DESCRIPTION OF PROVISIONS IN H.R. 4738

Scheduled for Markup
before the
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Prepared by the Staff
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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup on October 9, 1998, on the provisions of H.R. 4738, introduced by Chairman Bill Archer on October 8, 1998.

This document,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposals contained in the H.R. 4738.[2] Part I of this document contains the expiring provision proposals, Part II contains other proposals, and Part III contains revenue offset proposals.

A separate document (JCX-68-98) provides estimates of the budget effects of the tax proposals.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Provisions in H.R. 4738* (JCX-66-98), October 9, 1998. (References in this document to the "1997 Act" refer to the Taxpayer Relief Act of 1997.)

[2] A separate document provides a description of the Chairman's mark relating to proposed tax technical corrections. (See JCX-67-98.)

I. EXTENSION OF EXPIRING PROVISIONS

A. Extension of Research Tax Credit

Present Law

General rule

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and generally does not apply to amounts paid or incurred after June 30, 1998.

A 20-percent research tax credit also applied to the excess of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the "university basic research credit" (see sec. 41(e)).

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.[3]

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[3] A special rule is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm will be assigned a fixed-base percentage of 3 percent for each of its first five taxable years after 1993 in which it incurs qualified research expenditures. In the event that the research credit is extended beyond the scheduled expiration date, a start-up firm's fixed-based percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenditures will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-based percentage will be its actual ratio of qualified research expenditures to

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

Alternative incremental research credit regime

Taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1 percent (i.e., the base amount equals 1 percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 2.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of 2 percent. A credit rate of 2.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2 percent. An election to be subject to this alternative incremental credit regime may be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years (in the event that the credit subsequently is extended by Congress) unless revoked with the consent of the Secretary of the Treasury.

Eligible expenditures

Qualified research expenditures eligible for the research tax credit consist of: (1) "in-house" expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called "contract research expenses").[4]

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gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

[4] Under a special rule, 75 percent of amounts paid to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under sec. 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or quality of a business component.

Expenditures attributable to research that is conducted outside the United States do not enter into the credit computation. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

Relation to deduction

Deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year. Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

Description of Proposal

The research tax credit would be extended for 18 months--i.e., generally, for the period July 1, 1998, through December 31, 1999.

Effective Date

Extension of the research credit would be effective for qualified research expenditures paid or incurred during the period July 1, 1998, through December 31, 1999.

B. Extension of the Work Opportunity Tax Credit

Present Law

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The eight targeted groups are: (1) families eligible to receive benefits under the Title IV-A Temporary Assistance for Needy Families Program (the successor to the Aid to Families with Dependent Children Program); (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income (SSI) benefits.

The credit generally is equal to 40 percent (25 percent for employment of 400 hours or less) of qualified wages. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the 1-year period beginning with the day the individual begins work for the employer. For a vocational rehabilitation referral, however, the period begins on the day the individual begins work for the employer on or after the beginning of the individual's vocational rehabilitation plan.

Generally, no more than $6,000 of wages during the first year of employment is permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual is $2,400. With respect to qualified summer youth employees, the maximum credit is 40 percent of up to $3,000 of qualified first-year wages, for a maximum credit of $1,200.

In general, an individual is not to be treated as a member of a targeted group unless: (1) on or before the day the individual begins work for the employer, the employer received in writing a certification from the designated local agency that the individual is a member of a specific targeted group; or (2) on or before the day the individual is offered work with the employer, a prescreening notice is completed with respect to that individual by the employer and within 21 days after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for certification. The prescreening notice will contain the information provided to the employer by the individual that forms the basis of the employer's belief that the individual is a member of a targeted group.

No credit is allowed for wages paid unless the eligible individual is employed by the employer for at least 120 hours. The credit percentage is 25 percent for employment of 400 hours or less, assuming that the minimum employment period is satisfied with respect to that employee. For employment of more than 400 hours, the credit percentage is 40 percent.

The credit is effective for wages paid or incurred to a qualified individual who began work for an employer before July 1, 1998.

Description of Proposal

The proposal would extend the work opportunity tax credit through December 31, 1999.

Effective Date

The proposal would be effective for wages paid or incurred to a qualified individual who begins work for an employer on or after July 1, 1998, and before January 1, 2000.

C. Extend the Deduction Provided for Contributions of Appreciated Stock to Private Foundations; Public Inspection of Private Foundation Annual Returns

1. Extend the deduction provided for contributions of appreciated stock to private foundations

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.[5] However, in the case of a charitable contribution of short-term gain, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.

In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property. However, under a special rule contained in section 170(e)(5), taxpayers are allowed a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation prior to July 1, 1998. Qualified appreciated stock is defined as publicly traded stock which is capital gain property. The fair-market-value deduction for qualified appreciated stock donations applies only to the extent that total donations made by the donor to private foundations of stock in a particular corporation did not exceed 10 percent of the outstanding stock of that corporation. For this purpose, an individual is treated as making all contributions that were made by any member of the individual's family.

Description of Proposal

The proposal would extend permanently the special rule contained in section 170(e)(5).

Effective Date

The provision would be effective for contributions of qualified appreciated stock to private foundations made on or after July 1, 1998.

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[5] 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)).

2. Public inspection of private foundation annual returns

Present Law

Tax-exempt organizations (other than churches and certain small organizations) are required to file an annual information return (Form 990) with the Internal Revenue Service ("IRS"), setting forth the organization's items of gross income and expenses attributable to such income, disbursements for tax-exempt purposes, plus certain other information for the taxable year.

Private foundations are required to make the current year's annual information return (Form 990-PF) available for public inspection at the foundation's principal office during regular business hours (sec. 6104(d)). Such return must be made available for inspection by any citizen on request made within 180 days after the date of publication of notice of its availability. Notice must be published, not later than the day the return is required to be filed, in a newspaper having general circulation in the county in which the principal office of the foundation is located. The notice must state that the annual return is available for public inspection by any citizen who requests it, and must state the address and telephone number of the private foundation's principal office and the name of its principal manager.

Tax-exempt organizations (other than private foundations) that are required to file a Form 990, including public charities, are required to allow public inspection at the organization's principal office (and certain regional or district offices) of their Forms 990 for the three most recent taxable years (sec. 6104(e)).

The Taxpayer Bill of Rights 2 imposed additional public inspection requirements on tax-exempt organizations. All tax-exempt organizations, except private foundations, will be required to comply with requests made in person or in writing by individuals who seek a copy of the organization's Form 990 for any of the organization's three most recent taxable years. Upon such a request, the organization is required to supply copies without charge other than a reasonable fee for reproduction and mailing costs. If the request for copies is made in person, then the organization must immediately provide such copies. If the request for copies is made in writing, then copies must be provided within 30 days. In addition, all tax-exempt organizations, including private foundations, will be required to comply in the same manner with requests made in person or in writing by individuals who seek a copy of the organization's application for recognition of tax-exempt status and certain related documents. However, an organization may be relieved of its obligation to provide copies if, in accordance with regulations to be promulgated by the Secretary of Treasury, (1) the organization has made the requested documents widely available or (2) the Secretary of the Treasury determined, upon application by the organization, that the organization was subject to a harassment campaign such that a waiver of the obligation to provide copies would be in the public interest. These additional public inspection provisions apply to requests made no earlier than 60 days after the date on which the Treasury Department publishes regulations defining when requested documents have been made

widely available or when a request is part of a harassment campaign, but in any event, not before December 31, 1998.[6] While proposed regulations have been issued, final regulations have not been published; therefore, the provision is not yet in effect.[7]

Upon written request to the IRS, members of the general public also are permitted to inspect annual information returns of tax-exempt organizations and applications for recognition of tax-exempt status (and related documents) at the National Office of the IRS in Washington, D.C. A person making such a written request is notified by the IRS when the material is available for inspection at the National Office, where notes may be taken of the material open for inspection, photographs taken with the person's own equipment, or copies of such material obtained from the IRS for a fee (Treas. Reg. secs. 301.6104(a)-6 and 301.6104(b)-1).

Description of Proposal

Under the proposal, private foundations would be subject to the public inspection requirements that currently apply to public charities and all other tax-exempt organizations that file annual information returns. Accordingly, private foundations would be required to comply with requests from individuals who seek a copy of the foundation's annual information return for any of the foundation's three most recent taxable years. Private foundations would no longer be subject to the publication requirements of section 6104(d).

Effective Date

The additional public inspection provisions would apply to requests made after the later of: (1) the date which is 60 days after the date on which the Treasury Department publishes regulations defining when requested documents have been made widely available or when a request is part of a harassment campaign, or (2) December 31, 1998. The repeal of the present-law publication requirement would apply only to those returns the due date for filing of which is on or after the date the public inspection requirements become effective.

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[6] However, the legislative history of the provision indicates that Congress expected that organizations will comply voluntarily with the public inspection provisions prior to the issuance of such final regulations.

[7] Prop. Treas. Reg. sec. 301.6104(e)-1.

D. Exceptions Under Subpart F for Certain Active Financing Income

Present Law

In general

Under the subpart F rules, certain U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, "foreign personal holding company income" and insurance income. The U.S. 10-percent shareholders of a CFC also are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other-country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income (Prop. Treas. Reg. sec. 1.953-1(a)).

Temporary exceptions from foreign personal holding company income and foreign base company services income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, insurance, or similar business.[8] These exceptions (described below) are applicable only for taxable years beginning in 1998.

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[8] The President canceled these exceptions in 1997 pursuant to the Line Item Veto Act. On June 25, 1998, the U.S. Supreme Court held that the cancellation procedures set forth in the Line Item Veto Act are unconstitutional. Clinton v. City of New York, 118 S. Ct. 2091 (June 25, 1998).

Income from the active conduct of a banking, financing, or similar business

A temporary exception from foreign personal holding company income applies to income that is derived in the active conduct of a banking, financing, or similar business by a CFC that is predominantly engaged in the active conduct of such business. For this purpose, income derived in the active conduct of a banking, financing, or similar business generally is determined under the principles applicable in determining financial services income for foreign tax credit limitation purposes. However, in the case of a corporation that is engaged in the active conduct of a banking or securities business, the income that is eligible for this exception is determined under the principles applicable in determining the income which is treated as nonpassive income for purposes of the passive foreign investment company provisions. In this regard, the income of a corporation engaged in the active conduct of a banking or securities business that is eligible for this exception is the income that is treated as nonpassive under the regulations proposed under section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997). See Prop. Treas. Reg. secs. 1.1296-4 and 1.1296-6. The Secretary of the Treasury is directed to prescribe regulations applying look-through treatment in characterizing for this purpose dividends, interest, income equivalent to interest, rents and royalties from related persons.

For purposes of the temporary exception, a corporation is considered to be predominantly engaged in the active conduct of a banking, financing, or similar business if it is engaged in the active conduct of a banking or securities business or is a qualified bank affiliate or qualified securities affiliate. In this regard, a corporation is considered to be engaged in the active conduct of a banking or securities business if the corporation would be treated as so engaged under the regulations proposed under prior law section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997); qualified bank affiliates and qualified securities affiliates are as determined under such proposed regulations. See Prop. Treas. Reg. secs. 1.1296-4 and 1.1296-6.

Alternatively, a corporation is considered to be engaged in the active conduct of a banking, financing, or similar business if more than 70 percent of its gross income is derived from such business from transactions with unrelated persons located within the country under the laws of which the corporation is created or organized. For this purpose, income derived by a qualified business unit ("QBU") of a corporation from transactions with unrelated persons located in the country in which the QBU maintains its principal office and conducts substantial business activity is treated as derived by the corporation from transactions with unrelated persons located within the country in which the corporation is created or organized. A person other than a natural person is considered to be located within the country in which it maintains an office through which it engages in a trade or business and by which the transaction is effected. A natural person is treated as located within the country in which such person is physically located when such person enters into the transaction.

Income from the active conduct of an insurance business

A temporary exception from foreign personal holding company income applies for certain investment income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. These rules differ from the rules of section 953 of the Code, which determines the subpart F inclusions of a U.S. shareholder relating to insurance income of a CFC. Such insurance income under section 953 generally is computed in accordance with the rules of subchapter L of the Code.

A temporary exception applies for income (received from a person other than a related person) from investments made by a qualifying insurance company of its reserves or 80 percent of its unearned premiums. For this purpose, in the case of contracts regulated in the country in which sold as property, casualty or health insurance contracts, unearned premiums and reserves are defined as unearned premiums and reserves for losses incurred determined using the methods and interest rates that would be used if the qualifying insurance company were subject to tax under subchapter L of the Code. Thus, for this purpose, unearned premiums are determined in accordance with section 832(b)(4), and reserves for losses incurred are determined in accordance with section 832(b)(5) and 846 of the Code (as well as any other rules applicable to a U.S. property and casualty insurance company with respect to such amounts).

In the case of a contract regulated in the country in which sold as a life insurance or annuity contract, the following three alternative rules for determining reserves apply. Any one of the three rules can be elected with respect to a particular line of business.

First, reserves for such contracts can be determined generally under the rules applicable to domestic life insurance companies under subchapter L of the Code, using the methods there specified, but substituting for the interest rates in Code section 807(d)(2)(B) an interest rate determined for the country in which the qualifying insurance company was created or organized, calculated in the same manner as the mid-term applicable Federal interest rate ("AFR") (within the meaning of section 1274(d)).

Second, the reserves for such contracts can be determined using a preliminary term foreign reserve method, except that the interest rate to be used is the interest rate determined for the country in which the qualifying insurance company was created or organized, calculated in the same manner as the mid-term AFR. If a qualifying insurance company uses such a preliminary term method with respect to contracts insuring risks located in the country in which the company is created or organized, then such method is the method that applies for purposes of this election.

Third, reserves for such contracts can be determined to be equal to the net surrender value of the contract (as defined in section 807(e)(1)(A)).

In no event can the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe or deficiency reserve. This rule applies whether the contract is regulated as a property, casualty, health, life insurance, annuity or any other type of contract.

A temporary exception from foreign personal holding company income also applies for income from investment of assets equal to: (1) one-third of premiums earned during the taxable year on insurance contracts regulated in the country in which sold as property, casualty, or health insurance contracts; and (2) the greater of 10 percent of reserves, or, in the case of a qualifying insurance company that is a startup company, $10 million. For this purpose, a startup company is a company (including any predecessor) that has not been engaged in the active conduct of an insurance business for more than 5 years. In general, the 5-year period commences when the foreign company first is engaged in the active conduct of an insurance business. If the foreign company was formed before being acquired by the U.S. shareholder, the 5-year period commences when the acquired company first was engaged in the active conduct of an insurance business. In the event of the acquisition of a book of business from another company through an assumption or indemnity reinsurance transaction, the 5-year period commences when the acquiring company first engaged in the active conduct of an insurance business, except that if more than a substantial part (e.g., 80 percent) of the business of the ceding company is acquired, then the 5-year period commences when the ceding company first engaged in the active conduct of an insurance business. Reinsurance transactions among related persons may not be used to multiply the number of 5-year periods.

Under rules prescribed by the Secretary, income is allocated to contracts as follows. In the case of contracts that are separate account-type contracts (including variable contracts not meeting the requirements of sec. 817), only the income specifically allocable to such contracts are taken into account. In the case of other contracts, income not specifically allocable is allocated ratably among such contracts.

A qualifying insurance company is defined as any entity which: (1) is regulated as an insurance company under the laws of the country in which it is incorporated; (2) derives at least 50 percent of its net written premiums from the insurance or reinsurance of risks situated within its country of incorporation; and (3) is engaged in the active conduct of an insurance business and would be subject to tax under subchapter L if it were a domestic corporation.

The temporary exceptions do not apply to investment income (includable in the income of a U.S. shareholder of a CFC pursuant to sec. 953) allocable to contracts that insure related party risks or risks located in a country other than the country in which the qualifying insurance company is created or organized.

Anti-abuse rule

An anti-abuse rule applies for purposes of these temporary exceptions. For purposes of applying these exceptions, items with respect to a transaction or series of transactions are disregarded if one of the principal purposes of the transaction or transactions is to qualify income or gain for these exceptions, including any change in the method of computing reserves or any other transaction or transactions one of the principal purposes of which is the acceleration or deferral of any item in order to claim the benefits of these exceptions.

Foreign base company services income

A temporary exception from foreign base company services income applies for income derived from services performed in connection with the active conduct of a banking, financing, insurance or similar business by a CFC that is predominantly engaged in the active conduct of such business or is a qualifying insurance company.

Description of Proposal

In general

The proposal would extend and modify the present-law temporary exceptions from subpart F for income that is derived in the active conduct of a banking, financing, or similar business or in the conduct of an insurance business. These exceptions (as modified) would be applicable only for taxable years beginning in 1999.

With respect to income derived in the active conduct of a banking, financing, or similar business, the proposal differs from the present-law temporary exceptions in the following significant respects. First, the proposal would require a CFC to conduct substantial activity with respect to its business in order to qualify for the exceptions. Second, the proposal would add certain nexus requirements which would require that income which is derived by a CFC or QBU from transactions with customers would be eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Third, the proposal would modify the tests for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing, or similar business, including modifications for income derived from a lending or finance business. Fourth, the proposal would extend the exceptions to income derived from certain cross border transactions, provided that certain requirements are met. Fifth, the determination of where a customer is treated as located would be made under rules prescribed by the Secretary of the Treasury. Finally, the look-through rule that was included in the present-law provision for purposes of determining the income eligible for the exceptions would be eliminated.

In the case of insurance, the proposal differs from present law in the following significant respects. In addition to the exception for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization that is provided under present law, the proposal would provide additional exceptions. First, the proposal would provide temporary exceptions from insurance income and from foreign personal holding company income for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, the proposal would add additional temporary exceptions from insurance income and from foreign personal holding company income for certain income of certain CFCs or branches with respect to risks located in any country other than the United States, provided that the requirements for these exceptions are met.

Income from the active conduct of a banking, financing, or similar business

Substantial activity requirement

The proposal would modify the exceptions from subpart F for income derived in the active conduct of a banking, financing, or similar business by, among other things, incorporating a substantial activity requirement. Under the proposal, the subpart F exceptions would apply to a CFC that is an eligible controlled foreign corporation (an "eligible CFC"). An eligible CFC would be defined as a CFC which is predominantly engaged in the active conduct of a banking, financing, or similar business, but only if it conducts substantial activity with respect to such business.

Whether a CFC would be considered to conduct substantial activity with respect to a banking, financing, or similar business would be determined under all the facts and circumstances. It would be intended that as part of this facts and circumstances analysis in determining whether the activities conducted by the CFC are substantial, all relevant factors would be taken into account, including the overall size of the CFC, the amount of its revenues and expenses, the number of its employees, the ratio of its revenues per employee, the amount of property it owns, and the nature, size, and relative significance of the applicable activities conducted by the CFC. Under the proposal, the Secretary would be granted the authority to prescribe regulations to carry out the purposes of these exceptions. It would be intended that such authority would include the authority to prescribe rules relating to whether a CFC (or, as relevant, a QBU) would be considered to conduct substantial activity.

It also would be intended that as part of this facts and circumstances analysis, a CFC would be required to conduct substantially all of the activities necessary for the generation of income with respect to the business, which generally would include the following:

- initial solicitation of customers (including vendors);
- advising customers on financial needs, including funding and financial products;

- providing financial and technical advice to customers;
- designing or tailoring financial products to customers' needs;
- negotiating terms with customers;
- performing credit analysis on customers and evaluating noncredit risks;
- providing related services to customers;
- making loans, entering into leases, extending credit or entering into other transactions with customers that generate income that would be considered derived in the active conduct of a banking, financing, or similar business;
- collecting from customers;
- performing remarketing activities (including sales) following termination of transactions with customers;
- responding to customers' failure to satisfy their obligations under transactions, including enforcement or renegotiation of terms, liquidation of collateral, foreclosure, and/or institution of litigation; and
- holding collateral for transactions with customers.

It would be intended that the performance of back-office functions (including accounting for income or loss, recordkeeping, and routine communicating with customers) not be taken into account in determining whether the substantial activity requirement would be satisfied. It also would be intended that the relevant activities of the business may be modified by Treasury regulation to take into account future changes in the operations of these businesses.

In general, the substantial activity requirement would be applied based on the activities of the CFC as a whole, including the activities of any QBUs of the CFC. In determining whether the substantial activity requirement would be satisfied, activities performed in the country in which the CFC is incorporated (or in the country in which the QBU has its principal office) by employees of a related person of the CFC would be taken into account, but only to the extent that the related person is compensated on an arm's-length basis for the services of such employees and such compensation is includible in the related person's income in such country for purposes of such country's income tax laws. For this purpose, a related person would have the meaning provided in section 954(d)(3), substituting "at least 80 percent" for "more than 50 percent." It would be intended that the activities of such a related person would not again be taken into

account in determining whether another CFC or QBU (e.g., the related person) satisfies the substantial activity requirement.

Predominantly engaged requirement

The proposal also would modify the rules for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing, or similar business. Alternative rules would apply for this purpose.

Banking or securities business.--The proposal would modify the present-law application of the banking or securities business tests for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing or similar business. Under the proposal, a CFC would be considered to be predominantly engaged in the active conduct of a banking, financing, or similar business if it is engaged in the active conduct of a banking business and is an institution licensed to do business as a bank in the United States (or is any other corporation not so licensed which is specified in regulations). In addition, a CFC would be considered to be predominantly engaged in the active conduct of a banking, financing, or similar business if it is engaged in the active conduct of a securities business and is registered as a securities broker or dealer under applicable U.S. securities laws (or is any other corporation not so registered which is specified in regulations). It generally would be intended that these requirements for the active conduct of a banking or securities business be interpreted in the manner provided in the regulations proposed under prior law section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997). See Prop. Treas. Reg. secs. 1.1296-4 and 1.1296-6. Specifically, it would be intended that these requirements would include the requirements for foreign banks under Prop. Treas. Reg. sec. 1.1296-4 as currently drafted. However, it would not be intended that these requirements be considered to be satisfied by a CFC merely because it is a qualified bank affiliate or a qualified securities affiliate within the meaning of the proposed regulations under former section 1296(b).

Lending or finance business.--The proposal would modify the present-law 70 percent test for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing, or similar business. Under the proposal, a CFC would be considered to be predominantly engaged in the active conduct of such business if more than 70 percent of its gross income is derived directly from the active and regular conduct of a lending or finance business from transactions with customers which are unrelated persons. For this purpose, it would be intended that transactions with customers located in the United States not be taken into account in determining whether the 70-percent test would be satisfied.

For this purpose, a CFC would be considered to be engaged in a lending or finance business if it is engaged in the business of:

(1) making loans;

(2) purchasing or discounting accounts receivable, notes (including loans), or installment obligations;

(3) engaging in leasing (including entering into leases and purchasing, servicing and disposing of leases and leased assets);

(4) issuing letters of credit and providing guarantees;

(5) providing charge and credit card services; or

(6) rendering services or making facilities available in connection with the foregoing activities carried on by the corporation rendering such services or facilities, or by another corporation which is a member of the same affiliated group.

For this purpose, whether two corporations are affiliated would be determined by reference to section 1504 with one modification: the exclusion for foreign corporations would be disregarded.

Whether any portion of a CFC's gross income is derived directly from the active and regular conduct of a lending or finance business would be determined under all the facts and circumstances. Under the proposal, the Secretary would be granted the authority to prescribe regulations to carry out the purposes of these exceptions. It would be intended that such authority would include the authority to prescribe rules relating to this determination.

Qualified banking or financing income exempt from subpart F

In general.--If a CFC would be treated as an eligible CFC (i.e., it satisfies the substantial activity and predominantly engaged requirements), the subpart F exceptions would apply to qualified banking or financing income of such corporation. Qualified banking or financing income would be defined as income which is derived in the active conduct of a banking, financing, or similar business by an eligible CFC or a QBU of such CFC if: (1) the income is derived from transactions with customers not located in the United States, (2) substantially all of the activities in connection with such transactions are conducted directly by the corporation or unit in its home country, and (3) the income is treated as earned by such corporation or unit in its home country for purposes of such country's tax laws. For this purpose, income would be considered to be earned by a CFC or a QBU in its home country if such income is sourced and allocable to such CFC or QBU in its home country for purposes of such country's tax laws. In addition, for this purpose, activities would be considered to be conducted by a CFC or QBU if such activities are performed by employees of the CFC or QBU. Except as provided by regulations, a CFC's home country would be defined as its country of creation or organization, and a QBU's home country would be defined as the country in which the unit maintains its principal office. Moreover, income derived from transactions with customers would apply only to transactions with customers acting in their capacity as such.

For this purpose, it would be intended that income derived by an eligible CFC or QBU of such CFC from the following types of activities be considered to be income derived in the active conduct of a banking, financing, or similar business (provided that the other requirements for these exceptions are satisfied):

(1) regularly making personal, mortgage, industrial, or other loans in the ordinary course of the corporation's trade or business;

(2) factoring evidences of indebtedness for customers;

(3) purchasing, selling, discounting, or negotiating for customers notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness;

(4) issuing letters of credit and negotiating drafts drawn thereunder for customers;

(5) performing trust services, including as a fiduciary, agent, or custodian, for customers, provided such trust activities are not performed in connection with services provided by a dealer in stock, securities or similar financial instruments;

(6) arranging foreign exchange transactions (including any section 988 transaction within the meaning of section 988(c)(1)) for, or engaging in foreign exchange transactions with, customers;

(7) arranging interest rate or currency futures, forwards, options or notional principal contracts for, or entering into such transactions with, customers;

(8) underwriting issues of stock, debt instruments or other securities under best efforts or firm commitment agreements for customers;

(9) engaging in leasing (including entering into leases and purchasing, servicing and disposing of leases and leased assets);

(10) providing charge and credit card services for customers or factoring receivables obtained in the course of providing such services;

(11) providing traveler's check and money order services for customers;

(12) providing correspondent bank services for customers;

(13) providing paying agency and collection agency services for customers;

(14) maintaining restricted reserves (including money or securities) in a segregated account in order to satisfy a capital or reserve requirement imposed by a local banking or securities regulatory authority;

(15) engaging in hedging activities directly related to another activity described herein;

(16) repackaging mortgages and other financial assets into securities and servicing activities with respect to such assets (including the accrual of interest incidental to such activity);

(17) engaging in financing activities typically provided in the ordinary course by an investment bank, such as project financing provided in connection with construction projects, structured finance (including the extension of a loan and the sale of participations or interests in the loan to other financial institutions or investors), and leasing activities to the extent incidental to such financing activities;

(18) providing financial or investment advisory services, investment management services, fiduciary services, or custodial services;

(19) purchasing or selling stock, debt instruments, interest rate or currency futures or other securities or derivative financial products (including notional principal contracts) from or to customers and holding stock, debt instruments and other securities as inventory for sale to customers, unless the relevant securities or derivative financial products are not held in a dealer capacity;

(20) effecting transactions in securities for customers as a securities broker; and

(21) any other activity that the Secretary of the Treasury determines to be a financing activity conducted by active corporations in the ordinary course of their business.

Qualified banking or financing income of an eligible CFC or QBU of such CFC would be determined separately for the CFC and each QBU, taking into account, in the case of an eligible CFC, only items of income, gain, deduction, loss or other items, as well as activities, of such CFC that are not properly allocable to any QBUs. Similarly, in the case of a QBU, qualified banking or financing income would be determined by taking into account such applicable items (e.g., income and activities) that are properly allocable to such QBU. Under the proposal, the Secretary would be granted the authority to prescribe regulations to carry out the purposes of these exceptions. It would be intended that such authority would include the authority to prescribe rules for properly allocating items and activities among branches or units of a CFC, and between the CFC and its branches or units.

Income from local customer transactions.--If the requirements above are satisfied, the exceptions would apply to income that is derived from transactions with customers located in the

CFC's home country. In addition, the exceptions would apply to income that is derived by a QBU of an eligible CFC from transactions with customers located in the QBU's home country.

For example, assume that a CFC is incorporated in the United Kingdom and has operations in France that constitute a QBU. Also assume that the activities of the U.K. CFC's head office together with the activities of the French QBU satisfy the substantial activity requirement. Under the proposal, income derived by the U.K. CFC from transactions with customers in the United Kingdom would be eligible for the exceptions if substantially all of the activities in connection with the transaction are performed in the United Kingdom by employees of the U.K. CFC, and the income is treated as earned by the U.K. CFC in the United Kingdom for U.K. income tax purposes. In addition, income derived by the French QBU from transactions with customers in France would be eligible for the exceptions if substantially all of the activities in connection with the transactions are performed in France by employees of the French QBU, and the income is treated as earned by the French QBU in France for French income tax purposes.

Income from cross border transactions.--If the requirements above are satisfied, the exceptions also would apply to income from certain cross border transactions, but only if a higher standard with respect to the substantial activity requirement is satisfied. Under the proposal, income derived by a CFC from transactions with customers not located in the CFC's home country or the United States would be eligible for the exceptions if the CFC conducts substantial activity with respect to a banking, financing, or similar business in its home country. In addition, income derived by a QBU of an eligible CFC from transactions with customers not located in the QBU's home country or the United States would be eligible for the exceptions, but only if the QBU conducts substantial activity with respect to such a business in its home country. For this purpose, the substantial activity requirement would be applied by looking only at the activities of the applicable CFC or QBU on a stand-alone basis. Thus, income derived by a QBU from transactions with customers not located in its home country (or in the United States) would be eligible for the exceptions if the activities of the QBU itself constitute substantial activities (provided that the other requirements are satisfied).

Consider again the U.K. CFC and the French QBU. If the head office of the U.K. CFC derives income from a transaction with a customer in Germany, the income would be eligible for the exceptions if the activities of the CFC itself (without regard to those of the French QBU) satisfy the substantial activity requirement. Alternatively, if the French QBU derives income from a transaction with a German customer, the income would be eligible for the exceptions if the activities of the French QBU itself satisfy the substantial activity requirement.

Home country requirement for income earned with respect to a lending or finance business.--In the case of a lending or finance business, in addition to the requirements described above, the proposal would include an additional requirement to qualify for the exceptions in the case of income earned by a CFC which qualifies as an eligible CFC by satisfying the predominantly engaged requirement for an active lending or finance business. For such an

eligible CFC, income derived by such CFC would be eligible for the exceptions only if such CFC derives more than 30 percent of its gross income directly from the active and regular conduct of a lending or finance business from transactions with customers that are unrelated persons and that are located within the CFC's home country (the "home country" requirement). In addition, income derived by a QBU of such an eligible CFC would be eligible for the exceptions only if such QBU derives more than 30 percent of its gross income directly from the active and regular conduct of a lending or finance business from transactions with customers that are unrelated persons and that are located within the QBU's home country. For this purpose, it would be intended that transactions with customers located in the United States not be taken into account.

The home country requirement would be applied on a stand-alone basis to the particular CFC or QBU. Thus, the 30-percent gross income test would take into account only the gross income of a particular CFC (without regard to the income of its QBUs) from transactions with its home-country unrelated customers. Similarly, in the case of a QBU, there would be taken into account the gross income of the particular QBU (without regard to the income of the CFC or other QBUs) from transactions with its home-country unrelated customers. Accordingly, if more than 70 percent of the CFC's gross income is derived directly from the active and regular conduct of a lending or finance business from transactions with unrelated customers, and one of the CFC's QBUs satisfies the home country requirement but another QBU does not satisfy such requirement, income derived by the QBU that satisfies the home country requirement would be eligible for the exceptions from subpart F (provided that the other requirements are satisfied), but income derived by the other QBU would not be eligible for the exceptions.

Coordination with other rules.--The proposal would provide that the exceptions under section 954(h) for income derived in the active conduct of a banking, financing, or similar business would not apply to income described in the dealer exception under section 954(c)(2)(C)(ii) (described below) for a dealer in securities which is an eligible CFC that satisfies the predominantly engaged requirement for a securities business.

In addition, it would be expected that the Treasury Department and the Internal Revenue Service would issue timely guidance to make conforming changes to existing regulations in order to reflect the exceptions under section 954(h).

Exception for securities dealers

The proposal would provide an additional exception from foreign personal holding company income for certain income derived by a securities dealer within the meaning of section 475 (the so-called "dealer exception"). The dealer exception would apply to interest or dividends (or equivalent amounts described in sec. 954(c)(1)(E) or (G)) from any transaction (including a hedging transaction or a transaction consisting of a deposit of collateral or margin described in sec. 956(c)(2)(J)) entered into in the ordinary course of the dealer's trade or business as such a securities dealer, but only if the income is attributable to activities of the dealer in the country in

which the dealer is created or organized (or, in the case of a QBU of the dealer, is attributable to activities of the QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity). For this purpose, income would be considered to be attributable to activities of the dealer in its country of incorporation (or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity), if such income is attributable to activities performed in such country by employees of the dealer (or QBU), and such income is treated as earned in such country by the dealer (or QBU) for purposes of such country's tax laws. For this purpose, income would be considered to be earned in the country in which the dealer is created or organized (or, in the case of a QBU, in the country in which the QBU both maintains its principal office and conducts substantial business activity), if such income is sourced and allocable to such dealer (or QBU) in such country for purposes of such country's tax laws. It would be intended that the dealer exception not apply to income from transactions with persons located in the United States with respect to U.S. securities. Thus, it would be intended that the exception from current inclusion under subpart F for income earned by dealers in securities not apply to activities that would otherwise be conducted in the United States. In addition, it would be intended that the dealer exception would apply to interest paid by customers to the dealer on margin loans in connection with sales of securities (provided that the other requirements of the provision are satisfied).

Insurance income

In general

The proposal would provide a temporary exception to insurance income under section 953. For purposes of the exception to insurance income, reserves for an exempt insurance or annuity contract would be determined in the same manner as under the temporary exception, described below, for foreign personal holding company income relating to certain insurance contracts (sec. 954(i), as added by the proposal). For purposes of these provisions, reserves would be intended to include discounted unpaid losses or losses incurred, as appropriate, for property and casualty contracts.

Operation of the exception

The proposal would provide an exception from insurance income for income derived by a qualifying insurance company that is attributable to the issuing (or reinsuring) of an exempt contract by the qualifying insurance company or a qualifying insurance company branch of such a company, and that is treated as earned by the company or branch in that company's, or branch's, home country for purposes of that country's tax laws. The exception from insurance income would not apply to income attributable to the issuing (or reinsuring) of an exempt contract as the result of any arrangement whereby another corporation receives a substantially equal amount of premiums or other consideration in respect of issuing (or reinsuring a contract that is not an exempt contract). An exempt contract would be an insurance or annuity contract issued or reinsured by a qualifying insurance company or qualified insurance company branch in

connection with property in, liability arising out of activity in, or the lives or health of residents of, a country other than the United States.

No contract would be treated as an exempt contract unless the qualifying insurance company or branch derives more than 30 percent of its net written premiums from exempt contracts (determined without regard to this sentence) covering applicable home country risks, and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person (within the meaning of sec. 954(d)(3)). Applicable home country risks would be risks in connection with property in, liability arising out of activity in, or the lives or health of residents of, the home country of the qualifying insurance company or branch, as the case may be. In all cases, the 30-percent test would be applied on a unit-by-unit basis. Accordingly, income derived by a qualifying insurance company branch of a CFC would qualify only if such branch alone satisfies the 30-percent test (without regard to the net written premiums of any other branch). Income derived by the CFC would qualify only if the CFC alone satisfies the 30-percent test without regard to the net written premiums of any other unit or branch of the CFC.

When determinations under the proposal are made separately with respect to a qualifying insurance company and its qualifying insurance company branch or branches, then in the case of the qualifying insurance company, only income, gain, or loss and activities of the company not properly allocable or attributable to any qualifying insurance company branch would be taken into account. In the case of a qualifying insurance company branch, only income, gain, or loss and activities of the branch that are properly allocable or attributable to it would be taken into account. Under the proposal, the Secretary would be granted the authority to carry out the purposes of these exceptions. It would be intended that such authority would include the authority to prescribe rules for properly allocating items and activities among branches or units of a CFC, and among the CFC and its branches or units.

The home country of a CFC would be the country in which the CFC is created or organized. The home country of a qualified business unit that is a qualifying insurance company branch of a qualifying insurance company would mean the country in which the principal office of such unit is located and in which such unit is licensed, authorized, or regulated by the applicable insurance regulatory body to sell insurance, reinsurance or annuity contracts to persons other than related persons (within the meaning of sec. 954(d)(3)) in that country.

Qualifying insurance company

A qualifying insurance company would be a CFC that meets the following requirements, which would be intended to distinguish firms that have a real business nexus with a foreign country or countries from firms that do not. The first requirement would be that the CFC be subject to regulation as an insurance (or reinsurance) company by its home country, and that the CFC be licensed, authorized, or regulated by the applicable insurance regulatory body for its home country to sell insurance, reinsurance, or annuity contracts to persons other than related persons (within the meaning of section 954(d)(3)) in its home country.

The second requirement would be that the CFC derive more than 50 percent of its aggregate net written premiums from the insurance or reinsurance by the CFC (on an aggregate basis, including qualifying insurance company branches) covering applicable home country risks (as described above) of the CFC or branch, as the case may be. For purposes of this rule, if a policyholder, insured, annuitant, or beneficiary is a related person, then the contract would be treated as not covering home country risks. A related person would have the meaning set forth in section 954(d)(3). In the case of a qualifying insurance company branch, premiums would be taken into account under this second requirement only to the extent that the premiums would be treated as earned by the branch in its home country for purposes of that country's tax laws.

The 50-percent test would apply on an aggregate basis. For example, assume that a German CFC has a branch in France and a branch in Italy. Assume that $50 of net written premiums are properly allocable to the Italian branch, $100 of net written premiums are properly allocable to the French branch, and $100 of net written premiums are properly allocable to the CFC in Germany. For the Italian branch, assume $20 of the $50, or 40 percent, is from home country risks. For the French branch, assume that $80 of the $100, or 80 percent, is from home country risks. For the CFC in Germany, assume that $60 of the $100, or 60 percent, is from home country risks. Taking into account the respective amounts and percentages, the CFC would have 64 percent of its net written premiums from home country risks on an aggregate basis.

The third requirement would be that the CFC be engaged in the insurance business and that it would be subject to tax under subchapter L if it were a domestic corporation. A CFC would be considered to be engaged in the insurance business, within the meaning of this proposal, if it operates in a manner consistent with the operation of other bona fide commercial insurance companies that sell insurance products to unrelated parties in its home country, and conducts managerial activities in that country with respect to the major functions of the insurance business. A factor, among others, that could be considered in determining whether it conducts managerial activities in its home country with respect to the major functions of the insurance business may be whether in its home country it exercises key decision making in determining business strategy with respect to the major functions of the insurance business. For purposes of the requirement that the CFC be engaged in the insurance business, activities performed in the home country of the CFC by employees of the CFC and of a related person would be taken into account, to the extent that the related person is compensated on an arm's-length basis for the services of such employees and such compensation is includible in the related person's income in such country for purposes of that country's tax laws. For this purpose, a related person would have the meaning provided in section 954(d)(3), substituting "at least 80 percent" for "more than 50 percent." In determining whether a CFC would be engaged in the insurance business, for example, an entity that is not engaged in regular and continuous transactions with persons that are not related persons (as described in the anti-abuse rules) would not be considered as engaged in the insurance business.

Qualifying insurance company branch

A qualifying insurance company branch would be a qualified business unit of a CFC that meets two requirements. A qualified business unit would mean any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records (within the meaning of sec. 989(a)). The first requirement would be that the unit be licensed, authorized, or regulated by the applicable insurance regulatory body for its home country to sell insurance, reinsurance or annuity contracts to persons other than related persons (within the meaning of sec. 954(d)(3)) in that country. It would be intended that the applicable insurance regulatory body be the regulatory body that has the authority to license, authorize, or regulate with respect to the insurance business in the country where the branch is located and a branch that is regulated by such a body be considered to be regulated in the country where the branch is located. The second requirement would be that the CFC (of which the branch is a unit) be a qualifying insurance company, taking the unit into account for purposes of the applicable tests (above) as if it were a qualifying insurance company branch.

Additional requirements in the case of cross border risks

The proposal would impose additional requirements with respect to any contract that covers cross border risks (that is, risks other than applicable home country risks), due to the increased concern about mobility of income in cross border business. A contract issued by a qualifying insurance company or qualifying insurance company branch that covers risks other than applicable home country risks would not be treated as an exempt contract unless such company or branch, as the case may be, (1) conducts substantial activity in its home country with respect to the insurance business, and (2) performs in its home country substantially all of the activities necessary to give rise to the income generated by the contract.

Whether a CFC or unit thereof would be considered to perform in its home country substantial activities with respect to the insurance business would be determined under all the facts and circumstances. It would be intended that as part of this facts and circumstances analysis in determining whether the activities conducted by the CFC or unit are substantial, all relevant factors would be taken into account, including the overall size of the CFC or unit, the amount of its revenues and expenses, the number of its employees, the ratio of its revenues per employee, the amount of property it owns, and the nature, size and relative significance of the applicable activities conducted by the CFC or unit. Under the proposal, the Secretary would be granted the authority to carry out the purposes of these exceptions. It would be intended that such authority would include the authority to prescribe regulations relating to whether a CFC or unit would be considered to conduct substantial activity.

It also would be intended that as part of this facts and circumstances analysis, a CFC or unit would be required to conduct substantially all of the activities necessary for the generation of income with respect to the insurance business. Such activities of an insurance business generally would depend on the line of business, and could include:

- designing or tailoring insurance products to meet market or customer requirements;
- performing actuarial analysis with respect to insurance products;
- determining investment options for separate account-type products;
- performing underwriting functions with respect to insurance products;
- performing analysis for purposes of risk assessment;
- performing analysis for purposes of setting premium rates;
- performing analysis for purposes of calculating reserves;
- performing claims management and adjustment functions;
- developing marketing strategies, advertising and other public image activities;
- making (or arranging for) sales to customers;
- maintaining reserves and surplus (other than excess surplus);
- making (or arranging for) investments; and
- collecting from customers.

It further would be intended that the performance of back-office functions (including accounting for income or loss, recordkeeping, and routine communicating with customers) not be taken into account in determining whether the substantial activity requirement would be satisfied. It also would be intended that the relevant activities of the business may be modified by Treasury regulation to take into account the actual operation of lines of insurance business and future changes in the operation of lines of insurance business.

It further would be intended that activities performed in the CFC's or unit's home country by employees of a related person (within the meaning of sec. 954(d)(3), substituting "at least 80 percent" for "more than 50 percent") be taken into account, to the extent that the related person is compensated on an arm's-length basis for the services of such employees and such compensation is includible in the related person's income in that country for purposes of such country's tax laws. It also would be intended that the activities of such a related person would not again be taken into account in determining whether another CFC or unit (e.g., the related person) satisfies the substantial activity requirement.

In addition, with respect to a contract issued by a qualifying insurance company or qualifying insurance company branch that covers risks other than applicable home country risks, the qualifying insurance company or qualifying insurance company branch would be required to perform in its home country substantially all of the activities necessary to give rise to the income generated by the contract.

Foreign personal holding company income with respect to insurance

The proposal would provide a temporary exception from foreign personal holding company income for certain investment income derived by a qualifying insurance company and by certain qualifying insurance company branches.

The exception would apply to income (received from a person other than a related person) from investments made by a qualifying insurance company or qualifying insurance company branch of its reserves allocable to exempt contracts or 80 percent of its unearned premiums from exempt contracts. For this purpose, an exempt contract would have the meaning provided under the proposal.

In the case of exempt contracts that are property, casualty, or health insurance contracts, unearned premiums and reserves would mean unearned premiums and reserves for losses incurred determined using the methods and interest rates that would be used if the qualifying insurance company or qualifying insurance company branch were subject to tax under subchapter L of the Code, with certain modifications. For this purpose, unearned premiums and losses incurred would be determined in accordance with section 832(b) and 846 of the Code (as well as any other rules applicable to a U.S. property and casualty insurance company with respect to such amounts). However, in applying these rules, there would be substituted for the applicable Federal interest rate the interest rate determined for the functional currency of the company or branch and which (except as provided by the Treasury Secretary) would be calculated in the same manner as the Federal mid-term rate under section 1274(d). In addition, there would be substituted for the loss payment pattern under section 846 the appropriate foreign loss payment pattern determined by the Treasury Secretary for the line of business. In the case of health insurance contracts, it would be intended that appropriate foreign mortality and morbidity tables be used for this purpose. In the case of disability contracts (other than credit disability) which are subject to section 846(f)(6)(A), it would be intended that mortality and morbidity tables reasonably reflect appropriate experience and foreign mortality and morbidity factors.

In the case of an exempt contract that is a life insurance or annuity contract, reserves for such contracts would be determined as follows. The reserves would equal the greater of: (1) the net surrender value of the contract (as defined in section 807(e)(1)(A)), including in the case of pension plan contracts; or (2) the amount determined by applying the tax reserve method that would apply if the qualifying insurance company were subject to tax under Subchapter L of the Code, with the following modifications. First, there would be substituted for the applicable Federal interest rate an interest rate determined for the functional currency of the qualifying

insurance company's home country, calculated (except as provided by the Treasury Secretary in order to address insufficient data and similar problems) in the same manner as the mid-term applicable Federal interest rate ("AFR") (within the meaning of section 1274(d)). Second, there would be substituted for the prevailing State assumed rate the highest assumed interest rate permitted to be used for purposes of determining statement reserves in the foreign country for the contract. Third, in lieu of U.S. mortality and morbidity tables, there would be applied mortality and morbidity tables that reasonably reflect the current mortality and morbidity risks in the foreign country. Fourth, the Treasury Secretary may provide that the interest rate and mortality and morbidity tables of a qualifying insurance company may be used for one or more of its branches when appropriate.

In no event would the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe, equalization, or deficiency reserve or any similar reserve. In the case of a contract that is a property, casualty, or health insurance contract, it would be intended that this limitation would apply with respect to unpaid losses by line of business (similar to sec. 846(a)(3)). These rules would apply whether the contract is regulated as a property, casualty, health, life insurance, annuity, or any other type of contract.

The proposal also would provide an exception from foreign personal holding company income for income from investment of assets equal to (1) one-third of premiums earned during the taxable year on exempt contracts regulated in the country in which sold as property, casualty, or health insurance contracts, and (2) 10 percent of reserves (determined for purposes of the proposal) for contracts regulated in the country in which sold as life insurance or annuity contracts. In no event would the exception from foreign personal holding company income apply to investment income with respect to excess surplus.

To prevent the shifting of relatively high-yielding assets to generate investment income that qualifies under this temporary exception, the proposal would provide that, except as provided by the Treasury Secretary, income would be allocated to contracts as follows. In the case of a separate account-type contract (including a variable contract not meeting the requirements of section 817), the income credited under the contract would be allocable only to that contract. Income not so allocated generally would be allocated ratably among all contracts that are not separate account-type contracts, subject to the anti-abuse rules (described below).

Other definitions and anti-abuse rules relating to insurance

The proposal would provide that the present-law statutory definition of a life insurance contract (under secs. 7702 or 101(f)), as well as the distribution on death requirement of section 72(s) and the diversification requirement of section 817(h), would not apply for purposes of determining reserves for a life insurance or annuity contract under sections 953 and 954 of the Code, provided that neither the policyholders, the insureds or annuitants, nor the beneficiaries with respect to the contract are U.S. persons.

The proposal would provide a rule coordinating the exception to insurance income with the present-law special rule for certain captive insurance companies (sec. 953(c)). Under the coordination rule, the scope of the present-law rule that related party insurance income is treated as subpart F income would be retained. The exception under the proposal from the definition of insurance income would not include income derived from exempt contracts that cover risks other than applicable home country risks, for purposes of the rules of section 953(c).

The anti-abuse rules applicable under the subpart F exceptions provided in section 954(h) (other than sec. 954(h)(7)(B)) (as added by the proposal) would apply to these exceptions for insurance. In addition, the proposal would provide anti-abuse rules applicable under the exceptions from subpart F income relating to insurance.

The proposal would provide that there shall be disregarded any item of income, gain, loss, or deduction of, or derived from, an entity which is not engaged in regular and continuous transactions with persons that are not related persons. This rule would be intended, for example, to address the use of fronting companies or similar entities (that are not engaged in regular and continuous transactions with persons that are not related persons) to reinsure risks in a manner to cause a CFC or branch to qualify as a qualifying insurance company or qualifying insurance company branch by meeting percentage requirements with respect to home country risks that it would not otherwise meet.

The proposal would provide that there shall be disregarded any change in the method of computing reserves or any other transaction or transactions one of the principal purposes of which is the acceleration or deferral of any item in order to claim the benefits of these exceptions.

The proposal also would provide that a contract is not treated as an exempt contract (as described above), if any policyholder, insured or annuitant, or beneficiary is a resident of the United States, the contract was marketed to the U.S. resident, and was written to cover a risk outside the United States.

The proposal also would provide that a contract is not treated as an exempt contract, if the contract covers risks located both within and outside the United States, and the qualifying insurance company or branch does not maintain such records, and file such reports, with respect to the contract as the Treasury Secretary requires. It would be intended that documentation that is contemporaneous with the issuance of the contract be maintained by the qualifying insurance company or branch.

The proposal also would provide that the Treasury Secretary may prescribe rules for the allocation of contracts (and income from contracts) among two or more qualifying insurance company branches of a qualifying insurance company in order to clearly reflect the income of such branches.

The proposal also would provide that premiums from a contract would be treated as not covering home country risks (and are treated as covering risks other than home country risks) for purposes of the tests for 30 percent and 50 percent, respectively, of net written premiums if the contract reinsures a contract issued or reinsured by a related person (within the meaning of sec. 954(d)(3)).

The proposal also would provide that the Treasury Secretary may prescribe regulations as may be necessary or appropriate to carry out the purposes of the exceptions from insurance income and foreign personal holding company income provided under sections 953(e) and 954(i) (as added by the proposal).

Other anti-abuse rules

The proposal generally includes the anti-abuse rules of the present-law provision, with certain further refinements. Under the proposal, the anti-abuse rules would provide that items with respect to a transaction or series of transactions would be disregarded if one of the principal purposes of the transaction or transactions is to qualify income or gain for these exceptions, including any transaction or a series of transactions a principal purpose of which is the acceleration or deferral of any item in order to claim the benefits of these exceptions. In addition, the anti-abuse rules would provide that items of an entity which is not engaged in regular and continuous transactions with customers which are not related persons would be disregarded. Moreover, items with respect to a transaction or series of transactions would be disregarded if one of the principal purposes of the transaction or transactions is to qualify income or gain for these exceptions, including utilizing or doing business with: (1) one or more entities in order to satisfy any home country requirement, or (2) a special purpose entity or arrangement, including a securitization or financing arrangement or any similar entity or arrangement. Finally, the anti-abuse rules would provide that a related person, officer, director, or employee with respect to any CFC (or QBU) which otherwise would be treated as a customer of such corporation or unit with respect to any transaction would not be treated as a customer, if a principal purpose of such transaction is to satisfy any requirement for these exceptions.

Sale of assets of an active financing business

The proposal would include a modification to address the treatment of sales of assets of an active financing business. In general, foreign personal holding company income includes net gains from the sale or exchange of property that gives rise to dividends, interest, royalties, rents, or annuities. The proposal would provide an exception from this rule for income that qualifies for the exception from subpart F for income derived in the active conduct of a banking, financing, or similar business. Under the proposal, foreign personal holding company income would not include net gains from the sale or exchange of property that gives rise to dividends, interest, royalties, rents, or annuities if such property gives rise to income not treated as foreign personal holding company income for the taxable year by reason of the exceptions under section 954(h) or (i) (as added by the proposal) for income derived in the active conduct of a banking, financing, or

similar business or in the conduct of an insurance business. It would be intended that this exception would apply only to the extent that, prior to its disposition, the property was held to generate or generated income which qualifies for the exceptions under section 954(h) or (i) (and such property was not so held for a principal purpose of taking advantage of this exception).

Exceptions from foreign base company services income

The present-law provision includes a corresponding exception from foreign base company services income for income derived by a CFC from the performance of services that are directly related to a transaction entered into by the CFC that gives rise to income that is eligible for these exceptions from subpart F. Under the proposal, foreign base company services income would not include income that is not treated as foreign personal holding company income by reason of the exceptions under section 954(h) or 954(i) or the securities dealer exception under section 954(c)(2)(C)(ii), or treated as exempt insurance income by reason of section 953(e) (as added by the proposal).

Other matters

Nothing in this provision is intended to alter the Treasury Department's agreement, as reflected in Notice 98-35, not to finalize regulations regarding so-called hybrid entities prior to January 1, 2000, in order to allow Congress the opportunity to fully consider the tax policy issues involved.

Effective Date

The proposal would apply only to taxable years of foreign corporations beginning in 1999, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

E. Extension of the Generalized System of Preferences

Present Law

Title V of the Trade Act of 1974, as amended, grants authority to the President to provide duty-free treatment on imports of certain articles from beneficiary developing countries subject to certain conditions and limitations. To qualify for GSP privileges, each beneficiary country is subject to various mandatory and discretionary eligibility criteria. Import sensitive products are ineligible for GSP. The GSP program, which is designed to promote development through trade rather than traditional aid programs, expired after June 30, 1998.

Description of Proposal

The proposal would reauthorize the GSP program to terminate after December 31, 1999. Refunds would be authorized, upon request of the importer, for duties paid between July 1, 1998, and the date of enactment of the bill.

Effective Date

The proposal would be effective for duties paid on or after July 1, 1998, and before January 1, 2000.

F. Permanent Extension of Income Averaging for Farmers

Present Law

The 1997 Act included a provision that allows individuals engaged in the trade or business of farming an election to calculate their current year regular income tax liability by averaging, over the prior three-year period, all or a portion of their taxable income attributable to the farming business.

Under the provision, a taxpayer (1) designates all or a portion of the current year income from the farming business as "elected farm income," (2) allocates one-third of the "elected farm income" to each of the prior three taxable years, and (3) determines the current year regular income tax liability by determining the sum of (a) his or her current year income tax liability (without the elected farm income) plus (b) the increases in the income tax liability for each of the three prior taxable years by taking into account the allocable share of the elected farm income for those years.

The provision does not apply for purposes of the self-employment tax or the alternative minimum tax. The provision is effective for taxable years beginning after December 31, 1997, and before January 1, 2001.

Description of Proposal

The proposal would make permanent the income averaging provision for farmers.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

G. Disclosure of Return Information to Department of Education in Connection with Income Contingent Loans

Present and Prior Law

Under section 6103(l)(13) of the Code, the Secretary of Treasury was authorized to disclose to the Department of Education certain return information with respect to any taxpayer who has received an "applicable student loan." An "applicable student loan" is any loan made under (1) part D of title IV of the Higher Education Act of 1965 or (2) parts B or E of title IV of the Higher Education Act of 1965 which is in default and has been assigned to the Department of Education, if the loan repayment amounts are based in whole or in part on the taxpayer's income. The Secretary is permitted to disclose only taxpayer identity information and the adjusted gross income of the taxpayer. The Department of Education may use the information only to establish the appropriate income contingent repayment amount for an applicable student loan.

The disclosure authority under section 6103(l)(13) terminated with respect to requests made after September 30, 1998.

Description of Proposal

The proposal would reinstate the disclosure authority under section 6103(l)(13) with respect to requests made after the date of enactment and before October 1, 2003.

Effective Date

The disclosure authority under section 6103(l)(13) would apply to requests made after the date of enactment, and before October 1, 2003.

II. OTHER PROVISIONS

A. Comprehensive Study of Recovery Periods and Depreciation Methods Under Section 168

Present Law

A taxpayer is allowed to deduct a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property that is used a trade or business or is held for the production of income. For most tangible personal and real property placed in service after 1986, the amount of the deductible allowance is determined under section 168 using the applicable recovery period, the applicable depreciation method, and the applicable convention specified in section 168.

For some types of assets, the applicable recovery period of an asset is provided in section 168. In other cases, the recovery period of an asset is determined by reference to its class life. The class life of an asset may be provided by section 168, or may be determined with regard to the list of class lives provided by the Treasury that was in effect on November 9, 1990. The Treasury Department is required to monitor and analyze actual experience with respect to all depreciable assets.

The applicable depreciation method determines the rate at which the cost of the property is recovered. In general, the applicable depreciation method specified in section 168 varies with the recovery period of the property. For property with a recovery period of 10 years or less, the applicable method is the 200 percent declining balance method, switching to straight-line in the first year in which that method yields a larger allowance. The 150 percent declining balance, (switching to straight-line) is the applicable method for property with a recovery period of 15 or 20 years, as well as for all property used in the trade or business of farming. The straight-line method must be used for property with a longer recovery period, as well as for certain specified types of property.

The applicable convention determines the point of time during the year that the property is considered placed in service. Applicable conventions specified in section 168 include the mid-year, the mid-quarter and the mid-month conventions.

Description of Proposal

The Secretary of the Treasury (or his delegate) would be directed to conduct a comprehensive study of the recovery periods and depreciation methods under section 168 of the Code, and to provide recommendations for determining such periods and methods in a more rational manner.

Effective Date

The Secretary of the Treasury (or his delegate) would be directed to submit the results of the study and recommendations to the House Ways and Means and Senate Finance Committees by March 31, 2000.

B. Farm Production Flexibility Contract Payments

Present law

A taxpayer is generally required to include an item in income no later than the time of its actual or constructive receipt, unless such amount is properly accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount whether or not the taxpayer makes the demand and actually receives the payment.

The Federal Agriculture Improvement and Reform Act of 1996 (the "FAIR Act") provides for production flexibility contracts between certain eligible owners and producers and the Secretary of Agriculture. These contracts generally cover crop years from 1996 through 2002. Annual payments are made under such contracts at specific times during the Federal government's fiscal year. Section 112(d)(2) of the FAIR Act provides that one-half of each annual payment is to be made on either December 15 or January 15 of the fiscal year, at the option of the recipient.[9] This option to receive the payment on December 15 potentially results in the constructive receipt (and thus potential inclusion in income) of one-half of the annual payment at that time, even if the option to receive the amount on January 15 is elected.

The remaining one-half of the annual payment must be made no later than September 30 of the fiscal year. The Emergency Farm Financial Relief Act of 1998 added section 112(d)(3) to the FAIR Act which provides that all payments for fiscal year 1999 are to be paid at such time or times during fiscal year 1999 as the recipient may specify. Thus, the one-half of the annual amount that would otherwise be required to be paid no later than September 30, 1999 can be specified for payment in calendar year 1998. This potentially results in the constructive receipt (and thus required inclusion in taxable income) of such amounts in calendar year 1998, whether or not the amounts are actually received or the right to their receipt is fixed.

Description of Proposal

The time a production flexibility contract payment under the FAIR Act is properly includible in income would be determined without regard to the options granted by section 112(d)(2) (allowing receipt of one-half of the annual payment on either December 15 or January 15 of the fiscal year) or section 112(d)(3) (allowing the acceleration of all payments for fiscal year 1999) of that Act.

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[9] This rule applies to fiscal years after 1996. For fiscal year 1996, this payment was to be made not later than 30 days after the production flexibility contract was entered into.

Effective Date

The proposal would be effective for production flexibility contract payments made under the FAIR Act in taxable years ending after December 31, 1995.

C. Increase Deduction for Health Insurance Expenses of Self-Employed Individuals

Present Law

Under present law, self-employed individuals are entitled to deduct a portion of the amount paid for health insurance for the self-employed individual and the individual's spouse and dependents. The deduction for health insurance expenses of self-employed individuals is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse. The deduction is available in the case of self insurance as well as commercial insurance. The self-insured plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

The portion of health insurance expenses of self-employed individuals that is deductible is 45 percent for taxable years beginning in 1998 and 1999, 50 percent for taxable years beginning in 2000 and 2001, 60 percent for taxable years beginning in 2002, 80 percent for taxable years beginning in 2003, 2004, and 2005, 90 percent for taxable years beginning in 2006, and 100 percent for taxable years beginning in 2007 and thereafter.

Under present law, employees can exclude from income 100 percent of employer-provided health insurance.

Description of Proposal

The proposal would increase the deduction for health insurance of self-employed individuals to 75 percent for taxable years beginning in 2002 and to 100 percent for taxable years beginning in 2003 and thereafter.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2001.

D. Increase State Volume Limits on Private Activity Tax-Exempt Bonds

Present Law

Interest on bonds issued by States and local governments is excluded from income if the proceeds of the bonds are used to finance activities conducted and paid for by the governmental units (Code sec. 103). Interest on bonds issued by these governmental units to finance activities carried out and paid for by private persons ("private activity bonds") is taxable unless the activities are specified in the Internal Revenue Code. Private activity bonds on which interest may be tax-exempt include bonds for privately operated transportation facilities (airports, docks and wharves, mass transit, and high speed rail facilities), privately owned and/or provided municipal services (water, sewer, solid waste disposal, and certain electric and heating facilities), economic development (small manufacturing facilities and redevelopment in economically depressed areas), and certain social programs (low-income rental housing, qualified mortgage bonds, student loan bonds, and exempt activities of charitable organizations described in Code sec. 501(c)(3)).

The volume of tax-exempt private activity bonds that States and local governments may issue for most of these purposes in each calendar year is limited by State-wide volume limits. The current annual volume limits are $50 per resident of the State or $150 million if greater. The volume limits do not apply to private activity bonds to finance airports, docks and wharves, certain governmentally owned, but privately operated solid waste disposal facilities, certain high speed rail facilities, and to certain types of private activity tax-exempt bonds that are subject to other limits on their volume (qualified veterans' mortgage bonds and certain "new" empowerment zone and enterprise community bonds).

Description of Proposal

The proposal would increase the present-law annual State private activity bond volume limits to $75 per resident of each State or $225 million (if greater) beginning in calendar year 2007. The increase would be phased-in as follows, beginning in calendar year 2003:

Calendar Year	Volume Limit
2003	$55 per resident ($165 million if greater)
2004	$60 per resident ($180 million if greater)
2005	$65 per resident ($195 million if greater)
2006	$70 per resident ($210 million if greater)

Effective Date

The volume limit increases would be effective beginning in calendar year 2003.

E. Modification of Individual Estimated Tax Safe Harbors

Present Law

Under present law, an individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to: (1) 100 percent of the tax shown on the return of the individual for the preceding year (the "100 percent of last year's liability safe harbor") or (2) 90 percent of the tax shown on the return for the current year. The 100 percent of last year's liability safe harbor is generally modified to be a 110 percent of last year's liability safe harbor for any individual with an AGI of more than $150,000 as shown on the return for the preceding taxable year, except that it is 105 percent of last year's liability for taxable years beginning in 1999, 2000, and 2001, and 112 percent of last year's liability for taxable years beginning in 2002. If a married individual files a separate return for the year for which an estimated tax installment payment was due, the $150,000 amount becomes $75,000.

Description of Proposal

For taxable years beginning in 2000 and 2001, the 105 percent of last year's liability safe harbor for any individual with an AGI of more than $150,000 as shown on the return for the preceding taxable year would be a 106 percent of last year's liability safe harbor.

Effective Date

The proposal would be effective for taxable years beginning in 2000 and 2001.

III. REVENUE OFFSET PROVISIONS

A. Treatment of Certain Deductible Liquidating Distributions of Regulated Investment Companies and Real Estate Investment Trusts

Present Law

Regulated investment companies ("RICs") and real estate investment trusts ("REITs") are allowed a deduction for dividends paid to their shareholders. The deduction for dividends paid includes amounts distributed in liquidation which are properly chargeable to earnings and profits, as well as, in the case of a complete liquidation occurring within 24 months after the adoption of a plan of complete liquidation, any distribution made pursuant to such plan to the extent of earnings and profits. Rules that govern the receipt of dividends from RICs and REITs generally provide for including the amount of the dividend in the income of the shareholder receiving the dividend that was deducted by the RIC or REIT. Generally, any shareholder realizing gain from a liquidating distribution of a RIC or REIT includes the amount of gain in the shareholder's income. However, in the case of a liquidating distribution to a corporation owning 80-percent of the stock of the distributing corporation, a separate rule generally provides that the distribution is tax-free to the parent corporation. The parent corporation succeeds to the tax attributes, including the adjusted basis of assets, of the distributing corporation. Under these rules, a liquidating RIC or REIT might be allowed a deduction for amounts paid to its parent corporation, without a corresponding inclusion in the income of the parent corporation, resulting in income being subject to no tax.

A RIC or REIT may designate a portion of a dividend as a capital gain dividend to the extent the RIC or REIT itself has a net capital gain, and a RIC may designate a portion of the dividend paid to a corporate shareholder as eligible for the 70-percent dividends-received deduction to the extent the RIC itself received dividends from other corporations. If certain conditions are satisfied, a RIC also is permitted to pass through to its shareholders the tax-exempt character of the RIC's net income from tax-exempt obligations through the payment of "exempt interest dividends," though no deduction is allowed for such dividends.

Description of Proposal

Any amount which a liquidating RIC or REIT may take as a deduction for dividends paid with respect to an otherwise tax-free liquidating distribution to an 80-percent corporate owner is includible in the income of the recipient corporation. The includible amount is treated as a dividend received from the RIC or REIT. The liquidating corporation may designate the amount distributed as a capital gain dividend or, in the case of a RIC, a dividend eligible for the 70-percent dividends received deduction or an exempt interest dividend, to the extent provided by the RIC or REIT provisions of the Code.

The proposal does not otherwise change the tax treatment of the distribution to the parent corporation or to the RIC or REIT. Thus, for example, the liquidating corporation will not recognize gain (if any) on the liquidating distribution and the recipient corporation will hold the assets at a carryover basis, even where the amount received is treated as a dividend..

Effective Date

The provision is effective for distributions on or after May 22, 1998, regardless of when the plan of liquidation was adopted.

No inference is intended regarding the treatment of such transactions under present law.

B. Add Vaccines Against Rotavirus Gastroenteritis to the List of Taxable Vaccines

Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose (sec. 4131) on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, and varicella (chicken pox). The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

Description of Proposal

The proposal would add vaccines against rotavirus gastroenteritis to the list of taxable vaccines.

Effective Date

The proposal would be effective for vaccine purchases after the date of enactment. No floor stocks tax would be collected for amounts held for sale on that date.

C. Clarify and Expand Mathematical Error Procedures

Present Law

Taxpayer identification numbers ("TINs")

The Internal Revenue Service ("IRS") may deny a personal exemption for a taxpayer, the taxpayer's spouse or the taxpayer's dependents if the taxpayer fails to provide a correct TIN for each person for whom the taxpayer claims an exemption. This TIN requirement also indirectly affects other tax benefits currently conditioned on a taxpayer being able to claim a personal exemption for a dependent (e.g., head-of-household filing status and the dependent care credit). Other tax benefits, including the adoption credit, the child tax credit, the Hope Scholarship credit and Lifetime Learning credit, and the earned income credit also have TIN requirements. For most individuals, their TIN is their Social Security Number ("SSN"). The mathematical and clerical error procedure currently applies to the omission of a correct TIN for purposes of personal exemptions and all of the credits listed above except for the adoption credit.

Mathematical or clerical errors

The IRS may summarily assess additional tax due as a result of a mathematical or clerical error without sending the taxpayer a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and a period of 60 days to request that the IRS abate its assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60-day period for objecting to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. The request for abatement of the assessment is the only procedure a taxpayer may use prior to paying the assessed amount in order to contest an assessment arising out of a mathematical or clerical error. Once the assessment is satisfied, however, the taxpayer may file a claim for refund if he or she believes the assessment was made in error.

Description of Proposal

For purposes of the mathematical and clerical error procedure, the proposal would provide that a correct TIN is a TIN assigned by the Social Security Administration (or in certain limited cases, the IRS) to the individual identified on the return. The IRS would be authorized to determine that the individual identified on the tax return corresponds in every aspect (including name, age, date of birth, and SSN) to the individual to whom the TIN is issued. The IRS would be authorized to use the mathematical and clerical error procedure to deny eligibility for the dependent care tax credit, the child tax credit, and the earned income credit even though a correct TIN has been supplied if the IRS determines that the statutory age restrictions for eligibility for

any of the respective credits is not satisfied (e.g., the TIN issued for the child claimed as the basis of the child tax credit identifies the child as over the age of 17 at the end of the taxable year).

Effective Date

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

D. Restrict 10-Year Net Operating Loss Carryback Rules for Specified Liability Losses

Present Law

Under present law, that portion of a net operating loss that qualifies as a "specified liability loss" may be carried back 10 years rather than being limited to the general two-year carryback period. A specified liability loss includes amounts allowable as a deduction with respect to product liability, and also certain liabilities that arise under Federal or State law or out of any tort of the taxpayer. In the case of a liability arising out of a Federal or State law, the act (or failure to act) giving rise to the liability must occur at least 3 years before the beginning of the taxable year. In the case of a liability arising out of a tort, the liability must arise out of a series of actions (or failures to act) over an extended period of time a substantial portion of which occurred at least three years before the beginning of the taxable year. A specified liability loss cannot exceed the amount of the net operating loss, and is only available to taxpayers that used an accrual method of accounting throughout the period that the acts (or failures to act) occurred.

Description of Proposal

Under the proposal, specified liability losses would be limited to product liability losses and amounts allowable as a deduction (other than a deduction under sec. 468(a)(1) or sec. 468A(a)) that are in satisfaction of a liability under a Federal or State law requiring the reclamation of land, decommissioning of a nuclear power plant (or any unit thereof), dismantlement of a drilling platform, remediation of environmental contamination, or a payment under any workers compensation act (within the meaning of sec. 461(h)(2)(C)(i)), if the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the taxable year. As under present law, the specified liability loss (as redefined) cannot exceed the amount of the net operating loss and is only available to taxpayers that used an accrual method of accounting throughout the period that the act (or failure to act) giving rise to the liability occurred. No inference regarding the interpretation of the specified liability loss carryback rules under present law is intended.

Effective Date

The proposal would be effective for net operating losses arising in taxable years ending after the date of enactment.