there was no deduction for estate and gift tax purposes for transfers to spouses. Nonetheless, in civil law States (e.g., California, Texas, Louisiana), each spouse owns one-half of property acquired during the marriage which effectively resulted in citizens in such States having lower effective transfer taxes. As a result, in 1948, Congress provided a 50% marital deduction for estate and gift tax purposes. In order to qualify for such a marital deduction, under the so-called "terminable interest rule," the transferred property must be in a form that there will be a estate or gift tax to the transferee spouse on unspent transferred proceeds. Thus, the effect of a marital deduction with the terminable interest rule is to provide only a method of deferral of the estate or gift tax, not exemption. One of the special terminable interest rules (Code sec. 2056(b)(5)) provides that the marital deduction is allowed where the decedent transfers property to a trust that is required to pay income to the surviving spouse and the surviving spouse has a general power of appointment at that spouse's death (under this so-called "power of appointment trust", the power of appointment both provides the surviving spouse with power to control the ultimate disposition of the trust assets and assures that the trust assets will be subject to estate or gift tax) . In 1976, Congress increased the marital deduction to 100% of the first $250,000 plus 50% of the ex-

cess. In the Economic Recovery Tax Act of 1981, the marital deduction was increased to 100% of all amounts transferred to a spouse and provide another special terminable interest rule called the "qualified terminable interest trust" rule ("QTIP") under which a marital deduction is allowed for transfers to a trust that is required to distribute income to the surviving spouse if the donor spouse elects to subject the trust in the donee spouse's estate and gift taxes.

(1) Allow for reformation of defective marital trusts

Present Law

To qualify for the marital deduction, a marital trust must meet certain requirements, such as the terminable interest rule. Thus, if there is a technical defect in the instrument, the marital deduction may be lost.

Description of Proposal

The proposal would allow the marital deduction with respect to a defective trust if there is a "qualified reformation" of the trust that corrects the defect. In order to qualify, there must be sufficient evidence that the trust was intended to qualify for the marital deduction, the reformation of the trust should commence soon after death, and, as part of the reformation, a QTIP election would be mandatory.

(2) Treat QTIP like power-of-appointment trusts

Present Law

In the case of a QTIP, the surviving spouse cannot hold an intervivos power of appointment while such an intervivos power of appointment are permissible in the case of a power of appointment trust. Also, a surviving spouse is treated as transferring all of the property in the QTIP where that spouse transferred any of that spouse's income interest; the surviving spouse is treated as transferring an interest in a power of appointment trust only to the extent that the power of appointment has been exercised to transfer property to another person.

Description of Proposal

The proposal would treat QTIPs the same as power of appointment trusts.

h. Provide for Federal disclaimer rules

Present Law

Historically, there must be acceptance of a gift in order for the gift to be completed under State law and there is no taxable gift for Federal gift tax purposes unless there is a completed gift. Most States have rules that provide that, where there is a disclaimer of a gift, the property passes to the person who would be entitled to the property had the disclaiming party died before the purported transfer.

In the Tax Reform Act of 1976, Congress clarified when a disclaimer must be made in order to be effective for Federal gift tax purpose (Code sec. 2518)—generally within nine months of the purported transfer. The effect of the provision is limited to estate and gift purposes (i.e., "for purposes of this subtitle" which is subtitle B which deals with estate, gift and generation-skipping transfer taxes.

In 1981, Congress provided for a uniform disclaimer rule which required that the disclaimer be a written transfer of the disclaimant transferor's "entire interest in the property" to persons who would have received the property had there been a valid disclaimer under State law. The legislative history indicated that a transfer of an "undivided portion" of property could qualify as a disclaimer. Present Treasury Regulations 25.2518–3(b) provides that there can be a disclaimer of a specific pecuniary amount provided that "no income or other benefit of the disclaimed amount inured to the benefit of the disclaimant" and the disclaimed amount is segregated from any non-disclaimed portion.

Description of Proposal

The proposal would clarify that (a) partial disclaimers are permitted, (b) a spouse can make a disclaimer that is effective for gift tax purposes where the disclaimed property passes to a trust in which that surviving spouse has an income interest (e.g., a credit shelter trust), and (c) provide that a disclaimer would also be effective for income, as well as estate and gift tax, purposes (specifically, disclaimers of interests in annuities and income in respect of a decedent).

i. Provide that disclaimer of interests in qualified plans do not violate the spendthrift restriction applicable to such plans

Present Law

In order to assure that funds in pension plans are actually available for retirement, section 401(a)(13) generally required that qualified plans prohibit their transfer by assignment of alienation.

Description of Proposal

The proposal would clarify that a disclaimer would not violate the prohibition against alienation.

j. Modify rules for qualified domestic trusts (QDOTs)

Background

Prior to the 1948, there was no deduction for estate and gift tax purposes for transfers to spouses. Nonetheless, in civil law States (e.g., California, Texas, Louisiana), each spouse owns one-half of property acquired during the marriage which effectively resulted in citizens in such States having lower effective transfer taxes. As a result, in 1948, Congress provided a 50% marital deduction for estate and gift tax purposes. In order to qualify for such a marital deduction, under the so-called "terminable interest rule," the transferred property must be in a form that there will be a estate or gift

tax to the transferee spouse on unspent transferred proceeds. Under the terminable interest rule, a marital deduction generally was only a method of deferral, not exemption. In 1976, Congress increased the marital deduction to 100% of the first $250,000 plus 50% of the excess. In the Economic Recovery Tax Act of 1981, the marital deduction was increased to 100% of all amounts transferred to a spouse.

In spite of the terminable interest rule, the marital deduction could result in exemption where the spouse was a noncitizen who gave up residence in the U.S. before death or making transfers by gift. As a result, in 1987, the marital deduction was limited to spouses who were U.S. citizens, or other spouses if the transferred assets where placed in a trust (called a "qualified domestic trust" or "QDOT ") over which the U.S. retained jurisdiction.

The Proposal would make the following 5 changes to the rules which permit a marital deduction for bequests to qualified domestic trust (QDOT) for the benefit of a noncitizen spouse.

(1) Modification of rules relating to trustee of a QDOT

Present Law

In order to assure the U.S. retains jurisdiction over the QDOT, the present rules require that at least one trustee of the trust be a U.S. citizen or a U.S. corporation.

Description of Proposal

The proposal would provide one of three alternatives under which a marital deduction would be allowed if the trust for the benefit of a noncitizen spouse : (1) requires that at least one trustee be a U.S. trustee who has either the power to withhold, or pay directly from the trust from corpus distributions, the tax imposed by section 2056A; (2) requires that either all of the trustees be U.S. trustees or that at least one trustee be a U.S. trustee who has the power to withhold the section 2056A tax; or (3) provide that any trust that met either the present law rule of either of the two previous alternatives when the trust instrument was executed. The proposal would grandfather prior transfers without meeting any of these alternatives where the transferor has died or became incompetent within one year of present law rules (i.e., 1990).

Legislative Background

The basic problem is that Congress has provided three different rules for the required trustees of a QDOT—(1) all trustees are domestic ("TAMRA" or "1988 Act"), (2) at least one trustee must be domestic and no distributions can be made without that trustee's approval ("OBRA" or "1989 Act"), and (3) at lease one domestic trustee that has the power to approve distributions ("RRA" or "1990 Act").

Portions of this proposal already are part of the simplification package (sec. 604 of H.R. 3419—trust will qualify for QDOT if, in case of trust executed before 1990 Act, all trustees are domestic—1 above).

(2) Modify non-estate tax consequences of transfers by surviving spouse to QDOT

Present Law

Under a special rule, property that is transferred by the surviving spouse into a QDOT by the filing date of the estate tax return for the deceased spouse qualifies transfers to the surviving spouse for the marital deduction to the estate of the deceased spouse even though the deceased spouse's will did not transfer the property to a QDOT (sec. 2056(d)(2)). The statute provides that such rule applies " . . . for purposes of [the marital deduction]". Proposed Treasury regulations sec. 20.2056A-4(b)(5) provides that such transfers will be treated as made by the deceased spouse solely for the purpose of computing the marital deduction to the deceased spouse. "For all other purposes (e.g., income gift, estate, generation-skipping transfer tax, and section 1491 excise tax), the surviving spouse is treated as the transferor of the property to the QDOT." Prop. Treas. reg. sec. 20.2056A-4(b)(5) provides that the effective of a transfer by a noncitizen surviving spouse to a QDOT is to be treated as a transfer by the deceased spouse to the QDOT solely for estate tax purposes.

Description of Proposal

The proposal would provide that the transfer of property by a surviving spouse to a QDOT is to be treated as passing directly from the deceased spouse to the QDOT for income and transfer tax purposes.

(3) Transfers in civil law countries to QDOT

Present Law

Trusts are not permitted in some civil law countries.[39] As a result, it is not possible to create a QDOT in these countries.

Description of Proposal

The proposal would provide the creation of a procedure that would allow a marital deduction in jurisdictions that do not allow the creation of a trust (i.e., since there is no equivalent to a trust in such counties, presumably legal title to the marital property is transferred to the surviving spouse). Possible procedures may include the adoption of a bilateral treaty that provides for the collection of U.S. estate and gift tax from the noncitizen surviving spouse or the allowance of the marital deduction if the surviving spouse and the IRS enter into a closing agreement under which the U.S. would retain jurisdiction to impose gift and estate tax on transfers by the surviving spouse of the property transferred by the deceased spouse.

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[39] Note that in some civil law States (e.g., Louisiana) an entity similar to a trust, called a usufruct exists.

(4) Delete requirement that U.S. trustee have power to approve distributions from a QDOT

Present Law

In order for a trust to be a QDOT, a U.S. trustee must have the power to approve all corpus distributions from the trust. Nonetheless, there are some countries where the trusts in that country cannot have any U.S. trustees and, therefore, cannot be a QDOT.

Description of Proposal

The proposal would delete the requirement of a QDOT that it have a U.S. trustee.

(5) Clarification of who is the transferor for GST purposes in case of QDOT

Present law

Sec. 2056A(b)(7) provides that "[f]or purposes of section 2056(d), any tax paid under paragraph (1) shall be treated as an estate tax paid under section 2001 with respect to the estate of the decedent" (the first spouse to die).

Description of Proposal

The proposal would provide an election to a surviving spouse allowing the surviving spouse to be treated as the "transferor" of a qualified domestic trust (QDOT) with respect to generation-skipping transfers after that spouse's death.

k. Modification of generation-skipping transfer tax rules

Present Law

The generation skipping transfer tax (GST) is determined by multiplying a flat rate equal to the highest estate tax rate (i.e., currently 55%) by the "inclusion percentage" and the value of the trust assets at the taxable event. There are basically three taxable events: (1) a direct skip—the direct transfer subject to estate or gift tax from one generation to someone more than one generation younger than the transferor (e.g., a transfer from grandparent to grandchild), (2) a taxable termination—the termination of an interest or power in a trust and no distributions after the termination may be made to a skip person (e.g., the death of the last transferor's last surviving child in a trust which can make income an corpus distribution initially only to the trust creator's children for their lives), or (3) a taxable distribution—a distribution from the trust to a beneficiary that is more than one generation younger than the transferor (e.g., a trust distribution to a grandchild of the trust's creator). Present law is unclear whether a transaction should be taxed as a direct skip or taxable termination or distribution where the transaction meets both definitions (e.g., a distribution from an intervivos trust to the creator's grandchildren upon the creator's death or a distribution from a marital deduction trust to the creator's grandchildren upon the death of the creator's spouse). The "inclusion percentage" is the number one minus the

"exclusion percentage". The exclusion percentage is the fraction whose numeration is that portion of the $1 million exclusion allocated to this trust and whose denominator is the value of that trust's assets as of the date of death of the trust's grantor (the "estate tax inclusion period"). Assuming that assets generally appreciate over time, it is to the taxpayer's advantage for the estate tax inclusion period to be as soon as possible since that will result in a larger exclusion percentage and, consequently, a smaller inclusion percentage and a smaller GST. Section 2642(f)(4) provides that, except as provided by Treasury Regulations, the "estate tax inclusion period" is to be determined on the basis an individual and that individual's spouse. Proposed Treasury Regulations sec.26.2632–1(c) provides that the estate tax inclusion period extends to the death of the transferor's spouse.

Direct skips are taxed less than taxable terminations and distributions since GST on direct skips is paid by the transferor (sec. 2603(a)(3)) and, therefore, the base for the direct skip GST is tax exclusive (like the Federal gift tax), while the GST on taxable terminations and distributions is paid by the trust or beneficiary (secs. 2603(a)(1) & (2)) and, therefore, the base of the GST on taxable terminations and distributions is tax inclusive (like the Federal estate tax).

A credit is allowed against the Federal estate tax for any State estate, inheritance or other death taxes (sec. 2011). The State death tax credit was enacted in 1921 as way of sharing the revenues from the estate tax with States in lieu of repealing the Federal estate tax. Most States—New York being a notable exception—impose inheritance taxes that are lower than the permissible Federal credit. However, most States also impose a "soak-up" or "make-up" estate tax so that the maximum State death credit is available.

The Proposals would make the following 9 changes to the generation-skipping transfer tax.

(1) Effect of severing trusts on GST inclusion ratio

Description of Proposal

The proposal would permit severing a trust into two trusts—one with an inclusion ratio of zero and the other with an inclusion ratio of one. Presumably the amount of trusts that would be placed in the trust with an inclusion ratio of one would be the same percentage of the value of all of the assets in the trust prior to the severance as its inclusion ratio.

(2) Definition of "transferor" for GST purposes

Present Law

Under section 2514(e), the lapse of a general power of appointment (e.g., a power of withdrawal) is a taxable transfer by gift except to the extent that the power does not exceed the greater of $5,000 or 5% of the fair market value of the property out of which the power could have been exercised. Example 5 of Proposed Treasury Reg. sec. 26.2652–1(a)(5) involves a trust created by a parent that provided an income interest to his child for life, remainder to

his grandchild with the child having a power of withdrawal $10,000 within 60 days of the creation of the trust. The example states that the parent is the transferor with respect to the entire trust and the child is the transferor as to the excess of $10,000 over the greater of $5,000 or 5% of the trust.

Description of Proposal

The proposal would clarify the rule in Example 5 of the proposed Treasury regulations sec. 26.2652–1(a)(5) such that an individual cannot be treated as a "transferor" with respect to any portion of a trust with respect to which another person is the "transferor".

(3) Permit executor of trust beneficiary to elect to include trust in estate in lieu of GST

Description of Proposal

The proposal would permit an executor to elect to include a trust (or portion of a trust) in the estate of a trust beneficiary who dies at the same time that the GST is imposed under current law (i.e., a taxable termination). The proposal also would allow the estate to recover from the trust the additional estate tax on the beneficiary's estate by reason of the election.

(4) Provide that certain transfers be treated as direct skips instead of taxable terminations

Description of Proposal

The proposal would provide that, when a transfer is described as both a direct skip and a taxable termination or distribution, the transaction will be treated as a direct skip (i.e., direct skips take precedence of taxable terminations and distributions).

(5) Repeal of the Federal GST credit for State GST taxes

Description of Proposal

The proposal would repeal the credit against the Federal GST for any State GST paid.

(6) Postpone allocation of GST exemption

Description of Proposal

The proposal would postpone the determination whether a transfer is a direct skip or taxable termination until the end of the estate tax inclusion period.

(7) GST spousal unity rule

Present Law

Section 2642(f)(4) provides that, except as provides by Treasury regulations, any individual or transferor includes his or her spouse.

Description of Proposal

The proposal would repeal the spousal unity rule (sec. 2642(f)(4)).

(8) Application of GST where a non-resident alien in involved

Present Law

The generation skipping tax is designed to insure that a transfer tax is imposed once a generation. Section 2663(2) provides the Treasury Department with authority to issue regulations "consistent with the principles of chapters 11 and 12 providing for the application of this chapter in the case of transferors who are nonresidents not citizens of the United States." Pursuant to that delegation, the Treasury Department has proposed to impose a generation skipping tax on a nonresident, non citizen if the transfer is to a skip person (or a trust for a skip person) who is a citizen or resident of the United States.

Description of Proposal

The proposal would prohibit adoption of the Proposed Regulations and permit the imposition of a generation skipping tax only where the transfer creating the trust was subject to U.S. estate or gift tax or the transfer was subject to U.S. gift or estate tax.

l. Modification of period of limitations for assessment and collection against transferees

Present Law

Federal tax laws create two independent ways of collecting gift taxes from transferee (donees). First, a lien attaches to the transferred property (or the proceeds from the disposition of the transferred property). Second, the transferee also has liability for any gift tax (Code sec. 6901(a)(1)). Several courts have stated that the donor is "primarily liable" for the tax and the transferee "secondarily liable". Nonetheless, case law holds that the transferee's liability is not limited to cases where the transfer is fraudulent or the transfer was made for the purpose of avoiding the tax. The period of limitations with respect to the transferee expires one year of the expiration of the period of limitations against the transferor (Code sec. 6901(c)).[40]

Description of Proposal

The proposal would limit the additional one year period for collection of tax to (1) transfers where avoidance or evasion was the purpose of the transfer, (2) transfers that were directly made to the transferee (e.g., life insurance), and (3) transfers where the tax had been assessed against the transferor.

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[40] The additional one year for the period of limitations in the case of transferees provided by section 6901(c) applies to all income and estate taxes, not just gift taxes. Indeed, legislative history of the provision providing for transferee liability gives examples involving income tax and transfers by corporations to shareholders and transfers from husbands to wives.

Legislative Background

The predecessor of section 6901(c) was enacted in sec. 280(b) of the Revenue Act of 1926 (See Seidman, pp. 639 and 640) (see also sec. 311 of the Revenue Act of 1928; sec. 526(b) of the Revenue Act of 1932; and sec. 1015 of the Internal Revenue Code of 1939). The legislative history of the 1-year rule does not give any guidance for its adoption. See House Conference Report 356, 69th Cong. 1st Sess., p. 44. This legislative history indicates that the purpose of the one-year rule was to protect transferee who, otherwise would not have sufficient time to file a refund claim after the statute closed against the transferor.

m. Extension of tax-free transfers between former spouses to all types of property and to transfers at a spouse's death

Present Law

In general, no gain or loss is recognized on the transfer of property between spouses or former spouse if the transfer is incident to the divorce (Code sec. 1041). Transfers are incident to the divorce if the transfer occurs one year after the date on which the marriage ceases or the transfer is related to the cessation of the marriage. Such transfers are treated as transfers by gift in which the transferor's basis in the property is carried over to the transferee. The nonrecognition rule applies to transfers of installment sale notes (Code sec. 453B(g)) and Code sec. 409 and individual retirement accounts (Code sec. 408(d)(6)).

Description of Proposal

The proposal would extend the present law nonrecognition rule to terminations of marriages by death as well as divorce and to transfers of all types of property including U.S. savings bonds and income in respect of a decedent (Code sec. 691) and to transfers between revocable trusts of spouses or former spouses.

9. Required notices to charitable beneficiaries of charitable remainder trusts

Present Law

Subject to certain limitations, an estate generally is allowed a deduction for transfers of property to charitable organizations, the United States, or a State or local government (sec. 2055(a)). Where a remainder interest is transferred to the charity in trust, however, a deduction is only permitted if the interest passing to the charitable remainderman is in the form of a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund (sec. 2055(e)).

In order for the estate to take the deduction authorized by section 2055, the Treasury regulations require that the executor submit a copy of the transfer instrument with the estate tax return and stipulate that no actions have been filed or are (according to the executor's information and belief) contemplated to contest the decedent's will in a manner affecting the charitable deduction claimed. Treas. Reg. sec. 20.2055–1(c).

A qualifying charitable remainder trust is generally exempt from tax unless it has unrelated business taxable income. The fiduciary of a qualifying charitable remainder trust must presently file (1) an annual information return on Form 5227 and (2) Form 1041–A unless all net income is required to be distributed currently to the beneficiaries. A charitable remainderman generally may inspect any such returns upon written request to the Internal Revenue Service (sec. 6103). Presently, the executor and trust fiduciaries generally are not required under the Code to provide any information directly to the charitable remainderman.

Description of Proposal

The proposal would require that, within 60 days of his or her qualification, an executor must provide each charitable remainderman with the following information (the "Qualification Notice"): (1) the fact of the executor's qualification; (2) the name, address and date of death of the decedent; (3) the name and address of each charitable beneficiary; (4) a copy of the governing instrument relating to the transfer in trust; and (5) a description of the interest to which the charitable remainderman may be entitled, and any preliminary statements (if required by law) on the financial condition of the estate.

The proposal also would require that the charitable remainderman be notified of the filing of a Federal estate tax return and be provided with a copy of the pertinent parts thereof (together with such other information as may be required by form or Treasury regulation) on or before the due date for such return. If the executor has provided the Qualification Notice, this requirement would be waived unless the remainderman has agreed to reimburse the fiduciary for the reasonable costs of furnishing such information.

Further, the proposal would require the fiduciary of each charitable remainder trust to furnish each charitable remainderman with a copy of any returns required to be filed pursuant to chapter 61 of the Code. If the fiduciary provides this information for any taxable year, this requirement would be waived for each subsequent taxable year unless the remainderman has agreed to reimburse the fiduciary for the reasonable costs of furnishing such information.

An executor or other fiduciary who fails to provide such information would be subject to a penalty under section 6652 of $10 for each day that the failure to furnish such information continues (but not in excess of $5,000 for any single return).

Effective Date

The proposal would be effective on the date of enactment. Alternatively, the proposal could be limited to trusts created on or after the date of enactment.

Legislative Background

The proposal is similar to H.R. 32, introduced by Mr. Gibbons on January 4, 1995. The proposal is the same as section 7301 of H.R.

11 (102d Cong.), as passed by the House and Senate and vetoed by President Bush.

Q. Excise Taxes

1. Modifications to diesel fuel excise tax provisions

Present Law

An excise tax totaling 24.4-cents-per-gallon is imposed on diesel fuel (Code sec. 4081). In the case of fuel used in highway transportation, 17.5 cents per gallon (20 cents after September 20, 1995) is dedicated to the Highway Trust Fund. Revenues equal to 0.1 cent per gallon are dedicated to the Leaking Underground Storage Trust Fund. The remaining portion of this tax is imposed on transportation generally and is retained in the General Fund.

The diesel fuel tax is imposed on removal of the fuel from a registered and bonded pipeline or barge terminal facility (i.e., at the "terminal rack"). Present law provides that tax is imposed on all diesel fuel removed from bonded terminal facilities unless the fuel is destined for a nontaxable use *and* is indelibly dyed pursuant to Treasury Department regulations.

In general, the diesel fuel tax does not apply to non-transportation uses of the fuel. Off-highway business uses are included within this non-transportation use exemption. This exemption includes use on a farm for farming purposes and as fuel powering off-highway equipment (e.g., oil drilling equipment). Use as heating oil also is exempt. (Most fuel commonly referred to heating oil is diesel fuel.) The tax also does not apply to fuel used by State and local governments, to exported fuels, and to fuel used in commercial shipping. Fuel consumed in (or by) intercity buses and trains is partially exempt from the diesel fuel tax.

Nontaxable (and partially taxable intercity bus and rail) users of diesel fuel realize their exemption in one of two ways. First, they may use dyed diesel fuel on which tax is never paid. Alternatively, they may purchase tax-paid, undyed diesel fuel and file a claim for refund of tax paid. In the case of diesel fuel sold to States and local governments and to farmers, the refunds are claimed by registered ultimate vendors who sell the fuel to the consumers without collecting tax. These claims accrue interest unless they are paid within 20 days. Other nontaxable users of diesel fuel may claim refunds in either of two ways. First, the refund may be claimed on the taxpayer's income tax return. (Estimated income tax payments may be reduced to adjust for these amounts.) Second, if the total amount of refund due a taxpayer exceeds $750 at the end of any of the first three quarters in a calendar year, the person may file a separate refund claim at that time.

To ensure that diesel fuel dye concentrations (which enable law enforcement officials to ensure that untaxed fuel is not used in a taxable use) are not diluted, present law imposes a penalty of $10 per gallon ($1,000, if less) on persons who dilute dye concentrations below prescribed minimum levels. In certain circumstances, untaxed kerosene is blended with diesel fuel. When this blending occurs, tax is due on the kerosene unless the fuel is destined for a nontaxable use, in which case dye must be added to the fuel mixture to ensure that required concentrations are maintained.

Present law also imposes a penalty of $10 per gallon ($1,000 minimum) on persons who sell or use untaxed diesel fuel in a tax-

able use after the fuel is removed from a registered and bonded terminal facility. For example, the Treasury Department has undertaken a program of spot checks for dyed diesel fuel at truck stops and State highway weigh stations. Truck owners having dyed diesel fuel in their vehicle tanks are subject to this penalty. Similarly, owners of truck stops having dyed diesel fuel in pumps dispensing to highway users are subject to the penalty.

A similar dyeing regime exists for diesel fuel under the Clean Air Act. That Act prohibits the use on highways of diesel fuel with a sulphur content exceeding prescribed levels. This "high sulphur" diesel fuel is required to be dyed by the EPA. The State of Alaska was exempted from the Clean Air Act, but not the excise tax, dyeing regime for three years.

Present law allows taxpayers a business expense deduction for the amount of bad debt losses (nonpayment of bills by customers) and for casualty losses. These deductions include the amount of any diesel fuel excise tax that is imbedded in the cost of fuel for which dealers are not paid or which is lost in a casualty.

Description of Proposals

The following alternative proposals relate to the excise tax on diesel fuel:

Retail collection of tax on recreational boat fuel

Owners of diesel-powered recreational boats would be permitted to use dyed diesel fuel (non-tax-paid on removal from a terminal) without imposition of the penalties for use of dyed fuel in a taxable use. Marina operators would be liable for collection of tax from these persons.

Penalty-free dilution of dye concentrations in certain cases

The penalty for dilution of dye concentrations in non-tax-paid diesel fuel would be amended to exclude situations where kerosene is blended with diesel fuel after the fuel is removed from a terminal facility. This would permit, e.g., home heating oil distributors to blend kerosene with diesel fuel without maintaining the generally required dye concentration.

Refunds for bad debt and casualty losses

Persons that experience bad debt losses and casualty losses related to tax-paid diesel fuel would be allowed a refund of tax presumed to be imbedded in their product cost in addition to the currently allowed deductions for these amounts.

Interest-bearing refunds for certain diesel fuel users

The refund provisions for nontaxable users of diesel fuel would be modified to require that the Treasury Department pay the refunds within a prescribed number of days after they are filed, or pay interest on the amounts, as follows:

Heating oil vendors—Currently allowable consumer refunds would be eliminated with vendors (rather than consumers) being made eligible for refunds of tax imposed on undyed fuel sold as heating oil. Refund claims could be filed weekly if the claimed

amount was $200 or more, and would bear interest unless paid within 20 days.

Intercity bus owners—Partially exempt intercity bus owners electing to use undyed diesel fuel on which tax is paid in full on removal from a terminal facility would be allowed to file refund claims weekly if the claim was for at least $200; interest would accrue unless they were paid within 20 days.

Other nontaxable users of diesel fuel—The current quarterly refund provision for other nontaxable users of diesel fuel would be replaced by a provision allowing claims to be filed monthly if the claim was for at least $250. Refunds would bear interest unless paid within 20 days.

Exempt Alaska from diesel dyeing requirement

Diesel fuel sold in the State of Alaska would be exempt from the diesel dyeing requirement during the remainder of the period when that State is exempt from the Clean Air Act dyeing requirements. Thus, dyed diesel fuel could be used in taxable uses without penalties being imposed (subject to a certification procedure to be established by the Treasury Department).

Effective Date

The proposals would be effective on the date of enactment.

Legislative Background

The diesel fuel compliance provisions were enacted by the Omnibus Budget Reconciliation Act of 1993. The Treasury Department has reported that, during calendar year 1994 (the first year when the changes were effective), increased diesel fuel tax receipts attributable to improved compliance totaled approximately $1.3 billion.

2. Treat kerosene as a diesel fuel for excise tax purposes

Present Law

Diesel fuel is taxed at 24.4 cents per gallon (Code sec. 4081). The tax is collected on removal of the fuel from a registered and bonded pipeline or barge terminal. Tax is imposed on all diesel fuel removed from a terminal facility unless the fuel is indelibly dyed and is destined for a nontaxable use. Jet fuel used in noncommercial aviation is taxed at the retail level (sec. 4041).

Kerosene is used both as a highway motor fuel and as a jet fuel. Kerosene also is blended with diesel fuel destined both for taxable and nontaxable uses (e.g. as heating oil) to, among other things, prevent gelling of the diesel fuel in cold weather. Under present law, kerosene is not taxed unless it is blended with taxable diesel fuel or is sold for use in noncommercial aviation. When kerosene is blended with dyed diesel fuel to be used in a nontaxable use, the dye concentration of the fuel mixture must be adjusted to ensure that it meets Treasury Department regulations for untaxed, dyed diesel fuel.

Wholesale distributors have reported that, because of improved diesel fuel tax compliance resulting from tax changes enacted by the Omnibus Budget Reconciliation Act of 1993, greatly increased

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amounts of kerosene are now being blended with diesel fuel for use in taxable uses without payment of excise tax.

Description of Proposal

The proposal would statutorily define kerosene as a diesel fuel. As such, kerosene would be subject to tax whenever it was removed from a registered and bonded pipeline terminal unless it was indelibly dyed and destined for a nontaxable use. To accommodate State safety regulations requiring clear (K–1) kerosene to be used in certain space heaters, a new refund procedure would be established under which registered ultimate vendors would be eligible for refunds of any tax paid earlier in the fuel distribution chain on kerosene sold for that use.

Effective Date

The proposal would be effective after September 30, 1995.

3. Modify rail diesel motor fuel tax rate

Present Law

Diesel fuel used in trains is subject to a 6.9-cents-per-gallon excise tax (Code sec. 4041). After September 30, 1995, the tax rate will be 5.55 cents per gallon: 0.1 cents per gallon of the tax is dedicated to the Leaking Underground Storage Trust Fund; the remaining amount of the tax is retained in the General Fund for deficit reduction.

Other transportation modes also are subject to a diesel fuel deficit reduction tax. After September 30, 1995, the deficit reduction tax rate on diesel fuel used in other transportation modes will be 4.3 cents per gallon (rather than the 5.55 cents per gallon applicable to railroads).

Description of Proposal

There are two proposals for modifying the rail diesel tax:

(a) The 1.25-cents-per-gallon additional deficit reduction tax imposed on rail diesel would be imposed on diesel fuel used by all (including rail) competing transportation modes at a reduced (revenue neutral) rate.

(b) AMTRAK would be exempted from the rail diesel tax.

Effective Date

The proposals would be effective for fuel used after September 30, 1995.

Legislative Background

The deficit reduction component of the diesel fuel tax was first enacted at a rate of 2.5 cents per gallon by the Omnibus Budget Reconciliation Act of 1990, to expire after September 30, 1995. The 1990 rate applied only to highway and rail use. The Omnibus Budget Reconciliation Act of 1993 ("1993 Act") extended the expiration date of the 2.5-cents-per-gallon rate to September 30, 1999; dedicated the highway use portion of the tax to the Highway Trust

Fund beginning on October 1, 1995; and, reduced the rail portion of that tax to 1.25 cents per gallon, also effective on October 1, 1995. The 1993 Act also imposed the 4.3-cents-per-gallon rate on highway, rail, aviation, and inland waterway transportation as a permanent deficit reduction rate.

4. Expand off-highway business use exemption from motor fuels excise taxes

Present Law

Gasoline, diesel fuel, and special motor fuels used in highway vehicles are subject to Federal excise taxes (Code secs. 4041 and 4081). Revenues from most of these taxes are deposited in trust funds to finance specified Federal highway and environmental programs; 4.3-cents-per-gallon (6.8 cents per gallon on rail use through September 30, 1995, and 5.55 cents thereafter) of these taxes is retained in the General Fund as a deficit reduction measure.

Treasury Department regulations define the term highway vehicle and the conditions under which fuels consumed in such a vehicle for non-highway purposes are exempt from tax. In general, fuel used in a highway vehicle to power nonhighway engines (e.g., power take-offs on trash disposal trucks) is not taxable if the engine powering the nonhighway equipment is separate from the vehicle's highway engine. When a vehicle's highway engine is used to power both on- and off-highway activities, all fuel used in the engine is taxable.

Description of Proposal

The proposal would allow truck owners to claim refunds for fuels used in highway engines to power nonhighway functions of the trucks. Examples of nontaxable uses would be the operation of power take-offs on dump trucks and pumps for removing fuel and other liquids from tanker trucks. The proposal is not intended to cover fuel consumed in a highway engine for "idle time" running.

Effective Date

The proposal would be effective for fuels used after December 31, 1995.

5. Modify gasoline tax refund procedure for gasoline sold to States and local governments

Present Law

An 18.4-cents-per-gallon excise tax is imposed on gasoline used in highway vehicles (Code sec. 4081). This tax is imposed when the fuel is removed from a registered and bonded pipeline or barge terminal. The tax is imposed on removal of all gasoline without regard to of its intended ultimate use.

Off-highway business use of gasoline and use by States and local governments is not subject to tax. These exemptions generally are realized by means of refunds to consumers equal to the tax previously paid by vendors who remove the gasoline from terminal facilities. In the case of gasoline sold to States and local govern-

ments, wholesale distributors are permitted to sell the gasoline to these governments at a tax-exclusive price and file refund claims with the Treasury Department.

Before 1994, the diesel fuel excise tax was imposed on sale of the diesel fuel by a wholesale distributor. Many gasoline wholesale distributors also distribute diesel fuel. To expedite gasoline tax refunds, the Treasury Department administratively permitted these distributors to claim gasoline tax refunds for gasoline sold to States and local governments as a credit against their diesel fuel tax liability. The 1994 change imposed the diesel fuel tax at a point in the distribution chain of that fuel before wholesale distributors acquire the fuel; thus, these persons no longer directly pay the diesel fuel tax and are unable to realize gasoline tax refunds by means of diesel fuel tax credits.

Description of Proposal

The proposal would provide that refunds of gasoline tax to wholesale distributors could be filed weekly if the amount of the refund exceeded $200 and would bear interest unless they were paid within 20 days.

Effective Date

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

Legislative Background

The current gasoline tax collection rules were enacted by the Omnibus Budget Reconciliation Act of 1990. The diesel fuel tax collection rules were enacted by the Omnibus Budget Reconciliation Act of 1993, effective on January 1, 1994.

6. Adjust certain fuels tax rates for BTU equivalency to gasoline

Present Law

Gasoline, diesel fuel, and special motor fuels generally are taxed on a per-gallon basis without regard to their respective BTU contents: 18.4 cents per gallon for gasoline and special motor fuels and 24.4 cents per gallon for diesel motor fuel (Code secs. 4041 and 4081). 11.5 cents per gallon of the gasoline and special motor fuels taxes (14 cents per gallon after September 30, 1995) is dedicated to the Highway Trust Fund. Certain methanol fuel derived from natural gas is exempt from 7 cents per gallon of this Highway Trust Fund rate; this exemption results in a net Highway Trust Fund rate approximately proportional to the respective BTU contents of methanol and gasoline.

The Highway Trust Fund portion of the special motor fuels excise tax applies only to liquid fuels. Thus, the tax applies to propane and liquified natural gas ("LNG"), but not to compressed natural gas ("CNG").

The Omnibus Budget Reconciliation Act of 1993 imposed 4.3 cents per gallon of these taxes as a deficit reduction measure. CNG, as well as LNG, propane, and methanol are subject to this deficit reduction component of the tax. CNG is taxed at a rate of 48.54

cents per MCF, which is based on the respective BTU contents of CNG and propane.

Description of Proposal

Three alternative proposals relate to the taxation of certain special motor fuels.

(1) Exempt LNG from the Highway Trust Fund component of the special motor fuels excise tax, and adjust the rate of the deficit reduction component of the tax to reflect LNG's BTU equivalence to CNG.

(2) Continue to impose tax as under current law, but reduce the aggregate tax rates on propane, methanol, LNG, and CNG to reflect their BTU equivalence to gasoline.

(3) Adjust only the propane tax rate to a rate based on propane's BTU equivalence to gasoline.

Effective Date

The proposals would be effective beginning on January 1, 1996.

Legislative Background

The provision basing the tax on methanol derived from natural gas on BTU content was enacted by the Omnibus Budget Reconciliation Act of 1990. The tax on CNG and the 4.3-cents-per-gallon deficit reduction component of these taxes were enacted by the Omnibus Budget Reconciliation Act of 1993.

7. Modifications to the retail truck excise tax

Present Law

A 12-percent excise tax is imposed on the sale of trucks having a gross vehicle weight ("GVW") of more than 33,000 pounds and trailers having a GVW of more than 26,000 pounds (Code sec. 4051). Revenues from the tax are dedicated to the Highway Trust Fund. The tax is imposed on the first retail sale of a taxable vehicle or addition thereto.

Generally repairs of used vehicles are treated as remanufacture (giving rise to tax on the entire vehicle) if—

(1) the transportation function of the truck is changed by additions or modifications to the chassis of the truck;

(2) a new vehicle is fabricated from a wrecked vehicle; or

(3) modifications to a used vehicle are so extensive that they extend the vehicle's useful life.

The mere addition of a fifth wheel to a taxable truck is not treated as remanufacture, although the fifth wheel itself would be taxed.

Description of Proposal

There are two proposals related to the retail truck excise tax—

(1) Imposition of the retail truck tax would be moved from first retail sale to sale by the manufacturer.

(2) Present law would be clarified that the following activities do not constitute remanufacture when performed on a used truck chassis:

(a) removal of a fifth wheel and addition of a power take-off, hoist, and dump body; or

(b) simple addition of a power take-off, host, and dump body.

These activities would remain taxable to the extent of the modifications made.

Effective Date

The first proposal would be effective beginning on January 1, 1996.

The second proposal would be effective on the date of its enactment. Clarification would be included that the legislation is not intended to infer that present law is inconsistent with the proposal.

8. Consolidate collection of aviation gasoline excise tax

Present Law

The Airport and Airway Trust Fund is financed by excise taxes on the aviation industry and the flying public. For commercial aviation, taxes are imposed on the value of passenger tickets and freight waybills (and in the case of international departures, a flat per person excise tax). Noncommercial aviation, or air transportation that is not for hire, is subject to a fuels tax on gasoline and jet fuel. These fuels also are subject to a 4.3-cents-per-gallon rate for deficit reduction and a 0.01-cent-per-gallon rate to fund the Leaking Underground Trust Fund. The aggregate aviation gasoline excise tax rate is 19.4 cents per gallon, of which 18.4 cents per gallon is collected at the same point as the highway and deficit reduction gasoline taxes, upon removal of the fuel from registered and bonded a pipeline or barge terminal. The remaining 1 cent per gallon is collected at the retail level.

Description of Proposal

The proposal would consolidate collection of the aviation gasoline excise tax at the terminal removal level, with the full 19.4-cents-per-gallon tax being collected at that point.

Effective Date

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

9. Expand aviation excise tax exemptions for air ambulances

Present Law

Among the excise taxes that fund the Airport and Airway Trust Fund are a 10-percent passenger ticket tax, a 6.25-percent freight waybill tax, and taxes on gasoline and jet fuel used in noncommercial aviation. Helicopters engaged in emergency medical transportation are exempt from these taxes when the operations do not involve landing or taking off from Federally supported airports or use of other aviation services supported by the Airport and Airway Trust Fund. (Code secs. 4261(e) and 4041 (l)).

Description of Proposal

The proposal would expand the current exemption for emergency medical helicopters to include fixed-wing aircraft and would delete the condition of exemption that exempt aircraft not take off or land at Federally supported airports or otherwise use Federal aviation services.

Effective Date

The proposal would be effective upon enactment.

10. Reduce harbor maintenance excise tax

Present Law

Under present law, an excise tax of 0.125 percent is imposed on the value of commercial cargo (including the value of passenger fares) loaded or unloaded at U.S. ports (sec. 4461). The tax does not apply to cargo donated for overseas use. The tax also does not apply to cargo (other than cargo destined for a foreign port) shipped between the U.S. mainland and Alaska (other than crude oil), Hawaii, or a U.S. possession, or for cargo shipped between Alaska (other than crude oil), Hawaii, or a U.S. possession. In addition, the tax does not apply to passenger ferry boats, operating between points within the United States or between the United States and Canada or Mexico.

Revenues from the harbor maintenance excise tax go to the Harbor Maintenance Trust Fund ("Harbor Trust Fund"), generally to finance costs of operating and maintaining U.S. ports.

Description of Proposal

The bill (H.R. 1138) would reduce the 0.125-percent harbor maintenance excise tax by 0.02 percentage points each year for 3 years, beginning in 1996 (to 0.065 percent in 1998). Thereafter, if the Harbor Maintenance Trust Fund balance exceeds $100 million at the beginning of a fiscal year, the tax would be reduced by 0.01 percentage point for the following calendar year; or, if the Harbor Maintenance Trust Fund begins a fiscal year with a balance of $100 million or less, the tax would be increased by 0.01 percentage point for the following calendar year.

Effective Date

The bill would be effective for calendar years after 1995.

Legislative Background

H.R. 1138 was introduced by Mr. McDermott on March 6, 1995.

11. Reduce excise fuel tax subsidy if carbon dioxide produced as a by-product is marketed by the producer

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 al-

lowed 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 reduce the income tax credits and excise tax exemptions for ethanol if carbon dioxide produced as a by-product is marketed for sale at retail by the ethanol producer.

Effective Date

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

Legislative Background

A proposal to impose an excise tax on carbon dioxide sold by ethanol producers was the subject of a hearing before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means in September of 1993.

12. Provide a lower rate of tax on certain hard ciders

Present Law

Under present law distilled spirits are taxed at a rate of $13.50 per proof gallon; beer is taxed at a rate of $18.00 per barrel (approximately 58 cents per gallon); and still wines of 14 percent alcohol or less are taxed at a rate of $1.07 per wine gallon. Higher rates of tax are provided for wines with greater alcohol content and for sparkling wines.

Certain small wineries may claim a credit against the excise tax on wine of 90 cents per wine gallon on the first 100,000 gallons of wine produced annually. Certain small breweries pay a reduced excise tax of $7.00 per barrel (approximately 22.6 cents per gallon) on the first 60,000 barrels of beer produced annually.

Apple cider containing alcohol is taxed as a wine.

Description of Proposal

The proposal would tax apple cider having an alcohol content of no more than seven percent at 22.6 cents per gallon.

Effective Date

The proposal would be effective on the date of enactment.

13. Wine spirits—permit the use of other agricultural products

Present Law

Under present law, a credit is allowed against the excise tax generally imposed on distilled spirits (i.e., $13.50 per proof gallon) based on the wine content of distilled spirits (sec. 5010). For purposes of this credit, the term "wine" means wine on which tax would be imposed by paragraph (1), (2), or (3) of section 5041(b) but for its removal to bonded premises, and does not include any sub-

stance which has been subject to distillation at a distilled spirits plant after receipt in bond (sec. 5010(c)(1)).

The wine spirits authorized to be used in wine production are brandy and wine spirits produced exclusively from (1) fresh or dried fruit, or their residues, (2) the wine or wine residues therefrom, or (3) special natural wine under such conditions as permitted by Treasury Department regulations (sec. 5373).

Description of Proposal

The proposal would amend present-law section 5373 to permit the use of other agricultural products (e.g., whey) in the making of wine spirits.

Effective Date

The proposal would be effective on the date of enactment.

Legislative Background

A similar proposal was the subject of hearings before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on June 17, 22, and 24, 1993.

14. Phased repeal and modifications of the luxury excise tax on automobiles

Present Law

Present law imposes a 10-percent excise tax on the portion of the retail price of an automobile above $32,000 (Code sec. 4001). The threshold for any year is computed by increasing $30,000 by the cumulative inflation since 1990, with the result rounded down to the nearest increment of $2,000. The tax applies to sales before January 1, 2000.

A separate provision of present law (sec. 179A) provides for a deduction of up to $2,000 for the purchase of an electric car (qualified "clean fuel vehicle"). The deduction is phased out between 2002 and 2004.

Description of Proposals

1. The proposal would ratably phase down the tax after the date of enactment so that tax rates would be 10 percent for 1995, 8.0 percent for 1996, 6.0 percent for 1997, 4.0 percent for 1998, and 2.0 percent for 1999.

2. As an alternative, the proposal would ratably phase down the tax after the date of enactment so that tax rates would be 10 percent for 1995, 9.0 percent for 1996, 8.0 percent for 1997, 7.0 percent for 1998, and 6.0 percent for 1999.

3. The proposal would provide that electric cars eligible for the deduction provided under section 179A are exempt from the luxury excise tax on automobiles.

Effective Date

All proposals would be effective for sales after the date of enactment.

Legislative Background

The luxury tax on automobiles was imposed by the Omnibus Budget Reconciliation Act of 1990, at a rate of 10 percent of the amount of the price of an automobile in excess of $30,000, for sales on or after January 1, 1991. That Act also imposed luxury excise taxes on the sale of certain aircraft, boats, furs, and jewelry.

The Omnibus Budget Reconciliation Act of 1993 repealed the luxury excise taxes for sales of aircraft, boats, furs, and jewelry after December 31, 1992, and indexed for inflation the $30,000-threshold applicable to the luxury tax applicable to automobiles.

15. Modifications to the excise tax on ozone-depleting chemicals

Present Law

An excise tax is imposed on the sale or use by the manufacturer or importer of certain ozone-depleting chemicals (Code sec. 4681). 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 taxed chemical. The base tax amount is $5.35 per pound in 1995 and will increase by 45 cents per pound per year thereafter.

Taxed chemicals that are recovered and recycled within the United States are exempt from tax.

The tax applicable to chemicals used as propellants in metered-dose inhalers is limited to $1.67 per pound.

Description of Proposals

1. Extend the exemption from tax for domestically recovered recycled ozone-depleting chemicals to imported recycled ozone-depleting chemicals.

2. Provide that the rate of tax applicable to chemicals used as propellants in metered-dose inhalers is zero for calendar years prior to the year 2000.

Effective Date

1. The proposal would be effective on the date of enactment.

2. The proposal would be effective for sales on or after January 1, 1995.

Legislative Background

The excise tax on ozone-depleting chemicals was enacted in 1989, applicable to chemicals manufactured or imported after December 31, 1989. The list of chemicals subject to tax was expanded in 1990 effective January 1, 1991, and in 1992 the base tax amount was increased effective January 1, 1993. In 1992, the tax applicable to chemicals used as propellants in metered-dose inhalers was limited to $1.67 per pound.

16. Exemption from gas guzzler excise tax for limousines

Present Law

An excise tax is imposed on automobiles that do not meet statutory standards for fuel economy (Code sec. 4064). The tax is imposed on the manufacturer or importer. Lengthening of existing automobiles is considered to be manufacture. The tax generally applies to passenger automobiles with unloaded gross vehicle weights of 6,000 pounds or less; however, limousines are subject to the tax regardless of their weight (sec. 4064(b)(1)(A)). The amount of the tax varies according to the fuel efficiency of a model of automobile. The rates of tax begin at $1,000 for automobile models that do not meet a 22.5 miles per gallon fuel economy rating, and increase to $7,700 for automobile models with fuel economy ratings of less than 12.5 miles per gallon.

Description of Proposal

The proposal would exempt limousines weighing more than 6,000 pounds (e.g., "stretch limousines") from the gas guzzler excise tax.

Effective Date

The proposal would be effective on the date of enactment.

Legislative Background

The gas guzzler excise tax was enacted in 1978 to be effective for automobile models manufactured for 1980 and beyond. The Omnibus Budget Reconciliation Act of 1990 generally doubled the existing rates of tax to their current level. Prior to that Act an exemption was permitted for manufacturers who lengthened existing automobiles (stretch limousines), and Treasury could prescribe a different (reduced) tax rate for "small" manufacturers. OBRA90 eliminated these exemptions.

17. Allow in-bond transfers of bottled distilled spirits among commonly owned distilled spirits plants

Present Law

Distilled spirits are subject to a $13.50 per proof gallon excise tax. A proof gallon is a liquid gallon containing 50 percent alcohol. The tax is imposed upon removal of the distilled spirits from the distillery at which they are produced.

Description of Proposal

The proposal would allow bottled distilled spirits to be transferred without payment of tax among commonly owned distilled spirits plants, and from contract bottlers back to the distilled spirits plant from which they were transferred for bottling.

Effective Date

The proposal would be effective on the date of enactment.

18. Drawback of distilled spirits tax on spirits used in nonbeverage products

Present Law

Distilled spirits are subject a $13.50 per proof gallon excise tax (Code sec. 5001). A proof gallon is a liquid gallon containing 50 percent alcohol. The tax is imposed on removal of the spirits from the distillery. Distilled spirits that are used for nonbeverage purposes, including use in the manufacture or medicines, food products, flavors, or flavoring extracts, are exempt from tax. This exemption is achieved by a refund of tax paid (less a $1 administrative fee).

Description of Proposal

The proposal would allow distilled spirits to be removed from distilleries upon payment of only the $1 administrative fee when the person removing the spirits certified to the distiller that the spirits were destined for an exempt nonbeverage use.

Effective Date

The proposal would be effective on the date of enactment.

R. Exempt Organizations

1. Treatment of certain costs of private foundation in removing hazardous substances

Present Law

Tax-exempt private foundations generally are required to make annual "qualifying distributions" of a specified minimum amount called the "distributable amount" (sec. 4942). The "distributable amount" is an amount equal to five percent of the fair market value of the foundation's investment assets for the year, reduced by (1) any excise tax on the foundation's investment income (under sec. 4940), (2) any tax on unrelated business taxable income (under sec. 511), and (3) by carryovers of excess distributions from prior years. "Qualifying distributions" include direct expenditures to accomplish charitable purposes and grants to public charities or private operating foundations. In addition, if certain requirements are met, qualifying distributions also may include amounts set aside to be paid within five years for a specific charitable project.

Description of Proposal

The distributable amount of a private foundation for purposes of section 4942 would be reduced by any amounts paid or incurred (or permanently set aside) for (1) investigatory costs, (2) direct costs of removal, and (3) costs of remedial action with respect to a hazardous substance released at certain facilities which were owned or operated by the private foundation. The proposal would be limited to a facility that was transferred to the foundation before December 11, 1980, on which active operation by the foundation was terminated before December 12, 1980. The proposal would not apply, however, to costs incurred pursuant to a pending order issued to the foundation unilaterally by the President or the President's assignee under section 106 of the Comprehensive Response, Compensation and Liability Act, or pursuant to a nonconsensual judgment against the foundation in a governmental costs recovery action under section 107 of such Act. For purposes of the proposal, "hazardous substance" has the meaning given to such term by section 9601(14) of the Comprehensive Environmental Compensation and Liability Act.

Effective Date

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

Legislative Background

The proposal was included in H.R. 11 (102nd Cong.), as passed by the House and the Senate and vetoed by President Bush.

2. Prevent reclassification of certain dues paid to agricultural or horticultural organizations

Present Law

Tax-exempt organizations generally are subject to the unrelated business income tax ("UBIT") on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions (sec. 511–514). Dues payments made to a membership organization generally are not subject to the UBIT. However, several courts have held that, with respect to postal labor organizations, dues payments were subject to the UBIT when received from individuals who were not postal workers but who became "associate" members for the purpose of obtaining health insurance available to members of the organization. See *National League of Postmasters of the United States v. Commissioner*, No. 8032–93, T.C. Memo (May 11, 1995); *American Postal Workers Union, AFL–CIO v. United States*, 925 F.2d 480 (D.C. Cir. 1991); *National Association of Postal Supervisors v. United States*, 944 F.2d 859 (Fed. Cir. 1991).

In Rev. Proc. 95–21 (issued March 23, 1995), the IRS indicated its position regarding when associate member dues payments received by an organization described in section 501(c)(5) will be treated as subject to the UBIT. The IRS indicated that dues payments from associate members will not be treated as subject to UBIT unless, for the relevant period, "the associate member category has been formed or availed of for the principal purpose of producing unrelated business income." Thus, under Rev. Proc. 95–21, the focus of the inquiry is upon the organization's purposes in forming the associate member category (and whether the purposes of that category of membership are substantially related to the organization's exempt purposes other than through the production of income), rather than upon the motive of the individuals who join as associate members.

Description of Proposal

The bill (H.R. 783) would provide that, if an agricultural or horticultural organization described in section 501(c)(5) requires annual dues not exceeding $100 to be paid in order to a be a member of such organization, then in no event will any portion of such dues be subject to the UBIT by reason of any benefits or privileges to which members of such organization are entitled. For taxable years beginning after 1995, the $100 amount would be indexed for inflation. The term "dues" would be defined as "any payment required to be made in order to be recognized by the organization as a member of the organization."

Effective Date

The proposal would apply to taxable years beginning after 1994. In addition, the proposal would provide retroactive relief for dues (even if exceeding $100) received during any taxable year beginning before 1995 if an agricultural or horticultural organization had a "reasonable basis" for not treating such dues as subject to the UBIT (meaning that the organization reasonably relied on (1)

judicial precedent, published rulings , technical advice with respect to the organization, or a letter ruling to the organization, (2) a past IRS audit of the organization in which there was no reclassification of dues for purposes of the UBIT, or (3) long-standing recognized practice of agricultural or horticultural organizations).

Legislative Background

The bill (H.R. 783) was introduced by Mr. Camp on February 1, 1995.

3. Private foundations

a. Modify rules for private foundation grants to foreign organizations

Present Law

Tax-exempt private foundations generally are required to make annual "qualifying distributions" of a specified minimum amount called the "distributable amount" (sec. 4942). The "distributable amount" is an amount equal to five percent of the fair market value of the foundation's investment assets for the year, reduced by (1) any excise tax on the foundation's investment income (under sec. 4940), (2) any tax on unrelated business taxable income (under sec. 511), and (3) by carryovers of excess distributions from prior years. "Qualifying distributions" include direct expenditures to accomplish charitable purposes and grants to public charities or private foundations, as well as certain amounts set aside for a specific charitable project In addition, grants made by a private foundation to donee private foundation that is not an operating foundation may be treated as "qualifying distributions" made by the donor foundation only if (1) not later than the close of the taxable year after the year in which the grant is received, the grantee foundation in turn makes qualifying distributions equal to the amount of the grant, and (2) the distributions made by the grantee foundation are treated as "distributions out of corpus" under the rules of section 4942(h). (See sec. 4942(g)(3).)

In the case of a grant made by a domestic private foundation to a foreign grantee organization that has not received a ruling or determination letter from the IRS that it is entitled to public charity or operating foundation status, the grantor foundation may nonetheless treat the grantee as a public charity or operation foundation (and, thus, disregard the "out of corpus" rule of section 4942(h)) if the grantor foundation has made a "good faith determination" (such as through receipt of an affidavit from the grantee setting forth sufficient facts or an opinion of counsel) that the grantee meets the requirements under the Internal Revenue Code for public charity or operating foundation status. (See Treas. Reg. sec. 53.4942(a)–3(a)(6); Rev. Proc. 92–94, I.R.B. 1992–46, 34.)

Description of Proposal

The bill (H.R. 733) would amend section 4942(g)(3) to allow a grant made by a private foundation to a foreign organization to be treated as a "qualifying distribution" for purposes of the income distribution requirement of section 4942(a) if (1) the grantee orga-

nization is not controlled (directly or indirectly) by the grantor foundation or certain disqualified persons with respect to the grantor foundation, (2) the grantee organization makes expenditures equal to the amount of such grant to accomplish a charitable purpose before the close of its first taxable year after its taxable year in which the grant is received, and (3) the grantor foundation exercises expenditure responsibility with respect to the grant under section 4945(h) (meaning that the grantor foundation makes reasonable efforts and establishes reasonable procedures to ensure that the grant is spent solely for charitable purposes, obtains complete reports from the grantee organization on how the grant is spent, and makes detailed reports on the grant to the IRS). In contrast to present law, the grantee organization would not be required to demonstrate that it has made a distribution equal to the amount of the grant that satisfies the "out of corpus" requirement of sections 4942(g)(3) and 4942(h).

Effective Date

The proposal would be effective taxable years beginning after 1994.

Legislative Background

The bill (H.R. 733) was introduced by Mr. Jacobs (for himself and Mr. Camp) on January 30, 1995.

b. Extend due date for first quarter estimated tax by private foundations

Present Law

Under section 4940, tax-exempt private foundations generally are required to pay an excise tax equal to two percent of their net investment income for the taxable year. Under section 6655(g)(3), private foundations are required to pay estimated tax with respect to their excise tax liability under section 4940.[41] Section 6655(c) provides that this estimated tax is payable in quarterly installments and that, for calendar year foundations, the first quarterly installment is due on April 15th. Under section 6655(i), foundations with taxable years other than the calendar year must make their first quarterly estimated tax payment no later than the 15th day of the fourth month of their taxable year.

Description of Proposal

The bill (H.R. 733) would amend section 6655(g)(3) to provide that a calendar-year foundation's first quarter estimated tax payment is due on May 15th (which is the same day that its annual return, Form 990–PF, for the preceding year is due). Under present-law section 6655(i), fiscal-year foundations would be required to make their first quarterly estimated tax payment no later than the 15th day of the fifth month of their taxable year.

[41] Generally, the amount of the first quarter payment must be at least 25 percent of the lesser of (1) the prior year's tax liability, as shown on the foundation's Form 990–PF, or (2) 95 percent of the foundation's current-year tax liability.

Effective Date

The proposal would apply to taxable years beginning after 1995.

Legislative Background

The bill (H.R. 733) was introduced by Mr. Jacobs (for himself and Mr. Camp) on January 30, 1995.

4. Common investment fund for private foundations

Present Law

Code section 501(c)(3) requires that an organization be organized and operated exclusively for an exempt purpose in order to qualify for tax-exempt status under that section.

Section 501(f) provides that an organization is treated as organized and operated exclusively for charitable purposes if it is comprised solely of members that are educational institutions and is organized and operated solely to hold, commingle, and collectively invest (including arranging for investment services by independent contractors) in stocks and securities, the moneys contributed thereto by the members, and to collect income therefrom and turn over the entire amount thereof, less expenses, to such members.

Description of Proposal

The bill (H.R. 734) provides that a cooperative service organization comprised solely of members that are tax-exempt private foundations and community foundations would be treated as organized and operated exclusively for charitable purposes if: (1) it has at least 20 members; (2) no one member holds (after the organization's second taxable year) more than 10 percent (by value) of the interests in the organization; (3) it is organized and controlled by its members, but no one member by itself controls the organization or any other member; (4) the members are permitted to dismiss any of the organization's investment advisors, if (following reasonable notice) members holding a majority of interest in the account managed by such advisor vote to remove such advisor; and (5) the organization is organized and operated solely to hold, commingle, and collectively invest (including arranging for investment services by independent contractors) in stocks and securities, the monies contributed by the members, and to collect income therefrom and turn over the entire amount thereof, less expenses, to such members.[42]

A cooperative service organization meeting the criteria of the proposal would be subject to the present-law excise tax provisions applicable to private foundations (e.g., sec. 4941 rules governing self-dealing arrangements), other than sections 4940 and 4942.[43] In ad-

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[42] It is intended that an organization would be deemed to be organized and operated solely to collectively invest in stocks and securities if its investment portfolio consists solely of stocks and securities, and ordinary and routine investments held in connection with a stock and securities portfolio.

[43] In addition, the bill provides that the present-law expenditure responsibility requirements of section 4945(d)(4)(B) would not apply to grants made by private foundations to the cooperative service organization and that such grants would be deemed to be qualifying distributions for purposes of 4942.

dition, each member's allocable share (whether or not distributed) of the capital gain net income and gross investment income of the organization for any taxable year of the organization would be treated, for purposes of the excise tax imposed under present-law section 4940, as capital gain net income and gross investment income of the member for the taxable year of such member in which the taxable year of the organization ends.

Effective Date

The proposal would be effective for taxable years ending on or after December 31, 1994.

Legislative Background

The bill (H.R. 734) was introduced by Mr. Jacobs (for himself and Mr. Camp) on January 30, 1995. The proposal was included in H.R. 11 (102nd Cong.), as passed by the House and the Senate and vetoed by President Bush.

5. Exclusion from UBIT for corporate sponsorship payments received by tax-exempt organizations in connection with public events

Present Law

Although generally exempt from Federal income tax, tax-exempt organizations are subject to the unrelated business income tax (UBIT) on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions (secs. 511–514). Contributions or gifts received by tax-exempt organizations generally are not subject to the UBIT. However, present-law section 513(c) provides that an activity (such as advertising) does not lose its identity as a separate trade or business merely because it is carried on within a larger complex of other endeavors.[44] If a tax-exempt organization receives sponsorship payments in connection with conducting a public event, the solicitation and receipt of such sponsorship payments may be treated as a separate activity. The Internal Revenue Service (IRS) has taken the position that, under some circumstances, such sponsorship payments may be subject to the UBIT.[45]

Description of Proposal

Under the bill (H.R. 1161), qualified sponsorship payments received by certain tax-exempt organizations in connection with qualified public events would be excluded from the UBIT.

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[44] See *United States v. American College of Physicians*, 475 U.S. 834 (1986)(holding that activity of selling advertising in medical journal was not substantially related to the organization's exempt purposes and, as a separate business under section 513(c), was subject to tax).

[45] See Prop.Treas. Reg. sec. 1.513–4 (issued January 19, 1993, EE–74–92, IRB 1993–7, 71). These proposed regulations generally exclude from the UBIT financial arrangements under which the tax-exempt organization provides so-called "institutional" or "good will" advertising to a sponsor (i.e., arrangements under which a sponsor's name, logo, or product line is acknowledged by the tax-exempt organization). However, specific product advertising (i.e., "comparative or qualitative descriptions of the sponsor's products") provided by a tax-exempt organization on behalf of a sponsor is not shielded from UBIT under the proposed regulations.

The term "qualified public event" would be defined as any event conducted by a tax-exempt organization described in paragraph (3), (4), (5), or (6) of section 501(c),[46] that is either:

(1) a public event that is substantially related to the exempt purposes of the organization conducting such event, or
(2) any other public event provided that such event is the only event of that type conducted (i.e., patronized by, or broadcast to, members of the public) by such organization during a calendar year and such event does not exceed 30 consecutive days.[47]

Public events that are substantially related to the exempt purposes of the organization conducting the event (e.g., symphony concerts, museum exhibits, intercollegiate athletic events, and county and agricultural fairs) would be governed by the proposal, even if held for more than a 30-day period. A public event conducted once a year for a period that does not exceed 30 days also would be governed by the proposal, even if the event is not substantially related to the exempt purposes of the organization (e.g., an annual vaudeville show conducted by a hospital or an annual auction or other fundraising event).

For purposes of the proposal, "qualified sponsorship payments" received by a tax-exempt organization that are excluded from UBIT would be defined as any payment made by a person engaged in a trade or business with respect to which the person will receive no substantial return benefit other than:

(1) the use of the name or logo of the person's trade or business in connection with a qualified public event under arrangements (including advertising) in connection with such event which acknowledge such person's sponsorship or promote such person's products or services, or
(2) the furnishing of facilities, services, or other privileges in connection with such event to individuals designated by such person (e.g., tickets furnished to employees).[48]

To prevent avoidance of the 30-day rule governing unrelated events, the Secretary of the Treasury would be granted authority

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[46] In addition, events conducted by State colleges and universities described in section 511(d)(2)(B) would be eligible for the UBIT exception provided for by the bill.

[47] The bill provides that an event would be treated as a qualified public event with respect to all qualified tax-exempt organizations that receive sponsorship payments with respect to the event if such event is a qualified public event with respect to one of such organizations, but only to the extent that such payment is used to meet expenses of such event or for the benefit of the organization with respect to which the event is a qualified public event. Thus, if a national charitable organization receives sponsorship payments with respect to several local fundraising events conducted in conjunction with local affiliates (e.g., walk-a-thons at different sites around the country), the national organization would not be subject to UBIT with respect to sponsorship payments used to meet event expenses or distributed to local affiliates (assuming the events are qualified public events with respect to the local affiliates).

[48] The bill's "in connection with" requirement would be satisfied only if benefits provided to the sponsor (or individuals designated by the sponsor) are provided within a reasonable time period compared to when the qualified public event itself is patronized by (or broadcast to) the public and only if the benefits are provided in a manner reasonably related to the conduct of the public event activities (e.g., providing advertising in a program or brochure distributed to event patrons, or providing special seating at the event, or related pre- or post-event functions, to employees of the sponsor).

to prescribe regulations to prevent avoidance of the purposes of the provision through the use of entities under common control.[49]

The exception provided for by the proposal would be in addition to other present-law exceptions from the UBIT (e.g., the exceptions for activities substantially all the work for which is performed by volunteers and for activities not regularly carried on). No inference would be intended as to the tax treatment under present-law rules of sponsorship payments received in connection with events not governed by the provision (e.g., unrelated events held more than once per year or for more than 30 days) or events held by organizations that are not covered by the provision (e.g., 501(c)(10) fraternal organizations).

Effective Date

The proposal would apply to events conducted after 1994.

Legislative Background

The bill (H.R. 1161) was introduced by Mr. Camp (for himself and Mr. McDermott) on March 8, 1995. The proposal was included in H.R. 11 (102nd Cong.) as passed by the House and the Senate and vetoed by President Bush.

6. Repeal 1986 Act extension of UBIT to games of chance

Present Law

Although generally exempt from Federal income tax, tax-exempt organizations are subject to the unrelated business income tax (UBIT) on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions (secs. 511–514). Certain income, however, is exempted from the UBIT (such as interest, dividends, royalties, and certain rents), unless derived from debt-financed property (sec. 512(b)). Other exemptions from the UBIT are provided for activities in which substantially all the work is performed by volunteers and for income from the sale of donated good (sec. 513(a)).

A specific exemption from the UBIT is provided for certain bingo games[50] conducted by tax-exempt organizations, provided that the conducting of the bingo games is not an activity ordinarily carried out on a commercial basis and the conducting of which does not violate any State or local law (sec. 513(f)). In addition, a specific exemption from the UBIT is provided for qualified public entertainment activities (meaning entertainment or recreation activities of a kind traditionally conducted at fairs or expositions promoting agricultural and educational purposes) conducted by an organization described in section 501(c)(3), (c)(4), or (c)(5) which regularly con-

[49] For this purpose, it is intended that organizations that conduct public events would not be treated as under common control solely as a result of their common affiliation with a national sanctioning body.

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

ducts an agricultural and educational fair or exposition as one of its substantial exempt purposes (sec. 513(d)).

Description of Proposal

The proposal would exempt from the UBIT any trade or business which consists of conducting a game of chance if (1) the conducting of such game or chance by the organization does not violate any State or local law, and (2) there was a State law in effect as of October 5, 1983, which permitted the conducting of such game of chance by nonprofit organizations but not by for-profit entities.

During a one-year period following enactment, tax-exempt organizations could claim refunds of tax paid with respect to games of chance conducted after October 22, 1986, even if such refunds otherwise were barred by operation of law (such as the statute of limitations or res judicata).

Effective Date

The proposal would be effective for games of chance conducted after October 22, 1986. Otherwise barred refunds could be claimed if filed before the end of the one-year period beginning on the date of enactment.

Legislative Background

A similar proposal[51] was included in H.R. 11 (102nd Cong.) as passed by the House and the Senate and vetoed by President Bush.

7. Clarify UBIT treatment of licensing of Olympic trademarks

Present Law

Although generally exempt from Federal income tax, tax-exempt organizations are subject to the unrelated business income tax (UBIT) on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions (secs. 511–514). Moreover, present-law section 513(c) provides that an activity (such as providing advertising) does not lose its identity as a separate trade or business merely because it is carried on within a larger complex of other endeavors.[52] Certain passive investment income (such as interest, dividends, royalties, and certain rents) is specifically exempted from the UBIT, unless such income is derived from debt-financed property or from certain controlled organizations (sec. 512(b)). Other exemptions from the UBIT are provided for activities substantially all the work is performed by volunteers and for income from the sale of donated goods (sec. 513(a)).

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[51] The provision contained in H.R. 11 exempted from the UBIT any trade or business of conducting a game of chance if (1) the conducting of such game by a nonprofit organization does not violate State or local law, (2) the conducting of such game by for-profit entities would violate State or local law, and (3) no substantial part of the work in conducting such game is performed by individuals principally engaged in performing gaming services for hire. This provision in H.R. 11 was effective for games of chance conducted after the date of enactment.

[52] See *United States v. American College of Physicians*, 475 U.S. 834 (1986)(holding that activity of selling advertising in medical journal was not substantially related to the organization's exempt purposes and, as a separate business under section 513(c), was subject to tax).

Description of Proposal

The proposal would amend the UBIT rules to specifically provide that, in the case of a qualified amateur sports organization described in present-law section 501(j)(2), or an organization that would be so described but for the cultural events it organizes in connection with national or international amateur sports competitions, a payment received (directly or indirectly) by such an organization will be deemed to be a "royalty" exempt from the UBIT if a substantial part of the consideration provided by the organization for such payment is the right to use trademarks, designations, or similar properties indicating a connection with such organization or its competitions, events, or teams.

Effective Date

The proposal would be effective upon the date of enactment.

Legislative Background

A similar proposal[53] was included in H.R. 11 (102nd Cong.) as passed by the House and the Senate and vetoed by President Bush.

8. Extend the exception for debt-financed investments in real property to certain private foundations

Present Law

In general, an organization that is otherwise exempt from Federal income tax is taxed on income from a trade or business that is unrelated to the organization's exempt purposes (Unrelated Business Taxable Income or "UBTI") (sec. 511). Certain types of income, including rents, royalties, dividends, and interest are excluded from UBTI, unless such income is derived from "debt-financed property." Income from debt-financed property generally is treated as UBTI in proportion to the amount of debt financing (sec. 514(a)).

An exception to the rule treating income from debt-financed property as UBTI is available to pension trusts, educational institutions and certain title holding companies (collectively referred to as "qualified organizations") that make debt-financed investments in real property (sec. 514(c)(9)(A)). Under this exception income from investments in real property is not treated as income from debt-financed property. The exception is conditioned, however, on certain restrictions (described in sec. 514(c)(9)(B)) being satisfied.

Description of Proposal

The proposal would add certain private foundations to the list of qualified organizations that are eligible for the real property exception from the debt-financed property rules. A private foundation would be treated as a qualified organization if (1) at any time, more than half of the foundation's total assets acquired by gift or devise consisted of improved and unimproved real property; (2) vacant real estate acquired by gift or devise exceeded 10 percent of the value of all assets held by the foundation at the time that the

[53] The provision in H.R. 11 applied only with respect to royalty income received in connection with the Olympic Games to be conducted in 1996.

debt was incurred; and (3) no member of the organizations's governing body was a disqualified person (as defined in sec. 4946) other than by virtue of being a "foundation manager" for the period that the debt was outstanding.

Effective Date

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

Legislative Background

The proposal was subject of a hearing before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means in June 1993.

9. Permit tax-free liquidation of certain closely held corporations whose stock was given to charity; and exempt certain assets from section 514(c)(2) debt financed rules.

Present Law

A taxable corporation that liquidates into a tax-exempt organization must pay corporate level tax on the appreciation in corporate assets at the time of liquidation. An exception applies in cases where the exempt organization would pay unrelated business income tax on income from the asset. Unrelated business income tax generally is imposed on income from certain debt financed property, including property acquired subject to a mortgage. However, under section 514(c)(2)(B), certain property acquired by gift or bequest subject to a mortgage is not treated as debt-financed property for a period of 10 years if the mortgage is not assumed by the tax-exempt organization in order to acquire the equity and the organization makes no payment for the equity in the property.

Description of Proposal

A qualifying taxable U.S. corporation could liquidate into a domestic section 501(c)(3) tax exempt organization without the payment of corporate level tax on its assets. The tax exempt organization would be permitted to receive income from certain debt-financed property acquired in such a liquidation transaction for 10 years without the payment of unrelated business income tax, under rules similar to the rules of present law regarding property acquired by gift or bequest and subject to a mortgage. However, the proposal would further modify the rules of section 514(c)(2)(B) to delete the prohibition against assumption of a mortgage in circumstances such as a qualifying liquidation.

A qualifying corporation would be one in existence prior to January 1, 1987 and having no more than 5 shareholders after family attribution (all of which are U.S. persons) in the 5 years prior to a gift or bequest of 80 percent of the stock to the tax exempt organization. No charitable deduction would be permitted for the gift or bequest if the taxpayer elects to use the provision. The corporation would also be required to satisfy certain additional tests regarding passive income and changes in the nature of its business. Specifically, the proposal would apply only to companies whose gross in-

come from real estate and other portfolio investments during each of the 5 taxable years prior to such gift or bequest is at least 50 percent of total gross income, following the concepts of qualifying income in section 954(c) without regard to the exceptions of section 954(c)(2) and (3). A continuity of business enterprise requirement as under section 382(c)(1) would apply for the 5 taxable years prior to the gift or bequest. Also, the liquidated corporation could not receive more than 10 percent of the fair market value of its assets as a capital contribution from its shareholders during such 5-year period. Income and business enterprise testing would apply on a consolidated basis. Banks and savings and loan institutions would not be eligible for the exemption.

Effective Date

The proposal would be effective for liquidations under plans adopted on or after January 1, 1996 if the gifts or bequests were made on or after January 1, 1994.

10. Allow conversion of scholarship funding corporation to taxable corporation

Present Law

Qualified scholarship funding corporations

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

Qualified student loan bonds

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

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

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

Arbitrage restrictions and rebate requirement

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

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

Private foundation excess business holding restrictions

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

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

Description of Proposal

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.

11. Treatment of certain amounts received by telephone cooperatives

Present Law

Mutual or cooperative telephone companies ("telephone cooperatives") are exempt from Federal income tax if 85 percent or more of their income consists of amounts collected from members for the sole purpose of meeting losses and expenses (sec. 501(c)(12)(A)). In applying this 85-percent test, certain income received by a telephone cooperative is disregarded, including income received from a nonmember telephone company for the performance of communication services which involve members of the telephone cooperative, certain pole rental income, and income from the sale of display listings in a telephone directory furnished to members of the telephone cooperative (sec. 501(c)(12)(B)).

Tax-exempt organizations generally are subject to the unrelated business income tax (UBIT) on income from a trade or business that is not substantially related to the organization's tax-exempt purposes. Under special rules, certain investment income (e.g., interest, dividends, royalties, and certain rents) generally is exempt from UBIT, although some tax-exempt organizations, such as social clubs described in section 501(c)(7) and certain mutual benefit organizations, are subject to UBIT on their investment income.

Description of Proposal

The bill (S. 112) would amend section 501(c)(12) to provide that 50 percent of the income received by a telephone cooperative from a nonmember telephone company for performing communication services—e.g., fees received for originating (or terminating) a long-distance call placed by (or to) a member—would be treated as collected from members of the telephone cooperative for the sole purpose of meeting the losses and expenses of the telephone cooperative.[54] The remaining 50 percent of income received by a telephone cooperative from a nonmember telephone company, as under present law, would be excluded from the 85-percent test under section 501(c)(12)(B)(i).

The bill also would exclude from the 85-percent test under section 501(c)(12) amounts received by a telephone cooperative from billing and collection services performed for another telephone company.[55]

In addition, the bill would provide that telephone cooperatives will not lose their tax-exempt status under section 501(c)(12) if they earn certain investment "reserve income" in excess of 15 percent of their total income, but only if such reserve income (when added to other income not collected from members) does not exceed 35 percent of the cooperative's total income. For purposes of this provision, "reserve income" would be defined as income that otherwise would be excluded from UBIT under section 512(b) (e.g., interest and dividends) and that is set aside for the repair or replacement of telephone facilities of the cooperative. Under the bill, tax-exempt telephone cooperatives would be subject to the UBIT on such reserve income between the 15-percent and 35-percent range.[56]

Effective Date

The proposal would be effective for amounts received or accrued after 1994.

Legislative Background

The bill (S. 112) was introduced by Senator Daschle (for himself, and Senators Grassley, Harkin, Conrad, and Dorgan) on January 4, 1995. The proposal was included in H.R. 11 (102nd Cong.) as passed by the House and the Senate and vetoed by President Bush.

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[54] Amounts received by a telephone cooperative from a nonmember telephone company (e.g., long-distance carrier) for performing communication services often are referred to as "access charges." Thus, under the bill, 50 percent of such access charges received by a telephone cooperative from another telecommunications company would be treated as member-source income for purposes of the 85-percent test of section 501(c)(12).

[55] Telephone cooperatives (and other local telephone companies) often serve as billing and collection agents for other telecommunications companies. (That is, a telephone cooperative bills, and collects from, its members not only charges for local phone service provided by the cooperative but also charges for amounts owed to a long-distance carrier for the member's long-distance calls.) Telephone cooperatives are compensated for performing billing and collection services, generally by retaining a portion of the long-distance charges collected from members. Similar to the present-law treatment of certain pole rental income and directory listing (e.g., "yellow pages") revenue, the bill would treat such billing and collection revenues as excluded from the 85-percent test under section 501(c)(12).

The bill would provide that, for purposes of the UBIT, no inference would be intended regarding the treatment of income from billing and collection services.

[56] Income that is not taken into account under section 501(c)(12)(B) likewise would be disregarded for purposes of the 15-percent and 35-percent thresholds.

12. Clarify that parent holding companies for hospitals may qualify as public charities rather than private foundations

Present Law

Organizations described in section 501(c)(3) (commonly referred to as "charities") are divided into two groups: public charities and private foundations. Certain so-called "supporting organizations" to public charities are, themselves, treated as public charities (sec. 509(a)(3)).

Nonprofit hospitals are eligible for tax-exempt status under section 501(c)(3) if they satisfy a "community benefit" standard and meet other requirements of that section. (See Rev. Rul. 69–545, 1969–2 C.B. 117.) Hospitals (and certain medical research organizations) described in section 501(c)(3) are treated as public charities rather than private foundations (secs. 170(b)(1)(A)(iii) and 509(a)(1)).

Description of Proposal

The proposal would clarify that organizations that serve as parent holding companies for nonprofit hospitals and certain medical research organizations (i.e., an organization which is organized and operated for the benefit of, and which directly or indirectly controls a nonprofit hospital or medical research organization) would qualify as public charities rather than private foundations (assuming that all present-law requirements of section 501(c)(3) are satisfied).

Effective Date

The proposal would be effective on the date of enactment.

Legislative Background

The proposal was included in H.R. 3600, the "Health Security Act" (103rd Cong.), as passed by the House.

13. Treatment of rural electric cooperatives

Present Law

Mutual or cooperative electric companies ("electric cooperatives") are exempt from Federal income tax if 85 percent or more of their income consists of amounts collected from members for the sole purpose of meeting losses and expenses (sec. 501(c)(12)(A)). In applying this 85-percent test, certain income received by an electric cooperative is disregarded, including certain pole rental income, and income from the prepayment of certain REA loans (sec. 501(c)(12)(C)).

Description of Proposal

Under the proposal, payments by an investor-owned utility for its allocable share of the maintenance, operating, production, and other expenses attributable to power it takes from an electric generating facility that is jointly-owned and operated by the utility and an electric cooperative (of which the utility is not a member)

would not be included in the electric cooperative's income for purposes of applying the 85 percent test.

Effective Date

The proposal would apply to taxable years ending on or after June 30, 1981.

14. Codify IRS directive governing calculation of UBIT liability from charitable gaming

Present Law

Although generally exempt from Federal income tax, tax-exempt organizations are subject to the unrelated business income tax (UBIT) on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax exempt functions (secs. 511–514). Certain income, however, is exempted from the UBIT (such as interest, dividends, royalties, and certain rents), unless derived from debt-financed property (sec. 512(b)). Other exemptions from the UBIT are provided for activities in which substantially all the work is performed by volunteers and for income from the sale of donated goods (sec. 513(a)). In addition, a specific exemption from the UBIT is provided for certain bingo games[57] conducted by tax-exempt organizations, provided that the conducting of the bingo games is not an activity ordinarily carried out on a commercial basis and the conducting of which does not violate any State or local law (sec. 513(f)). A specific exemption from UBIT also is provided for qualified public entertainment activities (meaning entertainment or recreation activities of a kind traditionally conducted at fairs or expositions promoting agricultural and educational purposes) conducted by an organization described in section 501(c)(3), (c)(4), or (c)(5) which regularly conducts an agricultural and educational fair or exposition as one of its substantial exempt purposes (sec. 513(d)).

In *South End Italian Independent Club, Inc. v. Commissioner*, 87 T.C. 168 (1986), *acq.* 1987–2 C.B. 1, the court held that gambling profits of a social club described in section 501(c)(7) that were required by State law to be used charitable purposes were fully deductible under section 162 in computing the UBIT liability of the social club. The net effect of this court decision was to exempt gambling income of that social club from UBIT. In contrast, in *Executive Network Club v. Commissioner*, T.C. Memo 1995–21 (January 18, 1995), the court held that profits from a casino operated by a charity were subject to the UBIT.

Description of Proposal

The proposal would provide that UBIT liability would not be imposed with respect to income from any "qualified game of chance," meaning any game of chance (other than bingo) if (1) the conduct

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

of such game by the organization is pursuant to a State license that is available only to organizations that are nonprofit corporations or are exempt from Federal income tax under section 501(a), and (2) the conduct of such game does not violate State or local law.

Effective Date

The proposal would be effective for games conducted after the date of enactment.

Legislative Background

A similar proposal[58] was included in H.R. 11 (102nd Cong.) as passed by the House and the Senate and vetoed by President Bush.

15. Extend private inurement rule to sec. 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.[59]

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.[60] 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

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[58] The provision contained in H.R. 11 exempted from the UBIT any trade or business of conducting a game of chance if (1) the conducting of such game by a nonprofit organization does not violate State or local law, (2) the conducting of such game by for-profit entities would violate State or local law, and (3) no substantial part of the work in conducting such game is performed by individuals principally engaged in performing gaming services for hire.

[59] 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).

[60] 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.

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.

Legislative Background

The proposal was included in H.R. 11 (102nd Cong.) as passed by the House and the Senate and vetoed by President Bush.

16. Permit certain corporate conversions to tax exempt title holding company without asset appreciation tax where corporation is wholly owned by tax-exempt entity that received stock as a gift or bequest

Present Law

A taxable corporation that liquidates into a tax exempt entity is taxed on appreciation in its assets as if it had sold its assets at fair market value, except to the extent of any assets that would produce income subject to the unrelated business income tax. A taxable corporation that converts to subchapter S status is taxed on net built-in gain in its assets realized within 10 years after the conversion (sec. 1374).

Description of Proposal

The proposal would provide that a taxable subsidiary that is wholly owned (directly or indirectly) by a charitable organization can convert to a tax-exempt title holding company under sections 501(c)(2) or 501(c)(25) without incurring tax on the unrealized appreciation of the subsidiary's assets held in its title-holding function. The provision would apply only if 100 percent of the stock of the taxable corporation is owned by an organization that is tax exempt under section 501(c)(3) and that acquired the stock by gift or bequest, and only if the title holding company elects to be subject to the 10-year built in gain rules of section 1374 of the Code.

Effective Date

The provision is effective for conversions after December 31, 1994.

S. Financial Institutions

1. Delete 1993 Act retroactive denial of losses reimbursed by FSLIC assistance for failed thrifts

Present Law and Background

A taxpayer may claim a deduction for a loss on the sale or other disposition of property only to the extent that the taxpayer's adjusted basis for the property exceeds the amount realized on the disposition and the loss is not compensated for by insurance or otherwise (sec. 165 of thatched). In the case of a taxpayer on the specific charge-off method of accounting for bad debts, a deduction is allowable for the debt only to extent that the debt becomes worthless and the taxpayer does not have a reasonable prospect of being reimbursed for the loss. If the taxpayer accounts for bad debts on the reserve method, the worthless portion of the debt is charged against the taxpayer's reserve for bad debts, potentially increasing the taxpayer's deduction for an addition to this reserve.

A special statutory tax rule, enacted in 1981, excluded from a thrift institution's income financial assistance received from the Federal Savings and Loan Insurance Corporation (FSLIC), and prohibited a reduction in the tax basis of the thrift institution's assets on account of the receipt of the assistance. Under the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), taxpayers generally were required to reduce certain tax attributes by one-half the amount of financial assistance received from the FSLIC pursuant to certain acquisitions of financially troubled thrift institutions occurring after December 31, 1988. These .special rules were repealed by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) but still apply to transactions that occurred before May 10, 1989.

In September, 1990, the Resolution Trust Corporation (RTC), in connection with the requirements of FIRREA, issued a report to Congress and the Oversight Board of the RTC on certain FSLIC-assisted transactions (the 1988/89 FSLIC transactions). The report recommended further study of the covered loss and other tax issues relating to these transactions. A March 4, 1991 Treasury Department report on tax issues relating to the 1988/89 FSLIC transactions concluded that deductions should not be allowed for losses that are reimbursed with exempt FSLIC assistance.

Under a provision included in H.R. 11 (as passed by the House and Senate in 1992 and vetoed by President Bush) and enacted in the Omnibus Reconciliation Act of 1993, in certain cases involving FSLIC assistance in transactions not subject to FIRREA, any FSLIC assistance with respect to any loss of principal, capital, or similar amount upon the disposition of an asset shall be taken into account as compensation for such loss for purposes of section 165 of the Code; and any FSLIC assistance with respect to any debt shall be taken into account for purposes of determining whether such debt is worthless (or the extent to which such debt is worthless) and in determining the amount of any addition to a reserve for bad debts. This rule regarding FSLIC assistance applied to the 1988/89 FSLIC transactions. The provision applied to FSLIC assistance that was not credited before March 4, 1991, with respect to

(1) assets disposed of and charge-offs made in taxable years ending on or after March 4, 1991; and (2) assets disposed of and charge-offs made in taxable years ending before March 4, 1991, but only for purposes of determining the amount of any net operating loss carryover to a taxable year ending on or before March 4, 1991. The provision was enacted with no inference as to prior law. The rule was contained in section 13224 of P.L. 103–66.

Description of Proposal

The proposal would repeal section 13224 of P.L. 103–66.

Effective Date

The proposal would be effective for all years to which section 13224 of P.L. 103–66 would otherwise apply.

2. Treat small commercial finance companies as small banks for purposes of bad debt reserve deductions.

Present Law

In general, most taxpayers may not charge off bad debts until such debts become worthless in whole or in part. Under section 585, small banks (i.e., those with less than $500 million of assets) may use the experience method of accounting for bad debts. Under the experience method, the taxpayer is allowed a deduction to the extent necessary to increase the balance of the taxpayer's reserve for bad debt losses. The balance of the reserve is the greater of (1) the amount that bears the same ratio to the loans outstanding at the close of the taxable year as (a) the total bad debts sustained during the taxable year and the five preceding years to (b) the sum of the loans outstanding for such six years or (2) the balance of the reserve at the close of the base year.[61] The base year is the last taxable year before adoption of the experience method.

Description of Proposal

Allow qualified commercial finance companies to use the reserve method applicable to small banks (i.e., the experience method). Qualified commercial finance companies would be defined as a company whose principal business is providing commercial financing through commercial loans, the purchase of accounts receivable, or leveraged leases and whose average adjusted basis of all assets are $500 million or less (or is a member of a parent-sub controlled that meets the asset test).

Effective Date

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

[61] If the amount of loans outstanding at the close of the taxable year is less than the amount of loans outstanding at the end of the base year, the amount that bears the same ratio to the loans outstanding at the close of the taxable year as the balance of the reserve at the close of the base year bears to the amount of loans outstanding at the close of the base year is substituted for the balance of the reserve at the close of the base year.

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Legislative Background

The Tax Reform Act of 1986 repealed the reserve method for bad debts for all taxpayers other than small banks and thrift institutions.

T. Foreign

1. Increase in section 911 exclusion from $70,000 to $100,000 with indexing

Present Law

Under section 911, U.S. citizens who reside outside the United States are generally entitled to exclude from gross income for U.S. tax purposes their foreign earned income. The amount which may be excluded under this provision is limited to $70,000 per year.

Description of Proposal

The proposal would increase the maximum exclusion for foreign earned income to $100,000. In addition, the proposal would provide for the indexing of this amount for taxable years beginning after 1995.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1994.

Legislative Background

The proposal is contained in H.R. 57, which was introduced by Mr. Archer on January 4, 1995.

2. Repeal of limitation on foreign sales corporation exemption for military property

Present Law

A portion of the foreign trade income of an eligible foreign sales corporation (FSC) is exempt from federal income tax. Foreign trade income is defined as the gross income of a FSC that is attributable to foreign trading gross receipts. In general, the term "foreign trading gross receipts" means the gross receipts of a FSC from the sale or lease of export property, services related and subsidiary to the sale or lease of export property, engineering or architectural services for construction projects located outside the United States, and certain managerial services for an unrelated FSC or DISC.

Section 923(a)(5) contains a special limitation relating to the export of military property. Under regulations prescribed by the Treasury Secretary, the portion of a FSC's foreign trading gross receipts from the disposition of, or services relating to, military property that may be treated as exempt foreign trade income is limited to 50 percent of the amount that would otherwise be so treated. For this purpose, the term "military property" means any property that is an arm, ammunition, or implement of war designated in the munitions list published pursuant to federal law. Under this provision, the export of military property through a FSC is accorded one-half the tax benefit that is accorded to exports of non-military property.

Description of Proposal

The proposal would repeal the special FSC limitation relating to the export of military property, thus providing exports of military property through a FSC with the same treatment currently provided exports of non-military property.

Effective Date

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

Legislative Background

The proposal was the subject of a hearing on miscellaneous tax proposals held by the Subcommittee on Select Revenue Measures of the Committee on Ways and Means in June 1993.

3. Inclusion of computer software as foreign sales corporation export property

Present Law

A portion of the foreign trade income of an eligible foreign sales corporation (FSC) is exempt from federal income tax. Foreign trade income is defined as the gross income of a FSC that is attributable to foreign trading gross receipts. In general, the term "foreign trading gross receipts" means the gross receipts of a FSC from the sale or lease of export property, services related and subsidiary to the sale or lease of export property, engineering or architectural services for construction projects located outside the United States, and certain managerial services for an unrelated FSC or DISC.

For purposes of the FSC rules, export property is defined as property (1) manufactured, produced, grown, or extracted in the United States by a person other than a FSC, (2) held primarily for sale, lease, or rental, in the ordinary conduct of a trade or business, by or to a FSC for direct use, consumption, or disposition outside the United States, and (3) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States. Excluded from the definition of export property, however, are copyrights other than films, tapes, records, or similar reproductions for commercial or home use. Treasury regulations promulgated under this provision specifically provide that copyrights on computer software do not constitute export property (Treas. Reg. sec. 1.927(a)–1T(f)(3)).

Description of Proposal

The proposal would provide that computer software, whether or not patented, would not be excluded from the definition of export property.

Effective Date

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

Legislative Background

The proposal was the subject of a hearing on miscellaneous tax proposals held by the Subcommittee on Select Revenue Measures of the Committee on Ways and Means in June 1993.

4. Recharacterization of overall domestic loss for foreign tax credit limitation purposes

Present Law

A premise of the foreign tax credit is that it should not reduce a taxpayer's U.S. tax on its U.S. source income; rather, it should only reduce U.S. tax on foreign source income. The Code contains an overall foreign tax credit limitation which prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. The overall limitation is calculated by prorating a taxpayer's pre-credit U.S. tax on its worldwide income between its U.S. source and foreign source taxable income. The ratio (not exceeding 100 percent) of the taxpayer's foreign source taxable income to worldwide taxable income is multiplied by its pre-credit U.S. tax to establish the amount of U.S. tax allocable to the taxpayer's foreign source income and, thus, the upper limit on the foreign tax credit for the year. If the taxpayer's foreign source taxable income exceeds worldwide taxable income (because of a domestic source loss), then the full amount of pre-credit U.S. tax may be offset by the foreign tax credit.

If a taxpayer's losses from foreign sources exceed its foreign source income, the excess ("overall foreign loss") may reduce the U.S. tax on the taxpayer's worldwide income. Such a taxpayer's actual U.S. tax liability falls short of the hypothetical tax that would apply to the taxpayer's U.S. source income standing alone. To eliminate a double benefit (that is, the reduction of U.S. tax just noted and, later, full allowance of a foreign tax credit with respect to foreign source income), an overall foreign loss recapture rule was enacted in 1976. Under this rule, a portion of foreign source taxable income earned after an overall foreign loss year is recharacterized as U.S. source taxable income for foreign tax credit purposes (and for purposes of the possessions tax credit) (sec. 904(f)(1)). Foreign source taxable income up to the amount of the overall foreign loss may be so treated. Unless a taxpayer elects a higher percentage, however, generally no more than 50 percent of the foreign source taxable income earned in any particular taxable year is resourced as U.S. source taxable income.[62] The effect of the recapture is to reduce the foreign tax credit limitation in one or more years following an overall foreign loss year and, therefore, the amount of U.S. tax that can be offset by foreign tax credits in the later year or years.

[62] If a taxpayer with an overall foreign loss disposes of property that was used predominantly outside the United States in a trade or business, the taxpayer generally is deemed to have received and recognized foreign source taxable income as the result of a disposition in an amount at least equal to the lesser of the gain actually realized on the disposition or the remaining amount of the unrecaptured overall foreign loss. Furthermore, the annual 50-percent limit on the resourcing of foreign source income does not apply to that amount of foreign source income realized by reason of the disposition.

An overall U.S. source loss reduces pre-credit U.S. tax on worldwide income to an amount less than the hypothetical tax that would apply to the taxpayer's foreign source income standing alone. The existence of foreign source taxable income in the year of the U.S. loss reduces or eliminates any net operating loss carryover that the U.S. loss would otherwise have generated absent the foreign income. In addition, because pre-credit U.S. tax on worldwide income is reduced, so is the foreign tax credit limitation. As a result, it may be that some foreign taxes for the year of the U.S. loss must be credited, if at all, in a carryover year. Tax on domestic source taxable income in a subsequent year may be offset by a net operating loss carryforward, but not by a foreign tax credit carryforward. The Code has no mechanism for resourcing such subsequent U.S. source income as foreign.

Description of Proposal

The proposal would apply a resourcing rule to U.S. income where the taxpayer has suffered a reduction in the amount of its foreign tax credit limitation due to a domestic loss. Under the proposal, in the case of a taxpayer that has incurred an overall domestic loss, that portion of the taxpayer's U.S. source taxable income for each succeeding taxable year which is equal to the lesser of (1) the amount of the unrecharacterized overall domestic loss, or (2) 50 percent of the taxpayer's U.S. source taxable income for such succeeding taxable year, would be recharacterized as foreign source taxable income.

The proposal defines an "overall domestic loss" for this purpose as any domestic loss to the extent it offsets foreign source taxable income for the current taxable year or for any preceding taxable year by reason of a net operating loss carryback. For this purpose, the term "domestic loss" means the amount by which the U.S. source gross income for the taxable year is exceeded by the sum of the deductions properly apportioned or allocated thereto, except that there shall not be taken into account any net operating loss deduction carried back from a subsequent taxable year. Under the proposal, an overall domestic loss would not include any loss for any taxable year unless the taxpayer elected the use of the foreign tax credit for that taxable year.

Any U.S. source income that would be resourced under the proposal would be allocated among and would increase the various foreign tax credit separate limitation categories in the same proportion that those categories were reduced by the domestic losses responsible for the resourcing.

It is anticipated that situations could arise where a taxpayer would generate an overall domestic loss in a year following a year in which it had an overall foreign loss, or vice versa. In such a case, it would be necessary for ordering and other coordination rules to be developed for purposes of computing the foreign tax credit limitation in subsequent taxable years. The proposal would grant the Secretary of Treasury authority to prescribe such regulations as may be necessary to coordinate the operation of the overall foreign loss recapture rules with the operation of the overall domestic loss recharacterization rules that would be added by the proposal.

Effective Date

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

Legislative Background

The proposal is included in H.R. 1690, which was introduced by Mr. Levin and Mr. Houghton on May 24, 1995. A similar proposal was included in H.R. 5270 (102nd Cong.).

5. Election to use earnings and profits basis for allocation of interest expense for foreign tax credit limitation purposes

Present Law

The foreign tax credit is intended to reduce a taxpayer's U.S. tax only on foreign source income and not on U.S. source income. The overall limitation on the foreign tax credit is designed to prevent taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. For purposes of applying these foreign tax credit provisions, taxpayers must determine their income from foreign sources. Accordingly, taxpayers must allocate and apportion expenses between foreign source income and U.S. source income.

In the case of interest expense, all allocations and apportionments must be made on the basis of the taxpayer's assets and cannot be made on the basis of the taxpayer's gross income. Detailed rules regarding the allocation and apportionment of interest expense are provided in Treasury regulations. Such regulations provide that a taxpayer may elect to make allocations and apportionments of interest expense based on either the tax book value or the fair market value of its assets. Treasury regulations also provide that taxpayers may in certain circumstances apportion other deductions on the basis of assets, using for this purpose either tax book value or fair market value.

Description of Proposal

The proposal would permit taxpayers allocating and apportioning expenses on the basis of assets to make such allocations and apportionments on the basis of the adjusted bases of their assets. For this purpose, the adjusted bases would be determined by applying the rules and principles of subsections (k) and (n) of section 312 (relating to the effect on earnings and profits of depreciation and certain other adjustments to more accurately reflect income).

Effective Date

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

Legislative Background

The proposal is included in H.R. 1690, which was introduced by Mr. Levin and Mr. Houghton on May 24, 1995.

6. Extension and modification of special allocation of research and experimental expenditures to U.S. source income for foreign tax credit limitation purposes

Present Law

The foreign tax credit is intended to reduce a taxpayer's U.S. tax only on foreign source income and not on U.S. source income. The overall limitation on the foreign tax credit is designed to prevent taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. For purposes of applying these foreign tax credit provisions, taxpayers must determine their income from foreign sources. Accordingly, taxpayers must allocate and apportion expenses between foreign source income and U.S. source income.

A statutory special rule for the allocation of research and experimental expenditures between U.S. and foreign source income encourages taxpayers to conduct research and experimental activities in the United States. This temporary rule has generally expired. Under this rule, 50 percent of the taxpayer's research and experimental expenditures attributable to activities conducted within the United States was allocated and apportioned to U.S. source income. Similarly, 50 percent of the taxpayer's research and experimental expenditures attributable to activities conducted outside the United States was allocated and apportioned to foreign source income. The remainder of the taxpayer's research and experimental expenditures was apportioned on the basis of gross sales or gross income, at the taxpayer's election. This special rule has been modified and extended several times, but generally is not applicable for taxable years beginning after August 1, 1994.

Description of Proposal

The proposal would make the special place-of-performance allocation rule for research and experimental expenditures permanent.

The proposal would also increase the percentage of a taxpayer's research and experimental expenditures that is allocated under the special place-of-performance rule. Under the proposal, 64 percent of the taxpayer's research and experimental expenditures attributable to activities conducted within the United States would be allocated and apportioned to U.S. source income and 64 percent of the taxpayer's research and experimental expenditures attributable to activities conducted outside the United States would be allocated and apportioned to foreign source income.

An alternative proposal would allow a taxpayer to elect not to be subject to the place-of-performance rule with respect to the taxpayer's research and experimental expenditures attributable to activities conducted outside the United States, provided that the taxpayer waives the application of the place-of-performance rule with respect to the taxpayer's research and experimental expenditures attributable to activities conducted within the United States.

Effective Date

The proposal (and the alternative proposal) would be effective for taxable years beginning after the last taxable year to which the

special allocation rule for research and experimental provisions would have applied but for the proposal.

Legislative Background

The proposal (other than the alternative proposal) is included in H.R. 1690, which was introduced by Mr. Levin and Mr. Houghton on May 24, 1995.

7. Repeal foreign tax credit basket for "10/50" noncontrolled corporations

Present Law

Under present law, dividends received from *each* "noncontrolled foreign corporation" will be placed in a foreign tax credit basket. Taxpayers are allowed to use foreign taxes (i.e., both withholding taxes and deemed paid taxes) associated with the dividends to offset only the U.S. tax on those dividends and, therefore, are precluded from using such foreign taxes to offset U.S. tax on other foreign source income. A foreign corporation qualifies as a noncontrolled foreign corporation if it is not a controlled foreign corporation with respect to the shareholder and the ownership requirements of section 902(a) and/or (b) are satisfied.

Description of Proposal

The proposal contains two provisions. Under the first provision, a U.S. shareholder would be allowed to look through to the underlying character of the earnings and profits of the noncontrolled foreign corporation in determining the foreign tax credit basket in which a dividend and the associated foreign taxes from such a corporation would be placed if the information to make the determination is available. If the information is not available, then the second provision would provide that the dividend and the associated foreign taxes with respect to a noncontrolled foreign corporation would be placed in a basket for dividends from *all* noncontrolled foreign corporations.

Effective Date

The proposal would apply to taxable years of foreign corporations ending after December 31, 1995, and to taxable years of U.S. shareholders in which or with which such taxable years of such foreign corporation end.

Legislative Background

The proposal is included in H.R. 1690, which was introduced by Mr. Levin and Mr. Houghton on May 24, 1995. A similar proposal was included in H.R. 1409 (103rd Cong.).

8. Extension of period to which excess foreign tax credit may be carried

Present Law

The foreign tax credit is subject to an overall limitation. That is, the total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income bears to the taxpayer's worldwide taxable income for the taxable year. In addition, the foreign tax credit limitation is calculated separately for various categories of income, generally referred to as "separate limitation categories." The total amount of the credit for foreign taxes on income in each separate limitation category may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income in that category bears to its worldwide taxable income.

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back to the two immediately preceding taxable years and carried forward to the first five succeeding taxable years and credited (not deducted) to the extent that the taxpayer otherwise has excess foreign tax credit limitation for those years. For purposes of determining excess foreign tax credit amounts, the foreign tax credit separate limitation rules apply. Thus, if a taxpayer has excess foreign tax credits in one separate limitation category for a taxable year, those excess credits are carried back and forward only as taxes allocable to that category notwithstanding the fact that the taxpayer may have excess foreign tax credit limitation in another category for that year.

Description of Proposal

The proposal would extend the excess foreign tax credit carryforward period from 5 to 15 years.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995. It would apply only with respect to taxes actually paid or accrued (or deemed paid) by the taxpayer in such taxable years. The present-law carryforward period continues to apply with respect to taxes actually paid or accrued (or deemed paid) by the taxpayer in taxable years beginning on or before December 31, 1995.

Legislative Background

The proposal is included in H.R. 1690, which was introduced by Mr. Levin and Mr. Houghton on May 24, 1995.

9. Expansion of de minimis exception to Subpart F income treatment

Present Law

Under the rules of subpart F (secs. 951–964), the United States shareholders (as defined in sec. 951(b)) of a controlled foreign cor-

poration (CFC) are required to include in income currently for U.S. tax purposes certain types of income of the CFC, whether or not such income is actually distributed currently to the shareholders. The types of income subject to this current inclusion rule (generally referred to as "subpart F income") include foreign base company income and certain qualifying insurance income. Under a de minimis rule, if the gross amount of such income for a taxable year is less than the lesser of five percent of the CFC's gross income or $1,000,000, then no part of the CFC's gross income is treated as foreign base company income or qualifying insurance income.

Description of Proposal

The proposal would expand the de minimis exception from subpart F income treatment to 10 percent of gross income. Accordingly, under the proposal, if the gross amount of a CFC's foreign base company income and qualifying insurance income for the taxable year is less than 10 percent of the CFC's gross income, then no part of the CFC's gross income would be treated as foreign base company income or qualifying insurance income subject to current inclusion by the United States shareholders of the CFC.

Effective Date

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

Legislative Background

The proposal is included in H.R. 1690, which was introduced by Mr. Levin and Mr. Houghton on May 24, 1995.

10. Treatment of foreign base company sales and services income of controlled foreign corporations in the European Union

Present Law

Under the rules of subpart F (secs. 951–964), the United States shareholders (as defined in sec. 951(b)) of a controlled foreign corporation (CFC) are required to include in income currently for U.S. tax purposes certain types of income of the CFC, whether or not such income is actually distributed currently to the shareholders. The types of income subject to this current inclusion rule (generally referred to as "subpart F income") include, among other things, foreign base company sales income and foreign base company services income. Foreign base company sales income consists of income of the CFC that is attributable to related-party purchases or sales of goods, if the country in which the CFC is created or organized is neither the origin nor the destination of such goods. Foreign base company services income consists of income of the CFC that is attributable to services performed for or on behalf of a related party, if such services are performed outside the country in which the CFC is created or organized.

Description of Proposal

The proposal would treat the countries included in the European Union as a single country for purposes of applying the subpart F rules regarding foreign base company sales income and foreign base company services income to a CFC that is created or organized in a country in the European Union.

Effective Date

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

Legislative Background

The proposal is included in H.R. 1690, which was introduced by Mr. Levin and Mr. Houghton on May 24, 1995. A similar proposal was contained in H.R. 1401 (103rd Cong.), which was included in the hearing on miscellaneous tax proposals held by the Subcommittee on Select Revenue Measures of the Committee on Ways and Means in June 1993.

11. Exclusion of foreign base company shipping income from Subpart F income for certain controlled foreign corporations

Present Law

Under the rules of subpart F (secs. 951–964), the United States shareholders of a controlled foreign corporation (CFC) are required to include in income currently for U.S. tax purposes certain types of income of the CFC, whether or not such income is actually distributed currently to the shareholders. The type of income subject to this current inclusion rule (generally referred to as "subpart F income") includes, among other things, foreign base company shipping income. Foreign base company shipping income consists of income derived from the use of any aircraft or vessel in foreign commerce, the performance of services directly related to the use of any such aircraft or vessel, or the disposition of any such aircraft or vessel.

Description of Proposal

The proposal would allow a CFC that meets certain eligibility requirements to exclude foreign base company shipping income from subpart F income. The exclusion would apply to a CFC that is part of a controlled group of corporations which (1) operates at least four U.S.-flag ships of at least 10,000 deadweight tons or derives at least 90 percent of its income from operations in the Caribbean and (2) is not principally engaged in the business of exploring for, or extracting, refining, or marketing, petroleum or related products or byproducts.

Effective Date

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

12. Exempt controlled foreign corporations from uniform capitalization rules

Present Law

In general

For purposes of computing a taxpayer's taxable income and earnings and profits, certain costs reduce net income as they are incurred (e.g., ordinary and necessary business expenses); other costs reduce net income only to the extent that the income-producing assets with which those costs are associated generate income. Generally accepted accounting principles ("GAAP") guide businesses in determining which costs to expense and which costs to capitalize into the basis of property (or include in inventory) in preparing financial statements. Pursuant to the Code, Treasury Regulations prescribe a different set of rules for this purpose (the "uniform capitalization rules") which tend to allow less costs to be expensed, and require more costs—including both direct and indirect costs allocable to property—to be capitalized or included in inventories, than do GAAP (sec. 263A(a)). In general, the uniform capitalization rules apply to property produced by a taxpayer or acquired by a taxpayer for resale. Property produced for a taxpayer under contract with the taxpayer is treated as being produced by the taxpayer.

In the case of interest expense, the uniform capitalization rules apply only to interest paid or incurred during the property's production period[71] and that is allocable to property produced by the taxpayer or acquired for resale which (1) is either real property or property with a class life of at least 20 years, (2) has an estimated production period exceeding 2 years, or (3) has an estimated production period exceeding 1 year and a cost exceeding $1,000,000 (sec. 263A(f)).

Application to foreign persons

In general

The uniform capitalization rules apply to foreign persons, whether or not engaged in business in the United States. In the case of a foreign corporation carrying on a U.S. trade or business, for example, the uniform capitalization rules apply for purposes of computing the corporation's U.S. effectively connected taxable income, as well as computing its effectively connected earnings and profits for purposes of the branch profits tax.

When a foreign corporation is not engaged in business in the United States, its taxable income and earnings and profits may nonetheless be relevant under the Code. For example, the subpart F income of a controlled foreign corporation is currently includible on the return of a U.S. shareholder of the controlled foreign corporation. And whether or not a foreign corporation is U.S.-controlled, its accumulated earnings and profits must be computed in order to determine the indirect foreign tax credit carried by dis-

[71] The production period with respect to a property is the period beginning on the date on which production of the property begins and ending on the date on which the property is ready to be placed in service or to be held for sale.

tributions from the foreign corporation to any domestic corporation that owns at least 10 percent of its voting stock.

The Code provides that the earnings and profits or deficit in earnings and profits of any foreign corporation, for any taxable year, shall be determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary of Treasury (sec. 964(a)). The regulations under section 964 do not provide for any exception to the application of the uniform capitalization rules in the case of foreign corporations. Moreover, the preamble to the temporary regulations under the uniform capitalization rules included the following statement:

> The provisions of section 263A (including the effective dates thereof) are applicable to all persons engaging in the production of property, or the acquisition of property for resale, including, for example, certain foreign persons which may be organized and operated exclusively outside the United States.[72]

Thus, foreign persons generally are required to capitalize costs in accordance with the uniform capitalization rules.

U.S. ratio election

In 1988, the IRS issued Notice 88–104[73] to inform taxpayers of forthcoming guidance designed to provide an elective simplified method of accounting for the costs required to be capitalized in connection with foreign businesses of foreign or U.S. persons under the uniform capitalization rules. The notice stated that the guidance will provide a simplified "U.S. ratio" method of accounting for costs other than interest that are required to be capitalized.

To apply the U.S. ratio method, there must be a U.S. trade or business carried on by the person carrying on the foreign business, or by a related party. The U.S. business so carried on that is the same or most similar to the foreign business must distinguish between costs capitalized in the basis of its relevant property before application of the uniform capitalization rules, and costs capitalized only as a result of those rules, and compute the ratio of the latter to the former ("the U.S. ratio"). The foreign business multiplies this U.S. ratio by the amount of its costs capitalized (without regard to the uniform capitalization rules) in the basis of its relevant property. The product of this multiplication yields the amount of additional costs (other than interest) required to be capitalized by a foreign person under the uniform capitalization rules.[74]

All expenses that the foreign person otherwise treats as deductible are decreased ratably, to equal the amount of the increase in costs capitalized under the U.S. ratio method for the taxable year. The appropriate ratio is applied to the costs of property produced or property acquired for resale incurred by the foreign person for each taxable year. A separate ratio is required to be computed for each taxable year for properties related to each separate trade or business.

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[72] 52 Fed. Reg. 10059 (March 30, 1987).

[73] 1988–2 C.B. 443.

[74] "Additional section 263A costs" as defined in Temp. Treas. Reg. sec. 1.263A–1T(b)(5)(iii).

An election to use the U.S. ratio method was originally limited by Notice 88-104 to taxable years beginning before January 1, 1988. However, the IRS subsequently extended the provisions of that Notice to taxable years beginning after 1987 and acknowledged that those provisions would remain in effect until further guidance under the uniform capitalization rules is issued.[75] The IRS further provided in Notice 89-67 that if a taxpayer failed to elect the use of the U.S. ratio method for its first taxable year for which the uniform capitalization rules applied, it could so elect (1) on an amended tax return for such first taxable year, or (2) on its tax return for the second taxable year for which the uniform capitalization rules were effective, if and only if the method used by the taxpayer for the prior taxable year was a correct method of accounting under the uniform capitalization guidelines. In addition, the Notice provided that it is anticipated that forthcoming regulations will permit a taxpayer to elect the U.S. ratio method regardless of whether it had made the election for previous taxable years.

Capitalization of interest expense

The IRS has also provided advance guidance on the application of the interest capitalization rules of section 263A(f).[76] Under the interest capitalization rules, taxpayers must first capitalize debt which is *directly attributable* to the production expenditures of a property specified in section 263A(f)(1)(B) (i.e., "traced debt"). Debt generally is allocated to a particular expenditure by tracing disbursements of the debt proceeds to that expenditure. Traced debt includes only amounts of the taxpayer's eligible debt that do not exceed the property's accumulated production expenditures.

After determining the amount of traced debt directly attributable to the property's production expenditures, taxpayers then must assign any other eligible debt to any remaining production expenditures and interest on such debt must be capitalized, to the extent that the taxpayer's interest costs could have been reduced if such production expenditures had not been incurred (i.e., "avoided cost debt").[77] The determination of whether the taxpayer's interest costs could have been reduced if such production expenditures had not been incurred is made by assuming that the amounts expended for production had instead been used to repay the taxpayer's debt, thus reducing the principal balance of such debt and the interest costs thereon. The operation of the avoided cost concept does not depend on whether, in fact, the taxpayer actually would have used the amounts otherwise expended for production to repay debt.

Capitalization of the interest of parties related to producers of property

The interest costs of parties (including foreign corporations) related to the taxpayer producing qualified property can also be subjected to capitalization requirements (and avoided cost rules).[78] In

[75] Notice 89-67, 1989-1 C.B. 723.
[76] Notice 88-99, 1988-2 C.B. 422.
[77] Notice 88-99 allows taxpayers to elect to forego the debt tracing step by treating all of its debt that would be traced debt as avoided cost debt.
[78] For taxable years of the producing taxpayer beginning on or after January 1, 1988, a person is considered related to the producing taxpayer if such person and the taxpayer are members

Continued

the case of related parties to which the avoided cost rules apply, a deferred asset method generally is used to comply with the interest capitalization requirements. Under this method, the related party is required to capitalize interest equal to an amount that the producing taxpayer would have capitalized, using the avoided cost principles, had the producing taxpayer itself incurred the interest on the eligible debt of the related party.[79]

Under the deferred asset method, the related party accounts for capitalized interest as an asset in the same manner (and at the same time) as the producing taxpayer would have accounted for such interest had the interest been capitalized into the basis of the qualified property on the taxpayer's books and records. The interest capitalized by the related party is then recovered at the same time and in the same manner as it would have been recovered had it been capitalized into the basis of the property produced by the taxpayer.[80]

A producing taxpayer may elect to use a substitute cost method instead of subjecting the related party to the deferred asset method. Under the substitute cost method, the producing taxpayer capitalizes, during each year of the production period, certain "substitute" costs in lieu of the taxpayer's related parties being required to capitalize interest on their related party avoided cost debt.

For taxable years of producing taxpayers beginning on or after January 1, 1988, if interest incurred by related parties becomes subject to the interest capitalization rules, the following ordering rules apply in determining which related party's interest is first capitalized, and in determining the production expenditures of which producing taxpayer are first subject to the deferred asset method: (1) with respect to producing taxpayers organized outside of the United States, interest incurred by every related party organized outside the United States must be capitalized before the interest of any other related party is capitalized; (2) with respect to producing taxpayers organized within the United States, interest incurred by every related party organized within the United States must be capitalized before the interest of any other related party is capitalized.

Explanation of Provision

The proposal would provide that the uniform capitalization rules shall apply to any taxpayer who is not a U.S. person only to the

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of the same parent-subsidiary controlled group of corporations as defined in section 1563(a)(1) regardless of whether such persons would be treated as component members of such group under section 1563(b). For this purpose, the constructive ownership rules of section 1563(e) apply. *See* Notice 88-99. Thus, a foreign corporation may be treated as a member of a controlled group, even though it is not a member of the consolidated group, and thus may be subject to the interest capitalization and avoided cost rules.

[79] The interest incurred by related parties is subject to these rules only if the producing taxpayer's accumulated production expenditures exceed the total amount of its traced and avoided cost debt, and only if interest on the eligible debt of related parties has not already been allocated by the related party with respect to *its own* production expenditures of qualified property for the taxable year.

[80] In the event that the related party leaves the controlled group, the producing taxpayer increases its basis in the qualified property by the amount remaining in the deferred asset account of the related party that corresponds to the particular qualified property. The former related party is not permitted to continue to amortize, deduct, or take into account the capitalized interest.

extent necessary for purposes of determining the amount of tax imposed on U.S. effectively connected income.

Effective Date

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

Legislative Background

The proposal is included in H.R. 1690, which was introduced by Mr. Levin and Mr. Houghton on May 24, 1995. The proposal also was included in H.R. 5270 (102nd Cong.).

13. Reporting of foreign corporation earnings and profits on a U.S. GAAP basis

Present Law

The concept of earnings and profits ("E&P") is relevant for foreign corporations for numerous reasons. For example, a distribution from a foreign corporation constitutes a dividend only if it is paid out of the distributee's current or accumulated E&P. Such a dividend may carry deemed paid foreign tax credits to a U.S. shareholder of the distributee if the requirements of section 902 are satisfied. As another illustration, the amount of current E&P of a controlled foreign corporation (as defined in sec. 957) is the upper limit for the amount of the corporation's subpart F income for the year. A foreign corporation is generally required to compute its E&P using U.S. tax accounting principles (sec. 964).

Description of Proposal

The proposal would require controlled foreign corporations to compute their E&P using U.S. generally accepted accounting principles ("GAAP") for purposes of computing their subpart F income.

Effective Date

The proposal would be effective for distributions by a controlled foreign corporation for taxable years of the controlled foreign corporation beginning after December 31, 1995 and for the determination of any section 951 inclusions (i.e., subpart F inclusions, sec. 956 inclusions and sec. 956A inclusions) with respect to a controlled foreign corporation for taxable years of the controlled foreign corporation beginning after December 31, 1995.

Legislative Backgound

The proposal is included in H.R. 1690, which was introduced by Mr. Levin and Mr. Houghton on May 24, 1995.

14. Permit shareholder of a "10/50" corporation to elect to treat it as a CFC for foreign tax credit and Subpart F purposes

Present Law

For purposes of determining a taxpayer's foreign tax credit, a foreign tax credit limitation is computed separately for certain specified categories of income. As a general rule, dividends from foreign corporations may be subject to three different sets of rules, depending on the ownership of the corporation paying the dividend. If the corporation that pays the dividend is a controlled foreign corporation of which the recipient is a "U.S. shareholder" (as that term is defined below), then the dividend generally is treated as a "look-through" payment for purposes of determining in which foreign tax credit separate limitation category the dividend is to be classified (sec. 904(d)(3)). In the case of a foreign corporation the dividends from which do not qualify for look-through treatment, but with respect to which the shareholder is permitted to claim an indirect foreign tax credit (generally referred to as a "noncontrolled section 902 corporation"), the shareholder is required to compute a separate foreign tax credit limitation with respect to dividends from *each* such corporation (sec. 904(d)(1)(E)). Thus, if a taxpayer owns stock in 10 different noncontrolled section 902 corporations, current law requires 10 separate foreign tax credit limitations. Dividends received from foreign corporations other than those specified above generally are classified as passive income, subject to recharacterization as general limitation income if the dividends are subject to high rates of foreign tax (sec. 904(d)(2)(A)).

A controlled foreign corporation generally is defined as a foreign corporation more than 50 percent of the total voting power or value of which is owned directly or indirectly by U.S. shareholders (sec. 957(a)). For this purpose, a U.S. shareholder generally is a U.S. person who owns directly, indirectly, or constructively 10 percent or more of the total combined voting power of all classes of the corporation's voting stock. A U.S. shareholder of a controlled foreign corporation generally is required to include in gross income its pro rata share of the corporation's subpart F income.[81]

Explanation of Provision

The proposal would permit a domestic corporation that normally treats a foreign company as a noncontrolled section 902 corporation to elect to treat that company as a controlled foreign corporation (of which the electing domestic corporation is a U.S. shareholder) for foreign tax credit limitation and subpart F purposes. Thus, for example, where such an election is exercised, dividends received from the foreign corporation are entitled to look-through treatment under the foreign tax credit rules, gain on the sale of the stock of the foreign corporation is subject to recharacterization as a dividend under section 1248, and income earned by the foreign corporation is subject to inclusion by the domestic corporation under

[81] Subpart F income includes, for example, insurance income, foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil related income.

the rules of subpart F (secs. 951–964). The election would be made at the U.S. shareholder level, and once made generally may not be revoked. In order to make the election, a U.S. corporation would be required to treat as controlled foreign corporations all foreign corporations that would, absent the election, be noncontrolled section 902 corporations with respect to it.

A taxpayer may make the election for any taxable year beginning after December 31, 1995. Unless revoked with the consent of the Secretary, an election applies to the taxable year for which made and all subsequent years of the electing taxpayer, and to all taxable years of its noncontrolled section 902 corporations that end with or within any such taxable year of the taxpayer. The election may be made for any taxable year at any time on or before the due date, including extensions, for filing the electing corporation's income tax return for that year.

Effective Date

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

Legislative Background

The proposal is included in H.R. 1690, which was introduced by Mr. Levin and Mr. Houghton on May 24, 1995. The proposal also was included in H.R. 5270 (102nd Cong.).

15. Increase in reporting threshold for stock ownership of a foreign corporation

Present Law

U.S. persons who own or acquire 5 percent or more of the value of the stock of a foreign corporation, others who become U.S. persons while owning that percentage of the stock of a foreign corporation, and U.S. citizens and residents who are officers or directors of foreign corporations with such U.S. ownership are required to file information returns concerning the corporation and its shareholders (sec. 6046; see schedule O (Form 5471)). Regulations excuse any shareholder from furnishing required information if it is furnished by another person having an equal or greater stock interest in the corporation (Treas. Reg. sec. 1.6046–1(e)(5)).

Description of Proposal

The proposal would increase the 5-percent reporting threshold for stock ownerhsip of a foreign corporation to 10-percent.

Effective Date

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

Legislative Background

The proposal is included in H.R. 1690, which was introduced by Mr. Levin and Mr. Houghton on May 24, 1995.

16. Modification of excess passive assets provision for corporations with active financing income

Present Law

Under section 956A, the United States shareholders of a controlled foreign corporation (CFC) are required to include in income currently for U.S. tax purposes an amount with respect to the CFC's earnings invested in excess passive assets. A CFC has excess passive assets if its passive assets exceed 25 percent of its total assets. A passive asset is any asset that produces, or is held for the production of, passive income. For this purpose, income derived in the active conduct of a banking business does not constitute passive income. No similar exception applies to income of finance companies.

Description of Proposal

The proposal would provide a special rule for computing both the passive assets and the total assets of a corporation that earns active financing income. Under the proposal, for purposes of section 956A, such a corporation's assets, both passive and active, would be reduced proportionately by the amount of the interest-bearing debt of the corporation owed to unrelated parties.

Effective Date

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

17. Exception from foreign personal holding company income and foreign base company services income for active financing income

Present Law

Under the rules of subpart F (secs. 951–964), the United States shareholders (as defined in sec. 951(b)) of a controlled foreign corporation (CFC) are required to include in income currently for U.S. tax purposes certain types of income of the CFC, whether or not such income is actually distributed currently to the shareholders. The types of income subject to this current inclusion rule (generally referred to as "subpart F income") include, among other things, foreign base company services income and foreign personal holding company income. Foreign base company services income consists of income of the CFC that is attributable to services performed for or on behalf of a related party, if such services are performed outside the country in which the CFC is created or organized. Foreign personal holding company income generally consists of passive income within the following categories: dividends, interest, royalties, rents, and annuities; net gains from sales or exchanges of property that gives rise to the foregoing types of income, that does not give rise to income, or that is a trust, partnership or REMIC interest; net gains from commodities transactions; net gains from foreign currency transactions; and income that is equivalent to interest. A variety of exceptions from foreign personal holding company are provided for income earned by the CFC in connection with an active

business. For example, certain export financing interest derived in the conduct of a banking business is not foreign personal holding company income.

Under section 1296, a foreign corporation is a passive foreign investment company (PFIC) if the corporation satisfies either a passive income test or a passive assets test. For this purpose, passive income is defined by reference to foreign personal holding company income under subpart F.

Description of Proposal

The proposal would provide an exception from foreign personal holding company income for certain active financing income. The exception from foreign personal holding company income would extend only to income derived from sources within the country in which the CFC is created or organized and would cover (1) income derived in the active conduct of a banking, financing or similar business by a CFC that is predominantly engaged in such active conduct and (2) dividends, interest, and gains from the sale or exchange of stock or securities derived from certain investments made by a CFC that is a qualifying insurance company. For this purpose, a qualifying insurance company would be an insurance company that is regulated as an insurance company in its country of incorporation and that realizes at least 50 percent of its gross income (other than investment income) from premiums with respect to risks situated within its country of incorporation.

The proposal would also provide an exception from foreign base company services income for income derived by a CFC in the active conduct of a banking, financing or similar business, if the CFC is predominantly engaged in such conduct and the income is from sources within the country in which the CFC is created or organized.

Effective Date

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

Legislative Background

The proposal is included in H.R. 1690, which was introduced by Mr. Levin and Mr. Houghton on May 24, 1995.

18. Repeal of excess passive assets provision and modification of passive foreign investment company provisions

Present Law

Under the rules of subpart F (secs. 951–964), the United States shareholders (as defined in sec. 951(b)) of a controlled foreign corporation (CFC) are required to include in income currently for U.S. tax purposes certain earnings of the CFC, whether or not such earnings are actually distributed currently to the shareholders. This current inclusion rule applies to certain passive income earned by the CFC (generally referred to as "subpart F income"). In addition, under section 956A, a United States shareholder of a CFC is required to include in income currently an amount with re-

spect to the CFC's earnings invested in excess passive assets. A CFC has excess passive assets if its passive assets exceed 25 percent of its total assets. For purposes of the subpart F rules, a United States shareholder is a U.S. person that owns 10 percent or more of the total combined voting power of the CFC's stock.

Under section 1296, a foreign corporation is a passive foreign investment company (PFIC) if the corporation satisfies either a passive income test or a passive assets test. Under the income test, a foreign corporation is a PFIC if 75 percent or more of its income is passive income. Under the asset test, a foreign corporation is a PFIC if 50 percent or more of its assets produce passive income or are held for the production of passive income. The asset test is generally applied based on the value of the corporation's assets; however, in the case of a CFC (or any other corporation that so elects), the asset test is applied based on the adjusted bases of the corporation's assets and not their value.

A U.S. person owning stock in a PFIC is subject to an interest charge with respect to distributions from the PFIC and gains on dispositions of the stock of the PFIC, unless the shareholder elects to include in income currently for U.S. tax purposes the income of the PFIC. These rules apply without regard to the percentage of the PFIC's stock that is owned by the U.S. person. Moreover, these rules apply to all the income of the PFIC without regard to the character of the income.

A corporation that is a CFC will also be a PFIC if it satisfies the passive income or passive assets test. Therefore, a United States shareholder of a CFC that is also a PFIC is subject to both the subpart F rules and the PFIC provisions; in such cases, ordering rules apply to prevent the same income from being includible by the shareholder under both regimes. A U.S. person who holds stock in a CFC but is not a United States shareholder of the CFC is subject to the PFIC provisions.

Description of Proposal

The proposal would repeal the excess passive assets provision of section 956A.

In addition, the proposal would modify the PFIC provisions. As one alternative, the proposal would provide an exclusion from the PFIC provisions for any CFC. As a second alternative, the proposal would eliminate the requirement that, for a CFC, the asset test for PFIC status must be applied based on the adjusted bases of its assets; the proposal would provide that, for any foreign corporation including a CFC, the asset test would be applied based on the value of the corporation's assets unless the corporation elected to use adjusted bases instead of value. As a third alternative, the proposal would eliminate the asset test for PFIC status and would reduce the gross income test from 75 percent to 50 percent; under this alternative, a foreign corporation would be a PFIC if 50 percent or more of its gross income is passive income.

Effective Date

The proposal would be effective for taxable years beginning after September 30, 1995.

19. Exemption of United States shareholders of controlled foreign corporations from passive foreign investment company provisions

Present Law

Under the rules of subpart F (secs. 951–964), the United States shareholders (as defined in sec. 951(b)) of a controlled foreign corporation (CFC) are required to include in income currently for U.S. tax purposes certain types of income of the CFC, whether or not such income is actually distributed currently to the shareholders. The types of income subject to this current inclusion rule (generally referred to as "subpart F income") include foreign base company income and certain qualifying insurance income. Other types of income earned by a CFC are not subject to current inclusion by the CFC's United States shareholders. For purposes of the subpart F rules, a United States shareholder is a U.S. person that owns 10 percent or more of the total combined voting power of the CFC's stock.

Under section 1296, a foreign corporation is a passive foreign investment company (PFIC) if the corporation satisfies either a passive income test or a passive assets test. A U.S. person owning stock in a PFIC is subject to an interest charge with respect to distributions received from the PFIC, unless the shareholder elects to include in income currently for U.S. tax purposes the income of the PFIC. These rules apply without regard to the percentage of the PFIC's stock that is owned by the U.S. person. Moreover, these rules apply to all the income of the PFIC without regard to the character of the income.

A corporation that is a CFC will also be a PFIC if it satisfies the passive income or passive assets test. Therefore, United States shareholders of a CFC that is also a PFIC are subject to both the subpart F rules and the PFIC provisions; in such cases, ordering rules apply to prevent the same income from being includible by the shareholders under both regimes.

Description of Proposal

The proposal would provide an exemption from the PFIC provisions for a taxpayer's interest in a foreign corporation if the corporation is a CFC and the taxpayer is a United States shareholder of the CFC.

Effective Date

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

Legislative Background

The proposal is included in H.R. 1690, which was introduced by Mr. Levin and Mr. Houghton on May 24, 1995.

20. Valuation of assets of a controlled foreign corporation under the passive foreign investment company and excess passive assets provisions

Present Law

Under section 1296, a foreign corporation is a passive foreign investment company (PFIC) if the corporation satisfies either an income test or an asset test. The asset test is generally applied based on the value of the corporation's assets. However, in the case of a corporation that is a controlled foreign corporation (CFC), within the meaning of section 957, the asset test is applied based on the adjusted bases (as determined for purposes of computing earnings and profits) of its assets rather than their value. A corporation that is not a CFC may elect to apply the asset test based on the adjusted bases of its assets.

Under the rules of subpart F (secs. 951–964), a United States shareholder (as defined in sec. 951(b)) of a CFC is required to include in income currently for U.S. tax purposes an amount with respect to the CFC's earnings invested in excess passive assets. The amount, if any, of a CFC's excess passive assets is determined based on the adjusted bases of the corporation's assets.

Description of Proposal

The proposal would modify the rules relating to both the asset test under the PFIC provisions and the excess passive assets determination under subpart F. Under the proposal, the rules requiring that these asset determinations be made based on the adjusted bases of a corporation's assets would not apply to any CFC the stock of which is publicly traded. In the case of a CFC the stock of which is publicly traded, the determination of the corporation's assets would be made based on the market value of the corporation's stock.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1994.

21. Exempt certain income derived by insurance brokers or agents from PFIC rules

Present Law

U.S. citizens and residents and U.S. corporations (collectively, "U.S. persons") generally are taxed currently by the United States on their worldwide income. Income earned by a foreign corporation, the stock of which is owned in whole or in part by U.S. persons, generally is not taxed by the United States until the foreign corporation repatriates those earnings by payment to its U.S. stockholders.

Under the subpart F rules (secs. 951–964), a controlled foreign corporation (CFC) is defined generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock, taking into account only so-called "U.S. shareholders": namely, those U.S. persons that own (directly, indirectly or by attribution)

at least 10 percent of its voting stock. A "U.S. shareholder" may be taxed by the United States on certain earnings of the CFC that have not been distributed by the foreign corporation to the U.S. shareholder. For example, under section 956A, a United States shareholder of a CFC is required to include in income currently an amount with respect to the CFC's earnings invested in excess passive assets. A CFC has excess passive assets if its passive assets exceed 25 percent of its total assets.

Separately, if any foreign corporation (including a controlled foreign corporation) is a "passive foreign investment company" (PFIC), U.S. persons (including 10-percent "U.S. shareholders") that own any stock in the PFIC may be subject to one of two other sets of operating rules that eliminate or reduce the benefits of deferral. A PFIC generally is defined as any foreign corporation if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of its assets consist of passive assets, defined as assets that produce, or are held for the production of, passive income.

A U.S. person owning PFIC stock may elect to include currently in gross income its share of the PFIC's total earnings. A nonelecting U.S. person owning PFIC stock pays no current tax on the PFIC's undistributed income. However, when realizing income earned through ownership of PFIC stock (such as certain dividends distributed by the PFIC or capital gains from selling PFIC stock), the nonelecting U.S. person may pay an additional interest charge.

Description of Proposal

The proposal would exclude, for CFCs that are insurance brokers or agents, certain investment income from the definition of passive income under the PFIC rules and subpart F excess passive assets rules. Thus, income earned on fiduciary funds held by a CFC insurance broker or agent would be so excluded. Furthermore, such funds would have a tax basis equal to their original purchase price under the proposal.

Effective date

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

Legislative Background

The proposal is the same as H.R. 4626 (103rd Cong.).

22. Prizes and awards received from a foreign payor by a nonresident alien relating to competitions held in the United States are not treated as U.S. source income

Present Law

There are no specific statutory or regulatory provisions with respect to the source of income from prizes and awards. In Rev. Rul. 89–67, 1989–1 CB 233, the IRS concluded that if the income from a fellowship, scholarship, prize or award is includible in an individual's gross income and such individual is not required to perform services for the payor, the income is sourced according to the

payor's residence. Proposed regulations have been issued adopting the situs-of-the-payor rule of Rev. Rul. 89–67 for scholarships and fellowships.

Description of Proposal

The proposal would codify the rules adopted by Rev. Rul. 89–67 and clarify that prizes and awards received by a nonresident alien from a foreign payor for competition held outside the United States would be treated as foreign source income, notwithstanding the fact that the winners from such a competition would be eligible to further compete in a related contest held within the United States.

Effective Date

The proposal would be effective for prizes and awards received on or after the enactment date.

23. Exempt service income of a nonresident alien earned on international ships or aircraft from U.S. tax

Present Law

Nonresident aliens are generally subject to U.S. taxation and withholding on their U.S. source income. Compensation for labor and personal services performed within the United States are considered U.S. source unless such income qualifies for a de minimis exception. To qualify for the exception, the compensation paid to a nonresident alien must not exceed $3,000 and must reflect services performed on behalf of a foreign employer while the employee is present in the United States for not more than 90 days during the year. Special rules apply to exclude certain items from the gross income of a nonresident alien. Two of the exclusions relate to gross income derived by a nonresident alien from the international operation of ships or aircraft if the country in which such individual is resident provides a reciprocal exemption for U.S. residents. However, no similar exclusion is available for personal services performed by an individual crew member on board a ship or aircraft. Consequently, wages earned by nonresident individual crew members of a foreign ship or aircraft exceeding $3,000 in a taxable year that are earned while the vessel is within the U.S. territories are subject to income taxation by the United States.

In general, a non–U.S. citizen is considered a resident of the United States if the individual (1) has entered the United States as a lawful permanent U.S. resident (the "green card test"); or (2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for a substantial period of time—183 or more days during a 3-year period weighted toward the present year (the "substantial presence test").[82] An individual is generally treated as present in the United States on any day such individual is physically present in the Unit-

[82] The definitions of resident and nonresident aliens are set forth in Code section 7701(b). The substantial presence test will compare 183 days to the sum of (1) the days present during the current calendar year, (2) one-third of the days present during the preceding calendar year, and (3) one-sixth of the days present during the second preceding calendar year. An individual who is present for an average of 122 days (or more) per year over a three-year period is treated as a U.S. resident for income tax purposes.

ed States at any time during the day.[83] Certain categories of individuals (e.g., foreign government-related individuals and certain students) are not treated as U.S. residents even if they are present in the United States for the requisite period of time. Crew members of a foreign vessel who are on board of a vessel that is stationed within the United States territorial waters are not excluded. Consequently, a crew member of a foreign vessel will be taxed as a U.S. resident if the individual satisfies the substantial presence tax despite the fact that such an individual may be precluded to land on U.S. soil under an immigration statute. Crew members of a foreign aircraft are subject to similar provisions.

Description of Proposal

The proposal would treat gross income of a nonresident alien individual, who is temporarily present in the United States as a member of the crew of a foreign vessel or aircraft, from the performance of personal services in connection with the international operation of ships or aircraft as income from foreign sources. Thus, such income would be exempt from U.S. income and withholding tax. In addition, for purposes of determining whether an individual is a U.S. resident under the substantial presence test, the proposal would disregard the days that such individual is temporarily present as a crew member of a foreign vessel or aircraft.

Effective Date

The proposal to exempt gross income from the performance of personal services in connection with the international operation of ships or aircraft as foreign source income and the related amendments to the withholding provisions would be effective for remuneration paid after the date of enactment. The provision with respect to the definition of a resident alien would be effective for tax years beginning after December 31, 1994.

24. Repeal portfolio interest exemption

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

[83] For purposes of the substantial presence test, "United States" includes, inter alia, the U.S. territorial waters and the air space over the United States.

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

Legislative Background

The bill (H.R. 281) was introduced by Mr. Jacobs on January 4, 1995.

25. Exempt certain short-term OID obligations held by a non-resident alien from U.S. estate tax

Present Law

The United States imposes its estate tax on estates of individuals who were U.S. citizens or U.S. domiciliaries at the time of their death, and on assets of nondomiciliaries where the assets are situated in the United States at the time of their death. Certain exceptions are available with respect to the general situs rule. For example, the stock of a domestic corporation, which is includible in the gross estate of a nonresident alien, notwithstanding its physical location (sec. 2014(a)). Debt obligations of a U.S. person, the United States, a political subdivision of a State, or the District of Columbia are considered property located within the United States if held by a nonresident not a citizen of the United States (sec. 2014(c)).

Special rules apply to treat certain bank deposits and debt instruments the income from which qualify for portfolio interest exemption as property from without the United States despite the fact that such items are obligations of a U.S. person, the United States, a political subdivision of a State, or the District of Columbia (sec. 2105(b)). Income from such items are exempt from U.S. income tax in the hands of the nonresident recipient (secs. 871(h) and 871(i)(2)(A)). The effect of the special rules is to exclude the items from the U.S. gross estate of a nonresident not a citizen of the United States. However, no equivalent exemption is available for obligations that generate short-term OID income despite the fact

that such income also is exempt from U.S. income tax in the hands of the nonresident recipient (sec. 871(g)(2)).

Description of Proposal

The proposal would treat any debt obligation the income from which would be eligible for the exemption for short-term OID exclusion under section 871(g)(2) as property located outside of the United States for determining the U.S. estate tax liability of a nonresident not a U.S. citizen.

Effective Date

The proposal would be effective for short-term OID instruments held by decedents who are nonresident not a citizen of the United States after the date of enactment.

26. Carryover of excess possession tax credit

Present Law

Certain domestic corporations with business operations in the U.S. possessions may elect the use of the section 936 credit which generally eliminates the U.S. tax on certain income related to their operations in the possession. The amount of the credit is generally dependent upon a taxpayer's taxable income from qualified activities from possession sources.

The Revenue Reconciliation Act of 1993 added a provision which subjects the section 936 credit to two alternative limitations. The first limitation is generally based on the sum of three factors that are deemed to reflect the corporation's economic activity in the possession (sec. 936(a)(4)(A)). The three items are the qualified compensation, depreciation expenses and, in the case of a corporation that does not elect the profit-split method, taxes paid or accrued to the possession. The second limitation is a stated percentage of the section 936 credit that would have been allowed under section 936(a)(1) (the "percentage limitation"). The option of which alternative limitation to apply is left to the taxpayer. In order to utilize the percentage limitation, however, a corporation must elect to use that limitation for its first taxable year beginning after 1993 for which it claims a section 936 credit.

Description of Proposal

The proposal would minimize the fluctuations with respect to the first limitation (which is more sensitive to year-by-year changes in a taxpayer's economic activity). The proposal would permit a taxpayer who elects to be subject to the first limitation to carryback or carryover any "excess possession credit." The amount of excess possession credit is the difference between the pre-limitation section 936 credit and the amount of section 936 credit that is allowed under the limitation. Under the proposal, any unused excess possession credit may be carried to an excess limitation year (i.e., where the limitation exceeds the amount of section 936 credit.) Such credits may be carried back two years and then carried forward five years.

Effective Date

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

27. Pass-through treatment for certain dividends paid by a regulated investment company to foreign persons

Present Law

Regulated investment companies

A regulated investment company ("RIC") is a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act (sec. 851(a)).

In addition, to qualify as a RIC, a corporation must elect such status and must satisfy certain tests (sec. 851(b)). These tests include a requirement that the corporation derive at least 90 percent of its gross income from dividends, interest, payments with respect to certain securities loans, and gains on the sale or other disposition of stock or securities or foreign currencies, or other income derived with respect to its business of investment in such stock, securities, or currencies.

Generally a RIC pays no income tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. The amount of any distribution generally is not considered as a dividend for purposes of computing the dividends paid deduction unless the distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class (sec. 562(c)). For distributions by RICs to shareholders who made initial investments of at least $10,000,000, however, the distribution is not treated as non-pro rata or preferential solely by reason of an increase in the distribution due to reductions in administrative expenses of the company.

A RIC generally may pass through to its shareholders the character of its long-term capital gains. It does this by designating a dividend it pays as a capital gain dividend to the extent that the RIC has net capital gain (i.e., net long-term capital gain over net short-term capital loss). These capital gain dividends are treated as long-term capital gain by the shareholders. A RIC generally also can pass through to its shareholders the character of tax-exempt interest from State and municipal bonds, but only if, at the close of each quarter of its taxable year, at least 50 percent of the value of the total assets of the RIC consists of these obligations. In this case, the RIC generally may designate a dividend it pays as an exempt-interest dividend to the extent that the RIC has tax-exempt interest income. These exempt-interest dividends are treated as interest excludable from gross income by the shareholders.

The Internal Revenue Service has stated its position that if a RIC has two or more classes of stock and it designates the dividends that it pays on one class as consisting of more than that class's proportionate share of a particular type of income, the designations are not effective for Federal tax purposes to the extent that they exceed the class's proportionate share of that type of in-

come (Rev. Rul. 89–81, 1989–1 C.B. 226). Thus, in order to achieve all the tax effects provided under the Code for such RIC dividends, a capital gain dividend or an exempt-interest dividend must be pro rata within a class of RIC stock, and, with respect to any one class of RIC stock, generally cannot (under the Service's interpretation of present law) exceed that proportion of the relevant capital gain or exempt interest income of the RIC that the amount of dividends paid to shareholders of that class of stock bears to the total amount of dividends paid by the RIC.

U.S. source investment income of foreign persons

Under the Code, the United States generally imposes a flat 30-percent tax, collected by withholding, on the gross amount of U.S. source investment income payments, such as interest and dividends, to nonresident alien individuals and foreign corporations ("foreign persons") (secs. 871(a), 881, 1441, and 1442). Under treaties, the United States may reduce or eliminate such taxes. Even taking into account U.S. treaties, however, the tax on a dividend generally is not entirely eliminated. Instead, U.S. source portfolio investment dividends received by foreign persons generally are subject to U.S. withholding tax at a rate of at least 15 percent.

Interest

There is no 30-percent gross-basis U.S. tax with respect to U.S. source bank deposit interest that is not effectively connected with the conduct of a trade or business within the United States. Nor is there such a tax on the amount includible in gross income as original issue discount on an obligation payable 183 days or less from the date of original issue (without regard to the period held by the taxpayer).

Nor is there 30-percent gross-basis U.S. tax on so-called "portfolio interest." Portfolio interest includes interest (including original issue discount) which would be subject to the gross-basis U.S. tax but for the fact that certain requirements are met with respect to the obligation on which the interest is paid, and with respect to the interest recipient (or the location of the interest recipient). Pursuant to these requirements, the obligation must be in registered form or be "foreign-targeted." The U.S. person who otherwise would be required to withhold tax must receive a statement that the beneficial owner of the obligation is not a United States person. If the obligation was issued by a corporation or a partnership, the recipient of the interest must not be a "10-percent shareholder" of the corporation or partnership. A corporate recipient of the interest must be neither a controlled foreign corporation receiving interest from a related person, nor (unless the obligor is the United States) a bank receiving the interest on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business. The payment of interest must not be to any person within a foreign country (and must not be a payment addressed to, or for the account of, persons within a foreign country) with respect to which the Treasury Secretary has determined that exchange of information is inadequate to prevent evasion of U.S. income tax by U.S. persons. This last requirement does not currently

affect the exemption from tax on interest, as no such determinations have been made to date.

Capital gains

Under the Code, foreign persons generally are not subject to U.S. tax on gain realized on the disposition of stock or securities issued by a U.S. person (other than a "U.S. real property holding corporation," as described below), unless the gain is effectively connected with the conduct of a trade or business in the United States. This exemption does not apply, however, to the extent that the foreign person is a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year. Foreign persons receiving capital gain dividends from U.S. RICs have been treated as receiving capital gains not subject to U.S. tax, rather than dividends subject to the ordinary U.S. withholding tax on dividends (see Rev. Rul. 69–244, 1969–1 C.B. 215).

Under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), as amended, gain or loss of a foreign person from the disposition of a U.S. real property interest is subject to net basis tax as if the taxpayer were engaged in a trade or business within the United States and the gain or loss were effectively connected with such trade or business. In addition to fee ownership of U.S. real property, U.S. real property interests include (among other things) any interest in a domestic corporation unless the taxpayer establishes that the corporation was not, during a 5-year period ending on the date of the disposition of the interest, a U.S. real property holding corporation (which is defined generally to mean a corporation the fair market value of whose U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of its real property interests and any other of its assets used or held for use in a trade or business).

Under FIRPTA, a distribution by a real estate investment trust ("REIT") to a foreign person is, to the extent attributable to gain from sales or exchanges by the REIT of U.S. real property interests, treated as gain recognized by the foreign person from the sale or exchange of a U.S. real property interest. Under Treasury regulations, a REIT is generally required to withhold tax upon such a distribution to a foreign person, at a rate of 34 percent times the maximum amount of that distribution that could be designated by the REIT as a capital gain dividend (Treas. Reg. sec. 1.1445–8(a)(2), (b)(1), and (c)(2)).

In view of the nature of a REIT, an interest in a REIT may in some cases be considered to be a U.S. real property interest. However, an interest in a domestically-controlled REIT is not considered a U.S. real property interest. Also, the foreign ownership percent of taxable appreciation in the value of a U.S. real property interest held by a domestically-controlled REIT is subject to tax in the hands of the REIT under special FIRPTA rules upon distribution of the U.S. real property interest by the REIT.

Estate taxation

For U.S. citizens and residents, the amount subject to Federal estate tax generally is determined by reference to all the decedent's

property, wherever situated. For nonresident noncitizens, the amount subject to that tax under the Code generally is determined only by reference to the decedent's property situated in the United States. Property situated in the United States generally includes debt obligations of U.S. persons, including the Federal government and State and local governments (sec. 2104(c)), but does not include either bank deposits or portfolio obligations, the interest on which would be exempt from U.S. income tax under section 871 (sec. 2105(b)). Stock owned and held by a nonresident noncitizen is treated as property situated in the United States if and only if the stock was issued by a domestic corporation (sec. 2104(a); Treas. Reg. sec. 20.2104–1(a)(5)).

Treaties may reduce U.S. taxation on transfers by estates of foreign decedents. Under newer treaties, for example, U.S. tax may generally be eliminated except insofar as the property transferred includes U.S. real property or business property of a U.S. permanent establishment.

Description of Proposal

In general

Under the bill (H.R. 1891), a RIC that earns certain interest income which would not be subject to U.S. tax if earned by a foreign person generally may, to the extent of such income, designate a dividend it pays as deriving from such interest income. A foreign person who is a shareholder in the RIC generally would treat such a dividend as exempt from gross-basis U.S. tax, just as if the foreign person had earned the interest directly. Similarly, a RIC that earns an excess of net short-term capital gains over net long-term capital losses, which excess would not be subject to U.S. tax if earned by a foreign person, generally may, to the extent of such excess, designate a dividend it pays as deriving from such excess. A foreign person who is a shareholder in the RIC generally would treat such a dividend as exempt from gross-basis U.S. tax, just as if the foreign person had realized the excess directly. The estate of a foreign decedent would be exempt from U.S. estate tax on a transfer of stock in the RIC in proportion that the assets held by the RIC are debt obligations, deposits, or other property that would generally be treated as situated outside the United States if held directly by the estate.

Interest-related dividends

Under the bill, a RIC could, under certain circumstances, designate all or a portion of a dividend as an "interest-related dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. An interest-related dividend received by a foreign person generally would generally be exempt from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442.

This exemption would not apply, however, to a dividend on shares of RIC stock in a case where the withholding agent does not receive a statement, similar to that required under the portfolio interest rules, that the beneficial owner of the shares is not a U.S. person. The exemption would not apply to a dividend paid to any

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person within a foreign country (or dividends addressed to, or for the account of, persons within such foreign country) with respect to which the Treasury Secretary has determined, under the portfolio interest rules, that exchange of information is inadequate to prevent evasion of U.S. income tax by U.S. persons.

In addition, the exemption generally would not apply to dividends paid to a controlled foreign corporation to the extent such dividends are attributable to income received by the RIC on a debt obligation of a person with respect to which the recipient of the dividend is a related person. Nor would the exemption generally apply to dividends to the extent such dividends are attributable to income (other than short-term original discount or bank deposit interest) received by the RIC on indebtedness issued by any corporation or partnership with respect to which the recipient of the dividend is a 10-percent shareholder with respect to any entity the obligations of which are held by the RIC. In these two cases, however, the RIC remains exempt from its withholding obligation unless the RIC knows that the dividend recipient is such a controlled foreign corporation or 10-percent shareholder. To the extent that an interest-related dividend received by a controlled foreign corporation is attributable to interest income of the RIC that would be portfolio interest if received by a foreign corporation, the dividend would be treated as portfolio interest for purposes of the de minimis rules, the high-tax exception, and the same country rules of subpart F (see sec. 881(c)(4)).

The aggregate amount designated as interest-related dividends for the RIC's taxable year (including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in section 855) generally is limited to the qualified net interest income of the RIC for the taxable year. The qualified net interest income of the RIC equals the excess of (a) the amount of qualified interest income of the RIC over (b) the amount of expenses of the RIC properly allocable to such interest income.

Qualified interest income of the RIC is the sum of bank deposit interest, short term original issue discount that is currently exempt from the gross-basis tax under section 871, and any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of Code sections 1271–1288, and such other amounts as regulations may provide) on an obligation which is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder.

Where the amount designated as an interest-related dividend is greater than the qualified net interest income described above, then the portion of the distribution so designated which constitutes an interest-related dividend will be only that proportion of the amount so designated as the amount of the qualified net interest income bears to the amount so designated.

Taxable interest dividends

Under the bill, a RIC could also designate all or a portion of a dividend as a "taxable-interest dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. A taxable-interest dividend would be treated by the re-

cipient shareholder as interest for all purposes of the income tax provisions of the Code. The aggregate amount designated as taxable-interest dividends for the RIC's taxable year (including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in section 855) generally is limited to the net taxable interest income of the RIC for the taxable year. The net taxable interest income of the RIC equals the excess of (a) the amount of interest income of the RIC for the year other than amounts excludable from gross income under section 103(a)) over (b) the amount of expenses of the RIC properly allocable to such interest income.

Interest income of the RIC includes amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of Code sections 1271–1288, and such other amounts as regulations may provide.

Where the amount designated as a taxable-interest dividend is greater than the net taxable interest income described above, then the portion of the distribution so designated which constitutes a taxable-interest dividend will be only that proportion of the amount so designated as the amount of the net taxable interest income bears to the amount so designated.

Short term capital gain dividends

Under the bill, a RIC could also, under certain circumstances, designate all or a portion of a dividend as a "short term capital gain dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. For purposes of the U.S. gross-basis tax, a short term capital gain dividend received by a foreign person generally would be exempt from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442. This exemption would not apply to the extent that the foreign person is a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year. In this case, however, the RIC remains exempt from its withholding obligation unless the RIC knows that the dividend recipient has been present in the United States for such period.

The aggregate amount designated as short term capital gain dividends for the RIC's taxable year (including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in section 855) is the excess of the RIC's net short-term capital gains over net long-term capital losses. As is provided under present law for purposes of computing the amount of a capital gain dividend, the amount is determined (except in the case where an election under section 4982(e)(4) applies) without regard to any net capital loss or net short-term capital loss attributable to transactions after October 31 of the year. Instead, that loss would be treated as arising on the first day of the next taxable year. To the extent provided in regulations, this rule would apply also for purposes of computing the taxable income of the RIC.

In computing the amount of short term gain capital gain dividends for the year, no reduction is made for the amount of expenses of the RIC allocable to such net gains. For example, assume that the RIC has net income of $100 before paying dividends, comprised of dividend income of $60, short-term capital gains of $60,

and expenses of $20. Shareholders of the RIC receive dividends of $100. Under the bill, the expenses are effectively allocated solely to the RIC's dividend income, with the result that only 40 percent of the foreign RIC shareholders' dividend income may be subject to U.S. withholding tax under the bill, even though 50 percent of the RIC's gross income is income that would be subject to U.S. withholding tax if earned directly by the shareholder.

Where the amount designated as short term capital gain dividends is greater than the amount as defined above, then the portion of the distribution so designated which constitutes a short term capital gain dividend will be only that proportion of the amount so designated as the amount of the excess bears to the amount so designated.

As is true under current law for distributions from REITs, the bill provides that any distribution by a RIC to a foreign person shall, to the extent attributable to gains from sales or exchanges by the RIC of an asset (for example, stock) that is considered a U.S. real property interest, be treated as gain recognized by the foreign person from the sale or exchange of a U.S. real property interest. The bill also extends the special rules for domestically-controlled REITs to domestically-controlled RICs.

Estate tax treatment

Under the bill, a portion of the stock in a RIC held by the estate of a nonresident noncitizen decedent would be treated as property situated outside the United States. The portion so treated would be based on the proportion of the assets held by the RIC at the end of the quarter immediately preceding the decedent's death (or such other time as the Secretary may designate in regulations) that are "qualifying assets." Qualifying assets for this purpose are bank deposits of the type that are exempt from gross-basis income tax, portfolio debt obligations, debt obligations of a domestic corporation that are treated as giving rise to foreign source income, and other property not within the United States.

Effective Date

The bill would be effective with respect to taxable years of RICs beginning after date of enactment.

Legislative Background

The proposal (with some modifications) was passed by the Senate in H.R. 11 (the Revenue Bill of 1992, which was vetoed by the President).

28. Consolidate income and loss of same country foreign corporations that elect to be taxed as domestic insurance companies

Present Law

Any net operating loss ("NOL") of a foreign corporation electing to be treated as a domestic insurance company (under sec. 953(d)) is treated as a dual consolidated loss and may not be allowed to reduce the taxable income of any other member of the affiliated

group (for the taxable year or any other taxable year). Such NOL is denied even if it is not used to offset the income of any foreign corporation (secs. 953(d)(3)). Thus, two affiliated foreign corporations that made section 953(d) elections and are incorporated in the same country may not reduce their overall U.S. taxable income by the NOL incurred by one of the companies. On the other hand, if a foreign corporation that made the section 953(d) election operates through multiple branches in the same country and the NOL of each branch is made available to offset the income of the other branches under the tax laws of the foreign country, then the foreign branches shall be treated as a single "separate unit." The NOL of a separate unit may not offset, for U.S. tax purpose, the taxable income of any domestic affiliates. However, the NOL of a foreign branch may be used to offset the income of another branch that forms part of the same separate unit.

Description of Proposal

The proposal would allow two affiliated foreign corporations that elect to be treated as domestic insurance companies under section 953(d) and incorporated in the same foreign country to net their income and loss as is they were two branches of a single separate unit.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1995.

U. Housing Cooperatives

1. Treatment of certain housing cooperatives

Present Law

Deductions by membership organizations

Under section 277(a), costs incurred by a "membership organization" attributable to furnishing services, insurance, goods or other items of value to its members are deductible in any taxable year only to the extent of any income the organization has derived from its members or transactions with members. Any excess deductions may be carried over and used to offset income from members in subsequent taxable years.

For purposes of section 277(a), the U.S. Tax Court has determined that interest earned by a housing cooperative on reserve accounts mandated by the Federal Housing Authority and the state development housing authority does not constitute "income derived . . . from members or transactions with members". See *Concord Consumers Housing Cooperative v. Commissioner*, 89 T.C. 105 (1987).[84]

The Internal Revenue Service has held that section 277 applies to housing cooperatives,[85] while certain courts have held that section 277 does not apply to cooperatives subject to tax under subchapter T of the Code.[86] Subchapter T generally applies to any Farmer's cooperative and any other nonexempt corporation operating on a cooperative basis, except certain mutual savings banks, mutual insurance companies, building and loan associations, and companies engaged in furnishing electric energy or providing telephone service in rural areas (sec. 1381). It is not clear whether housing cooperatives are subject to subchapter T.

Tax treatment of cooperatives

In general, a cooperative is an organization, usually a corporation, which benefits its members and patrons by selling goods to them, purchasing products from them, and returning any income in excess of costs to them. A cooperative that is subject to subchapter T may exclude any patronage dividends paid to its members and patrons from its taxable income (sec. 1382). For a cooperative other than an "exempt cooperative",[87] a patronage dividend must be determined solely by reference to the net earnings of the organization from business done with or for its patrons. The U.S. Court of Appeals for the Eighth Circuit has held that a nonexempt cooperative may not use patronage losses to offset nonpatronage income. See

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[84] The U.S. Tax Court did not address the interrelationship of sections 216, 277 and subchapter T because the record was insufficient to determine whether "petitioner [was] a 'cooperative housing corporation' within the meaning of section 216(b)(1) or that petitioner [was] 'operating on a cooperative basis' within the meaning of section 1381(a)(2)." *See* 89 T.C. at 106, n.3.

[85] See Rev. Rul. 90–36, 1990–1 C.B. 59.

[86] See *Buckeye Countrymark, Inc. v. Commissioner*, 103 T.C. 547 (1994). *Landmark v. United States*, 25 Ct. Cl. 100, 92–1 Tax Cas. (CCH) para. 50,058 (Ct. Cl. 1992); *Farm Services Cooperative v. Commissioner*, 70 T.C. 145, 155–57, (1978), *rev'd on other grounds*, 611 F.2d 1270 (8th Cir. 1980).

[87] An "exempt cooperative" is a farmers' cooperative association described in section 521(b)(1). An exempt cooperative may allocate to its patrons and deduct, not only earnings from patronage activities, but also dividends on capital stock and earnings from nonpatronage sources (sec. 1382(c)).

Farm Services Cooperative v. Commissioner, 611 F.2d 1270 (8th Cir. 1980).

Description of Proposal

Under the bill (H.R. 1546), subchapter T would apply, and section 277 would not apply, to a "cooperative housing corporation" (as described in section 216(b)(1)).[88] The bill, however, would adopt a rule similar to section 277 that patronage losses of a cooperative housing corporation cannot offset earnings that are not patronage earnings.

For this purpose, the bill would define patronage earnings and losses to mean "earnings and losses . . . derived from business done with or for patrons of the corporation." Moreover, the bill specifically would treat the following items as "patronage earnings": (1) interest on reasonable reserves established in connection with the corporation, including reserves required by a government agency or lender, (2) rents from laundry and parking to the extent attributable to use of the facilities by tenant-stockholders (as defined in section 216(b)(2)) and their guests, and (3) in the case of certain "limited equity cooperative housing corporations",[89] rental income attributable to housing projects operated by such corporations.

Effective Date

H.R. 1546 would apply to taxable years beginning after the date of enactment.

Legislative Background

H.R. 1546 was introduced by Mr. Schumer on May 2, 1995. The bill is the same as section 4653 of H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush. Also, the bill is the same as a proposal that was one of the subjects of a hearing on miscellaneous tax proposals held by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means in June 1993.

2. Treatment of cooperatives owning only land

Present Law

Under section 216, a tenant-stockholder of a cooperative housing corporation may deduct amounts paid to the cooperative which represent his or her proportionate share of the allowable real estate taxes and interest relating to the cooperative's land and buildings. Also, the "residence" of a tenant-stockholder is defined to include

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[88] Under section 216(b)(1), a cooperative housing corporation is a corporation (1) having only one class of stock outstanding, (2) each stockholder of which is entitled, by reason of his or her stock ownership, to occupy a residence owned or leased by the corporation, (3) which derives at least 80 percent of its gross income during the taxable year from tenant-stockholders, and (4) no stockholder of which is entitled to a distribution out of earnings and profits, except on a complete or partial liquidation of the corporation.

[89] A cooperative housing corporation would qualify for this treatment if it met the requirements under section 143(k)(9)(D)(i). Generally, a cooperative will meet those requirements if the amount paid by a tenant stockholder for stock in the corporation cannot exceed the sum of (1) the consideration paid by the first tenant-stockholder, adjusted for cost of living, (2) payments for improvements to the dwelling unit, and (3) payments to amortize corporate indebtedness arising from the acquisition or development of real property (sec. 143(k)(9)(D)(i)).

stock in a cooperative housing corporation that qualifies under section 216 if the ownership of such stock entitles him to occupy a residence in the cooperative. (See Temp. Treas. Reg. sec. 1.163–10T(q).) Thus, a tenant-stockholder in such a cooperative may deduct interest he or she personally incurs to acquire the stock in the cooperative.

To qualify as a cooperative housing corporation under section 216, each stockholder must have the right, solely because of his or her stock ownership, to occupy a house or apartment owned or leased by the cooperative. Thus, under present law, a cooperative that only owns (or leases) the land on which the residences are located does not qualify under section 216 and the tenant-stockholders therefore may not deduct their share of the cooperative's mortgage interest and taxes or deduct interest incurred to purchase stock in that cooperative.

Description of Proposal

The bill (H.R. 737) would provide that a cooperative housing corporation under section 216 would include corporations that only own (or lease) the land on which the residences of the tenant-stockholders are located. (The bill also would make a conforming amendment to the determination of whether a tenant-stockholder's stock is fully paid under section 216(b)(2)). The bill does not apply where the residence situated on the cooperative's land is a mobile home.

Effective Date

The bill would apply to taxable years beginning after December 31, 1987.

Legislative Background

H.R. 737 was introduced by Mrs. Lowey on January 30, 1995. A similar bill (H.R. 1418, 103rd Cong.) was one of the subjects of a hearing on miscellaneous tax proposals held by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means in June 1993.

V. Insurance

1. Treatment of salvage and subrogation of property and casualty insurance companies

Present Law

Under present law, property and casualty insurance companies are required to reduce the deduction allowed for losses incurred (both paid and unpaid) by estimated recoveries of salvage and subrogation attributable to such losses (sec. 832(b)(5)(A)). This rule was enacted in the Revenue Reconciliation Act of 1990 (the "1990 Act").

The 1990 Act provided that, in the case of a property and casualty insurance company that did not take into account estimated salvage and subrogation recoverable in determining losses incurred for its last taxable year beginning before January 1, 1990, a "fresh start" (i.e., income forgiveness) transition rule applied with respect to 87 percent of the discounted amount of the estimated salvage and subrogation recoverable as of the close of the last taxable year beginning before January 1, 1990. The remaining 13 percent is required to be recognized over a 4-year period.

The 1990 Act also provided parallel transition relief in the case of any property and casualty insurance company that did take into account estimated salvage and subrogation recoverable in determining losses incurred for its last taxable year beginning before January 1, 1990. In such a case, 87 percent of the discounted amount of the estimated salvage and subrogation amount recoverable as of the close of the last taxable year beginning before January 1, 1990, is allowed as a special deduction ratably over the first 4 taxable years beginning after December 31, 1989.

Treasury regulations implementing the salvage and subrogation provision of the 1990 Act provide a rule of mutual exclusivity for the two types of transition relief. The regulations provide that an insurance company that claims the benefit of the "fresh start" with respect to estimated salvage recoverable may not claim the special deduction, and a company that claims the special deduction may not claim the benefit of the "fresh start" (Treas. Reg. 1.832–4(f)(3)). The regulations effectively prevent a company from claiming both a special deduction for some lines of business and a "fresh start" for other lines of business.

The 1990 Act also provides a special rule for overestimates, which requires a company to include in income (in a subsequent taxable year) the amount of the "fresh start" benefit attributable to an overestimate of salvage recoverable under the provision. The special rule for overestimates does not apply to the special deduction under the provision.

Description of Proposal

The proposal would eliminate the Treasury regulations' rule of mutual exclusivity for the two types of transition relief under the salvage and subrogation provision of the 1990 Act. Thus, the proposal would provide that a property and casualty insurance company that took estimated salvage and subrogation into account with respect to some, but not with respect to other lines of busi-

ness, could take the "fresh start" benefit with respect to those lines of business for which it did *not* take into account estimated salvage and subrogation recoverable in determining losses incurred for its last taxable year beginning before January 1, 1990, and could take the special deduction with respect to those lines of business for which it *did* take such estimated salvage and subrogation into account, provided that all the requirements for the "fresh start" benefit and the special deduction, respectively, are met.

The proposal would also extend the special income inclusion rule for overestimates of salvage recoverable (which currently applies in the case of the "fresh start" benefit) to the special deduction. Thus, under the proposal, the income inclusion rule would also apply with respect to overestimates of estimated salvage recoverable in the case of the special deduction.

In addition, the proposal would clarify that these rules apply to property and casualty insurance companies but not life insurance companies.

Effective Date

The proposal would be effective as if enacted with the provisions of the 1990 Act regarding salvage and subrogation.

2. Health insurance organizations eligible for benefits of section 833

Present Law

An organization described in section 501(c)(3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance (sec. 501(m)). Special rules apply to certain eligible health insurance organizations. Eligible health insurance organizations are (1) Blue Cross or Blue Shield organizations existing on August 16, 1986, which have not experienced a material change in structure or operations since that date, and (2) other organizations that meet certain community-service-related requirements and substantially all of whose activities involve the providing of health insurance. Section 833 provides that eligible organizations are generally treated as stock property and casualty insurance companies.

Section 833 provides a special deduction for eligible organizations, equal to 25 percent of the claims and expenses incurred during the year, less the adjusted surplus at the beginning of the year. This deduction is calculated by computing surplus, taxable income, claims incurred, expenses incurred, tax-exempt income, net operating loss carryovers, and other items attributable to health business. The deduction may not exceed taxable income attributable to health business for the year (calculated without regard to this deduction).

In addition, section 833 eliminates, for eligible organizations, the 20-percent reduction in unearned premium reserves that applies generally to all property and casualty insurance companies.

Description of Proposal

The proposal would apply the special rules under section 833 to the same extent they are provided to certain existing Blue Cross or Blue Shield organizations, in the case of any organization that (1) is not a Blue Cross or Blue Shield organization existing on August 16, 1986, and (2) otherwise meets the requirements of section 833(c)(2) (including the requirement of no material change in operations or structure since August 16, 1986). Under the proposal, an organization qualifies for this treatment only if (1) it is not a health maintenance organization and (2) it is organized under and governed by State laws which are specifically and exclusively applicable to not-for-profit health insurance or health service type organizations

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1986 (i.e., as if originally enacted with Code sec. 833.

Legislative Background

The proposal was included in H.R. 3600 (the Health Security Act, 103rd Cong.), as passed by the House, and in S. 2351 (the Health Security Act, 103rd Cong.), as reported by the Senate Finance Committee. A similar proposal was also included in H.R. 11 (102nd Cong.), as passed by the House and the Senate and vetoed by President Bush.

3. Treatment of certain gains and losses of life insurance companies under sec. 818(b)

Present Law

In the case of a taxpayer that is a corporation, losses from the sale or exchange of a capital asset generally are allowed only to the extent of gains from such sales or exchanges (sec. 1211(a)). A loss on the sale or exchange of property used in the trade or business of the taxpayer, however, may be treated as an ordinary loss, rather than as a loss from the sale or exchange of a capital asset (secs. 1221(2), 1231).

A special limitation on ordinary loss treatment applies in the case of a life insurance company, under section 818(b). Section 818(b) provides that property used in the trade or business includes only property used in carrying on an insurance business. Thus, for example, a loss on the sale or exchange of real estate that is held by a life insurance company and that is not used in the insurance business is treated as a capital loss, and is allowed only to the extent of the taxpayer's capital gain.

Description of Proposal

The proposal would provide an election not to apply section 818(b) capital loss treatment to a percentage of a life insurance company's losses from dispositions of foreclosed real estate, and to allow such losses as ordinary losses in equal amounts over each of the first five taxable years following the year of disposition.

Present-law section 818(b) treatment would be retained for the percentage of such losses that are not eligible for the treatment provided by the proposal.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1994.

4. Treatment of certain charitable risk pools

Present Law

An organization described in section 501(c)(3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance (sec. 501(m)). For purposes of this rule, commercial-type insurance does not include insurance provided at substantially below cost to a class of charitable recipients. Present law does not specifically accord tax-exempt status to an organization that pools insurable risks of a group of tax-exempt organizations described in section 501(c)(3).

Description of Proposal

The bill (H.R. 1299) would treat a qualified charitable risk pool as a tax-exempt charitable organization. The bill would make inapplicable to a qualified charitable risk pool the present-law rule that a charitable organization described in section 501(c)(3) is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance.

A qualified charitable risk pool would be an organization organized and operated solely to pool insurable risks of its members (other than medical malpractice risks) and to provide information to its members with respect to loss control and risk management. No part of the net earnings of the organization could inure to the benefit of any member or other person (other than through providing insurance coverage or information). Only charitable tax-exempt organizations could be members. A qualified charitable risk pool would be required to (1) be organized as a non-profit organization under State law authorizing risk pooling for charitable organizations; (2) be exempt from State income tax; (3) obtain at least $1 million in startup capital from nonmember charitable organizations; and (4) meet other organizational and operational requirements.

Effective Date

The bill would apply to taxable years beginning after December 31, 1991.

Legislative Background

H.R. 1299 was introduced by Mr. Thomas on March 22, 1995. A similar proposal was introduced in the 103rd Congress as H.R. 2612 by Mr. Stark on July 1, 1993.

5. Deduction for small property and casualty insurance companies

Present Law

Treatment of small life insurance companies

A life insurance company with assets as of the end of any taxable year of less than $500 million (determined on a controlled group basis) is allowed a special deduction in determining taxable income for such year. The deduction equals 60 percent of the first $3 million of tentative taxable income, reduced by 15 percent of the tentative taxable income in excess of $3 million (the deduction is completely phased out when tentative taxable income equals $15 million). Tentative taxable income is defined as the taxable income of the company determined without regard to the small life insurance company deduction and any items attributable to noninsurance businesses.

Treatment of small property and casualty insurance companies

An insurance company other than a life insurance company (a "property and casualty insurance company") is exempt from Federal income tax for any taxable year that the net written premiums (or, if greater, the direct written premiums) of the company do not exceed $350,000. In addition, a property and casualty insurance company may elect to be taxed solely on taxable investment income for any taxable year that the net written premiums (or, if greater, the direct written premiums) of the company exceed $350,000 but do not exceed $1.2 million. For this purpose, the net written premiums or direct written premiums of a property and casualty insurance company that is a member of a controlled group of corporations include the net written premiums or direct written premiums of each insurance company that is a member of the controlled group.

Description of Proposal

The bill (H.R. 1515) would provide that a property and casualty insurance company with assets as of the end of any taxable year of less than $500 million (determined on a controlled group basis) is allowed a special deduction in determining taxable income for such year. The deduction would equal 60 percent of the first $3 million of tentative taxable income, reduced by 15 percent of the tentative taxable income in excess of $3 million (the deduction is completely phased out when tentative taxable income equals $15 million).

Tentative taxable income would be defined as the taxable income of the company determined without regard to the special deduction and any items attributable to noninsurance businesses.

Effective Date

The provision would apply to taxable years beginning after December 31, 1994.

Legislative Background

H.R. 1515 was introduced by Mr. Thomas on April 7, 1995. A similar proposal (but with reduced deduction and phaseout percentages) was included in H.R. 11 (102nd Cong.) as passed by the House and Senate and vetoed by President Bush.

6. Treatment of deposits under certain perpetual insurance policies

Present Law

Present law provides that in the case of a mutual fire insurance company exclusively issuing perpetual policies, the amount of single deposit premiums paid to such company are not included in gross-income (sec. 832(b)(1)(C)). In addition, no deduction is allowed for policyholder dividends and similar distributions paid or declared by a mutual fire insurance company that exclusively issues perpetual policies (sec. 832(c)(11)).

Present law also provides rules for imputing interest income in the case of certain loans with below-market interest rates (sec. 7872). The Internal Revenue Service issued a technical advice memorandum in March of 1988 (TAM 8831004) which provides that the imputed interest provisions of section 7872 of the Code do not apply to payments made under a perpetual insurance policy. This technical advice memorandum was revoked by the Internal Revenue Service in December of 1989 (TAM 8952001).

Description of Proposal

The proposal would provide that the provisions of present law which treat certain arrangements as below-market rate loans are not to apply to any deposit made by a policy-holder under a qualified perpetual policy.[90] For this purpose, a qualified perpetual policy would be any insurance policy that (1) provides insurance for property damage or casualty with respect to qualified residential property (or the contents thereof); and (2) is funded only by the policyholder placing with the insurance company a cash deposit (and does not provide for any periodic premiums) and such deposit is fully refundable (except for a penalty for early cancellation) upon cancellation of the policy. For this purpose, qualified residential property would mean any personal residence and any building used for residential purposes with 10 or fewer dwelling units. Damage or casualty with respect to the contents of qualified residential property is intended to mean such damage or casualty wherever it occurs (whether or not in the residential property), if such coverage is customarily provided under perpetual policies with respect to such property.

Effective Date

The provision would apply to taxable years ending after the date of enactment.

[90] The amount deposited under a perpetual insurance contract, however, would not be treated as a written premium for purposes of the small company provisions contained in sections 501(c)(15) and 831(b) of the Code.

Legislative Background

The proposal was introduced as H.R. 1668 (103rd Cong.) by Mr. Cardin on April 2, 1993. The proposal was also included in H.R. 11 (102nd Cong.), as passed by the House and Senate and vetoed by President Bush.

7. Extend section 130 exclusion to structured settlements for workmen's compensation payments

Present Law

Under present law, an exclusion from gross income is provided for amounts received for agreeing to a qualified assignment to the extent that the amount received does not exceed the aggregate cost of any qualified funding asset (sec. 130).

A qualified assignment means any assignment of a liability to make periodic payments as damages on account of a personal injury or sickness (in a case involving physical injury or physical sickness), provided the terms of the assignment satisfy certain requirements. Generally, these requirements are that (1) the periodic payments are fixed as to amount and time; (2) they payments cannot be accelerated, deferred, increased, or decreased by the recipient; (3) the assignee's obligation is no greater than that of the person assigning the liability; and (4) the payments are excludable by the recipient as damages.

Description of Proposal

The bill (H.R. 1037) would provide that a qualified assignment, for purposes of the section 130 exclusion, would include any assignment of liability to make periodic payments as compensation under any workmen's compensation act. The bill would modify the requirements for a qualified assignment to require that the payments be excludable by the recipient either as damages or as an amount received under a workmen's compensation act as compensation for personal injuries or sickness.

Effective Date

The bill would be effective for claims under workmen's compensation acts filed after date of enactment.

Legislative Background

H.R. 1037 was introduced by Mr. Jacobs on February 24, 1995.

8. Treatment of certain small property and casualty insurance companies under the alternative minimum tax

Present Law

Present law provides that certain small property and casualty insurance companies may elect to be taxed only on taxable investment income for regular tax purposes (sec. 831(b)). Eligible property and casualty insurance companies are those whose net written premiums (or if greater, direct written premiums) for the taxable year exceed $350,000 but do not exceed $1,200,000.

Under present law, all corporations including insurance companies are subject to an alternative minimum tax. For taxable years beginning before 1990, alternative minimum taxable income was increased by one-half of the amount by which the corporation's pretax book income exceeded the corporation's alternative minimum taxable income (determined without regard to this adjustment and without regard to net operating losses). For taxable years beginning after 1989, alternative minimum taxable income is increased by 75 percent of the excess of adjusted current earnings over alternative minimum taxable income (determined without regard to this adjustment and without regard to net operating losses).

Description of Proposal

The proposal would provide that a small property and casualty insurance company that elects for regular tax purposes to be taxed only on taxable investment income determines its adjusted current earnings under the alternative minimum tax without regard to any amount not taken into account in determining its gross investment income under section 834(b). Thus, adjusted current earnings of an electing company would be determined without regard to underwriting income (or underwriting expense, as provided in sec. 56(g)(4(b)(i)(II)).

The proposal also would provide that only net investment income as reported in the company's applicable financial statement would be taken into account in determining adjusted net book income under the prior law provisions of the alternative minimum tax, in the case of a small property and casualty insurance company that elects for regular tax purposes to be taxed only on taxable investment income. Thus, adjusted net book income of an electing company would be determined without regard to underwriting income and expense.

Effective Date

The adjusted current earnings provision would be effective for taxable years beginning after December 31, 1989. The book income provision is effective for taxable years beginning after December 31, 1986 and before January 1, 1990.

Legislative Background

The proposal was included in H.R. 11 (102nd Cong.), as passed by the House and Senate and vetoed by President Bush.

9. Tax treatment of consolidations of life insurance departments of mutual savings banks

Present Law

Special rules for mutual savings banks with life insurance business.—Present law provides for special treatment of a mutual savings bank conducting a life insurance business in a separate life insurance department (Code sec. 594). Under the special rule, the insurance and noninsurance businesses of such banks are bifurcated, and the tax imposed is the sum of the partial taxes computed on

(a) the taxable income of the mutual savings bank determined without regard to items properly allocable to the life insurance business, and (b) the income of the life insurance department, calculated in accordance with the rules applicable to life insurance companies (subchapter L of the Code). This special treatment applies so long as the mutual savings bank is authorized under State law to engage in the business of issuing life insurance contracts, the life insurance business is conducted in a separate department the accounts of which are maintained separately from the other accounts of the mutual savings bank, and the life insurance department would qualify as a life insurance company under Code section 816 if it were treated as a separate corporation.

Rules for corporate reorganizations.—Present law provides that certain corporate reorganization transactions, including recapitalizations, generally are treated as tax-free transactions (sec 368(a)(1)(E)). No gain or loss is recognized if stock or securities in a corporation that is a party to a reorganization are (in pursuance of the plan of reorganization) exchanged solely for stock or securities in that corporation or in another corporation that is a party to the reorganization, except that gain (if any) to the recipient is recognized to the extent the principal amount of securities received exceeds the principal amount of the securities surrendered (secs. 354, 356(a)(1)). If such an exchange has the effect of distribution of a dividend, then the portion of the distributee's gain that does not exceed his ratable share of the corporation's earnings and profits is treated as a dividend (sec. 356(a)(2)). If the exchange is not treated as a dividend, the recipient generally may take into account income from the exchange under the installment method (provided the requirements for use of the installment method are otherwise met) (sec. 453).

Rules for life insurance companies.—A life insurance company generally is permitted to deduct the amount of policyholder dividends paid or accrued during the taxable year (sec. 808). In the case of a mutual life insurance company, the amount of the deduction for policyholder dividends is reduced (but not below zero) by the differential earnings amount (sec. 809). The term policyholder dividend includes (1) any amount paid or credited (including as an increase in benefits) if the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management; (2) excess interest; (3) premium adjustments; and (4) experience-rated refunds.

Description of Proposal

The proposal would provide that the consolidation of two or more life insurance departments of mutual savings banks into a single life insurance company by requirement of State law would be treated as a tax-free reorganization described in section 368(a)(1)(E) (i.e., a recapitalization). Any payments required to be made to policyholders in connection with the consolidation would be treated as policyholder dividends deductible by the company under section 808, provided that certain requirements are met. The requirements would be: (a) the payments are only with respect to policies in effect immediately before the consolidation; (b) the payments are only with respect to policies that are participating (i.e., on which

policyholder dividends are paid) before and after the consolidation; (c) the payments cease with respect to any policy if the policy lapses after the consolidation; (d) the policyholders before the consolidation had no divisible right to the surplus of any life insurance department and had no right to vote; and (e) the approval of the policyholders was not required for the consolidation.

Effective Date

The proposal would be effective on December 31, 1991.

10. Extend section 832(e) to financial guarantee insurance

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 8 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, 1995, with transition rules similar to those that applied upon original enactment of section 832(e).

11. Increase dollar limits for burial insurance

Present Law

To qualify as a life insurance contract for Federal income tax purposes, a contract must be a life insurance contract under the applicable State or foreign law and must satisfy either of two alternative tests: (1) a cash value accumulation test or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement (sec. 7702). A contract satisfies the cash value accumulation test if the cash surrender value of the contact may not at any time exceed the net single premium that would have to be paid at such time to fund future benefits under the contract. A contract satisfies the guideline premium and cash value corridor tests if the premiums paid under the contract do not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums, and if the death benefit under the contract is not less than a varying statutory percentage of the cash surrender value of the contract. Under these rules, the death benefit is generally deemed not to increase (sec 7702(e)(1)(A)).

Special rules apply with respect to a contract that is purchased to cover payment of burial expenses or in connection with prearranged funeral expenses. For such a contract, death benefit increases may be taken into account in applying the cash value accumulation test if the contract (1) has an initial death benefit of $5,000 or less and a maximum death benefit of $25,000 or less, and (2) provides for a fixed predetermined annual increase not to exceed 10 percent of the initial death benefit or 8 percent of the death benefit at the end of the preceding year (sec. 7702(e)(2)(C)).

Description of Proposal

The proposal would increase the dollar limits applicable in the case of an insurance contract to cover payment of burial expenses or in connection with prearranged funeral expenses. For such a contract, death benefit increases could be taken into account in applying the cash value accumulation test if the contract has an initial death benefit of $7,000 or less and a maximum death benefit of $34,000 or less (and other requirements of present law are met). In addition, these dollar limits would be adjusted annually, after the first year, for inflation in accordance with the consumer price index.

Effective Date

The proposal would be effective for contracts entered into after December 31, 1995.

Legislative Background

A similar proposal was introduced as S. 2130 (103rd Cong.) by Senator Dole.

12. Foreign companies carrying on insurance business

Present Law

A foreign company that is carrying on an insurance business in the United States generally is taxed in the same manner as a U.S. insurance company on its income that is effectively connected with its conduct of a U.S. trade or business. However, under section 842, the net investment income of a foreign insurance company that is effectively connected with the conduct of an insurance business in the United States may not be less than the minimum effectively connected net investment income (i.e., the product of the required U.S. assets of the company for the taxable year and the domestic investment yield applicable to the company for the taxable year). Section 842 was modified by the Omnibus Budget Reconciliation Act of 1987.

The required U.S. assets of a foreign insurance company for any year is the product of the mean of the company's total insurance liabilities on U.S. business and the domestic asset/liability percentage applicable to the company. Each year, the Treasury Department must prescribe a domestic asset/liability percentage applicable to foreign life insurance companies and a separate domestic asset/liability percentage applicable to foreign property and casualty insurance companies. The domestic asset/liability percentage for each type of insurance company equals the mean of the assets of the domestic companies of that type divided by the mean of the total insurance liabilities of the domestic companies of that type.

In addition, for each year, the Treasury Department must prescribe a domestic investment yield for foreign life insurance companies and a separate domestic investment yield for foreign property and casualty insurance companies. The domestic investment yield for each type of insurance company equals the net investment income of domestic companies of that type divided by the mean of the aggregate assets of the domestic companies of that type.

The Treasury Department determines the domestic asset/liability percentage and the domestic investment yield for each type of insurance company on the basis of data derived from a representative sample of domestic insurance companies. For any taxable year, the domestic asset/liability percentages and the domestic investment yields are based on data from the second preceding taxable year. The Treasury Department generally relies on data from the annual statements of the domestic insurance companies in making these determinations, but may also rely on tax return data where such data is available.

The Treasury Department is authorized to promulgate such regulations as may be necessary or appropriate to effectuate the purposes of section 842, including regulations that provide proper adjustments in succeeding taxable years where the actual effectively connected net investment income of a foreign insurance company

for any year exceeds the minimum effectively connected net investment income of such insurance company for such year.

Description of Proposal

Recomputation of effectively connected net investment income in subsequent taxable year

The bill (H.R. 1178) would provide that the effectively connected net investment income of a foreign insurance company for any taxable year would initially equal the actual effectively connected net investment income of the company for that taxable year. Subsequently, after the Treasury Department makes the requisite data available with respect to domestic insurance companies for that taxable year, a foreign insurance company would be required to compute its minimum effectively connected net investment income for that taxable year and to recompute its effectively connected net investment income for that taxable year. Any adjustments to income resulting from this recomputation would increase or decrease (as appropriate) the effectively connected net investment income for the second taxable year following the taxable year for which income is recomputed. Interest would also be charged (or paid) on any underpayment (or overpayment) resulting from the adjustment.

Cumulative determination of recomputed effectively connected net investment income

The recomputed effectively connected net investment income of a foreign insurance company for any taxable year would be determined on a cumulative basis. Thus, the recomputed effectively connected net investment income would equal the greater of (1) the cumulative actual effectively connected net investment income or (2) the cumulative minimum effectively connected net investment income, reduced by the recomputed effectively connected net investment income for all preceding taxable years.

Use of tax return data rather than annual statement data

The determination of the domestic asset/liability percentage and the domestic investment yield for any taxable year would be based on representative tax return data of U.S. insurance companies for such taxable year rather than annual statement data of U.S. insurance companies (unless such data is unavailable, in which case the Treasury Department may use such representative data as it considers appropriate).

Effective Date

The bill would apply as if originally included in the Omnibus Budget Reconciliation Act of 1987.

Legislative Background

H.R. 1178 was introduced by Mr. Camp on March 9, 1995. A similar bill (H.R. 1228, 103rd Cong.) was one of the subjects of a hearing on miscellaneous tax proposals held by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means in June 1993.

W. Low-Income Housing

1. Provide 15-year depreciation and other tax incentives to encourage the preservation of low-income housing

Present Law

A taxpayer is allowed to recover, through annual depreciation allowances, the cost or other basis of residential rental property that is used in a trade or business or that is held for the production of rental income. For regular tax purposes, the amount of the depreciation deduction allowed with respect to residential rental property generally is determined by using the straight-line method and a recovery period of 27.5 years. For alternative minimum tax purposes, the amount of the depreciation deduction allowed with respect to residential real property for any taxable year is determined by using the straight-line method and a recovery period of 40 years.

Under present law, the passive loss rules limit deductions and credits from trade or business activities. Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the next taxable year. Suspended losses from an activity are allowed in full when the taxpayer disposes of his entire interest in the activity. Passive activities generally are defined to include rental activities[91] , and trade or business activities in which the taxpayer does not materially participate. An individual may, however, offset up to $25,000 of income that is not treated as passive, by using losses and credits from rental real estate activities with respect to which the individual actively participates. The $25,000 allowance is phased out ratably by half of the amount by which the taxpayer's income exceeds $100,000, and the allowance is fully phased out for taxpayers whose adjusted gross income exceeds $150,000.[92]

Present law provides a low-income housing credit with respect to a percentage of the qualified basis of a certain low-income housing buildings (sec. 42). Present law also provides, in the case of certain rehabilitation expenditures, a 10-percent credit with respect to certain substantially rehabilitated buildings, and 20-percent credit with respect to certain certified historic structures.

Description of Proposal

The bill (H.R. 931) would provide for a recovery period of 15 years for determining the amount of the depreciation deduction allowed with respect to a broad category of low-income housing projects that were originally placed in service at least 10 years before the taxpayer acquires an interest in the project, and with respect to which rehabilitation expenses over the 24-month period following the taxpayer's acquisition of the property equal or exceed 10 percent of the basis of the residential rental property.

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[91] A special rule applies the material participation standard for determining whether rental real estate activities of certain taxpayers in the real property business are treated as passive activities (sec. 469(c)(7)).

[92] The income phaseout does not apply with respect to the low-income housing credit, and is higher with respect to the rehabilitation credit. The active participation requirement does not apply with respect to the low-income housing and rehabilitation credits.

The bill would also provide an exception to the passive loss limitations for $50,000 of losses attributable to residential rental property that is eligible for the 15-year depreciation provided under the bill.

For alternative minimum tax purposes, the bill would provide that the recovery period is 15 years, rather than 40 years, for determining half of the taxpayer's allowable AMT depreciation with respect to eligible low-income housing property under the bill.

These benefits would not be allowed with respect to low-income housing projects for which the taxpayer claims benefits under the low-income housing credit or the rehabilitation credit allowable under present law.

Effective Date

The bill would apply to property placed in service after December 31, 1995.

Legislative Background

H.R. 931 was introduced by Mr. Jefferson on February 14, 1995.

2. Low-income housing credit provisions

In general

A tax credit is allowed in annual installments over ten years for certain investments in qualifying newly constructed or substantially rehabilitated low-income residential rental housing. For most qualifying housing, the maximum credit is an amount having a present value of 70 percent of the qualified basis of the low-income housing units. For housing receiving other Federal subsidies (e.g., tax-exempt bond financing) and for the acquisition cost of existing housing that is substantially rehabilitated (e.g., costs other than rehabilitation expenditures), the maximum credit is an amount having a present value of 30 percent of qualified basis. The maximum credit percentages are increased to 91 percent and 39 percent for qualifying housing in certain qualified census tracts and difficult development areas. Generally, that part of the building for which the credit is claimed must be rented to qualified low-income tenants at restricted rents for 15 years after the building is placed in service. In addition, a subsequent additional 15-year period of low-income use generally is required.

a. Allow HOME funds to be used with 91% credit

Present Law

Under present law, a building is not treated as Federally subsidized solely because the building receives assistance under the National Affordable Housing Act of 1990 (as in effect on the date of enactment of "The Omnibus Budget Reconciliation Act of 1993") if 40 percent or more of the aggregate residential rental units in the residential rental project receiving the assistance are occupied by individuals with 50 percent or less of area median income (25 percent in the case of certain high-cost housing areas). These buildings are eligible for the 70 percent and 30 percent credits but not

for the 91-percent or 39 percent credits otherwise available in qualified census tracts and difficult development areas.

Description of Proposal

The proposal would extend eligibility for the 91 percent and 39 percent credits to otherwise qualified buildings with HOME Funds.

Effective Date

The proposal would be effective for low-income housing tax credits allocated after December 31, 1995.

b. Expand community service area costs eligible for credit

Present Law

Generally the qualified basis on which the low-income housing tax credit is computed equals that percentage of the eligible basis of a qualified low-income building attributable to low-income residential rental units. The eligible basis is limited to the adjusted basis of the residential units, related facilities for use by tenants, and other facilities reasonably required by the project. Non-housing portions of a building that provides transitional housing for the homeless may be eligible for the credit if such portions are used to provide supportive services for such homeless persons.

Description of Proposal

The proposal would provide that community service buildings in projects located in qualified census tracts are included in eligible basis as functionally related and subordinate facilities if (a) the size of the facilities is commensurate with tenant needs, (b) the use of the facilities is predominantly (although not exclusively) by tenants and employees of the project owner, and (c) no more than 20 percent of the housing project's eligible basis is attributable to such facilities. Qualified census tracts are census tracts designated by the Secretary of Housing and Urban Development which are located in a metropolitan statistical area and in which 50 percent or more of the households have an income which is less than 60 percent of area median gross income.

Effective Date

The proposal would be effective for low-income housing tax credits allocated after December 31, 1995.

Legislative Background

The proposal was included in the conference report of H.R. 4210 (103rd Congress).

c. Change State credit authority limitation stacking rule

Present Law

Each State receives an annual allocation of low-income housing tax credits in an amount equal to $1.25 per resident. To qualify for the credit, a building owner must receive a credit allocation from

the appropriate State credit authority. An exception is provided for property which is financed substantially with the proceeds of tax-exempt bonds subject to the State's private-activity bond volume limitation.

That portion of a State's credit authority which is unallocated in the year in which it originally arises may be carried forward and added to the State's credit authority for the subsequent calendar year. If allocations in the subsequent year exceed that year's annual per capita credit authority, but do not exhaust the sum of that year's annual credit authority plus any credit authority carried forward from the preceding year, any remaining carried-forward credit authority is allocated in the next subsequent year to the national pool. That is, credit authority carried forward from the preceding year is stacked after the current year's per capita credit authority.

Description of Proposal

For purposes of the carryforward rule, the proposal would treat credits carried forward from previous years as used before current year per capita credits. That is, the proposal would stack credit authority carried forward from the previous year before the current year's per capita credit authority.

Effective Date

The proposal would be effective for low-income housing tax credits allocated after December 31, 1995.

Legislative Background

The proposal was included in the conference report of H.R. 4210 (103rd Congress).

d. Expand credit to lead paint removal

Present Law

Generally with the exception of certain functionally related and subordinate facilities (e.g., lobby areas, and laundry rooms) the low-income housing credit (LIHC) is only available for that portion of a qualified LIHC building which is qualified low-income rental units. In order to be a qualified LIHC building, an income requirement and other requirements must be satisfied. Under the income requirement either: (1) at least 20%of the units must be occupied by residents at or below 50% of area median income or, (2) at least 40% of the units must be occupied by residents at or below 60% of area median income. The maximum LIHC is 70% (30% for buildings that receive other Federal subsidies like grants or tax-exempt bonds).

Description of Proposal

The proposal would allow the LIHC for the costs of lead paint removal throughout a building if it is located in a census tract where 70% of the residents' income are at or below 50% of area median income. Unlike under present law, these buildings would not have to meet the income targeting requirement. Also, unlike present law, the LIHC would be available for expenses incurred on areas

outside of the low-income units and functionally related and subordinate facilities. Also, the cost of the lead paint removal would be eligible for a maximum credit equal to the percentage of residents in the whole census tract at or below 50% of area median income rather than the general 70% (30%) rules.

Effective Date

The proposal would be effective for low-income housing for credits allocated after December 31, 1995.

e. Expand credit to certain cooperative housing

Present Law

Low income housing credit

Under present law the low-income housing credit is limited to rental housing and therefore is not available to housing cooperatives which are owned occupied housing.

Cooperative housing corporations

Generally a tenant-stock holder in a cooperative housing corporation is treated for tax purposes as an owner occupant and therefore is allowed a deduction for certain amounts paid or accrued to the cooperative housing corporation within the taxable year. The amount of the deduction may not exceed the tenant-stock holder proportionate share of: (1) real estate taxes on the cooperative housing corporation's land and building, and (2) interest allocable on debt contracted on such land or building.

Description of Proposal

The proposal would create a new entity for Federal income tax purposes, the "section 42 housing cooperative". The section 42 housing cooperative would have two classes of shares: patron shares owned by residents of the building and non-patron shares owned by the tax credit equity investors. The low-income housing credit would flow through to the non-patron shareholders along with all other tax benefits other than interest and real estate tax deductions from the project. Also, the patron and non-patron shareholders would have the ability to allocate proportionately or otherwise any deductions for interest and real estate tax between the patron and non-patron shareholders.

Effective Date

The proposal would be effective for low-income housing for credits allocated after December 31, 1995.

X. Partnerships

1. Permanent extension of publicly traded partnership grandfather rule

Present Law

Under present law, a partnership generally is not subject to tax at the partnership level, but rather, partnership items of income, gain, loss, deduction and credit are taken into account for tax purposes by the partners. By contrast, a corporation is subject to income taxation at the corporate level, and corporate distributions to shareholders generally are subject to income tax in the hands of the shareholders.

A publicly traded partnership is treated as a corporation for Federal income tax purposes. An exception to this provision is provided for certain partnerships, 90 percent or more of whose gross income is passive-type income (which includes interest, dividends, real property rents, gain from disposition of real property, income and gains from certain natural resources activities, and gains from certain other types of property). A publicly traded partnership is a partnership whose interests are (1) traded on an established securities market, or (2) readily tradable on a secondary market (or the substantial equivalent thereof) (sec. 7704).

The provision treating a publicly traded partnership as a corporation for Federal income tax purposes was enacted in the Omnibus Budget Reconciliation Act of 1987 (the "1987 Act"). The provision generally became effective for taxable years beginning after December 31, 1987.

The 1987 Act provides a 10-year grandfather rule for certain existing partnerships, under which the provision became effective for taxable years beginning after December 31, 1997. An existing partnership is defined in the 1987 Act as any partnership if: (1) it was a publicly traded partnership on December 17, 1987; (2) a registration statement indicating that the partnership was to be a publicly traded partnership was filed with the Securities and Exchange Commission with respect to the partnership on or before December 17, 1987; or (3) with respect to the partnership, an application was filed with a State regulatory commission on or before December 17, 1987 seeking permission to restructure a portion of a corporation as a publicly traded partnership. Additional rules prohibiting the addition of a substantial new line of business, and coordinating with the passive-type income requirements, apply under the grandfather rule.

Description of Proposal

The bill (H.R. 1686) would provide that a publicly traded partnership that is an existing partnership eligible for the 10-year grandfather rule in the 1987 Act is not subject to the provision of present law treating a publicly traded partnership as a corporation for Federal income tax purposes. The effect of the proposal is to extend permanently the 10-year grandfather rule.

Effective Date

The bill would take effect as if included in the 1987 Act.

Legislative Background

The bill (H.R. 1686) was introduced by Mr. Houghton on May 23, 1995 The proposal was introduced in the 103rd Congress as H.R. 3619 and S. 2179.

Y. Passive Losses

1. Modify the application of passive loss rules to timber activities

Present Law

The passive loss rules limit deductions and credits from passive trade or business activities. (Sec. 469.) Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the next taxable year. Suspended losses from an activity are allowed in full when the taxpayer disposes of his entire interest in the activity. Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial. Treasury regulations set forth several tests for determining material participation.

One of the tests in the regulations for determining material participation is a facts and circumstances test. The regulations provide two limitations on the application of the facts and circumstances test. First, an individual taxpayer's management services are not taken into account under this test unless (a) no one else who performs management services received earned income for such services, and (b) no one else performs more management services (by hours) than the taxpayer does. Second, an individual cannot meet this test if he participates for 100 hours or less in the activity during the taxable year. (Temp. Treas. Reg. Sec. 1.469–5T(b)(2)(ii) and (iii).)

Description of Proposal

The proposal would loosen the passive loss rules, by eliminating the Treasury Regulations' 2-part limitation (regarding management services, and number of hours worked), in the case of closely held timber activities, for purposes of determining an individual's material participation under the passive loss rules.

Under the proposal, a timber activity would be closely held if at least 80 percent of the ownership interests in the activity is held either by 5 or fewer individuals, or by individuals who are members of the same family.

A timber activity would mean the planting, cultivating, caring, cutting, or preparation (other than milling) for market, of trees.

Effective Date

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

Legislative Background

The proposal was included in H.R. 11 (102nd Cong.), as passed by the House and the Senate and vetoed by President Bush.

2. Modify the application of passive loss rules to farming activities

Present Law

The passive loss rules limit deductions and credits from passive trade or business activities. (sec. 469.) Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the next taxable year. Suspended losses from an activity are allowed in full when the taxpayer disposes of his entire interest in the activity. Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate.

Treasury regulations set forth several tests for determining material participation, including a facts and circumstances test. The regulations provide two limitations on the application of the facts and circumstances test. First, an individual taxpayer's management services are not taken into account under this test unless (a) no one else who performs management services received earned income for such services, and (b) no one else performs more management services (by hours) than the taxpayer does. Second, an individual cannot meet this test if he participates for 100 hours or less in the activity during the taxable year. (Temp. Treas. Reg. Sec. 1.469–5T(b)(2)(ii) and (iii).)

Description of Proposal

The proposal would loosen the passive loss rules, by eliminating the Treasury Regulations' 2-part limitation (regarding management services, and number of hours worked), in the case of closely-held farming (including equine) activities, for purposes of determining an individual's material participation under the passive loss rules.

Under the proposal, a farming activity would be closely held if at least 80 percent of the ownership interests in the activity is held either by 5 or fewer individuals, or by individuals who are members of the same family.

Effective Date

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

Legislative Background

The proposal is similar to section 7619 of H.R. 11 (102nd Cong.), as passed by the House and the Senate and vetoed by President Bush, except that the H.R. 11 provision would have applied to timber activities and applied for taxable years beginning after December 31, 1992.

Z. Pass-Through Entities

1. Subchapter S reform proposals

Legislative Background

There have been various proposals to amend subchapter S of the Internal Revenue Code. S.758 (the "S Corporation Reform Act of 1995") was introduced on May 4, 1995, by Senators Hatch and Pryor (and was co-sponsored by Senators Simpson, Breaux, Lugar, Leahy, Hutchison, Murray, Bond, Kempthorne, Johnston, Ford, Robb, Dorgan, Kerrey, Kyl, Baucus, Craig, Cochran, Cohen, Grassley, D'Amato, Bennett, and Bingaman). Following are descriptions of the provisions of S. 758; differences between S. 758 and other proposals are noted below. S. 758 is similar to S. 1690 introduced by Senators Pryor and Danforth and H.R.4056 introduced by Mr. Hoagland and others in the 103rd Congress. In addition, as noted below, S. 758 contains some of the subchapter S provision that were included in H.R. 11 (the "Revenue Act of 1992"), vetoed by President Bush in 1992 and in H.R. 3419 (the "Tax Simplification and Technical Corrections Act of 1993"), as passed by the House of Representatives on May 17, 1994.

a. Types and number of eligible shareholders and eligible corporations

Present Law

The taxable income or loss of an S corporation is taken into account by the corporation's shareholders, rather than by the entity, whether or not such income is distributed. A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 35 shareholders; (2) as a shareholder, a person (other than certain trusts or estates) who is not an individual; (3) a nonresident alien as a shareholder; and (4) more than one class of stock. For purposes of the 35 shareholder limitation, a husband and wife are treated as one shareholder. An "ineligible corporation" means any corporation which is a member of an affiliated group, certain financial institutions, certain insurance companies, a section 936 corporation, or a DISC or former DISC.

Description of Proposal

The bill (S. 758) would make the following changes to the shareholder limitations imposed upon S corporation eligibility:

The maximum number of eligible shareholders would be increased from 35 to 50. (Another proposal would increase the number to 75 shareholders).

All family members owning stock could elect to be treated as one shareholder. A family would be defined as the lineal descendants of a common ancestor (and their spouses and former spouses). The common ancestor could not be more than six generations removed from the youngest generation of shareholder at the time the S election is made (or the effective date of the provision, if later). The election would be made available to only one family per corpora-

tion, must be made with the consent of all shareholders of the corporation and would remain in effect until terminated.

b. Tax-exempt entities allowed to be shareholders

Present Law

A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 35 shareholders; (2) as a shareholder, a person (other than certain trusts or estates) who is not an individual; (3) a nonresident alien as a shareholder; and (4) more than one class of stock. Thus, tax-exempt entities described in sections 401(a) (relating to qualified retirement plan trusts) or 501(c)(3) (relating to certain charitable organizations) cannot be a shareholder in an S corporation.

A tax-exempt entity may be a partner in partnership. If a partnership carries on a trade or business that is an unrelated trade or business with respect to the tax exempt entity, the tax- exempt partner is required to include its distributed share of income from such trade or business as unrelated business taxable income (sec. 512(c)).

Description of Proposal

Tax-exempt organizations described in Code sections 401(a) and 501(c)(3) would be allowed to be shareholders in small business corporations. Items of income or loss of an S corporation would flow-through to the tax exempt organization for purposes of the unrelated business income tax applicable to such organizations in a manner similar to the treatment of items of income or loss that flow through to tax exempt organizations that are partners in partnerships under present law.

Another bill (H.R. 2088, introduced by Mr. Ballenger and others on May 12, 1993) would have allowed employee stock ownership plans to be S corporation shareholders.

c. Nonresident aliens allowed to be shareholders

Present Law

A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 35 shareholders; (2) as a shareholder, a person (other than certain trusts or estates) who is not an individual; (3) a nonresident alien as a shareholder; and (4) more than one class of stock.

A nonresident alien individual engaged in a trade or business within the United States is subject to tax on his or her taxable income which is effectively connected with the conduct of a trade or business within the United States (sec. 871). A nonresident alien individual may be a partner in a domestic partnership. A nonresident alien partner is considered to be engaged in a trade or business within the United States if the partnership is so engaged (sec. 875). If a partnership has effectively connected taxable income

and any portion of such income is allocable to a foreign partner, the partnership is required to withhold tax with respect to such income on behalf of such partner.

Description of Proposal

A nonresident alien would be allowed to be a shareholder in a small business corporation. Any effectively connected U.S. income allocable to the nonresident alien would be subject to a withholding tax in a manner similar to the treatment of such income allocable to nonresident aliens that are partners in U.S. partnerships under present law.

d. Certain trusts eligible to hold stock in S corporations

Present Law

Under present law, trusts other than grantor trusts, voting trusts, certain testamentary trusts (for a 60-day or two-year period) and "qualified subchapter S trusts" may not be shareholders in a S corporation. A "qualified subchapter S trust" is a trust which is required to have only one current income beneficiary (for life). All the income (as defined for local law purposes) must be currently distributed to that beneficiary. The beneficiary is treated as the owner of the portion of the trust consisting of the stock in the S corporation.

Description of Proposal[93]

In general

The provision would allow stock in an S corporation to be held by certain trusts ("electing small business trust"). In order to qualify for this treatment, all beneficiaries of the trust must be an individual, estate, or an organization described in section 401(a) or 501(c)(3). No interest in the trust may be acquired by purchase. For this purpose, "purchase" means any acquisition of property with a cost basis (determined under section 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, etc.

A trust must elect to be treated as an electing small business trust. An election applies to the taxable year for which made and could be revoked only with the consent of the Secretary of the Treasury or his delegate.

Each potential current beneficiary of the trust would be counted as a shareholder for purposes of the 50-shareholder limitation (or if there were no potential current beneficiaries, the trust would be treated as the shareholder). A potential current income beneficiary means any person, with respect to the applicable period, who is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. Where the trust disposes of all the stock in an S corporation, any person who first became so eligible during the 60 days before the disposition shall not be treated as a potential current beneficiary.

[93] A similar provision was included in H.R. 11 (the "Revenue Act of 1992"), vetoed by President Bush in 1992 and in H.R. 3419 (the "Tax Simplification and Technical Corrections Act of 1993"), as passed by the House of Representatives on May 17, 1994.

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A qualified subchapter S trust with respect to which an election is in effect, and an exempt trust would not be eligible to qualify as an electing small business trust.

Treatment of items relating to S corporation stock

The portion of the trust which consists of stock in one or more S corporations would be treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. The trust would be taxed at the highest individual rate (39.6 percent) on this portion of the trust's income. The taxable income attributable to this portion includes (i) the items of income, loss, or deduction allocated to it as an S corporation shareholder under the rules of subchapter S, (ii) gain or loss from the sale of the S corporation stock, and (iii) to the extent provided in regulations, any state or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock. Otherwise allowable capital losses would be allowed only to the extent of capital gains.

In computing the trust's income tax on this portion of the trust, no deduction would be allowed for amounts distributed to beneficiaries, and no deduction or credit would be allowed for any item other than the items described above. This income would not be included in the distributable net income of the trust, and thus would not be included in the beneficiaries' income. No item relating to the S corporation stock could be apportioned to any beneficiary.

On the termination of all or any portion of an electing small business trust the loss carryovers or excess deductions referred to in section 642(h) would be taken into account by the entire trust, subject to the usual rules on termination of the entire trust.

Treatment of remainder of items held by trust

In determining the tax liability with regard to the remaining portion of the trust, the items taken into account by the subchapter S portion of the trust would be disregarded. Although distributions from the trust would be deductible in computing the taxable income on this portion of the trust, under the usual rules of subchapter J, the trust's distributable net income would not include any income attributable to the S corporation stock.

e. Financial institutions as eligible corporations

Present Law

A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which meets certain other requirements. An "ineligible corporation" means any corporation which is a member of an affiliated group, certain financial institutions (i.e., banks, domestic savings and loan associations, mutual savings banks, and certain cooperative banks), certain insurance companies, a section 936 corporation, or a DISC or former DISC.

Description of Proposal

A financial institution would be allowed to be an eligible small business corporation unless such institution uses a reserve method of accounting for bad debts as described in section 585 (the experience method generally available to small banks) or 593 (the percentage of taxable income method generally available to domestic savings and loan associations, mutual savings banks, and certain cooperative banks).

f. Requirement that an S corporation have one class of stock

Present Law

A small business corporation eligible to be an S corporation may not have more than one class of stock. Certain debt ("straight debt") is not treated as a second class of stock so long as such debt is an unconditional promise to pay on demand or on a specified date a sum certain in money if: (1) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors; (2) there is no convertibility (directly or indirectly) into stock, and (3) the creditor is an individual (other than a nonresident alien), an estate, or certain qualified trusts.

Description of Proposal

The bill would make the following changes to the one class of stock rule applicable to S corporations:

(1) A small business corporation would be permitted to issue certain preferred stock. In general, such stock would be stock that is not convertible and does not participate in corporate growth to any significant extent. Only eligible S corporation shareholders would be allowed to own preferred stock. Payments made on the preferred stock would be treated as interest.

Another proposal would allow an S corporation to issue preferred stock that could be converted into common stock.

(2) The definition of "straight debt" would be expanded to include debt that is convertible into the stock of the corporation under terms that are substantially the same as the terms that could have been obtained from an unrelated person.

(3) The definition of "straight debt" would be expanded to include debt held by creditors, other than individuals, that are actively and regularly engaged in the business of lending money.

g. S corporation permitted to hold S or C subsidiaries

Present Law

A small business corporation may not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). Thus, an S corporation may not own 80 percent or more of the stock of another corporation (whether an S corporation or a C corporation).

In addition, a small business corporation may not have as a shareholder another corporation (whether an S corporation or a C corporation).

Description of Proposal

An S corporation would be allowed to own 80 percent or more of the stock of a C corporation.[94] Dividends received by an S corporation from a C corporation in which the S corporation has an 80 percent or greater ownership stake would not be treated as passive investment income to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business.

In addition, an S corporation would be allowed to own 100 percent of a qualified S corporation, as well as a chain of S corporations. The qualified S corporation would not be treated as a separate corporation and all the assets, liabilities, and items of income deduction, and credit of the subsidiary would be treated as the assets, liabilities, and items of income, deduction, and credit of the parent S corporation. Thus, transactions between the S corporation parent and subsidiary would not be taken into account and all attributes of the subsidiary (include C corporation earnings and profits, passive investment income, built-in gains, etc.) would be considered to be attributes of the parent. In addition, if a subsidiary ceases to be a qualified S corporation subsidiary (i.e., fails to meet the wholly-owned requirement), the subsidiary will be treated as a new corporation acquiring all of its assets (and assuming all of it liabilities) immediately before such cessation from the parent S corporation in exchange for its stock.[95]

h. Authority to validate certain invalid elections

Present Law

Under present law, if the Internal Revenue Service (IRS) determines that a corporation's Subchapter S election is inadvertently terminated, the IRS can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and shareholders agree to be treated as if the election had been in effect for that period. Such waivers generally are obtained through the issuance of a private letter ruling. Present law does not grant the IRS the ability to waive the effect of an inadvertent invalid Subchapter S election.

In addition, under present law, a small business corporation must elect to be an S corporation no later than the 15th day of the third month of the taxable year for which the election is effective. The IRS may not validate a late election.

Description of Proposal[96]

Under the bill, the authority of the IRS to waive the effect of an inadvertent termination would be extended to allow the Service to waive the effect of an invalid election caused by an inadvertent fail-

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[94] A similar provision was included in H.R. 11 (the "Revenue Act of 1992"), vetoed by President Bush in 1992 and in H.R. 3419 (the "Tax Simplification and Technical Corrections Act of 1993"), as passed by the House of Representatives on May 17, 1994.

[95] Similar rules apply with respect to wholly owned subsidiaries of real estate investment trusts (REITs) under sec. 856(i) of present law.

[96] A similar provision was included in H.R. 11 (the "Revenue Act of 1992"), vetoed by President Bush in 1992 and in H.R. 3419 (the "Tax Simplification and Technical Corrections Act of 1993"), as passed by the House of Representatives on May 17, 1994.

ure to qualify as a small business corporation or to obtain the required shareholder consents (including elections regarding qualified subchapter S trusts), or both. The bill also would allow the IRS to treat a late Subchapter S election as timely where the Service determines that there was reasonable cause for the failure to make the election timely. These portions of the provision would apply to taxable years beginning after December 31, 1982.[97]

Finally, the provision would direct the IRS to adopt an automatic waiver procedure with respect to terminations in the cases that the Secretary of the Treasury deems appropriate.

i. Allow interim closing of the books on termination of shareholder interest with consent of corporation and affected shareholders

Present Law

In general, each item of S corporation income, deduction and loss is allocated to shareholders on a per-share, per-day basis. However, if any shareholder terminates his or her interest in an S corporation during a taxable year, the S corporation, with the consent of all its shareholders, may elect to allocate S corporation items by closing its books as of the date of such termination rather than apply the per-share, per-day rule.

Description of Proposal

The bill would provide that, under regulations to be prescribed by the Secretary of the Treasury, the election to close the books of the S corporation upon the termination of a shareholder's interest would be made by, and apply to, all affected shareholders rather than by all shareholders. For this purpose, "affected shareholders" would mean any shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the year. If a shareholder transferred shares to the corporation, "affected shareholders" would include all persons who were shareholders during the year.

j. Expand the post-termination period and amend subchapter S audit procedures

Present Law

Distributions made by a former S corporation during its post-termination period are treated in the same manner as if the distributions were made by an S corporation (i.e., treated by shareholders as nontaxable distributions to the extent of the accumulated adjustment account). Distributions made after the post-termination period are generally treated as made by a C corporation (i.e., treated by shareholders as taxable dividends to the extent of earnings and profits).

The "post-termination period" is the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of: (1) a date that is one year later, or (2) the due date for filing the return for the last taxable year and the 120-

[97] This is the effective date of the present-law provision regarding inadvertent terminations.

day period beginning on the date of a determination that the corporation's S corporation election had terminated for a previous taxable year.

In addition, the audit procedures adopted by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) with respect to partnerships also apply to S corporations. Thus, the tax treatment of items is determined at the corporate, rather than individual level.

Description of Proposal

The present-law definition of post-termination period would be expanded to include the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the S corporation's election and that adjusts a subchapter S item of income, loss or deduction of the S corporation during the S period. In addition, the definition of "determination" would be expanded to include a final disposition of the Secretary of the Treasury of a claim for refund and, under regulations, certain agreements between the Secretary and any person, relating to the tax liability of the person.

In addition, the bill would repeal the TEFRA audit provisions applicable to S corporations and would provide other rules to require consistency between the returns of the S corporation and its shareholders.[98]

k. Termination of election and additions to tax due to passive investment income

Present Law

An S corporation is subject to corporate-level tax, at the highest marginal corporate tax rate, on its net passive income if the corporation has (1) subchapter C earnings and profits[99] at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

In addition, an S corporation election is terminated whenever the corporation has subchapter C earnings and profits at the close of three consecutive taxable years and has gross receipts for each of such years more than 25 percent of which are passive investment income.

For these purposes, "passive investment income" generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). "Passive investment income" generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, or gain or loss from any section 1256 contract (or related property) of an options or commodity dealer.[100] "Net passive income" is defined as

[98] A similar provision was included in H.R. 11 (the "Revenue Act of 1992"), vetoed by President Bush in 1992 and in H.R. 3419 (the "Tax Simplification and Technical Corrections Act of 1993"), as passed by the House of Representatives on May 17, 1994.

[99] An S corporation generally will have subchapter C corporation earnings and profits if it had been a C corporation prior to electing to be an S corporation.

[100] See, Treas. reg. sec. 1.1362(c)(5).

passive investment income reduced by the allowable deductions that are directly connected with the production of the income.

Description of Proposal

The bill would increase the passive investment income threshold from 25 percent of gross income to 50 percent of gross income for purposes of levying the corporate-level tax on such income. In addition, "passive investment income" generally would not include gain from the sale of capital assets.

The provision also would eliminate the rule that terminates an S corporation election whenever the corporation has excessive passive income for three consecutive years. Rather, for a taxable years beginning after 1995, if an S corporation has excessive passive investment income (as re-defined under the bill) for more than three consecutive taxable years, the rate of corporate-level tax applicable to such income is increased by 10 percentage points for each such succeeding taxable year (capped at a 50 percentage point increase after the seventh consecutive year). For example, if an S corporation has excessive passive investment income for 5 consecutive years, the corporate-level rates of tax applicable to such income would be 35 percent (the top marginal corporate tax rate) in the first three years, 45 percent in the fourth year, and 55 percent in the fifth year.

l. Treatment of distributions by S corporations during loss year

Present Law

Under present law, the amount of loss an S corporation shareholder may take into account for a taxable year cannot exceed the sum of the shareholder's adjusted basis in his or her stock of the corporation and the adjusted basis in any indebtedness of the corporation to the shareholder. Any excess loss is carried forward.

Any distribution to a shareholder by an S corporation generally is tax-free to the shareholder to the extent of the shareholder's adjusted basis of his or her stock. The shareholder's adjusted basis is reduced by the tax-free amount of the distribution. Any distribution in excess of the shareholder's adjusted basis is treated as gain from the sale or exchange of the stock.

Under present law, income (whether or not taxable) and expenses (whether or not deductible) serve, respectively, to increase and decrease an S corporation shareholder's basis in the stock of the corporation. These rules appear to require that the adjustments to basis for items of both income and loss for any taxable year apply before the adjustment for distributions applies.[101]

These rules limiting losses and allowing tax-free distributions up to the amount of the shareholder's adjusted basis are similar in certain respects to the rules governing the treatment of losses and cash distributions by partnerships. Under the partnership rules (unlike the S corporation rules), for any taxable year, a partner's

[101] See section 1366(d)(1)(A); H. Rep. 97–826, p. 17; S. Rep. 97–640, p. 18; Treas. reg. sec. 1.1367–1(e).

basis is first increased by items of income, then decreased by distributions, and finally is decreased by losses for that year.[102]

In addition, if the S corporation has accumulated earnings and profits,[103] any distribution in excess of the amount in an "accumulated adjustments account" will be treated as a dividend (to the extent of the accumulated earnings and profits). A dividend distribution does not reduce the adjusted basis of the shareholder's stock. The "accumulated adjustments account" generally is the amount of the accumulated undistributed post–1982 gross income less deductions.

Description of Proposal[104]

The bill would provide that the adjustments for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for the year. Thus, distributions during a year would reduce the adjusted basis for purposes of determining the allowable loss for the year, but the loss for a year would not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year.

The bill also would provide that in determining the amount in the accumulated adjustment account for purposes of determining the tax treatment of distributions made during a taxable year by an S corporation having accumulated earnings and profits, net negative adjustments (i.e., the excess of losses and deductions over income) for that taxable year are disregarded.

The following examples illustrate the application of these provisions:

Example 1.—X is the sole shareholder of corporation A, a calendar year S corporation with no accumulated earnings and profits. X's adjusted basis in the stock of A on January 1, 1996, is $1,000 and X holds no debt of A. During 1996, A makes a distribution to X of $600, recognizes a capital gain of $200 and sustains an operating loss of $900. Under the bill, X's adjusted basis in the A stock is increased to $1,200 ($1,000 plus $200 capital gain recognized) pursuant to section 1368(d) to determine the effect of the distribution. X's adjusted basis is then reduced by the amount of the distribution to $600 ($1,200 less $600) to determine the application of the loss limitation of section 1366(d)(1). X is allowed to take into account $600 of A's operating loss, which reduces X's adjusted basis to zero. The remaining $300 loss is carried forward pursuant to section 1366(d)(2).

Example 2.—The facts are the same as in Example 1, except that on January 1, 1996, A has accumulated earnings and profits of $500 and an accumulated adjustments account of $200. Under the bill, because there is a net negative adjustment for the year, no adjustment is made to the accumulated adjustments account before determining the effect of the distribution under section 1368(c).

[102] Treas. reg. sec. 1.704–1(d)(2); Rev. Rul. 66–94, 1966–1 C.B. 166.

[103] An S corporation may have earnings and profits from years prior to its subchapter S election or from pre–1983 subchapter S years.

[104] A similar provision was included in H.R. 11 (the "Revenue Act of 1992"), vetoed by President Bush in 1992 and in H.R. 3419 (the "Tax Simplification and Technical Corrections Act of 1993"), as passed by the House of Representatives on May 17, 1994.

As to A, $200 of the $600 distribution is a distribution of A's accumulated adjustments account, reducing the accumulated adjustments account to zero. The remaining $400 of the distribution is a distribution of accumulated earnings and profits ("E&P") and reduces A's E&P to $100. A's accumulated adjustments account is then increased by $200 to reflect the recognized capital gain and reduced by $900 to reflect the operating loss, leaving a negative balance in the accumulated adjustment account on January 1, 1997, of $700 (zero plus $200 less $900).

As to X, $200 of the distribution is applied against X's adjusted basis of $1,200 ($1,000 plus $200 capital gain recognized), reducing X's adjusted basis to $1,000. The remaining $400 of the distribution is taxable as a dividend and does not reduce X's adjusted basis. Because X's adjusted basis is $1,000, the loss limitation does not apply to X, who may deduct the entire $900 operating loss. X's adjusted basis is then decreased to reflect the $900 operating loss. Accordingly, X's adjusted basis on January 1, 1997, is $100 ($1,000 plus $200 less $200 less $900).

m. Permit consent dividends to by-pass the accumulated adjustments account

Present Law

The accumulated adjustments account (AAA) of an S corporation generally is the amount of undistributed earnings of the S corporation that have been subject to shareholder-level tax. If an S corporation with both AAA and C corporation earnings and profits makes a distribution to shareholders, the amount of the distribution is deemed to first reduce the AAA. An S corporation may, with the consent of all its affected shareholders, elect to have all distributions made during a taxable year by-pass the AAA. Treasury regulation 1.1368–1(f)(3) allows the election to apply to deemed dividends.

Description of Proposal

The Treasury regulation allowing the election to by-pass the AAA to apply to deemed dividends would be codified. Any such distribution to an organization described in section 511(a)(2) would be treated as unrelated business taxable income to such organization.

n. Treatment of S corporations as shareholders in C corporations

Present Law

Present law contains several provisions relating to the treatment of S corporations as corporations generally for purposes of the Internal Revenue Code.

First, under present law, the taxable income of an S corporation is computed in the same manner as in the case of an individual (sec. 1363(b)). Under this rule, the provisions of the Code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction, do not apply to S corporations.

Second, except as otherwise provided by the Internal Revenue Code and except to the extent inconsistent with subchapter S, subchapter C (i.e., the rules relating to corporate distributions and adjustments) applies to an S corporation and its shareholders (sec. 1371(a)(1)). Under this second rule, provisions such as the corporate reorganization provisions apply to S corporations. Thus, a C corporation may merge into an S corporation tax-free.

Finally, an S corporation in its capacity as a shareholder of another corporation is treated as an individual for purposes of subchapter C (sec. 1371(a)(2)). The Internal Revenue Service has taken the position that this rule prevents the tax-free liquidation of a C corporation into an S corporation because a C corporation cannot liquidate tax-free when owned by an individual shareholder.[105] Thus, a C corporation may elect S corporation status tax-free or may merge into an S corporation tax-free, but may not liquidate into an S corporation tax-free.[106] Also, the Service's reasoning would prevent an S corporation from making an election under section 338 where a C corporation was acquired by an S corporation.

Description of Proposal[107]

The bill would repeal the rule that treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus, the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules, including the provisions of sections 332 and 337 allowing the tax-free liquidation of a corporation into its parent corporation. Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax under section 1374 upon a subsequent disposition. An S corporation also will be eligible to make a section 338 election (assuming all the requirements are otherwise met), resulting in immediate recognition of all the acquired C corporation's gains and losses (and the resulting imposition of a tax).

The repeal of this rule would not change the general rule governing the computation of income of an S corporation. For example, it would not allow an S corporation, or its shareholders, to claim a dividends received deduction with respect to dividends received by the S corporation, or to treat any item of income or deduction in a manner inconsistent with the treatment accorded to individual taxpayers.

o. Elimination of pre-1983 earnings and profits of S corporations

Present Law

Under present law, the accumulated earnings and profits of a corporation are not increased for any year in which an election to be treated as an S corporation is in effect. However, under the subchapter S rules in effect before revision in 1982, a corporation elect-

[105] See PLR 8818049, (Feb. 10, 1988). However, see PLR 9245004, (July 28, 1992) for a contrary ruling.

[106] Tax is imposed with respect to LIFO inventory held by a C corporation becoming an S corporation.

[107] A similar provision was included in H.R. 11 (the "Revenue Act of 1992"), vetoed by President Bush in 1992 and in H.R. 3419 (the "Tax Simplification and Technical Corrections Act of 1993"), as passed by the House of Representatives on May 17, 1994.

ing subchapter S for a taxable year increased its accumulated earnings and profits if its earnings and profits for the year exceeded both its taxable income for the year and its distributions out of that year's earnings and profits. As a result of this rule, a shareholder may later be required to include in his or her income the accumulated earnings and profits when it is distributed by the corporation. The 1982 revision to subchapter S repealed this rule for earnings attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.

Description of Proposal[108]

The bill would provide that if a corporation is an S corporation for its first taxable year beginning after December 31, 1995, the accumulated earnings and profits of the corporation as of the beginning of that year would reduced by the accumulated earnings and profits (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S. Thus, such a corporation's accumulated earnings and profits would be solely attributable to taxable years for which an S election was not in effect. This rule is generally consistent with the change adopted in 1982 limiting the S shareholder's taxable income attributable to S corporation earnings to his or her share of the taxable income of the S corporation.

p. Treatment of certain charitable contributions of property

Present Law

Taxpayers generally are allowed to deduct the fair market value of property contributed to a charitable organization. In the case of business property contributed to a charity and used in the tax-exempt function of the charity, donors must reduce the amount of the deduction by the amount of gain that would not have been long-term capital gain had the property been sold by the donor (sec. 170(e)(1)(A)).[109] However, the amount of the reduction is capped in the case of a corporation (other than an S corporation) that contributes (1) certain inventory used by the donee solely for the care of the ill, needy, or infants (sec. 170(e)(3)(B)) or (2) certain scientific property used for research (sec. 170(e)(4)). In such cases, the amount of the reduction is limited to the sum of (1) one-half of the amount of gain that would not have been long-term capital gain had the property been sold and (2) the amount (if any) by which the charitable contribution (determined by taking into account the amount described in (1)) exceeds twice the basis of the property.

If an S corporation contributes appreciated property to a charity, the shareholders of the corporation must reduce their basis in their S corporation stock by the amount of the contribution that flows through to them.

[108] A similar provision was included in H.R. 11 (the "Revenue Act of 1992"), vetoed by President Bush in 1992 and in H.R. 3419 (the "Tax Simplification and Technical Corrections Act of 1993"), as passed by the House of Representatives on May 17, 1994.

[109] Greater reductions are required if the property is not used in the charity's tax-exempt function (sec. 170(e)(1)(B)).

Description of Proposal

The bill would provide that S corporations would be treated the same as C corporations with respect to charitable contributions of (1) certain inventory used by the donee solely for the care of the ill, needy, or infants and (2) certain scientific property used for research.

The bill also allows an increase in the basis of S corporation stock for the excess of the deduction for charitable contribution over the basis of the property contributed by the corporation.

q. Treatment of certain fringe benefits

Present Law

For fringe benefit purposes, an individual that owns two percent or more of the stock of the S corporation at any time during the year is treated the same as a partner in a partnership.

Self-employed individuals may deduct up to 30 percent of the amount paid during the year for medical insurance that covers the individual and his or her spouse and dependents. For this purposes, an individual that owns two percent or more of the stock of the S corporation at any time during the year is treated as a self-employed individual.

A qualified deferred compensation plan of an S corporation is prohibited from making loans to shareholder-employees that own more than five percent of the S corporation stock. Should this prohibition be violated, the plan may be subject to an excise tax.

Description of Proposal

For fringe benefit purposes, an S corporation generally would be treated as a C corporation rather than as a partnership. However, two-percent shareholders would be treated as self-employed individuals for purposes of the deduction for medical insurance (i.e., their deductions for medical insurance would be limited to 30 percent of their cost.)

In addition, the restriction on loans from qualified plans would be repealed.

r. Treatment of losses on liquidation of S corporation

Present Law

If an S corporation is liquidated, gain or loss on the property distributed in liquidation is measured at the corporate level (by comparing the fair market value of the property to its adjusted basis in the hands of the corporation) and flowed through to the shareholders. The character of such gain or loss is also determined at the corporate level and may be flowed through to shareholders as ordinary gain or loss. The gain increases the shareholders' adjusted bases in their stock. The shareholders then have individual-level gain or loss with respect to the property received (measured by comparing the fair market value of the property to the shareholders' adjusted bases in their stock). Such gain or loss generally is capital gain or loss. Thus, a shareholder of an S corporation may

have ordinary gain and a capital loss upon the liquidation of an S corporation.

Description of Proposal

Loss recognized by a shareholder in complete liquidation of an S corporation would be treated as ordinary loss to the extent the shareholder's adjusted basis in the S corporation stock is attributable to ordinary income that was recognized as a result of the liquidation.

s. Treatment of certain losses carried over under the at-risk rules

Present Law

Under section 1366, the amount of loss an S corporation shareholder may take into account cannot exceed the sum of the shareholder's adjusted basis in his or her stock of the corporation and the unadjusted basis in any indebtedness of the corporation to the shareholder. Any disallowed loss is carried forward to the next taxable year. Any loss that is disallowed for the last taxable year of the S corporation may be carried forward to the post-termination period. The "post-termination period" is the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of: (1) a date that is one year later, or (2) the due date for filing the return for the last taxable year and the 120-day period beginning on the date of a determination that the corporation's S corporation election had terminated for a previous taxable year.

In addition, under section 465, a shareholder of an S corporation may not deduct losses that are flowed through from the corporation to the extent the shareholder is not "at-risk" with respect to the loss. Any loss not deductible in one taxable year because of the at-risk rules is carried forward to the next taxable year.

Description of Proposal

Losses of an S corporation that are suspended under the at-risk rules of section 465 would be carried forward to the S corporation's post-termination period.

t. Effective date and transition rule for elections after termination

Present Law

A small business corporation that terminates its subchapter S election (whether by revocation or otherwise) may not make another election to be an S corporation for five taxable years unless the Secretary of the Treasury consents to such election.

Description of Proposal

Except as otherwise provided, the provisions of the bill relating to elections after termination would be effective for taxable years beginning after December 31, 1995.

In addition, for purposes of the 5-year rule, any termination of subchapter S status in effect immediately before the date of enactment of the bill would not be taken into account. Thus, any small business corporation that had terminated its S corporation election within the 5-year period before the date of enactment may re-elect subchapter S status upon enactment of the bill without the consent of the Secretary of the Treasury.[110]

2. Treatment of certain real estate held by an S corporation

Present Law

Under present-law section 1237, a lot or parcel of land held by a taxpayer *other than a corporation* generally is treated as capital gain property solely by reason of the land being subdivided if (1) such parcel had not previously been held as inventory-like property and if in the year of sale, the taxpayer held no other property and (2) no substantial improvement has been made on the property by the taxpayer, a related party, a lessee, or a government, and (3) the land has been held by the taxpayer for 5 years.

Description of Proposal

The proposal (H.R. 1213, introduced by Mr. Stark) would allow the present-law capital gains presumption in the case of property held by an S corporation.[111]

Effective Date

The proposal would be effective for sales after January 1, 1992, and to sales before January 1, 1992 for purposes of characterizing post–1991 sales as falling under section 1237.

3. Treatment of financial asset securitization investment trusts ("FASITs")

Present Law

The ownership of income-producing assets can be structured several different ways, with different consequences for Federal income tax purposes. An individual can own income-producing assets directly, or indirectly through an entity. That entity may be an entity that is subject to tax, or an entity that is a conduit generally not subject to tax or a partial conduit that generally is subject to tax only to the extent its income is not distributed to its owners.

Direct ownership

An individual who owns income-producing assets directly generally includes all income generated by the property, and deducts or capitalizes all items of expense related to the property. When such assets are disposed of in a taxable transaction, the individual recognizes gain or loss, which may be capital gain or loss.

[110] A similar provision was included in the Subchapter S Revision Act of 1982.

[111] The proposal was contained in H.R. 11 as passed by the House of Representatives and the Senate in 1992 and vetoed by President Bush. The proposal is not contained in S. 758.

Indirect ownership

An individual can own income-producing assets indirectly through the ownership of an interest in an entity that owns such assets. These entities include corporations, partnerships, and trusts.

Corporations.—A corporation generally is a taxable entity, separate from its stockholders. Thus, income earned by a corporation is taxed to the corporation. In addition, when the after-tax earnings of a corporation are distributed to the corporation's stockholders as dividends, generally such earnings also are taxed to the stockholders. Because interest is deductible, as described below, a corporation may reduce its entity-level tax and tend more toward treatment as a conduit entity the more it uses debt in its capital structure.

Partnerships.—A partnership generally is a complete conduit for Federal income tax purposes. Thus, each partner takes into account his "distributive share" of the partnership's income, loss, deduction, and credit separately. A partnership itself generally has no Federal income tax liability.

Trusts.—A trust generally is treated as a partial conduit for Federal income tax purposes since the trust, although in form a separate taxable entity, is allowed a deduction for amounts distributed to its beneficiaries, which amounts generally are includible in the beneficiaries' income. A trust is an arrangement whereby trustees take title to property and become responsible for the protection and conservation of such property on behalf of the persons holding the beneficial interest in the property.

Classification rules.—Treasury regulations provide that whether a particular entity is classified as an association taxable as a corporation or as a partnership, trust, or some other entity not taxable as a corporation is determined by taking into account the presence or absence of certain characteristics associated with corporations. These characteristics are (1) the presence of associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for entity debts limited to entity property, and (6) free transferability of interests in the entity.

Corporations and partnerships share the first two characteristics described above, and so the classification of an unincorporated entity as an association taxable as a corporation rather than a partnership depends on whether the entity has at least three of the remaining four characteristics. Nonetheless, certain entities that otherwise satisfy the test for partnership classification, but whose interests are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof), are treated as corporations for Federal income tax purposes (sec. 7704).

Corporations and trusts share the last four characteristics described above. Accordingly, the Treasury regulations provide that whether a particular unincorporated entity is treated as a trust or as an association taxable as a corporation depends on whether the entity has associates and an objective to carry on business and divide the gains therefrom. Generally, if the purpose of an arrangement is to grant to trustees exclusive responsibility for the protec-

tion and conservation of trust property, and the persons with the beneficial interest in the property cannot share in the discharge of that responsibility, there are no associates or objective to carry on business. Such an arrangement generally is treated as a trust. A trust that holds income-producing assets (such as a fixed investment trust) may be treated as a trust if there is no power under the trust agreement to vary the investment.

Under Treasury regulations, an arrangement having more than one class of ownership interests generally is not treated as a trust, but is treated as a corporation for Federal income tax purposes. Under these regulations, a trust is treated as having one class of ownership if all of the beneficiaries of the trust have undivided interests in all of the trust property. Thus, under the regulations, if a trust held a portfolio of debt obligations, and interests in the trust assets were divided so that one class of beneficiaries was to receive all principal collected by the trust and a specified rate of interest thereon, until the trust had collected a specified amount of principal on the debt obligations, and another class of beneficiaries was to receive all remaining amounts collected by the trust, such trust would be treated as an association taxable as a corporation.

Statutory vehicles

The Internal Revenue Code (the "Code") establishes a number of vehicles that are treated as conduits or partial conduits through which individuals can own income-producing assets indirectly. These vehicles include S corporations, real estate investment trusts, regulated investment companies and real estate mortgage investment conduits.

S corporations.—An S corporation generally is a complete conduit for Federal income tax purposes. Thus, although S corporations are corporate entities, their shareholders generally account for a proportionate amount of the corporation's items of income, loss, deduction, and credit separately under subchapter S of the Code (sacs. 1361 *et seq.*). The S corporation itself generally has no tax liability. In general, to be entitled to elect and retain S corporation status, a domestic corporation must have 35 or fewer shareholders (none of whom are corporations or nonresident aliens) and may issue only one class of stock.

Real estate investment trusts ("REITs").—A REIT generally is treated as a partial conduit for Federal income tax purposes. Conduit treatment is achieved by allowing the REIT a deduction for earnings distributed to shareholders on a current basis, provided that the REIT makes certain minimum annual distributions (sec. 857). Income that is not distributed to a REIT's shareholders currently is taxed at the REIT level, as in the case of ordinary corporations.

In general, an entity may qualify as a REIT if it is a trust or corporation with freely transferable interests, the beneficial ownership of which is held by 100 or more persons, which trust or corporation would be taxable as an ordinary domestic corporation but for its meeting certain specified requirements, including that its assets are comprised substantially of real estate assets and its income is substantially realized from certain real estate and related sources. A REIT's ability to engage in regular business activities is

limited by a requirement that income from the sale or other disposition of stock or securities held for less than 1 year, real property held for less than 4 years, or certain other property, must account for less than 30 percent of the REIT's gross income. Further, a 100 percent tax is imposed on gains from the sale of property held for sale to customers in the ordinary course of the REIT's trade or business (other than foreclosure property).

Regulated investment companies ("RICs").—In general, a RIC is an electing domestic corporation that either meets, or is excepted from, certain registration requirements under the Investment Company Act of 1940 (15 U.S.C. 80), that derives at least 90 percent of its ordinary income from specified passive income and that meets certain other requirements, such as asset diversification requirements. A RIC, like a REIT, generally is subject to the regular corporate tax, but receives a deduction for dividends paid to its shareholders, provided that it meets certain minimum annual income distribution requirements. The ability of a RIC to engage in short-term trading of its assets is limited by a requirement that less than 30 percent of the RIC's gross income may be derived from gain on the sale or other disposition of stock or securities held for less than three months.

Real estate mortgage investment conduits ("REMICs").—In general, a REMIC is an entity that owns a fixed pool of mortgages and that issues multiple classes of interests in that pool. If specified requirements are met, the REMIC generally is not subject to Federal income tax.

The income of the REMIC is allocated to, and taken into account by, the holders of the interests therein. Holders of "regular interests" issued by a REMIC generally take into income the portion of the REMIC's income that would be recognized by an accrual method holder of a debt instrument having the same terms as the particular regular interest; holders of "residual interests" take into account all of the taxable income of the REMIC not taken into account by the holders of the regular interests or the net loss of the REMIC.

A portion of the income a residual holder derives from a REMIC is treated as unrelated business taxable income for tax-exempt entities and as subject to withholding at the statutory rate when paid to foreign persons, and generally may not be offset by net operating losses.

A REMIC's ability to engage in an active business is limited by a 100 percent tax on its net income from certain prohibited transactions, including certain dispositions of the assets a REMIC is entitled to hold, the receipt of income from assets other than assets a REMIC is entitled to hold, and the receipt of any compensation for services.

REMICs are the exclusive means of issuing multiple class real estate mortgage-backed securities without the imposition of two levels of Federal income tax. Any arrangement that qualifies as a "taxable mortgage pool" ("TMP") is treated as a taxable corporation that is not an includible corporation for purposes of filing consolidated returns. Any entity other than a REMIC is a TMP if (1) substantially all of the entity's assets consist of debt obligations (or interests in debt obligations) and a majority of the assets consists of

real estate mortgages, (2) the entity issues debt obligations with two or more maturities, and (3) payments on such debt obligations are to bear a relationship to payments on the debt obligations (or interests therein) held by the entity.

Treatment of debt obligations

Deduction for interest paid.—Interest on debt incurred by a corporation to finance the acquisition of income-producing assets generally is deductible to the corporation incurring the debt. To the extent that income from debt-financed property is paid to the debtholders in the form of interest, the interest deduction offsets any corporate-level tax on such income, resulting in the imposition of only a single tax on the income, which is borne by the debtholder. In contrast, a corporation is not able to deduct dividends distributed to shareholders for purposes of calculating its taxable income.

Classification rules.—The determination of whether an instrument issued by a corporation is debt or equity is based on all the facts and circumstances. Factors that may be taken into account to determine whether an interest in a corporation is debt include (1) whether a written unconditional promise exists to pay on demand or on a specified date a sum certain in money and to pay a fixed rate of interest, (2) whether a preference exists over any other indebtedness of the corporation, (3) the ratio of debt to equity of the corporation, (4) whether the interest is convertible into the stock of the corporation, and (5) whether there is a relationship between stock holdings and debt ownership. The Secretary of the Treasury is authorized to prescribe regulations to determine whether an interest in a corporation is stock or debt for Federal tax purposes (sec. 385(a)). Treasury regulations were issued under this authorization, but were subsequently withdrawn.

Original issue discount.—If the borrower receives less in a lending transaction than the amount to be repaid at the loan's maturity, the difference represents "discount." Discount performs the same function as stated interest, i.e., compensation of the lender for the use of the lender's money. Code sections 1272 through 1275 and section 163(e) (the "OID rules") generally require the holder of a debt instrument issued at a discount (provided that such discount is not less than a certain *de minimis* amount) to include annually in income a portion of the original issue discount ("OID") on the instrument, and allow the issuer of such an instrument to deduct a corresponding amount, irrespective of the methods of accounting that the holder and the issuer otherwise use.

Special rules for calculating the accrual of OID apply to regular interests in REMICs, qualified mortgages held by REMICs, and any debt instruments that have maturities that are initially fixed, but that may be accelerated based on prepayments of other debt obligations securing the debt instruments (or, to the extent provided in Treasury regulations, by reason of other events) (sec. 1272(a)(6)). These rules require OID for an accrual period to be calculated taking into account expected and actual rates of prepayments of the principal of the REMIC regular interests, the REMIC qualified mortgages, or the debt instruments.

Market discount.—Similarly, a debt obligation may be subject to the market discount rules (sec. 1276–1278). Market discount is de-

fined as the excess of the stated redemption price of an obligation over its basis immediately after acquisition (provided that such excess is not less than a certain *de minimis* amount). In the case of a bond that has original issue discount, for purposes of the market discount rules, its stated redemption price generally is treated as the sum of its issue price and the amount of original issue discount that would have been includible in the income of an original holder.

Unlike in the case of OID, a holder of a debt obligation generally is not required to include accrued market discount in income currently. In general, however, gain on the disposition of a debt obligation that was issued after July 18, 1984, generally is treated as ordinary income to the extent of any accrued market discount. In addition, if indebtedness is incurred to purchase or carry a debt obligation that has market discount, interest on such indebtedness in excess of the amount of interest includible in income with respect to such obligation is deductible only to the extent that such interest exceeds the accrued market discount allocable to the taxable year.

Coupon stripping rules.—Where there is a separation of ownership of the right to receive any payment of principal or interest on a debt obligation, other than a pro rata share of all payments, the holder who disposes of the right to receive certain payments on the debt obligation must allocate his basis in the obligation between the portion of the debt obligation that is disposed of and the portion retained for purposes of recognizing gain or loss (sec. 1286). This allocation is made based on the two positions' relative fair market values. The OID rules then govern the amount that the respective holders of the "stripped" debt obligation and the "stripped" coupons must include in income annually.

Description of Proposal

In general

The bill (H.R. 1967) would create a new type of statutory entity called a financial asset securitization investment trust (a "FASIT") that would facilitate the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans. A FASIT generally would not be taxable as a corporation; the FASIT's taxable income or net loss would flow through to the persons holding ownership interests in the FASIT. Ownership interests issued by a FASIT would be required to satisfy certain tests and FASIT ownership interests generally could be held only by corporations and certain other specified entities. In addition, a FASIT generally could hold only debt obligations and would be subject to certain restrictions on its activities. An entity or arrangement that qualified as a FASIT could issue certain instruments with yields to maturity of up to 5 percentage points over the yield to maturity on specified United States government obligations and treat those instruments as debt without concern that such instruments would be recharacterized as equity for Federal income tax purposes.

Qualification as a FASIT

In order for an entity or arrangement to qualify as a FASIT, it would be subject to certain requirements, including (1) the entity or arrangement must elect to be treated as a FASIT, (2) substan-

tially all of its assets must be limited to certain specified assets described below, (3) the interests in the entity must be limited to ownership interests, permitted debt instruments or qualified debt instruments, and (4) there may be only one class of ownership interest.

For an entity or arrangement to qualify as a FASIT, substantially all of its assets would be required to consist of (1) cash or cash items, (2) debt obligations, (3) foreclosure property acquired on default (or imminent default) of debt obligations held by the FASIT (subject to certain limitations as to the time the FASIT could retain such assets), (4) instruments or contracts that represented a hedge or guarantee of debt held or issued by the FASIT, (5) to the extent permitted in regulations, interests in other FASITs, and (6) contract rights to acquire any of the above assets (collectively, "permitted assets"). A FASIT would have to meet the asset test at the ninetieth day after its formation and at all times thereafter. Permitted assets could be acquired at any time by a FASIT, including any time after its formation.

Debt instruments issued by FASITs

The bill would allow FASITs to issue "qualified debt instruments" that would be treated as debt for Federal tax purposes, regardless of whether instruments with similar terms issued by non–FASITs might be recharacterized as equity. To be treated as a qualified debt instrument an instrument would be required to (1) unconditionally entitle the holder to receive a specified principal amount, (2) pay interest that is based on one or more rates that are fixed or whose variations can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which the instrument is denominated, (3) have a maturity of no more than 30 years, (4) be issued with a premium of not more than 25 percent of its principal amount, and (5) have a yield to maturity at issue no more than five percentage points above the yield to maturity on outstanding marketable obligations of the United States government having a comparable maturity. Further, any interest payable on the instrument would be required to be of a type that would be qualified interest under the rules that apply to FASIT preferred ownership interests.

A FASIT also could issue permitted debt instruments, which would be any instrument issued by a FASIT that is designated as a permitted debt instrument and that meets the first four (but not the fifth) conditions described above.

Ownership interests issued by FASITs

In general, an ownership interest in a FASIT is any interest in the FASIT that is designated as an ownership interest, provided that there is only one class of such interest, and that all distributions (if any) with respect to the interest are pro rata.

Transfers to non-permitted holders of certain FASIT interests

A transfer of an ownership interest or a permitted debt instrument to an impermissible holder would be ignored under the proposal. Thus, the transferor would continue to be liable for any taxes due with respect to the transferred interest. An impermis-

sible holder generally is any holder other than a pass-through entity or a corporation that is not exempt from corporate income and is a U.S. person. A pass-through entity is any RIC, REIT, common trust fund, partnership, trust, estate, certain cooperatives, and any S corporations.

The bill also would provide that if, at any time during a taxable year of a pass-through entity, the pass-through entity held, directly or indirectly, an ownership interest in a FASIT, and a record holder of an interest in the pass-through entity was not itself a permitted holder, the pass-through entity generally would be subject to a tax at the highest corporate rate on any taxable income from the ownership interest that was allocable to any such record holder. This tax generally would not apply to a pass-through entity that originated the debt obligations held by the relevant FASIT in connection with the pass-through entity's sale of goods or services, or to any pass-through entity that was a dealer in FASIT ownership interests. The tax on pass-through entities would not apply if a pass-through entity obtained from the record holder an affidavit that the record holder was a permitted holder and the pass-through entity had no actual knowledge during the period that the affidavit was false.

Taxation of a FASIT and interests in the FASIT

In general.—A FASIT generally would not be subject to tax. However, a FASIT would be required to pay a tax equal to 100 percent from gross income derived from any asset that is not a permitted asset, gain from the disposition of any asset that was acquired by the FASIT for the principal purpose of recognizing gains (or reducing losses) as a result of an increase in the market value of the asset following its acquisition (other than an increase attributable to any bond discount), compensation for services. A FASIT also would be subject to tax at the highest corporate rate on income from any foreclosure property.

Under the bill, the taxable income of a FASIT generally would be calculated as if it were a corporation. The constant yield method and principles that apply for purposes of determining OID accrual on debt obligations whose principal is subject to acceleration would apply to all debt obligations held by a FASIT to calculate the FASIT's interest and discount income and premium deductions or adjustments. A FASIT's income would be taken into account by the holders of its ownership interests, as described below.

Taxation of holders of debt instruments.—A holder of qualified or permitted debt instruments generally would be taxed in the same manner as a holder of any other debt instrument to which the rules of taxation generally applicable to debt instruments apply, except that the holder of a qualified or permitted debt instrument would be required to account for income relating to the interest on the accrual method of accounting regardless of the method of accounting otherwise used by the holder.

Taxation of holders of ownership interests.—A holder of a FASIT ownership interest would take into account its daily portion of the FASIT's taxable income or net loss allocable to ownership interests of the same class. The character, source, and other attributes of the

income to the holder of an ownership interest would be determined as if the income had been incurred directly by the holder.

A portion of any net loss of a FASIT could be taken into account by a holder of an ownership interest to the extent of its adjusted basis in the interest. Disallowed losses would be carried forward by the holder.

A special rule provides that a holder of a FASIT ownership interest cannot offset income from that interest by any other losses. This rule would not apply to certain holders that received their ownership interests in exchange for transfers to the FASIT of debt obligations originated by the holder.

Transfers to and distributions from FASITs

Gain or loss generally would not be recognized immediately by either the transferor or the FASIT upon the transfer of assets to a FASIT in a qualified exchange. A qualified exchange generally is defined as the transfer of assets to a FASIT by a person that holds any ownership interests of the FASIT immediately after the exchange. If a transferor receives "boot" (i.e., money or other property other than ownership interests) in a qualified exchange, the "boot" would be treated as a distribution with respect to the holder's interest.

A portion of any "built-in" gain in an asset that was transferred to a FASIT would be recognized periodically (not less than annually) by owners of the FASIT. The amount of gain (or loss) that would be recognized periodically would be the increase (or decrease) in the product of (A) any excess of the fair market value of the FASIT's assets over the FASIT's aggregate basis in such assets, (B) one, minus the amount determined by dividing (i) the fair market value of the FASIT's ownership interests, by (ii) the fair market value of the FASIT's assets, and (C) the fraction of the FASIT's ownership interests that are held by the holder.

A distribution of assets by a FASIT with respect to an interest or instrument generally would be treated as a sale of the assets and distribution of the sale proceeds. In addition, a distribution by a FASIT with respect to an ownership interest generally would not be included in gross income by the holder to the extent that the distribution does not exceed the adjusted basis of the holder's interest, and would be treated as gain from the sale or exchange of the interest to the extent it exceeds the adjusted basis of the interest.

The basis of any holder's ownership interest in a FASIT would be increased by any money (and the transferor's basis in any property) contributed by the holder and the amount of the taxable income taken into account by the holder from the FASIT with respect to the interest. The basis would be decreased by the amount of any distributions to the holder, the amount of any deductions taken into account by the holder, and the amount of any losses taken into account by the holder with respect to the interest.

Effective Date

The proposal would be effective on the date of enactment.

Legislative Background

The bill (H.R. 1967) was introduced by Mr. Shaw and others on June 29, 1995.

4. Treatment of tax-exempt municipal investment conduits (TEMICs)

Present Law

As discussed earlier in the proposal to establish financial asset securitization investment trusts, the ownership of income-producing assets can be structured several different ways, with different consequences for Federal income tax purposes. An individual can own income-producing assets directly, or indirectly through an entity. That entity may be an entity that is subject to tax, or an entity that is a conduit generally not subject to tax or a partial conduit that generally is subject to tax only to the extent its income is not distributed to its owners.

Tax-exempt conduits

As discussed earlier, a regulated investment company (a "RIC") generally is subject to the regular corporate tax, but receives a deduction for dividends paid to their shareholders. A RIC may pass through to its shareholders tax-exempt interest from state and municipal bonds, qualified scholarship funding bonds, and other exempt obligations, if at least half of the value of the RIC's assets consist of such obligations at the close of each quarter of its tax year.

As discussed earlier, a real estate mortgage investment conduit (a "REMIC") is an entity that owns a fixed pool of mortgages and that issues multiple classes of interests in that pool. A REMIC generally is not subject to Federal income tax.

Tax-exempt bonds

Interest on State and local government bonds generally is excluded from income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units. Present law also excludes the interest on State and local government bonds when a governmental unit incurs debt as a conduit to provide financing for private parties, if the financed activities are specified in the Internal Revenue Code. Tax-exempt bonds may not be issued to finance private activities not specified in the Code.

Description of Proposal

The proposal would create a vehicle (a tax-exempt municipal investment conduit or "TEMIC") similar to the REMIC, but for tax-exempt municipal bonds rather than real estate mortgages. Under the proposal, tax-exempt bonds issued by state and local governments would be deposited in a trust (the TEMIC). Interests in the TEMIC would be sold to investors, backed by the cash flow from the bonds held in the TEMIC. The TEMIC itself would be a tax-exempt entity. All cash flows from the bonds would flow through the TEMIC to investors. Interests in the TEMIC could be struc-

tured in a variety of ways, in much the same way that REMIC securities are structured currently.

Effective Date

The proposal would be effective on the date of enactment.

5. Modification of rules for real state investment trusts (REITs)

Present Law

Overview

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that receives conduit treatment for income that is distributed to shareholders. If an entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level; the REIT is subject to a corporate tax only on the income that it retains and on certain income from property that qualifies as foreclosure property. Thus, the REIT may serve as a means whereby numerous small investors can have a practical opportunity to invest in a diversified portfolio of real estate assets and have the benefit of professional management.

Election to be Treated as a REIT

In order to qualify as a REIT, and thereby receive conduit treatment, an entity must elect REIT status. A newly-electing entity generally cannot have earnings and profits accumulated from any year in which the entity was in existence and not treated as a REIT (sec. 857(a)(3)). To satisfy this requirement, the entity must distribute, during its first REIT taxable year, any earnings and profits that were accumulated in non–REIT years. For this purpose, distributions by the entity generally are treated as being made from the most recently accumulated earnings and profits.

Taxation of REITs

Overview

In general, if an entity qualifies as a REIT by satisfying the various requirements described below, the entity is taxable as a corporation on its "real estate investment trust taxable income" ("REITTI"), and also is taxable on certain other amounts (sec. 857). REITTI is the taxable income of the REIT with certain adjustments (sec. 857(b)(2)). The most significant adjustment is a deduction for dividends paid. The allowance of this deduction is the mechanism by which the REIT becomes a conduit for income tax purposes.

Capital gains

A REIT that has a net capital gain for a taxable year generally is subject to tax on such capital gain under the capital gains tax regime generally applicable to corporations (sec. 857(b)(3)). However, a REIT may diminish or eliminate its tax liability attributable to such capital gain by paying a "capital gain dividend" to its shareholders (sec. 857(b)(3)(C)). A capital gain dividend is any

dividend or part of a dividend that is designated by the payor REIT as a capital gain dividend in a written notice mailed to shareholders. Shareholders who receive capital gain dividends treat the amount of such dividends as long-term capital gain regardless of their holding period of the stock (sec. 857(b)(3)(C)).

A regulated investment company ("RIC"), but not a REIT, may elect to retain and pay income tax on net long-term capital gains it received during the tax year. If a RIC makes this election, the RIC shareholders must include in their income as long-term capital gains their proportionate share of these undistributed long-term capital gains as designated by the RIC. The shareholder is deemed to have paid the shareholder's share of the tax, which can be credited or refunded to the shareholder. Also, the basis of the shareholder's shares is increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the RIC) included in the shareholder's long-term capital gains.

Income from foreclosure property

In addition to tax on its REITTI, a REIT is subject to tax at the highest rate of tax paid by corporations on its net income from foreclosure property (sec. 857(b)(4)). Net income from foreclosure property is the excess of the sum of gains from foreclosure property that is held for sale to customers in the ordinary course of a trade or business and gross income from foreclosure property (other than income that otherwise would qualify under the 75-percent income test described below) over all allowable deductions directly connected with the production of such income.

Foreclosure property is any real property or personal property incident to such real property that is acquired by a REIT as a result of default or imminent default on a lease of such property or indebtedness secured by such property, provided that (unless acquired as foreclosure property), such property was not held by the REIT for sale to customers (sec. 856(e)). A property generally may be treated as foreclosure property for a period of two years after the date the property is acquired by the REIT. The IRS may grant extensions of the period for treating the property as foreclosure property if the REIT establishes that an extension of the grace period is necessary for the orderly liquidation of the REIT's interest in the property. The grace period cannot be extended beyond 6 years from the date the property is acquired by the REIT.

Property will cease to be treated as foreclosure property if, after 90 days after the date of acquisition, the REIT operates the foreclosure property in a trade or business other than through an independent contractor from whom the REIT does not derive or receive any income (sec. 856(e)(4)(A)).

Income or loss from prohibited transactions

In general, a REIT must derive its income from passive sources and not engage in any active trade or business. Accordingly, in addition to the tax on its REITTI and on its net income from foreclosure property, a 100 percent tax is imposed on the net income of a REIT from "prohibited transactions" (sec. 857(b)(6)). A prohibited transaction is the sale or other disposition of property described in section 1221(1) of the Code (property held for sale in the

ordinary course of a trade or business) other than foreclosure property. Thus, the 100 percent tax on prohibited transactions helps to ensure that the REIT is a passive entity and may not engage in ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project. A safe harbor is provided for certain sales that otherwise might be considered prohibited transactions (sec. 857(b)(6)(C)). The safe harbor is limited to seven or fewer sales a year or, alternatively, any number of sales provided that the gross income from the sales does not exceed 10 percent of the adjusted basis of all the REIT's assets at the beginning of the REIT's taxable year.

Requirements for REIT Status

Overview

A REIT must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. These tests are intended to allow conduit treatment in circumstances in which a corporate tax otherwise would be imposed, only if there really is a pooling of investment arrangement that is evidenced by its organizational structure, if its investments are basically in real estate assets, and if its income is passive income from real estate investment, as contrasted with income from the operation of business involving real estate. In addition, substantially all of the entity's income must be passed through to its shareholders on a current basis.

Organizational structure requirements

To qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees (sec. 856(a)). The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership held by 100 or more persons. In addition, the entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income. A REIT is disqualified for any year in which it does not comply with regulations to ascertain the actual ownership of the REIT's outstanding shares.

Income requirements

Overview

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the "95-percent test"). In addition, at least 75 percent of its income generally must be from certain real estate sources (the "75-percent test"), including rents from real property.

In addition, less than 30 percent of the entity's gross income may be derived from gain from the sale or other disposition of stock or securities held for less than one year, real property held less than four years (other than foreclosure property, or property subject to an involuntary conversion within the meaning of sec. 1033), and

property that is sold or disposed of in a prohibited transaction (sec. 856(c)(4)).

Definition of rents

For purposes of the income requirements, rents from real property generally include rents from interests in real property, charges for services customarily rendered or furnished in connection with the rental of real property, whether or not such charges are separately stated, and rent attributable to personal property that is leased under or in connection with a lease of real property, but only if the rent attributable to such personal property does not exceed 15 percent of the total rent for the year under the lease (sec. 856(d)(1)).

Services provided to tenants are regarded as customary if, in the geographic market within which the building is located, tenants in buildings that are of a similar class (for example, luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance, and of janitorial and cleaning services, the collection of trash, the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard service, parking facilities and swimming pool facilities are examples of services that are customarily furnished to tenants of a particular class of buildings in many geographical marketing areas (Treas. Reg. sec. 1.856–4(b)).

In addition, amounts are not treated as qualifying rent if received from certain parties in which the REIT has an interest of 10 percent or more (sec. 856(d)(2)(B)). For purposes of determining the REIT's ownership interest in a tenant, the attribution rules of section 318 apply, except that 10% is substituted for 50% where it appears in subparagraph (C) of section 318(a)(2) and 318(a)(3) (sec. 856(d)(5)).

Finally, where a REIT furnishes or renders services to the tenants of rented property, amounts received or accrued with respect to such property are not treated as qualifying rents unless the services are furnished through an independent contractor (sec. 856(d)(2)(C)). In general, an independent contractor is a person who does not own more than a 35 percent interest in the REIT, and in which no more than a 35 percent interest is held by persons with a 35 percent or greater interest in the REIT (sec. 856(d)(3)).

Hedging instruments

Interest rate swaps or cap agreements that protect a REIT from interest rate fluctuations on variable debt incurred to acquire or carry real property are treated as securities under the 30-percent test and payments under these agreements are treated as qualifying under the 95-percent test (sec. 856(c)(6)(G)).

Treatment of shared appreciation mortgages

For purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transaction provisions, any income derived from a "shared appreciation provision" is treated as gain recognized on the sale of the "secured property." For

these purposes, a shared appreciation provision is any provision that is in connection with an obligation that is held by the REIT and secured by an interest in real property, which provision entitles the REIT to receive a specified portion of any gain realized on the sale or exchange of such real property (or of any gain that would be realized if the property were sold on a specified date). Secured property for these purposes means the real property that secures the obligation that has the shared appreciation provision.

In addition, for purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transactions provisions, the REIT is treated as holding the secured property for the period during which it held the shared appreciation provision (or, if shorter, the period during which the secured property was held by the person holding such property), and the secured property is treated as property described in section 1221(1) if it is such property in the hands of the obligor on the obligation to which the shared appreciation provision relates (or if it would be such property if held by the REIT). For purposes of the prohibited transaction safe harbor, the REIT is treated as having sold the secured property at the time that it recognizes income on account of the shared appreciation provision, and any expenditures made by the holder of the secured property are treated as made by the REIT.

Asset requirements

To satisfy the asset requirements to qualify for treatment as a REIT, under prior law, at the close of each quarter of its taxable year, an entity must have at least 75 percent of the value of its assets invested in real estate assets, cash and cash items, and Government securities (sec. 856(c)(5)(A)). Moreover, not more than 25 percent of the entity's assets can be invested in securities of any one issuer (other than a government or a REIT), which securities comprise more than five percent of the entity's assets or more than 10 percent of the outstanding voting securities of such issuer (sec. 856(c)(5)(B)). The term real estate assets is defined to mean real property (including interests in real property and mortgages on real property) and interests in REITs (sec. 856(c)(6)(B)).

REIT subsidiaries

Under present law, all the assets, liabilities, and items of income, deduction, and credit of a "qualified REIT subsidiary" are treated as the assets, liabilities, and respective items of the REIT that owns the stock of the qualified REIT subsidiary. A subsidiary of a REIT is a qualified REIT subsidiary if and only if 100 percent of the subsidiary's stock is owned by the REIT at all times that the subsidiary is in existence. If at any time the REIT ceases to own 100 percent of the stock of the subsidiary, or if the REIT ceases to qualify for (or revokes an election of) REIT status, such subsidiary is treated as a new corporation that acquired all of its assets in exchange for its stock (and assumption of liabilities) immediately before the time that the REIT ceased to own 100 percent of the subsidiary's stock, or ceased to be a REIT as the case may be.

Distribution requirements

To satisfy the distribution requirement, a REIT must distribute as dividends to its shareholders during the taxable year an amount equal to or exceeding (i) the sum of 95 percent of its REITTI other than net capital gain income and 95% of the excess of its net income from foreclosure property over the tax imposed on that income minus (ii) certain excess noncash income (described below).

Excess noncash items include (a) the excess of the amounts that the REIT is required to include in income under section 467 with respect to certain rental agreements involving deferred rents, over the amounts that the REIT otherwise would recognize under its regular method of accounting, (2) in the case of a REIT using the cash method of accounting, the excess of the amount of original issue discount and coupon interest that the REIT is required to take into account with respect to a loan to which section 1274 applies, over the amount of money and fair market value of other property received with respect to the loan, and (3) income arising from the disposition of a real estate asset in certain transactions that failed to qualify as like-kind exchanges under section 1031.

Description of Proposals

Overview

The proposal would modify many of the provisions relating to the requirements for qualification as, and the taxation of, a REIT. In particular, the modifications would relate to the general requirements for qualification as a REIT, the taxation of a REIT, the income requirements for qualification as a REIT, and certain other provisions.

Election to be treated as a REIT

The proposal would change the ordering rule for purposes of the requirement that newly-electing REITs distribute earnings and profits that were accumulated in non–REIT years. Under the proposal, distributions of accumulated earnings and profits generally would be treated as made from the entity's earliest accumulated earnings and profits, rather than the most recently accumulated earnings and profits.

Taxation of REITs

Capital gains

The proposal would permit a REIT to elect to retain and pay income tax on net long-term capital gains it received during the tax year, just as a RIC is permitted under present law. Thus, if a REIT made this election, the REIT shareholders would include in their income as long-term capital gains their proportionate share of the undistributed long-term capital gains as designated by the REIT. The shareholder would be deemed to have paid the shareholder's share of the tax, which could be credited or refunded to the shareholder. Also, the basis of the shareholder's shares would be increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the REIT) included in the shareholder's long-term capital gains.

Income from foreclosure property

The proposal would lengthen the original grace period for foreclosure property until the last day of the third full taxable year following the election. The grace period also could be extended for an additional three years by filing a request to the IRS. Under the proposal, a REIT could revoke an election to treat property as foreclosure property for any taxable year by filing a revocation on or before its due date for filing its tax return.

The proposal would also modify the rule that prevents a REIT from deriving any income from an independent contractor who operates the foreclosure property. Under the proposal, a REIT could treat qualified health care property as foreclosure property in circumstances where the REIT acquired the property after the termination or expiration of a lease of the property and the REIT derived rental income from the independent contractor with respect to property or properties other than the foreclosure property. Qualified health care property is defined as property that has been used as a health care facility (including hospitals, nursing homes, congregate care facilities, and other health care facilities), and certain related uses (including medical offices and parking facilities).

Finally, the proposal would conform the definition of independent contractor for purposes of the foreclosure property rule (sec. 856(e)(4)(C)) to the definition of independent contractor for purposes of the general rules (sec. 856(d)(2)(C)).

Income or loss from prohibited transactions

The proposal would modify the 10-percent test for purposes of the safe harbor from the prohibited transactions tax. Under the proposal, the safe harbor would be limited to seven or fewer sales a year or, alternatively, any number of sales provided that the gross income from the sales does not exceed 10 percent of the adjusted basis (*determined before any reduction for any allowed or allowable depreciation or amortization*) of all the REIT's assets at the beginning of the REIT's taxable year.

The proposal also would exclude property that was involuntarily converted from the prohibited sales rules.

Organizational structure requirements

The proposal would replace the rule that disqualifies a REIT for any year in which the REIT failed to comply with regulations to ascertain its ownership, with an intermediate penalty for failing to do so. The penalty would be $25,000 ($50,000 for intentional violations) for any year in which the REIT did not comply with the ownership regulations. The REIT also would be required, when requested by the IRS, to send curative demand letters.

In addition, a REIT that complied with the regulations for ascertaining its ownership, and which did not know, or have reason to know, that it was so closely held as to be classified as a personal holding company, would not be treated as a personal holding company.

Income requirements

Overview

The proposal would repeal the rule that requires less than 30 percent of a REIT's gross income be derived from gain from the sale or other disposition of stock or securities held for less than 1 year, certain real property held less than four years, and property that is sold or disposed of in a prohibited transaction.

Definition of rents

The proposal would permit a REIT to render a de minimis amount of "non-customary" services to tenants, or in connection with the management of property, and still treat amounts received with respect to that property as rent. The value of the impermissible services could not exceed 1% of the gross income from the property. For these purposes, the services could not be valued at less than 150% of the REIT's direct cost of the services.

In addition, the proposal would modify the application of section 318(a)(3)(A) (attribution to partnerships) for purposes of defining rent in section 856(d)(2), so that attribution would occur only when a partner owns a 25% or greater interest in the partnership.

Hedging instruments

The proposal would treat income from all hedges of REIT liabilities, not just from interest rate swaps and caps, as qualifying income under the 95-percent test. Thus, payments to a REIT under an interest rate swap, cap agreement, option, futures contract, forward rate agreement or any similar financial instrument entered into by the REIT to hedge its indebtedness incurred or to be incurred (and any gain from the sale or other disposition of these instruments) would be treated as qualifying income for purposes of the 95-percent test.

Treatment of shared appreciation mortgages

The proposal would exclude income derived from a shared appreciation mortgage for purposes of the 30-percent rule and the prohibited transaction provisions, under circumstances where the obligor defaults on the mortgage and the secured property is sold pursuant to the bankruptcy of the obligor (as discussed above, the proposal also would eliminate the 30-percent rule).

The proposal would clarify that shared appreciation mortgages can be based on appreciation in value as well as gain.

Asset requirements

REIT subsidiaries

The proposal would permit any wholly-owned corporation of a REIT to be treated as a qualified subsidiary, regardless of whether the corporation had always been owned by the REIT. The proposal would treat any such subsidiary as being liquidated as of the time of acquisition by the REIT and then reincorporated (thus, any of the subsidiary's pre–REIT built-in gain would be subject to tax under the normal rules of section 337). In addition, any pre–REIT

earnings and profits of the subsidiary must be distributed before the end of the REIT's taxable year.

Distribution requirements

The proposal would (i) expand the class of excess noncash items to include income from the cancellation of indebtedness and (ii) extend the treatment of original issue discount and coupon interest as excess noncash items to REITs that use an accrual method of taxation.

Effective Date

The provisions of the Act generally are effective for taxable years beginning after the date of enactment. The intermediate sanctions for failure to comply with the regulations to ascertain ownership would be effective for all open taxable years.

6. Allow bank common trust funds to transfer assets to regulated investment companies without taxation

Present Law

Common Trust Funds

A common trust fund is a fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, guardian, or custodian of certain accounts and in conformity with rules and regulations of the Board of Governors of the Federal Reserve System or the Comptroller of the Currency pertaining to the collective investment of trust funds by national banks (sec. 584(a)).

The common trust fund of a bank is not subject to tax and is not treated as a corporation (sec. 584(b)). Each participant in a common trust fund includes his proportional share of common trust fund income, whether or not the income is distributed or distributable (sec. 584(c)).

No gain or loss is realized by the fund upon admission or withdrawal of a participant. Participants generally treat their admission to the fund as the purchase of an interest. Withdrawals from the fund generally are treated as the sale of an interest by the participant (sec. 584(e)).

Regulated Investment Companies (RICs)

A RIC also is treated as a conduit for Federal income tax purposes. Conduit treatment is accorded by allowing the RIC a deduction for dividend distributions to its shareholders. Present law is unclear as to the tax consequences when a common trust fund transfers its assets to one or more RICs.

Description of Proposal

In general, the proposal would permit a common trust fund to transfer substantially all of its assets to one or more open-end RICs without gain or loss being recognized by the fund or its participants. The fund must transfer its assets to the RICs solely in exchange for shares of the RICs, and the fund must then distribute

the RIC shares to the fund's participants in exchange for the participant's interests in the fund. In addition, each participant's pro-rata interest in each of the RICs must be substantially the same as was the participant's pro-rata interest in the fund.

The basis of any asset that is received by a RIC will be the basis of the asset in the hands of the fund prior to transfer (increased by the amount of gain recognized by reason of the rule regarding the assumption of liabilities). In addition, the basis of any RIC shares ("converted shares") that are received by a fund participant will be an allocable portion of the participant's basis in the interests exchanged. However, the proposal would require that the basis of converted shares that are redeemed subsequent to the transfer be determined as if there had been a partial redemption of the participant's entire holdings in the pooled funds ("basis pooling"). Thus, for purposes of determining gain or loss on redemption of any converted shares, the basis of the converted shares redeemed would be deemed equal to the fair market value of the converted shares redeemed multiplied by the ratio of the total basis in all converted shares owned prior to the redemption divided by the fair market value of all converted shares owned prior to the redemption.

The tax-free transfer is not available to a common trust fund with assets that are not diversified under the requirements of section 368(a)(2)(F)(ii), except that the diversification test is modified so that Government securities are not to be included as securities of an issuer and are to be included in determining total assets for purposes of the 25 and 50 percent tests.

No inference is intended as to the tax consequences under present law when a common trust fund transfers its assets to one or more RICs.

Effective Date

The provision would be effective for transfers after the date of enactment.

Legislative Background

A proposal to permit tax-free transfers from a common trust fund to a single mutual fund was included in H.R. 11 (102nd Cong.), as passed by the House and the Senate and vetoed by President Bush. A bill (H.R. 3631, 103rd Cong.) introduced by Mr. Coyne and others would permit tax-free transfers from a common trust fund to one or more mutual funds (but would not require basis pooling upon redemptions)

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AA. Peace Tax Fund

1. Establish U.S. Peace Tax Fund to receive conscientious objectors' income, estate, or gift tax payments to be used only for WIC, Head Start, U.S. Institute of Peace, and Peace Corps

Present Law

Taxpayers may not designate particular Federal programs to receive the Federal income, estate, or gift tax payments for which they are liable. An exception to this rule is that individuals may designate on their income tax returns that $3 ($6 for a married couple filing a joint return) of their tax liability be paid over to the Presidential Election Campaign Fund (Code sec. 6096). In general, Federal income, estate, and gift tax payments are deposited into the general fund of the United States Treasury, from which amounts are appropriated by law to a variety of Federal agencies and programs.[112]

The IRS is required to include two pie charts in individual income tax form instruction booklets (based on data available for the most recent fiscal year) depicting sources of Federal Government revenue and the relative sizes of the following major outlay categories: (1) defense, veterans, and foreign affairs, (2) social security, medicare, and other retirement, (3) physical, human, and community development, (4) social programs, (5) law enforcement and general government, and (6) interest on the debt (Code sec. 7523).

Courts have repeatedly held that taxpayers are not relieved from paying any portion of their Federal income tax liability, despite the taxpayers' claim that they are conscientiously opposed to funding military (or other) activities of the Federal Government.[113] Taxpayers who refuse on grounds of conscientious objection to make Federal tax payments otherwise due are subject to criminal and civil penalties under chapters 68 and 75 of the Internal Revenue Code.

Description of Proposal

Designation by individual taxpayers

The "United States Peace Tax Fund Act" (H.R. 1402) would allow individual taxpayers (other than nonresident aliens) to designate that their income, estate, and gift tax payments for any taxable year be paid into a "United States Peace Tax Fund" (the Peace Tax Fund) to be established under the bill. The designation may be made with respect to a taxable year at the time of filing the return for that year, or at any other time thereafter as specified in Treasury regulations.[114]

[112] In contrast, taxpayers who make charitable contributions to the Federal Government generally may designate particular Federal agencies or programs to receive the contributions. (See note 117 *supra*.)

[113] See, e.g., *United States v. Douglass*, 476 F.2d 260 (5th Cir. 1973); *United States v. Malinowski*, 472 F.2d 850 (3rd Cir. 1973).

[114] In the case of an eligible individual filing a joint income tax return, upon the consent of such individual's spouse, the joint income tax payment may be designated to the Peace Tax Fund.

Eligible conscientious objectors

Under the bill, taxpayers eligible to make such a designation would be limited to individuals (1) who by reason of religious training and belief, are conscientiously opposed to participation in war in any form, and (2) who have (a) been exempted or discharged from combat service and training in the United States Armed Forces as a conscientious objector under section 6(j) of the Military Selective Service Act,[115] or prior corresponding law, or (b) certified in a statement in a questionnaire filed with the tax return that they are conscientiously opposed to participation in war in any form within the meaning of section 6(j) of the Military Selective Service Act.[116]

In the questionnaire filed with the taxpayer's return, the taxpayer would have to certify the taxpayer's beliefs about participation in war, the source or genesis of such beliefs, and how the beliefs affect the taxpayer's life. Under the bill, each IRS publication of general instructions for an income tax return (or questionnaire provided for by the bill) must include an explanation of the purpose of the Peace Tax Fund, the criteria for determining whether an individual is eligible to make a designation to the Peace Tax Fund, and an explanation of the process for making such a designation. In addition, upon receipt of the questionnaire, the IRS would be required to issue a receipt (originally attached to the questionnaire) to the taxpayer indicating timely filing of the questionnaire.

Estate and gift tax returns

The bill also would apply to Federal estate and gift tax liability. In the case of estate tax payments, the bill would allow an election to be made by the executor or administrator of a taxable estate to have the Federal estate tax imposed by section 2001 transferred when paid to the Peace Tax Fund. The election could be made if the executor or administrator has the written authority of the decedent who qualified as an eligible conscientious objector (under the criteria discussed above). Similarly, the bill would allow eligible individuals to elect that the Federal gift tax imposed by section 2501 be transferred when paid to the Peace Tax Fund.[117]

United States Peace Tax Fund

Establishment of the Fund.—The bill would establish the Peace Tax Fund within the Department of the Treasury. On at least a

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[115] Section 6(j) of the Military Selective Service Act provides that a person shall not be subject to combatant training and service in the armed forces if that person, by reason of religious training and belief, is conscientiously opposed to participation in war in any form. As used in that provision, the term "religious training and belief" does not include "essentially political, sociological, or philosophical views, or a merely personal moral code." (50 U.S.C. App. 456(j)).

Conscientious objector claims under section 6(j) of the Military Selective Service Act turn on the resolution of factual questions relating to the nature of the registrant's beliefs concerning war, basis of the objection in conscience and religion, and registrant's sincerity. See *McGee v. United States*, 402 U.S. 479 (1971).

[116] The Secretary of the Treasury may require any taxpayer who makes a designation under the bill to provide additional information as may be necessary to verify the taxpayer's status as an eligible individual. If the Secretary of the Treasury determines that an individual is not eligible under the bill to make a designation, then the Secretary must send written notice to the taxpayer stating the reasons for denial of the designation, and the taxpayer may challenge the Secretary's ruling by bringing a declaratory judgment action in the United States Tax Court or in United States district court.

[117] The elections in estate and gift tax cases would be made in the manner as prescribed by Treasury Department regulations.

monthly basis, amounts would be transferred from the general fund of the Treasury to the Peace Tax Fund on the basis of estimates by the Secretary of the Treasury of the amounts designated during the fiscal year by individuals of their Federal income, estate, and gift tax payments to be deposited into the Peace Tax Fund.[118]

Appropriations from the Fund.—The bill would require that, with respect to each fiscal year, the Comptroller General shall determine the percentage of actual appropriations made by the Federal Government for military purposes.[119] This percentage would then be used to determine the portion of the Peace Tax Fund that would be authorized for appropriation for certain eligible nonmilitary purposes under the bill.[120] The remaining portion of amounts in the Peace Tax Fund (i.e., the surplus amount not appropriated for nonmilitary purposes under the bill) would then be returned back to the general fund of the Treasury. The bill further provides that no part of the funds transferred from the Peace Tax Fund to the general fund could be appropriated for any expenditure (or otherwise obligated) for a military purpose.

Eligible nonmilitary activities.—Under the bill, funds appropriated would be available to make grants, loans, or other arrangements for the following eligible activities: (1) the Special Supplemental Food Program for Women, Infants, and Children (WIC); (2) Head Start; (3) the United States Institute of Peace; and (4) the Peace Corps. It is intended that the Peace Tax Fund shall not operate to release funds for military expenditures that, were it not for the existence of the Fund, would otherwise have been appropriated for nonmilitary expenditures.

Amnesty program for taxable years ending before 1996

The bill would provide that any civil or criminal penalty imposed on an individual for failing or refusing to pay all (or a part of) the taxpayer's income tax liability would be vacated and set aside if the individual (1) pays the tax due (with interest) and (2) establishes to the satisfaction of the Secretary of the Treasury that the individual was an eligible conscientious objector under the criteria of the bill (discussed above). Under the bill, delinquent amounts so paid by eligible individuals would be deposited into the Peace Tax Fund.

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[118] The bill provides that adjustments would be made in amounts subsequently transferred to the extent that prior estimates were in excess of, or less than, the amounts actually designated by individuals.

The Secretary of the Treasury would be required to report to Congress each year on the total amount transferred into the Peace Tax Fund during the preceding fiscal year.

[119] For purposes of the bill, the term "military purposes" means: "any activity or program which any agency of the Government conducts, administers, or sponsors and which effects an augmentation of military forces or of defensive and offensive intelligence activities, or enhances the capability of any person or nation to wage war."

The bill defines the term "actual appropriations made for a military purposes" as including (but not limited to) amounts appropriated by the United States in connection with: (a) the Department of Defense, (b) the Central Intelligence Agency, (c) the National Security Council, (d) the Selective Service System, (e) activities of the Department of Energy that have a military purpose, (f) activities of the National Aeronautics and Space Administration that have a military purpose, (g) foreign military aid, and (h) the training, supplying, or maintaining of military personnel, or the manufacture, construction, maintenance, or development of military weapons, installations, or strategies.

[120] The percentage of actual appropriations for military purposes determined by the Comptroller General with respect to a fiscal year would be multiplied by all the funds transferred to the Peace Tax Fund for that year, the product of which would be authorized for appropriation for the eligible nonmilitary purposes enumerated in the bill.

Effective Date

The provisions of the bill generally would apply to taxable years beginning after (and estates of decedents dying after, and gifts made after) December 31, 1995, and any taxable year ending before January 1, 1996, for which the time for filing a claim for refund or credit of an overpayment of tax has not expired on the date of enactment of the bill.

Legislative Background

The bill (H.R. 1402) was introduced by Mr. Jacobs on April 5, 1995, and is the same as H.R. 2019 (103rd Cong.) except for the effective date. A similar proposal (same tax provisions but with a more elaborate trust fund administration) was introduced as H.R. 1870 (102nd Cong.). H.R. 1870 (102nd Cong.) and was a subject of hearings before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on May 19, 1992.

BB. Pensions and Employee Benefits

A. Pensions

1. Nondiscrimination rules

a. Repeal special nondiscrimination tests for qualified cash or deferred arrangements

Present Law

Nondiscrimination rules for qualified cash or deferred arrangements

A qualified plan may not discriminate in favor of highly compensated employees with respect to contributions or benefits under the plan (sec. 401(a)(4)). This general nondiscrimination requirement applies to all plan aspects, including those not addressed under the numerical coverage tests. Thus, it may apply not only with respect to contributions or benefits, but also with respect to optional forms of benefit and other benefits, rights, and plan features such as actuarial assumptions, rates of accrual, methods of benefit calculation, availability of plan loans, social security supplements, and disability benefits.

A profit-sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual is $7,000 (indexed, $9,240 for 1995). A special nondiscrimination test applies to cash or deferred arrangements.

The special nondiscrimination test applicable to elective deferrals under qualified cash or deferred arrangements is satisfied if the actual deferral percentage for eligible highly compensated employees for a plan year is equal to or less than either (1) 125 percent of the actual deferral percentage of all nonhighly compensated employees eligible to defer under the arrangement, or (2) the lesser of 200 percent of the actual deferral percentage of all eligible nonhighly compensated employees or the actual deferral percentage for all eligible nonhighly compensated employees plus 2 percentage points. The actual deferral percentage for a group of employees is the average of the ratios (calculated separately for each employee in the group) of the elective deferrals paid to the plan on behalf of the employee to the employee's compensation.

If a cash or deferred arrangement satisfies the special nondiscrimination test, it is treated as satisfying the general nondiscrimination rules (sec. 401(a)(4)) with respect to the amount of elective deferrals. However, the group of employees eligible to participate in the arrangement is still required to satisfy the minimum coverage test (sec. 410(b)).

Nondiscrimination rules relating to employer matching contributions and after a tax employee contributions

A special nondiscrimination test is applied to employer matching contributions and after-tax employee contributions under qualified defined contribution plans (sec. 401(m)).[121] This special nondiscrimination test is similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements. Contributions which satisfy the special nondiscrimination test are treated as satisfying the general nondiscrimination rules (sec. 401(a)(4)) with respect to the amount of contributions.

The term "employer matching contributions" means any employer contribution made on account of (1) an employee contribution or (2) an elective deferral under a qualified cash or deferred arrangement.

The special nondiscrimination test is satisfied for a plan year if the contribution percentage for eligible highly compensated employees does not exceed the greater of (1) 125 percent of the contribution percentage for all other eligible employees, or (2) the lesser of 200 percent of the contribution percentage for all other eligible employees, or such percentage plus 2 percentage points. The contribution percentage for a group of employees for a plan year is the average of the ratios (calculated separately for each employee in the group) of the sum of matching and employee contributions on behalf of each such employee to the employee's compensation for the year.

Description of Proposal

Under the proposal, the special nondiscrimination tests applicable to qualified cash or deferred arrangements and the special nondiscrimination tests applicable to employer matching contributions and employee contributions would be repealed.

Effective Date

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

Legislative Background

H.R. 3419, as passed by the House of Representatives during the 103rd Congress, contained a provision to modify the special nondiscrimination rules for qualified cash or deferred arrangements and employer matching contributions and employee contributions by permitting employers to satisfy a design-based safe harbor, which would eliminate the need to satisfy the special nondiscrimination rules each year.

[121] These rules also apply to certain employee contributions to a defined benefit plan.

b. Modify definition of highly compensated employee to eliminate 1-officer rule

Present Law

In general

For purposes of the qualification rules applicable to employer-provided pension plans, an employee, including a self-employed individual, is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee: (1) was a 5-percent owner of the employer (as defined under the top-heavy rules (sec. 416)); (2) received more than $75,000 indexed ($100,000 in 1995) in annual compensation from the employer; (3) received more than $50,000 indexed ($66,000 in 1995) in annual compensation from the employer and was a member of the top-paid group of the employer during the same year; or (4) was an officer of the employer who received compensation greater than $60,000 (in 1995). These dollar amounts are adjusted annually for inflation at the same time and in the same manner as the adjustments to the dollar limit on benefits under a defined benefit pension plan (sec. 415(d)). If, for any year, no officer has compensation in excess of the applicable dollar limit, then the highest paid officer of the employer for such year is treated as a highly compensated employee.

Family aggregation rules

A special rule applies with respect to the treatment of family members of certain highly compensated employees. Under the special rule, if an employee is a family member of either a 5-percent owner or 1 of the top 10 highly compensated employees by compensation, then any compensation paid to such family member and any contribution made or benefit accrued under the plan on behalf of such family member is aggregated with the compensation paid and contributions made or benefits accrued on behalf of the 5-percent owner or the highly compensated employee in the top 10 employees by compensation. Therefore, such family member and employee are treated as a single highly compensated employee.

An individual is considered a family member if, with respect to an employee, the individual is a spouse, lineal ascendant or descendant, or spouse of a lineal ascendant or descendant of the employee.

Description of Proposal

The proposal would modify the definition of a highly compensated employee in the same manner as H.R. 3419, described in the legislative background, below, and would repeal the rule requiring that the highest paid officer of an employer be treated as a highly compensated employee without regard to compensation.

Effective Date

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

Legislative Background

H.R. 3419, as passed by the House of Representatives during the 103rd Congress, contained a provision to simplify the definition of highly compensated employee.

H.R. 3419 provided that an employee would be highly compensated with respect to a year if the employee (1) was a 5-percent owner of the employer at any time during the year or the preceding year, or (2) had compensation for the preceding year in excess of $50,000. The $50,000 threshold would be adjusted for cost-of-living increases in the same manner and at the same time (and using the same base year) as the limitations on contributions and benefits (sec. 415(d)).

Under H.R. 3419, if no employee was a 5-percent owner or had compensation for the preceding year in excess of $50,000 (indexed), then the highest paid officer for the year would be treated as a highly compensated employee.

H.R. 3419 would have repealed the family aggregation rules.

c. Repeal top-heavy rules (sec. 416)

Present Law

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code ("a qualified plan") is accorded special tax treatment under present law. The employer maintaining the plan is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee is not required to include qualified plan benefits in income until the benefits are distributed from the plan. The purpose of the tax benefits for qualified plans is to encourage employers to establish nondiscriminatory retirement plans for their employees.

The qualification standards and related rules governing qualified plans are generally designed to ensure that qualified plans benefit an employer's rank-and-file employees as well as the employer's highly compensated employees. They also define the rights of plan participants and beneficiaries and provide limits on the tax deferral possible under qualified plans.

The qualification rules include minimum participation rules that limit the age and service requirements an employer can impose as a requirement of participation in a plan; coverage and nondiscrimination rules designed to prevent qualified plans from discriminating in favor of highly compensated employees (including special nondiscrimination requirements applicable to qualified cash or deferred arrangements (sec. 401(k)); vesting and accrual rules which limit the period of service an employer can require before an employee earns or becomes entitled to a benefit under a plan; limitations on the contributions made on behalf of and benefits of a plan participant; and minimum funding rules designed to ensure the solvency of defined benefit pension plans.

Under present law, additional qualification requirements are provided for certain plans which primarily benefit an employer's key employees (top-heavy plans). These additional requirements (1) provide greater portability of benefits for plan participants who are non-key employees by requiring more rapid vesting than is other-

wise required, (2) provide minimum nonintegrated contributions or benefits for plan participants who are non-key employees, and (3) reduce the aggregate limit on contributions and benefits for certain key employees. Further, additional restrictions are placed on distributions to key employees.

A qualified plan is top heavy if, as of the determination date, more than 60 percent of the value of benefits accrued under the plan is allocable to key employees. In general, an individual is a key employee of an employer if the individual is (1) an officer with compensation in excess of a specified amount, (2) is one of the 10 employees with compensation in excess of a specified amount owning the largest interests in the employer, (3) owns more than a 5-percent interest in the employer, or (4) owns more than a 1-percent interest in the employer and has compensation from the employer in excess of $150,000.

Description of Proposal

Under the proposal, the additional requirements for top-heavy plans would be repealed.

Effective Date

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

d. Modify leased employee rules

Present Law

An individual (a leased employee) who performs services for another person (the service recipient) may be required to be treated as the service recipient's employee for various employee benefit provisions if the services are performed pursuant to an agreement between the service recipient and a third person (the leasing organization) who is otherwise treated as the individual's employer (sec. 414(n)). The individual is to be treated as the service recipient's employee only if the individual has performed services for the service recipient on a substantially full-time basis for a year, and the services are of a type historically performed by employees in the service recipient's business field.

An individual who otherwise would be treated as a service recipient's leased employee will not be treated as such an employee if the individual participates in a safe harbor plan maintained by the leasing organization meeting certain requirements. The requirements for a safe harbor plan generally are: (1) the plan must be a money purchase pension plan with an employer contribution for each participant of at least 10 percent of compensation; (2) the plan must provide for full and immediate vesting; and (3) each employee of the leasing organization (other than employees who perform substantially all of their services for the leasing organization) must be eligible to participate immediately upon commencement of employment. Regardless of the existence of a safe harbor plan, each leased employee is to be treated as an employee of the service recipient if more than 20 percent of an employer's nonhighly compensated workforce are leased.

Description of Proposal

Under the proposal, an additional safe harbor plan maintained by certain qualified employee leasing organizations would be added so that leased employees covered under such a plan would not be treated as employees of the service recipient. Generally, this new safe harbor plan would have to meet the following requirements: (1) the plan would have to provide benefits or contributions equal to the maximum permitted under the Code (sec. 415)[122]; (2) benefits under the plan must vest at least as rapidly as under a graduated schedule that provides that benefits are 30 percent vested after one year of service, 50 percent vested after two years of service, 70 percent vested after three years of service, 90 percent vested after four years of service, and 100 percent vested after five years of service, determined without regard to breaks in service; (3) participants covered by a plan maintained by the service recipient could not have a more favorable vesting schedule than the one in the leasing organization's plan; and (4) the benefit provided to each participant covered by a plan maintained by the service recipient could not exceed 100 percent of any available benefit. This new safe harbor would apply regardless of the percentage of an employer's workforce that is leased.

Under an alternative proposal, the requirements for the new safe harbor plan would be identical to those described above, except that all benefits under the plan would have to be immediately 100 percent vested.

A qualified employee leasing organization would be defined as an organization which: (1) fills job function positions for a service recipient, pursuant to a written agreement, which are not short-term in duration and which are not for a defined period of time; (2) is registered with the Internal Revenue Service; (3) is not a member of a controlled group of corporations (sec. 1563(a)) or an affiliated service group (sec. 414(m)) which includes the service recipient; (4) pays all payroll and related taxes and benefits costs from its own account and under its own name as the employer; (5) pays any premiums required by any worker's compensation programs or similar insurance; and (6) allows the service recipient to be responsible only for the direction of the operational duties of the assigned employees.

The proposal would also add a new rule which would treat certain leasing organizations as the sole employer of its leased employees for all Code puposes (regardless of whether the leasing organization maintains a safe harbor plan). Under this new rule the service recipient would not have to treat employees of such a leasing organization as its own employees. The new rule would generally apply if the leasing organization: (1) retains the sole and exclusive right to (a) hire, terminate, and transfer the employees, (b) pay the employees from its own accounts, and (c) direct, control, and evaluate the manner and means of the employees' performance of services; (2) is responsible for paying its employees regardless of

[122] The lesser of 100 percent of average annual compensation or $120,000 (for 1995) in the case of a defined benefit plan, or the lesser of 25 percent of compensation or $30,000 (for 1995) in the case of a defined contribution plan. The dollar limits are increased for inflation in $5,000 increments.

reimbursement from the service recipient; (3) provides universal fringe benefits among its employees without discrimination; (4) bills the service recipient on a total-fee basis rather than on a direct cost pass-through basis, (5) does not lease any 5-percent owner of the service recipient, and (6) is treated as the employer of such employees under common law standards (or otherwise as provided under sec. 3121(d)).

If a leasing organization is considered the sole employer of its leased employees, the proposal additionally provides than any 10-percent excise tax owing as a result of an accumulated funding deficiency (sec. 4971) in such leasing organization's plan would be the liability of the service recipient corporation or corporations.

Effective Date

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

e. Exempt state judicial retirement plans from nondiscrimination requirements

Present Law

A plan of deferred compensation that meets the qualification standards of the Code (a "qualified plan"), is accorded special tax treatment under present law. Among the qualification standards are coverage and nondiscrimination rules designed to ensure that qualified plans benefit a significant number of an employer's rank-and-file employees as well as highly compensated employees. These rules include numerical minimum coverage rules (sec. 410(b)), a minimum participation rule requiring that a plan benefit a minimum number of employees (sec. 401(a)(26)), and a general nondiscrimination requirement (sec. 401(a)(4)). Special nondiscrimination rules apply to qualified cash or deferred arrangements (sec. 401(k)), employer matching contributions, and after-tax employee contributions (sec. 401(m)).

The Internal Revenue Service has announced that these rules will be deemed satisfied with respect to governmental plans (including State judicial retirement plans) generally until: (1) plan years beginning on or after January 1, 1997, with respect to the special nondiscrimination rules applicable to qualified cash or deferred arrangements, employer matching contributions, and after-tax contributions; and (2) plan years beginning on or after January 1, 1999, with respect to the other nondiscrimination and coverage rules.

Description of Proposal

Under the proposal (H.R. 1314), State judicial retirement plans would be exempt from the coverage and nondiscrimination rules other than the special rules applicable to qualified cash or deferred arrangements, employer matching contributions, and after-tax contributions. A State judicial retirement plan would be defined as a plan (or a portion of a plan) established by a State, or political subdivision thereof, which provides contributions or benefits which are primarily for, by, or on behalf of judges or justices appointed or

elected in accordance with the laws of such State or political subdivision.

Effective Date

The proposal would apply for all taxable years both before and after the date of enactment.

Legislative Background

H.R. 1314 was introduced by Mr. Zimmer on March 23, 1995.

f. Repeal OBRA 1993 provision limiting compensation taken into account to $150,000

Present Law

Under present law, the amount of a participant's compensation that can be taken into account under a tax-qualified pension plan is limited (sec. 401(a)(17)). The limit applies for determining the amount of the employer's deduction for contributions to the plan as well as for determining the amount of the participant's benefits. The limit on includible compensation for 1993 was $235,840, indexed annually for inflation. The Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993") reduced the limit on compensation taken into account to $150,000 and indexed the limit in $10,000 increments. The limit on compensation taken into account for 1995 would be $245,000 if the OBRA 1993 provision did not apply. The provision of OBRA 1993 was generally effective with respect to benefits accruing in plan years beginning after December 31, 1993.

Description of Proposal

The proposal would repeal the reduction in the limit on compensation taken into account for qualified plan purposes enacted in OBRA 1993.

Effective Date

The proposal generally would be effective for benefits accruing in plan years beginning after December 31, 1995.

g. Repeal for pilots OBRA 1993 provision limiting compensation taken into account to $150,000

Present Law

Under present law, the amount of a participant's compensation that can be taken into account under a tax-qualified pension plan is limited (sec. 401(a)(17)). The limit applies for determining the amount of the employer's deduction for contributions to the plan as well as for determining the amount of the participant's benefits. The limit on includible compensation for 1993 was $235,840, indexed annually for inflation. The Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993") reduced the limit on compensation taken into account to $150,000 and indexed the limit in $10,000 increments. The provision of OBRA 1993 was generally effective with

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respect to benefits accruing in plan years beginning after December 31, 1993.

A special transition rule was provided for plans maintained pursuant to a collective bargaining agreement. In the case of a plan maintained pursuant to one or more collective bargaining agreements ratified before the date of enactment, the OBRA 1993 provision did not apply to contributions or benefits accruing under such agreements in plan years beginning before the earlier of (1) the latest of (a) January 1, 1994, (b) the date on which the last of such collective bargaining agreements terminates (without regard to any extension or modification on or after the date of enactment), or (c) in the case of a plan maintained pursuant to collective bargaining under the Railway Labor Act, the date of execution of an extension or replacement of the last of such collective bargaining agreements in effect on the date of enactment, or (2) January 1, 1997.

Description of Proposal

The proposal would repeal the reduction in the limit on compensation taken into account for qualified plan purposes enacted in OBRA 1993 with respect to collectively bargained plans maintained for airline pilots.

Effective Date

The proposal would be effective for benefits accruing in plan years beginning after December 31, 1993.

h. Repeal minimum participation rule (sec. 401(a)(26))

Present Law

Under present law, an employer-sponsored pension plan is required to satisfy certain requirements to be tax-qualified. Among these qualification standards are coverage and nondiscrimination rules designed to ensure that qualified plans benefit a significant number of an employer's rank-and-file employees as well as highly compensated employees. These rules include numerical minimum coverage rules (sec. 410(b)), a minimum participation rule requiring that a plan benefit a minimum number of employees (sec. 401(a)(26)), and a general nondiscrimination requirement (sec. 401(a)(4)). Special nondiscrimination rules apply to qualified cash or deferred arrangements, employer matching contributions, and after-tax employee contributions.

Under the minimum participation rule, a plan is not a qualified plan unless it benefits no fewer than the lesser of (a) 50 employees of the employer or (b) 40 percent of all employees of the employer (sec. 401(a)(26)). In the case of a cash or deferred arrangement or the portion of a defined contribution plan (including the portion of a defined benefit plan treated as a defined contribution plan (sec. 414(k)) to which employee contributions or employer matching contributions are made, an employee will be treated as benefiting under the plan if the employee is eligible to make or receive contributions under the plan.

A special sanction applies to violations of the minimum participation rule. Under this sanction, if one of the reasons a plan fails to

be a qualified plan is because it fails either the coverage rules or the minimum participation rule, then highly compensated employees are to include in income the value of their vested accrued benefit as of the close of the year in which the plan fails to qualify. Individuals who were not highly compensated employees in any year are not taxed on their benefits if the only reason a plan is not a qualified plan is a failure to satisfy the coverage requirements or the minimum participation rule.

Description of Proposal

Under the proposal, the minimum participation rule would be repealed.

Effective Date

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

Legislative Background

H.R. 3419, as passed by the House of Representatives during the 103rd Congress, would have repealed the application of the minimum participation rule to defined contribution plans.

2. Distribution rules

a. Repeal 15-percent excise tax on excess distributions

Present Law

Present law imposes a 15-percent excise tax on excess distributions from qualified retirement plans, tax-sheltered annuities, and individual retirement arrangements ("IRAs") (sec. 4980A). Excess distributions are generally the aggregate amount of retirement distributions from such plans made with respect to an individual during any calendar year which exceed $150,000. In the case of certain lump-sum distributions, the dollar limit is $750,000.

Present law also imposes a 15-percent additional estate tax on an individual's excess retirement accumulation. An individual's excess retirement accumulation is generally defined as the excess (if any) of the present value of the decedent's interests in all qualified retirement plans, tax-sheltered annuities, and IRAs, over the present value (as determined under rules prescribed by the Secretary as of the applicable valuation date) of a single life annuity with annual payments equal to the annual excess distribution limit (as in effect for the year in which death occurs and as if the individual had not died). Because a 15-percent additional estate tax is imposed on excess retirement accumulations, no 15-percent excise tax is imposed on distributions made after an individual's death.

For purposes of determining the amount of excess distributions or excess retirement accumulations, certain amounts are excluded. Excludable amounts include (1) amounts representing a return of an employee's after-tax contributions (but not earnings thereon) or other amounts that are treated as part of the employee's investment in the contract, (2) amounts excluded from the recipient's income because they are rolled over into another plan or an IRA, (3)

amounts excluded from the participant's income because they are (or would be) payable to a former spouse pursuant to a qualified domestic relations order (sec. 414(p)) and includible in the spouse's income, (4) the value of distributed annuity contracts not included in the recipient's income, and (5) certain corrective distributions from qualified cash or deferred arrangements (sec. 401(k)). Further, state community property laws are disregarded in determining the amount of excess distributions or excess retirement accumulations, with respect to an individual.

Description of Proposal

The proposal would repeal the 15-percent excise tax on excess distributions and the 15-percent additional estate tax on excess retirement accumulations.

Effective Date

The repeal of the excise tax on excess distributions would apply to distributions made after the date of enactment. The repeal of the excise tax on excess retirement accumulations would apply to estates of decedents dying after the date of enactment.

b. Provide that pension distributions are taxed as capital gains

Present Law

Under present law, distributions from qualified retirement plans, tax-sheltered annuities, and individual retirement arrangements ("IRAs") that are includible in gross income are generally taxed as ordinary income. There is a special transition rule which permits participants who attained age 50 by January 1, 1986, to elect capital gains treatment with respect to the pre–1974 portion of a lump-sum distribution. Under this rule, the capital gains portion of the lump-sum distribution is taxed at a special rate of 20 percent, regardless of the maximum effective capital gains rate under present or prior law. Present law taxes long-term capital gains at a maximum rate of 28 percent (sec. 1(h)).

Description of Proposal

Under the proposal, all distributions from qualified retirement plans, tax-sheltered annuities, and IRAs would be treated as long-term capital gains.

Effective Date

The proposal would be effective for distributions made after December 31, 1995.

c. Reinstate 10-year forward averaging

Present Law

Under present law, an individual is permitted to make an election with respect to a lump-sum distribution received from a qualified plan on or after the individual attains age 59½ to use 5-year forward income averaging under the tax rates in effect for the tax-

able year in which the distribution is made. Generally, this election allows the taxable portion of the lump-sum distribution to be taxed in the year of distribution at a lower marginal rate as if the lump-sum distribution had been received ratably over a 5-year period. However, only one such election on or after age 59½ may be made with respect to any participant. The same individual may make a 5-year averaging election with respect to amounts received as a participant and as a beneficiary of another participant, provided that the latter amounts are received on or after such other participant had attained age 59½. An income averaging election (other than an election made after the participant attains age 59½) made with respect to a distribution prior to 1987 does not preclude the participant from making a single 5-year forward income averaging election with respect to a distribution after 1986.

There is a special transition rule which permits a participant who has attained age 50 by January 1, 1986, to make one election to use 5-year forward averaging (under current tax rates) or 10-year forward averaging (under the tax rates in effect for 1986, taking into account the prior-law zero bracket amount) with respect to a single lump-sum distribution, without regard to whether the participant has attained age 59½. An election under the special transition rule to use income averaging on a lump-sum distribution received before, on, or after the employee attains age 59½ eliminates the availability of an income averaging election on or after age 59½ under the 5-year forward income averaging rule.

Description of Proposal

Under the proposal, a participant would be permitted to elect to use 10-year forward income averaging (under the tax rates in effect for the taxable year in which the distribution is made) with respect to any lump-sum distribution from a qualified plan. This election would be permitted regardless of the age of the participant.

Effective Date

The proposal would be effective for distributions made after December 31, 1995.

d. Permit penalty-free withdrawals for unemployed individuals

Present Law

Present law imposes an additional 10-percent income tax on certain early distributions from qualified retirement plans, tax-sheltered annuities, and individual retirement arrangements ("IRAs") (sec. 72(t)). The additional income tax on early distributions only applies to the portion of a distribution that is otherwise includible in the recipient's gross income.

Present law contains several exceptions to the additional income tax on early distributions. The additional income tax on early distributions does not apply to distributions which are: (1) made after the employee (or owner) attains age 59½; (2) part of a scheduled series of substantially equal periodic payments for the life or life expectancy of the participant (or the joint lives or life expectancies

of the participant and the participant's beneficiary); (3) to a participant who has attained age 55 and subsequently separated from service; (4) made to a participant to the extent such distribution does not exceed the amount of deductible health expenses for the year (sec. 213) (determined without regard to whether the taxpayer itemizes deductions); (5) made after the death of the participant; and (6) attributable to the participant becoming disabled.

In addition, the additional tax on early distributions does not apply to the following distributions: (1) payments made to or on behalf of an alternate payee pursuant to a qualified domestic relations order (sec. 414(p)); (2) certain distributions of excess contributions, excess deferrals, or excess aggregate contributions; and (3) dividend distributions for which the employer is allowed a deduction (sec. 404(k)).

In the case of distributions from IRAs (including simplified employee pensions ("SEPs")), the age 55 and medical expense exceptions do not apply. The exception for distributions pursuant to a qualified domestic relations order applies to an IRA only to the extent the IRA is subject to the rules relating to qualified domestic relations orders. The exception for substantially equal payments applies to distributions from plans qualified under sections 401(a) or 403(a) and tax-sheltered annuities and custodial accounts only if the distribution is made after separation from service.

Description of Proposal

The proposal (H.R. 1148) would create an additional exception from the additional income tax on early distributions for certain distributions which are made to a participant during "periods of unemployment." Under the proposal, a "period of unemployment" would be defined as a period during which the participant (1) is receiving unemployment compensation, or (2) would have been entitled to receive unemployment compensation, but for the termination of the period during which such compensation was payable or an exhaustion of the participant's rights to such compensation. This exception would only apply to the extent the distributions during any period of unemployment do not exceed the reasonable living expenses of the participant for such period, and would only apply to distributions from an IRA and distributions of amounts attributable to elective deferrals from a qualified cash or deferred arrangement (sec. 401(k)) or a tax-sheltered annuity (sec. 403(b)).

Effective Date

The proposal would apply to distributions made after the date of enactment.

Legislative Background

H.R. 1148 was introduced by Mr. Lazio on March 7, 1995. A similar proposal was included with the Administration's budget proposal (S. 452 and H.R. 980).

3. Limits on contributions and benefits (sec. 415)

Present Law

In general

Present law provides limits on contributions and benefits under qualified plans based on the type of plan, i.e., based on whether the plan is a defined contribution plan or a defined benefit pension plan (sec. 415). An overall limit applies if an individual is a participant in both a defined benefit pension plan and a defined contribution plan.

Defined contribution plan limit

Under a defined contribution plan, annual additions to the plan with respect to each participant for a limitation year cannot exceed the lesser of (1) 25 percent of compensation or (2) $30,000 (for 1995). Annual additions generally are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. The $30,000 limit is indexed for inflation in $5,000 increments.

Defined benefit plan limit

The limit on the annual benefit payable to (or with respect to) a participant by all defined benefit pension plans of the same employer is generally the lesser of (1) 100 percent of average compensation for the three years in which it was the highest or (2) $120,000 (for 1995). The $120,000 limit is indexed for inflation in $5,000 increments. If a benefit is payable under the plan in a form other than a straight life annuity, then the benefit must be actuarially adjusted to an equivalent annual straight life annuity before applying the limit on benefits. In addition, if a benefit is payable beginning at an age other than the participant's social security retirement age, the $120,000 dollar limitation is actuarially adjusted so that it equals an annual benefit that is equivalent to the dollar limitation at the participant's social security retirement age. The limit is reduced if benefits begin before social security retirement age, and increased if benefits begin after social security retirement age.

The Retirement Protection Act of 1994, enacted as part of the implementing legislation for the General Agreement on Tariffs and Trade ("GATT"), modified the actuarial assumptions that must be used in adjusting benefits and limitations. In general, in adjusting a benefit that is payable in a form other than a straight life annuity and in adjusting the dollar limitation if benefits begin before social security retirement age, the interest rate to be used cannot be less than 5 percent or the rate specified in the plan. Under the Retirement Protection Act, if the benefit is payable in a form subject to the requirements of section 417(e)(3),[123] then the interest rate

[123] Benefits subject to these rules include all forms of benefit except nondecreasing annuity benefits payable for the life of the participant or, in the case of a preretirement survivor annuity, the life of the surviving spouse. For this purpose, a nondecreasing annuity includes a qualified joint and survivor annuity, a qualified preretirement survivor annuity, and an annuity that

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on 30-year Treasury securities is substituted for 5 percent.[124] Also under the Retirement Protection Act, for purposes of adjusting any limit or benefit, the mortality table prescribed by the Secretary must be used.

This provision of the Retirement Protection Act are effective as of the first day of the first limitation year beginning in 1995 [125].

The maximum benefit payable under present law may be less than the maximum benefit payable under prior law because the 30-year Treasury rate required to be used to adjust benefits and limits under the Retirement Protection Act is higher than the 5-percent interest rate used under prior law. A plan is permitted, but not required, to reduce benefits below the level that would have been paid under prior law as of the last day of the last limitation year beginning before January 1, 1995. A plan will not be treated as violating the Code rule prohibiting cutbacks in accrued benefits (sec. 411(d)(6)) merely because it reduces benefits to comply with this provision of the Retirement Protection Act. Thus, a participant's accrued benefit may be reduced if the reduction results solely from the application of this provisions.

Combined plan limit

An additional limit applies if an employee participates in both a defined benefit pension plan and a defined contribution plan maintained by the same employer (sec. 415(e)). The combined plan limitation is designed to prevent avoidance of the separate plan limits through the creation of different types of plans.

The combined limit is satisfied if the sum of the "defined benefit plan fraction" and the "defined contribution plan fraction" is not greater than 1.0. Although the sum of these fractions may not exceed 1.0, the plan fractions effectively provide an aggregate limit of the lesser of 1.25 (as applied with respect to the dollar limits) or 1.4 (as applied with respect to the percentage limits).

The defined benefit plan fraction is designed to measure the portion of the maximum permitted defined benefit plan limit that the employee actually uses. The numerator is the participant's projected normal retirement benefit determined at the close of the year. The denominator is generally the lesser of 125 percent of the dollar limitation for the year, or 140 percent of the employee's average compensation for the three years of employment in which the employee's average compensation was highest.

The defined contribution plan fraction measures the portion that the employee actually uses of the maximum permitted contributions to a defined contribution plan for the employee's total years of service with the employer. The numerator is generally the total of the contributions and forfeitures allocated to the employee's account for each of the employee's years of service with the employer through the close of the year for which the fraction is being determined. The denominator is the sum of the lesser of the following

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decreases merely because of the cessation or reduction of social security supplements or qualified disability payments. See Rev. Rul. 95–29, 1995–15 I.R.B. 10 (April 10, 1995).

[124] In adjusting the $120,000 limit in the case of benefits that begin after social security retirement age, the interest rate used may not be greater than the lesser of 5 percent or the rate specified in the plan.

[125] An employer may elect to treat the changes as being effective on or after December 8, 1994 (the date of enactment).

amounts, computed separately for such year and each prior year of service with the employer: (1) 125 percent of the dollar amount in effect for such year, or (2) 140 percent of the 25 percent of compensation limit for the participant.

Description of Proposals

a. Modification of interest and mortality rate provisions of the Retirement Protection Act

The proposal would modify the effective date of the new interest rate and mortality assumptions that must be used to calculate the limits on benefits under the Retirement Protection Act. Under the proposal, a plan would not be required to use the new assumptions in determining the maximum payable benefit under section 415 with respect to years beginning before the first plan year beginning in 1999.[126] This rule would apply only in the case of plans that were adopted and in effect before the date of enactment of the Retirement Protection Act of 1994 (December 8, 1994).

Alternatively, each plan participant would be able to make a one-time election to have the prior-law rules apply rather than the rules in the Retirement Protection Act.

b. Eliminate combined plan limit for participants in both a defined contribution plan and a defined benefit plan

The proposal would repeal the combined limit for participants in both a defined contribution plan and a defined benefit pension plan maintained by the same employer.

Effective Date

The proposals relating to the assumptions used to calculate maximum benefits would be effective as if included in the Retirement Protection Act.

The repeal of the combined plan limit would apply to years beginning after December 31, 1995.

Legislative Background

The Administration has proposed repealing the combined plan limitation as part of its pension simplification proposals.

4. Employee stock ownership plans ("ESOPs")

a. Modify rules relating to deferral of gain on certain sales of stock to an ESOP (sec. 1042)

Present Law

In general, an employee stock ownership plan ("ESOP") is a tax-qualified pension plan that is designed to invest primarily in securities of the employer maintaining the ESOP. ESOPs generally are subject to the same qualification rules applicable to other types of qualified pension plans. Certain other special tax benefits apply to ESOPs in addition to those provided to qualified plans generally.

[126] This rule is similar to a transition rule provided under the Retirement Protection Act with respect to a change in the interest rate used to calculate lump-sum distributions.

Under present law, if certain requirements are satisfied, a taxpayer may elect to defer recognition of long-term capital gain on the sale of certain qualified securities to an ESOP to the extent that the taxpayer reinvests the proceeds in qualified replacement property within a specified period (sec. 1042). Qualified securities are securities of the employer establishing the ESOP that (1) are issued by a domestic corporation that has no class of readily tradable securities; (2) were not acquired by the taxpayer from a qualified plan or in a transfer to which section 83 applies or pursuant to an option granted by the employer (unless full consideration was paid); and (3) which have been held by the taxpayer for at least 3 years prior to the disposition (sec. 1042). In general, qualified replacement property is securities of a domestic operating corporation.

One of the requirements that must be satisfied in order for nonrecognition treatment to be available is that the employer securities acquired in the transfer cannot be allocated to the taxpayer, family members of the taxpayer, or any person who owns more than 25 percent of the number of shares of any class of outstanding securities of the corporation or 25 percent of the total value of any class of outstanding securities (sec. 409(n)).

Description of Proposal

The proposal would provide that securities to which section 83 applies (i.e., securities acquired by the taxpayer for services performed) and securities acquired pursuant to options granted by the employer would qualify for nonrecognition treatment under section 1042. The 3-year holding period would not apply to such securities. The employer would not be entitled to a deduction with respect to such securities to the extent that section 1042 applies. Upon disposition of any qualified replacement property, gain, if any, would be recognized as ordinary income to the extent that there would have been ordinary income recognized but for the application of the proposal.

The proposal would also modify the definition of a 25-percent shareholder for purposes of the rule prohibiting allocation of securities acquired by an ESOP in a deferral transaction to such shareholders. Under the proposal, a 25-percent shareholder would mean a person who owns at least 25 percent of the voting power of all classes of stock of the corporation or 25 percent of the total value of all classes of stock of the corporation.

Effective Date

The first part of the proposal would apply to sales of qualified securities after the date of enactment. The second part of the proposal would be effective on the date of enactment (and, thus, would apply with respect to sales that have already occurred).

b. Permit ESOP to be a beneficiary of a charitable remainder trust

Present Law

Subject to certain limitations, a deduction generally is allowed for income tax or estate and gift tax purposes for transfers of property to charitable organizations, the United States, or a State or local government (secs. 170, 2055(a), 2522). If a remainder interest is transferred to the charity in trust, however, a deduction is only permitted if the interest passing to the charitable remainderman is in the form of a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund (secs. 170(f)(2), 2055(e), 2522(c)(2)).

A charitable remainder annuity trust is a trust from which a sum certain or a specified amount (not less than five percent of the initial net fair market value of all property placed in trust) is to be paid at least annually to the income beneficiary or beneficiaries (sec. 664(d)(1)).

A charitable remainder unitrust is a trust that specifies that the income beneficiary or beneficiaries are to receive payments at least annually based on a fixed percentage (not less than five percent) of the net fair market value of the trust's assets as determined each year (sec. 664(d)(2)). In the alternative, a qualified charitable remainder unitrust can provide for the distribution each year of five percent of the net fair market value of its assets or the amount of the trust income (other than capital gains), whichever is lower. The trust instrument may provide that any such income deficiencies are to be made up in later years when the trust's income exceeds the amount otherwise payable to the income beneficiary for that year.

Charitable remainder annuity trusts and unitrusts cannot have non-charitable remainder interests. The remainder interest must pass to a charity upon the termination of the last income interest. An income interest in the trust may be a life estate or for a term of years, but the term of years generally cannot be in excess of 20 years.

A trust that qualifies as a charitable remainder annuity trust or a charitable remainder unitrust is generally exempt from tax, except to the extent that it has unrelated business taxable income (sec. 664(c)).

Description of Proposal

The proposal would permit an ESOP to be a beneficiary of a charitable remainder trust with respect to the portion of the remainder interest in the trust that consists of securities that are not readily tradeable and that were previously transferred from a decedent to a charitable remainder unitrust or annuity trust. Securities transferred to an ESOP from the trust are to be held in a suspense account until allocated to plan participants. The securities could not be allocated to or for the benefit of relatives of the decedent or to or for the benefit of any person owning more than 5 percent of either the total number of outstanding shares or the total market value of the corporation establishing the ESOP.

No deduction would be permitted with respect to transfers from the trust to the ESOP. Such transferred amounts would not affect

the deduction otherwise available to the employer for contributions to qualified pension plans.

The allocation of securities to ESOP participants would be treated as an annual addition for purposes of the limitation on contributions to a defined contribution plan (sec. 415(c)). However, the allocations would not be taken into account in applying the contribution limits to any other amounts. Allocation of such securities would not be taken into account in applying the combined plan limit on contributions and benefits in the case of a participant in both a defined benefit plan and defined contribution plan of the same employer (sec. 415(e)).

The proposal also would modify certain other trust provisions to treat an ESOP the same as a charity. Thus, the proposal would provide that the grantor of a trust is not treated as the beneficial owner of a trust merely because the grantor or nonadverse party has the power to allocate assets among charitable trust or to an ESOP.

Effective Date

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

c. Treatment of certain securities transferred to an ESOP from terminated defined benefit pension plan

Present Law

The Budget Reconciliation Act of 1989 ("1989 Act") provided that the deduction for dividends paid on employer securities (sec. 404(k)) does not apply to dividends used to repay an acquisition loan unless the dividends are paid on securities acquired with that loan. The provision applies to dividends on securities acquired after August 4, 1989.

Description of Proposal

Under the proposal, the 1989 Act provision would not apply to employer securities acquired with assets transferred from a defined benefit plan in a transaction exempt from the excise tax on employer reversions. (There was an exception from the excise tax for amounts transferred to an ESOP after March 31, 1985, and before January 1, 1989, or after December 31, 1988, pursuant to a termination that occurred after March 31, 1985, and before January 1, 1989.) The proposal would be limited to securities acquired before October 1, 1989, and with respect to plan terminations which were the subject of a determination letter in effect on August 4, 1989, and at all times thereafter before the securities were acquired.

Effective Date

The proposal would be effective upon the date of enactment.

Legislative Background

This provision was included in H.R. 11 (102nd Cong.), which passed the House of Representatives and the Senate in 1992 and was vetoed by President Bush.

d. Permit payment of estate tax liability by an ESOP

Present Law

Under present law, an estate tax is imposed on the transfer of the taxable estate of decedents who are residents or citizens of the United States.

Description of Proposal

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

Under the proposal, the ESOP or cooperative which receives the qualified securities for which an agreement is in effect would be liable for a portion of the estate taxes otherwise imposed upon the decent's taxable estate equal to the lesser of (1) the value (for Federal estate tax purposes) of the qualified employer securities received from the decedent or his or her executor, or (2) the estate tax imposed with respect to the taxable estate, reduced by the sum of allowable credits against such estate tax.

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

To the extent that (1) the decedent's estate is otherwise eligible to make deferred payments of estate taxes pursuant to section 6166 with respect to the decedent's interest in qualified employer securities, and (2) the executor elects to make payments pursuant to that section, then the plan administrator of the ESOP or an authorized officer of the cooperative could also elect to pay any estate taxes attributable to the qualified employer securities transferred to the ESOP or cooperative in installments pursuant to that section. For purposes of determining the portion to which the special 4-percent interest rate applies (sec. 6601(j)), the portion of the estate tax for which the decedent's executor remains liable would be aggregated with the portion for which the ESOP or cooperative is liable. Such portion would then be allocated proportionately between the portion for which the executor remains liable and the portion for which the ESOP or cooperative is liable.

Special rules would apply in determining whether installment payments are accelerated due to a disposition of a closely held business or withdrawal of funds from the business (sec. 6166(g)). The transfer of employer securities to an ESOP or cooperative would not be considered a withdrawal or disposition causing acceleration. In addition, section 6166(g) would be applied separately to the interest held after such a transfer by the estate and the ESOP or cooperative. Distributions from the ESOP or cooperative due to the death of a plan participant, retirement of a participant after attaining age 59½, disability of a participant, or the separation of the

participant from service for any period which results in a break in service (sec. 411(a)(6)(A)) would not be treated as a disposition or withdrawal.

The proposal would also provide that the assumption of estate tax liability by the ESOP or cooperative does not violate the Employee Retirement Income Security Act of 1974, as amended.

Effective Date

The proposal would apply to transfers of employer securities after the date of enactment.

Legislative Background

A similar provision permitting an ESOP or cooperative to assume estate tax liability was enacted in the Deficit Reduction Act of 1984. The provision was repealed by the Omnibus Budget Reconciliation Act of 1989.

5. Permit permanently disabled persons to contribute to section 401(k) plans

Present Law

Under a qualified cash or deferred arrangement (sec. 401(k)), an employee may elect to have the employer make payments (e.g., a portion of current salary) directly to the employee in cash or as contributions to a qualified defined contribution plan on behalf of the employee. Qualified cash or deferred arrangements are subject to special rules including an annual limit on the amount of elective deferrals that may be contributed to the plan on behalf of an employee ($9,240 for 1995) (sec. 402(g)).

For purposes of making contributions to a qualified cash or deferred arrangement, Treasury regulations define an employee as an individual who performs services for the employer who is either a common-law employee, a self-employed individual who is treated as an employee (sec. 401(c)(1)), or a leased employee treated as an employee of the service recipient (sec. 414(n)). Consequently, former employees, including permanently disabled former employees, who do not perform services for an employer may not participate in a qualified cash or deferred arrangement maintained by the employer, regardless of whether they receive any form of compensation (including disability benefits) from such employer.

Description of Proposal

Under the proposal, permanently disabled former employees would be treated as employees for purposes of making contributions to a qualified cash or deferred arrangement. Such permanently disabled former employees could thus make elective deferrals with respect to employer-provided disability benefits.

Effective Date

The proposal would be effective on the date of enactment.

6. Modify sanctions for failure to comply with qualification requirements

Present Law

Under present law, if a qualified pension plan is determined by the Internal Revenue Service ("IRS") not to be qualified, employer contributions to the plan generally are not deductible, the trust holding the plan's assets will be taxable (rather than tax exempt), and plan participants generally must pay tax on their accrued benefits to the extent they are vested.

In addition, understatement penalties may be imposed on the employer, plan participants, or the trust (sec. 6662).

The IRS may, under certain circumstances, impose sanctions short of retroactive plan disqualification.

Description of Proposal

The proposal would modify the sanctions for failure to satisfy the qualification requirements to (1) add deminimis error rules for which no separate sanctions would apply, (2) repeal penalties for noncompliance unless the errors are not corrected after the employer is notified, and (3) impose penalties only in egregious cases.

Effective Date

The proposal would be effective on the date of enactment.

7. Allow prenuptial waiver of spousal annuity benefits

Present Law

Present law contains a number of rules designed to provide income to the surviving spouse of a deceased employee. These rules are in both the Internal Revenue Code and title I of the Employee Retirement Income Security Act of 1974, as amended.

Under the spousal protection rules, defined benefit pension plans and money purchase pension plans are required to provide that vested retirement benefits with a present value in excess of $3,500 are payable in the form of a qualified joint and survivor annuity ("QJSA") or, in the case of a participant who dies before the annuity starting date, a qualified preretirement survivor annuity ("QPSA").

The survivor benefit rules do not apply to defined contribution plans other than money purchase pension plans if (1) the plan provides that, upon the death of the participant, the participant's accrued benefit is payable to the participant's surviving spouse, (2) the participant does not elect payment of benefits in the form of an annuity, and (3) the plan is not a transferee plan of a plan subject to the joint and survivor rules.

Benefits from a plan subject to the survivor benefit rules may be paid in a form other than a QJSA or QPSA if the participant waives the QJSA or QPSA (or both) and the applicable notice, election, and spousal consent requirements are satisfied. Similarly, under a defined contribution plan not subject to the survivor benefit rules, the spouse can consent to have benefits paid to another beneficiary.

Present law contains detailed rules regarding the waiver of the QJSA or QPSA forms of benefit and the spousal consent requirements. Generally an election to waive the QJSA or QPSA forms of benefit must be in writing, and, if the participant is married on the annuity starting date, must be accompanied by a written spousal consent acknowledging the effect of such consent and witnessed by a plan representative or notary public. Both the participant's waiver and the spousal consent must state the specific nonspouse beneficiary who will receive the benefit, and, in the case of a QJSA waiver, must specify the particular optional form of benefit that will be paid. The waiver will not be valid unless the participant has previously received a written explanation of (1) the terms and conditions of the QJSA or QPSA forms of benefit, (2) the participant's right to make, and the effect of, an election to waive these forms of benefits, (3) the rights of the participant's spouse, and (4) the right to make, and the effect of, a revocation of an election to waive these forms of benefits.

In the case of a QJSA, this written explanation must generally be provided to participants no less than 30 days and no more than 90 days before the annuity starting date. The participant's election to waive the QJSA and the spousal consent must be made no more than 90 days before the annuity starting date.

In the case of a QPSA, this written explanation must generally be provided within the following period, whichever ends last: (1) the period beginning on the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year preceding the plan year in which the participant attains age 35, or (2) the one-year period beginning on the date the individual becomes a participant. The participant's election to waive the QPSA and the spousal consent generally cannot be made before the first day of the plan year in which the participant attains age 35.

In order for benefits to be paid to another beneficiary under a defined contribution plan not subject to the survivor benefit rules, generally the same conditions for waiving the QPSA form of benefit must be satisfied. However, the participant's election and the spousal consent may be made at any time.

Under Treasury regulations, if a participant divorces his or her spouse prior to the annuity starting date, any election made while the participant was married with respect to the spouse remains valid, unless otherwise provided in a qualified domestic relations order ("QDRO") (sec. 414(p)), or unless the participant changes the election (with the former spouse's consent) or is remarried. If a participant dies after the annuity starting date, the spouse on the annuity starting date is entitled the QJSA protection under the plan even if the participant and the spouse are not married on the date of the participant's death, except as provided in a QDRO or unless waived by the participant and consented to by such former spouse. No agreement made prior to marriage—such as a prenuptial agreement or similar contract—will satisfy the applicable spousal consent requirements.

Description of Proposal

Under the proposal, a prenuptial waiver of survivor benefits would be permitted. Requirements similar to those for a post-mar-

riage waiver of survivor benefits, e.g., a written explanation and a properly made "spousal consent," would have to be satisfied in order for the prenuptial waiver to be valid. In addition, the prenuptial waiver and "spousal consent" would have to be made within a reasonable period—such as one year—prior to marriage.

Effective Date

The proposal would be effective for prenuptial waivers made on or after January 1, 1996.

8. Deny Federal tax information to States imposing a pension source tax

Present Law

Under present law, upon a written request by certain State officials, Federal tax return information (including, income, estate, gift, social security (FICA), unemployment (FUTA), self-employment (SECA), withholding, alcohol, tobacco, and highway use tax information) may be disclosed solely for the purpose of, and only to the extent necessary in, the administration of the State's tax laws (sec. 6103(d)).

Description of Proposal

Under H.R. 1762, the disclosure of Federal tax return information to certain State officials would not be permitted during any period that the State imposed a pension source tax. For purposes of this prohibition on disclosure, a pension source tax would mean any tax on the retirement income of an individual who is not a resident or domiciliary of the State. Retirement income would include any benefits under a qualified retirement plan, a simplified employee pension, an eligible deferred compensation plan (sec. 457), a governmental plan (sec. 414(d)), a trust described in section 501(c)(18), or a nonqualified deferred compensation plan (sec. 3121(v)(2)(C)). The term retirement income would also include retired or retainer pay to a member or former member of the military.

Effective Date

The bill would be effective on the first day after the close of the 1-year period beginning on the date of enactment. This 1-year period would not end before the earlier of (1) the close of the first session of the State legislature beginning after the date of enactment or (2) the close of a session of the State legislature that begins before the date of enactment and remains in session for at least 25 calendar days after the date of enactment. In the case of a State with a 2-year legislative session, each year of the session would be treated as a separate regular session of the State legislature.

Legislative Background

H.R. 11 (102nd Cong.), as passed by the Senate in 1992, included a provision that would have prohibited States from imposing an income tax on the qualified pension income of any individual who

was not a resident or domiciliary of the State. A similar proposal was introduced by Congresswoman Vucanovich (H.R. 394) on January 4, 1995.

9. Unfunded deferred compensation plans of tax-exempt and governmental organizations (sec. 457)

Present Law

Under section 457 of the Code, compensation deferred under an eligible deferred compensation plan of a tax-exempt or governmental employer that meets certain requirements is not includible in gross income until paid or made available. One of the requirements for a section 457 plan is that the maximum annual amount that can be deferred is the lesser of $7,500 or 33⅓ percent of the individual's taxable compensation. This maximum limit is coordinated with the annual limit on elective deferrals under qualified cash or deferred arrangements (sec. 401(k) plans), which is $9,240 for 1995 and the limit on elective deferrals under tax-sheltered annuities (sec. 403(b) plans), which is $9,500 for 1995. Under this rule, elective deferrals to section 401(k) and 403(b) plans are treated as amounts deferred under a section 457 plan (and vice versa). Thus, for example, if an individual who is a participant in both a section 403(b) plan and a section 457 plan elects to contribute $2,000 to the 403(b) plan, then the maximum about that can be deferred in that year under the section 457 plan is $5,500.

Another requirement under section 457 is that (until the compensation is made available to the participant), all amounts of compensation deferred under the plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights must remain solely the property and rights of the employer, subject only to the claims of the employer's general creditors.

Amounts deferred under plans of tax-exempt and governmental employers that do not meet the requirements of section 457 (other than amounts deferred under tax-qualified retirement plans, section 403(b) annuities and certain other plans) are includible in gross income in the first year in which there is no substantial risk of forfeiture of such amounts.

Description of Proposals

a. Exempt deferred compensation plans for volunteer fire fighters

Under the proposal (H.R. 4655, 103rd Cong.), the requirements of section 457 would not apply to any plan paying solely length of service awards to bona fide volunteers (or their beneficiaries) on account of fire fighting and prevention, emergency medical, and ambulance services performed by such volunteers. An individual would be considered a "bona fide volunteer" if the only compensation received by such individual for performing such services is reimbursement (or a reasonable allowance) for expenses incurred in the performance of such services, or reasonable benefits (including length of service awards) and nominal fees for such services cus-

tomarily paid by tax-exempt or governmental employers in connection with the performance of such services by volunteers.

In addition, any amounts exempt from the requirements of section 457 under the proposal would not be considered wages for purposes of the Federal Insurance Contribution Act ("FICA") taxes.

b. Increase deferred compensation limit for group medical practices

Under the proposal, the $7,500 annual limit on deferred compensation would be increased to $25,000 in the case of benefits provided under an excess benefit plan to individuals who are members or employees of a group medical practice. A group medical practice would be defined as a group medical practice or an integrated health care delivery system which employs groups of physicians to provide clinical services which is exempt from taxation under section 501(a). An excess benefit plan would mean a plan maintained solely to provide benefits in excess of the limitations on contributions and benefits under section 415. Amounts deferred under such plans would not be taken into account in determining whether other amounts meet the requirements of section 457.

The proposal would increase the $7,500 and $25,000 limits annually for inflation.

The proposal would provide that the rule coordinating deferrals under a section 457 plan with elective deferrals would not apply to amounts deferred under a plan maintained by a group medical practice.

c. Require individual ownership of plan assets

The proposal would provide that all amounts of compensation deferred under a section 457 plan and all income attributable to such amounts are to be used to purchase an annuity contract or insurance contract or held in a custodial account that provides that the rights of the participant are nonforfeitable (except, in the case of an annuity or life insurance contract, for failure to pay future premiums).

Effective Dates

The proposal exempting deferred compensation of volunteer fire fighters from section 457 would be effective for taxable years beginning after the date of enactment. The proposal exempting such deferred compensation from FICA would apply to remuneration paid after the date of enactment.

The proposal relating to group medical practices would apply to taxable years beginning after December 31, 1994.

The proposal relating to individual ownership of plan assets would apply to amounts deferred after December 31, 1995.

10. Provisions relating to individual retirement arrangements ("IRAs")

a. Permit tax-free rollover of certain severance payments

Present Law

Under present law, severance payments made to an employee are includible in gross income.

Description of Proposal

Under the bill (H.R. 1251), qualified separation payments received by an individual upon termination of employment would be excludable from gross income to the extent the amounts are transferred to an individual retirement arrangement ("IRA") within 60 days of the date of receipt of the payment. Qualified separation payments would mean payments received by an individual if (1) the payment was voluntarily paid by the individual's employer on account of termination of employment before normal retirement age, and (2) the termination was in connection with a substantial reduction in the work force of the employer.

Separation payments transferred to an IRA under the provision (and earnings thereon) would be includible in income when withdrawn under the rules relating to taxation of IRAs.

Effective Date

The proposal would apply to payments received on or after January 1, 1995. In the case of any payment received on or after January 1, 1995, and before the date of enactment, the 60-day rollover period would not expire before the date 60 days after the date of enactment.

b. H.R. 682 (the "Savings and Investment Incentive Act of 1995")

Present Law

An individual may make deductible contributions to an individual retirement arrangement ("IRA") up to the lesser of $2,000 or the amount of the individual's compensation if the individual (and, if married, the individual's spouse) is not an active participant in an employer-sponsored retirement plan. If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the $2,000 limit is phased out between $40,000 and $50,000 of adjusted gross income ("AGI") for married taxpayers filing a joint return, $25,000 to $35,000 of AGI for single taxpayers, and $0 to $10,000 of AGI for married taxpayers filing a separate return.

In the case of a married individual whose spouse has no compensation (or who elects to be treated as having no compensation), the $2,000 limit on IRA contributions is increased to $2,250.

Individuals are permitted to make nondeductible contributions to an IRA to the extent they are not permitted to (or do not make) deductible contributions, up to the lesser of $2,000 or the individual's compensation.

Amounts withdrawn from an IRA are includible in gross income (except to the extent they represent a return of nondeductible contributions). An additional 10-percent tax generally applies to distributions from an IRA prior to age 59½, death, or disability.

IRAs are not permitted to invest in collectibles, such as works of art, metals, gems, stamps, and coins. The prohibition on investment in collectibles does not apply to certain U.S. commemorative gold and silver coins or coins issued under the laws of any State.

Description of Proposal

In general, H.R. 682 (the "Savings and Investment Incentive Act of 1995") would modify the present-law rules relating to deductible IRAs, create a new IRA Plus account to which nondeductible contributions could be made and withdrawals from which would be tax free if certain requirements are satisfied, and permit penalty-free withdrawals from IRAs and elective deferrals for certain purposes.

The bill would make a number of modification to the present-law rules relating to IRAs. The bill would increase the AGI phase out limit for deductible IRA contributions for active participants in an employer-sponsored retirement plan in 1995, 1996, 1997, and 1998, and would repeal the limits for years after 1998. In the case of married taxpayers filing a joint return, the phase out range (before repeal) would be as follows: in 1995, $65,000 to $75,000; in 1996, $90,000 to $100,000; in 1997, $115,000 to $125,000, and in 1998, $140,000 to $150,000. For single taxpayers, the phase out range (before repeal) would be as follows: in 1995, $50,000 to $60,000; in 1996, $75,000 to $85,000; in 1997, $100,000 to $110,000; and in 1998, $125,000 to $135,000.

An individual would not be considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is an active participant. The $2,000 limit on IRA contributions would be indexed for inflation in $500 increments beginning after 1995. The bill would provide that the compensation of both spouses is taken into account in determining the IRA deduction of each spouse. Thus, a couple would be permitted to make up to a total of $4,000 of deductible IRA contributions if the aggregate compensation of the couple is at least $4,000. The bill would provide that IRAs may invest in certain coins and bullion. The IRA deduction limit would be coordinated with the limit on elective deferrals under section 401(k) plans and similar arrangements.

The bill would also create new IRA Plus accounts to which nondeductible contributions could be made. An individual could make contributions to an IRA Plus to the extent they are eligible to and do not make deductible contributions to an IRA. The active participant rules and the rule coordinating IRA contributions with the elective deferral limit would not apply in determining the maximum permitted deductible contribution for this purpose. Distributions from IRA Plus accounts would not be includible in income to the extent attributable to contributions that have been in the IRA Plus account for at least 5 years. Amounts withdrawn prior to the expiration of the 5-year period would be includible in income and subject to the 10-percent early withdrawal tax (unless an exception applies). The bill would permit amounts in IRAs to be transferred into an IRA Plus without imposition of the 10-percent early withdrawal tax. The amount transferred would be includible in gross income in the year of the transfer, except that amounts transferred to an IRA Plus before January 1, 1997, would be includible in income ratably over a 4-year period.

The bill would provide that distributions from an IRA (including an IRA Plus) and distributions of elective deferrals (and earnings thereon) from a 401(k) plan and similar arrangements would not be subject to the 10-percent early withdrawal tax if used for first-

time home purchase, medical expenses that exceed 7.5 percent of adjusted gross income, higher education expenses, or long-term care insurance. Distributions of such amounts from a 401(k) plan or similar arrangement would not disqualify the plan. In addition, the 10-percent early withdrawal tax would not apply to certain distributions from an IRA to an individual who is unemployed.[127]

Effective Date

The provisions relating to deductible IRAs and IRA Plus accounts generally would apply to taxable years beginning after December 31, 1994. The provisions relating to penalty-free withdrawals would apply to payments and distributions after the date of enactment.

Legislative Background

H.R. 682 was introduced by Mr. Thomas on January 25, 1995. H.R. 682 contains provisions similar to those in H.R. 1215, the Tax Fairness and Deficit Reduction Act of 1995, as passed by the House. H.R. 1215 would create American Dream Savings accounts to which individuals could make nondeductible contributions. Contributions to such an account would be in addition to any contributions that could be made to an IRA. Qualified distributions from the account would not be includible in income. H.R. 1215 would also provide that the compensation of both spouses is taken into account in determining the maximum IRA deduction for each spouse.

11. Treatment of Indian tribal governments under section 403(b)

Present Law

Under present law, organizations that are tax exempt under section 501(c)(3) of the Code and certain State and local government educational organizations are permitted to maintain tax-sheltered annuity plans (sec. 403(b)). Indian tribal governments are treated as States for this purpose, so certain educational organizations associated with a tribal government are eligible to maintain tax-sheltered annuity plans. However, while tax exempt, Indian tribes themselves are not the type of tax-exempt organization permitted to maintain tax-sheltered annuity plans.

Description of Proposal

The proposal would permit Indian tribes to maintain tax-sheltered annuities.

Effective Date

The proposal would generally apply to tax-sheltered annuity contracts purchased in a plan year beginning on, before, or after January 1, 1996.

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[127] The bill also has provisions relating to aid to families with dependent children not discussed here.

Legislative Background

A similar proposal was included in H.R. 11 (102nd Cong.), which passed the House of Representatives and the Senate in 1992 and was vetoed by President Bush.

12. Special rules for church pension plans

Present Law

In general, a church plan is a plan established and maintained for employees (or their beneficiaries) by a church or a church convention or association of churches that is exempt from tax (sec. 414(e)). Church plans include plans maintained by an organization, whether a corporation or otherwise, that has as its principal purpose or function the administration or funding of a plan or program for providing retirement or welfare benefits for the employees of the church or convention or association of churches. Employees of a church include any minister, regardless of the source of his or her compensation, and an employee of an organization which is exempt from tax and which is controlled by or associated with a church or a convention or association of churches.[128]

Plans maintained by churches and certain church-controlled organizations are exempt from certain of the requirements applicable to pension plans under the Code pursuant to the Employee Retirement Income Security Act of 1974 (as amended) ("ERISA"). For example, such plans are not subject to ERISA's vesting, coverage, and funding requirements. In some cases, such plans are subject to provisions in effect before the enactment of ERISA. Church plans may elect to waive the exemption from the qualification rules (sec. 410(d)). Electing plans become subject to all the Code section 401(a) qualification requirements, title I of ERISA, the excise tax on prohibited transactions, and participation in the pension plan termination insurance program administered by the Pension Benefit Guaranty Corporation.

Certain eligible employers may maintain tax-sheltered annuity plans (sec. 403(b)). These plans provide tax-deferred retirement savings for employees of public education institutions and employees of certain tax-exempt organizations (including churches and certain organizations associated with churches). In addition to tax-sheltered annuities, alternative funding mechanisms that provide similar tax benefits include church-maintained retirement income accounts (sec. 403(b)(9)).

Description of Proposal

In general, H.R. 528 (the "Church Retirement Benefits Simplification Act of 1995") would revise the rules relating to church-maintained qualified retirement plans. In addition, the bill would modify the rules relating to employee annuity contracts and retirement income accounts maintained for the benefit of church employees.

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[128] With respect to certain provisions (e.g., the exemption for church plans from nondiscrimination requirements applicable to tax-sheltered annuities), the more limited definition of church under the emloyment tax rules applies (secs. 3121(w)(3)(A) and (B)).

a. Consolidation and modification of rules relating to church-maintained qualified retirement plans

In general

The bill would add a new section 401A to the Code that would define a qualified church plan. If the requirements of the new section are met, then the qualified church plan would be treated as satisfying the general qualification requirements of section 401(a). None of the general qualification requirements would apply to church plans except as specifically provided in the new Code section.

Definition of qualified church plan

In general

In order to be a qualified church plan, the plan would have to be a church plan as under present law (sec. 414(e)). In addition, the church that maintains the plan could not have elected (pursuant to section 410(d)) to waive the exemption from certain qualification requirements available to church plans (e.g., participation, vesting and funding rules).

Employee contributions and vesting

In order for a church plan to be qualified, an employee's rights in his or her accrued benefit derived from his or her own contributions would have to be nonforfeitable. In addition, accrued benefits derived from employer contributions would have to vest at least as rapidly as under a 10-year cliff vesting schedule or a 5- to 15-year vesting schedule. A plan would satisfy the 10-year cliff vesting schedule if an employee who has at least 10 years of service has a nonforfeitable right to 100 percent of his or her accrued benefit derived from employer contributions. A plan would meet the 5- to 15-year vesting schedule if benefits vest at least as rapidly as under the following schedule:

Years of service	Nonforfeitable percentage:
5	25
6	30
7	35
8	40
9	45
10	50
11	60
12	70
13	80
14	90
15 or more	100

As under present law, a qualified church plan would have to meet the funding requirements of section 401(a)(7) as that section

was in effect on September 1, 1974 (before the enactment of ERISA).

Additional requirements

A qualified church plan would have to meet the requirements of sections 401(a)(1) (contributions are to be made to a trust for the purpose of distributing the trust income and principal to plan participants), 401(a)(2) (a plan must be maintained for the exclusive benefit of participants and plan assets cannot be diverted for any other purpose), 401(a)(8) (forfeitures under a defined benefit plan cannot be used to increase benefits), 401(a)(9) (benefits under a church plan must begin no later than the later of age 70½ or retirement), 401(a)(16) (benefits under the plan must not exceed certain limits provided in sec. 415), 401(a)(17) (the amount of compensation taken into account under a qualified plan cannot exceed $150,000 (indexed)), 401(a)(25) (defined benefit pension plans must specify actuarial assumptions used to determine benefits), 401(a)(27) (plans intended to be profit-sharing or money purchase plans must be designated as such), and 401(a)(30) (employee elective deferrals cannot exceed a certain dollar amount).

In addition, the requirements of sections 401(b) (relating to retroactive changes in the plan), 401(c) (special rules for owner-employees and self-employed individuals), and 401(h) (separate accounts in defined benefit plans used to pay retiree health benefits) would apply to such plans.

If the plan includes employees of an organization that is not a church, then the plan would have to meet the requirements (minimum coverage rules) of sections 401(a)(3) and 401(a)(6) as in effect on September 1, 1974, as well as sections 401(a)(4) (general nondiscrimination rule), 401(a)(5) (special rules relating to nondiscrimination)[129] and 401(m) (special nondiscrimination test for employer matching and employee after-tax contributions). The plan administrator could elect to treat the portion of a plan covering employees that are not church employees as a separate plan.

Definitions and special rules

Definition of church.—A church would be defined as a church or a convention or association of churches, including organizations (controlled by or associated with a church) whose principal function is to fund or maintain a plan for churches. The definition of church would also include tax-exempt church controlled organizations other than (1) schools above the secondary level (other than those for religious training) or (2) health care organizations (including hospitals) that provide community service for inpatient care if not more than 50 percent of total patient days are customarily assignable to certain categories of medical treatment.

Satisfaction of trust requirements.—A church plan would not fail to be a qualified plan merely because such plan is funded through a church, convention or association of churches, or an organization controlled by or associated with a church the principal function of

[129] Sec. 401(a)(5) provides generally that a plan is not considered discriminatory merely because it is limited to salaried or clerical employees or because benefits bear a uniform relationship to compensation. Sec. 401(a)(5) also provides that benefits may favor highly compensated employees by a permitted disparity (sec. 401(l)).

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which is to provide benefits to church employees, rather than through a trust if: (1) such organization is subject to fiduciary requirements under applicable State law, (2) such organization is separately incorporated from the church which controls it, (3) the assets which equitably belong to the plan are separately accounted for, and (4) under the plan, prior to satisfaction of all liabilities with respect to plan participants and beneficiaries, plan assets cannot be used for or diverted to purposes other than for the exclusive benefit of participants and their beneficiaries.

Failure of one organization to qualify.—If one or more organizations maintaining a church plan fails to satisfy the qualification requirements applicable to church plans, the plan would not be disqualified with respect to the other organizations maintaining the plan that meet such requirements.

Special rules relating to highly compensated and excludable employees.—For purposes of the nondiscrimination requirements applicable to church plans, a person would generally be considered highly compensated if the person is an officer, shareholder, or person whose principal duties consist of supervising the work of other employees. Under the bill, no employee would be considered to be highly compensated under this definition if such employee during the year or the preceding year received compensation of less than $50,000 (indexed). In addition, certain employees covered by collective bargaining agreements (as described in sec. 410(b)(3)(A)) would not be taken into account in applying the church plan qualification rules.

Effective date

The new qualification provisions relating to church plans would generally be effective for years beginning after December 31, 1994. The vesting provisions would be effective for years beginning after December 31, 1996.

No regulation or ruling under the general qualification standards (sec. 401(a)) issued after December 31, 1994, would apply to a qualified church plan (as defined in the bill) unless such regulation or ruling is specifically made applicable to such plans.

A church plan (within the meaning of sec. 414(e)) could not be deemed to have failed to satisfy the applicable qualification requirements for any year beginning prior to January 1, 1995.

b. Retirement income accounts of churches

Under present law, retirement income accounts (described in sec. 403(b)(9)) maintained by certain churches are treated as tax-sheltered annuities. The bill would modify certain rules relating to such accounts. First, the bill would allow tax exempt church-controlled organizations to maintain such accounts. Second, the bill would provide that ministers (including self-employed ministers) are treated as employees for purposes of the rules relating to retirement income accounts.

Effective date.—The provision would generally be effective for years beginning after December 31, 1994. A church plan (within the meaning of sec. 414(e)) could not be deemed to have failed to satisfy the applicable requirements of section 403(b) for any year beginning prior to January 1, 1995.

c. Tax-sheltered annuity contracts purchased by churches

The bill would modify several rules relating to tax-sheltered annuity contracts purchased by churches. The first modification relates to the nondiscrimination rules. Under the bill, if a contract is purchased under a church plan by (1) schools above the secondary level (other than those for religious training) or (2) health care organizations (including hospitals and medical research organizations) which provide community service for inpatient care if not more than 50 percent of total patient days are customarily assignable to certain categories of medical treatment, the plan must meet the requirements of sections 401(a)(3) and (a)(6) as in effect on September 1, 1974 (minimum coverage rules), 401(a)(4) (general nondiscrimination rule), 401(a)(5) (special rules relating to nondiscrimination), 401(a) (17)(limit on includible compensation) and 401(m) (nondiscrimination rules for employer matching and employee after-tax contributions).

The bill would define a contract purchased by a church to include an annuity (sec. 403(b)(1)), a custodial account (sec. 403(b)(7)), and a retirement income account (sec. 403(b)(9) as amended by the bill). A church would be defined as a church or a convention or association of churches, including tax-exempt church controlled organizations.

The vesting requirements that apply for purposes of the new church plan qualification requirements would apply to contracts purchased by a church. The present-law vesting rules relating to tax-sheltered annuities would not apply (secs. 403(b)(1)(C) and 403(b)(6)). In addition, salary reduction amounts would have to be nonforfeitable. The rules relating to the failure of one organization to meet the requirements of section 403(b) and the rules relating to highly compensated and excludable employees would be similar to the rules applicable to qualified church plans.

The bill would treat as an employee for section 403(b) purposes certain self-employed ministers and any other duly ordained, commissioned or licensed minister that is employed by an organization other than an organization described in section 501(c)(3). Thus, these individuals could participate in tax-sheltered annuity programs.

Effective date.—The modifications relating to the purchase of contracts by churches generally would be effective for years beginning after December 31, 1994. The vesting standards would be effective for years beginning after December 31, 1996.

No regulation or ruling under section 401(a) or 403(b) issued after December 31, 1994, would apply to a contract purchased by a church unless such regulation or ruling is specifically made applicable to such contracts.

d. Modification of distribution requirements

Under present law, a tax-sheltered annuity contract must provide that distributions cannot begin before age 59½, separation from service, death, disability (as defined in sec. 72(m)(7)) or (with respect to principal under the contract) in the case of hardship. The bill would modify the definition of disability for purposes of retirement income accounts to conform to the definition used for pur-

poses of the rules relating to cash or deferred arrangements (sec. 401(k)(2)).

Effective date.—The modification would apply to years beginning after December 31, 1988.

e. Modification of required beginning date for distributions

Under present law, distributions under qualified pension plans are required to begin no later than April 1 of the year following the year in which a participant attains 70½ (sec. 401(a)(9)). With respect to church plans, the required beginning date is the later of the date described in the preceding sentence and April 1 of the year after the year in which the employee retires. Under the bill, the special rule for church plans applies to all church plans described in section 414(e) instead of the present law rule that applies the special rule only to those churches treated as such for employment tax purposes (secs. 3121(w)(3)(A) and (B)).

Effective date.—The provision would be effective as if included in the Tax Reform Act of 1986.

f. Exclusion of ministers from nondiscrimination requirements

The bill would provide that ministers are excluded in applying the nondiscrimination requirements applicable to pensions and certain other employee benefits. In particular, the bill would excludes ministers from being considered when an employer applies the following sections: 401(a)(3), (4) and (5) as those sections were in effect on September 1, 1974, as well as sections 401(a)(4) and 401(a)(5) under present law, 401(a)(26) (minimum participation rule), 401(k)(3) (special nondiscrimination rules for qualified cash or deferred arrangements), 401(m) (special nondiscrimination rules for employer matching and after-tax employee contributions), 403(b)(1)(D) (nondiscrimination requirements for tax-sheltered annuities), 410 (minimum coverage rules), 79(d) (nondiscrimination rules for employer-provided group-term life insurance), 105(h) (nondiscrimination requirements for self-insured medical reimbursement plans), 125(b) (nondiscrimination rules for cafeteria plans), and 129(d)(2), (3) and (8) (nondiscrimination rules for dependent care assistance plans).

The church plan in which a minister participates would be treated as a plan or contract meeting the requirements of section 401(a), 401A (the new requirements for qualified church plans), or 403(b) with respect to such minister's participation.

Effective date.—This provision would be effective for years beginning before, on, or after December 31, 1994.

g. Aggregation rules not to apply to churches

The bill would exempt churches from certain aggregation rules (secs. 414(b), (c), (m), (o) and (t)) that must be applied in order to determine who is the employer for certain nondiscrimination rules and for certain other purposes (secs. 401(a)(3), (4), and (5) as those sections were in effect on September 1, 1974, 401(a)(4), (a)(5), (a)(17), (a)(26), 401(h), 401(m), 410(b), 411(d)(1) and 416).

The exemption would be available to church-related organizations except in the case of such organizations that are not exempt

from tax under section 501(a) and which have a common, immediate parent.

A church-related organization could make an election to use this provision for itself and other related organizations on or before the last day of the plan year beginning on or after January 1, 1998.

Effective date.—The provision would be effective as if included in the provision of P.L. 93–406 (ERISA as enacted), P.L. 98–369 (the Deficit Reduction Act of 1984), or P.L. 99–514 (the Tax Reform Act of 1986) to which the amendment relates.

h. Self-employed ministers treated as employees for purposes of certain welfare benefit plans

Under the bill, self-employed ministers would be treated as employees for purposes of certain welfare benefit and qualified plan rules. In particular, self-employed ministers would be treated as employees for purposes of the exclusions for employer-provided group-term life insurance, employer-provided accident or health insurance, and employee death benefits. In addition, self-employed ministers would be treated as employees for purposes of the rules relating to cafeteria plans (sec. 125) and pension plans.

Effective date.—The provision would be effective for years beginning before, on, or after December 31, 1994.

i. Deductions for contributions by certain ministers to retirement income accounts

Under the bill, if a minister makes a contribution to a retirement income account, such contribution would be treated as though it were made to a tax-exempt pension trust and would be deductible to the extent it does not exceed the exclusion allowance applicable to tax-sheltered annuities (sec. 403(b)(2)).

Effective date.—The provision would be effective for years beginning after December 31, 1994.

j. Modification of rules for plans maintained by more than one employer

Under the bill, a church plan would not be treated as a single plan merely because employers commingle assets solely for purposes of investment and pooling of mortality experience.

Effective date.—The provision would be effective for years beginning before, on, or after December 31, 1994.

k. Section 457 not to apply to deferred compensation of church employees

Present law imposes dollar limits and certain other requirements on deferred compensation of employees of tax exempt and State and local government employers (sec. 457). Under present law, these rules do not apply to churches (as defined in sec. 3121(w)(3)(A)) and certain church-controlled organizations (as defined in sec. 3121(w)(3)(B)). The bill would expand the definition of churches under this rule to include all churches as defined under the qualification requirements applicable to church plans (new sec. 401A).

Effective date.—The provision would be effective for years beginning after December 31, 1978.

l. Modification to health benefits accounts in church plans

Under present law, a pension or annuity plan may provide for the payment of retiree medical expenses through a segregated account (sec. 401(h)). In the case of a key employee, a separate account must be maintained and any additions to the account with respect to such employee are treated as annual additions for purposes of the rules relating to limitations on contributions and benefits (sec. 415). Under the bill, with respect to a church plan maintained by more than one employer, a separate account would not be required for an employee who is a key employee solely by reason of being an officer with annual compensation greater than $45,000. The bill would modify the amount of the annual addition under section 415 with respect to participants of church plans.

Effective date.—The provision would apply to years beginning after March 31, 1984.

m. Modification of rule relating to investment in contract

The bill would grant foreign missionaries the exception to the special rules for computing employees' contributions (sec. 72(f)) currently available only with respect to certain contributions relating to credits for service performed prior to January 1, 1963.

Effective date.—The provision would be effective for taxable years beginning after December 31, 1994.

n. Modification of rule relating to elective deferral catch-up limitation for retirement income accounts

The bill would modify the elective catch-up provisions relating to retirement income accounts by repealing one of the limitations on the amount of such catch-up contribution (sec. 402(g)(8)(A)(iii)).

Effective date.—The provision would be effective as if included in the Tax Reform Act of 1986.

o. Church plans may annuitize benefits

Under the bill, a retirement income account, a church plan, or an account comprised of qualified voluntary employee contributions (permitted under prior law) would not fail to meet the qualification requirements merely because it pays benefits to participants and their beneficiaries from a pool of assets administered or funded through an organization whose principal purpose is to provide such benefits (described in sec. 414(e)(3)(A)), rather than through the purchase of annuities from an insurance company.

Effective date.—The provision would be effective for years beginning before, on, or after December 31, 1994.

p. Church plans may increase benefits

Under the bill, a retirement income account, a church plan, or an account comprised of qualified voluntary employee contributions (permitted under prior law) would not fail to meet applicable qualification requirements merely because it provides benefit payments that (1) take into account the investment performance of the underlying assets or favorable interest or mortality experience, or (2) that increase in an amount not in excess of 5 percent per year.

Effective date.—The provision would be effective for years beginning before, on, or after December 31, 1994.

q. Exemption for church plans from nondiscrimination rules applicable to self-insured medical accounts

The bill would exempt plans maintained by churches from the nondiscrimination rules relating to self-insured medical plans (sec. 105(h)).

Effective date.—The provision would apply to years beginning before, on, or after December 31, 1994.

r. Retirement benefits of ministers not subject to tax on net earnings from self-employment

The bill would provide that retirement benefits of ministers are not subject to self-employment taxes.

Effective date.—The provision would apply to years beginning before, on, or after December 31, 1994.

Effective Dates

The effective dates of the various provisions of the bill are described above.

Legislative Background

H.R. 528 was introduced by Mr. Cardin on January 1, 1995. Certain provisions contained in the bill (or similar provisions) were included in H.R. 11 (102d Cong.), which was passed by the House of Representatives and the Senate in 1992 and was vetoed by President Bush. In particular, H.R. 11 included the new vesting requirements applicable to qualified church plans, the provision providing that the failure of one organization to satisfy the qualification requirements does not disqualify a plan with respect to other organizations maintaining the plan, the modification to the definition of highly compensated employee and the rule relating to exclusion of certain employees covered by a collective bargaining agreement, the revision of the definition of hardship for purposes of distributions from a tax-sheltered annuity, a provision permitting self-employed ministers to participate in denomination church plans (such ministers would be disregarded in applying applicable nondiscrimination rules), a provision specifying that church plans do not have to maintain separate accounts under section 401(h) for key employees, repeal of the special years of service catch-up election under section 403(b), and modification to the minimum distribution rules as applied to churches.

B. Employee Benefits

1. Tax treatment of certain disability benefits for police and fire fighters

Present Law

Under present law, amounts received under a worker's compensation act or under a statute in the nature of a worker's compensation act which provides compensation to employees for personal injuries or sickness incurred in the course of employment are excludable from gross income. The exclusion does not apply to a retirement pension or annuity to the extent that it is determined by

reference to the employee's age or length of service or the employee's prior contributions, even though the employee's retirement is occasioned by an occupational injury or sickness.[130]

Under Internal Revenue Service ("IRS") rulings, the exclusion does not apply if there is a presumption that an injury is work related. In addition, the exclusion does not apply if the plan under which the benefits are paid does not distinguish between disabilities that are work related and those that are not.

Description of Proposals

a. Presumption of disability

The proposal would provide that certain payments made by the State of Connecticut in calendar year 1989, 1990, or 1991, to or on behalf of an individual who was a full-time employee of a police or fire department and who suffered from heart disease or hypertension are deemed to be work related for Federal income tax purposes and therefore are excludable from gross income. This treatment would apply only to payments made under a State law that irrebuttably presumed that such illnesses are work related, and only for employees who separated from service before July 1, 1992.

Claims for credit or refund of any overpayment resulting from the proposal could be made within 1 year after the date of enactment (regardless of the regularly applicable statute of limitations).

b. No distinction between job-related and other disabilities

Under this proposal, amounts paid to (or with respect to) police and fire fighters employed by a State or political subdivision would be excludable from income if there is an admission by the employer or its agent or there is a finding or determination by a Sate or local worker's compensation board that the disability was job related and the plan under which the amounts are paid was established on January 1, 1980, by State law, pays disability benefits regardless of whether the disability resulted form employment, and does not vary the amount of disability benefits on the basis of whether the disability resulted from employment. The exclusion would not apply to the portion of any benefit based on length of service, age, or the employee's contribution or with respect to disabilities that are presumed to be work related.

Effective Date

The first proposal would be effective on the date of enactment. The second proposal would apply to amounts paid after the date of enactment.

Legislative Background

A provision similar to the first proposal was included in H.R. 11 (102nd Cong.), which was passed by the House of Representatives in 1992 and vetoed by President Bush.

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[130] Sec. 104; Treas. reg. sec. 1.104–1(b).

2. Exclude from income retirement benefits that an employee elects to use to purchase employer-provided accident or health care

Present Law

Under present law, an employee is not required to include in gross income the value of employer-provided coverage under an accident or health plan (sec. 106).

Benefits distributed to an employee from a tax-favored employer-provided retirement plan generally are includible in gross income in the year paid or distributed under the rules relating to the taxation of annuities (sec. 72), unless the amount distributed represents the employee's investment in the contract. Special rules apply in the case of lump-sum distributions from a qualified plan, distributions that are rolled over to an IRA or to another qualified plan, and distributions of employer securities. Early withdrawals from qualified plans and other tax-favored retirement arrangements are subject to an additional 10-percent income tax (sec. 72(t)). Excess distributions from qualified plans and other tax-favored retirement arrangements are subject to a 15-percent tax (sec. 4980A).

Under a cafeteria plan, a participant is offered a choice between cash and one or more qualified benefits. The mere availability of cash or certain taxable benefits under a cafeteria plan does not cause an employee to be treated as having received the available cash or taxable benefits for income tax purposes if certain conditions are met (sec. 125). Under present law, a cafeteria plan does not include any plan that provides for deferred compensation, other than elective deferrals under a qualified cash or deferred arrangement.

The Internal Revenue Service ("IRS") has taken the position that an employee who elects to have all or a portion of an employer contribution to a qualified pension plan allocated to a retiree health account is subject to tax in the year the employer contribution is so allocated (PLR 9513027). Further, the IRS has taken the position that an employee who is given an election at retirement to choose to have the amounts in a retiree medical account used to pay for coverage under a retiree medical plan or to have such amounts distributed in accordance with the normal distribution rules of the plan would be required to include in income the amounts used to pay for retiree medical coverage (PLR 9405021).

Description of Proposal

Under the proposal, an individual who elects to use qualified pension benefits allocated to a retiree medical account to purchase health insurance would not be required to include the value of the retiree medical coverage in income. Similarly, an individual who elects to have a portion of employer contributions to a qualified plan allocated to a separate retiree health account would not be required to include the amount so allocated in income.

Effective Date

The proposal would be effective for elections made in years beginning after December 31, 1995.

3. Modify restrictions on golden parachute payments

Present Law

Under present law, no corporate deduction is allowed for "excess parachute payments" (sec. 280G) and a nondeductible 20-percent excise tax is imposed on the recipient of any excess parachute payment (sec. 4999).

A parachute payment is generally defined as any payment of compensation to a "disqualified individual" that is contingent on the change in the ownership or effective control of the corporation, but only if the aggregate present value of all such payments is at least 3 times the individual's "base amount," i.e., the individual's average annual compensation includible in gross income over the last 5 taxable years. A "disqualified individual" generally is any individual who is an employee, independent contractor, or other person specified in Treasury regulations who performs personal services for the corporation, and who is an officer, shareholder, or highly compensated individual. "Excess parachute payments" are any parachute payments in excess of the "base amount" which are not reasonable compensation. There is a presumption that all parachute payments are not reasonable compensation which is rebuttable only by clear and convincing evidence.

Present law contains a special rule for small business and privately-held corporations. Under this rule, the term parachute payment does not include any payment made to (or for the benefit of) a disqualified individual: (1) with respect to a corporation that was, immediately before the change in control, a small business corporation (as defined in sec. 1361(b), relating to S corporations); or (2) with respect to a corporation no stock of which was, immediately before the change in control, readily tradable on an established securities market, or otherwise, provided approval by shareholders owning more than 75 percent of the voting power of all outstanding stock of the corporation was obtained with respect to the payment to the disqualified individual. For this purpose, the term "stock" does not include any stock that is nonvoting, nonconvertible, limited and preferred as to dividends, or has redemption or liquidation rights that do not exceed the issue price of such stock, and the rights of which are not adversely affected by the parachute payments.

Description of Proposal

The proposal would expand the special rule for small business and privately-held corporations to exclude form the definition of "parachute payments" payments made to a disqualified individual with respect to a corporation if, immediately before the change in control, more than 50 percent of the voting power of all outstanding stock of the corporation is held by a single person who is neither related to the qualified individual nor is a corporation whose stock is readily tradable on an established securities market, or other-

wise. No shareholder approval of the payment to the qualified individual would be necessary in order for this exception to apply. Further, under the proposal, the exception would apply to a payment with respect to a corporation (whether or not publicly traded) that is a member of an affiliated group (as defined in sec. 1504) whose common parent satisfies the requirements of the exception, i.e., more than 50 percent controlled by a single person unrelated to the disqualified individual and which is not publicly-traded.

Effective Date

The proposal would be effective for amounts received after the date of enactment.

4. Employee housing for certain medical research institutions

Present Law

Under Code section 119(d), employees of an educational institution do not have to include in income the fair market value of campus housing as long as the rent is at least five percent of the appraised value of the housing. If the rent is too low to meet the five-percent safe harbor, there is inclusion into income to the extent that the lesser of the fair rental value or five percent of the appraised value exceeds the rent that was charged. Some medical research institutions fail the definition of an "educational institution" because the students that they teach do not matriculate there.

Description of Proposal

The proposal would allow certain medical research institutions ("academic health centers") that engage in basic and clinical research, have a regular faculty and teach a curriculum in basic and clinical research to students in attendance at the institution to be treated as an "educational institution" for purposes of Code section 119(d).

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1994.

CC. Tax-Exempt Bonds

1. Expansion of arbitrage rebate exception for certain bonds

Present Law

In general, issuers of all tax-exempt bonds are subject to two sets of restrictions on investment of their bond proceeds.

Yield restriction requirement.—Tax-exempt bonds proceeds generally may not be invested at a yield materially higher than the bond yield, i.e., only limited arbitrage profits may be earned. Exceptions are provided to this restriction for investments during any of several "temporary periods" pending use of the proceeds (generally prescribed in Treasury Department regulations). Additional exceptions are provided throughout the term of the issue for bond proceeds invested as part of a reasonably required reserve or replacement fund and for a "minor" portion of the issue proceeds. Further, Treasury Department regulations in substance allow temporary periods during which yield restriction does not apply to be extended indefinitely if issuers make certain "yield restriction payments" of arbitrage profits. (Treas. reg. sec. 1.148–5(c))

Unlike the rebate requirement, described below, the yield restriction requirement applies both to investments unrelated to the purpose of the borrowing ("nonpurpose investments") and to investments such as a loan to the ultimate borrower of the bond proceeds in the case of private activity bonds ("purpose investments").

Rebate requirement.—Generally, all arbitrage profits earned on nonpurpose investments of bond proceeds during periods when such earnings are permitted must be rebated to the Federal Government. Permitted arbitrage profits on purpose investments (limited by the yield restriction requirement described above) are not subject to the rebate requirement. Present law includes three principal exceptions to the rebate requirement on nonpurpose arbitrage profits.

First, if all gross proceeds of an issue are spent for the purpose of the borrowing within six months after the bonds are issued, no rebate is required. This exception may be satisfied notwithstanding the presence of a reasonably required reserve or replacement fund if all proceeds other than those invested as part of that fund are so spent and profits on the reserve fund (and any bona fide debt service fund subject to rebate) are rebated.

Second, bonds, other than private activity bonds, issued by governmental units having general taxing powers are not subject to the rebate requirement if the governmental unit (and all subordinate units) issues $5 million or less of governmental bonds during a calendar year.

Third, no rebate is due in the case of certain construction bond issues if the available construction proceeds are spent for the purpose of the borrowing at least at specified rates during the 24-month period after the bonds are issued. An issue will satisfy this exception from rebate if at least 10 percent of available proceeds are spent for the purpose of the borrowing within 6 months after the bonds are issued, at least 45 percent of the available proceeds are spent within 12 months, at least 75 percent of the available proceeds are spent within 18 months, and at least 100 percent of

the available proceeds are spent within 24 months. An issue may delay, until after 24 months, spending a reasonable retainage amount (not exceeding 5 percent of the issue) if that amount is spent within the following 12 months. Construction bonds eligible for this exception include all governmental bonds, qualified 501(c)(3) bonds, and private activity bonds the proceeds of which are used to finance property owned by a governmental unit.

Description of Proposal

The proposal would expand eligibility for the construction bond exception from arbitrage rebate to all bonds (other than refunding issues and tax and revenue anticipation issues), and extend the 24-month requirement of the present law construction bond exception. Under the proposal, no rebate (other than on reasonably required reserve funds) would be required if : (a) at least 33 1/3 percent of available proceeds are spent for the purpose of the borrowing within 12 months after the bonds are issued, (b) 75 percent was spent within 24 months after the bonds are issued; and, (c) 100 percent was spent within 36 months after the bonds were issued. The proposal also would make conforming changes to the election and penalty provisions of the arbitrage rules under present law.

Effective Date

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

2. Bonds for certain output facilities

Present Law

The Code provides a special limit on tax exempt bond financing for certain output facilities, such as electric and gas generation, transmission and related activities (but not water facilities). In the case of bonds five percent or more of the proceeds of which is to be used to finance these output projects, the maximum amount of bond-financing that may be used by nongovernmental persons on a basis other than as a member of the general public is $15 million. Thus, with respect to any such issue, the amount of bond proceeds used by such persons may not exceed the lesser of 10 percent of the proceeds or $15 million. In determining whether the $15 million limit is exceeded, all prior issues with respect to the project are counted.

Description of Proposal

The bill (H.R. 677) would repeal the $15 million limitation.

Effective Date

The bill would be effective for bonds issued after the date of enactment.

Legislative Background

H.R. 677 was introduced by Mr. Neal on January 25, 1995.

3. Bonds for emergency response vehicles of certain volunteer fire departments

Present Law

Qualified volunteer fire departments may issue tax-exempt bonds (not subject to most private activity bond restrictions) for the acquisition, construction, reconstruction, or improvement of: (1) firehouses (including land which is functionally related and subordinate thereto) or (2) firetrucks.

A qualified fire department is defined as an organization which (1) is organized and operated to provide firefighting or emergency medical services for persons in an area that is not provided with any other firefighting services, and (2) is required (by written agreement) by the relevant political subdivision to furnish firefighting services in that area.

Description of Proposal

The bill (H.R. 282) would allow qualified volunteer fire departments to issue tax-exempt bonds for ambulances and other emergency response vehicles. The bill would also treat any organization that provides volunteer emergency medical services as a volunteer fire department for purposes of eligibility for this type of tax-exempt financing.

Effective Date

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

Legislative Background

H.R. 282 was introduced by Mr. Jacobs on January 4, 1995.

4. Spaceport exempt-facility bonds

Present Law

Qualified bonds

Interest on State and local government bonds generally is excluded from income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units. Present law also excludes the interest on State and local government bonds ("private activity bonds") when a governmental unit incurs debt as a conduit to provide financing for private parties, if the financed activities are specified in the Internal Revenue Code (the "Code"). Tax-exempt bonds may not be issued to finance private activities not specified in the Code.

One type of private activity bonds is exempt-facility bonds. Exempt facility bonds are bonds 95 percent of the proceeds of which are used to finance any of the following: airports, docks and wharves; mass commuting facilities or high-speed intercity rail facilities; water, sewage, solid waste, or hazardous waste disposal facilities; facilities for the local furnishing of electricity or gas; local district heating or cooling facilities; certain low-income rental hous-

ing projects; and environmental improvements to hydroelectric facilities.

Federal guarantee

Subject to exceptions for certain Federal programs in existence before 1984; interest on any obligation is not tax-exempt if the obligation is Federally guaranteed. An obligation is treated as Federally guaranteed if (1) the payment of the principal or interest on the obligation is guaranteed, in whole or in part, by the United States or any agency or instrumentality thereof; (2) a significant portion of the proceeds of the issue of which the obligation is a part is to be used in making loans or other investments the payments on which are guaranteed in whole or in part by the United States or any agency or instrumentality thereof; (3) a significant portion of the proceeds of the issue is to be invested, directly or indirectly, in Federally insured deposits or accounts in a financial institution; or (4) the payment of the principal or interest of the obligation is otherwise indirectly guaranteed, in whole or in part, by the United States or an agency or instrumentality thereof.

Description of Proposal

Qualified bonds

The proposal would expand the list of facilities that may be financed with exempt-facility bonds to include spaceports owned by governmental units. Generally, spaceports would be treated identically to airports for purposes of tax-exempt financing rules. The proposal would also extend tax-exempt financing to spaceport ground leases.

The term "spaceport," would be defined to include facilities directly related to the operation of the spaceport located at, or in proximity to, the launch site. It would also include certain functionally related and subordinate facilities at, or adjacent to, the spaceport.

Federal guarantee

The proposal would exempt spaceport exempt-facility bonds from the Federal guarantee rules.

Effective Date

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

Legislative Background

The proposal is the same as H.R. 2740, (103rd Congress).

5. Bonds for solar energy facility

Present Law

Qualified bonds

Interest on State and local government bonds generally is excluded from income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance

direct activities of these governmental units. Present law also excludes the interest on State and local government bonds ("private activity bonds") when a governmental unit incurs debt as a conduit to provide financing for private parties, if the financed activities are specified in the Internal Revenue Code (the "Code"). Tax-exempt bonds may not be issued to finance private activities not specified in the Code.

One type of private activity bonds is exempt-facility bonds. Exempt-facility bonds are bonds 95 percent of the proceeds of which are used to finance the following: airports; docks and wharves; mass commuting facilities or high-speed intercity rail facilities; water, sewage, solid waste, or hazardous waste disposal facilities; facilities for the local furnishing of electricity or gas; local district heating or cooling facilities; certain low-income rental housing projects; and environmental improvements to hydroelectric facilities.

Federal guarantee

Subject to exceptions for certain Federal programs in existence before 1984; interest on any obligation is not tax-exempt if the obligation is Federally guaranteed. An obligation is treated as Federally guaranteed if (1) the payment of the principal or interest on the obligation is guaranteed, in whole or in part, by the United States or any agency or instrumentality thereof; (2) a significant portion of the proceeds of the issue of which the obligation is a part is to be used in making loans or other investments the payments on which are guaranteed in whole or in part by the United States or any agency or instrumentality thereof; (3) a significant portion of the proceeds of the issue is to be invested, directly or indirectly, in Federally insured deposits or accounts in a financial institution; or (4) the payment of the principal or interest of the obligation is otherwise indirectly guaranteed, in whole or in part, by the United States or an agency or instrumentality thereof.

Description of Proposal

Qualified bonds

The proposal would expand the list of exempt-facility bonds to include bonds used to finance a facility for the generation of electricity from solar energy.

Federal guarantee

The proposal would exempt exempt-facility bonds for the solar energy facility from the Federal guarantee rules.

Effective Date

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

6. Bonds for the sale of the Alaska Power Administration facility

Present Law

Generally interest on bonds used to acquire nongovernmental output property (other than bonds issued in connection with the furnishing of water) is taxable. Nongovernmental output property generally is defined as output property used or held for use by a person other than a State or local government after October 13, 1987. Output property includes, e.g., facilities such as electric and gas generation, transmission, distribution, and other related facilities.

Description of proposal

The proposal would provide an exception from certain provisions of the output property rule for the sale of the Snettisham hydroelectric project from the Alaska Power Administration to the State of Alaska but would not provide an exception from the State private activity volume limitation.

Effective Date

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

7. Bonds for the United Nations

Present Law

Interest on State and local government bonds generally is excluded from income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units. Present law also excludes the interest on State and local government bonds ("private activity bonds") when a governmental unit incurs debt as a conduit to provide financing for private parties, if the financed activities are specified in the Internal Revenue Code (the "Code"). Tax-exempt bonds may not be issued to finance private activities not specified in the Code.

Private activity bonds are bonds (1) more than 10 percent of the proceeds of which satisfy a private business use and payment test, or (2) more than five percent ($5 million, if less) of the proceeds are used to finance loans to persons other than State or local governmental units.

Under the tax-exempt bond rules, all persons and entities other than states and local governments are treated as private parties, eligible for financing only if specifically authorized. No such authorization exists for the United Nations or any other foreign government entity or international organization.

Description of Proposal

The proposal would authorize the issuance by a State or local government of tax-exempt private activity bonds when at least 95 percent of the net proceeds would be used to finance the construc-

tion or acquisition of real property used for offices (and functionally related and subordinate land and space for supporting activities) for use by the United Nations and its agencies and instrumentalities. These bonds would be subject to the State private activity bond volume limit of the State where the bonds are issued and to all other private activity bond rules (except the rehabilitation requirement on acquisition of existing property).

Effective Date

The proposal would apply to bonds issued after the date of enactment.

Legislative Background

The proposal was included in the conference report of H.R. 11 (103rd Congress).

8. Bonds for certain pre-1990 issues in the State of Connecticut

Present Law

The Omnibus Budget Reconciliation 1989 Act (OBRA 1989) provided an exception from arbitrage rebate for bona fide debt service funds if the underlying issue satisfied the 6-month exception from arbitrage rebate. Under the 6-month exception from arbitrage rebate, no rebate is required if all the gross proceeds of an issue are spent for the purpose of the borrowing within 6 months after the bonds are issued and other restrictions are satisfied. This provision was effective for bonds issued December 19, 1989.

Description of Proposal

The proposal would extend the rebate exception for bona fide debt service funds to certain bond issues in the State of Connecticut before December 19, 1989, that otherwise satisfied the requirements of OBRA 1989.

Effective Date

The proposal would be effective on date of enactment.

9. Bonds related to the transfer of Port Everglades, Florida

Present Law

Generally a governmental bond or qualified 501(c)(3) bond originally issued after December 31, 1985 may be advance refunded one time. An advance refunding is any refunding where all of the refunded bonds are not redeemed (i.e., called in such a manner that no further interest occurs on the bonds) within 90 days after the refunding bonds are issued. Under Treasury Regulation sec. 1.150–1d(2)(v) certain refinancing issues in connection with asset acquisition are not treated as a refunding. Specifically, if within six months before or after a person assumes the obligations of an unrelated party in connection with an asset acquisition and the as-

sumed obligation is refinanced, the refinancing issue is not treated as a refunding issue.

Description of Proposal

The proposal provides that a certain refinancing issue in connection with the dissolution of the Port Everglades Florida Authority and transfer of its control to Boward County, Florida would not be treated as an advance refunding. This proposal therefore would allow the refinancing issue to proceed notwithstanding the existence of a previous advance refunding by the Port Everglades Authority. The refinancing issue would be subject to yield restriction.

Effective Date

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

10. Qualified mortgage bonds—home improvement loans

Present Law

Qualified mortgage bonds ("QMBs") are tax-exempt bonds the proceeds of which are used to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied residences located within the jurisdiction of the issuer of the bonds. Qualified governmental units may elect to exchange QMB authority for authority to issue mortgage credit certificates ("MCCs"). Persons receiving QMB loans must satisfy principal residence, purchase price, borrower income, first-time homebuyer, and other requirements. An exception from the first-time homebuyer requirement is provided for qualified home improvement loans (not in excess of $15,000).

The volume of QMBs and MCCs that a State may issue is limited by an annual State private activity bond volume limit.

Description of Proposal

The proposal would increase the maximum size of a qualified home improvement loan under the QMB and MCC programs from $15,000 to $25,000 per borrower.

Effective Date

The proposal would be effective for bonds issued and bond volume authority traded in for authority to issue MCCs after the date of enactment.

11. Qualified veterans' mortgage bonds

Present Law

Qualified veterans' mortgage bonds are tax-exempt general obligation bonds, the proceeds of which are used to make mortgage loans to certain veterans. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984, and issuance is subject to State volume limitations based on the volume of issuance by each State before that

date. The States eligible to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin. Loans financed with qualified veterans' mortgage bonds may be made only with respect to principal residences and may not be made to acquire or replace existing mortgages. Qualified veterans' mortgage bonds are not subject to the State volume limitations for private activity bonds. Unlike QMBs in 10, above, loans made with these bonds are not subject to purchase price, first time homebuyer, and income limits.

Mortgage loans made with the proceeds of qualified veterans' mortgage bonds can be made only to veterans who served on active duty before 1977, and who applied for the loan before the later of (1) 30 years after the veteran leaves active service, or (2) January 31, 1985.

Description of Proposals

The first proposal would repeal the requirements that veterans receiving loans financed with these bonds must have served before 1977 and have must applied for the loan before the later of (1) 30 years after leaving active service or (2) January 31, 1985.

The second proposal would be the same as the first but would repeal the separate qualified veterans' mortgage bond limitation and instead would place qualified veterans' mortgage bonds under the State volume limitation for private activity bonds.

Under the third proposal, veterans who commenced active duty on or after January 1, 1977, would be eligible for the program under bonds issued on or after July 1, 1996. The amount of qualified veterans' bonds used for these more recent veterans would be phased-in over time. In 1996, the new veterans would be eligible for 10 percent of the relevant States' total qualified veterans' mortgage bond limit. In 1997, the maximum percentage would be 20 percent. In 1998, the maximum percentage would be 30 percent. In 1999, the maximum percentage would be 40 percent. In 2000, and thereafter the maximum percentage would be 50 percent. The proposal would also limit the maximum qualified veterans' mortgage bond limit for any of the five States' to $340 million annually regardless of pre–June 22, 1984 issuance levels. This part of the proposal would be effective for 1996.

The fourth proposal is the same as the third except that the maximum State limit would be $250 million annually.

Effective Date

The proposal generally would apply to bonds issued after the date of enactment unless otherwise noted above.

12. Modification of exception to bank interest deduction disallowance for qualified 501(c)(3) bonds

Present Law

Banks and other financial institutions generally are denied a deduction for the portion of their interest expense (e.g., interest paid to depositors) that is attributable to investment in tax-exempt bonds acquired after August 7, 1986. This disallowance is computed using a pro-rata formula that compares the institution's av-

erage adjusted basis in tax-exempt bonds acquired after that date with the average adjusted basis of all assets of the institution.

An exception to the pro-rata disallowance rule is permitted for governmental bonds and qualified 501(c)(3) bonds issued by or on behalf of governmental units that reasonably expect to issue no more than $10 million of such bonds during a calendar year (the "small-issuer exception").

Description of Proposal

The proposal would modify the small-issuer exception so that, an issue could qualify if no sec. 501(c)(3) organization borrowed more than $5 million in the calendar year regardless of the annual issuance of the governmental unit. This expansion would enable larger than $10 million issues and bonds issued by entities issuing more than $10 million in a calendar year to qualify.

Effective Date

The proposals would be effective in taxable years of financial institutions ending after the date of enactment but only for bonds issued after the date of enactment.

13. Qualified small-issue bonds

Present Law

Interest on certain small issues of private activity bonds issued by State or local governments ("qualified small-issue bonds") is excluded from gross income if certain conditions are met. First, at least 95 percent of the bond proceeds must be used to finance manufacturing facilities or certain agricultural land or equipment. Second, the bond issue must have an aggregate face amount of $1 million or less, or alternatively, the aggregate face amount of the issue, together with the aggregate amount of certain related capital expenditures during the six-year period beginning three years before the date of the issue and ending three years after that date, must not exceed $10 million. (The maximum face amount of bonds would not be increased over present-law amounts.)

Issuance of qualified small-issue bonds, like most other private activity bonds, is subject to annual State volume limitations and to other rules.

Description of Proposal

The proposal would increase the maximum capital expenditure limit under present law from $10 million to $20 million.

Effective Date

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

14. Repeal Student Loan Marketing Association's exception to the rule disallowing interest deductions on debt used to acquire or carry investments in tax-exempt bonds

Present Law

Present law disallows income tax deductions for interest on debt used directly or indirectly to acquire or hold investments the income on which is tax-exempt ("tax-exempt bonds") (Code sec. 265). In Revenue Procedure 72–18, 1972–1 C.B. 740, the Internal Revenue Service provided guidelines for applying this interest deduction disallowance. Under the revenue procedure, deductions are disallowed only when indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt bonds. This purpose may be established either by direct or circumstantial evidence. Direct evidence exists when the proceeds of the indebtedness are directly traceable to the purchase of tax-exempt bonds or when the bonds are pledged as collateral for the taxpayer's indebtedness.

Absent direct evidence, a deduction is disallowed only if the totality of facts and circumstances establishes a sufficiently direct relationship between the borrowing and the investment in tax-exempt bonds. For corporations other than financial institutions, Revenue Procedure 72–18 provides that no such indirect link will be presumed if the average adjusted basis of the corporation's tax-exempt bonds does not exceed two percent of the average adjusted basis of all assets held in the active conduct of the trade or business (the so-called "two-percent de minimis rule").

Financial institutions investing in tax exempt bonds are subject to a separate, statutory limit enacted in 1986. Under this rule, financial institutions are disallowed deductions for a portion of their interest expense equal to the portion of their total assets that is comprised of tax-exempt bonds acquired after August 7, 1986, and do not qualify for the two-percent de minimis rule.

Section 439(h)(1) of the Higher Education Act of 1965 provides that the Student Loan Marketing Association ("SLMA") is not treated as having used borrowed funds to acquire or hold tax-exempt bonds (and therefore experiences no deduction disallowance) to the extent that its investment in tax-exempt bonds does not exceed its shareholder's equity.

Description of Proposal

The proposal would repeal SLMA's special rule for applying the interest deduction disallowance rules of Code section 265, effective for taxable years beginning after December 31, 1995. The repeal would not apply to bonds held by SLMA on January 1, 1996, and to bonds acquired before January 1, 1997, pursuant to a binding contract in existence on January 1, 1996. Under the proposal, except for these grandfathered bonds, interest on SLMA's borrowings would be nondeductible in the same proportion as SLMA's tax-exempt holdings bear to SLMA's total assets (i.e., SLMA would not qualify for the two-percent de minimis rule), and SLMA's assets and tax-exempt investments would not be considered in applying section 265 to any other corporation with which it may become affiliated.

Effective Date

The proposal would be effective on the date of enactment.

Legislative Background

H.R. 1720, as ordered reported by the Committee on Economic and Educational Opportunities on June 8, 1995, would provide for the reorganization of SLMA over a nine-year period. The bill anticipates that SLMA would be phased-out as a government-sponsored enterprise and that its functions, as well as other business activities, would be undertaken by a new, State-chartered corporation or group of corporations. The proposal is a conforming change to H.R. 1720.

DD. Tax Return Checkoff

1. Permit individual tax return checkoff for U.S. Olympic Trust Fund

Present Law

Taxpayers may not designate particular Federal programs to receive the Federal income tax payments for which they are liable. An exception to this rule is that individuals may designate on their income tax returns that $3 ($6 for a married couple filing a joint return) of their tax liability be paid over to the Presidential Election Campaign Fund (Code sec. 6096).

Description of Proposal

The proposal would allow taxpayers to designate on their Federal income tax returns that $1 ($2 in the case of a joint return) of any overpayment of tax be contributed (or a cash contribution made with the tax return) to a "United States Olympic Trust Fund" (Trust Fund) in the Department of the Treasury. Amounts designated by taxpayers under the bill would be appropriated to the Trust Fund. Such amounts (minus certain administrative expenses of the Trust Fund) would be transferred to the U.S. Olympic Committee no more frequently than quarterly.

The designation could be made only at the time the return is filed. The checkoff box for the contribution would be on the first page of the return. For administrative purposes, any portion of overpayment designated for debt reduction would be treated as refunded to the taxpayer.

Effective Date

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

2. Permit individual tax return checkoff for deficit reduction

Present Law

Taxpayers may not designate particular Federal programs to receive the Federal income tax payments for which they are liable. An exception to this rule is that individuals may designate on their income tax returns that $3 ($6 for a married couple filing a joint return) of their tax liability be paid over to the Presidential Election Campaign Fund (Code sec. 6096).

IRS publications inform taxpayers that they may make a gift to the Federal Government to reduce the public debt. Page 34 of the Instructions for Form 1040 (1994) states:

> If you wish to do so, enclose a separate check with your income tax return. Make it payable to "Bureau of the Public Debt." You may be able to deduct this gift on your 1995 tax return if you itemize deductions. Do not add your gift to any tax you

may owe. If you owe tax, include a separate check for that amount payable to the "Internal Revenue Service." [131]

Thus, current IRS practice and forms do not permit taxpayers simply to designate on their income tax returns that overpayment amounts be contributed to the Federal Government. Instead, taxpayers who wish to make such a gift are instructed to write a separate check to the "Bureau of the Public Debt." The Instructions for Form 1040 clarify that a taxpayer making a gift to the Federal Government when filing the current year's tax return may claim a charitable contribution deduction on the tax return filed during the next year only if the taxpayer itemizes deductions on the return filed during the next year.

Description of Proposal

The bill (H.R. 1442) would allow taxpayers to designate on their Federal income tax returns that a portion of any overpayment of tax be contributed (or a cash contribution made with the tax return) for purposes of reducing the public debt. The designation could be made only at the time the return is filed and would be pursuant to Treasury regulations. The checkoff box for the contribution would be required to be on either the first page of the return or on the signature page. For administrative purposes, any portion of overpayment designated for debt reduction would be treated as refunded to the taxpayer.

The Treasury would periodically transfer amounts designated for debt reduction to the special account established under 31 U.S.C. 3113(d) and would submit annual reports to Congress.

Effective Date

The bill would be effective for taxable years beginning after December 31, 1994.

Legislative Background

H.R. 1442 was introduced by Mr. Minge on April 6, 1995.

Title VI (Section 6341 et seq.) of H.R. 1215 ("Tax Fairness and Deficit Reduction Act"), as passed by the House on April 5, 1995, would establish a Public Debt Reduction Trust Fund, which would allow taxpayers to designate up to 10 percent of their tax liability to reduce the public debt.

[131] Similar language is contained in the instructions for Forms 1040A and 1040EZ.

EE. Trusts and Estates

1. Income tax rates applicable to trusts and estates

Present law

The Omnibus Budget Reconciliation Act of 1993 imposed a new truncated, graduated income tax rate schedule applicable to estates and trusts. For 1995, the income tax rates applicable to estates and trusts are as follows: (1) 15 percent on income up to $1,550; (2) 28 percent on income between $1,550 and $3,700; (3) 31 percent on income between $3,700 and $5,600; (4) 36 percent on income between $5,600 and $7,650; and (5) 39.6 percent on income above $7650. The tax rate bracket thresholds are indexed for inflation.

Description of Proposals

H.R. 329

The bill (H.R. 329) would replace the current income tax rate schedule applicable to estates and trusts with the tax rate schedule applicable to married individuals filing separately. Thus, under the bill, the tax rates applicable to estates and trusts for 1995 would be as follows: (1) 15 percent on income up to $19,500; (2) 28 percent on income between $19,500 and $47,125; (3) 31 percent on income between $47,125 and $71,800; (4) 36 percent on income between $71,800 and $128,250; and (5) 39.6 percent on income above $128,250. The tax rate bracket thresholds would be indexed for inflation.

H.R. 960

The bill (H.R. 960) would provide a special tax rate schedule applicable to trusts established exclusively for the support and maintenance of one or more beneficiaries who are mentally ill or have a disability.[132] Potential reversion of the trust corpus to the grantor or a member of his or her family upon the death of the beneficiary would not disqualify the trust from eligibility for the special rate schedule. Under the bill, the tax rates applicable to eligible trusts for 1993 would be as follows: (1) 15 percent on income up to $3,300; (2) 28 percent on income between $3,300 and $9,900; and (3) 31 percent on income above $9,900. The tax rate bracket thresholds would be indexed for inflation.

Effective Date

H.R. 329 would apply to taxable years beginning after December 31, 1994. H.R. 960 would apply to taxable years beginning after December 31, 1992.

Legislative Background

H.R. 329 was introduced by Mr. McCrery on January 4, 1995. H.R. 960 was introduced by Mr. Payne on February 15, 1995.

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[132] For this purpose, an individual generally would be treated as having a disability if she has a physical or mental impairment that substantially limits a major life activity of such individual, a record of such an impairment, or is regarded as having such an impairment (42 U.S.C. 12102(2)).

FF. Other

1. Allow nonprofit educational foundations to sell U.S. Savings Bonds

Present Law

Qualified issuing or paying agents for U.S. Savings Bonds transactions may not charge a separate fee to their customers for the transactions.

In part, 31 U.S.C. 333(a) prohibits any person from using the words "United States Savings Bonds" or the name of any other obligation issued by the Treasury in an advertisement or solicitation in a manner that conveys the false impression that the Treasury approved such use.

Code section 135 provides that interest income earned on a qualified U.S. Series EE savings bond issued after December 31, 1989, is excludible from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses (generally, tuition and required fees for the enrollment of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at an eligible postsecondary educational institution) paid by the taxpayer during the taxable year. The exclusion is phased out for certain higher-income taxpayers.

Description of Proposal

The proposal would allow nonprofit educational foundations to sell U.S. Savings Bonds. It would allow them to sell savings bonds by credit card and to charge a separate processing fee for the service.

In addition, the proposal would remove the prohibition contained in 31 U.S.C. 333(a) against the use of the words "United States Savings Bonds" or the name of any other obligation issued by the Treasury in an advertisement or solicitation in a manner that conveys the false impression that the Treasury approved such use.

Effective Date

The proposal would be effective as of the date of enactment.

II. POSSIBLE MODIFICATIONS TO SIMPLIFICATION PROVISIONS CONTAINED IN H.R. 3419 (103rd Congress)

1. Provisions relating to individuals

a. Permit payment of taxes by credit card (section 112 of the bill)

Consideration is being given to clarifying that the fees that may be imposed for using a credit card to pay Federal taxes could not be borne by the Federal government.

b. Election by parent to claim unearned income of certain children on parent's return (section 113 of the bill)

Consideration is being given to deleting the provision contained in H.R. 3419, because it is included in the technical corrections provisions contained in H.R. 1215, as passed by the House of Representatives on April 5, 1995.

c. Expanded access to simplified income tax returns (section 116 of the bill)

Consideration is being given to deleting the provision in H.R. 3419 directing the Internal Revenue Service to study whether the ability of taxpayers to file simplified Federal income tax returns should be expanded.

2. Pension simplification

a. Tax-exempt organizations eligible under section 401(k) (section 212 of the bill)

H.R. 3419 would permit nongovernmental tax-exempt organizations to maintain qualified cash or deferred arrangements (i.e., 401(k) plans) for their employees. Consideration is being given to providing that a tax-exempt employer that elects to establish a 401(k) plan for its employees would not also be permitted to provide for the deferral of compensation pursuant to section 457.

b. Nondiscrimination rules for qualified cash or deferred arrangements and matching contributions (sec. 223 of the bill)

H.R. 3419 provides a design-based safe harbor that employers can utilize to satisfy the nondiscrimination requirements for qualified cash or deferred arrangements. Consideration is being given to extending this design-based safe harbor to simplified employee pensions ("SEPs").

c. Full-funding limitation of multiemployer plans (section 235 of the bill)

H.R. 3419 would repeal the 150-percent of current liability full funding limit for multiemployer pension plans. Consideration is being given to deleting this provision of the bill.

d. Alternative full-funding limitation (section 236 of the bill)

H.R. 3419 would provide that the 150 percent of current liability full-funding limit would be increased for certain employers. The Treasury Department would be directed to adjust the full-funding

limit for all other employers so as to ensure that the provision is approximately revenue neutral. Consideration is being given to deleting this provision of the bill.

e. Special rules for plans covering pilots (section 242 of the bill)

Under present law, a special provision permits plans covering airline pilots covered under a collective bargaining agreement to be tested separately for nondiscrimination purposes. H.R. 3419 would extend this special provision to all airline pilots without regard to whether they are covered under a collective bargaining agreement. Consideration is being given to deleting this provision of the bill.

f. Treatment of employer reversions required by contract to be paid to the United States (section 244 of the bill)

H.R. 3419 would provide an exception to the excise tax on reversions in the case of a reversion of excess pension plan assets that is required, by Federal law or regulation, to be paid to the Federal government. Consideration is being given to deleting this provision of the bill.

g. Continuation health coverage for employees of failed financial institutions (section 245 of the bill)

H.R. 3419 would provide that the Resolution Trust Corporation would be required to provide continuation health coverage to certain employees of failed financial institutions. Consideration is being given to deleting this provision of the bill.

h. Clarify relationship between community property rights and retirement benefits

Consideration is being given to including a provision that would clarify the relationship between community property rights and retirement benefits (e.g., the interaction of qualified plan requirements with state community property laws).

3. Treatment of large partnerships

a. Simplified flow through for large partnerships (section 301 of the bill)

H.R. 3419 would modify the tax treatment of a large partnership (generally, a partnership with at least 250 partners, or an electing partnership with at least 100 partners) and its partners. The bill reduces the number of possible items that must be separately reported to partners. Consideration is being given to deleting this provision.

b. Simplified audit procedures for large partnerships (section 302 of the bill)

H.R. 3419 would create a new audit system for large partnerships (in addition to the present-law system of partnership audit rules enacted in TEFRA). The bill would define "large partnership" the same way for audit and reporting purposes (generally partnerships with at least 250 partners). Under the bill, partnership adjustments generally would flow through to the partners for the year in which the adjustment takes effect. Thus, the current-year partners' share of current-year partnership items of income, gains,

losses, deductions, or credits would be adjusted to reflect partnership-level adjustments that take effect in that year. The adjustments generally would not affect prior-year returns of any partners. Consideration is being given to deleting this provision.

c. Partnership returns on magnetic media (section 304 of the bill)

H.R. 3419 would authorize the Internal Revenue Service ("IRS") to require large partnerships and other partnerships with 250 or more partners to provide the tax return of the partnership (Form 1065), as well as copies of the schedules sent to each partner (Form K–1), to the IRS on magnetic media. Consideration is being given to requiring that magnetic media filing of partnership tax returns (Form 1065) and copies of schedules sent to each partner (Form K–1) be made mandatory, effective for partnership taxable years beginning after December 31, 1995 (in lieu of authorizing the IRS to require magnetic media filing).

4. Foreign provisions

a. Deferral of tax on income earned through foreign corporations and exceptions to deferral (sections 401–404 of the bill)

H.R. 3419 would provide some coordination among the various anti-deferral regimes applicable to U.S. persons who hold stock in foreign corporations. Consideration is being given to the possibility of applying Subpart F to U.S. persons who hold stock in foreign corporations without regard to the level of U.S. ownership in such corporations.

5. Provisions relating to regulated investment companies

a. Require brokers and mutual funds to report basis to customers (section 522 of the bill)

Consideration is being given to deleting the mandatory information reporting requirement in H.R. 3419 because it is understood that much of the industry is voluntarily reporting basis to shareholders.

6. Tax-exempt bond provisions

a. Clarification of definition of "investment-type property" (section 535 of the bill)

The provision contained in H.R. 3419 would be deleted because the issue was clarified by a recent Treasury regulation (Treas. reg. section 1.148–1(b)).

7. Administrative provisions

a. Administrative practice and procedural simplification (sections 831–839 of the bill)

H.R. 3419 would make nine modifications related to administrative practice and procedure. Because these provisions have generally been included in bills relating to taxpayer bill of rights, which are likely to be considered separately by the Committee, consideration is being given to dropping these provisions from H.R. 3419.

8. Estate and gift tax provisions

a. Statute of limitations applicable to valuation of gifts

Present Law

The Federal estate and gift taxes are unified so that a single progressive rate schedule is applied to an individual's cumulative gifts and bequests. The tax on gifts made in a particular year is computed by determining the tax on the sum of the taxable gifts made that year and all prior years and then subtracting the tax on the prior years taxable gifts and the unified credit. Similarly, the estate tax is computed by determining the tax on the sum of the taxable estate and prior taxable gifts and then subtracting the tax on taxable gifts and the unified credit. Under a special rule applicable to the computation of the gift tax (sec. 2504(c)), the value of gifts made in prior years is the value that was used to determine the prior year's gift tax. There is no comparable rule in the case of the computation of the estate tax.

Generally any estate or gift tax must be assessed within 3 years after the filing of the return. No proceeding in a court for the collection of an estate or gift tax can be begun without an assessment within the 3-year period. If no return is filed, the tax may be assessed, or a suit commenced to collect the tax without assessment, at any time. If an estate or gift tax return is filed, and the amount of unreported items exceeds 25 percent of the amount of the reported items, the tax may be assessed or a suit commenced to collect the tax without assessment, within 6 years after the return was filed (sec. 6501).

Commencement of the statute of limitations generally does not require that a particular gift be disclosed. A special rule, however, applies to certain gifts that are valued under the special valuation rules of Chapter 14. The gift tax statute of limitations runs for such a gift only if it is disclosed on a gift tax return in a manner adequate to apprise the Secretary of the Treasury of the nature of the item.

Most courts have permitted the Commissioner to redetermine the value of a gift for which the statute of limitations period for the gift tax has expired in order to determine the appropriate tax rate bracket and unified credit for the estate tax. *See, e.g.*, Evanson v. United States, 74 AFTR 2d 94–5128 (9th Cir. 1994); Stalcup v. United States, 946 F. 2d 1125 (5th Cir. 1991); Estate of Levin, 1991 T.C. Memo 1991–208, *aff'd* 986 F. 2d 91 (4th Cir. 1993); Estate of Smith v. Commissioner, 94 T.C. 872 (1990). *But see* Boatman's First National Bank v. United States, 705 F. Supp. 1407 (W.D. Mo. 1988) (Commissioner not permitted to revalue gifts).

Description of Proposal

Consideration is being given to adding a new proposal that would provide that a gift for which the limitations period has passed cannot be revalued for purposes of determining the applicable estate tax bracket and available unified credit. For gifts made after the date of enactment, the proposal also would extend the special rule governing gifts valued under Chapter 14 to all gifts. Thus, the statute of limitations would not run on an inadequately disclosed

transfer after the date of enactment, regardless of whether a gift tax return was filed for other transfers in that same year. In addition, the statute of limitations would run on an adequately disclosed gift notwithstanding the taxpayer's use of the unified credit with respect to the gift, for gifts after the date of enactment.

Effective Date

The proposal would apply to decedents dying after date of enactment.

9. Other provisions

a. Treatment of pre-need funeral trusts

Present Law

The Internal Revenue Service has ruled that the purchaser of a pre-need funeral is treated as the grantor of a grantor trust, and is subject to taxation on the income of the trust. In a pre-need funeral arrangement, the purchaser of the funeral generally enters into a contract with the seller, which is usually a funeral home. Usually, the seller deposits a percentage of the payment into a trust.

Description of Proposal

Consideration is being given to adding a new proposal permitting the seller of a pre-need funeral to elect to treat earnings on the funds deposited in the trust as income to the seller and not to the purchaser.

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